Financial Conduct Authority

MS15/2.2: Annex 9

Market Study

Asset Management Market Study

Interim Report: Annex 9 – International Comparisons

November 2016

Annex 9: International Comparisons

International comparisons: summary

This section summarises the key observations from our review of the asset management sectors of the countries we selected for international comparisons. We conducted international comparisons principally to understand how other jurisdictions have sought to address issues in the asset management industry. We have found that the most relevant initiatives relate to:

- Improving consumer education and awareness. Initiatives include investor bulletins, consumer guidance on funds, case studies and illustrations, cost comparison measures, and disclosure of fees
- Creating tools for consumers. Initiatives include creating tools to calculate fees, compare funds, and look at costs over a longer period
- Driving value for money. Initiatives include driving better fiduciary standards and addressing conflicts of interest
- Improving governance. Initiatives include making fund boards more independent and improving Board codes of conduct)
- Specific pension fund initiatives. Initiatives include funds with a limited range of fees, pension dashboards, and identifying vulnerable schemes.
- Evaluation of asset managers. Initiatives include work looking at closet trackers[1], work looking at costs relating to the level of active management, fee comparisons of active vs passive management, and recommendations aimed to drive better practices by active fund.

While the legislative and regulatory interventions and industry measures highlighted above should be considered in the context of that particular jurisdiction and the dynamics of competition at play there, we have taken the key learnings and considered these in light of our findings in the UK and our proposed remedies.

Introduction

1. We conducted an international comparison of asset management sectors in other jurisdictions in order to understand whether there were any regulatory or market changes which are relevant to our findings. This annex reports our findings.

Aim and scope of work

2. In this chapter we provide a brief overview of the international markets we have considered. We also set out some of the key regulatory and market developments in these markets, including a section comparing the costs of asset management products in these markets. As part of our scope, we considered the regulatory

[1] *Closet tracking*, also known as *index hugging*, exists when an investment is presented as an actively managed fund and the fees are charged in line with this, but the fund closely follows the benchmark in reality.

landscape across Australia, Denmark, France, Germany, Ireland, Netherlands and the United States.

3. We chose these countries based on a number of different factors, including the relative size of different markets and the comparability with the UK market. We also considered the regulatory focus and initiatives aimed at driving better competition in the asset management industry. In addition, we considered a couple of markets (Australia & the Netherlands) because of recent industry and regulatory focus in the pension funds space.

4. We focussed our analysis on understanding the regulatory initiatives in different markets and how they affect competition in the asset management industry. In addition, we considered whether other regulators have undertaken any relevant work:
   - to gauge whether competition was working effectively in the asset management sectors of these countries and/or improve the way competition is working,
   - to understand and improve the ability and willingness of asset managers to control costs in the value chain; and
   - to understand and improve the effectiveness of different intermediaries (including investment consultants) in the value chain for asset management.

5. This assessment is intended to inform the analysis conducted during the market study, particularly, where there are any issues or market features in the UK which could benefit from similar interventions. Our work is not intended to provide a comprehensive comparative analysis of the international asset management sectors; rather it focuses on the key areas of interest for the market study.

Approach and Limitations

6. In carrying out the international comparison work, we contacted the relevant regulator(s) in the jurisdictions concerned and also conducted desk-based research of publicly available data and information.

7. It is important to note that the international comparisons work is limited by the availability of comparable data; and the degree to which societal differences and the investor base influences the differences between the international and UK markets.

Summary of Asset Management Sectors for the countries selected

United States of America (US)

Key features of the market

8. The US is the biggest asset management industry in terms of AUM. AUM has been steadily growing since 2009. In 2014 AUM was at $31 trillion[2], increasing to $36.1 trillion in 2015.[3] Between 2009 and 2014, passive strategies received $593 billion of net flows. 2016 data suggests that the proportion of passively managed AUM 40% of the US equity fund assets, up from 18.8% a decade ago.[4] Boston Consulting Group data suggests that in 2015, of the top 15 mutual fund categories in the US (by net

[2] ambenchmark.mckinsey.com/NA/McKinsey_Navigating_Shifting_Terrain_NA_Asset_Management_2015.pdf

[3] www.bcgperspectives.com/content/articles/financial-institutions-global-asset-management-2016-doubling-down-on-data/?chapter=3#chapter3

[4] www.ft.com/cms/s/0/2e975946-fdbf-11e5-b5f5-070dca6d0a0d.html#axzz4LLz5Xvvk

flows) 8 were passive. The report also identifies the expansion of passive strategies beyond core asset classes into specialty asset classes.[5]

9. An Ernst & Young report[6] on the US Fund distribution landscape outlines the distribution landscape in the US. Asset management services are distributed to investors through five channels: direct to customer (D2C), professional advice, retirement plan, supermarket platforms and institutional.

10. The retirement plan channel is the largest channel and includes primarily corporate 401(k) retirement plans in which beneficiaries choose from a range of investment options. 72% of American households own funds distributed through employer-sponsored retirement plans.

11. In the D2C channel the asset manager offers products directly to the investor, bypassing traditional distributors. Fewer than 30% of households in the US that owned funds over the last decade purchased through the D2C channel.

12. In 2012, 53% of households owning investment products purchased them through the professional investment advice channel. This includes a range of professionals operating under different titles: financial advisers, private bankers, registered investment advisers, full-service brokers, independent financial planners, investment service representatives of banks and savings institutions, insurance agents and accountants. The feature of this channel is that it offers personalised service and ongoing assistance to investors.

13. The supermarket channel is made up of brokers that offer mutual funds from a large number of fund sponsors. The channel includes many 'no-advice' discount brokers that operate almost exclusively online. The main feature of this channel is that consumers can buy a wide range of funds through a convenient platform, without having to incur transaction fees.

