EXECUTIVE SUMMARY

COLLECTIVE INVESTMENT SCHEMES
COSTS AND CHARGES
Implications for consumers

A REPORT FOR THE FINANCIAL SERVICES CONSUMER PANEL

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ABOUT THIS REPORT

The Financial Services Consumer Panel is an independent statutory body established in 1998 to represent the interests of consumers in the development of policy for the regulation of financial services. The Panel's foremost task is to advise and challenge the Financial Conduct Authority. Where possible, the Panel also seeks to effect beneficial change on a broad range of financial issues that affect the wellbeing of consumers.

The Panel has commissioned JAITLY LLP to prepare a report in accordance with terms of engagement agreed with the Panel, on the state of play on charges, costs and expenses on retail collective investment schemes, in order to assist the Panel in considering what the issues are, and how they might be addressed in the interests of consumers. The report is limited in scope as agreed with the Panel. No liability, whatsoever or howsoever arising, is accepted to any third party.

JAITLY LLP is a global risk consultancy that specialises in operational risk and operational and structural due diligence of investment funds generally and hedge funds specifically and in the corporate governance of funds. The author of this report is the managing partner of the consultancy and acts as a non-executive director on funds. He has advised the Pensions Regulator on costs and charges and asset protection in pensions and was a member of the expert panel on the Office of Fair Trading's market study on defined contribution pension schemes published in September 2013.

The author of the report has declared to the Panel certain conflicts of interest, and in particular, that he has been active in promoting the use of, and his participation in, independent governance committees on collective investment schemes used for pension provision. He has also drawn to the Panel's attention his current non-executive directorship roles and that he has held senior executive positions with asset managers. Some examples used in the report are based on investments in collective investment schemes that the author is invested in and reflect his experiences on these investments. The author also directly holds shares in a large insurance company providing pension products and a large international bank and indirectly in financial services businesses through investments in collective investment schemes.

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A substantial portion of the report was written in May 2014. Rules and issues on charges, pensions and investment products are constantly evolving as a result of policy and regulatory changes both in the UK and Europe and therefore may not reflect the latest position on matters discussed.

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EXECUTIVE SUMMARY

Overview

This executive summary provides an overview of the full report of the same title.

The report was commissioned by the Financial Services Consumer Panel (FSCP) and the work on it took place between April and July 2014.

Collective investment schemes[1] are one of the most important investment structures used by UK investors for their long-term savings goals. These structures are generally referred to as 'investment funds' or just 'funds'. However, the shorthand term 'funds' masks very important differences between the types of structures that can be used. These can have significant implications for investors' outcomes, particularly in relation to costs and risks. Even professionals in the market may not understand some of the complexities. Put simply, the old adages 'what you see is what you get', and 'you get what you pay for', often do not stand up to scrutiny in the world of retail investment funds.

The FSCP recognises the increasing importance of investment funds for consumers who want to achieve their long-term investment goals, particularly in the light of the raised limits for Individual Savings Accounts (ISAs) and the role that investment funds will play as a result of the automatic enrolment of private sector employees in defined contribution (DC) pension schemes.

Costs and charges[2] have a major impact on the investment outcome, yet the true costs of retail investment funds are usually not known.[3]

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[1] *This term is used in its broadest sense and includes pooled investments offered by insurance companies and investment managers and is intentionally not limited by the statutory definition.*

[2] *Costs and charges are frequently used as interchangeable terms. More accurately, 'charges' usually refer to specific disclosed deductions usually expressed as a percentage value of the fund (e.g., the annual management charge or AMC) paid by the investor for the investment management services and, where relevant, to the 'wrapper' – for example the administration charge of a pension scheme. 'Costs' usually refer to the largely undisclosed deductions to the value of the fund applied by the investment manager, such as transaction costs for investments which have typically been reflected as reduced values of the assets rather than as explicit charges. Recent changes in the SORP for financial statements of authorised funds on how transaction costs should be accounted for have explicitly removed the reference to transaction costs being included as part of the consideration but state that these costs should be deducted from capital. Other examples of undisclosed costs can be the charges deducted in other layers of investments such as charges by funds in a fund of funds investment product.*

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Studies show that this problem persists despite regulatory intervention, because industry succeeds in obtaining exemptions from providing information on all costs. Indeed, the recent findings of the Office of Fair Trading (OFT), in its market study of DC work-based pension schemes (published in September 2013 and updated in February 2014), demonstrated that little had changed since the OFT first highlighted the problem of schemes' costs and charges in 1997.

