RUSSELL INVESTMENTS

CMA Market Investigation into Investment Consultancy and Fiduciary Management services

Response to the CMA Working Paper (4) on Trustee Engagement.

1. SUMMARY

1.1 This document outlines Russell Investments' response to the CMA Working Paper (4) on Trustee Engagement, dated 12th April 2018. We welcome the opportunity to comment on the Working Paper and its emerging findings.

1.2 In summary, we support the CMA's investigation into the extent to which trustees are able to assess the value for money of providers and act on the outcome of that assessment, either through switching provider or improving the terms offered by their current provider. We agree with the theory of harm that any barriers to trustees' ability to do this effectively may limit their capacity to drive effective competition between providers, resulting in higher prices and / or lower quality services than would otherwise be the case. As noted in our response to the CMA Working Paper on Conflicts of Interest, 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.

1.3 In terms of the CMA's emerging findings on trustee engagement, we highlight the following key points:

- We believe that tendering rates are better indicators of the level of engagement than switching rates. We note that the levels for the category "switched and/or tendered" in the 5 last years are marginally lower for Fiduciary Management (FM) than for Investment Consulting (IC), but that for both FM and IC, the majority of schemes do not appear to have engaged in this process in the last 5 years.
- We note that the use of third party evaluators (TPEs) during tendering is almost double that for FM compared to IC. We strongly agree with this approach as we believe that the use of TPEs helps to improve the quality of decision-making.
- The fact that 89% of professional trustees have at least one relevant qualification resonates with our experience that boards which include professional trustees benefit from the experience and skills that these individuals bring with them, and that the presence of professional trustees can facilitate good decision-making.

1.4 In terms of the emerging findings on switching process and costs:

- We emphasise that whilst switching and transition costs may appear to be higher upfront under an FM approach, clients may ultimately have better visibility and cost-certainty versus an IC approach (which may ultimately incur similar costs if not higher over the longer-term).
- We highlight with respect to disclosure of costs that many FM providers are now required to provide detailed estimations of transaction costs and associated third party costs under MiFID II (known as "ex-ante" reporting).

1.5 In terms of potential remedies:

- We believe that **measures to better inform trustees of FM switching costs** are largely covered by the new MiFID II regulation on costs and charges, which were brought into effect on 3rd January 2018.
- We believe that **measures to drive trustee engagement** should include the provision of appropriate guidance to trustees; the use of professional trustees, sub-committees, in-house advisors, and TPEs; and mandatory tendering (but not mandatory switching).
- We believe that **measures to reduce FM switching costs** include appropriate assessments of clients' legacy portfolios and retaining assets where suitable and appropriate. We also believe that FM providers that have integrated implementation platforms and / or in-house transition management businesses, or have built favourable terms with specialist providers, are likely to incur lower transition costs for their customers.

1.6 We set out our comments following the general format of the Working Paper, covering:

- the conceptual framework;
- the background to the working paper;
- the headline indicators of engagement;
- the switching process and costs; and
- potential remedies.

2. COMMENTS ON THE CONCEPTUAL FRAMEWORK

2.1 We agree with and emphasise the comments that understanding the quality of investment advice is challenging (paragraph 22), and as highlighted in the CMA Working Paper (1) on information on fees and quality with regards to performance, this issue may exist more so for IC customers than for FM given it has been cited that the objectives and accountability for ICs may be less clear[1].

3. COMMENTS ON THE BACKGROUND TO THE WORKING PAPER

3.1 With reference to the fact that 89% of professional or corporate trustees have at least one "relevant[2]" qualifications (paragraph 41, part a)), we note that in our experience, boards which include professional trustees benefit from the experience, skills and exposure these individuals

[1] p.39 of the CMA Working Paper (1) on information on fees and quality
[2] As described by The Pensions Regulator (TPR)

have across their client portfolios in terms of being aware of market developments and industry trends.

3.2 With reference to the fact that 41% of small scheme trustees / directors do not have "relevant" qualifications (compared to 30% overall), our expectation would be that smaller schemes may stand to benefit the most from the inclusion of professional trustees on their boards.

4. COMMENTS ON THE HEADLINE INDICATORS OF ENGAGEMENT

4.1 We believe that the level of tendering is a better indicator of the level of engagement than switching (paragraph 54):

- We agree with and emphasise the fact that low switching rates are not necessarily indicative of low levels of trustee engagement (paragraph 5). If providers are achieving their objectives on competitive terms then customers would have little reason to switch.
- However, customers may still proceed to conduct tenders in order to review the market and evidence the fact that their terms with that provider are still favourable. By extension, low tendering may be an indicator of low engagement, whereas low switching may not.

