

INVESTMENT CONSULTANCY MARKET INVESTIGATION

FOLLOW-UP TO CMA RESPONSE HEARING

This document contains further information from Mercer Limited (**Mercer**) by way of follow-up to the CMA's Provisional Decision Response Hearing, which took place on 28 September 2018 (the **Response Hearing**).

We cover six specific issues below:

- 1 our concerns about the design and application of the CMA's proposed standards for how investment consulting (**IC**) and fiduciary management (**FM**) providers report performance of recommended asset management (**AM**) 'products' and 'funds';
- 2 the extent to which the CMA's proposed remedies may be applicable to defined contribution (**DC**) schemes;
- 3 examples of where "comply or explain" approaches have been effective in practice;
- 4 the appropriate scope of a mandatory tendering remedy, if the CMA decides to pursue this approach despite the concerns expressed in our response to the Provisional Decision dated 24 August (**PDR Response**);
- 5 examples of documents Mercer has used when introducing IC clients to FM services; and
- 6 the applicability of the designated professional bodies exemption in circumstances where the FCA regulatory perimeter is extended.

We would be happy to provide further clarification on these points, or any others, if this would be helpful to the CMA.

1 Design and application of Remedy 8

- 1.1 We refer to the points made in our PDR Response (including Annex 2 of the PDR Response), and our follow-up call with the CMA which took place on 17 October 2018. The illustrative case studies discussed on this call can be found at Annex 1 of this document, and the key points are summarised below.

Gross versus net of AM fees

- 1.2 We believe that any remedy in this area should be as useful as possible for trustees. As such, and as we have explained, we have material concerns with the mandatory presentation of returns on a net of AM fees basis which may in fact weaken comparability and introduce confusion for clients.
- 1.3 A gross of fees presentation is the best way to ensure a standard is transparent, and makes it easier for trustees to compare their IC provider's performance with others. Case Studies 1 and 2 of Annex 1 demonstrate the primary comparison issues as discussed with the CMA.
- 1.4 In particular, a net of fees presentation only provides a reliable basis for comparing products for prospective customers with the same average AUM as those who are already invested in that product. This means that an IC provider with smaller existing clients (who would tend to pay a higher average fee) appears to achieve lower net performance, even where it may be equally good, or better, at selecting managers on a gross of fees basis. A larger client considering this provider's services would be shown a higher net of fee price than would in fact be paid.
- 1.5 We think this distortion is not helpful for clients: the average AM fee factored into the net performance figures would not be representative and may lead to an incorrect investment

decision being taken. In these circumstances, a trustee would need to go through a number of additional steps to:

- (a) understand the average AM fee factored in by a consultant;
 - (b) understand whether this average is representative for its own investment; and
 - (c) strip out this average fee and consider the fee it would likely face itself.
- 1.6 This issue is more pronounced still where a trustee is simultaneously comparing across different products and IC providers, using a variety of net of fees approaches. However, even if an estimated net figure is provided based on “rack rate” AM fees, we still consider this less useful to trustees than a gross figure which they can adjust themselves based on the fees they would actually pay.
- 1.7 We have provided detailed estimates of the considerable additional costs arising from a net of fees approach in Annex 2 of our PDR response.

Selecting the benchmark against which to measure return

- 1.8 Following our call with the CMA, we welcome the confirmation that this remedy should give IC providers the flexibility to select an appropriate benchmark for comparison, as opposed to setting specific requirements as to the type of benchmark to be used. As we have explained, a compulsory move to a manager-selected benchmark could distort comparability of AM products within the same asset class or market. Conversely, Mercer adds value to clients by helping them compare similar products within a ‘universe’ against an objective benchmark. We believe that this results in significantly more meaningful comparison. More detail and worked examples can be found in Case Study 3 of Annex 1.

2 Application of remedies to DC schemes

- 2.1 At the Response Hearing the CMA asked Mercer for its views on the application of the proposed remedies to DC schemes. As a starting point, it is helpful to consider the specific market and regulatory context that applies to DC schemes.¹ We have set out some high level comments in this regard below. We then go on to comment on the applicability of each remedy in turn to DC schemes.

