FINANCIAL CONDUCT AUTHORITY

Asset Management Market Study

Final Decision: Market Investigation Reference (MIR) on investment consultancy services and fiduciary management services

September 2017

This relates to

In this report we set out our final decision to make a market investigation reference.

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How to navigate this document onscreen

returns you to the contents list

takes you to helpful abbreviations

Contents

1 Overview

1.1 This document sets out our final decision to make a Market Investigation Reference[1] (MIR) in relation to investment consultancy services and fiduciary management services.[2]

1.2 Alongside our interim report of our Asset Management Market study[3] we provisionally decided to make a MIR. We received a number of responses which we have carefully taken into account when reaching our final decision. In addition, the three largest investment consultants offered us a package of undertakings in lieu (UIL) of a reference to the Competition and Markets Authority (CMA) to address the concerns identified in our provisional decision.

1.3 Alongside our Asset Management Market study final report we published our provisional view which was to reject the UIL. Following consultation the FCA has carefully considered the responses received and has made a final decision to reject the UIL and make a MIR to the CMA in relation to investment consultancy services and fiduciary management services.

Next steps

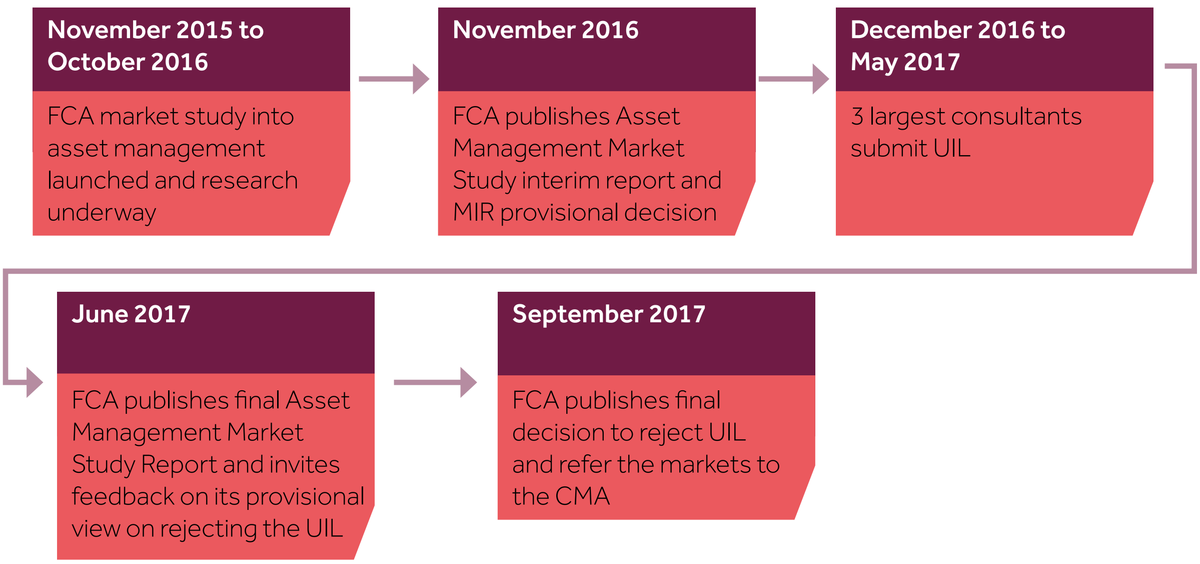
1.4 The CMA will now begin a market investigation into the supply and acquisition of investment consultancy services and fiduciary management services under the Terms of Reference set out in Annex 1. It will investigate whether any market feature (or a combination of features) prevent, restrict or distort competition in connection with the referred markets.

1.5 Should it find an adverse effect on competition, the CMA[4] must decide whether to take such action as it considers reasonable and practicable to 'remedy, mitigate or prevent' the adverse effect along with any detrimental effects on customers (insofar as those effects have resulted from, or may be expected to result from, the adverse effect on competition). When considering remedial action, the CMA must in particular have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition and any detrimental effects on customers. In doing so it should in particular have regard to the effect of any action on any relevant customer benefits.[5]

1 FCA in exercise of its functions under Part IV of the Enterprise Action 2002 (as provided for by section 234I of the Financial Services and Markets Act 2000 (FSMA)).
2 See our Terms of Reference in Annex 1 for our definition of investment consultancy services and fiduciary management services.
3 Asset Management Market Study – Interim Report (November 2016) . www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf
4 Sections 134 and 138 of the Enterprise Act 2002.
5 Section 134 of the Enterprise Act 2002.

2 Background

Background to the reference of investment consultancy services and fiduciary management



2.1 We launched our market study into asset management in November 2015 with the publication of Terms of Reference.[6] This followed feedback from the wholesale sector competition review, identifying areas within the asset management value chain where competition may not be working effectively.

2.2 The areas we identified for consideration, based on feedback received about institutional asset management, included:

1. whether investors find it difficult to monitor asset managers and ensure they are getting value for money
2. whether asset managers have the incentive and ability to effectively control costs incurred on behalf of investors, and
3. the role of investment consultants and whether there are potential conflicts of interest in the provision of both advice and asset management services.