4.2 We would request further commentary and / or breakdown of the indicators for the adjusted headline rate of switching for FM (17%, paragraph 63). We understand that the CMA has not presented disaggregated results as per the analysis carried out for IC due to the low numbers in each category for FM, but advocate that qualitative and / or directionally-correct indicators at a minimum may be helpful.

4.3 We corroborate from our own experience that schemes with an investment sub-committee are significantly more likely than average to have undertaken a formal review of fees and / or quality; as are large schemes (paragraph 65).

4.4 Regarding the data presented in table 4 (paragraph 65), we highlight that:

- The levels for the category "switched and/or tendered" in the 5 last years are marginally lower for FM than for IC (37% versus 41%), but that for both FM and IC, the majority of schemes (c. 60%) do not appear to have engaged in this process in the last 5 years.
- Whilst the headline numbers for formal reviews of fees and / or quality are the highest out of all categories (63% for IC and 53% for FM), the quality of the review may be subject to bias if conducted by the incumbent provider and not independently by the board of trustees or a third party provider. For this reason, the headline numbers for external review of fees and / or quality may be a better method to assess engagement. We highlight the fact that the level of engagement with third parties / external providers in this regard is low for both IC and FM (15% and 22%).

4.5 We would add that participation in third party client satisfaction surveys could be another effective form and / or indicator of engagement (paragraph 66).

4.6 We corroborate from our own experience that an increased presence of professional trustees leads to boards being more likely to challenge advice from ICs (paragraph 69), and that the presence of professional trustees can also facilitate good decision making (paragraph 70) – please refer to our comments in paragraph 3.1 above.

4.7 We highlight with reference to paragraph 80 on the importance of scheme sponsors in monitoring and scrutinising their investment consultant that we have encountered instances where sponsors can sometimes be conflicted and drive their own agenda – for example, to reduce their ongoing funding requirements. Like all conflicts of interest, trustees should be aware of this potential conflict and manage it accordingly.

4.8 We note in paragraph 86 that the use of third party evaluators (TPEs) during tendering is almost double that for FM (59%) compared to IC (31%). We strongly agree with this approach, as we believe that the use of TPEs helps to improve the quality of decision-making. There may also be evidence to substantiate this given the lower switching rates observed for FM versus IC (9% versus 27%). Likewise, we also believe that the increased use of TPEs – as well as independent trustees – may be an effective way to address concerns over the extent to which trustees are able to assess value for money of their current provider (paragraph 11).

5. COMMENTS ON THE SWITCHING PROCESS AND COSTS

5.1 We agree with the comments that the initial switching costs will typically be higher for FM, which are largely driven by transaction costs incurred from reconfiguring the portfolio at inception (paragraphs 95 and 98).

- However, we emphasise the point that these transaction costs may still exist under an IC approach, albeit spread out over a longer period of time given portfolio changes may occur gradually (paragraph 94) rather than at inception as per FM. It is plausible that the costs for carrying out manager searches and strategy changes / reviews would likely be incurred as ongoing costs under an IC approach, rather than appearing under the cost of “switching” as they are not incurred upfront or at the point of investment. These longer-term costs may or may not be disclosed at the point of switching IC, i.e. there may be a lack of visibility and / or cost certainty for the client. These costs may also increase significantly if there is a high rate of churn in the portfolio, which may also be unclear at the point of switching IC.

- By comparison, under an FM approach it is unlikely that future portfolio reconfigurations would occur for some time post the initial reconfiguration at inception, limiting the scope for associated transaction costs. We would also agree that transaction costs may be lower for FM compared to IC given FM providers’ engagement of specialist teams to reduce frictional costs, as cited in paragraph 95. On that basis, we would argue that whilst the switching costs for FM mandates may *appear* to be higher upfront, clients perhaps have better visibility and cost-certainty under an FM approach. We would also comment that the analysis of upfront switching costs also needs to take into account the long-term benefit from portfolio reconfiguration, which may have a significantly better risk / return profile and match the client’s objectives and suitability more appropriately than the legacy portfolio.

5.2 We highlight with reference to paragraph 108 regarding disclosure of estimated transaction costs, that many FM providers are now required under to provide detailed estimations of transaction costs and associated third party costs under MiFID II (known as “ex-ante” reporting). As the CMA is well aware, these changes were brought into effect on 3rd January 2018.

