APFI Responds to CMA Working Paper: ‘Supply of Fiduciary Management Services by Investment Consultants’

With effect: 5 April 2018

What: The following outlines the Association of Professional Fund Investors (APFI) initial view of the ongoing consultation set out in: ‘Investment Consultants Market Investigation: Working paper: Supply of Fiduciary Management Services by Investment Consultants’ issued on 29 March 2018: https://assets.publishing.service.gov.uk/media/5abba6b240f0b67d64e21b4c/icim-fm-conflicts-of-interest-working-paper.pdf

The APFI wishes to support the CMA, applying our experience in these matters to help drive outcomes that are in the best interests of end investors, the industry, agencies, gatekeepers and hitherto professional fund investors. We look forward to further engaging with the CMA. This is an area of great interest to our members, some of whom reside in large consultancies, others in smaller firms, research agencies, wealth managers, advisory firms, multi-managers, insurance firms and platforms. Consequently we have attempted to be balanced in our response to these interests; as well as what we believe to be in the best interests of end investors and wider industry.

The APFI is committed to promoting professionalism in fund investing, research, manager selection, value for money, transparency and advocacy. The APFI is generally supportive and agreeable to the observations and findings of the CMA to date as set out in the latest working paper, for example;

“..we found wide agreement that this arrangement also leads to potential conflicts between the interests of IC-FM firms and those of the clients that they advise, which need to be managed effectively. It is not clear whether existing FCA regulation fully addresses these potential conflicts of interest (for example, some IC services do not fall within the scope of the FCA’s regulatory perimeter).”

In response to specific questions raised in the latest working paper, we continue to draw CMA’s attention to our previous submissions also attached. Subsequently APFI has provided CMA with the following in response to the latest working paper, as follows;

Summary point 11 states:

“Based on internal and client documents produced by firms and other evidence reviewed to date, we have seen some examples of IC-FM firms:

(a) having strong and persistant strategies to sell FM to existing IC clients; (b) mentioning their own FM service to IC clients, but not mentioning other FM providers;

(c) producing documents that compare their own FM service to alternative (non-FM) products or services;

(d) producing documents that provide advice on FM and do not mention conflicts of interest, or only mention conflicts of interest in a general sense."

APFI Response: The APFI believes that effective professional fund investing must be objective, independent, transparent and fair. This extend to screening methods, shortlisting, Request for Proposal and eventual selection. We support CMAs assertion that conflicts of interest may arise, and APFI believes this can extend to both non-integrated and integrated 'FM-IC' firms, leading to a bias towards the IC's own FM service. In non integrated firm's bias can still exist unless full management and economic autonomy exists (which is rare). Whilst such conflicts may impact competition; more critically it may impact the suitability of the eventual fund strategy selected over superior third party alternatives.

In context to the CMA's 'theory of harm'; APFI supports that a third party (TPE) should recommend fund strategies independently to the investment consultant services being offered. Otherwise those recommending funds from within the IC-FM should operate within an independent function to the IC or FM services and ideally be regulated for that activity ('Fiduciary perimeter'). E.g. fall into scope of the Certified Persons regime and can demonstrate an independent reporting line and revenue stream. CMA sets 'theory of harm' out as;

"when investment consultancy firms act as advisors to their customers and also offer FM services, customers are steered towards consultants' in- house FM services, when an alternative solution or deal could have been in their best interests."

APFI Response: We agree with the above theory and plausible variants (point 21) and consequences (22) as outlined. We believe the remedies lie in greater independence, transparency and professionalism around the manager search and selection process.

APFI Response: Under the analytical framework proposed (26), we recommend that CMA expands its assessment of point 3 'Customer Outcomes' to include;

1. **How customer needs were initially defined**
2. **How the manager search, screening and selection process took into account those needs, clearly outlying metrics and quantitative and qualitative inputs used.**
3. **Evidence of a transparent, independent screening, search and selection process**
4. **Transparent screening and selection process that can be audited**
5. **Convincing Request for Proposal (RFP) process that enabled fair competition between fund managers including**
6. **Shortlisted managers for RFP all appeared credible to the needs of the customer**
7. **Evidence of robust and fair due diligence on shortlisted managers was used**

8. **Clear justifications for managers shortlisted and material considerations including rationale for IC's FM being included.**

9. **Clear selection process, e.g. scoring, ranking of capability, value for money etc**

10. **How the manager eventually selected most met the overall needs of the customer including; risk-adjusted profile of the customer, investment capability, risk management, cash flow matching, duration, value for money etc.**

The CMA notes under point (42) that not all activities are regulated;

"Regulation applies to some, but not all, of the activities carried out by IC-FM firms. Whereas it covers the principal activities which are undertaken in the course of providing FM services, it covers only partially the activities undertaken in the course of providing IC services. By way of example:

(a) In respect of IC services, the regulated activity of 'advising on investments' covers personal recommendations made by an investment consultant in respect of certain investments.17 For most FCA-authorised firms, strategic advice (such as advice on strategic asset allocation) that does not constitute a personal recommendation will not in itself be a regulated activity, but it could still be covered by FCA regulation if, for example, it forms an integral part of another regulated activity. Similarly the regulated activity of 'advising on investments' does not cover advice on the suitability of an FM service, in so far as the FM service in question does not in itself constitute a specified investment to which that regulated activity applies."

APFI Response: In respect to advising the suitability of a fund manager, manager recommendations and ratings are typically not a regulated activity and we believe such activities should be regulated to ensure effective independence and professionalism. As previously suggested to CMA, this may take the form of accreditation or subscribing to a professional charter and specific training relating to fund manager selection. Continuous Professional Development is encouraged. Training may also extend to scheme trustees to improve the level of governance. The APFI proposes a Certified Professional Fund Investor accreditation and is happy to follow up with the CMA and FCA to outline details either directly or as part of a subsequent working group.