2.3 In relation to point 3 above, we wanted to understand how institutional investors procure and use asset management services and how asset managers compete to win this business. As part of this we wanted to learn about the relationship between institutional investors, particularly pension trustees, and their investment consultants. We also wanted to understand the role investment consultants play in helping institutional investors get value for money from asset management services.

6 Asset Management Market Study – Terms of Reference November 2015 www.fca.org.uk/publication/market-studies/ms15-02-1.pdf

2.4 We met with and sent information requests to 13 investment consultants, met 32 institutional investors and conducted an online survey with 89 respondents. We also commissioned academic research to look at the effectiveness of oversight committees.

2.5 In November 2016 we published our Asset Management Market Study Interim Report[7] along with our provisional decision to refer the investment consultancy market to the CMA.[8] In this case we considered the following features were preventing, distorting or restricting competition:

- a weak demand side (which is explained in more detail in Chapter 3)
- inability to assess the quality of advice provided by consultants
- persistent levels of concentration and relatively stable market shares among investment consultants
- high barriers to entry and expansion, particularly the inability of smaller or newer consultants to develop their business outside of niche, specialist areas
- vertically integrated business models

2.6 Following the publication of our provisional decision the three largest investment consultants (Aon Hewitt, Mercer and Willis Towers Watson) submitted UIL designed to address our concerns.

2.7 In June 2017 we published our final Asset Management Market Study Report. Alongside this we invited the public to comment on our provisional view to reject the UIL.[9] Although we welcomed the UIL package proposed by the three largest investment consultants, after careful examination and in view of our analysis and the responses received, we have made the final decision to reject the UIL and refer investment consultancy services and fiduciary management to the CMA.

2.8 The following chapters provide more detail on the scope of the MIR and the features of the investment consultancy market and fiduciary management services markets that have led us to reject the UIL and make our final decision to refer these markets to the CMA.

7 Asset Management Market Study – Interim Report (Chapter 8 & Annex 5) www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

8 Asset Management Market Study – Provisional decision to make a MIR on investment consultancy services https://www.fca.org.uk/publication/market-studies/ms15-2-2-a-mir.pdf

9 UIL letter to parties with provisional view to reject UIL https://www.fca.org.uk/publication/correspondence/provision-view-uil-mir-investment-consultancy-services.pdf

3 The reference test

3.1 In this chapter we set out our powers to make a MIR, the responses we received to our provisional MIR decision and conclusions.

Our powers to make a MIR

3.2 We have the power to refer a market to the CMA if we have reasonable grounds for suspecting that any feature, or combination of features, of a market or markets in the UK for financial services prevents, restricts or distorts competition in connection with the supply or acquisition of those services in the UK or a part of the UK.[10] We call this the 'reference test'. The relevant market features can be structural in nature or can relate to the conduct of firms or customers. In practice there might not be a clear division between structural and conduct-related features.[11]

3.3 For the reasons set out in this Chapter, after careful review of the responses received, we are satisfied that the reference test is met. The FCA has reasonable grounds for suspecting that a feature, or combination of features, of a market or markets in the UK for investment consultancy services and fiduciary management services prevents, restricts or distorts competition in connection with the supply and acquisition of those services in the UK or a part of the UK.

3.4 We then have to consider whether to exercise our discretion to make a MIR. In Chapter 4 we explain how we have exercised our discretion.

Provisional MIR - Consultation responses

3.5 In November 2016 we published our Asset Management Market Study Interim Report, along with our provisional decision to refer the market to the CMA. We received 153 responses to our Asset Management Market study final report with 37 responding to our provisional decision to make a MIR. The range of respondents was diverse, with the largest group being investment consultants (11), followed by asset managers (7), trade bodies, a pension scheme and other interested parties. Most agreed with our provisional decision to make a referral to the CMA, however many investment consultants did not see a need for a MIR.

3.6 Those in agreement with the referral of this market to the CMA mainly supported our interim report and the concerns we raised. Respondents were especially concerned over conflicts of interest where firms provide both advisory and fiduciary management services. Those who did not consider a MIR necessary felt our interim report overstated some of the issues raised, particularly in relation to the levels of concentration in the market and trustees' experience and their ability to assess the quality of advice provided by investment consultants.

10 Section 131 of the Enterprise Act 2002 and FCA guidance on Market Studies and market investigation references (FG15/9) : www.fca.org.uk/publication/finalised-guidance/fg15-09.pdf

11 See Market Investigation Guidance about the making of references under Part 4 of the Enterprise Act 2002 OFT 511 (OFT 511).