14. Lastly, the institutional channel covers investments from corporations, insurance companies, endowments, private family offices, defined benefit pension plans, foundations and universities.[7] These institutional investors may be advised by investment consultants. According to a study conducted in 2012 by the Investment Company Institute, 17% of fund-owning households held funds both within employer-sponsored retirement plans and through investment professionals, 5% owned mutual funds both within employer-sponsored retirement plans and through the direct market channel, 10% held funds through investment professionals and the direct market channel and 13% of households owned funds through all three channels.[8]

15. Key players leading reforms:
    - The Dodd-Frank Act established the Investor Advisory Committee (IAC) and authorised the committee to advise the SEC on regulatory priorities
    - Securities and Exchange Commission (SEC)
    - Investment Company Institute (ICI)
    - Financial Industry Regulatory Authority (FINRA)

[5] www.bcgperspectives.com/content/articles/financial-institutions-global-asset-management-2016-doubling-down-on-data/?chapter=3#chapter3

[6] www.ey.com/Publication/vwLUAssets/ey-the-state-of-us-fund-distribution-in-2014/$File/ey-us-fund-distribution-report.pdf

[8]ibid

Recent Developments

16. In the US, regulators seem to be focusing on: distributor incentives (e.g., commissions and revenue-sharing), transparency in pricing, tools to help investors understand their investments and developments to drive value for money through fund governance reforms.

Driving value for money through broker dealer fiduciary recommendations

17. In 2013, the IAC noted that over time the roles of broker-dealers and investment advisers had converged.[9] The IAC noted that, while differences remained, many broker-dealers offer advisory services, such as investment planning and retirement planning that are similar to the services offered by investment advisers. In addition, many broker-dealers use titles such as financial adviser for their registered representatives and market themselves in ways that highlight the advisory aspect of their services. They further noted that, because federal regulations have not kept pace with changes in business practice, broker dealers and investment advisers are subject to different legal standards when they offer advisory services.

18. The IAC noted that the legal standards – a suitability standard for broker-dealers and a fiduciary duty for investment advisers – afford different levels of protection to the investors who rely on those services. Key differences include the requirements that investment advisers, as fiduciaries, act in the best interests of their clients and appropriately manage and fully disclose conflicts of interest that could bias their recommendations.

19. The IAC stated its belief that investors typically make no distinction between broker-dealers and investment advisers and may be harmed if they choose a financial adviser under a mistaken belief that the financial adviser is required to act in their best interest. Some expect that SEC will introduce a new rule[10] that will make the landscape clearer from an investor's point of view and mitigate some concerns highlighted above.

Driving value for money by looking at share class picks by distributors

20. The SEC's Office of Compliance Inspections and Examinations (OCIE) has recently undertaken an initiative to address the risk that registered advisers may be making certain conflicted recommendations to clients. Specifically, OCIE is seeking to identify conflicts of interest tied to advisers' compensation or financial incentives for recommending share classes that have substantial loads or distribution fees. [11] The SEC found that some firms placed clients in share classes that charged fees for marketing and distribution despite the clients being eligible to buy shares in fund classes without those additional charges. [12]

Driving value for money through 401k Conflict of Interest rulemaking[13]

21. A 401(k) plan is a defined contribution pension plan under which an employee can elect to have the employer contribute a portion of their employee's income to the plan on a pre-tax basis.[14] To invest into these plans, many investors seek investment advice from professionals.

[9] www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation-2013.pdf.

[10] *See, e.g.*, www.financial-planning.com/news/sec-to-propose-fiduciary-rule-next-spring-maybe.

[11] www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf.

[12] E.g., www.sec.gov/news/pressrelease/2016-52.html.

[13] www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf

[14] www.irs.gov/retirement-plans/plan-participant-employee/401k-resource-guide-plan-participants-401k-plan-overview

22. The US Department of Labor has suggested that while many advisers do act in their customers' best interest, not everyone is legally obligated to do so. Many investment professionals, consultants, brokers, insurance agents and other advisers operate within compensation structures that are misaligned with their customers' interests and often create strong incentives to steer customers into particular investment products.

23. The Department has introduced a rule to reduce this conflict of interest. It aims to protect investors by requiring all who provide retirement investment advice to abide by a "fiduciary" standard, which requires advisers to put their clients' best interest before their own profits. Going forward, those that provide investment advice to plans, plan sponsors, fiduciaries, plan participants, beneficiaries and individual Retirement Accounts and Annuities (IRAs) and IRA owners must either avoid payments that create conflicts of interest or comply with the protective terms of an exemption issued by the Department.

24. Under new exemptions adopted with the rule, firms will be obligated to acknowledge their status and the status of their individual advisers as "fiduciaries." Firms and advisers will be required to make prudent investment recommendations without regard to their own interests, or the interests of those other than the customer; charge only reasonable compensation; and make no misrepresentations to their customers regarding recommended investments.[15] With 50% of US financial assets in retirement accounts, the impact of the rule is expected to be widespread across asset managers, broker dealers, and insurance companies.

Improving consumer education and awareness: increased disclosure in Mutual Fund Account Statements

25. In 2004, the Securities and Exchange Commission (SEC), the government agency that oversees and regulates mutual funds, added a requirement for funds to disclose costs per $1,000 investment as a dollar amount in their annual shareholder report. Despite this, in 2012 the IAC stated that many mutual fund investors do not have a good grasp of the amount they pay annually in mutual fund fees or the long-term impact of those fees on their portfolio's performance.[16] The SEC reported in its 2012 financial literacy report, that "many investors … are not fully aware of investment costs and their impact on investment returns."

26. The IAC has made a number of recommendations to the SEC to explore ways to enhance investors' understanding of the actual costs they bear when investing in mutual funds and the impact of those costs on total accumulations over the life of their investment.

27. One of the key issues identified by the IAC is that the presentation of the costs can give the appearance that costs are negligible when this is not the case. The IAC report suggested that this could be due to a number of factors. One reason suggested was the absolute magnitude effect and the fact that costs are presented as percentages versus the absolute value of the item (for example, 1% versus a dollar amount of 100). Cost data was presented in documents that it was thought many investors did not read, the disclosures that were provided required the investor to extrapolate their own costs based on the hypothetical costs presented. The IAC also suggested that existing disclosures did not explain how costs might impact total accumulations. The IAC concluded that mutual fund investors, many of whom have little understanding of what constitutes a low, average, or high cost fund within a

[15] www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dol-final-rule-to-address-conflicts-of-interest

[16] www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-mf-fee-disclosure-041916.pdf.

particular fund category, could likely benefit from information that helps them to put those costs in context.

