

INVESTMENT CONSULTANCY MARKET INVESTIGATION

RESPONSE TO “DRAFT DEFINITIONS FOR THE PURPOSE OF POTENTIAL REMEDIES” CONSULTATION PAPER

This response sets out Mercer’s preliminary comments on the draft definitions of investment consultancy (IC) and fiduciary management (FM) proposed in the CMA’s consultation paper of 2 November 2018 (the **Consultation Paper**).¹

1 Introduction

1.1 We welcome the opportunity to comment on the CMA’s proposed definitions of IC and FM. We have previously explained why we do not think the evidence supports a mandatory tendering regime for first appointment of FM, and we do not intend to repeat those points at length in this submission.² While we consider that a best practice approach combined with a ‘comply or explain’ requirement would be a more effective and proportionate method of encouraging trustees to engage actively with their choice of FM provider, to the extent the CMA chooses to proceed with a mandatory tendering regime, it will be extremely important that:

- (a) Both trustees and providers are given **sufficient certainty** as to how the mandatory tendering obligation applies to them in practice. In particular, trustees must be able easily to identify when their proposed appointment of an FM provider would trigger an obligation to conduct a competitive tender. There are a number of areas in the proposed definitions which we think would benefit from greater clarity.
- (b) The scope of the CMA’s remedies package does not produce **inadvertent consequences**, such as by over-capturing mandates which would not be appropriate to include within a mandatory tendering regime. As drafted, the proposed FM definitions risk including products offered by a significant number of asset managers that we believe should fall outside of the regime. In addition, the definitions could result in an inconsistent regime that applies differently to providers of the same underlying product, depending on whether they are classed for this purpose as FM providers or not.

1.2 In order to ensure any remedies are proportionate, and that any benefits are not outweighed by costs, we also propose that certain exclusions should apply. Our understanding is that from a drafting perspective the exclusions would sit outside of the definitions.

2 Investment consultancy service

2.1 We are concerned that the CMA’s proposed definition of IC (and particularly the items listed in paragraphs 1(a)-(d) and 2 of the Consultation Paper) are not sufficiently clear as to the activities which would be captured in practice. In light of this, we believe the CMA should identify in more detail the specific services constituting “advice” for the purposes of the IC definition.

2.2 Further, to give trustees and providers sufficient certainty about the circumstances in which “advice” has been given, we propose that this be defined as “written advice” for the purposes of this definition.

2.3 As regards the reference to “controlling employer” in paragraphs 3 and 6, we note that this terminology is not generally recognised in UK pensions legislation and, if retained, further guidance may be needed to ensure its meaning is clear.

¹ We note that the Consultation Paper definitions are proposed for the purpose of potential remedies being considered by the CMA; we do not make any comment in this response on broader questions of market definition in IC and FM.

² See, for example, our PDR Response and our response to the CMA’s Updated Market Outcomes Working Paper.

3 Fiduciary management service

- 3.1 Our comments on the CMA's proposed FM definition focus on three main areas:
- (a) Master Trust;
 - (b) asset management products such as Diversified Growth Funds; and
 - (c) joint FM appointments.
- 3.2 Finally, we comment on some potential areas which we believe should be excluded from the scope of any mandatory tendering remedy.

Master Trust

- 3.3 We interpret the CMA's current proposed definition of FM to exclude the appointment of a Master Trust provider. Paragraph 4(b) of the Consultation Paper states that it applies where a "*provider... is appointed by the trustees to make investment decisions on behalf of the trustees...*". In Mercer's experience, decisions to appoint a Master Trust provider are taken by the employer, not by the trustees.
- 3.4 This applies equally to contract-based arrangements in the context of DC schemes (e.g. Group Personal Pensions), where employers are responsible for designing the set-up and governance of a pension arrangement. In these cases, the employer contracts their pension arrangements to a third party (such as an insurance provider). Our understanding is that any appointments made by the employer in these contexts would also be excluded from the CMA's proposed definition of FM.
- 3.5 We agree with this approach: we believe it is not necessary for a potential mandatory tendering remedy to apply to Master Trusts or certain contract-based arrangements for reasons we have set out in detail in previous submissions, including for the very reason that provider appointments are taken by the employer, not the trustees. As a result, the CMA's findings on trustee engagement are irrelevant to these arrangements and the CMA has not produced evidence supporting the imposition of a remedy in these segments.³