Features of investment consultancy services and fiduciary management services sector

3.7 In our view the features of this sector which give rise to the competition concerns identified in our provisional decision remain broadly the same. However we have refined our assessment of investment consultancy services and fiduciary management services, following further analysis and the responses to our consultation, and consider the features are:

- a weak demand side:
  - trustees of many pension schemes often have limited or variable experience together with limited resources, resulting in higher dependency on investment consultants
  - trustees find it difficult to assess the quality of advice provided by investment consultants and the services of fiduciary managers
  - switching rates are low
- relatively high levels of concentration and relatively stable market shares among investment consultants, which indicate that competition may not be working effectively in this sector
- barriers to expansion, which particularly restrict smaller, newer consultants from developing their business outside of niche, specialist areas
- Vertically integrated business models (where firms are offering both advisory and fiduciary management services) creating conflicts of interest

Weak demand side

3.8 UK pension trustees are required to obtain and consider 'proper advice'[12] as to whether an investment is satisfactory. For existing investments, trustees should obtain advice periodically.[13] Our concerns centred around three key issues in relation to these services:

- trustees of many pension schemes often have limited or variable experience together with limited resources, resulting in a high dependency on investment consultants
- trustees find it difficult to assess the quality of advice provided by investment consultants and the services of fiduciary managers

12 Section 36(6) of the Pensions Act 1995 says that 'Proper advice' means advice from someone authorised under FSMA to provide a regulated activity, or the advice of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of investments of trust schemes.

13 Section 35 of the Pensions Act 1995, says that trustees from time to time must revise a written statement of principles which govern investment decisions of the scheme and in doing so need to seek advice. Regulation 2 (2a) *The Occupational Pension Schemes (Investment) Regulations 2005*, 'Before preparing or revising a statement of investment principles, the trustees of a trust scheme must – (a) obtain and consider the written advice of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investments of such schemes'.

- switching rates are low

Trustees have limited or variable experience together with limited resources, resulting in a high dependency on investment consultants

3.9 Academic research[14] we commissioned for the Asset Management Market study suggests that trustees have a tendency to rely heavily on investment consultants. This appears to be driven by a number of factors, including limited or variable experience on the board of trustees, limited resources available to trustees, and often fear of complexity and looking ignorant in front of their peers. These factors can contribute to trustees being unwilling or unable to challenge consultants, and therefore to accept strategies they do not fully understand. Our research found a significant proportion (33% of our survey respondents) of trustees rarely challenge their consultant.

3.10 Many respondents to our interim report and UIL consultation agreed with our concerns about the weak demand side in this sector. However, a small number of respondents, mainly larger investment consultants, challenged its existence, and disagreed that smaller clients are less likely to challenge than larger clients.

3.11 We agree that the market is not homogenous and clients vary by size, type and behaviour. However, we continue to believe the issues highlighted are likely to affect a large proportion of the market as well as the effective functioning of competition in the whole market. Therefore a thorough understanding of how trustees interact with investment consultants, the information they receive, and whether improvements to this are necessary is required.

Inability to assess the quality of advice provided by investment consultants and the services of fiduciary managers

3.12 In our provisional decision to refer this market, we found that the advice of investment consultants and Employee Benefit Consultants (EBCs)[15] is a 'credence good'. By this we mean that it is difficult to assess the quality of advice, both when selecting potential advisors and even after implementing the advice. For example, it is difficult for institutional investors to assess whether good performance achieved is the result of implementing high quality advice on asset allocation/manager selection or other factors (such as luck).

3.13 This is exacerbated by the limited availability of transparent and comparable data on the performance of investment consultant advice. We heard this was even greater in fiduciary management. As a result institutional investors concentrate on more observable dimensions of service eg the speed and quality of responses to requests.

3.14 A few investment consultants gave us details of how they currently monitor both qualitative and quantitative elements of the services they present to clients. Most respondents to our interim report agreed that providing comparable data on the performance of investment consultants' advice would benefit trustees and the sector as a whole. Some thought that this might be difficult to achieve, especially in relation to asset allocation.

3.15 A few respondents stated that a template-style disclosure would not prove beneficial as it assumes a significant level of standardisation. A respondent also pointed out

14 Tilba & Baddeley (2016), the FCA commissioned this work to explore the dynamics of, and obstacles to, effective investment decisions by oversight committees.

15 This reference applies to EBCs for the provision of advice in relation to the design and implementation of pension schemes in respect of Defined Benefit and Defined Contribution schemes or a combination of these.

that investment consulting advice is only one factor in trustee decision-making, so it is difficult to judge the performance of advice by using only scheme outputs. Some respondents believe the value of advice should be measured against client or scheme-specific objectives and not against an 'arbitrary benchmark'. A few firms told us they have developed their own benchmarks and feel they can demonstrate the value of their advice.

3.16 In addition to our concerns about trustees assessing the quality of the advice they receive, our interim report considered the fees of fiduciary managers to be the most unclear part of the asset management value chain. A lack of publically available, comparable information on fiduciary managers also makes it hard for investors to assess value for money.

3.17 A number of investment consultants responding to our interim report and UIL consultation agreed that improvements to the disclosure of fiduciary fees would benefit trustees. Suggestions included unbundling of fiduciary management fees so the proportion of fees going to the asset manager, the fiduciary manager and other components are clear to investors. Additionally, respondents noted that there was a lack of consistency between different fiduciary management offerings and that consistent disclosure would be helpful for investors to compare providers.

3.18 We continue to believe that currently there isn't an easy way for trustees to assess the advice given by investment consultants either before purchasing their services, or once they have been purchased. We also consider that more can be done to improve the disclosure of fiduciary management fees. Better information in these areas would allow trustees to compare investment consultants and decide whether their advice and fiduciary management services are delivering good outcomes and value for money. The responses received to consultations will be passed to the CMA to help inform their analysis.