6. COMMENTS ON POTENTIAL REMEDIES

Measures to better inform trustees of FM switching costs (paragraphs 125 to 128)

6.1 With reference to the fact that the CMA has seen limited evidence of firms providing detail of FM service exit or switching costs (paragraph 125), and with regards to mandating the provision of information on costs on a timely basis (paragraph 127), we highlight that many FM providers are now required under MiFID II to provide detailed estimations of transaction costs, exit costs and associated third party costs prior to investment (known as “ex-ante” reporting). As the CMA is well aware, these changes were brought into effect on 3rd January 2018.

Measures to drive trustee engagement (paragraph 129)

6.2 We strongly agree with the provision of guidance to trustees (a) as an effective method to drive trustee engagement, as per our comments to the CMA Working Paper (3) on the supply of Fiduciary Management services by Investment Consultancy firms.

6.3 We strongly agree with the proposed measures to improve governance standards (b), particularly mandating the use of professional trustees, sub-committees, in-house advisors, and also TPEs, as effective methods to drive trustee engagement. However, we note that for smaller schemes the cost to do so may in cases be onerous, and that additional measures may need to be taken to reduce this cost and / or pool resources amongst schemes. We believe that the resource issue, particularly for smaller schemes, and less vested interest from the corporate sponsor, may help to explain why the levels of engagement may be lower amongst these types of schemes (cited in paragraphs 44 and 81 respectively).

6.4 We do not have a strong view as to whether or not enhanced obligations on trustees to obtain value-for-money would help to drive trustee engagement (c).

6.5 We agree with the concept of mandatory tendering (d) – but not necessarily mandatory switching – as an effective method to drive trustee engagement, as per our comments to the CMA Working Paper (3) on the supply of Fiduciary Management services by Investment Consultancy firms.

6.6 We are not convinced by the concept of trustee reporting to scheme members (e) as an effective method to drive trustee engagement, as per our comments to the CMA Working Paper (3) on the supply of Fiduciary Management services by Investment Consultancy firms.

Measures to reduce FM switching costs (paragraphs 130 to 132)

6.7 With respect to whether particular business models have higher switching costs (paragraph 130), we believe that those providers with integrated implementation platforms and / or in-house transition management businesses are likely to incur lower transition costs for customers. Those FM providers which do not have these proprietary services but have built strong relationships and favourable terms with specialist implementation services providers and / or transition managers are also likely to incur lower costs.

6.8 With respect to whether specific approaches adopted by different FM providers potentially leading to lower costs (paragraph 132), it is our view that unnecessary costs can be avoided by carrying out a thorough analysis of the legacy portfolio and ascertaining which assets should remain in the portfolio based on their suitability and appropriateness, i.e. an FM provider should not unnecessarily disinvest from legacy holdings for the sake of it. We further believe that the concerns raised regarding competition in the FM space are exacerbated if FM providers invoke minimum terms or exit fees.

Questions on potential remedies (paragraph 138)

1) How can switching costs be reduced?

a. We believe that the following measures can help to reduce the costs of switching providers:

- A thorough analysis of client's legacy assets to ascertain which assets should remain in the portfolio (assuming these assets are suitable and appropriate).
- Crossing trades where possible (i.e. weekly dealing dates to match trades and reduce transaction costs).
- Maintaining a preference for more liquid asset classes with lower dealing spreads.

b. We do not have a strong view on how switching costs may vary by the type of FM service provided.

2) Can FM providers present better information on switching and exit costs in advance?

a. We believe that limited disclosure with regards to the legacy investment strategy and the potential transaction costs can be a challenge for FM providers in providing accurate exit or switching costs in advance.

b. We believe that the key drivers of the cost of switching are the dealing costs within the underlying investments which are being bought and sold. These should be disclosed separately as they are often out of the FM providers' control. Good practice in all cases would be to provide customers with pre-transition reports which explicitly state worst case scenario transaction costs.

c. We believe that anticipated switching costs should be expressed in £ terms and as a % of the amount being traded.

d. We believe that a meaningful benchmark for switching costs could be the average or typical transaction costs for a scheme size of £100m dealing in the asset class or funds in question.

e. We believe that where not disclosed by a provider, lack of information on switching costs may result in trustees perceiving FM to have "cost free" trading when this is not the case.

3) Potential remedies in other working papers and ongoing developments

a. We believe that provision of guidance to trustees and mandatory tendering could be two effective ways of driving trustee engagement, as per our comments to the CMA Working Paper (3) on the supply of Fiduciary Management services by Investment Consultancy firms.

b. We do not have a strong view as to whether amendments to those potential remedies would more effectively drive trustee engagement.

c. We believe that both the new regulation on costs and charges under MiFID II, as well as the efforts of the FCA institutional disclosure working group, will help to drive transparency, consistency and standardisation of costs and charges information to investors.