

Barnett Waddingham's response to the CMA's *Working paper on the supply of fiduciary management services by investment consultancy firms*

This paper sets out Barnett Waddingham's comments in response to the CMA's *Working paper on the supply of fiduciary management services by investment consultancy firms* dated 29 March 2018 ('the Working Paper') as part of the *Investment Consultants Market Investigation*.

In terms of the definitions set out in the Working Paper, Barnett Waddingham can be considered as both a 'non-integrated IC firm' and a 'Third Party Evaluator' of all firms providing FM services to UK pension schemes.

We have commented on each area requested in the Working Paper below.

Paragraph 43. Views on whether the perimeter of existing regulation is sufficiently broad to cover the potential conflicts of interest faced by IC-FM firms in selling their in-house FM services to their existing IC clients.

We consider two specific potential areas of conflict faced by IC-FM firms:

1. Advising on the suitability of FM *in general* for an existing IC client
2. Advising on the suitability of an IC-FM firm's *in-house FM services* for an existing IC client

We believe that the perimeter of existing regulation may not sufficiently cover either of these areas. Our view is that this is symptomatic of regulations covering pension scheme investment advice in general being too vague.

As it stands, it is unclear whether regulation covers any investment decisions other than those which are directly linked to investment in a regulated product, i.e. fund selection. It could be argued that current regulation does not cover, for example, asset allocation decisions, which usually have a much more significant financial impact than fund selection decisions. On the other hand it could be argued that a decision to invest in a certain asset class will inherently lead to a decision on fund selection, thereby bringing asset allocation advice within the scope of current regulation.

The same can be said for advice on FM. While neither deciding to adopt a FM approach nor selecting a specific FM provider directly involves investing in a regulated product, once a Fiduciary Management Agreement (FMA) has been executed, the fiduciary manager is then able to invest in regulated products on a pension scheme's behalf. It is important for this to be captured by regulation in our view.

We present two alternative options for dealing with this.

Option A: Targeted change in regulation

Broadening regulation in two areas:

- **To cover advice on the suitability of a specific firm's FM service.**

Our suggestion for achieving this in practice is to put a legal obligation on trustees to take advice on the suitability of the provider's FMA.

- **To prohibit FMs from being able to advise clients on the suitability of their own FMA.**

While the FMA does not necessarily contain all of the information needed to determine whether a specific firm's FM service is suitable, the process of entering into a FMA is a common step for all FM appointments, therefore making this approach an effective means of capturing all future cases. Furthermore, the FMA sets out the guidelines for investment, including the investment return and risk profile of a pension scheme's assets, and as such is an area where regulated, expert advice is appropriate in our view.

Option B: Clarification of existing regulations

Clarification that:

- **All advice given in relation to a pension scheme's investments which could consequentially lead to investing in a regulated product, or lead to a *decision* about investing in a regulated product, is covered by existing regulation.**
- **Fundamentally this therefore covers advice on the suitability of FM in general and the suitability of a specific provider's FM services.**
- **It also covers the periodic review of a FM service, as an extension of the current requirement to periodically review the suitability of a pension scheme's investment arrangements.**

This is our preferred option as it would be easy to implement. Indeed, the advice we currently give to our clients regarding the suitability of FM is subject to the same internal compliance procedures as advice in relation to regulated products.

We believe the FCA is already considering the merits of broadening investment regulations separately from the CMA investigation. This option would be consistent with this direction of travel and may not require any new primary or secondary legislation in itself.

Under both options, we believe regulations should be supported by clear and strong industry guidance (e.g. from the Pensions Regulator) covering:

- a) Factors to consider when deciding on the suitability of FM in general
- b) Factors to consider when selecting a FM provider
- c) The regulated advice required at different stages of the FM journey
- d) A requirement for regulated advice to be provided by an independent organisation
- e) Periodic reviews of FM services by an independent and regulated adviser.

Point d) would be critical under Option B given that legislation would not explicitly prohibit IC-FM firms from advising on their firm's own FM services.