Therefore, the Panel decided to commission a report that sets out how costs and charges can be made on investment funds, how they are disclosed and the implications for consumers. In particular, to determine whether consumers' interests are served in relation to risk, transparency and value for money. The report's objective was to understand why there appear to be significant differences between the stated and the true cost of investment funds, and to discover where the root problems of poor transparency lie in the so-called 'value chain'. Importantly, the Panel is aware that the value chain spans the wholesale (institutional) and retail fund market – from the investment manager transacting in the wholesale market, via multiple layers of intermediation, down to the retail investor who saves £20 per month.

The overarching purpose of the report is two-fold. First, to provide a fresh approach to the current debate on the most effective way to introduce full disclosure of costs and charges by understanding why the current disclosure regime does not appear to have worked; second, to identify the type of governance body on investment funds that would be best-placed to understand – and act upon – the disclosed information, on behalf of retail fund investors. The scope of this challenge cannot be underestimated: its solution requires an insight into technical structures and market conduct in equal measure.

Summary of Key Findings

1. Consumers continue to suffer detriment 17 years after problems were first highlighted

Investment funds are a vital form of savings for consumers that enable them to achieve their long-term goals. Yet, the most recent OFT report shows that the causes of consumer detriment in DC pension schemes, in relation to costs and charges, continue to persist since the first time they looked at the subject almost 17 years ago, which suggests that radical intervention is required.

Investment management, like any other business, is driven by profit motives. But profit maximisation predicated on an ability not to have to disclose all investors' costs and evidence of poor management of conflicts of interests, skews the basis on which healthy competition depends.

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[3] *This point is equally applicable where funds are 'wrapped' for regulatory and tax purposes, and include other charges and costs, e.g., for administration, the use of a platform, etc. An example of a wrap is a pension scheme.*

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2. **Fund structures are complex and not well understood, leading to a lottery of outcomes for consumers**

Fund structures are highly complex. This complexity is frequently driven by regulatory and tax requirements, rather than by how investment managers actually manage funds in practice. Differences in fund structures can create a lottery of outcomes for retail investors in terms of costs, risks and protection.

Differentiation between retail and institutional investors (required by regulation) can create further complexities such as through the types of structures used and even the creation of 'share classes' within a structure to accommodate different types of investors with different terms. These differences between retail and institutional investor can often be cosmetic and do not necessarily reflect how investments in a fund are actually managed. This can create hidden risks for retail investors, who can also pay much higher charges than their institutional counterparts. Moreover, retail investors, unlike institutional investors, have little bargaining power over the terms of investment and are not in a position to influence or challenge investment managers' decisions.

3. **Weak fund governance and poor conflict of interest management does not work in the interests of consumers**

The governance of investment funds can often be weak and conflicted, especially in 'vertically integrated' financial services businesses, where affiliated companies control and manage multiple stages in the 'value chain', including investment management, brokerage and the administration at 'product' or wrapper level, e.g. in a DC pension scheme or ISA.

Weak governance also affects performance because it can be difficult to replace an under-performing investment manager. This can be due to the structure of commercial arrangements or through the operation of conflicts of interest because the manager effectively chooses those responsible for governance – a problem that can exist even when governors are supposed to be independent.

4. **Incomplete disclosures on costs and charges makes comparability and good decision making difficult**

Regulatory requirements on disclosure continue to omit full disclosure on all costs such as transaction costs. Transaction costs can form a significant proportion of the costs investors bear. In the absence of full information on all costs it is difficult to compare investments and make investment judgements.

5. **Fiduciary duties of investment managers to protect consumers are usually an illusion**

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Due to the complexity of investment products, full transparency and disclosure on their own are unlikely to ever be enough to protect retail investors in the absence of strong independent governance and greater duties for service providers.

Service providers do not usually have a fiduciary duty to act in the best interests of customers. Fiduciary duties do exist in the governance of investment funds but can be conflicted and therefore devoid of adequate challenge. Consumers sometimes refer to UK investment managers having a fiduciary duty, but this is usually not the case. The regulatory requirement for firms to 'treat customers fairly' (TCF) is not synonymous with fiduciary duty[4].

6. Economies of scale tend to benefit the investment business more than the consumer

'Integrated' or affiliated business models can lead to significant economies of scale. However, it is not a given that these savings are passed on to retail investors in the form of lower costs and charges.

7. Performance reporting can be very misleading

The reporting of performance – the main metric on which investment managers compete – can be very misleading. Investment managers can disguise investment losses when they close and merge poor-performing funds and transfer the assets to a new fund. This creates significant distortions ('survivorship biases') in the way performance is reported, which can serve to suppress the poor performance of the original fund in which the consumer invested.

Moreover, reporting on fund performance, and the provision of information for investors appears to be driven primarily by the technical and operational requirements of regulators and providers rather than the needs of retail customers and can be very confusing.