Switching rates are low

3.19 In our interim report we found that switching levels were low. The results from our online survey of institutional investors stated 91% of respondents had not switched consultants in the last 5 years.[16] Institutional investors told us that the costs associated with switching were not prohibitive, but saw the time and resource that goes into a tender process as a deterrent. Those that did switch said they found it easy to do. One investment consultant challenged the switching figures we used saying these were lower than they had seen in practice. They suggested our sample size was small and therefore might not represent the market. Based on the feedback provided we took a further look at the information provided by a sample of investment consultants on the number of clients leaving them each year. The data suggests that at least 74% of the investors in our sample did not switch over a 5-year period.[17] From the evidence we reviewed in the interim report and the subsequent responses, we believe that competition in the market could be improved if investors found it easier to compare providers.

16 Asset Management Market Study - Provisional decision to make a market investigation reference on investment consultancy services (Page 7) https://www.fca.org.uk/publication/market-studies/ms15-2-2-a-mir.pdf

17 This was based on data from a sample of investment consultants showing the number of clients leaving their practice each year between 2011 and 2015. This is a lower bound estimate as the data includes clients who switch multiple times and others who may have left the market.

Relatively high levels of concentration

3.20 Our interim findings considered investment consultancy services to be concentrated, with three firms taking a significant proportion of the market share. We estimate this at around 60%, with a modest decline in recent years showing that smaller firms are gaining ground.

3.21 Several asset managers and some smaller investment consultants agreed that investment consulting is an important part of the market, but they had particular concerns around the level of concentration. The larger investment consultants felt that the concentration levels were over-stated. They argued many smaller players were winning market share through trustees tendering for investment consultant services. Smaller investment consultants agreed they were taking some market share.

3.22 Some respondents disagreed with the concentration figure of 60% in our interim report and provided alternative figures suggesting that the market share of the 3 largest investment consultants could be less than 50%. There are a number of ways of measuring market share which lead to different outputs. The interim report used firm revenue data and on this basis, Aon Hewitt, Mercer and Willis Towers Watson combined have at least 56% of the advisory market. In 2015 the FCA collected revenue data on 12 of the biggest investment consultants and the largest 3 represented 71% of revenue. These data cover around 80% of mandates based on Mandatewire data. The size of mandates for the remaining 20% of the market are likely to be smaller meaning that the share of revenues will fall within the range of 56% and 71%. Including fiduciary management revenues we estimate the market share to be between 54% and 68%. In response to the feedback we received we also looked at the proportion of assets held by the clients each consultant advises. On this basis, the share of market held by the biggest players increases to up to 80%.[18] On the other hand, calculating the market share by the number of clients leads to lower market share estimates for the larger firms.[19]

3.23 Overall we think that these measures still suggest the market is relatively concentrated, and that market shares have not changed substantially over time. It is unclear whether the smaller firms will continue to gain ground, as stated in their responses, or whether further movement towards fiduciary management will benefit the largest investment consultants.

Barriers to expansion

3.24 At the interim stage of our market study we considered that expanding in this market is more challenging for smaller firms. In addition we identified that reputation matters and decision makers often prefer to choose an established, well-known firm.

3.25 Some existing firms did consider they were winning business from the 3 largest investment consultants and that the market had opened up to some degree. However, some asset managers and consumer interest groups had particular concerns over

18 The largest three consultants' clients represented almost 80% of the assets held in our sample meaning that an estimate of their market share on this basis would be between 63% and 80%.

19 Respondents suggested that the market share of the largest three consultants' based on number of clients was around 50% based on survey data from the PLSA, Mandatewire and Greenwich associates.

the level of concentration in the market and whether this was producing the best outcomes for investors.

3.26 Reputation and being a well-established firm mattered to trustees when selecting investment consultants. This, in addition to the difficulties trustees face when comparing providers, gives us no reason to believe the share of the largest three firms will change greatly.

3.27 Based on responses, we do not see the barriers to entry to this market as being particularly high. In our view it may be relatively easy to set up to provide investment consultancy services but expanding in this market is likely to be challenging. Expansion is limited by trustees often selecting firms based on well-known names and reputations, and the fact that investment consultants do not appear to compete principally on quality of advice, but on relationships and brand. Therefore we find there are reasonable grounds to suspect that there are barriers to expansion, which particularly restrict smaller, newer consultants from developing their business outside of niche, specialist areas.

Vertically integrated business models and conflicts of interest

3.28 Previously we raised concerns about vertical integration in this market [20] and the conflicts of interest it creates. A specific area of concern is the recommendation of an investment consultant's own products or services above other, potentially more appropriate options elsewhere. This was especially true in relation to investment consultants' provision of fiduciary management where 58% of respondents would appoint the fiduciary business of their existing investment consultant or actuarial adviser as their provider.[21] Similar issues arise with services provided by EBCs with an in-house master trust offering, where their own product/service may be chosen over potentially better external offerings.

3.29 A number of respondents had concerns that the research we referenced understated the current level of competitive tendering of fiduciary management appointments.[22] We have subsequently looked at a more recent third party survey and find that the level of tendering when choosing a fiduciary manager is still low.[23] While 63% of investors received third party advice, only 13% ran a selection process when the investment consultant proposed fiduciary management. This survey also suggests that 41% of respondents had not considered more than one fiduciary manager.

