CMA Market Investigation into Investment Consultancy and Fiduciary Management services

Response to Working Paper (3) on the supply of Fiduciary Management services by Investment Consultancy firms (Conflicts of Interest).

1. INTRODUCTION

1.1 This document outlines Russell Investments’ response to the CMA Working Paper on the supply of Fiduciary Management services (FM) by Investment Consultancy (IC) firms, dated 29th March 2018. We welcome the opportunity to comment on the working paper and its emerging findings.

12 In summary, we support the CMA’s investigation into whether customers are steered towards integrated providers’ in-house FM services when alternative solutions or deals could have been in their best interests (“integrated” being those providers which offer both IC and FM services, as per the definition in the working paper). We believe that more should be done to encourage competition within this segment of the market and drive broader awareness of alternative and potentially better deals for trustees.

13 We believe that the theories of harm presented in the working paper are plausible; and recognition that issues exist on both the demand side in terms of trustee engagement, as well as on the supply side in terms of alignment of interests, is fair and accurate. In terms of the proposed remedies to address the theories of harm:

- We support the measures to encourage trustee engagement on the demand side, such as mandatory tendering, encouragement of the use of 3rd party evaluators, and provision of advice and guidance for trustees.

- We support many of the measures set out to reduce the risk of conflicts through controlling or incentivising firm behaviours on the supply side, such as segregation of advice and marketing, and separation of firms’ advisory and FM practices.

14 We set out our comments following the general format of the working paper, covering:

- the conceptual framework;
- the background to the working paper;
- stakeholder views;
- the demand side assessment;
- the supply side assessment; and
- potential remedies.
2. COMMENTS ON THE CONCEPTUAL FRAMEWORK

2.1 We broadly agree with the areas of assessment, rationale and sources of evidence presented in the analytical framework in table 1 for assessing the theories of harm (paragraph 26), with the following additional comments.

2.1.1 Regarding (3) Outcomes for customers, we would add that the following are also key areas for consideration, in addition to fees, costs and other benefits:

- Ability to meet objectives, e.g. funding levels / performance
- Improvements to governance, e.g. more efficient decision-making
- Indirect benefits, e.g. time freed for trustees to focus on other aspects

2.1.2 We would also comment that consideration of external managers fees should be taken into account when comparing the fees charged to IC and FM clients, in order to ensure consistency. This is important as many FM providers make use of their scale and negotiating power to drive down the cost of investment for the client, and some may also offer a “bundled” or all-in fee to provide clients with cost certainty.

3. COMMENTS ON THE BACKGROUND TO THE WORKING PAPER

3.1 Regarding our views on the perimeter of existing regulation (paragraph 43), we believe that its current scope – particularly the regulation set-out in SYSC 10 on conflicts of interest – is sufficient to cover the handling of potential conflicts of interest within the scope that it is designed to cover. We agree that the current definition of a personal recommendation does not include the suitability of an FM service; however, to widen the definition to include “services” would impact a much broader set of services than just FM and may have significant impact on firms who are then brought into scope. Furthermore, it would put the UK out of line with the definition of investment advice as defined by MiFID.

4. COMMENTS ON STAKEHOLDER VIEWS

4.1 We would agree with and emphasise the point that ICs who do not offer FM may be subject to an equally serious conflict in failing to recommend FM to their advisory clients in order to avoid losing advisory work (paragraph 54). This can equally apply in cases where providers supplying both FM oversight services and IC recommend that clients move away from an FM approach to their own advisory approach.

5. COMMENTS ON THE DEMAND SIDE ASSESSMENT

5.1 We believe that a higher uptake of 3rd party evaluation for tender processes would have a positive impact in terms of reducing conflict and improving end outcomes for clients (paragraph 67).
6. COMMENTS ON THE SUPPLY SIDE ASSESSMENT

6.1 We would comment on the fact that FM accounts being viewed as more profitable than pure IC accounts (paragraph 76), and that FM services are significantly more expensive than IC services (paragraph 78), should also take into account the added accountability, risk and complexity of running an FM mandate versus an IC mandate.

- For FM, the supplier acts in the capacity of an investment manager, takes ownership of the investment outcome and bears the risk associated with dealing and managing investments (a regulated activity).

- For IC mandates, the customer bears the risk and ownership of the investment outcome and the IC’s role is to provide advice (a non-regulated activity). It should therefore be unsurprising that the costs are significantly lower for IC mandates compared to FM mandates.

7. COMMENTS ON POTENTIAL REMEDIES

7.1 We agree with most of the measures set out in paragraphs 128 and 129 to encourage trustee engagement on the demand side, and set out our comments as follows.

7.1.1 In terms of first appointment of FM:

- We support the idea of (a) mandatory tendering on first adoption and (b) the provision of guidance and advice to trustees, as effective methods to encourage more active consideration of the suitability of FM and choice of provider.

- However, we feel that the practical reality of enforcing trustee reporting to scheme members (c) could prove to be onerous and overly time-consuming, particularly for smaller schemes with fewer resources. We also question the extent to which members would moderate and challenge the reporting, assuming they are the primary consumers of this information. This would in-turn be an additional burden for them, although we understand that this may vary between DB and DC propositions. Whilst we recognise some of the merits behind the measure – such as incentivising trustees to test the market more rigorously – we believe there are more effective ways to encourage this, e.g. through use of 3rd party evaluators, than imposing additional layers of reporting.