28. The IAC has made a number of proposals to the SEC, to address these shortcomings including:

- *Communication of dollar amount fund costs*: The report recommended that the SEC should take immediate steps to require dollar amount cost disclosures on account statements as a supplement to existing prospectus disclosures to increase the likelihood that investors will appreciate the significance of those costs. They argue that this would not only directly benefit investors but also promote price competition.
- *Dollar amounts as an illustration*: The report suggested a standardised illustration of the fund's operation costs, expressed as a dollar amount, be included in account statements.
- *Category average cost:* Another recommendation was for the SEC to explore ways to put cost information in context by requiring funds to disclose their costs relative to a benchmark showing the category average cost. This would help investors determine whether their own costs are higher, lower, or in line with the category average. Another recommendation was to show the impact on total accumulations of the fund's actual expenses in comparison with the category average expense.

Improving consumer education and awareness: guidance, tools and calculators[17]

29. The Financial Industry Regulatory Authority (FINRA) offers investors a fund analyser which provides information and analysis on over 18,000 mutual funds. The tool estimates the value of the funds and impact of fees and expenses on investments. The tool also allows investors to look up applicable fees and available discounts for funds. Investors can input investment value, time horizon and return expectations into tool and calculate profit, loss and total cost. It also provides a split between different fees and charges and an illustration of the value of the fund over time with expenses.

Improving governance: fund governance rules

30. The Investment Company Act of 1940 is the primary federal law governing mutual funds and their directors. In addition, the SEC has issued numerous rules under the Investment Company Act that impose additional responsibilities on mutual fund directors. Under the 1940 Act, independent directors must constitute at least 40 percent of each board.

31. The industry has adopted its own best practices code in the form of "The Advisory Group on Best Practices for Fund Directors" code which is endorsed by the Investment Company Institute's ("ICI") Board of Governors. This recommends, inter alia, that independent directors comprise a "super-majority" (or at least two thirds on all fund boards) rather than the 40% required by the 40 Act. It also recommends that independent directors should meet separately from management to consider and vote upon the investment advisory contract and its renewal every year. The ICI reported in 2014 that 83% of fund ranges had boards with 75% or more independent directors, and 89% of fund ranges had boards with either independent chairs or

[17] apps.finra.org/fundanalyzer/1/fa.aspx

independent lead directors. 92% of fund ranges had directors represented by legal counsel independent of the asset manager. [18]

SEC initiative: Improving consumer education and awareness:

32. The SEC has been developing a number of tools, including guidance, to address the problems and questions investors may have relating to investments.

33. The SEC's Office of Investor Education and Advocacy issued a series of three Investor Bulletins earlier in 2016 to help inform investors about key information in a fund prospectus. The first guide is meant to help consumers understand the different investment objectives of a fund and what they mean (such as capital appreciation vs income), strategies (choice of securities to buy and sell) and provide education of the different types of risks (such as concentration risk).[19] The second guide is focussed on increasing awareness about the fee table and performance related measures[20] and the third one is focussed on shareholder information. [21]

34. In addition to these guides which are focussed on investor understanding of the prospectus, the SEC has issued several other investor bulletins to increase investor awareness. There is a 2014 bulletin on mutual fund fees and expenses, explaining the different types of fee components of a fund and the impact seemingly small fee differentials can make over a long period.

35. The SEC's Office of Investor Education and Advocacy also issued an Investor Bulletin to explain some of the most common mutual fund fees and expenses. This bulletin highlights the impact of fees on investor portfolios[22]. In addition to the impact of fees, the bulletin is focussed on clarifying the various fees charged to a fund.

SEC initiative: The role of independent directors[23]

36. In an industry forum earlier this year the SEC Chair Mary Jo White[24] talked about role of independent directors in assessing risks and also highlighted areas that boards should think about more broadly: liquidity risk, risks relating to cybersecurity, and asset managers' use of derivatives.[25]

SEC initiative: Fast tracking of certain ETFs

37. The SEC has approved "generic" listing standards for actively managed ETFs, [26] guidelines that aim to cut months off the process of bringing these funds to market (the time cut down from a few months to a few weeks)[27]

Netherlands

Key features of the market

[18] www.ici.org/pdf/pub_15_fund_governance.pdf.

[19] www.sec.gov/oiea/investor-alerts-bulletins/ib_mfprospectus1.html

[20] www.sec.gov/oiea/investor-alerts-bulletins/ib_mfprospectus2.html

[21] www.sec.gov/oiea/investor-alerts-bulletins/ib_mfprospectus3.html

[22] www.sec.gov/oiea/investor-alerts-bulletins/ib_mutualfundfees.pdf

[23] www.ft.com/content/ba033500-1600-11e6-9d98-00386a18e39d

[24] www.sec.gov/about/commissioner/white.htm

[25] www.sec.gov/news/speech/chair-white-mutual-fund-directors-forum-3-29-16.html

[26] www.sec.gov/rules/sro/nysearca/2016/34-77992.pdf

[27] www.sec.gov/rules/sro/nysearca/2016/34-77992.pdf

38. Total asset management AUM in the Netherlands was €460 billion in 2013, which amounts to 3% of the AUM in Europe. The AUM as a percentage of the GDP of the Netherlands was 73%. 85% of AUM in the Netherlands (compared to 69% in the UK) is in discretionary mandates[28] and 15% (31% in the UK) in investment funds. The dominance of discretionary mandates in the Netherlands reflects the important role played by occupational pension schemes in asset management. The number of registered asset managers in the Netherlands in 2013 was 188, with an average AUM of €2.4 billion.[29]

Key players leading reforms

- Netherlands Authority for the Financial Markets (AFM) has been responsible for supervising the operation of the financial markets since 1 March 2002
- De Nederlandsche Bank (DNB) responsible for safeguarding financial stability in the Netherlands

Recent Interventions

Improving consumer education and awareness: survey of pension fund costs (2014)

39. The AFM recently recommended that funds not only cite asset management costs but also include a breakdown of costs in their annual reports. The AFM conducted a survey of the annual reports of more than 50 pension funds and concluded that determining exactly how costs related to risk and return was difficult. It recommended pension funds make costs more transparent and called for more clarity on gross and net returns, as well as estimated costs.[30]