Asset management products

- 3.6 We do not believe that any mandatory tendering remedy should apply to the extent trustees are seeking to invest in products offered by asset managers, such as Diversified Growth Funds, single asset class multi-manager funds, and multi-asset class mandates.⁴ While these products may be offered as part of an FM solution, they are also commonly offered by a wide range of other providers outside of an FM solution and so to include them in the scope of any remedy would extend its application to a substantial number of firms who would not regard themselves as offering FM. This concern has been expressed by a number of other parties in this process.⁵
- 3.7 By the same token, where firms offering both IC and FM are able to offer access to such products in-house, it would be inconsistent for the CMA to impose on trustees an obligation to undertake a tender process prior to deciding whether to make that investment, but not where the provider is an asset manager only.
- 3.8 We understand that the CMA has sought to limit the definition of FM to where there is provision of advice and the delegation of discretion to the provider (paragraphs 4(a) and 4(b) respectively). Aside from the need to be clear as to what is meant by the provision of advice, we think this approach could have material unintended consequences. In practice, our usual approach when offering the products mentioned above or similar is to provide accompanying advice to the client –

³ Please see Section 2 of our submission by way of Follow-Up to the CMA Response Hearing dated 25 October 2018.

⁴ See Section 4 of our submission by way of Follow-Up to the CMA Response Hearing dated 25 October 2018.

⁵ See e.g. response hearing summaries of Aon, LCP and Russell Investments; and IC Select's response to the PDR.

this will be documented by way of a formal piece of advice provided for the purposes of enabling trustees to satisfy Section 36(3) of the Pensions Act 1995 (a **Section 36 letter**). However, our understanding is that this is not necessarily standard practice across the market, and so there may be difficulty in determining whether advice is being provided (i.e. in circumstances where no Section 36 letter is provided, or where the Section 36 letter is provided by a different adviser).

- 3.9 More concerning still would be a situation where the CMA's remedy proposal discouraged providers from giving advice to clients in respect of a particular product to avoid triggering a tendering obligation.
- 3.10 In our submission following the response hearing we proposed an alternative formulation, which was to identify FM services by reference to the benchmark against which they are measured.⁶ This approach relies on the fact that an asset management "product" will typically be benchmarked against market benchmarks, such as a relevant index. An FM solution will, in contrast, be benchmarked against the liabilities of the relevant scheme. We note that this approach has been supported by other parties in the investigation.⁷
- 3.11 This distinction applies across product types and regardless of whether full or partial FM is provided. We believe this is a more straightforward approach which would avoid the significant negative potential unintended consequences of the CMA's current proposal, and would ensure a level playing field amongst service providers.
- 3.12 Our proposed wording to achieve this is 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 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."

Joint FM appointments

- 3.13 We are aware of at least one current arrangement in the market where FM is provided jointly by two providers, with one firm providing the advice element and the other firm implementing the chosen solution. We would expect such an arrangement to fall within the scope of any FM-related remedies, but, as it stands, it would appear not to be captured by the CMA's proposed definition in paragraph 4 and so the definition would need to be revised accordingly.

Exclusions

- 3.14 We believe that to be workable in practice any proposed tendering remedy would need a number of exclusions. These include the following (and, as the design of any remedy is refined, others may arise):
- (a) As set out in our PDR response, we believe the CMA should exclude small schemes from the scope of any remedy. We have proposed a threshold of assets of £100 million in this regard.⁸
 - (b) We believe existing investments made in closed-end funds (such as private market mandates) should be excluded from any obligation to tender. These funds are structured so

⁶ See Section 4 of our submission by way of Follow-Up to the CMA Response Hearing dated 25 October 2018.

⁷ See e.g. response hearing summary of Russell Investments.

⁸ PDR Response, paragraph 5.28.

that an investor exiting before the end date would incur a significant penalty unless the investor could find a buyer for their interest on the secondary market. Given that it is highly unlikely in practice that a client will decide to switch away from such a fund, we believe that compelling trustees to run a tender exercise in these circumstances would incur substantial additional cost with no resulting benefit.