CMA (46) "We welcome views on whether the perimeter of existing regulation is sufficiently broad to cover the potential conflicts of interest faced by IC-FM firms."

APFI Response: We believe the regulatory perimeter should be expanded to account for all activity relating to the suitability, research and selection of fund managers.

CMA (63 & 64):

"Of the FM mandates awarded to the three largest IC-FM firms, we found that the firm was already supplying IC services to the client in the majority of cases (71%).

64. The CMA survey asked trustees about the FM providers that their pension scheme first selected and that they currently used. The survey indicated that:

(a) when appointing their first FM provider, around half of all schemes buying FM selected their existing IC (47%), and

(b) as of the time of the survey, the majority of schemes buying FM also bought IC services from that provider (74%).”

APFI Response: We believe the fund manager sector is large and competitive and it would seem unusual that such a high proportion of mandates should be awarded to a concentrated number of FMs. This differs with the broader market and professional fund investors are typically whole of market (unfettered) whereas the above survey results point to a more fettered process focussed around the internal fund proposition. A whole of market approach is supported by the u bar if available funds and statistical studies that indicate a large proportion of managers underperform the market over time. The APFI asserts that more professional approaches to investing are able to firstly understand the funds in question, identify superior managers and conduct more thorough due diligence to understand the risks arising.

CMA (78): “In general, FM services are significantly more expensive than IC services. This means that, even if net margins were equal in percentage terms across the two services, firms would generally earn greater profits per customer from FM services rather than IC services.”

APFI Response: Negotiating value for money and fees is a requisite part of Professional fund investing. We note the potential conflict arises between the IC and FM of the same firm.

CMA (101): Table 3 outlines the steps relating to Fund Manager Selection, Point 3 ‘FM product selection decision’.

APFI Response: We refer the CMA to our answer above re the ‘analytical framework’ (26) as to evidence best practice of a robust fund manager search, screening and selection process. The process applied, and rationale for the shortlist going into RFP, should be transparent to the trustees/customers in the manager selection report. Where this process takes an extended period (years) then evidence that old information is updated is evidence of best practice.

CMA (130 A): CMA digested the following remedy: “Segregation of advice and marketing materials. Keeping advice on the merits of using FM services separate from the firm’s own FM service provision reduces the risk of conflating the two.”

CMA (130 B): “Internal separation and controls. The requirement to adopt stronger internal controls, such as ‘chinese walls’ could reduce the incentive for advisory staff to promote the firm’s FM products and services.”

APFI Response: We believe these remedies are sensible and easy to implement.

CMA (130 E): “Prohibition of IC-FM firms acting as an evaluator or offering comparative advice. To ensure that tender processes or other selection exercises are conducted without perceived or actual bias IC/FM firms which are potential suppliers of FM services could be prohibited from being involved in any aspect of management of the process or assessment of offers.”

APFI Response: Unless regulated and/or independence can be demonstrated then the above remedy is a sensible remedy to reduce conflict of interest.

The APFI thanks the CMA for the opportunity to input into this consultant of great interest to professional fund investors. April 2018.

Please contact: JB Beckett, Chartered MCSI, UK Director, Association of Professional Fund Investors. www.profundinvestors.com

Ends.

Attach. Previous responses to CMA consultation.

Association of professional fund investors

Please also refer to our previous submission overleaf.

With effect: 22 March 2018

What: The following outlines the Association of Professional Fund Investors (APFI) initial view of the ongoing consultation set out in: 'Investment Consultants Market Investigation: Working paper: information on fees and quality' issued on 1 March 2018 https://assets.publishing.service.gov.uk/media/5a96db4ae5274a5b87c30054/icm-information-on-fees-and-quality.pdf

The APFI wishes to support the CMA, applying our experience in these matters to help drive outcomes that are in the best interests of end investors, the industry, agencies, gatekeepers and hitherto professional fund investors. We look forward to further engaging with the CMA. This is an area of great interest to our members, some of whom reside in large consultancies, others in smaller firms, research agencies, wealth managers, advisory firms, multi-managers, insurance firms and platforms. Consequently we have attempted to be balanced in our response to these interests; as well as what we believe to be in the best interests of end investors and industry.

The APFI is committed in promoting professionalism in fund research, selection and advocacy. The APFI is generally supportive and agreeable to the observations and findings of the CMA to date as set out in the latest working paper.

In response to specific questions raised in the latest working paper, we continue to draw CMA's attention to our previous submissions also attached. Subsequently APFI has provided CMA with the following to questions and attestations in the working paper, as follows;

Q) We have received some mixed responses from parties regarding the impact of MiFID II on fee reporting for advisory clients. We welcome further submissions on this point, and the impact of MiFID II more generally.

A) We believe the full implications of MiFID II are too complex for this consultation and have had insufficient time to mature, better referred back to FCA.

Remedies) Ongoing developments – to what extent will current or recent industry or regulatory developments address (or exacerbate) the shortfalls in information that we have identified in our emerging findings?

A) We believe latest developments in regulation will improve issues identified. However resolution of these issues will only occur through greater professionalism of fund investing; not necessarily greater regulation. This aside, an even playing field can only be achieved once investment consultants are regulated by FCA for recommendations made. Most consultants caveat their reports to some degree to state: "This does not contain regulated investment advice in respect of actions you should take. No investment decision should be made based on this information without obtaining prior specific, professional advice relating to your own circumstances." This is at the core of the issue between consultants and scheme trustees. It engenders a remoteness and lack of accountability for manager selection decisions taken.