Under both Options A and B, the result would be that all pension schemes entering into a FM service would receive advice from an independent and regulated investment adviser on the suitability of their investment decision.

We do not envisage this prohibiting firms providing both advisory and FM services to the same client. While we do not believe it is a necessity, we believe there can be benefits to the same organisation providing strategic

investment advice and FM services. However, any change to the investment guidelines in a pension scheme's FMA would be subject to independent scrutiny.

We recognise that a large number of pension schemes which currently receive FM services will have never received independent advice on the suitability of these services. We would strongly support the retrospective application of any broadening or clarification of the regulations to facilitate independent scrutiny of these arrangements.

Paragraph 106. Views on whether the comparison of an IC-FM firm's FM services with non-FM products or services may lead to a perception from trustees that they have adequately tested the market and may be less likely to also consider the FM services offered by rival FM providers.

Based on our experience, we agree with the assessments made in the Working Paper.

We have met and worked with a large number of trustee boards which have been considering whether to adopt fiduciary management investment approach, having been advised to do so by their incumbent IC (which is also an IC-FM). In many cases, our involvement has followed a series of advice stages over a year or more.

We are yet to see a case where an IC-FM has mentioned the FM services of specific rival FM providers. However, over the last couple of years, we have noticed a trend for more IC-FMs to suggest taking advice from an independent investment advisory firm (or Third Party Evaluator (TPE)) to their clients. This applies to both full and partial FM. Indeed, we receive direct referrals from some IC-FMs to independently advise their clients on the range of FM providers.

Notwithstanding these trends, we agree with the assessment that an IC-FM firm will often introduce the concept of fiduciary management, followed by their own FM services, providing only comparisons with non-FM products. In our view, we consider it possible that in a reasonable number of cases this will have resulted and could continue to result in a trustee perception that no further FM comparisons are necessary (although by definition we only meet with trustees who have not perceived this to be the case). Again, this is evidenced by the high proportion of pension schemes which have chosen their incumbent IC-FM's FM services without considering alternatives. We believe this could be explained primarily by one or more of the following reasons:

- The comparison of FM services to non-FM products could include inherent biases or behavioural 'nudges'. For example, placing more emphasis on the merits of FM than to non-FM, or describing FM services using more positive wording.
- Given the trusted adviser role of an IC, a client should reasonably expect that if their IC-FM is suggesting that FM in general or specifically their own FM service is suitable then it is indeed in their best interests.
- Our understanding is that IC-FMs do not research each other's FM services, hence are not in a position to be able to provide an adequate comparison.

Paragraph 110. Views on the matters identified regarding the customer journey towards a potential decision to purchase FM services and whether there are any other matters that should be taken into account.

Our response to this is partly covered by our response to the previous paragraph. However, we would identify the following issues (which are not all directly related):

- Based on our experience, a popular and influential step in the journey is the hard selling of FM services to pension scheme sponsors. This usually involves communication with a company finance director, who

in many cases, and particularly for smaller pension schemes, can have a large influence on the decision making of the trustee board. This communication can be based on an existing relationship or cold calling. It is a practice which we have witnessed from both IC-FM firms and 'non-integrated FM firms'. We have worked with a number of trustee boards whose primary reason for consider FM services is because they have been encouraged to do so by their pension scheme's sponsor.

- We have on numerous occasions witnessed FM services sold as a 'solution' rather than a service. For example, FM services are sometimes compared to non-FM services as a means of achieving a better funded pension scheme by taking less risk. We believe this practice is misleading as it is the investment strategy that is the means to achieving this objective; FM services are just a means for implementing the investment strategy. This practice can give the impression that the funding objective cannot be achieved through a non-FM approach.
- We have frequently witnessed the reporting of FM provider track records exaggerating the relative merits of a provider's FM services, including both IC-FM firms and non-integrated FM firms. This applies predominantly to full FM. A regular practice is for FMs to compare their clients' performance to the performance of the average pension scheme (the latter can be determined based on information provided in the Pensions Regulator's handbook). We believe the practice inevitably shows outperformance relative to the average pension scheme as a result of the prevailing investment market environment over the last 10 years since FM has become established in the UK, rather than as a result of the skill of the FM firm. Specifically, it is intrinsic to the vast majority of (if not all) full FM services to invest heavily in products which benefit from a falling/low interest rate environment. We believe this practice exaggerates the benefits of FM services and the decision making skill of FM firms. We would be happy to elaborate on this point further if required.