3.30 Many respondents to our interim report and UIL consultation raised concerns over the potential conflicts of interests and misaligned incentives that could affect the quality of advice/outcomes provided by investment consultants. Specifically, many concerns related to the advice of investment consultants who also provide fiduciary management services. Some respondents were concerned about the incentives firms had to provide complex advice to trustees. This complexity appears to reinforce the need for fiduciary management services, allowing investment consultants to deal

20 Vertical integration in this context is where investment consultancy firms are offering both advisory and fiduciary management services and EBCs are providing in-house master trust services.

21 Aon Hewitt Fiduciary Management Survey (2015) http://www.aon.com/unitedkingdom/attachments/retirement-investment/fiduciary-management/Aon_Hewitt_Fiduciary_Management_Survey_2015_Summary.pdf

22 KPMG Fiduciary Management Market Survey (2015).

23 LCP Fiduciary management survey 2016.

with the complex investment decisions on trustees' behalf. A few respondents were concerned that this complexity was generated in order to help firms to meet fiduciary management sales targets.

3.31 Respondents saw vertical integration as the most serious conflict in this market. Respondents also noted the hourly fee structure incentivised more complex strategies being created that generate higher revenue. Fee structures based on a retainer and fees for manager selection may also promote churn rather than focussing on asset allocation.

3.32 The FCA also raised a concern that gifts and hospitality from asset managers could create conflicts of interest for investment consultants that provide asset manager ratings and recommend services to clients. Respondents to our interim report raised a similar concern where the investment consultant provides these services while at the same time providing consultancy services to asset management firms. Specifically, they were concerned that any revenues investment consultants earned from asset managers could create conflicts of interest.

3.33 Following our interim report we further examined whether there was a link between asset managers providing gifts and/or hospitality to investment consultants, or investment consultants selling services to asset managers, and the likelihood of the asset managers' products being highly rated. This analysis took into account additional factors that could also explain positive ratings, such as asset class and an investment strategy's past performance. For some investment consultants in our sample we have found a significant positive association between receiving gifts and/or hospitality and the likelihood of providing a high rating. Although we have not been able to satisfy ourselves that our data are sufficiently reliable, or that there are no other factors which could explain the statistical association, we consider these reasonable grounds for suspecting there is a possible conflict of interest in this respect.

3.34 It is evident that investment consultants and some investors are aware of the conflicts. However given the combination of a weak demand side where investors struggle to assess the quality of advice provided by investment consultants and or EBCs, the high levels of firm concentration in this market, the vertically integrated businesses and potential conflicts identified, we remain concerned over the conflicts of interest in this area.

4 Final decision regarding the MIR

4.1 As set out in Chapter 3 we are satisfied that the reference test is met. We will only make a reference to the CMA when the reference test set out in section 131 EA02 is met and, in our view, each of the four criteria we should consider when deciding whether to exercise our discretion to make a MIR are met.

Discretion to make a MIR

4.2 CMA guidance identifies four factors to consider when deciding whether to exercise our discretion to make a MIR.[24] These are:

- the scale of the suspected problem and whether a reference would be an appropriate response
- the availability of appropriate remedies
- whether the UIL of making a MIR would address our concerns
- the alternative powers available to the FCA

4.3 We considered these elements when making our final decision to make a reference.

Scale of the suspected problem

4.4 In determining the scale of the suspected problem, the CMA's guidance[25] identifies three factors of particular significance:

- the size of the market
- the proportion of the market affected by the features
- the persistence of those features

4.5 Our view is that the size of these markets, the proportion of the markets likely to be affected by the features and the persistence of the suspected features in these markets suggest there are reasonable grounds for suspecting that detriment to investors could exist in this sector. We set out our reasons below.

Size of the market

4.6 UK Pension funds are the largest institutional client type with £2.1 trillion of assets under management.[26] Almost all Defined Benefit (DB) schemes take strategic

24 In FCA Guidance FG15/9 we stated that we intend to follow the CMA's own approach as set out in OFT511 in deciding whether or not to make a MIR.
25 Market investigation references Guidance about the making of references under Part 4 of the Enterprise Act 2002 OFT 511.
26 Asset Management in the UK 2015- 2016, a summary of the IA Annual Survey (September 2016).

investment advice from investment consultants[27] before setting their investment objectives and/or when selecting managers to implement their mandate. There are £1.5tn of assets under management in DB schemes.[28]

4.7 The scale of investment consultancy services is significant, providing advice on investment strategies, asset allocation and manager selection. In terms of the impact of their advice, twelve of the largest investment consultants potentially affect £1.6tn of assets.[29]

4.8 Defined Contribution (DC) schemes often use the services of EBCs to set the default strategy, select a scheme operator and then monitor that arrangement on an on-going basis. While individual DC scheme assets are on average smaller than DB schemes, membership of DC schemes is rising. Over 9 million[30] individuals save for their retirement though DC pension schemes.