- Feasibility – are the potential remedies achievable in practice? **A) Yes.**

- Effectiveness – will the potential remedy in each case address the shortfalls we have identified and will it be a comprehensive solution either on its own or in conjunction with others? **A) Only partially for reasons noted in this response.**

- Unintended consequences – what potentially harmful consequences should we be mindful of in designing each remedy? **A) There is a very real risk of over-simplifying Fund Selection on grounds of basic fund performance and cost metrics. This overlooks the risk budget, due diligence and other considerations required by the clients. We believe heavy lobbying from passive providers and some activists has over simplified this review and the debate in respect to active and passive funds.**

- Proportionality – are the remedies no more onerous than needed; and are they the least onerous of potential effective remedies? **A) We believe the measures proposed in the main are proportional.**

- Testing – would any specific proposal benefit from testing, and if so with whom? **A) Yes, we suggest one or two consultancies might volunteer under the auspices of a data monitoring agency and the APFI would happily provide additional support on an advisory capacity in respect to fund disclosure, reporting, value for money, selection and monitoring.**

- Implementation – how should the potential remedies be implemented? **A) APFI suggests the FCA creates a working group to implement these measures involving both consultants, regulators, interested parties like the APFI and IDWG and investors.**

- We also invite suggestions of any alternative potential remedy which we have not included in this paper.

- **A) The Professional Fund Investor (PFI) certification of investment consultants and nominated trustees in respect to fund governance and selection is a necessary measure towards better professionalism. The APFI is drafting global standards for certification, which could be adopted.**

Remedies: The APFI generally supports the remedies proposed without qualification;

Guidance and off the shelf materials for tenders: standardised performance and fee schedules.

Standardised information for tenders: Minimum standards.

Better fee information: e.g. frequency and format.

Standardised performance metrics: e.g. periods and benchmarks.

Stronger service quality metrics: e.g. mandatory use of standardised client survey.

Conceptual Framework: "This working paper is concerned with two of these areas – whether customers (trustees) have access to the necessary information to evaluate investment consultants and fiduciary managers, and to assess the value for money of alternative providers."

A) The APFI supports the above but adds that the CMA should refer back to the FCA the implementation of performance and fee information. APFI notes the tendency of consultants to show aggregated composite data per manager without qualification of market coverage, fund type etc. We support the use of verifiable data for proxy strategies, with comparable risk profiles, will offer a more real world comparison.

“We are focussing in particular on the information that customers receive on fees and quality. Within ‘quality’ we have concentrated primarily on investment performance. This is largely because trustees directly experience the ‘softer’ aspects of their provider’s quality, whereas evaluating investment performance/advice is inherently more complex. Further, the quality of investment advice is one of a number of key inputs that affects scheme returns and is therefore of direct importance to underlying members.”

A) The APFI urges caution in equating quality with investment performance, particular attention must be paid to ensure funds compared are comparable in terms of strategy, exposure, risk and liquidity.

Stakeholder views:

“Most parties indicated that some aspects of fee transparency could be improved (e.g. Aon, WTW, Cardano, Redington, IC Select), although some submitted that information on fees is generally clear (WTW, Russell Investments, Hymans, LCP).”

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“Some parties submitted that fee transparency was a particular issue in FM.

• BBS submitted that it can be unclear exactly what services are included in the FM fee.

• LCP, JLT, BBS and Baillie Gifford noted that third party fees are often bundled with FM fees, limiting transparency. 17

• BlackRock, SEI and Russell Investments noted that MiFID II would increase transparency in FM.”

A) We agree with the above views.

MiFID II: “MiFID (I and II) includes a general requirement that all information provided to clients or potential clients must be fair, clear and not misleading.”

A) The APFI supports this general aim but notes that trustees are not in the same position as retail investors and should be more skilled at interpreting technical information.

“Relevant developments are also ongoing at the FCA, particularly through the Institutional Disclosure Working Group (IDWG). The IDWG launch was supported by the FCA following their Asset Management Market Study with the aim of driving consistent and standardised disclosure of costs and charges across the industry.”

A) The APFI in conjunction with the Transparency Task Force is supportive of the progress towards cost transparency and the respective efforts of IDWG, DWP etc.

Fees paid to Third Parties: “In an advisory model, trustees enter into separate contracts with asset managers and other third parties. We would therefore not expect investment consultants to provide invoices or fee statements covering third party fees. Indeed, we have seen no examples of such documentation.“

A) **The APFI suggests that trustees should challenge consultants to demonstrate the value for money of third parties and thereby better understand the total costs of investing scheme assets. This would more closely resemble those with Fiduciary responsibility.**

"In a small number of cases, asset manager fees were reported in quarterly performance reports. However, no analysis was provided on the impact of such fees on returns, or whether fee levels were competitive. No information was provided on other third party fees."

A) The APFI supports transparency and fund reporting that shows the effect of charges between gross and net returns.

"FM clients do not generally contract separately with asset managers, and therefore do not receive this information directly from managers. Based on the documents we have seen, in many cases it is not clear how FM clients are made aware of all the fees paid by the scheme; or their impact on the net returns of the scheme."

A) APFI proposes that each scheme board has a certified person (PFI) whom can engage asset managers directly and also challenge the investment consultant findings.

"These regulatory requirements should ensure that trustees have clear information on third party fees. Indeed we have reviewed a number of VfM assessments undertaken by investment consultants, and these include clear and detailed information on third party fees."

A) The core issue is the capability of trustees to interpret information and gauge quality, cost and value for money for what are at times complex investment strategies.

"In some cases for example, the consultant reviews the management fee of alternative funds, as well as expected transition costs. It is not clear however how the overall costs of the revised strategy would compare to the current strategy (e.g. in £ and %), or how that would affect net returns."