8. Consumers have insufficient power to look after their own interests

Asymmetry of information in the principal-agent relationship between investors and managers allows investment managers to exploit retail investor behavioural biases, such as investor inertia. Investment fund boards may not be able to remove or replace an investment manager. Moreover,

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[4] *The Law Commission in its report on the Fiduciary Duties of Investment Intermediaries considered what fiduciary duties were within the legal framework in Chapter 3.* *http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties.pdf* *It noted that even lawyers can use the term in different ways. Fiduciary duties are short hand for a number of duties that a fiduciary owes. It is now recognised that fiduciaries owe both fiduciary and non-fiduciary duties. It notes that the distinguishing duty of a fiduciary is that of the 'duty of loyalty'. The courts have traditionally declined to provide a clear definition, preferring to preserve flexibility.*

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even where investors do successfully sue a manager, they may still have to pay for the manager's defence. There are therefore significant problems with the way contractual arrangements on funds can be structured.

9. Consumer protection lacks clarity and certainty

No compensation may be available on some investment products, depending on how the investment is made, or may be severely limited, depending on the investment structure chosen. The arrangements are complicated, lack clarity and can have uncertain outcomes. Current consumer legislation on unfair contract terms is weak in relation to challenging insurance contracts (which include 'unit-linked' funds) and securities transactions. Consolidation and updating of this legislation is currently underway but appears to continue to exclude insurance contracts. The regulators also have limited powers under these laws.

10. Regulatory arbitrage is possible to manage risks

There are too many regulators and ombudsmen with differences in the powers and functions they have over investment products and wrappers. This can lead to the risk of regulatory arbitrage if providers choose structures where there may be an assumption of a 'lighter touch' regulatory regime whether in relation to governance or costs which may reduce the risks of sanctions if things go wrong. Regulatory arbitrage is likely to benefit investment managers and product providers rather than consumers.

Background to the Key Findings

Investment funds can be inherently complex in the way they are structured, managed and marketed, largely due to regulatory and tax requirements. For the same level of investment in the same type of investment strategy, the differences in the structure, regulation, taxation, and investor protection regimes, can result in a lottery of outcomes for consumers.

These complexities, and their implications for the true costs and risks of investment, are rarely understood by retail investors. This is not surprising since even institutional investors and those who advise retail investors do not always fully understand the true costs of investments and the different risks of each fund structure

Problems relating to structures and transparency are exacerbated by the use of incorrect terminology and misleading shorthand descriptions – for example 'contract based' and 'trust based' in relation to DC pension schemes.   'Contract based' pension funds can sometimes be trusts in structure, and in some 'contract-based' schemes there may actually be no contract between the

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investor and investment manager. As a result of the confusion that arises from the use of this type of terminology, failings within funds can be incorrectly attributed to the legal or regulatory structure, when in practice the root problem lies in the inherent conflicts of interest in the structure and the way these conflicts are managed.

The Law Commission noted that there were serious problems with the law relating to 'contract-based pensions'. The 'contract model' assumed that savers were fully informed autonomous parties, able to make good judgements in the market place. Yet the evidence was that savers failed to engage with pensions. This had now become institutionalised by auto-enrolment, where people were being placed in pension schemes by default, without any conscious agreement to the charges or contract terms.[5]

Complexities in fund structures also create – and even facilitate – the development of multiple layers of intermediation in the value chain, each of which can introduce additional layers of costs. These structures are often 'wrapped' (such as a tax-favoured pension scheme or ISA, for example) to comply with different regulatory and tax requirements, but they may be managed quite differently with different wrappers and products being aggregated for investment management purposes. It then becomes the job of the middle and back offices of the investment manager to disaggregate the investment transactions and their associated profits, losses, costs and values back into the different products and wrappers.

Operationally therefore the investment manager may manage transactions at an aggregated level[6], with values, profits and costs being allocated as an accounting exercise in the disaggregation process. Transparency at each level of intermediation can therefore be poor, particularly where services are bundled for operational efficiencies or where there are 'vertically integrated' corporate structures that provide multiple or bundled services.[7] While vertical integration can deliver economies of scale for the business, this does not necessarily translate into benefits for retail investors in the form of lower charges.

A key problem identified in this report is that the governance of retail investment funds can be weak and conflicted, resulting in inadequate challenges to the actions of investment managers and in poor manager accountability. For example, it can be difficult (and in some cases constitutionally impossible) to replace the investment manager of a fund. If the investment manager – or one of its affiliated companies – selects (or strongly influences) the appointment of members of the

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[5] *http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties.pdf*

[6] *This is often referred to as the investment strategy level. E.g. an individual may manage the UK equity strategy and another a fixed income strategy*

[7] *Vertical integration describes the situation where an affiliated group of companies provide a range of services for the fund or product, including investment management, a range of investment funds through investment platforms, administration, and even investment transaction execution.*

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governance body, this can compound the issues. This can be the case even where there are independent directors on the governance board, as the same 'independents' might perform a similar role across a range of the investment managers' funds and be remunerated accordingly.

