LCP Response to CMA Working Paper

This is LCP's response to the CMA's working paper on conflicts of interest for investment consultants who offer fiduciary management services.

Our response has two main sections:

- Comments on the findings of the working paper.
- Comments on the potential remedies.

Throughout our response we have used the abbreviations adopted by the CMA in the working paper.

Comments on the findings of the working paper

We would like to make the following comments and observations about the findings of the working paper.

Scope of the working paper (1) – theories of harm

We note that in paragraph 20 the scope of this working paper has been kept deliberately narrow.

LCP notes the working paper does not address a number of issues that were set out in a paper submitted to the CMA by Compass Lexecon in December 2017 (published on the CMA's website on 1 March 2018) (**CL Paper**). This paper highlighted some potential conflicts of interest where an organisation offers both FM services and IC services to the same client – we refer to these potential conflicts below using the same numbering as in the CL Paper. Of the seven issues identified, only 1 (Issue 6) is squarely addressed in the working paper.

While we have no direct evidence that the issues raised in the CL Paper affect any FM provider or customer, we believe they are relevant to the CMA's investigation and are worth further investigation because they represent areas of potential harm to the functioning of the market and customer outcomes.

In particular, two issues that were highlight by Compass Lexecon that are not covered in this working paper, but are related to the process of selling FM services to existing IC clients are:

- The IC-FM firm may have an incentive to only recommend one approach for a given asset class; or potentially to be overly prescriptive in favouring certain

combinations of assets classes that align with in-house fiduciary products (Issue 3, CL Paper).

- The IC-FM firm may have an incentive to use favourable assumptions to justify asset allocation advice on the proportion to invest in its own partial-fiduciary products (Issue 2 CL Paper).

The CL Paper highlighted other areas that relate to outcomes for customers in selecting an FM service and the potential for conflicts of interest that may arise:

- The IC-FM firm may have an incentive to set a "soft" risk/return objective for the purpose of benchmarking the fiduciary manager (Issue 1 CL Paper).
- Fiduciary managers may have an incentive not to propose certain insurance solutions that reduce their assets under management (Issue 4 CL Paper).
- The IC-FM firm may have an incentive not to advise a client to replace its FM service provider. It may also have incentives not to be fully transparent over sources of underperformance (Issue 5 CL Paper).

As regards Issue 7 CL Paper (Increasing fiduciary product complexity to "lock-in" clients), we would hope that this will be addressed in the forthcoming CMA working paper on "High-level emerging thinking on market concentration and barriers to entry and expansion."

The issues raised in the CL Paper are important and we look forward to the CMA's analysis of them in due course.

Scope of the working paper (2) – other outcomes

In Table 1 and paragraph 27, the CMA says that "outcomes for customers" and "market outcomes" are not covered by this working paper. Based on the titles of expected future working papers detailed in the "Progress update" of 21 February 2018, it is not clear at what point these other important issues will be assessed.

FM services are distinct from advisory-only IC services

One of the IC-FM firms commented (paragraph 51) that it does not see a "cliff-edge" between investment consultancy and fiduciary management. This implies that the IC-FM firm sees fiduciary management as a natural extension of advisory-only investment consultancy and that it is one part of a broad service offering. Other IC-FM providers made similar points in their submissions in response to the CMA's statement of issues.

We disagree and see a clear distinction between IC services and FM services. The CMA's working paper does not explicitly address this point, although its underlying assumption appears similarly to be that IC services and FM services are quite distinct. We think it is worth making the arguments to support this view explicit, and in particular, to highlight where it creates a potential competition issue.

We understand why there may be a perception of a continuum of services from IC advice through to a full FM service. These services might cover:

- Advising on the suitability of options without a firm recommendation.
- Advising on the suitability of a wide range of options, but with a firm recommendation.
- Offering a firm recommendation with perhaps only limited consideration of other options as part of the advice: "directed" advice.
- Offering operational structures, such as fund platforms, to allow easy implementation of a recommendation, or offering a service to draft instructions to purchase or sell fund units in accordance with a recommendation.
- Fiduciary management.

We think this potential perception of a continuum means that it can be unclear to trustees as to when advisory services end and when FM services start. Many of the IC-FM firms are proposing FM services to existing IC clients as being merely a complementary service to their existing arrangements. See, for example, paragraph 1.4 of Willis Towers Watson's response to the CMA's statement of issues; and paragraph 2.3 of Mercer's response to the statement of issues.

However, we believe there is a clear distinction (and therefore a "cliff-edge") at the point at which FM services begin that makes them a fundamentally different offering. This distinction is important, as we believe the services of IC and FM can and should be clearly differentiated by the provider.