Improving consumer education and awareness: regulatory initiatives relating to transparency of asset management costs (2015)[31]

40. The DNB and the AFM have analysed the reported asset management fees of 242 pension funds and found a number of areas of improvement. Pension funds reported that for 2013 their asset management costs (excluding transaction costs) were EUR 5 billion (against EUR 4.5 billion for 2012), which is equal to 0.55 per cent of the investments made (against 0.53 per cent for 2012). Some of the key observations include:

- This increase in costs is caused primarily by performance-related fees. Also, funds often failed to report performance-related costs and many of the costs are placed under the wrong investment category.
- When pension funds outsource their asset management activities to parties who subsequently outsource such activities to another party, the pension funds need to retain an insight into the underlying costs of the activities outsourced. One of the suggestions is for pension funds to consider these arrangements more closely.
- Even though it is optional for pension funds to include transaction costs in their annual statements, the DNB and the AFM strongly suggest that they do this, particularly because it follows from the Dutch Pension Act that pension funds are required to include information on implementation costs in their annual report.

[28] Which give the asset management company the sole authority to buy and sell assets and execute transactions on behalf of the client

[29] www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf

[30] www.ipe.com/dutch-pension-funds-failing-to-clarify-asset-management-costs-afm-warns/10002535.fullarticle

[31] www.dnb.nl/nieuws/dnb-nieuwsbrieven/nieuwsbrief-pensioenen/nieuwsbrief-pensioenen-maart-2015/dnb320421.jsp#

Improving consumer education and awareness: Total cost of ownership as a solution to lack of insight into total costs (AFM 2012)[32]

41. The AFM reviewed fifteen investment firms, looking at the transparency of the costs of their investment services. The study focused on brokers, investment advisers and asset managers. The findings suggested that clarity and completeness of the publicly available information on costs can be greatly improved in many cases. Investment firms often give little explanation about the costs charged to the investor. For example, the costs associated with investing in funds were often not mentioned. The fee structures differed significantly and in some cases a highly differentiated tariff structure ensured that it was difficult to compare costs. In a number of cases, the finding was that the costs were very high compared to the expected yield. This suggested that the return net of fees does not outweigh the risk.

42. Given the finding that it was difficult for investors to understand the total cost of investment services, the AFM published a discussion paper on the subject. The aim was to enable consumers to easily understand the direct and indirect costs of investment products. Some of the recommendations included:

- A total cost of ownership (TCO)[33] measure as a solution for the lack of insight into the total costs of investing prior to and during the provision of the services.
- Information regarding costs should be publicly available. This includes information relating to indirect costs, such as costs charged by product providers. Cost descriptions should be presented in one place, with clear subheadings.
- Firms should provide an explanation of which (direct and indirect) costs the consumer will face with respect to investment services, and use video and means of communication other than text to provide explanations for consumers.
- Information should identify all costs (e.g. all costs withdrawn from fund and included in the KIID)
- Public information should include an estimate of average costs of different investment products and indicate a range of cost variance during normal market conditions (can be done by asset class)
- When different price structures are offered within a service concept, the investment firm should preferably make efforts initially and continuously to allow the consumer to select the price structure that is most favourable for the consumer.
- Costs to consumers should not be excessively high.
- Performance fees should not have very low thresholds.
- Timing of charges should be favourable to consumers (investors shouldn't be charged before cost is incurred, timing should be clear)
- Where the expected return is not proportionate to the risk taken, appropriate cost reduction measures should be taken.

43. The AFM has now implemented the proposal[34], which is now called a Comparative Cost Standard (formerly TCO). This standard is expected to provide investors with better insight into the total cost of services (including transaction costs), thus enabling investors to better compare services and the related costs in advance.

[32] www.afm.nl/nl-nl/nieuws/2012/nov/inzicht-beleggingskosten-prof

[33] The AFM has now implemented the proposal and this now called a Comparative Cost Standard- (www.afm.nl/en/nieuws/2014/juni/voorstel-nvb-inzicht-in-beleggingskosten)

[34] www.afm.nl/en/nieuws/2014/juni/voorstel-nvb-inzicht-in-beleggingskosten [35] www.afm.nl/en/professionals/nieuws/2015/dec/eob-rapport

Creating tools for consumers: AFM research on the behaviour of self-directed investors[35]

44. In 2015, AFM conducted research on the behaviour and performance of self-directed investors. In many cases, actual investor behaviour turned out to be very different from how regulators and policy makers assume investors might behave, or how they expect or want them to behave. Some of the key observations are:

- On average, self-directed consumers underperformed benchmarks (sub-optimal diversification)
- In many cases, investors didn't evaluate alternative options (this finding was confirmed by both quantitative and qualitative research)
- Many investors didn't know of the variety of platforms and support services available
- Some investors based choices on what they 'felt' about the investment whereas others felt that complex technical commentary meant that the product was well researched and sophisticated
- To consumers, 'safe' investments meant controlling the investments themselves (as against the riskiness of the investment)
- The report strongly encouraged providers to look at their choice architecture (i.e. online mediums etc.)

45. On the last recommendation relating to 'choice architecture' the focus was on the fact that biases and heuristics that hinder decision making also make consumers less inclined to acknowledge or admit that they might need a little help. Therefore, a more promising route to improve outcomes might be to change the (online) environment in which consumers make decisions i.e. 'modifying the choice architecture.' Possible examples of modifying the choice architecture for self-directed investors would be to use smart defaults for novice investors, layering the product offer instead of showing every type of financial instrument at once or adapting the content and form of the appropriateness test in such a way that its warnings become a more effective tool for investor protection. The feedback mechanisms mentioned above could also be part of a more investor-friendly choice architecture, for example, including a reminder of an investor's stated long-term investment goal when they are about to make a speculative investment decision. The report strongly encourages providers to use the insights in the report to explore options to improve the choice architecture for self-directed investors, perhaps in cooperation with scientists.