The complexities of fund structures and asymmetries of information between the retail investor and the investment manager, together with investor biases and the fact that retail investors have little or no bargaining power over the terms on which they invest, all contribute to an extremely unbalanced principal-agent relationship. Investor biases suggest that even full disclosure of costs and conflicts of interest is unlikely to enable consumers to make meaningful rational choices.

Not unreasonably, investment management, like any other business, is driven by profit motives. But profit maximisation predicated on not having to disclose all investors' costs combined with poor management of conflicts of interest, skews the basis on which healthy competition depends. This report reveals a market characterised by complexity, well-meaning but ineffectual regulation and disclosure requirements, complex tax laws, embedded conflicts of interest, poor understanding by investors (retail, but also institutional), weak governance, weak buy-side (retail investor) bargaining power, opacity of costs, and complex multiple layers of intermediation.

The problem of weak governance is exacerbated by the absence of a fiduciary duty on the part of most investment managers in the UK to act in the best investors of retail investors.[8] In practice, the contractual terms under which investment managers typically operate contain no such fiduciary requirements. They even go so far as to contractually exclude most types of liability to investors, except in certain extreme circumstances.[9] Moreover, in common with many commercial contracts, the investor is required to indemnify the investment manager against losses and expenses that might be incurred in the discharge of the manager's duties[10] – losses and expenses that would be paid out of the fund. So, if investors sue a manager, they may still be liable to pay for the costs of the manager's defence unless those costs and expenses fall within the specified exclusions.

Regulation does try to rectify this anomaly. For example, it requires all regulated firms to treat customers fairly (TCF) and to disclose certain costs. However, there is a significant difference

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[8] *There are statutory provisions enabling pension trustees to delegate investment management duties. However investment managers can contract for a discretionary investment management mandate so that responsibility for investment decisions remains ultimately with the trustees*

[9] *Common contractual exclusions for liability in any type of contract usually state that all liability is excluded except for negligence, fraud or wilful default. The contract can then be further watered down by making the investment mandate extremely wide, specifically excluding liability for losses arising from poor investment decisions such that it would be difficult to run a successful action for negligence against the manager.*

[10] *Typical exclusions from the indemnity would include instances where the manager has been negligent, acted fraudulently or in wilful default. Technically an investor might succeed in claiming damages against a manager but if these do not arise from their negligence, fraud or wilful default the investor may still be liable to the manager under the indemnity.*

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between TCF and the legal effect of fiduciary responsibility, while the cost disclosure requirements are far from comprehensive. Regulatory fairness is often met through a duty to disclose, but investor biases mean that investors do not always act rationally to such disclosures. They may, in any case, have limited choice. If for example investors were to avoid financial services firms that had been subject to regulatory action, they could be considerably limited in their choice, as it would preclude investment with many of the larger providers of financial services. In addition, many risks that are disclosed are not given sufficient importance because most people discount such risks as being generic in nature. Investors' interests therefore need to be protected through mechanisms that go beyond disclosure.

It can be argued that ultimately investors can vote with their feet, but the principal-agent problems identified in this report, together with asymmetries of information and also investor biases – for example on investor inertia – mean that investors do not always act rationally to disclosures and regulatory actions. The regulators do fine firms that have broken their rules and these details are published, but for reasons that are not well understood, the fact that a financial services firm has been subject to regulatory action appears to have little effect on investors' buying choices.

Apart from the lack of disclosure of the true costs of retail investment funds, there are undisclosed risks for consumers that result from the way investment managers aggregate retail and institutional money, in order to manage investments more efficiently. This means that what happens in the institutional or wholesale market can still be relevant for retail investor outcomes. Indeed, as this report explains, the distinctions between the two markets can be blurred.

For example, institutional investors may invest in the same fund structure as retail investors but achieve quite different economic outcomes in terms of costs and, therefore, performance. Sometimes institutional investors may be placed in a different share class in order to give them different economic terms – but this separation is cosmetic as the investments will be managed as an aggregated whole.[11] In addition, retail investors can be exposed to undisclosed risks as a consequence of the aggregation of their 'share class' with institutional share classes, which creates what is known as cross-class liability.[12] Retail investors might also pay much higher charges than their institutional counterparts ('differential charging') – a practice that is rarely challenged.