Paragraph 121. Views on whether and if so how the practices identified in the Working Paper impact competition and customers.

We have no doubt that the practices undertaken by IC-FMs have led to many trustee boards appointing their incumbent IC for the provision of FM services without considering the alternatives. We believe that many trustee boards will have either not been aware of the alternatives or have entered into service arrangements based on the strength of their existing trusted adviser relationship. This is more likely to be have been the case where a knowledgeable professional trustee was not a member of the trustee board, making it more difficult to identify the importance of considering alternatives. It is also more likely to have been the case in our view where the IC-FM also provided Scheme Actuary services to the client, as a Scheme Actuary from a rival firm would have been more likely to suggest consideration of alternative options.

From our experience, there has been a trend to move away from these past practices to encouraging a more competitive environment but we do not yet consider this to be the widespread norm and we strongly doubt this would happen without a combination of regulation and industry guidance.

Paragraph 124. Views on the theory of harm, evidence and emerging findings set out in this document.

We would make the following additional points (which are not all directly related):

- **Paragraph 20.** In terms of past practice by IC-FMs, the theory of harm used in the Working Paper is reasonable in our view.
- From a forward-looking perspective, the theory of harm could be broadened to additionally capture the trend for IC-FMs to steer customers toward FM in general, rather than the in-house FM services. Of the

variant theories of harm considered, we believe 21(a) and 21(d) are most reflective of the current market environment.

- **Paragraph 26.** Regarding your analytical framework, we would issue caution when assessing the outcome for customers. Given the prevailing market environment of high returns from risk assets and falling/low interest rates, and taking into account the intrinsic investment approach of FMs, it is almost inevitable that customer outcomes have generally been good. However, this is not guaranteed to be the case from a forward-looking perspective.
- **Paragraph 31.** We would issue caution about the definition used for ‘full FM mandates’ in the Working Paper if this is later used in legislation (for example) as this could encompass investment managers who manage all of a pension scheme’s assets but who do not consider their arrangement to be FM in nature.
- **Paragraph 64.** We would issue caution with relying on the results the CMA survey. We believe the differences between the two points identified in this paragraph can partly be explained by a lack of understanding from the respondents, in terms of the question they were being asked or even the services they have in place. For example, according to the CMA survey results, 7 respondents believe that Barnett Waddingham are their FM, which cannot be true as we are not a FM provider.
- We believe a large proportion of respondents to the CMA survey have included independent professional trustees as a third party who they have sought advice from when buying FM for the first time. While we believe many professional trustees have experience at working with FM providers, only a relatively small proportion of these individuals have sufficient expertise and to adequately advise trustee boards on the suitability and risks of entering into a specific provider’s FMA.
- **Paragraph 85.** We found it reassuring that your findings indicate that no IC-FM firms any longer have schemes that directly link the pay of advisory staff to FM sales.

Paragraph 131. Views on any aspect of the potential remedies set out below, in particular in terms of their potential effectiveness, proportionality and how they could be implemented.

We have set out our views below on the potential remedies suggested in the Working Paper.

Measures to encourage trustee engagement

(a) **Mandatory tendering on first adoption of FM Services.**

Given the wide range and varying nature of FM services, we believe it is extremely important for trustees to consider alternative options. We would therefore support mandatory tendering on first adoption. However, we recognise circumstances differ, and we would therefore discourage a highly prescriptive framework for this. We would support a flexible framework set out in best practice industry-wide guidance. For example, we believe the advisory firm should have the freedom to recommend whether a full market review is appropriate or whether a simple benchmarking exercise would be more suitable given the circumstances.