Evaluation of asset managers: AFM Report on closet trackers/Index Huggers[36]

46. In 2015, the AFM looked at the impact of so called index-huggers (closet trackers) and how these products may harm consumer interests. Index hugging (also known as "closet indexing") exists when an investment is presented as an actively managed fund and the fees charged are in line with this, but the fund closely follows the benchmark in reality. The AFM published a final report in May 2016. This states that when a fund remains too close to the benchmark, then the potential for outperformance is too small to justify the higher costs to provide long-term added value. The AFM therefore believes that for funds that qualify as index huggers, either the costs must be in line with the proposition or the fund needs to change its investment philosophy to be more active.

[35] www.afm.nl/en/professionals/nieuws/2015/dec/eob-rapport

[36] www.afm.nl/nl-nl/professionals/nieuws/2016/mei/indexhugging

47. The investigation by the AFM shows that 7 of the 85 Dutch funds reviewed can be regarded as index huggers. In 2014 these funds had nearly €0.5bn retail assets under management (2% of the assets of the 85 funds). The AFM wants index huggers to correct the costs in relation to the level of active management or start investing actively. The report provides some recommendations to prevent index hugging:

- Product creation due diligence: During product creation, specific attention must be paid to the operation of the Fund. Fund providers must assess whether an active fund, managed in this way, is the right choice and whether the cost of the product is appropriate given the level of activity.
- Recommendations for managers of active funds:
    - When it appears that a fund is an index hugger, managers must pay attention to the level of activity and the relationship with costs.
    - AFM recommends that the investments/activity should aim to beat the relevant benchmark.
    - Publication of relevant information for investors to make an informed decision including:
    - Publication of the active share.
    - Official publication of top 10 holdings and weightings of fund portfolio and benchmark, and largest deviations.
    - Official investment and freedom of investment fund manager (limits, tracking error etc.).

48. The report of the AFM is in line with the Public Statement of the European Securities and Markets Authority (ESMA) on February 2, 2016 in which ESMA called national supervisors to take action against closet tracking.

Pension fund initiatives in the Netherlands

49. A DNB working paper[37] looked at economies of scale in pension fund investments and the relationship between pension fund size and costs. A pension fund that has 10 times more assets under management, has on average 7.67 basis points lower annual investment costs than the smaller fund. These economies of scale are solely driven by management costs. An Investment & Pensions Europe article suggests a significant trend of consolidation in the Dutch pension fund industry.[38]

50. From 2005 to 2014, the total number of pension funds has dropped from 800 to 365. The largest reduction has taken place among company pension funds, whose number has fallen from 710 to 279. DNB has looked into the risk that small and shrinking pension funds will no longer be able to pay promised pensions in the medium term and identified 60 "potentially vulnerable schemes", which it said should address their vulnerabilities or consider their future as independent organisations. Meanwhile, half of the 60 vulnerable schemes have decided to liquidate, merge, or place their participants' pension rights with an insurer, according to DNB.

[37] www.dnb.nl/binaries/Working%20paper%20474_tcm46-322797.pdf

[38] www.ipe.com/pensions/pensions-in/netherlands/best-hands-on-deck-the-consolidation-of-dutch-pension-funds/10006890.fullarticle

Germany

Key features of the market[39]

51. Total AUM in Germany was €1.6 trillion in 2013, which amounted to 10% of the AUM of countries in Europe. The AUM as a percentage of GDP was 57%. 18% of AUM in Germany is in discretionary mandates and 82% in investment funds. The majority of the AUM in Germany is in institutional mandates (57%) with retail accounting for 43%. Institutional investors strongly dominate the discretionary mandate segment with 87% of discretionary mandates being held by institutional investors.

52. In terms of investment funds, 56% are held by institutional investors. Germany and France are the only two markets in Europe where investment funds' AUM is mainly institutional. This is because German investment fund assets include a product called special funds (Spezialfonds) reserved for institutional investors and these are popular investment vehicles used by insurance companies, pension funds and municipal agencies.

53. In terms of AUM held by institutional investors, 21% are held by pension funds, 41% by insurance companies, 14% by banks and 24% by other smaller institutional investors. In terms of asset allocation, 26% of AUM is equity, 47% is bonds, 5% is held in cash/money market and 22% in other asset classes. The high levels of bond allocation may reflect an increasing role of bonds in the financing of corporates.

54. In 2013, the total number of asset management companies in Germany stood at 313.[40]

Key players leading reform

- Federal Financial Supervisory Authority (BaFin) of Germany is the financial regulatory authority for Germany

Recent Interventions

Evaluation of asset managers: BaFin work on closet tracking

55. Following on from ESMA's work, the Federal Financial Supervisory Authority (BaFin) of Germany started an investigation into closet tracking. They looked at funds that displayed characteristics of index trackers, but charge higher fees by packaging the fund as an active fund.

Legal rules on fee structures

56. Where there is a change in fee structures of a fund, there is an obligation to notify each investor of any change via durable medium. The management company also needs to ensure that the amended investment rules are published in the Federal Gazette (Bundesanzeiger).

[39] www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf

[40] www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf

Australia

Key features of the market

57. In Australia, managed funds are funds where money is pooled together with other investors and an investment manager then buys and sells shares or other assets on the investor's behalf. These include different types of funds; single asset or multi-asset funds, active and passive funds and exchange traded funds.[41] At 30 June 2016, the managed funds industry had $2.7 trillion funds under management.

58. Superannuation in Australia refers to the arrangements investors make to accumulate funds to provide them with income in retirement. In Australia, employers initially choose the superannuation fund and thereafter, the employee can exercise choices within the fund. Superannuation funds and funds of life insurance corporations accounted for almost 70 per cent of total AUM in Australia (while investment funds accounted for 12 per cent of total AUM).[42] The industry AUM has more than doubled over the past decade, largely driven by the strong growth in superannuation. Superannuation funds are considered to have low liquidity risk since superannuation is compulsory and investors cannot access their superannuation until they retire and reach the preservation age (currently between 55 and 60 years old). The majority of superannuation fund assets are held in defined contribution funds.

Key players leading reforms

- Australian Securities and Investment Commission (ASIC) is one of three government bodies who regulate financial services in Australia
- Australian Prudential Regulation Authority (APRA) is the prudential regulator of banks, insurance companies and superannuation funds, credit unions, building societies and friendly societies
- Australian Institute of Superannuation Trustees (AIST) is is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds

Recent Interventions

Driving value for money: Superannuation Review[43]

59. In 2010, the Australian Government released the final report of the Super System Review, aimed at examining and providing recommendations to the Government in relation to the governance, efficiency, structure and operation of Australia's superannuation system.