A) As the funds will perform differently, and have different underlying costs, then comparing the costs in isolation offers limited insight. However the change in cost should be highlighted and the subsequent performance and risk of the outgoing and incoming fund should be reported back to trustees. Where an active fund is chosen then a comparable index fund could also be included.

"Many parties highlighted the need to focus on risk as well as overall returns when evaluating performance."

A) The Risk-adjusted return of funds invested in terms of cash-matching, liquidity, Drawdown risk are all material to assessing a fund for a pension strategy.

"We note that the performance reporting requirements under MiFID II appear to have less significant implications for investment consultants or fiduciary managers than the requirements regarding fee reporting."

A) The full implications of MiFID II will take time to be fully understood and will impact fund managers before pension schemes but should lead to better price transparency for funds invested into by pension schemes. The APFI encourages the CMA to defer the effective implementation to the FCA.

“Various detailed requirements to ensure fair, clear and not misleading information (where it is provided) on past performance, simulated past performance and future performance (e.g. prominent warnings on the non-reliability of figures for future performance). Information on future performance must be based on performance scenarios in different market conditions (both negative and positive scenarios), and reflect the nature and risks of the specific types of instruments included in the analysis.

• For portfolio management services –

• Firms must establish an appropriate method of evaluation and comparison (e.g. a meaningful

benchmark) based on the client’s investment objectives and the types of financial instruments included, to enable the client to assess the firm’s performance.

• Ex-ante provision of the specification of any benchmark against which the performance of the client portfolio will be compared.

• Provision of a periodic statement of the activities carried out and of the performance of the portfolio during the reporting period and where relevant (among other matters) a comparison of performance during the period covered by the statement with the benchmark (if any) agreed between the firm and the client.”

A) The APFI supports a more homogenous alignment of reporting requirements between professional fund investors whom exist within the Fiduciary perimeter (portfolio management services) and ratings agencies and consultants whom do not. This will level the playing field between these sectors and encourage cross-competition.

“We note a lack of consistency however in whether returns are reported gross or net of fees. TPR Code of Practice 3 recommends that investment returns are reported net of fees.”

A) The APFI supports the reporting of only net after fees charges alongside the most accurate annual cost for funds employed.

“In most cases however the scheme’s overall performance is not explicitly shown against its long-term strategic objectives. To properly assess the quality of investment advice they receive, we would expect trustees to have regular access to such information.

• This view is consistent with the TPR’s DB Investment Guidance, which emphasises the importance of the scheme’s investment strategy relative to manager performance, and encourages trustees to ‘focus on the long-term when monitoring investment strategy’.”

• **A) APFI agrees with the TPR guidance noted, and further notes the dichotomy of standardisation of performance versus benchmarks over short to medium timeframes; even if the Fund managers used should be compared over longer time periods. A growing fixation on short term performance has been further reinforced through factsheets and Key Investor Information Documents.**

“Many of the quarterly reports we have reviewed also include detailed information on both performance attribution and overall scheme risk. The latter includes information on the tracking error, volatility, scenario analysis and hedging analysis.”

A) The above are all sensible measures but are not exhaustive of those employed by professional fund investors.

" Although members of a DC Scheme are invested in a variety of different funds, TPR Code of Practice 13 ('the DC Code') emphasises that trustees should consider the overall investment strategy of the scheme, rather than simply the performance of underlying funds."

A) This creates a morale hazard with trustees then deferring individual fund choices and outcomes to the consultant. The APFI urges that trustees are accountable for individual fund performance and therefore competent to analyse individual funds.

Other Information on Quality:

"WTW noted that past performance is not the only factor that should influence choice of provider, as this can be driven by 'luck' as well as 'skill'."

A) Fund recommendations should be tracked more transparently to inform persistency and success of those recommendations.

"] told us that they sometimes use results from the Greenwich Associates institutional investor survey, although results are anonymised due to confidentiality rules."

A) The Greenwich Associates report is typically used by investment consultants and there may be an over-reliance on investment consultants relying on third party advocacy. Such reports may be behavioural and replay biases back to consultants.

"Asset manager recommendations

• Although a number of firms produce information on the performance of highly-rated or 'recommended' asset managers, methodologies can vary quite widely.

• [?] use a number of different metrics, including the 'cumulative net alpha of liquid managers' within their FM portfolio.

• [?] tracks the performance of 'model portfolios' within each asset class, combining a number of asset management products.

• In the table below, we compare some of the methodologies used to present aggregate manager recommendation figures.

- Although the methodologies are broadly similar, there are differences in the treatment of fees and asset classes used.
- **A) A number of more advanced techniques are being employed by professional fund investors globally and there are opportunities to create new performance templates to capture these best practices. The APFI is happy to advise the CMA further.**
- There may also be important technical differences that prevent like-for-like comparisons. [?] for example notes in one document that 'assumptions have been made for simulation purposes and are unlikely to be realised ... changes in the assumptions may have a material impact on the returns presented'."
- **A) Re-hypothecation and simulated returns should adhere to CFA GIPS methodology and be heavily caveated as to both calculation and assumptions.**

“4. C. Performance metrics: methodologies”

A) The illustrative table shown is over-simplified in respect to the methodologies employed by PFIs. Conversely this may usefully expose a divergence and Information gap between consultant and trustees. The considerations that go into manager selection are typically multi-faceted and forward looking whereas past performance tends to be used for screening from large manager samples down to a shortlist during a manager search. The APFI would be happy to advise CMA as to typical practises employed.

The APFI thanks the CMA for the opportunity to input into this consultant of great interest to professional fund investors. March 2018.

Please contact: JB Beckett, Chartered MCSI, UK Director, Association of Professional Fund Investors. www.profundinvestors.com

Ends.