7.1.2 In terms of addressing the issue for cases where appointment has already been made:

- We support the additional measure to require mandatory tendering within a fixed period after first appointment (a). However, we believe a more effective measure would be to require periodic mandatory tendering (c), which would also address the issue of incumbency on an ongoing basis. At the same time, we recognise that this may be harmful to customers at the smaller end for which the fixed cost of running a tender may be high in comparison to scheme size.

- We do not feel that requiring mandatory switching (b) would necessarily be in customers’ best interests, particularly if the incumbent provider is able to meet and / or outperform the objectives and service expectations of its clients, and if a strong level of trust has been developed between supplier and customer. As cited in the working paper, switching would also likely incur additional switching costs and could introduce
inefficiencies. The problem may be exacerbated if every new provider were to materially reconfigure a client’s portfolio.

7.2 We agree with most of the measures set out in paragraph 130 to reduce the risk of conflicts through controlling or incentivising firm behaviours on the supply side.

7.2.1 We support the measures to segregate advice and marketing materials (a), and in particular, introducing a minimum period before and after the decision to adopt FM and the provision of marketing materials (i). We recognise that there is a natural grey area between providing impartial advice and promoting one’s own capabilities, and we believe that this measure will go some way in helping to address the issue.

7.2.2 We broadly support the suggested measures to reduce firms’ incentive to promote their own FM services (b) by separating their advisory and FM practices.

- We agree that legal separation / sale of either one of a firm’s advisory or consultancy practices (i) would directly address the conflict at hand. However, we also recognise the broader benefits and synergies available to clients from having access to both services under one roof. The same would apply to the suggestion of prohibiting cross-selling advisory and FM services (ii).

- We also agree that improving internal separation and controls (iii), such as enforcing “chinese walls” between firms’ advisory and FM practices, would be a more proportionate but also less effective option than legal separation in addressing the conflict (particularly if internal controls are open to interpretation or improperly moderated).

7.2.3 We recognise that regulatory disclosure on the adoption of FM (c) may be effective in terms of making trustees more aware of the considerations of moving to FM for the first time, but we question to what degree additional disclosure would improve awareness of alternative offerings / information on other providers and the incumbency issue on an ongoing basis.

7.2.4 We do not believe that further regulatory obligations on firms’ conduct (d) would be effective in terms of addressing the conflict, as this is already covered under FCA regulation (and the majority of IC-FM firms are FCA-regulated).

7.2.5 We do not believe that prohibition of IC-FM firms acting as an evaluator or offering comparative advice (e) would have a significant impact as many IC-FM firms claim that they do not engage in this practice in the first place (paragraph 8).

7.3 We have provided comments to the questions on additional potential remedies as follows:

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

a. We believe that three suppliers (including the incumbent) is a reasonable minimum number for a competitive tender process, as well as face-to-face meetings with at least two of the suppliers.

b. We believe that a 3 year minimum tenure is sufficient before the requirement for an initial tender, with the option for a year’s extension if required, as a fair assessment of performance and service delivery prior to this would be premature.

c. We do not believe there should be a requirement for an open tender process, as an unnecessarily high number of supplier bids could be burdensome for clients (particularly
for smaller schemes with fewer resources). Our view is that the process only need be competitive and follow the requirements as suggested above.

d. We believe there should be encouragement, but not requirement, to use a 3rd party evaluator, as for some schemes the costs to do so might be too onerous.

e. Please see our response to question 1d. (Question: Should the above requirement exist for both partial and full FM mandates?)

f. We do not believe that there should be any specific requirements regarding incremental expansion as any associated suitability assessments, e.g. introduction of new products or asset classes into the portfolio, should form part of the ongoing assessment of a client’s objectives within an FM mandate.

g. We do not believe that any additional requirements need to be imposed at this stage for schemes which have already adopted an FM approach.

2) Segregation of marketing materials from advice.

a. We understand that there may be some business models for which separation of advice and marketing could be sub-optimal in terms of service delivery for a client, given the integrated nature of many firms. However, we also see this as a plausible measure to reduce the inherent conflict of interest.

b. At a high-level, we would consider “advice” as information which has the power to influence but is impartial, objective, and tailored to a client’s needs. We would consider “marketing” as anything that does not meet all three of these criteria simultaneously.

c. We would welcome the measure to further separate marketing and advice through a time gap between the decision to adopt FM and the provision of marketing materials.

3) Reporting to members.

a. We would question the tangible benefit and costs associated with requiring trustees to report their actions to members. We are not convinced that this would sufficiently incentivise trustees to more actively consider the appropriate range of options nor be necessarily beneficial to members. Please see our response in paragraph 7.1.1 above.

b. Please see our response to question 3a. (Question: What should be in the scope of this report and should there be any enhanced power for members to challenge any decision?)

4) Restrictions on selling both advisory and FM services.

a. We recognise that there are some benefits to trustees from receiving both advisory and FM services from the same provider and that in certain cases these might outweigh the harmful effects. However, we are generally supportive of separation between provision of advisory and FM services as a direct measure to address the conflict.

b. We believe that the same restrictions should apply whether an open tender process has been followed or not.