The change from IC to FM services occurs when the FM takes responsibility for implementing portfolio changes without prior notification or referral to the client. The IC / FM distinction is clear in regulation: discretionary portfolio management requires a firm to have and to exercise the specific FCA permission of Managing Investments.

Advising on investments, with the ultimate investment decision retained by the client, is a different service from one that entails taking discretionary control of assets. The latter, part of an FM service, is discretionary asset management by another name.

We note that many IC-FM firms have implicitly accepted this distinction in the conflicts of interest policies they have introduced that seek to manage the transition from one service to the other. If this is the case, then it should not now be argued that FM services and IC services are part of a continuum, no longer acknowledging this distinction. (We explain below that it is extremely difficult, if not impossible, to adequately manage this conflict through conflicts of interest policies alone.)

Evidence that there is uncertainty about what constitutes FM services

Paragraph 32 and footnote 11 indicate that of the 279 respondents who said they had bought FM services, the CMA could not confirm that the stated provider was a provider of FM services for 134 (48%). We suggest that the CMA confirms and, if possible, clarifies this data. It potentially implies that nearly half of clients are not clear what service – investment consultancy, asset management or fiduciary management – they have purchased from providers. If this is the case, it strongly suggests that the degree of uncertainty on this point among trustees is high and that these services do need to be clearly explained and differentiated by the providers.

Inadequate management of conflicts by IC-FM firms

Some of the IC-FM providers have stated that their IC staff do not recommend their own FM service – paragraphs 49 and 92. This may be strictly true, but it is not clear to us exactly what is meant by "recommend" in this assertion. We understand that most IC-FM firms will provide the formal Pensions Act 1995 related advice that trustees are required to receive – either under section 36 to confirm the suitability of the investment, or under section 34 to confirm the FM manager's competence.

There is also evidence in the working paper that many IC-FM firms will introduce their own FM service to existing trustee advisory clients. Depending on how the introduction is effected, our view is that this could be construed as an endorsement, or even a recommendation.

Perception of conflicts by trustees

We note that 60% of trustees see a problem with IC firms steering clients into their own FM services (paragraph 60); and that this figure is higher for professional trustees and large-scheme trustees.

Evidence of IC-FM steering IC clients to their FM service

The data provided in paragraphs 62, 63 and 67 does not appear to test directly the theory of harm highlighted at the beginning of the working paper: "…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."

The data does not directly provide the key information required to specifically test this theory. We suggest the key information is a response to the following question:

- Of those clients that the IC-FM has advised to use FM, and the client has moved to **any** FM service provider, what percentage has remained with the incumbent firm?

We refer to this as "the incumbent's conversion rate".

It could be argued that one should remove from the relevant population any client who used a third-party adviser in the selection exercise or who underwent a full tender exercise. We have deliberately not done this as the incumbent IC provider's advice and positioning ahead of a selection process for a potential FM provider may naturally influence the remit for the potential FM provider.

Much of the data provided uses the current clients receiving FM services as the base population. Some (many) of these may not have begun as IC clients of any IC-FM firm. These clients are not relevant in testing the specific question on the theory of harm.

The table below shows a client's possible situation before taking up any FM services and after taking up FM services.

Table 1 – Possible Switching Routes

Previous arrangement – IC services provided by:	Changed to FM services provided by:	
IC-specialist firm	FM-specialist	**W**
	IC-FM-integrated	
IC-FM integrated firm	FM-specialist	**Y**
	IC-FM-integrated (Same Firm) – **X**	
	IC-FM-integrated (New Firm)	
Other arrangements (eg in-house adviser)	FM-specialist	**Z**
	IC-FM-integrated	

The results of the survey conducted by IFF Research say that 51% of current FM clients previously used the same firm for IC services (table 122). This is:

- X / (W+Y+Z)

We think the key statistic is the incumbent's conversion rate to FM within the same firm. Calculated as:

- X / Y

It does not appear that the data is publically available to calculate this incumbent's conversion rate. The CMA and IFF may have the necessary information to calculate it.

However, we are able to combine the data from table 122 with other responses (table 108 of the IFF survey data for all schemes) to give an approximation of the incumbent's conversion rate. From table 108, broadly speaking around 70% of IC providers mentioned their own FM service at the time the trustees were considering using FM

services. We believe it is a reasonable assumption that for the remaining 30% the existing investment consultant did not mention its own service, because it did not have one and was an IC-specialist. This represents W in the table above. If this 30% is removed from the denominator, it suggests an incumbent's conversion rate of around 73%. This indicates a distinct lack of competition and suggests quite strongly that IC-FM integrated firms steer their clients into their own FM services.

We note that paragraph 66 already concludes: "Overall, the evidence from the CMA survey and the client data set out in the paragraphs above indicates that a significant proportion of pension schemes buying FM have appointed their existing investment consultant to supply these services". The analysis above may provide further evidence.