Attach. Previous responses to CMA consultation.

Association of professional fund investors

Please also refer to our previous submission overleaf.

With effect: 31 October 2017.

What: The following outlines the Association of Professional Fund Investors (APFI) initial view of the issues and remedies proposed by the CMA, which were set out in: https://assets.publishing.service.gov.uk/media/59c376f7ed915d408c10d131/investment-consultancy-market-investigation-issues-statement.pdf

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Background: The APFI notes that the CMA has pulled extensively from the FCA Asset Management Study and subsequent UIL ('undertaking in lieu') proposed by the large consultancy firms. The APFI responded to FCA at the time to reject the UIL and refer the issue to the CMA. The CMA has then broadly grouped potential remedies into three categories: demand-side and informational remedies; remedies addressing potential conflicts of interest; and remedies addressing potential barriers to entry and expansion. Our response to the UIL can be found here:

https://www.dropbox.com/s/0uebq3mijbtlgu4/APFI%20Response%20to%20FCA%20UIL%20CMA%20July17.pdf?dl=0

Our approach: The APFI recognises that this is a new area for the CMA to consider and therefore remedies and direction may take time to evolve iteratively. The CMA notes: "To help inform our initial thinking, we nonetheless welcome views from parties on potential remedies at this very early stage."

The APFI therefore wishes to support the CMA, applying our experience in these matters to help drive outcomes that are in the best interests of end investors, the industry, agencies, gatekeepers and hitherto professional fund investors. We look forward to further engaging with the CMA before and following the publication of the Provisional Decision Report and Final Report. This is an area of great interest to our members, some of whom reside in large consultancies, others in smaller firms, research agencies, wealth managers, advisory firms, multi-managers, insurance firms and platforms. Consequently we have attempted to be balanced in our response to these interests; as well as what we believe to be in the best interests of end investors and industry.

The APFI is committed in promoting professionalism in fund research, selection and advocacy.

View: We concur with CMA that Aon Hewitt, Mercer and Willis Towers Watson are the three largest investment consultants in the UK, representing approximately 60% of the market. However a vast part of the remaining market is also heavily concentrated in terms of of ratings and selection by the likes of Morningstar and Russell investments. The CMA would do well to also consider these firms and suggest that the 60% quoted for 3 firms is equates to 75% for 5 firms and means that only a quarter of the market enjoys healthy competition. To recap, the UIL offered by the three parties to the FCA related to the following areas:

(a) changes to the tender regime for both consultancy services and fiduciary management services;

(b) public disclosure of performance in relation to manager selection and fiduciary management services;

(c) industry standards on disclosure of fees and other costs;

(d) conflicts of interest;

(e) improvements to the redress mechanism for complaints; and

(f) adherence of investment consultants to a strict code of conduct.

The APFI felt that the UIL was positive in principle but did not fully address the conflict between fiduciary and non-fiduciary services and recommending funds outside of the fiduciary perimeter and particularly recommending funds offers within the same firm. The APFI proposes that the basic rule for such practices has to be 'potential conflict exists unless evidenced otherwise'. This would require consultants to demonstrate far more robust whole of market searches before recommending internal offerings (vie 'mandatory tendering').

<u>**The APFI has provided answers to questions posed by CMA as follows;**</u>

(a) Would the potential remedy be effective and proportionate in remedying any AECs that we may find in relation to investment consultancy services and/or fiduciary management services?

A) The measures proposed will alleviate the issues raised. The issues identified are symptomatic of the structure of DC pension fund governance today. Stronger fiduciary controls, professionalism, transparency and accountability are necessary to foster better competition of investment consulting.

(b) Would the potential remedy give rise to any unintended consequences or distortions?

A) Unintended consequences are always possible – the key one is to ensure that measures taken do not disadvantage smaller consultancies by raising the regulatory levy to an unobtainable point. Measures should engender better practices; not simply raise costs.

(c) Are there other potential remedies that would be as effective and proportionate in remedying any AECs that we may find that would be less costly or intrusive?

A) Better accreditation, fiduciary obligation, training for trustees and professionalism among those recommending fund managers to trustees and employers. For example bringing consultants within 'approved persons' regime is an existing structure.

(d) What are the relevant costs and benefits that we should take into account in considering the proportionality of the potential remedy? How could we quantify these?

A) The costs relating to the remedy should be scaled against a small consultancy made up of one two key staff with annual earnings of between £50,000 and £250,000 per annum.

(e) What provisions would need to be put in place for the monitoring and enforcement of the potential remedy and which body should be responsible for monitoring?

A) Monitoring should be completed in conjunction with recognised professional bodies and associations. Remedies can be entered through the T&C regime for firms. Firms should set-up advisory boards to review monitoring and progress.

(f) Should the potential remedy be time limited? If so, for how long should it apply? What type of changes in the market would warrant the variation or removal of the remedy?

A) The APFI supports the raising of professionalism and remedies should only be removed once an adequate fiduciary/governance framework is in place.

(g) Should the potential remedy apply only to pension funds and/or investment consultants of a certain size? If so, what should that threshold be?

A) In terms of short-term competition remedies then these should be applied to the top 30% of firms by size. In terms of remedies that improve professionalism and transparency (e.g. benchmarking) that support long-term competition then these should be broadly universal.

A. Demand side and informational remedies

"Insufficient information is available to trustees and employers to compare investment consultants' fees and quality."

A) The APFI agrees with the above statement.

"A particular concern expressed by the FCA is that trustees are insufficiently able to assess the quality of the advice that investment consultants give them or the fees that they are charging, with the result that the value for money"

A) The APFI agrees with the above statement.