In any event, trying to categorise assets into retail and institutional assets can be difficult. The Investment Management Association (IMA) estimates that of the £4.5 Trn of assets under management in the UK with its members, 81% are institutional with the balance being represented

[11] *Institutional and retail investors may be placed in different share classes that confer different terms, such as the fees payable (institutional investors tend to pay lower charges). However, the assets of the different classes would be aggregated for investment management purposes and not managed on a class by class basis.*

[12] *In many legal structures the existence of share classes would not be recognised in the event of the structure being wound up. Liabilities would be shared between the classes if there were insufficient assets in a class – this is cross-class liability*

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by retail and private clients. But in the UK funds market, which the IMA estimates has assets of £660Bn, retail funds account for 66% of the industry total.[13]

These classifications have difficulties and do not necessarily marry up with regulatory classifications on how assets are managed. For example a 'retail client' can be different from a retail fund. A retail fund may be a 'professional client' of an investment manager. Indeed the IMA appears to give far more importance to measuring retail sales flows in its statistics, which reflects the importance of retail sales in 'capturing' assets. Those assets can quickly aggregate into 'institutional assets' (where the 'client' may be a professional client or an eligible counterparty) comprising pension funds and other institutional type clients[14].

The reporting of performance – the main metric on which investment managers compete – can be very misleading because managers are able to disguise investment losses through the closure and merger of poor-performing funds, the assets of which are transferred to a new fund. This can create significant distortions ('survivorship biases') in the way performance is reported, which serve to suppress the poor performance of the original fund in which the consumer invested. In these cases it is difficult, if not impossible, for investors to trace their long-term progress because there is no ready reference point for the initial investment, and no easy way to calculate the returns achieved and the true costs deducted over the full investment period. Some managers are starting to report this information as good practice, but there is no requirement to do so. Many fund managers continue to report performance based only on opening and closing values for the current fund for each reporting period.

In theory the regulators should have the power to address some of the concerns outlined above. However, it can be argued that multiple regulators weaken their regulatory reach. They are weakened because differences in objectives, functions and powers of enforcement between them create loopholes. The need for liaison between them creates bureaucracy and delay. These weaknesses create the potential for regulatory arbitrage. For example, three regulators police DC pension schemes and the financial services firms that provide investment funds for them: the Prudential Regulation Authority (PRA), the Financial Conduct Authority (FCA), and the Pensions Regulator (TPR). Each regulator has different powers in terms of intervention and fines. In particular, while the FCA and TPR share the role of regulating DC pensions, the former appears to have much wider powers than the latter. Despite the memorandum of understanding (MoU) between the FCA and TPR in relation to DC pensions, this asymmetry in power might tempt providers of automatic enrolment pension schemes to 'choose' what they perceive as a 'regulation light' 'trust' structure regulated by TPR rather than the FCA. Furthermore, the level of fines the regulators can impose –

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[13] *http://www.investmentuk.org/research/ima-annual-industry-survey/key-statistics/*

[14] *The IMA defines a retail client in its statistics as including investment into unit trusts and OEICs but not life wrapped funds. Unit trusts and OEICs can have institutional classes for institutional investors but the structure itself can be treated as a professional client unless it opts otherwise.*

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even by the FCA – might not be considered punitive by firms. With regulators having to abide by principles of proportionality, fines may be treated as no more than 'the cost of doing business'.

Retail investors who wish to challenge a firm's behaviour face a confusing process because the three regulators do not normally deal with consumer complaints.[15] Complaints about firms regulated by the FCA are directed to the Financial Ombudsman Service (FOS), while those about pension schemes regulated by TPR go to the Pensions Ombudsman. There is also a grey area of overlap between them, for example in the case of transfers of members' money from defined benefit (DB) schemes to DC arrangements. The jurisdiction of compensation schemes such as the Financial Services Compensation Scheme (FSCS) and the Fraud Compensation Scheme (FCS) is also confusing.

It may of course be possible to challenge an investment management contract through the courts, but the options are limited due to the way contracts are structured and shortcomings in the legislation on unfair contract terms.

Summary of Key Recommendations

1. **Policy of disclosure to customers should not be relied upon as the main basis for TCF on retail funds**
   Significant, uncompromising mandatory change is required if the interests of investors are to be served in the retail investment fund market. The policy of disclosure to retail customers should not be relied upon as the main basis for TCF in creating good outcomes for consumers and for competition to work in the investment market.

2. **Stronger independent governance is essential on funds**
   The governance of investment funds should be completely independent of the investment manager and any related or affiliated companies. The investment manager should not be involved in the appointment of boards. Governance boards should be free to remove and replace the investment manager and should have a whistle-blowing duty to report poor practice to the regulators.