60. One of the key recommendations included the development of a low cost default fund for employees who do not actively choose a super fund. In addition, the report made recommendations to reduce conflicts of interest on trustee boards by establishing a code of trustee governance and suggested development of product dashboards to help investors compare products and make better choices. One of the recommendations also proposed improvements to the back office processing of superannuation transactions, with a greater focus on transacting electronically.

[41] www.moneysmart.gov.au/investing/managed-funds/choosing-a-managed-fund#type

[42] www.towerswatson.com/en-AU/Press/2015/11/Growth-slows-in-challenging-period-for-fund-managers

[43] www.treasury.gov.au/ConsultationsandReviews/Reviews/2009/Super-System-Review/Publications/Final-Report

Improving consumer education and awareness: AIST Report

61. Shortly after the Super System review, in 2010, the Australian Institute of Superannuation Trustees (AIST) published a research report [44] on Investment Management Fees. The review aimed to respond to specific issues raised as part of the Super System review and provided a number of recommendations:

- Change from fees as % of AUM: The report suggested that instead of asset-based fees, a modified fee basis using actual ASX (Australian stock exchange) data over 10 years could be used. The report suggested that, for a hypothetical portfolio of $100 million, the asset-based fee would have produced total fees (in dollar terms) some 80% higher than for the fixed dollar fee. The report suggested that the commercial difficulty fund trustees could face if they wish to negotiate a fee basis that moves away from asset-based fees is that managers may demand a higher initial fee to compensate for the loss of future fee growth but that this could be overcome using performance fees in an appropriate way.
- Performance-based fees: The report suggested that, provided the base fee can be set low enough, performance-based fees should enable investors to avoid paying for under-performance. The report recommended that a detailed standard be developed by APRA (prudential regulator) in consultation with the industry to cover performance fees where trustees believe they are appropriate.
- Actual management costs: The report suggested that for Australian equity index portfolios, management fees approach a "ceiling" of approximately $300,000 and that this may represent the basic fixed overhead for managing such a portfolio. In addition, it suggested that funds of all sizes could potentially obtain cost reductions of 20-40 basis points for Australian equities by adopting a 50% active / 50% index strategy partly because of lower costs for the index portfolio but also because of reduction in number of mandates.

Competition reforms based on the Financial System Inquiry report

62. In 2013, the Australian government announced the Financial System Inquiry to examine the financial system and to develop recommendations to foster an efficient, competitive and flexible financial system. Some of the recommendations included:

- Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.
- A competitive process to allocate new default fund members to high-performing superannuation (pension) funds. This was aimed to improve the competitive dynamics of the sector, reduce costs for funds and reduce compliance costs for employers. The competitive process could be an auction or tender. Current default fund members would also benefit as funds would not be allowed to price discriminate between their existing and new members.

63. The government responded [45] to the inquiry's final report [46] and stated that the Productivity Commission [47] would be asked to develop and release criteria to assess the efficiency and competitiveness of the superannuation system and also develop alternative models for a formal competitive process for allocating default fund

[44] www.aist.asn.au/media/43411/aist_research_report_webv.pdf

[45] www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2015/Government%20response%20to%20the%20Financial%20System%20Inquiry/Downloads/PDF/Summary_Government_response_to_FSI_2015.ashx

[46] fsi.gov.au/publications/final-report/

[47] www.pc.gov.au/about

members to products. Subsequent to the development of criteria and following the full implementation of the MySuper reforms the government will ask the Productivity Commission to review the efficiency and competitiveness of the superannuation system.

64. The response suggested that there was scope to improve governance in superannuation and some work had already been done in this area by requiring a minimum one-third of independent directors for superannuation trustee boards. The response suggests that these measures are ongoing and the legislation may be introduced by the end of 2016.

Improving consumer education and awareness: ASICs Moneysmart website

65. There are a number of investor tools on ASIC's Moneysmart website aimed at increasing better selection of funds and investments. These tools provide information about the fund type, underlying risk and investment timeframe, strategies and understanding performance (comparison against index, performance and ratings). The website contains a link to Super comparison websites, a case study example to provide more clarity to investors, a link to a fund fee calculator to look at the impact of charges and specific guidance for investors on ETFs.

Improving consumer education and awareness: Stronger Super reforms

66. The Super System Review found that many consumers do not have information or expertise required to make informed choices about their superannuation. [48] Therefore, the review concluded that access to a safe, low cost and simple default superannuation product was essential to help investors build their retirement savings. [49]

67. Following a consultation process, the government introduced a number of reforms and this led to the creation of a "My Super" default fund, with a limited range of fees. The intention was to ensure that the various fee components were clearly disclosed and consistent between funds and that there would be greater clarity across different fee components, for example: platform related costs, costs relating to advice, administration fees and Annual Management Charges.

Improving consumer education and awareness: My Super Dashboard

68. This product dashboard is intended to provide members with key information about the product in relation to five separate measures: the return target, the returns for previous financial years, a comparison between the return target (the return target must be worked out for a period of 10 years) and the returns for previous financial years, the level of investment risk (in terms of the anticipated number of years of negative returns for the product over 20 years), and a statement of fees and other costs (includes advice costs). The product dashboard must be publicly available at all times on the fund's website and should be prominently displayed.

Figure 1: Product dashboard template from ASIC's website

[48] strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/key_points.htm

[49] www.apra.gov.au/Insight/Documents/12-Insight-issue-1.pdf

Improving consumer education and awareness: Fee and cost disclosure requirements for superannuation trustees

69. The requirements include the introduction of an 'investment fee' and 'advice fee', as well as changes to the 'indirect cost' concept. The 'indirect cost' of a superannuation product is used as the basis of the amended definition of 'indirect cost ratio' for superannuation products. The indirect cost is any amount that a trustee of an entity knows, or reasonably should know, will reduce the return for a member and is not charged to that member as a fee. In addition, the portfolio holdings disclosure obligations will require trustees of all registrable superannuation entities (RSEs)[50] to publish information about the fund's portfolio holdings on the fund's website.