DC market developments and regulatory landscape

- 2.2 The DC market has grown significantly in recent years – and is expected to continue to do so – as the provision of occupational pensions shifts from defined benefit (DB) to DC.² This has, in part, been driven by the introduction of auto-enrolment which has led to the rapid increase in the set-up of new DC schemes and the adaption of existing ones. Many of the new DC schemes that are set up are contract-based (for example, Group Personal Pensions) or delivered via a Master Trust vehicle, rather than traditional trust-based schemes³.
- 2.3 In the case of contract-based and Master Trust schemes, it is the *employer* that is responsible for designing the set-up and governance of the pension arrangement. This means that Mercer deals directly with the employer, rather than existing pension scheme trustees. This is a material difference from DB schemes as the trustees of these types of DC schemes do not make decisions about the choice of IC or FM provider. The CMA’s findings on, for example,

¹ For further detail on the DC landscape and Mercer’s approach to DC (including Master Trust) please see [3].

² At the end of 2016, total UK DC asset amounted to £338bn and over the next 10 years is projected to rise to £871bn. See page 10 of Spence Johnson *Institutional Highlights – Master Trust: A Growth Story* (2018) (See Annex 2).

³ The increase in UK DC assets over the next 10 years is projected to be accounted for as follows: (i) £35bn increase in trust-based DC assets, (ii) £204bn increase in contract-based DC assets, and (iii) £294bn increase in Master Trust DC assets. See page 10 of Spence Johnson *Institutional Highlights – Master Trust: A Growth Story* (2018) (See Annex 2).

trustee engagement, would therefore not be relevant to the decision-makers for these schemes and would not justify the imposition of remedies on these schemes.

- 2.4 As a trust-based vehicle, a Master Trust will have a board of trustees. The board of trustees will retain the ultimate responsibility for the investment arrangements. The board will generally be made up of a mix of experienced pension professionals and professional trustees. From September 2018, individuals must undertake a formal fit and proper assessment to obtain authorisation from the Pensions Regulator (**tPR**) to act as a trustee of a Master Trust.⁴ In addition, it is common for employers to be represented on an investment sub-committee.⁵ As such, the CMA's concerns around trustee engagement and expertise are not applicable in the context of a Master Trust arrangement.
- 2.5 Within the DC segment, Master Trust is the primary source of growth and this trend is projected to continue.⁶ FM in DC is, therefore, already predominantly and increasingly offered through a Master Trust vehicle. Mercer offers a Master Trust solution to clients as part of its broader delegated DC offering. We have provided the CMA with significant detail on the Master Trust landscape and Mercer's own Master Trust offering by way of previous submissions.⁷
- 2.6 In brief summary, however, the legislative and regulatory framework concerning the administration and governance of DC schemes – including Master Trust – differs to that for DB schemes, and has been a particular source of focus for the Department for Work and Pensions (**DWP**) and tPR in recent years. We set out below some of the most relevant legislative and regulatory measures:
- (a) The DC Code of Practice 13 which entered into force in July 2016 outlines best practice for trust-based DC schemes, including Master Trusts (the **DC Code**).
 - (b) Under the DC Code, schemes are required to publish an annual governance statement. This must include detailed information on the governance of the default arrangement, processing of core financial transactions, disclosure of costs and charges (including transaction costs), trustee knowledge, the trustee board and an assessment of Value for Members (**VFM**) (see below). In addition, from 6 April 2018 qualifying schemes must:
 - (i) include a greater level of detail on the charges and transaction costs borne by members. This includes an illustrative example of the cumulative effect over time of the application of charges and transaction costs on the value of a member's accrued rights to money purchase benefits; and⁸
 - (ii) make certain elements of the annual governance statement publicly available online. This includes: (i) the statement of investment principles for the default arrangement, including a description of any review of the default arrangement or, if no review was carried out, the date of the last review; (ii) the level of charges and transaction costs paid for each default arrangement; (iii) the statement of unavailable transaction costs; and (iv) the VFM assessment.⁹
 - (c) Trustees of DC schemes, including Master Trusts, have a legal duty to produce an annual VFM assessment. TPR guidance states that this should include information on: (i)

⁴ For further information on tPR's fit and proper assessment for potential Master Trust trustees see <http://www.thepensionsregulator.gov.uk/docs/master-trust-fit-proper-assessment-guidance.pdf>.