4.9 Investment consultants also provide strategic asset allocation advice to other types of institutional investors. Trustees of non-profit making organisations (which include both charities and endowments) represent 1.3% of the UK institutional market or approximately £43bn.[31]

4.10 In 2015 institutional investors spent over £242m on investment advisory services provided by investment consultants.[32]

Proportion of the market affected by the features

4.11 We found that the concerns in the investment consultancy services sector are widespread and relate to fundamental aspects of the way that both the demand and supply side operate.

4.12 Without having carried out a full market study we are unable to confirm the proportion of the market affected by the features we have identified but consider from the work we have done that they are widespread and require an in-depth review.

Persistence of those features

4.13 The features we identify are long-standing in nature. We have heard from some smaller investment consultants that they are starting to gain market share but the relatively high levels of market concentration still persist. With the features of the demand side identified in Chapter 3 we have no reason to believe the share of the largest three firms will change greatly.

4.14 Looking back over the past few decades concerns around the investment consultancy sector not working well for institutional investors have been routinely expressed. In particular the ability of institutional investors to monitor and assess quality of advice has been cited as an issue. In 2004 the Myners review found that trustees relied heavily

27 Asset Management Market Study Provisional decision to make a market investigation reference on investment consultancy services MS15/2.2a – November 2016 (paragraph 4.7).

28 Asset Management in the UK 2015-2016. A summary of the IA Annual Survey (September 2016).

29 Twelve investment consultants gave the FCA estimates of the scale of their client assets under advice. This figure is the total of these estimates for 2015. There is potential that clients are advised by more than one adviser which means this estimate is likely an upper bound.

30 The Pensions Regulator data based on scheme returns (1 Jan 2016) (excludes hybrid DB and DC pension schemes).

31 Asset Management in the UK 2015-2016. The IA Annual Survey (September 2016).

32 Based on revenues data submitted to the FCA from twelve of the largest investment consultants relating to investment consultant advice.

on investment consultants and fund managers who sell them services.[33] The report highlighted the over-reliance by trustees on investment consultants in their asset allocation and the difficulties faced by investors when evaluating advisers and the advice they received. In addition the review found that the concentration of the market led to a narrow range of advice with limited innovation.

4.15 In 2012 the Kay Review looked at long-term decision making in equity markets and said the investment chains were too long, with growing numbers of intermediaries between investors and the companies in which they invest.[34] Professor Kay argued that this led to increased costs, misaligned incentives and reduced trust.

4.16 The Law Commission produced a report in 2014 on Fiduciary Duties of Investment Intermediaries raising concerns that the investment consultancy market was highly concentrated with three firms dominating the market.[35]

Availability of appropriate remedies

4.17 As part of its assessment the FCA has considered whether there are appropriate remedies that could be available to the CMA at the end of its market investigation.

4.18 If the CMA were to find one or more adverse effects on competition, it has wide-ranging powers to take action itself (by accepting undertakings or imposing an Order) or to recommend that action should be taken by others.[36] The CMA's powers enable it to put remedies in place which address the structure of the market directly (eg through divestiture, or vertical separation) or which address the behaviour of the market participants (eg through regulating outcomes or improving transparency). The CMA could impose a single remedy or a combination of remedies. At this stage we cannot identify what those remedies would be. However, we did identify some potential remedies and set these out in our provisional decision to make a market investigation reference, including:

- Requiring consultants to provide more standardised performance information to their clients and introduce a template for reporting this information. This might enhance transparency and assist investors' decision-making
- Requiring consultants to make their performance and fee information publically available (eg on their websites or other publically accessible databases) so that investors can compare across the market
- Prohibiting certain fee structures that may misalign incentives for consultants when they are advising clients
- Improving redress mechanisms when consultants underperform or an investor is not satisfied with the advice they have received

33 Myners Principles for institutional investment decision-making: review of progress (December 2004) http://uksif.org/wp-content/uploads/2012/12/MYNERS-P.-2004-Myners-principles-for-institutional-Investment-decision-making-review-of-progress.pdf
34 J Kay, The Kay Review of UK Equity Markets and Long-Term decision Making: Final Report (July 2012) Recommendation 9.
35 Fiduciary Duties of Investment Intermediaries – The Law Commission (LAW COM No 350) (2014).
36 Sections 138,159 and 161 of the Enterprise Act 2002.

- Requiring trustees to periodically review and re-tender contracts with their investment consultants

- Making recommendations to trustees and employers on best practices when managing their investments or managing their schemes

4.19 The CMA may conclude that some or all of these remedies would address any competition concerns it may identify in the market; or it could identify a completely different set of remedies to address concerns.

Undertakings in Lieu

4.20 We have the power to accept UIL of making a MIR having regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition concerned and any detrimental effects on customers so far as resulting from the adverse effect on competition.[37]

4.21 The three largest investment consultants, representing at least 56% of the market submitted a package of UIL designed to address the concerns we set out in our provisional decision to make a MIR. As part of the requirements under section 169 EA02 we had a duty to consult when making a decision that is likely to have a substantial impact on the interests of any person. We publicly consulted on our provisional view to reject the UIL in June 2017.