70. The Australian Prudential Regulation Authority (APRA) has the ability to apply a *scale test* to Superannuation funds, under which it will consider whether a super fund, or a particular My Super product, has a sufficient number of members and whether there is a sufficient pool of assets to operate efficiently. Funds are obliged to merge if they don't meet the threshold, leading to consolidation of Superannuation funds. The rate of industry consolidation increased significantly in 2014. The number of RSEs

[50] Registrable Superannuation Entity (**RSE**): A registrable superannuation entity (**RSE**) means a regulated superannuation fund or an approved deposit fund or a pooled superannuation trust but does not include a self-managed superannuation fund.

reduced by 24, to 169, over 2013/14 before declining by a further four, to 165, as at December 2014. The number of RSEs declined by 29, to 278, over 2013/14 and contracted by a further 19, to 259, by December 2014.[51]

Evaluation of asset managers: fee and performance analysis

71. AIST has commissioned research to examine what consumers are getting from not-for-profit superannuation funds when compared with superannuation funds run for profit (mainly by banks). The research examines over 5,000 investment options and analyses fees and investment returns, comparing what consumers get on a like to like basis. A key finding of the report is that, for non-default funds for profit funds, consumers are paying up to four times more in super fees and usually getting lower returns than those in not-for-profit funds.[52]

Ireland

Key features of the market[53]

72. Ireland is a major hub for cross-border fund distribution and Irish funds are sold in seventy countries across Europe, the Americas, Asia and the Pacific, the Middle East and Africa. A total of 841 fund managers (463 of Irish domiciled funds) have chosen Ireland to domicile and/or service their funds. In terms of Irish domiciled funds, 27% is held in equity investments, 19% in bonds, 24% in alternatives, 24% in money market instruments and the rest in other categories.[54] 18 of the largest 20 global asset managers have Irish domiciled funds. Ireland offers managers access to the EU-wide marketing passport for UCITS and AIFs. Over 75% of the assets of Irish domiciled funds are held in UCITS. The Irish market has about €1.4 trillion in UCITS and about 452 billion in AIFs. Ireland is also a leading European domicile for exchange traded funds. Irish domiciled ETFs represent approximately 50% of the total European ETF market.[55]

Recent Interventions

Driving value for money: thematic inspection of fund fees and disclosure [52]

73. The Central Bank of Ireland (CBI) has announced a thematic inspection of Investment Fund Fees as part of its 2016 supervisory programme. Using information from extracted from Key Investor Information Documents (KIIDs) and regulatory returns submitted by UCITS investment funds, the CBI will conduct a statistical analysis to look at the Total Expense Ratios of Irish- domiciled UCITS funds. The aim of this exercise is to build up a data-driven approach to understanding Total Expense Ratios and to identify funds that are outliers. The review will also examine the quality and effectiveness of fee disclosure by Irish domiciled UCITS funds.

[51] www.apra.gov.au/Insight/Documents/15-Insight-Issue-1.pdf

[52] www.aist.asn.au/policy/research-papers/2015-research.aspx

[53] www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf

[54] files.irishfunds.ie/1458836366-IF_WhyIreland_Brochure_EURO_Web.pdf.

[55] files.irishfunds.ie/1458836366-IF_WhyIreland_Brochure_EURO_Web.pdf

Denmark

Key features of the market

74. The Danish market consists of approximately 30 fund groups and 850 funds. The AUM in April 2014 was DKK 1,700 billion (approximately EUR 225 billion). Half of the funds were aimed at private investors with the other half aimed at institutional investors.[56] The Danish Investment Fund Association data suggests that at the end of 2015 there were a total of 1035 funds of which 555 funds aimed at retail investors, 349 at institutional investors and 131 marketed to overseas investors.[57] In terms of AUM the split was 57% institutional, 41% retail and the remaining was marketed to foreign investors. In terms of the asset allocation, 41% is invested in equities (5% in Danish equities and the rest in overseas equities), 48% in bonds, 2% in hedge funds and the rest in other investment categories.[58]

Recent Interventions

Driving value for money: review of fund governance

75. The Danish Financial Supervisory Authority (FSA) conducted an investigation on costs and fee structures for asset managers and UCITS. The report[59] concluded that the Board of UCITS funds are not active in choosing portfolio managers and assessing the costs involved. The investigation identified areas of bad practice, including how Boards made decisions about the cost of funds. Furthermore the report suggested best practice examples for the boards of UCITS funds in relation to cost structures.

Evaluation of asset managers: review of active and passive management in Danish UCITS:[60]

76. In April 2016, the Danish FSA published a memorandum on the investigation of active/passive management in equity-based sub-funds in Danish UCITS. The Danish FSA looked at 188 equity sub-funds, which, according to their prospectus, were following an active strategy. They found that 56 of the funds had an active share of less than 60% combined with a tracking error of less than 4%. Although the Danish FSA decided to lower the 'active share' percentage because funds using narrow benchmarks find it harder to achieve active share they also suggested that a positive or a negative gross additional return of less than 3 percentage points could indicate insufficient active management or potential passive management. As a result of the review, the Danish FSA has asked several funds to justify their status as active managers.

France

Key features of the market[61]

77. France is the second largest European jurisdiction in terms of AUM, with total of €3.2 trillion. This translated to a 20% market share of European AUM and the AUM was

[56] www.investering.dk/documents/10655/79593/Brochure+UK+maj/32018fa9-13f4-4ed7-803b-e9e16e78437b

[57] Reference

[58] www.investering.dk/documents/10655/79593/Brochure+UK+maj/32018fa9-13f4-4ed7-803b-e9e16e78437b

[59] www.finanstilsynet.dk/da/Lovgivning/Information-om-udvalgte-tilsynsomraader/Kollektive-investeringer/UCITS/Rapporter-og-artikler

[60] www.finanstilsynet.dk/en/Nyheder%20og%20presse/Pressemeddelelser/2016/PM-BSH-tale-IFB-200416

[61] www.efama.org/Publications/Statistics/Asset%20Management%20Report/150427_Asset%20Management%20Report%202015.pdf

154% of the GDP of France. 48% of the funds are held in discretionary mandates and 52% in investment funds. The share of the discretionary mandates reflects the size of the French insurance industry and the high level of asset management delegation by French and foreign institutional investors to asset managers. 79% of asset management AUM in France is institutional, with retail at 21%. Within the investment funds category, 69% is held by institutional investors. In France, this is partly due to the use of investment funds in workplace pension schemes as well as the important role played by money market funds in cash management of many French corporations. In terms of split of institutional investors 15% AUM is held by pension funds, 59% by insurance companies, 7% by banks and 19% by other institutional investors. In terms of asset allocation, 17% of AUM is equities, 49% bonds, 15% money market instruments and 19% in other investment categories. The total number of asset managers in France was 613 in 2013.

