Barnett Waddingham's response to the CMA's *Investment Consultants Market Investigation Provisional Decision Report*

This paper sets out Barnett Waddingham's comments in response to the CMA's Provisional Decision Report dated 18 July 2018 ('the Provisional Decision Report') as part of the Investment Consultants Market Investigation.

We have set out below our comments on the proposed remedies set out in the Provisional Decision Report.

Remedy 1 – Mandatory competitive tendering on first adoption of fiduciary management

BW response to Box 1: Consultation questions for mandatory tendering on first appointment

We absolutely support the requirement for trustees to hold a competitive tender process when first choosing fiduciary management (FM).

As detailed in our response to the supporting remedies, we believe all competitive tenders should involve advice from a regulated Third Party Evaluator (TPE). The benefit of this approach and some additional points are noted below.

a) It will be important to clearly define what is meant by FM. This is needed to ensure that the requirement for mandatory tendering captures all relevant cases of potential material detriment for customers, whilst avoiding bringing into scope investments which could theoretically be classed as FM but which do not risk material detriment (e.g. Diversified Growth Funds). To this end, our suggestion is that reference to 'fiduciary management' is not referred to in this part of the regulations; instead **we suggest that the regulatory requirement is for a competitive tender process when first choosing to enter into an investment mandate with an organisation or making changes to an existing investment mandate whereby an investment advisory agreement is already or expected to be in place with that same organisation**. This does rely on the expectation that any customer that has entered into an agreement with a FM firm will have taken advice from someone who does not work within the wider group of that FM firm and hence will have done some element of a competitive tender process in reaching that decision.

b) **We suggest that there is clear industry guidance and minimum standards on what constitutes a competitive tender.**

c) **We suggest that the default should be for all tender processes to be open, but with the possibility of running closed exercises if a regulated TPE advises that this would be suitable.** This is in recognition that there are circumstances in which a closed tender may be more beneficial for the client, but ensures that the minimum standard is set by the ongoing competency level of the TPE.

d) **We suggest that FM firms should be prohibited from accepting new tenders where advice has not been taken from a TPE.** The FM firm would, through its own compliance regime, be prevented from accepting a new appointment that did not have the appropriate sign off.

e) **We suggest that there is no minimum threshold for scheme size or scope/scale of mandate.** This would just encourage firms to seek ways to get around the rules. For example, if the scheme was worth £100m but the threshold was £10m, then the fiduciary manager could make a partial move to FM of say £9m before subsequently expanding the mandate to £100m (if there was then no requirement to undertake a formal assessment on expansion of the mandate) thereby circumventing the rules.

f) It may be disproportionate for the expansion of FM mandates to require an additional tender; this would depend upon the scope of both the original tender and the proposed expansion. **We suggest that advice should be provided by the regulated TPE on whether an additional tender is suitable.**

g) Trustee compliance should ultimately be a trustee responsibility. **We suggest disclosure should be noted in the annual reports and accounts and that TPEs should be prepared to submit their conclusions to the FCA/TPR if required to do so.**

All of the points above indicate that many of the issues can be addressed by widening the regulatory perimeter to introduce the role of a regulated TPE.

BW response to Box 2: Consultation questions on mandatory tendering for existing fiduciary management mandates

We also fully support the proposal for mandatory tendering for existing FM mandates.

In response to the questions in the consultation paper:

h) We believe that in some cases it will be difficult to judge whether the process followed when putting in place the existing FM mandate constitutes a competitive tender. We hear of situations in which the FM claims they were appointed via a competitive tender but the terms of that tender are questionable. **Therefore, similarly to our response in 1c) we suggest that the default should be for all schemes in FM to tender their existing FM mandate, with an exemption where a regulated TPE advises that the terms of that the original tender process meet minimum requirements (as per 1b))**

i) **As per 1c) we suggest that the nature of the competitive tender should be advised by the TPE.** For example, there may be cases where there was not competitive tender initially, but reviews have been undertaken since which show that investment performance and service levels have been good, and fees are competitive. In these cases, undertaking a full open tender would mean schemes incurring unnecessary fees and there may be unwillingness from fiduciary managers to participate if it is perceived to be a box ticking exercise. Regulated TPE advice would provide professional judgement on the suitability of work undertaken to date.

j) The combination of h) and i) means that a regulated TPE would review actions taken by the customer at the point of entering the existing mandate and actions taken since then, and provide a professional judgement as to whether the customer should carry out any further work to consider alternative providers. We believe this is consistent with the outcome which is ultimately being sought by the CMA.

k) **We agree that a 5 year tenure with a 2 year grace period is sensible**. Grace periods make sense because if the above is adopted you then need to have regulated TPE. While we believe there will be sufficient firms to provide capacity within these time periods, some possible TPEs will need to undertake further work in order to reach minimum competency.