(b) **Trustee reporting to scheme members or TPR.**

For a consistent approach to be taken, the difficulty of defining what constitutes FM services would pose a problem here, in our view. For example, where a pension scheme’s entire investment portfolio is invested in a single pooled multi-asset fund, would this be in scope of trustee reporting? This would be tantamount to fiduciary management but the investment manager may have never thought of itself in those terms.

Furthermore, we doubt whether this requirement would be effective in materially changing trustee behaviour. This would be dependent on the IC-FMs’ approach to communicating the requirement to trustees in advance,

which would be open to the same sort of abuse as has been identified regarding the customer journey in the Working Paper.

(c) The provision of guidance to trustees on the adoption and selection of an FM provider.

As stated earlier in our response, we believe this could be an effective remedy, but only if it is supplemental to a more fundamental broadening or clarification of investment regulations.

Historic mandates:

(a) Measures to require mandatory tendering within a fixed period after first appointment.

While this would be very remunerative for TPEs like ourselves, we do not believe mandatory re-tendering would be proportionate. From our experience to date in reviewing historic mandates, it would require a significant shift in a trustee board's investment objectives or very poor performance from the FM provider for switching to another FM provider to be in a scheme's interests (net of implementation costs). There is also again the problem of defining FM services and therefore which services or products would be in scope.

We would however support the mandatory periodic *review* of FM services by an independent and regulated organisation. This would not just be within a fixed period after first appointment, but on a periodic basis in the future. As stated earlier in our response, we believe this would be covered by regulation as trustees would be in effect making a decision about whether to continue or change their pension scheme's investments.

(b) Measures to require mandatory switching.

We would strongly oppose this.

Since the underlying investment funds which each FM uses vary considerably, mandatory switching would lead to unnecessary costs for pension schemes being forced to frequently change their investments. It could also lead to FMs investing in fewer illiquid investment opportunities, which could damage investment returns.

We see the selection of a FM provider as a decision which ideally only needs to be taken once, with the chosen provider guiding a pension scheme to its investment objective (e.g. buy-out with an insurer). Requiring mandatory switching would to a large extent defeat the object of full FM, in our view.

(c) Measures to require periodic mandatory tendering.

See response to (a) above.

Measures to reduce the risk of conflicts through controlling or incentivising firm behaviours

(a) Segregation of advice and marketing materials.

The objective of this remedy seems sensible but we would suggest keeping it simple. We would not support the complexity suggested in 130a (i) and (ii) as we believe this would be disproportionate.

(b) Measures to reduce firms' incentives to promote their own FM services.

(i) Legal separation of advisory and consultancy practices.

We have no comments on this remedy.

(ii) Prohibition of cross-selling advisory and FM services.

We believe this would be difficult to achieve in practice. For example, it would be difficult for an IC-FM that is advising a client on the suitability of FM *in general* to not refer to their own FM services. However, both options put forward earlier in this paper would protect trustees from malpractice, through the appointment of a regulated independent adviser, either by targeted regulation or by following clear guidance on best practice.

(iii) Internal separation and controls.

We agree this is likely to be a more proportionate but less effective remedy than 130(b) (i) or (ii). In general, we would be supportive of this.

(c) Regulatory disclosure on adoption of FM.

We doubt whether in practice this would reduce the incentives for IC-FM firms to promote their own FM services or FM more generally. We believe it is likely that this would be open to abuse in terms of communications and would likely turn into a tick-box exercise, which in turn could lead to compliance but with a false impression of good practice. Since IC-FMs do not research rival FM services it is not possible to provide the necessary comparisons.

A more simple solution would be to either introduce targeted regulation to prohibit IC-FMs from advising on the suitability of their own FM services, or to introduce best practice guidance to deter this behaviour.

(d) Regulatory obligations on firms' conduct.

We would expect the current regulatory framework to be sufficiently broad to cover the obligations on firms' conduct.

(e) Prohibition of IC-FM firms acting as an evaluator or offering comparative advice.

As per our previous comments we fully support this.