Summary of responses to our UIL consultation

4.22 We received 19 responses to the UIL consultation. The majority of respondents were from investment consultants (12) with the remainder made up of trade bodies, and other interested parties. The majority of respondents, including many investment consultants, supported our provisional view to reject the proposed UIL package and said that the market would benefit from an in-depth review by the CMA. Many respondents saw the proposed UIL as a positive starting point, but argued that they did not go far enough to address the concerns raised. This was especially true in relation to conflicts of interest.

4.23 All respondents who supported the rejection of the UIL cited vertically integrated business models (firms offering both advisory and fiduciary services) and the conflicts of interest present in these business models as their main concern. This was a significant contributing factor to their support for rejecting the UIL package proposed. A few firms went on to suggest separation of these services was necessary due to the extent of the conflicts.

4.24 A few firms considered the UIL could address the concerns if modified. One firm asked for an industry working group to be formed to provide an industry-led solution.

4.25 Some respondents were concerned that unintended consequences could occur as a result of the UIL. Two investment consultants stressed the need to focus the UIL on strategic asset allocation rather than manager selection. Concerns were that a focus on manager selection track records over and above other more impactful investment consulting roles (such as asset allocation and risk management) could have

37 Section 154 of the Enterprise Act 2002.

unintended consequences. One also felt this could favour larger firms with greater research resources. It would lead to clients making decisions based heavily on manager selection even though this is neither the most important aspect of competition between investment consultants nor the most important factor for clients when choosing an investment consultant. A further investment consultant also described an unintended consequence of the UIL package where a significant amount of tenders being received at any one time may be a struggle for smaller firms.

4.26 We received a number of specific comments relating to the UIL, for example around the disclosure proposed in the package. We will share these responses with the CMA.

4.27 Two respondents suggested that more accountability should be placed on individuals who wish to be trustees and that The Pensions Regulator (TPR) could provide more help to improve trustees' skills and experience.

4.28 A couple of respondents were concerned about the costs a CMA review may pass on to investors.

4.29 Some firms considered that changes to the terms of reference of the MIR were required as the current version did not adequately capture the market issues we had identified in our provisional decision to make a MIR. We have addressed this; see Chapter 5 for further detail.

Final Decision on the UIL

4.30 Investment consultancy services play a significant role in the market for institutional investors and it is important they get value for money from these services. The scale of investment consultancy services, providing advice on investment strategies, asset allocation and manager selection is considerable. Assets affected by their advice are significant, with the advice of 12 of the largest investment consultants potentially affecting £1.6tn of assets.[38]

4.31 As part our Asset Management Study final report published in June 2017 we shared our provisional view of the UIL as follows:

- Without having carried out a full market investigation we are unable to confirm our understanding of the competition issues in this sector. A full investigation of the sector by the CMA would enable them to identify all the relevant issues and put appropriate remedies in place

- In particular, the CMA would be able to fully investigate the most effective disclosures for trustees/investors ensuring the information provided was appropriate across the range of products and services provided by the sector

- The UIL package only covers appropriately 56% of the market, which leaves the competition issues for a large segment of the market potentially unaddressed.[39] In particular, some firms offering advisory and fiduciary management services would still face conflicts of interest

38 Twelve investment consultants gave the FCA estimates of the scale of their client assets under advice. This figure is the total of these estimates for 2015. There is potential that clients are advised by more than one adviser which means this estimate is likely an upper bound.

39 Page 55 of the Asset Management Market Study Final report https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf

- Finally, given the conflicts of interest we have raised over the vertically integrated business models in this market, we cannot reasonably be confident, at this stage, that structural remedies are not necessary

4.32 The responses have been helpful in our decision making. They echoed many of the concerns we previously raised and agree that the UIL package does not go far enough. As we have previously stated, the vertical integration of firms does appear to have inherent conflicts of interest; respondents highlighted these concerns and thought that the UIL would not sufficiently address these.

4.33 We consider that any disclosures to help trustees understand the value of advice and services provided need thorough consideration to minimise the risk of unintended consequences.

4.34 Although we recognise there will be costs to industry arising from a CMA review, a thorough review is required for an in-depth analysis of the issues, and should these issues be confirmed, to put appropriate remedies in place to ensure the industry is providing value for money.

4.35 Bringing together our analysis of investment consultancy, and the responses we have received over the course of this market study, our final decision is to reject the UIL and refer investment consultancy services and fiduciary management services to the CMA for a full investigation. Although we welcomed the UIL package proposed by the three largest investment consultants we cannot be confident that it would 'achieve as comprehensive a solution as is reasonable and practicable' to the potential adverse effects on competition identified. A full investigation of the sector by the CMA would enable the identification of all the relevant issues and that they are fully understood and (if the CMA were to find any adverse effect on competition) appropriate remedies put in place.

Alternative powers available to the FCA

4.36 We concluded, given the market-wide features of this sector, that a referral to the CMA was more appropriate than using any alternative powers available to the FCA.

4.37 Elements of investment consultancy services are not regulated by us, but still have a significant impact on returns for investors, such as strategic asset allocation advice. Therefore, in addition to our provisional decision to make a MIR, we considered recommending that the Treasury brings the provision of investment consulting and employee benefit consulting asset allocation advice within the FCA's regulatory perimeter. As detailed in our Asset Management Market Study final report we are recommending that the Treasury consider, subject to the market investigation reference, an extension of our regulatory perimeter to include asset allocation advice. If the Treasury make this legislation, we would consult on how to implement this in our Handbook and carry out a cost benefit analysis to facilitate a proportionate regime.