Remedy 2 – Warning when selling fiduciary management

BW response to Box 3: Consultation questions for warnings when selling fiduciary management

We support this remedy as we believe that the intention behind it is good. However, we are sceptical about whether it will be particularly effective at protecting customers. In particular, it assumes that customers will be sufficiently engaged to understand the warning and its implications and consequently take appropriate action to respond.

We believe it should apply to all providers of FM services.

We suggest that the warning should make clear the requirement to take regulated advice from a TPE.

We believe that in an ideal world it would be good to separate advice from marketing but this is inefficient. **We therefore support providing warnings in the format suggested**, although we would reiterate that this is likely to have minimal impact.

The requirement to take advice from a regulated TPE and greater use of professional trustees is a better solution in our view.

Remedy 3 – Enhanced trustee guidance on competitive tender processes

As per our response to the CMA's working paper on the supply of fiduciary management services by investment consultancy firms, we are supportive of TPR issuing trustee guidance.

We suggest that this covers both the competitive tender process and the ongoing monitoring of fiduciary manager performance and activity.

Our suggestion of such reviews being done via a regulated TPE enables TPR to enforce guidance through setting the bar as to the level of competency required to be a regulated TPE.

This assists the trustees in understanding how to respond to the guidance. It also protects trustees from being influenced by FM firms how to interpret this guidance.

Remedy 4 – Requirement on firms to report disaggregated fiduciary management fees to existing customers

BW response to Box 4: Consultation questions for fiduciary managers reporting disaggregated fees to existing customers

We are supportive of fiduciary managers being required to provide disaggregated fee information in principle.

However, this needs to be implemented with care to avoid unintended consequences which could result in worse outcomes for customers. For example, it is possible that the requirement to disaggregate fee information could on occasion discourage fiduciary managers to achieve fee savings through bulk buying opportunities (by aggregating customer assets) as showing how these savings apply to each customer might be too difficult in practice. **Our suggestion is therefore that the CMA takes note of fiduciary manager concerns in this area and do not automatically dismiss concerns as bleating from the industry.**

That said, as a minimum, we suggest it is made a requirement for fiduciary managers to disaggregate fees into the following levels:

- **Fees paid to the fiduciary manager as a result of the provision of FM services**
- **Fees paid to the fiduciary manager as a result of fund management services, where these are not already allowed for the in the FM services fee**
- **Fees paid to third party investment manager for fund management services**
- **Fees paid to other third parties (e.g. administrative, audit and custody fees).**

Fees should be reported in this way prior to the point of sale and quarterly thereafter, alongside investment performance information.

We would also note that there appears to be an overriding concern that cheaper is better, which we do not necessarily agree with. Arguably this is disproved by the DC product market, whereby the charge cap has led to the introduction of watered down products (arguably of worse quality).

We believe it is better to focus on investment returns net of fees, as this is ultimately what matters for trustees.

Remedy 5 – Minimum requirements on firms for fee disclosure when selling fiduciary management

BW response to Box 5: Consultation questions for fiduciary managers reporting disaggregated fees to new customers

We are supportive of fiduciary managers being required to provide a fee breakdown to prospective customers.

A common practice we have witnessed is for fiduciary managers to quote a lower price during the tender stage compared with what is subsequently implemented. The price quoted often reflects a lower risk and/or more passive portfolio than is implemented post appointment. An unmediated tender environment inevitably encourages this behaviour as fiduciary managers become concerned that the customer will overly focus on the headline fee without considering this in the context of the make-up of the portfolio. This is another example of where the involvement of a TPE can improve the process as it gives the fiduciary managers confidence that their fees will be considered in a suitable context, meanwhile the customer will be given better guidance.

We also strongly support fiduciary managers providing realistic estimates of the cost of transition, including on the basis that no savings are by cross-trading or in specie transfers, because:

(a) It is likely that when taking on a new FM mandate the customer will experience a 100% turnover of the pension scheme portfolio, especially if moving to a different FM provider to the incumbent investment consultant. In our experience as TPE, this is not fully understood by the customer until we become involved in the process.

(b) There is also misleading information provided to customers moving to/from single priced funds (many underlying FM funds are single priced). This leads customers to believe that single price means no transaction costs, whereas in reality transaction costs are reflected in the pricing basis of these funds. Furthermore, a large scale movement of assets is likely to cause such a pricing change.

We also suggest that fiduciary managers are required to notify prospective clients of the requirement to engage with a TPE and the high level costs associated with this. This is an aspect which is routinely overlooked by fiduciary managers in our experience.

Remedy 6 – Standardised methodology and template for reporting past performance of fiduciary management services to prospective clients

BW response to Box 6: Design questions for fiduciary management performance reporting

We are supportive in principle of there being a fiduciary management performance standard, as evidenced by our involvement in the IC Select Performance Standard Steering Group.