Conclusions on the findings and potential remedies

General

We consider FM services as a type of asset management. We do not think that FM-specialist firms should have a different regulatory standard to other asset managers. This could create unfair advantage for certain providers over others. For example, an FM service provider that uses in-house asset managers to provide security selection decisions could call its services "asset management"; this provider should not have an advantage over (or be at a disadvantage to) a FM service provider that uses third-parties for the security selection decision.

Much of the working paper focuses on the provision of FM services from an incumbent IC service provider. We would like to make it clear that we believe there are similar and equally important conflicts of interest when an incumbent asset manager or FM provider provides IC services to its client. These are less acute at the point of sale, but once appointed, issues 1 to 5 and issue 7 of the CL paper all potentially apply.

We, therefore, think that any remedy should aim to address the conflicts of interest when a firm offers both IC services and FM services, whether the original service was IC or FM.

We discuss the potential remedies in the sections below – these are ordered broadly in-line with our suggested preferences for remedies.

Prohibition of cross-selling advisory and FM services – para 130(b) (ii)

We believe it is very difficult to manage the conflicts of interest of a firm providing both IC services and FM services to the same client. We, therefore, think prohibiting the provision by a firm of both IC services and FM services to the same client is a proportionate and effective way to manage many of the potential conflicts of interest raised in this working paper.

We think the conflicts of interest arise whether a FM firm provides a full-FM service – the control of all the scheme's assets – or a partial-FM service – the management of only part of the assets.

Whilst the conflicts at the point of selling the service are most acute when an existing IC provider is offering FM services, the reverse situation (of an incumbent FM selling IC services) should be treated consistently. The outcome in both scenarios, of offering both services to the same client, raises conflict of interest concerns. It would also be unclear how the potential remedy would work in practice if it is not applied in both directions.

Mandatory tendering – parts of para 128 and 129

We believe this remedy, if applied to all FM services, is disproportionate. There is no such requirement for mandatory tendering for other asset management products.

In the case where a client is considering an incumbent IC provider for FM services (and if the CMA does not prohibit this possibility), we think the case for a tendering exercise to be mandatory is stronger and would like to see this remedy introduced. We suggest that there is also a period of time after ending an IC provider's contract and before appointing the same firm as an FM provider, during which a tender exercise is mandatory.

For similar reasons, we would also like to see the requirement for mandatory tendering if an existing FM service provider is being considered as a provider of IC services.

We do not think it is helpful to be overly prescriptive on the details of what needs to happen in the tendering exercise. This will be dependent on individual client circumstances. For the vast majority of schemes, the provision of guidance to trustees on the selection of an FM provider should ensure they follow an appropriate process.

Where a client does select the same provider, there is a good case that the fees for each service should be separately disclosed to the customer. This would improve competition for both FM and IC service provision.

Measures to address historic mandates – para 129

We do not think that mandatory retendering of historically awarded mandates is required or proportionate. The cost and effort involved may outweigh the potential benefits for many clients.

The provision of guidance to trustees on the adoption and selection of an FM provider – para 128(c)

There is evidence in the working paper to suggest that many trustees are not clear of the distinction between IC, FM and asset management services.

This may require a demand side response to make it clear that FM services are distinct from IC services. We believe this should take the form of provision of guidance on the adoption and selection of an FM provider.

Internal separation and controls – para 130(b)(iii)

We support this potential remedy in and of itself whether or not the remedies above are introduced.

We believe that clients will take greater comfort if IC services are managed at arm's length from FM services. This would help to ensure that there are no commercial incentives for IC staff to steer clients towards its related FM service provider; and that, through the operation of effective information barriers, FM service providers do not receive an advantage over other FM providers when selling FM services to IC clients of the firm.

Legal separation of advisory and consultancy practices [from the FM service provider] – para 130(b)(i)

We believe this is a disproportionate response to the conflict of interest issue. Even if this is phased in over a period of time, it is potentially highly disruptive to clients.

Note on Annex A

Annex A of the working paper gives an overview of the legal and regulatory framework in relation to the relevant conflicts of interest. We would like to add some clarification to Paragraph 140 to cover some circumstances for IC service providers that are regulated slightly differently.

Some firms offering IC services are not directly regulated by the FCA. For example, LCP provides some regulated investment services to its clients. We do this via our regulation by the Institute and Faculty of Actuaries, which is a Designated Professional Body recognised under Part XX of the Financial Services and Markets Act 2000.

These services are explicitly excluded from the scope of MIFID II – see Article 2(1)(c) of DIRECTIVE 2014/65/EU (MIFID II).

We do not offer FM services, which are a regulated activity that requires **direct** FCA regulation.

The CMA's statement of issues contained a potential remedy that would bring all IC services under direct FCA regulation. We understand this will be covered in a later working paper.