4.38 An in-depth review of this market is required to assess the issues and (if the CMA were to find any adverse effect on competition) any appropriate remedies. As a significant part of this market is not regulated it would be more appropriate for the CMA to carry out this review to identify the relevant issues. On completion the FCA could implement regulation if this was the most appropriate solution.

5 Scope of MIR

5.1 The FCA has made a final decision to make an ordinary MIR within the meaning of section 131 of the Enterprise Act 2002 (EA02), in respect of the supply and acquisition of investment consultancy services and fiduciary management services to institutional investors and employers in the UK.[40]

5.2 In Chapter 3 we set out our final view that there are reasonable grounds for suspecting that a feature, or combination of features, of a market or markets in the UK for investment consultancy services and fiduciary management services prevents, restricts or distorts competition in connection with the supply and acquisition of these services in the UK or a part of the UK (reference test). In Chapter 4 we explain why we have decided to use our discretion to make a final referral to the CMA.

5.3 When referring to institutional investors we include pension schemes, charities, insurance companies and endowment funds.

5.4 The investment consultancy market provides a number of different services to institutional investors, in particular pension trustees. These range from strategic asset allocation advice, manager selection advice, fiduciary management advice and advice to employers in relation to pension schemes for the benefit of their employees.

5.5 Strategic asset allocation advice and manager selection advice can currently be provided in a way that is not regulated by the FCA. Similarly, in the occupational pension sector, advice to employers in relation to pension schemes for the benefit of their employees (such as advice on the choice of provider and on how to set up and manage the scheme on an on-going basis) may also fall outside the scope of the FCA's remit.

5.6 Firms who provide fiduciary management advice generally also provide fiduciary management services. However some firms only provide fiduciary management services. These services make and implement decisions for the investor based on the investor's investment strategy. This service 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.

5.7 For the avoidance of doubt, we are referring to the CMA investment consultancy services and fiduciary management in the UK.

5.8 A number of respondents to our provisional decision to make a MIR and also at the UIL consultation stage suggested that fiduciary management and not just advice on fiduciary management should be included in the terms of reference. We have made the terms of reference clearer in this respect (see Annex 1) as many of the conflicts we previously identified refer to demand side issues with fiduciary management services and not just the advice received, for example understanding fees and charges and the value of these services.

40 As stated in the CMA's guidance referred to above, the FCA is not, however, obliged to provide a precise definition of the market or market to which any MIR relates. This reflects the fact that no market definition exercise is typically conducted during a Phase 1 investigation.

5.9 In addition, we have clarified that advice to employers by EBCs relates only to the design and implementation of pension schemes, including both DB and DC schemes.

Annex 1
Terms of Reference (14th September 2017)

1. The Financial Conduct Authority (FCA) in exercise of its power under sections 131 and 133 of the Enterprise Act 2002 (as provided for by section 234I of the Financial Services and Markets Act 2000) hereby makes an ordinary reference to the Chair of the CMA for the constitution of a group under Schedule 4 to the Enterprise and Regulatory Reform Act 2013 for an investigation of **the supply and acquisition of investment consultancy services and fiduciary management services to and by institutional investors and employers in the UK.**

2. The FCA has reasonable grounds for suspecting that a feature, or combination of features, of a market or markets in the UK for investment consultancy services and fiduciary management services prevents, restricts or distorts competition in connection with the supply and acquisition of those services in the UK or a part of the UK.

Terms of Reference

3. For the purposes of this reference:

4. "Institutional investors" means legal entities invested in funds or mandates, including pension schemes, charities, insurance companies, and endowment funds.

5. "Investment consultancy services" means the provision of advice in relation to strategic asset allocation, manager selection, fiduciary management, and to employers in the United Kingdom.

5.1 "Strategic asset allocation advice" means the provision of services in relation to clients' investment decision-making and on-going monitoring of investments, including:

- asset allocation, strategy selection, and managing risk; and
- advice on different types of investments, for example, whether it would be best for a client to invest directly or through a collective investment scheme.

5.2 "Manager selection advice" means the provision of services in relation to manager research including rating and recommending managers.

5.3 "Fiduciary management advice" means the provision of advice in relation to fiduciary management services.

5.4 "Advice to employers" means the provision of advice in relation to the design and implementation of pension schemes in respect of Defined Benefit (DB), Defined Contribution (DC) schemes or a combination of these.

6. “Fiduciary management services” means the provision of a service to institutional investors where the provider makes and implements decisions for the investor based on the investor’s investment strategy in the United Kingdom. This service 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.

Annex 2
Abbreviations used in this paper

CMA	Competition and Markets Authority
DB	Defined Benefit
DC	Defined Contribution
EA02	Enterprise Act 2002
EBCs	Employee Benefit Consultants
FCA	Financial Conduct Authority
MIR	Market Investigation Reference
TPR	The Pensions Regulator
UIL	Undertakings in Lieu

We have developed this work in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

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