⁵ Information on the governance model of the Mercer Master Trust is set out in our response to Q91 of the Market Information Request dated 23 October 2017.

⁶ See page 10 of Spence Johnson *Institutional Highlights – Master Trust: A Growth Story* (2018) (See Annex 2).

⁷ See [X].

⁸ Regulation 23 of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 as amended by the Regulation 2 of the Occupational Pensions Schemes (Administration and Disclosure) (Amendment) Regulations 2018.

⁹ Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 as amended by Regulation 3 of the Occupational Pensions Schemes (Administration and Disclosure) (Amendment) Regulations 2018.

costs and charges, (ii) whether the benefits and services received are of good quality and meet member needs; and (iii) a comparison of costs and charges against the market.¹⁰

- (d) Effective from April 2015, qualifying DC schemes, including Master Trusts, are subject to a statutory charge cap of 0.75% and restrictions on charges (e.g. member-borne commission charges are prohibited).
- (e) In addition, The Pension Schemes Act 2017 requires that from 1 October 2018 all new and existing Master Trusts must obtain authorisation to operate from tPR.¹¹ TPR has also stated that it expects all Master Trusts to obtain independent assurance under the ICAEW framework.¹²

2.7 As is evident from the above, existing legislative and regulatory measures already address critical areas of scheme governance and accountability, and the need for clear and comparable information. In this context, we consider further intervention by the CMA in these areas to be unnecessary, and risks cutting across recent measures introduced by DWP and tPR.

2.8 We set out our comments on the applicability of each remedy to DC schemes in turn below.

Remedy 1: Mandatory competitive tendering on first adoption of FM

2.9 In our PDR Response we proposed excluding DC schemes from the scope of the CMA's proposed mandatory tendering remedy. In addition to our broader reservations about this remedy, we do not believe it is proportionate to introduce mandatory competitive tendering on first adoption of FM for DC schemes (i.e. on first appointment of a Master Trust) for the following reasons:

- (a) As explained above, it is the employer rather than the existing pension scheme trustees that appoints a Master Trust provider.
- (b) The existing regulatory and legislative framework – in particular, the VFM assessment – provides DC trustees (including those of Master Trust vehicles) with the tools to benchmark against the market and compels them to do so on an annual basis. DC trustees are, therefore, already actively engaged in assessing the quality of their FM provider.
- (c) In our experience, the majority of DC mandates, including Master Trusts, are awarded following a competitive tender (often involving a third party evaluator (**TPE**)). All of Mercer's existing Master Trust appointments were the subject of a structured procurement process. As a result, we do not believe there is a need to impose a remedy in this area, and to do so would be disproportionate in the circumstances.

Remedy 2: Mandatory warnings when selling FM

2.10 We would not object to the application of this remedy to DC schemes provided that any measures are designed in accordance with the suggested approach set out in our PDR Response. It will be particularly important, if the remedy extends to DC schemes, that the exact wording of any notices can be adjusted to be relevant to the particular circumstances of the scheme in question.

¹⁰ See paragraphs 113 to 133 of the DC Code, tPR's guidance on VFM published on July 2016 available at <http://www.thepensionsregulator.gov.uk/trustees/value-for-money-in-your-dc-scheme.aspx> and Section 10 of tPR's 21st Century Trusteeship available at <http://www.thepensionsregulator.gov.uk/10-value-for-members.aspx>.

¹¹ Section 3 of the Pension Schemes Act 2017.

¹² See <http://www.thepensionsregulator.gov.uk/trustees/master-trust-assurance.aspx>.