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[15] *Whistleblowing is an example of an exception*

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3. **Impose fiduciary duty on investment managers of retail funds**
   There is an urgent need to reconsider the case for legislative reform, imposing the duties of a fiduciary on investment managers in relation to retail investors. TCF, supplemented with guidance, should not be relied upon as being a sufficient proxy for fiduciary duty in delivering good outcomes to retail investors.

4. **Simplify fund structures with a single charge**
   Retail investment structures should be simplified, so that they do not create a lottery of outcomes for the majority of investors who do not understand their complexities. The solution might be a single retail investment structure for retail products, with a single investment management charge. All other costs, charges and expenses incurred by the investment manager in managing an investment fund would be borne by the manager in such a structure.

5. **Track contributions and costs cumulatively**
   There should be a requirement for contributions and costs of consumers' original investments to be tracked cumulatively through fund closures and mergers, with the full history of associated costs and performance provided to investors on a mandatory basis.

6. **Change the basis of valuations**
   All costs and commissions for buying and selling should be stripped out of the pricing and valuation of all securities, so that investment managers value and quote on a true single price for securities and investment funds. The costs of buying and selling should be disclosed separately.

7. **Impose greater scrutiny and accountability on investment fund structures**
   Investment managers and fund boards should be required to justify differential charging and different share classes in the context of fairness to all investors in a fund, for example in relation to price, management of liquidity and risk.

8. **Strengthen legal protections for consumers**
   The original recommendations of the Law Commission in 2005, in relation to consumer contracts of insurance and unfair contract terms, should be revisited and implemented in order to give consumers the right to challenge exclusion clauses in all investment management contracts irrespective of their structure. The current Bill on consumer rights should look at the impact of the proposed exclusions for contracts of insurance given the

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importance of unit linked products and financial transactions.

9. **Remove the potential for regulatory arbitrage**
   Regulators' powers should have greater equivalence to prevent regulatory arbitrage in the way financial services firms select investment fund and product structures. The regulators should have an additional objective and function to operate and exercise their powers in tandem in the interests of consumers.

10. **Define charges subject to a cap with anti-avoidance provisions**
    Where charge caps are introduced, the charges should be comprehensively and clearly defined to prevent exploitation of loopholes, with anti-avoidance regulation-making powers available to regulators.

Background to the Key Recommendations

The Key Findings section indicates that there is an urgent need to examine the costs and risks of investment funds sold in the retail market to ensure retail investors' interests are protected over the whole investment term, and not just at the point of sale.[16] This is important if consumers, irrespective of their financial sophistication and access to regulated advice, are to receive value for money. Equally, such transparency is crucial if consumers are to trust the financial services markets.

The solutions to the problems identified in this report do not lie in piecemeal improvements in disclosure and transparency: the evidence indicates that this approach does not work and does not change the conduct of professionals in the value chain. Arguably, such approaches have been compromised in the past, due to the asymmetry of information between regulators and policymakers, on the one hand, and the industry on the other, which has been effective in its lobbying on the grounds that proposed changes were 'too difficult'.

The recommendations that are proposed in this paper, therefore, are based on the premise that significant, uncompromising mandatory change is required if the interests of investors are to be served in the retail investment fund market. These recommendations have not been placed in any particular order and range from proposals that could require significant changes to market practice, to those that could be implemented more easily.

To establish strong and independent governance, it is recommended that an independent professional group of individuals look after the interests of the consumer in the principal-agent

[16] *Or, in the case of non-advice (execution-only) transactions, at point of purchase*

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relationship with the fund's investment manager. This recommendation requires a fresh approach to the governance of investment funds, which needs to be undertaken by those who are completely independent of the investment manager. Those responsible for governance on retail investment funds should have the power to change the service providers, including the investment manager and contractual arrangements should not fetter this discretion. There should be a regulatory requirement for the governance boards to seek greater accountability for investment management services.

The proposed change would require the regulators to examine carefully the number of appointments directors accept for different funds managed by a single investment manager, provider, or affiliated group of companies; their relationship to that manager, provider or affiliated group of companies; and the manner in which they are appointed or how they can be removed.

This new governance model would need to balance the interests of different categories of investor and to ensure decisions are made in their best interests. Those responsible for governance must be protected from corporate 'capture' – i.e., where those responsible for governance might be unduly influenced by the investment manager, the remuneration structure, etc – and the fear that the investment manager will 'remove' them from their appointments. The new governance bodies should have a whistleblowing duty to report poor practice to the regulators.