We strongly believe the performance standard should be implemented as planned by the Steering Group. A huge amount of work has gone into the standard to date and the Steering Group has been working with the CFA to transfer the standard over to GIPS by 2020.

We also strongly believe that fiduciary managers should not be represented on the working group tasked to implement the standard. The inclusion of fiduciary managers in the Steering Group has been debated many times by the Steering Group and with the fiduciary managers. On each occasion the consensus, including that of the fiduciary managers, has been that this would hinder rather than further progress. The different fiduciary managers have very different views on methodology, with each fiduciary manager believing that their approach is correct. Putting each fiduciary manager on the working group (and it would either need to be none or all for fairness) would slow down the progress considerably. We are therefore disappointed that this Remedy suggests having the FM on the working group.

We suggest that funding the standard through a levy on the fiduciary managers will allow quicker progress and is a better alternative to that proposed.

Remedy 7 – Duty on trustees to set their investment consultants strategic objectives

We are strongly supportive of Trustees setting an overall performance objective for their Scheme. We have established such an objective for many of our engaged schemes and report on performance against that objective on a quarterly basis. We are still surprised at how many schemes do not have an overall objective.

Whilst we are strongly supportive of setting the overall objective, by itself measurement against this objective does not provide the Trustees with information on the performance of the investment consultant. This comes to the heart of the difference between a delegated (FM) and consultancy approach as recognized by the CMA. Again, we agree with the CMA that the performance against that objective will be a factor of both the consultant's and Trustees decision making. We believe that disaggregating the two is not a straightforward process and could well be far more challenging than suggested in the response.

Ultimately though, we agree with the CMA's proposal that Trustees should be clear on where they have, effectively, delegated authority to act to the consultant and where they have retained the decision making themselves. Where authority is delegated the performance of that delegation should be monitored. This supports good governance of any scheme. In practice, for trustees who follow the consultancy route, the vast majority of trustees wish to retain that authority themselves. In a number of cases the employer's views will also be a factor in decision-making and they oppose making changes proposed by the consultant and supported by the Trustees. Consultants also do not have control over the timing of when (and how quickly) changes are made.

We do not believe a minimum size should be established; however, schemes should be allowed flexibility in how they undertake this measurement. For a small scheme with a low governance budget and who do not engage a proactive consultancy model then monitoring can necessarily be lighter touch (in the same way a passive manager is monitored at a lower depth than an active manager)

As noted above, we believe regular monitoring of performance is appropriate, albeit should always be taken into context of the long term nature of such objectives and strategies. We do not believe it is appropriate, or required, to establish a set timeframe to evaluate an investment consultant. We also believe three years may be too short a timeframe in some circumstances; pension schemes will typically set 10/15 year objectives and if a consultant knows that they are to be formally and fully judged on a three year basis it may lead them to focus on only asset classes that have such a time horizon. Equally, sometimes a shorter than three year period may be appropriate for some roles a consultant is asked to adopt.

Remedy 8

Should basic standards apply to the reporting of recommended asset management 'products' and 'funds'?

Yes. Otherwise, it would be very difficult for clients, and prospective clients, to compare the effectiveness of one consultant's manager selection decisions to another. There is a great deal of subjectivity in judging how this could be done, particularly for firms who do not operate with 'buy' and 'sell' lists and some clarity of the expected methodology will clearly be needed,

It is reminiscent of the introduction of the Global Investment Performance Standards (GIPS) in the late '90s. These were helpful as they gave consultants (and clients) a level of comfort that there was at least some level of consistency being applied across the reported performance of all investment managers.

Are there any other areas that we should include in the reporting standards?

Not at present

Should standards be developed and agreed by an implementation committee similar to Remedy 6?

An Implementation Committee would be helpful as the design of a methodology and system is likely to not be straightforward, nor able to predict challenges that the various consultants may encounter due to differences in the way they operate.

Barnett Waddingham would be happy to join such a committee if other investment consultants were also doing so, but we can see a clear benefit in making the committee independent with consultants able to make submissions of views but not to be on the committee and driving decisions. It is important that the output is consistent with the needs of users.

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beyond the expected

What fees should be used to make the gross to net fees conversion?

All fees and expenses included within the *ongoing charge* (OCF) for an *institutional* share class (if a pooled fund) should be used to convert gross returns to net returns.

This may present problems for funds or managers with tiered fee scales, share classes based on mandate sizes or negotiable fee rates. A "typical" or "average" mandate size may need to be assumed. E.g. £50m. This will also help to make comparisons between consultants more like-for-like since larger pension schemes can often access lower fees and otherwise consultants with larger clients may appear to outperform those with smaller clients when selecting the same funds.