Remedy 3: Enhanced trustee guidance on competitive tender processes in FM

- 2.11 As noted above, we have concerns about the scope and content of the CMA's proposed mandatory tendering remedy, including when applied to DC. Notwithstanding this, we are supportive of any enhanced guidance that assists trustees in conducting their duties provided that it is developed in consultation with the industry and takes into account existing legislation and tPR guidance.

Remedy 4: Reporting disaggregated FM fees to existing customers

- 2.12 While we are supportive in principle of measures that allow for greater transparency and comparability of fees, we do not believe that this remedy is necessary in the context of DC schemes given the existing transparency obligations set out in the relevant legislation and tPR guidance.
- 2.13 In particular, the annual VFM assessment already provides members with the opportunity to review a detailed breakdown of costs and charges (including transaction costs) and an assessment as to whether this equates to value for members. Moreover, from 6 April 2018, trustees must include an even greater level of detail on costs and charges in their VFM assessment (which forms part of the annual governance statement) and must publish this information online. Trustees are therefore well aware of the costs and charges they are paying – since they need to engage with them in order to prepare their VFM assessment. In addition, all qualifying schemes are subject to the statutory charge cap.

Remedy 5: Minimum fee disclosure requirements when selling FM to prospective clients

- 2.14 Mercer already provides a detailed breakdown of fees to prospective DC clients (including DC FM clients) and believes this to be industry standard. Moreover, as a result of the new publication obligation concerning the annual VFM assessment, as of earlier this year there is market-wide transparency as to charges and costs allowing for greater comparability by members, trustees *and* employers.
- 2.15 As a result, this remedy would not be a useful addition for DC FM clients.

Remedy 6: Standardised methodology and template for reporting past performance of FM to prospective clients

- 2.16 We do not believe that the introduction of an industry-wide FM performance standard that applies to DC FM schemes is necessary or proportionate.
- 2.17 DC FM schemes – including Master Trusts – operate on the basis of default funds. This is in contrast with DB FM schemes, where the scheme investments will be tailored to match the specific liabilities of the scheme. As a result, there is some complexity in measuring DB FM performance because of the need to identify a consistent benchmark against which to assess performance in circumstances where scheme liabilities are not necessarily comparable. This issue does not arise for DC FM schemes, where the default funds already provide standardisation and comparability.
- 2.18 As a result, there are multiple industry sources that produce comparisons of DC scheme performance – including in respect of Master Trusts – on a regular basis which already allow for ease of comparability across DC providers. By way of example, we attach as Annexes 3 and 4 the latest Hymans Robertson *Master Trust Default Fund Performance Review* and the Corporate Adviser Intelligence *Master Trust Default Report*.
- 2.19 In these circumstances, for the CMA to impose its own preferred approach: (i) would be unnecessary, given the market has already moved to provide this service; and (ii) could hamper competition and innovation in the development of reporting services.

Remedy 7: Trustees to set strategic objectives for IC providers, and providers to report against those objectives

2.20 We set out in our PDR Response our comments regarding this remedy. The issues we raised apply equally to DC schemes.

3 Examples of “comply or explain” regimes

3.1 As set out in our PDR Response, we believe that an approach that encourages tendering while providing room for discretion is a more proportionate and appropriate means of achieving the CMA’s objective of promoting greater trustee engagement in the selection and appointment of their FM provider. In particular, we would support the following:

- (a) the introduction by tPR of enhanced guidance for trustees which states that tendering generally is best practice when IC clients move to FM;
- (b) a requirement on FM providers to provide a statement to trustees prompting them to consider testing the market before making a first appointment; and
- (c) a requirement on scheme trustees that do not carry out a tender before first appointment of an FM to provide a statement to members as to why this was the case.

3.2 We propose that this alternative model should operate on a “comply or explain” basis akin to the approach to corporate governance that UK listed companies are obliged to follow with regards to the UK Corporate Governance Code (the **Code**).