"The CMA has considered potential remedies to improve transparency over fees and performance. In broad terms, this potential set of remedies would involve developing an industry standard template for the reporting of fees and performance, which would make performance, fees and hence value-for-money, more transparent and comparable across different consultants, increasing competitive pressures on fees and quality of service. The potential remedies identified below could work alone or in combination, to achieve this outcome."

A) The APFI supports transparency around fees and performance but notes that a standard template may be difficult to implement and would need to adopted by a much broader set of services than simply investment consultants.

"Require investment consultants to provide clear, consistent information to trustees in relation to all fees."

A) The APFI supports better information and training for trustees. Trustees should also be required to disclose how consultants are selected.

"The CMA are considering the development of an industry standard on disclosure of all fees charged and comparison with those quoted for incumbent clients. This could involve comparing fees charged directly to fees quoted (eg at outset of a contract or during the competitive tender process).”

A) The APFI suggests that any such template should be considered in context to other cost templates being devised within the industry rather than in silo.

“Require investment consultants to report all fees to an independent benchmarking service to allow pension schemes and employers to compare their fees to the market.”

A) The APFI supports transparency but reporting must be on more KPIs than simply costs. The efficacy of the manager selection services, ratings should also be reported, measured and independently verified. Only once schemes and employers can see both value-added and cost can they determine Value for Money between service A and service B.

The CMA notes “ This potential remedy would involve the development of an industry standard for disclosure of all fees and costs incurred throughout a contract’s lifecycle and could also include establishing an independent benchmarking platform which would collate and publish this data on a regular basis, thus allowing pension schemes and trustees to compare investment consultants’ fees against other firms.”

A) The APFI supports any framework that enables smaller firms to compete with larger firms, including those available from advisory firms, fund ratings, insurance firms etc.

The CMA also notes “require investment consultants, when providing advice, to be clearer on the impact of a particular course of action on their own fees.”

A) We believe this could be easily addressed by bringing consultants into the fiduciary perimeter such as the approved persons’ regime.

The CMA notes “potential remedy would involve developing an industry standard that would oblige investment consultants to disclose the impact of a particular course of action on the fees that their clients would have to pay, following that course of action. Investment consultants would have to explain investment strategies, pricing models, etc to trustees prior to making the investments and ensure that trustees have fully understood the course of action and the impact on their investment prior to proceeding with an investment.”

A) We believe setting industry standards can have merit but risks complexity that makes comparison more difficult.

The CMA considers banning certain investment consultant pricing practices. The CMA notes “potential remedy would involve banning certain pricing models and mechanisms if they were misleading to trustees or likely to lead to perverse incentives.”

A) The APFI supports removing fee structures that are deemed misleading.

“The CMA considers if investment consultants should report on pension fund returns against agreed benchmarks.”

A) The APFI questions the use of benchmarks, which should promote long-term investing and reduce turnover versus increasing focus on short term returns, which encourages switching and herding. However some form of outcomes matching against

recommendations is prudent. There are a range of approaches including absolute return targets, risk-adjusted returns, hit rates etc.

“This potential remedy would involve developing an industry standard benchmark for relative returns. This could include requiring investment consultants to report on the relative performance of the fund against this benchmark, to increase industry transparency.”

A) The APFI questions the use of benchmarks, which should promote long-term investing and reduce turnover versus increasing focus on short term returns, which encourages switching and herding. Any use of benchmarks should be investable – e.g. ETFs.

“A particular challenge, as noted by the FCA, would be how to establish a link, in such reporting, between the performance of the fund in question and the asset allocation advice provided by the investment consultant. We would welcome the views of parties on this question.”

A) We suggest the services of the consultant should be clearly measured separately in terms of fund manager search, rating and selection and asset allocation advice. These are distinct disciplines and value added in one may be detracted by the other. Reporting distinctly allows better transparency and inferior services being offset.

“Require investment consultants to report the fees of asset managers selected and give details on the extent to which they have reduced fees for the trustees”

A) The APFI supports the above remedy and believes a key part of the role of professional fund investing is to negotiate competitive commercials and evidence that some managers were de-selected on grounds of cost.

“This potential remedy would involve developing an industry standard for disclosure of asset managers’ fees and require consultants to report how and to what extent they have reduced fees for their clients.”

A) The APFI supports any measures that drive better conviction in manager selection and securing value for money. Funds priced at a premium are best supported by evidence of cost negotiation and higher conviction to deliver future excess returns to alternatives.

“Require investment consultants to report the performance of their manager recommendations based on standardised performance metrics”

A) Standardised performance metrics may engender short-termism and skewed views of success. The metrics should reflect the nature of the mandate and thus standardisation is problematic. Metrics may be better based on measures like risk-adjusted return, hit rates, win-loss ratios.

“investment consultants would be required to report their relative performance in terms of asset manager recommendations against these metrics, to increase transparency and help increase competitive pressures on performance. There is a variety of ways in which this potential remedy could be implemented. Under one variant, for example, investment consultants could report against their own performance metrics, if they choose to do so, in addition to the standardised metrics. Under such an option, it would be important to ensure that the metrics developed by the investment consultant were used consistently over time to ensure comparability over time."

A) APFI supports any transparent means to show the value added by the consultant, particularly in terms of manager selection.

"Require pension schemes and employers to provide reviews of investment consultants, with aggregate results shared/available on websites."

A) The APFI challenges whether schemes and employers are sufficiently skilled to make accurate objective comparisons without education or support. However in principle disclosing in this way is potentially beneficial.

"Introduce mandatory tendering for consulting, fiduciary management services and/or master trusts"

A) Comparing the competency of different consultancies and services through 'mandatory tendering' is supportive of promoting better professionalism in asset management.