Recent Interventions

Pre-marketing of funds

The Autorité des marchés financiers (AMF) has introduced the concept of 'pre-marketing' of funds, which relaxes the marketing rules applicable to funds in France. Firms can measure interest in the fund by pre-marketing to a maximum of 50 prospective investors. Within this framework, management companies may provide potential investors with draft documentation regarding the fund. However, the management company may not provide final documentation or a subscription agreement or a comparable document allowing potential investors to subscribe to such fund's shares or units.[62]

Costs of asset management services

Attached below is a summary of the cost of asset management services in some of the different jurisdictions chosen for international comparisons.

US

- Research from the Investment Company Institute (ICI)[63] suggests that on an asset-weighted basis,[64] average expenses paid by mutual fund investors have fallen substantially. In 2003, equity fund investors incurred expenses of 1% and that reduced to 0.74% by 2013.
- Expense ratios[65] for mutual funds dropped in 2015 to the lowest level in at least 20 years, while money market fund expense ratios remained at their 2014 low, according to data released by the Investment Company Institute (ICI).[66]
- Weighted by assets, average equity fund expense ratios fell to 0.68% in 2015. The declining cost of actively managed funds was due in large part to competitive pressures and investor interest in lower-cost funds.

[62] www.amf-france.org/en_US/Actualites/Communiques-de-presse/AMF/annee-2016.html?docId=workspace%3A%2F%2FSpacesStore%2F9456b35b-c749-4ed2-8a0e-8f6bc8a67815&langSwitch=true

[63] www.ici.org/pdf/per20-02.pdf

[64] ICI evaluates fee trends using asset-weighted averages to summarize the expenses that shareholders actually pay through mutual funds. To compute the average, ICI weights each fund's expense ratio by that fund's end-of-year assets. Simple averages (counting each fund's expense ratio equally) overstate the impact of the expenses of funds in which investors hold few dollars.

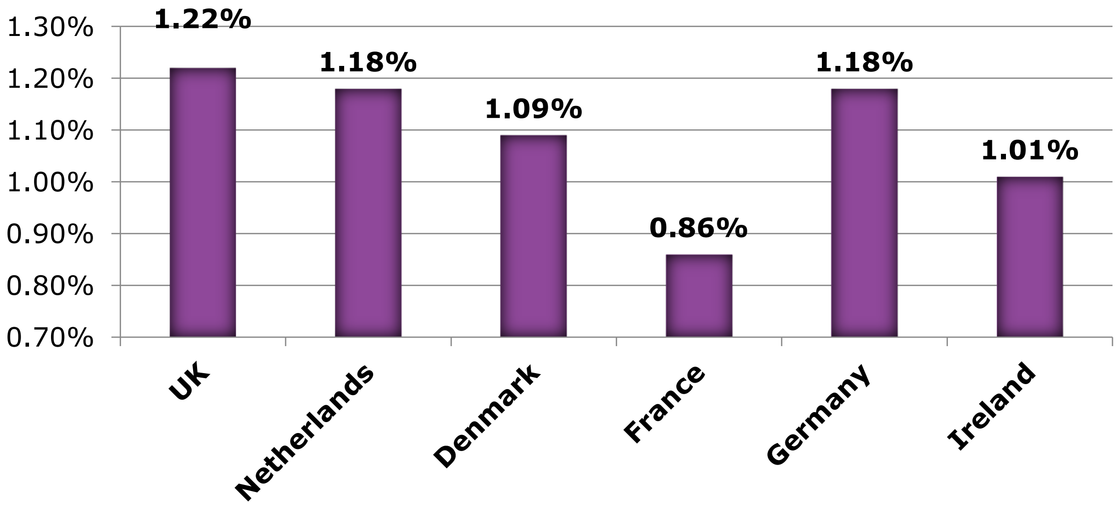
[65] A fund's expense ratio is the fund's total annual expenses expressed as a percentage of its net assets.

[66] www.ici.org/pressroom/news/16_news_trends_expenses

Europe

- A Morningstar study[67] of European investment funds has looked at the asset-weighted ongoing charge[68] across the European fund universe as part of two separate studies, one in 2013 and other in 2016.
- Since the 2013 report, there has been a change in landscape, especially in the UK and the Netherlands, where there has been a ban on product linked commissions to ensure more transparency in the industry. As a result of this, the number of clean share classes without distribution fees has increased.[69] While the 2016 report does consider the impact of this, the graph below illustrates 2013 charges across the countries we chose for international comparison. These charges are before the full effects of unbundling and therefore may be higher than more recent data. The average charge across the European fund universe was 1.09% in 2013.

Figure 2: asset-weighted average net expense ratio (%AUM)[70]



- The overall asset-weighted ongoing charge paid by passive equity fund investors across Europe is 0.31%, compared with 1.38% for active funds.
- The average weighted charges for equities, across all European domiciles was 1.43%

[67] media.morningstar.com/uk%5CMEDIA%5CResearch_Paper%5C2016_Morningstar_European_Cost_Study_17082016.pdf

[68] The most significant difference between total expense ratio and ongoing charge is that the performance fee is included in the total expense ratio but not in the ongoing charge. Therefore, the ongoing charge may understate actual fees for funds with a performance fee.

[69] www.investering.dk/documents/10655/79631/Morningstar+europ%C3%ABisk.pdf/841b5439-b8c5-4e3a-afcf-3c2a92df5026

[70] Based on data from Morningstar study which includes all asset classes and both active and passive strategies.

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