This approach is similar to the one adopted by the OFT in its recommendation for the Independent Governance Committees (IGCs) of so-called contract-based DC pension schemes using unit linked products for automatic enrolment. However, it goes further in defining the nature of that independence and it applies the concept across all types of retail investment fund.[17]

In order to give strength to the regulatory concept of treating customers fairly, it is recommended that investment managers are subject to the duty of a fiduciary in relation to retail investors. This would be separate from the existing fiduciary duty requirements of the governing body of the investment fund. This could operate in a manner similar to the way in which the US ERISA laws treat service providers of ERISA[18] plans (equivalent to DC pension schemes) as 'plan fiduciaries'. The Law Commission has examined the case for investment intermediaries to have fiduciary duties based upon the recommendations of the Kay Report.[19] The Commission has consulted on this and has concluded by recommending a strengthening of the regulatory requirements rather than a substantive change in the law, despite recognising that the law is complex, inaccessible and poorly understood. It has recommended a strengthening of the regulatory requirements including guidance for trustees and others on their duties and appears to have taken the view that an

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[17] *The author was a member of the OFT's expert panel for its September 2013 market study on DC pensions*

[18] *Employee Retirement Income Security Act (1974)*

[19] *The Kay Review of UK Equity Markets and Long-term Decision Making, July 2012*

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understanding of these duties by providing guidance to those responsible for governance should be sufficient. It appears to give insufficient consideration to the substantial influence and role that investment managers have in the investment management process and how that principal-agent role is accounted for, concluding that they can rely on the current regulatory structures to deliver good outcomes for investors. A fiduciary duty imposed on an investment manager creates different obligations that go beyond the regulatory requirements of treating customers fairly. For a fiduciary duty to take full effect in the complex UK investment market, it would be essential to consider a change in the law in the context of retail investors.

In addition to creating an independent and robust governance model, including the imposition of a fiduciary duty on the investment manager, there is a need to address the way assets and costs are managed in practice. It seems logical to recommend the creation of a simple, single tax-transparent fund structure for retail investors to which only a single investor charge can be applied: that of the investment manager. One possible approach to this solution would be to prevent investment managers from charging any costs to the investors' funds other than a single explicit charge, and to require that all income arising from the use of a fund's assets be attributed to that fund.

The single explicit charge (or Unitary Management Charge - UMC) deducted by the manager would need to take into account the manager's view on the costs of intermediation, transaction costs and any other costs, whether they were provisions or other contingencies. The manager would need to take a forward-looking view and price these into the UMC. The manager would bear all the costs of the fund including their own costs and would be able to benefit from any efficiency achieved. There would be only one disclosable charge against those assets that would be comparable across all similar structures.

Similarly it would be possible to compare the performance generated across all such structures, so that investors could assess both performance and the true costs in order to assess value for money.

Such a structure would only be possible if there were other fundamental changes. Perhaps the most important of these concerns the valuation of assets. Asset values for securities would need to be quoted as a single price, stripped of all the costs of buying and selling. These costs can currently be rolled into the investment fund valuation depending on how the fund is priced. The manager would account for these costs in the single charge quoted for the fund.

Furthermore, the original contributions of investors should be tracked cumulatively through fund closures and mergers, and the format of cost and performance disclosure should be changed and made mandatory for all retail investment fund reporting. When policy makers introduce charge caps – for example for default funds[20] of automatic enrolment pension schemes – this will make it easier

[20] *This is the fund used for employees who do not wish to make an investment choice and is expected to account for more than 90% of members.*

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to define the costs and charges to which the cap relates, and to prevent the exploitation of loopholes.

There may be occasions when an investor wishes to challenge an investment manager's conduct. In order to facilitate this right, it is recommended that the Law Commission's 2005 proposals on unfair contract terms legislation be implemented. The Law Commission recognised that consumer rights in this area were hard to understand because there were inconsistent overlapping pieces of legislation. It proposed a unified legislative regime that preserved the consumer protections afforded in the legislation and also proposed a strengthening of the legal grounds on which a consumer could bring a complaint. In particular, it argued that consumer contracts of insurance (which would include unit-linked funds) and contracts for the transfer of an interest in land and for the creation or transfer of interests in securities, should not be exempt under the unfair contracts legislation, as currently appears to be the case. It also proposed that the subject matter and price of a contract should be subject to challenge if it was substantially different from what a consumer could reasonably have expected. The Law Commission made further recommendations in 2013 and based on this there is a current Bill on consumer rights making its way through Parliament which consolidates the legislation in this area. However there continue to be exemptions in relation to contracts of insurance and other areas in financial services that may weaken the effectiveness of the proposed legislation and should be looked at in the context of the importance of unit linked funds which are treated as contracts of insurance.