"This potential remedy would involve introducing a mandatory tender regime for investment consultancy services, fiduciary management services and master trusts. This could happen periodically (for example every five, seven or ten years), including when seeking to procure these services for the first time. In addition, pension funds could be encouraged to review services from investment consultants and/or providers of master trusts on a regular (ie annual/biennial) basis."

A) The APFI agrees that frequency of tendering is important to long-term investing, minimising turnover.

Establish rules to improve the tendering process

"This potential remedy would involve working alongside investment consultants and pension funds to develop a set of industry standard rules to improve the tendering process and make it more transparent. Such rules could relate to, for example: the need to attract multiple bidders; the parameters of the tender documents; the selection criteria; and the use of a third-party adviser to run the tender"

A) The principles of good mandatory tendering would follow a similar format to the search, Request for Proposal and beauty parade selection practices of professional fund investors. Industry standards are helpful but need to be backed by better education for pension funds such as the template being designed by the Transparency Task Force.

Produce standardised off-the-shelf tender documents that smaller pension schemes and employers could (but would not be obliged to) use to make tendering cheaper, easier and more effective.

"This potential remedy would involve working with pension funds and consultants to develop a set of industry standard tender documents to help smaller pension funds with their tendering processes. Smaller pension funds and employers may not have the in-house capability and resources to develop these documents and standard off-the-shelf documents would make tendering cheaper, more transparent and effective for them."

A) The APFI notes similar services available digitally for fund due diligence questionnaires e.g. www.DOORfunds.com, www.InvestRFP.com, www.fundinfo.net.

“Recommend some form of aggregation/consolidation of pension trusts to benefit from economies of scale”

A) APFI notes that consolidating pension assets may support economies of scale but may also create asset concentration and should be approach with caution.

“This potential remedy would involve recommending aggregation or consolidation of trusts below a certain size and with similar investment criteria and strategies. The consolidation/aggregation could give rise to economies of scale by reducing fixed costs for the funds. We note, in this respect, that the FCA has recommended that ‘the Department for Work and Pensions (DWP)”

A) The move to better cost transparency is wholly supported by the APFI and we note that large institutional investors can access lower prices in the market. However consolidating trusts before addressing the concentration of investment consulting is not itself helpful. This might be alleviated if consolidated schemes enlist panels of consultants who can ‘tender’ on a regular basis as suggested in the remedies. Such panels should combine both large and small consultancy firms to allow trustees gauge quality, choice and value for money.

B. Potential remedies to address conflicts of interest

We set out below potential remedies to address any AECs that we may find in relation to potential conflicts of interest. We have grouped these remedies into four categories, corresponding to different hypotheses regarding the existence of conflicts of interest.

“Investment consultants encourage clients to use their fiduciary management services and/or master trust services even if it is not in the clients’ best interests”

A) We believe the offering of internal fund offerings and fund selection services poses a conflict of interest. Recommending a vertically-integrated framework or blend should be done so on the presumption of conflict until evidenced otherwise. Here again better professionalism in terms of fund selection will alleviate the risk of conflict. This includes ensuring staff are not incentivised either implicitly or tacitly to recommend the internal product.

“Require investment consultants to give greater clarity to trustees that they are moving into a different arrangement and that they could seek this service from other firms”

A) APFI supports better clarity for trustees to make better informed decision in terms of the consultant they use, through better information but also better training and accountability upon trustees to execute. The use of qualified and experienced professional fund investors may aid trustees to make such decisions with confidence.

“This potential remedy would involve developing an industry standard whereby investment consultants commit to inform their clients of the distinction between fiduciary management services and investment consultancy services. Investment consultants would have to advise consultancy clients that it would be best practice to conduct a competitive tender process for fiduciary management services. As a supplementary measure, the remedy could involve developing an industry standard whereby investment consultants commit to provide their clients with ‘cost benefit’ analyses for different options available to them.”

A) The above measure is helpful but the recommending of internal products should be segregated from the products themselves. Potentially a second consultant may be necessary to advise the trustees and firm would need to demonstrate how staff and incentives are segregated.

Require mandatory tendering of fiduciary management/master trust services
“This potential remedy would involve imposing a mandatory tender regime whereby trustees would be required to tender for fiduciary management services periodically (eg every five, seven or ten years). Under this remedy, investment consultants would also be required to encourage clients to review fiduciary management services periodically (eg every year or two years).”

A) The APFI supports this remedy and should be structured with an ongoing panel. Clients should be required to conduct mandatory tenders every 2-5 years irrespective.

“A similar remedy could apply to the selection of master trusts, whereby employers would be required to tender for the selection of a master trust scheme for their employees periodically.”

A) The APFI is supportive.

“Prohibit investment consultants from providing fiduciary management/master trust services. This potential remedy would involve prohibiting investment consultants currently offering investment consultancy services to their clients from providing fiduciary management services to those clients. A similar remedy would prohibit investment consultants advising an employer on the establishment of pension schemes from providing an in-house master trust scheme to the same employer.”

A) This remedy has the best likelihood of removing conflicts of interest presented by firms that offer fiduciary and consulting services.

Measures to control prices in relation to master trust services

“This potential remedy would involve reviewing the existing price cap in place for master trusts. We may want to consider the impact of this cap on competition and outcomes for pensioners, with a view to reviewing the level and/or scope of the cap. We note that any such remedy may address the demand-side issues identified under hypothesis A, as well as the conflicts issues under hypothesis B.”

A) Price intervention itself is complicated, promoting transparency and tendering process are likely more effective measures. Price caps tends to have unintended consequences that are hard to predict.