Paragraph 132. Questions on potential additional remedies.

Questions on additional potential remedies

1) Mandatory tendering at the point of adoption of FM or within a fixed period after first appointment.

As per our previous comments, we support mandatory tendering at the point of adoption as part of best practice industry-wide guidance, although the parameters for this should be flexible. We support periodic reviews thereafter, rather than mandatory re-tendering.

a) What could be the minimum scope of an acceptable competitive tender process (for example the number of firms invited to participate)?

We do not believe it would be helpful to be prescriptive in the scope or parameters of a tender process. We believe that the nature of each tender process should reflect the requirements and specific circumstances of a given trustee board. For example, there may be occasions where a trustee board are able to set such strong preferences about what they are looking for that there may only be a small number of FM providers whose service model fits, in which case setting a minimum number of firms to tender could lead to inefficiencies.

b) How long should an initial FM mandate last before the requirement for an initial tender?

We do not believe in mandatory re-tendering. However, any FM mandates which have previously been set up without independent advice on the suitability of the FMA should be reviewed as soon as is practically possible. This would be consistent with current investment regulations, if clarified as per Option B described earlier.

c) Should such an approach have a requirement for an open tender process?

We believe industry guidance should be that all FM appointments should be carried out on an open tender basis.

d) Should there be a requirement or encouragement to use a third party evaluator?

We believe industry guidance should be that all FM tender exercises should involve a TPE who is regulated to provide the necessary investment advice. The requirement for the TPE to be a regulated adviser would be consistent with current investment regulations, if clarified as per Option B described earlier.

e) Should this requirement exist for both partial and full FM mandates?

Our comments apply for both partial and full FM mandates.

f) Should there be specific requirements for any incremental expansion of an FM mandate (such as additional asset classes)?

Any changes to an FM mandate would result in a change to the FMA which would require regulated investment under either Option A or B described earlier.

g) Should any other requirement be imposed in relation to schemes which have already adopted an FM approach? If so, what? Should this be limited to schemes that did not competitively tender for FM?

We have nothing to add other than our comment in 1b).

2) Segregation of marketing materials from advice

a) Are there currently business models where separation of marketing and advice would be problematic?

We are not aware of any.

b) How could the key differentiators of marketing and advice be defined?

Advice must be compliant with regulatory and industry guidelines. Any material classed as marketing material should be clearly identified as such, e.g. through clearly visible disclosure.

c) Could marketing and advice be further separated through a time gap between the decision to adopt FM and the provision of marketing materials?

We do not support complexity in this area.

3) Reporting to members

a) Would a requirement to report the actions of trustees to members be sufficient to incentivise trustees to more actively consider an appropriate range of options?

Not in our opinion. Trustees do not typically have sufficient information or expertise to judge whether the range of options they have considered is appropriate.

b) What should be in the scope of this report and should there be any enhanced power for members to challenge any decision.

N/A.

4) Restrictions on selling both advisory and FM services

a) Would the benefits to trustees of receiving both advisory and FM services from the same provider outweigh the potential harm?

Our understanding is that in the vast majority of cases, trustees receiving FM services also receive investment advisory services from the same provider. This is because high-level investment strategy advice is usually taken before entering into the FMA.

We believe best practice industry-wide guidance would be for trustees to appoint an independent regulated adviser to advise trustees on the suitability of FM *in general* and the suitability of a FM provider. It would be possible to go a step further (as per Option A described earlier) and broaden regulation to prohibit FMs advising on the suitability of their own FMA. We believe the potential harm outweighs the benefits for trustees in these areas.

However, in terms of high-level investment strategy advice, we believe it is possible that the benefits outweigh the potential harm, but that this is most likely to be the case when an independent adviser oversees the advice given. We believe industry guidance should be for trustees to put in place arrangements to oversee both the advisory and implementation functions of their FM on a periodic basis.

b) Could any restriction be limited to situations where advisory and FM services have not been subject to an open tender process (either separately or in combination)?

Our response to 4a) applies equally to FM services which have and which have not been subject to an open tender process.