3.3 A “comply or explain” approach recognises that good governance should not be constrained by statutory regulations which tend towards a one-size-fits-all approach and may encourage box-ticking. The approach instead recognises that, in certain circumstances, deviation from best practice may be justified. This type of regime is believed to encourage decision-makers to take greater responsibility for their actions and examine more closely existing governance processes and structures.¹³

3.4 In this context, we note that the “comply or explain” approach to corporate governance is not limited to the UK; many countries have adopted similar regimes in recent years.¹⁴ The European Commission has adopted a principles-based “comply or explain” regime as a means of harmonising corporate governance practices across the EU Member States.¹⁵

3.5 In terms of the success of such an approach, following a comprehensive review of the Code by the Financial Reporting Council (**FRC**) in 2017, the revised Code – which is to be applied from 1 January 2019 – has retained the “comply or explain” approach. Indeed, in its statement following consultation on the revised Code, the FRC noted amongst respondents “continued support...[for] the “comply or explain” approach”.¹⁶

¹³ European Commission Green Paper on the EU corporate governance framework COM (2011) 164, page 18 available at <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52011DC0164&from=EN>

¹⁴ Countries that currently have a “comply or explain” regime include Australia, Canada, Germany, Hong Kong, Singapore and all OECD member countries with the exception of the United States. See Table 1 in Appendix 1 to the *House of Commons Library Briefing Paper on Corporate Governance Reform* (Number 8143, 16 July 2018) available at <https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-8143#fullreport>

¹⁵ Directive 2006/46/EC. See also Recommendation 2014/708/EU (Recommendation on the Quality of Corporate Governance Reporting (“Comply or Explain”).

¹⁶ See Financial Reporting Council, *Feedback Statement: UK Corporate Governance Code*. See also page 20 of the Business, Energy and Industrial Strategy (BEIS) House of Commons Committee report *Corporate Governance* (HC 702, 5 April 2017): “the evidence presented to us was overwhelmingly supportive of the comply or explain principle underpinning the Code. There was almost no support for supplanting the approach with regulation. Witnesses argued that further regulation would do little to influence individual behaviour and noted that not all company failures were the result of poor corporate governance...More significantly, it was argued that greater regulation would shift the culture towards a rules-based, compliance one, encouraging a tick-box mentality, rather than seeking to embed high standards and cultural change across the board as a self-evidently desirable objective for companies.” Available at <https://publications.parliament.uk/pa/cm201617/cmselect/cmbeis/702/702.pdf>

- 3.6 Moreover, compliance with the Code is currently at the highest levels in 16 years. Last year 66% of companies (and 78% of FTSE 100 companies) reported full compliance with the Code, and 95% of companies reported compliance with all but one or two of the 55 Code provisions. As noted above, in cases of non-compliance an explanation must be provided to stakeholders as to why this is appropriate.¹⁷
- 3.7 The “comply or explain” principle has also been recognised in the legislation and regulations concerning the governance of DC trust-based schemes by way of the annual governance statement. In particular, trustees must now include in their annual statement an explanation whether they have conducted a review of the default arrangement and, if no review was carried out, the date of the last review.¹⁸ This information must also be made publicly available online (see Section 2 above for further detail).
- 3.8 Experience shows, therefore, that a “comply or explain” approach can be effective and that it avoids some of the potential negative effects of an inflexible mandatory regime. Accordingly, if the CMA decides to impose a remedy in respect of tendering for first FM appointments, we believe “comply or explain” would be a more effective and more proportionate approach.

4 Proposed scope of the CMA’s mandatory tendering remedy

- 4.1 We set out in some detail in our PDR Response and at the Response Hearing the reasons for our view that a mandatory tendering remedy at the point of first appointment of FM is not appropriate and would impose unnecessary costs on the market.
- 4.2 If, notwithstanding our submission, the CMA decides to proceed with this remedy, it is important that FM is accurately scoped for this purpose. As we explained at the Response Hearing, as currently drafted the scope of “fiduciary management” is too broad and risks capturing a wide range of investment products rather than FM solutions in which the scheme’s overall asset allocation has been delegated.
- 4.3 In order to accurately describe the scope of FM for the purpose of this remedy, we propose that the CMA considers primarily the benchmark that is used. We believe the CMA should consider FM to be a service that is tailored to a particular pension scheme, based on and benchmarked against the specific liabilities of that scheme. In contrast, investment products (such as diversified growth funds) are typically measured against a market benchmark. Such products may form part of an FM solution but are typically offered by a large number – potentially even dozens – of providers. Including such products would broaden the scope of the remedy and bring within it a large number of additional parties.
- 4.4 Partial FM could still fit within the scope of the remedy on this basis, provided the FM provider has been delegated the management of a portion of the assets of the scheme with a benchmark linked to the liabilities of the scheme. If, on the other hand, a manager has been asked to manage a particular asset class and is being assessed against a market benchmark, we would consider that to be outside the scope of the remedy.
- 4.5 We would propose therefore that the scope of any mandatory tendering remedy be defined as follows:

“Fiduciary management services means the provision of a service to United Kingdom Defined Benefit institutional investors where the provider gives advice and executes decisions for the investor based on the investor’s strategic asset allocation. For the purpose of this definition, fiduciary management is limited to mandates where the benchmark for performance measurement is set by reference to the liabilities of the Defined Benefit scheme, regardless of whether the measurement is against all or part of the scheme’s total liabilities. As a result, fiduciary management may include responsibility

¹⁷ Grant Thornton, *Corporate Governance Review 2017*, pages 4, 26 and 27 (see Annex 5).

¹⁸ Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 as amended by Regulation 3 of the Occupational Pensions Schemes (Administration and Disclosure) (Amendment) Regulations 2018.

for all or some of the investor's assets. This service may include, but is not limited to, responsibility for asset allocation and fund/manager selection."

- 4.6 As a result, and for the avoidance of doubt, the following mandates would not form part of our proposed scope:
- (a) single asset class appointments under which the client delegates only manager selection and implementation responsibilities (i.e. where asset allocation decisions are not delegated);
 - (b) diversified growth fund and balanced mandate appointments (i.e. the mandate is benchmarked against the market rather than the client specific liabilities);
 - (c) appointments to manage the level of hedging of a portfolio (i.e. which entail no ongoing advice);
 - (d) solutions which are implementation-only, and where the client retains control of asset allocation and/or manager selection investment decisions (e.g. operating / investment platforms);
 - (e) private market appointments which use closed-end funds; and
 - (f) services in relation to DC mandates (as discussed further in Section 2 above).

5 Documentation in respect of the introduction of FM to existing IC clients

- 5.1 As we have explained, the adoption of a Mercer FM solution by an existing IC client follows consideration of the most suitable governance model given the specific circumstances of that client. In the normal course, the client "journey" to FM will include a number of discussions and presentations over a period of time.
- 5.2 We have provided the CMA with a comprehensive set of documents for the sample of clients selected by the CMA, which includes a number of clients who have chosen to adopt an FM solution. These documents cover the process of moving from IC to FM i.e. the client "journey" described above. [REDACTED].¹⁹
- 5.3 In relation to the specific question raised at the Response Hearing around examples of disclosures made to clients, we attach for ease of reference a sample of the documents provided to the CMA [REDACTED]:
- Annex 6 - Suitability Letter provided to [REDACTED] concerning the adoption of an FM approach to deliver a new investment strategy. The Suitability Letter sets out the steps taken by the trustees and Mercer prior to the decision to adopt FM and a conflict of interests statement is included on page 9.
 - Annex 7 – Suitability Letter provided to [REDACTED] concerning the adoption of Mercer's Dynamic De-risking Solution i.e. an FM approach. A conflicts of interest statement is included on page 4.
 - Annex 8 – Suitability Letter provided to [REDACTED] concerning the adoption of Mercer's Implemented Consulting Solution i.e. an FM approach. A conflicts of interest statement is included on page 3.

¹⁹ [REDACTED].

6 Designated professional body exemption

- 6.1 At the hearing, Mercer was asked to provide its views on the applicability of the designated professional body exemption in circumstances where the FCA's regulatory perimeter is extended.
- 6.2 Our view is that this issue should be dealt with through the appropriate design of the perimeter extension, such that issues around providers potentially having the opportunity to seek advantage by choosing between different regulatory regimes should not arise.