Bringing the supply of investment consultancy services and fiduciary management services within the FCA’s regulatory perimeter

“Currently some investment consultancy services and fiduciary management services can be provided in a way that is not regulated by the FCA. The FCA noted in its report that bringing the provision of those services within its regulatory perimeter may address some of the potential concerns, as it would be able to supervise and monitor the provision of those services. It would also give the FCA the power to implement and carry forward any recommendations or remedies that we may introduce to address any AECs that we may find. This remedy would potentially be relevant in enforcing and/or monitoring some of the conduct issues described in this category (and the sub-categories below) and may also have relevance to the other categories, in particular demand-side and informational issues (hypothesis A).”

A) The APFI believes in professionalism of fund investing and investment consulting. We believe all those whom influence the selection of managers should operate within the same fiduciary perimeter and that the playing field should be level. We support this remedy.

Investment consultants' recommendations are influenced by their business relationships with asset managers

Require full disclosure of business interests to trustees

"This potential remedy would involve working with trustees and investment consultants to develop an industry standard on full disclosure of business interests. Investment consultants would also have to make a full disclosure to trustees as regards all business interests that might affect – or be perceived to affect – the integrity of their advice and give rise to conflicts of interest. "

Impose measures to ensure there is stronger separation of different business areas within investment consultants

"This potential remedy would involve developing a set of business separation rules that investment consultants would be required to adhere to. The remedy could, for example, facilitate stronger business separation between investment consultancy services and fiduciary management services and the services that asset managers purchase from investment consultants (for example the organising/hosting of conferences, data and consulting services, as well as investment consultancy services)."

Investment consultants' recommendations are influenced by hospitality

Impose limits on the value of hospitality that investment consultants are allowed to receive from asset managers

A) We believe consultants should be subject to the same regulatory regime as other professional fund investors subject to FCA FG13/1 in the UK and Anti-trust laws and DOL-fiduciary in the US. Excessive hospitality is considered a potential inducement vie Anti Bribery Act.

"This potential remedy would involve working with trustees and investment consultants to develop an industry standard on managing conflicts of interest. Consultants would commit to refuse any gifts, hospitality or entertainment above a pre-agreed threshold. Consultants could also make their firms' policies in regards to hospitality public and disclose any hospitality that could give rise to a conflict of interest, regardless of the value of such hospitality."

A) This step is not required assuming investment consultants move within the scope of FCA Handbook and thus FG13/1. In absence of which the APFI would happily help support the creation of standards across professional fund investors.

Impose limits on the type of hospitality eg legitimate business meetings and conferences only

As above, this potential remedy would involve working with trustees and investment consultants to develop an industry standard on managing conflicts of interest. Investment consultants would need to commit to refuse any gifts, hospitality or entertainment outside a pre-agreed set of parameters (eg allow only business meetings, conferences, etc). Investment consultants would also have to make their firms' policies in regards to hospitality public and disclose any hospitality that could give rise to a conflict of interests to the trustees, regardless of the nature of such hospitality.

A) See response above.

Require full disclosure of hospitality received to trustees
"This potential remedy would involve working with trustees and investment consultants to develop an industry standard on managing conflicts of interest. Consultants would also

have to make their firms' policies in regards to hospitality public and disclose any hospitality to the trustees, regardless of the value and nature of such hospitality."

A) See response above.

Impose an outright ban on hospitality

A) This is not necessary; research is a necessary component of fund selection and some research events include some hospitality. However this should be proportional to content of the event, assets under influence and the individual. This should satisfy FG13/1 and any standards created.

This potential remedy would involve banning the offer and acceptance of any gifts, hospitality or entertainment of any value and nature between investment consultants and asset managers.

A) See above response.

C. Potential remedies to address barriers to entry and expansion

We set out below potential remedies to address any AECs that we may find in relation to barriers to entry and expansion.

Introduce mandatory tendering for investment consultancy services and/or fiduciary management services

"This potential remedy would involve introducing a mandatory tendering regime for both investment consultancy services and fiduciary management services, and pension funds could also be encouraged to review services from investment consultants on a regular basis."

A) We support this remedy.

Require divestiture of investment consultancy services

"This potential remedy would involve requiring firms to divest their investment consultancy services arm if these firms offer other services such as asset management services, etc. This remedy would seek to create a new source of competition or strengthen an existing source of competition by increasing the quantity of non-vertically integrated investment consultancy firms in the market."

A) The APFI believes better segregation is needed as many large consultancies operate partnership structures that allow sharing of information and cross-management.

Basic FCA accreditation scheme to provide certification of smaller consultants

A) We fully support schemes designed to encourage smaller consultancy that help reduce concentration in fund manager influence.

"This potential remedy would involve recommending that the FCA develop an accreditation scheme for smaller consultants, who are currently seen as risky by trustees. This remedy would be designed to increase switching between investment consultants and lower barriers to entry and expansion."

A) The APFI notes that many consultants have actuarial or accountancy training but no specific investment or manager selection training. APFI offers its services to support such accreditation as well as our links with other professional bodies to offer CPD

schemes, and to advise which courses would support better professionalism and standards in selecting and recommending funds.

Summary

“We have identified three initial high-level hypotheses for structuring our investigation and have set out some potential remedies that may help to address any of these issues if one or more AECs are identified through our investigation.

We should emphasise that we have not found any competition concerns and both the issues and potential remedies that we have described in this document are hypothetical at this early stage of our investigation. The CMA will only put in place remedies if, following our investigation we determine that there are AECs that require remedying and there is no presumption at this stage that AECs will be found and remedies required.

This statement provides a framework to prompt parties to submit evidence and views on both the issues that we envisage being relevant at this stage and on the potential remedies that we have identified or any other potential remedies.”

The APFI thanks the CMA for the opportunity to input into this consultant of great interest to professional fund investors. November 2017.

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Association of professional fund investors