Supporting Remedies – Recommendation A) Extension of FCA perimeter

BW response to Consultation questions on extension of the regulatory perimeter

In summary, we absolutely support the extension of the FCA perimeter in terms of investment advice in general and specifically with regard to FM. We repeat below the comments from our response to the CMA's working paper on the supply of fiduciary management services by investment consultancy firms.

Our view is that [the] 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.

In terms of FM, we presented two options:

- Option A involved (i) a targeted change to regulation such that it became a legal obligation for customers to take advice on the suitability of a fiduciary manager's FMA, and (ii) prohibiting fiduciary managers from being able to advise clients on the suitability of their own FMA.
- Option B involved a clarification of existing regulations such 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. This would naturally cover the suitability of FM.

Our preferred option was B – clarification of existing regulations – as we believe it would be easier to implement.

As part of our response to the most recent consultation paper, **we make the further suggestion that – as well as bringing advice on FM within the FCA's regulatory perimeter – the FCA specify that this a high risk area**

of work and that advisers in this area should be sufficiently qualified and experienced to advise on all relevant fields as well as CF30 competency. We believe this is important because:

- FM usually covers the majority if not the entirety of a pension scheme's assets. Moreover, the level of discretion in what a fiduciary manager can invest in is often much greater than with other investment products. By having significant discretion over the majority of assets, the actions of a fiduciary manager can have huge financial consequences for a pension scheme and its sponsor. Advising on the suitability of a single organisation to take on this role is therefore a high risk area and covers a breadth of advice covering far more than a single project ordinarily undertaken by a CF30.
- Much of the advice going into the suitability of an investment manager is linked to the competency requirements of a CF30, so it follows that all FM competent advisers should also be CF30 competent.

As explained earlier in our submission, there are clear advantages to customers and in some regards to fiduciary managers, in making TPE advice a statutory role.

Supporting remedies – Recommendation B) Enhanced trustee guidance and oversight of remedy 1

BW response to consultation questions on enhanced trustee guidance

We would welcome enhanced guidance for trustees on selecting and interacting with investment consultants. However, we think that it is very important that the guidance covers all aspects of investment consulting rather than simply manager selection. It was widely accepted that strategic advice and decisions are far more significant over the long term to performance than manager selection and the guidance should therefore cover these factors. In addition, trustees should have a consultant who they can trust is aligned correctly with their objectives, explains matters clearly and in sufficient detail and helps them to spend their governance time/budget most effectively.

With regard to FM, as per the comments from our response to the CMA's working paper on the supply of fiduciary management services by investment consultancy firms, **we believe regulations should be supported by clear and strong industry guidance 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) is consistent with our belief that FM advice should be provided only by regulated TPE firms with a required level of competency.

Trustees will always benefit from enhanced guidance but combining this with making TPE a regulated activity will increase the chance of this supporting remedy to be successful. As is the case for guidance around actuarial valuations and investment changes, employing a regulated TPE will remove some of the burden from the consumer in interpreting the guidance and acting accordingly.

We do not believe the guidance would need to be considerably detailed under this approach, as the regulated TPE would be well placed to supplement the high-level guidance.

Supporting remedies – Recommendation C) Improved Information on underlying asset manager fees and performance

We would fully support improvements to information in these areas and would note that this is already the direction of travel within the industry but that DB schemes have to an extent fallen behind DC schemes in terms of what information is disclosed

Further views

We do support the proposals made as a proportionate response to the CMA's remit.

We would expect that there may be some additional costs to schemes in implementing the remedies but in some cases, these costs are effectively rewarded via improved governance (i.e. receiving proper advice following a market review when appointing a fiduciary manager) and a net benefit to clients would be expected overall. Likewise, there will be some short term costs for clients in carrying out the objective setting proposed by the CMA but we would expect these to be relatively modest although there will potentially be additional monitoring fees (for schemes not already monitoring progress against strategic objectives). However, we do have some concerns that the additional costs could be higher for remedy 7 for consulting appointments if Trustees are required to effectively track the impact of their own (or the employer's impact) on investment strategy where they have chosen not to follow the advice of their consultant. This is one of the key reasons why we think careful consideration of the application of remedy 7 is required.

Some additional costs may be incurred by consulting firms in producing performance data on recommended managers under the agreed methodology although this may replace existing methods to an extent.

We believe that a three year transition for remedy 7 would be reasonable since investment strategies and objectives are often set (or reviewed) following a triennial valuation. Such a transition may help to limit the cost impact of the new requirement.

Once a reporting standard has been established for remedy 8, we would envisage that a six-month transition period might be reasonable in order for data to be collated using the required methodology.

Compliance with remedies 1 to 6 should be monitored by the FCA and remedy 8 for firms supervised by the FCA (and by IFoA for firms regulated by this route). Compliance with remedy 7 could be collected via a statement within the Pension Regulator's annual Scheme Return confirming that the Trustees have established a strategic objective for measuring the investment performance.

Barnett Waddingham LLP

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