Coherent regulation is crucial. There is a pressing need for greater coordination and for comparable powers to be given to the regulators involved in financial services, so that regulatory arbitrage does not become a driver for the investment manager or product provider's choice of investment structures. It is recommended that the regulators should have a statutory objective to collaborate and coordinate effectively in the interests of consumers in financial services, and in relation to investment funds in particular. The regulators' performance in this coordinated function should be examined periodically.

Finally, there is a need for simplification of regulation in relation to the ombudsmen, regulators and compensation regimes that operate for different products under the Financial Services Compensation Scheme and the Fraud Compensation Scheme. Such simplification is necessary to eliminate the lottery of outcomes that can arise because an investor has unwittingly chosen an investment vehicle that does not give the protection that might reasonably be assumed to apply.

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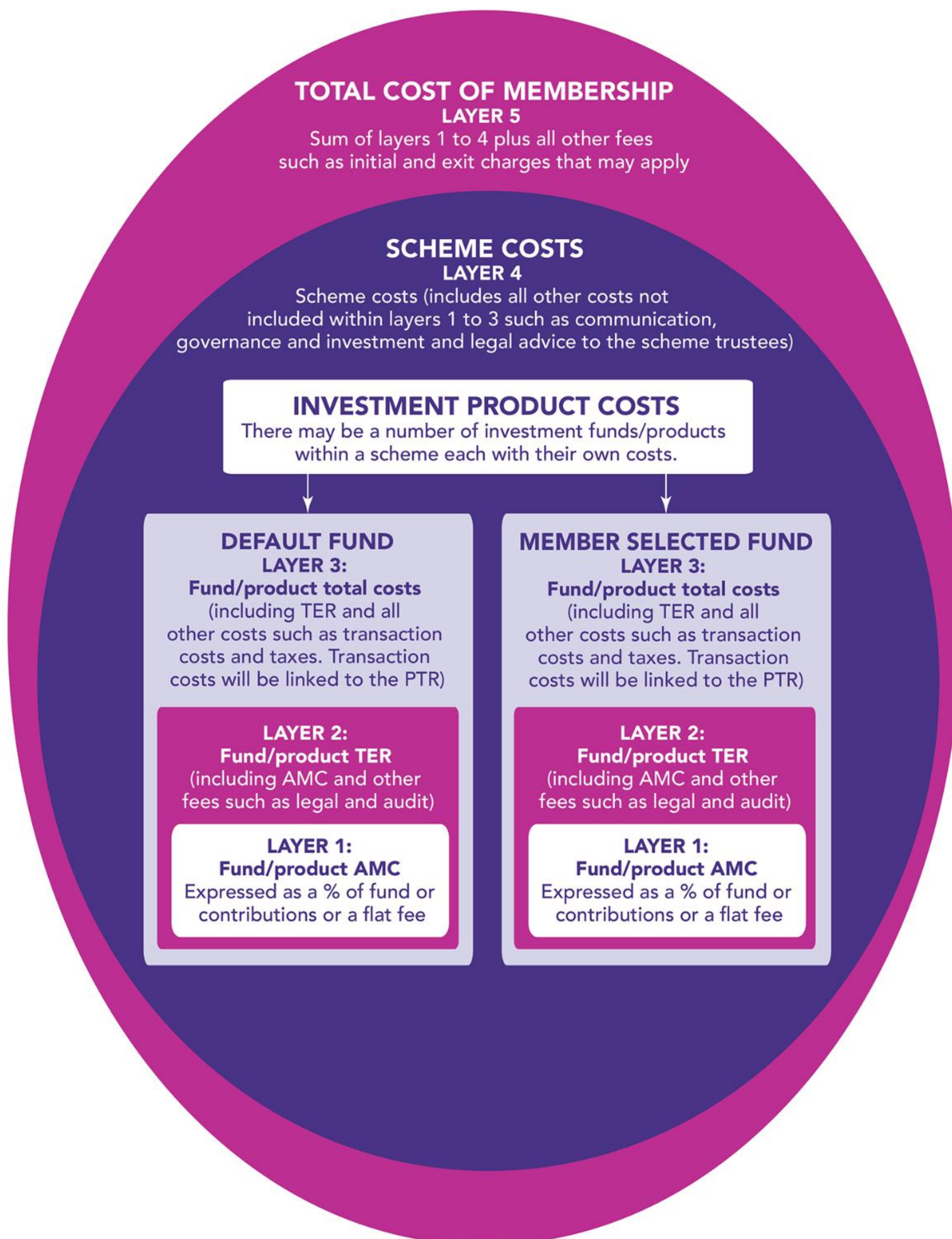

Figure 1: The different layers of costs and charges on a pension scheme, prepared by the Pensions Regulator [21]

[21] http://www.thepensionsregulator.gov.uk/images/costs-and-charges.PNG

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