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COLLECTIVE INVESTMENT SCHEMES

COSTS AND CHARGES

Implications for consumers

A REPORT FOR THE FINANCIAL SERVICES CONSUMER PANEL

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ABOUT THIS REPORT

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

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

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

The author of the report has declared to the Panel certain conflicts of interest, and in particular, that he has been active in promoting the use of, and his participation in, independent governance committees on collective investment schemes used for pension provision. He has also drawn to the Panel's attention his current non-executive directorship roles and that he has held senior executive positions with asset managers. Some examples used in the report are based on investments in collective investment schemes that the author is invested in and reflect his experiences on these investments. The author also directly holds shares in a large insurance company providing pension products and a large international bank and indirectly in financial services businesses through investments in collective investment schemes. These conflicts have also been noted in Section 11.

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

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1. Executive Summary

1.1 Overview

This executive summary provides an overview of the findings and recommendations in this report.

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

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

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

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

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

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[1] This term is used in its broadest sense and includes pooled investments offered by insurance companies and investment managers and is intentionally not limited by the statutory definition.
[2] Costs and charges are frequently used as interchangeable terms. More accurately, 'charges' usually refer to specific disclosed deductions usually expressed as a percentage value of the fund (e.g., the annual management charge or AMC) paid by the investor for the investment management services and, where relevant, to the 'wrapper' – for example the administration charge of a pension scheme. 'Costs' usually refer to the largely undisclosed deductions to the value of the fund applied by the investment manager, such as transaction costs for investments which have typically been reflected as reduced values of the assets rather than as explicit charges. Recent changes in the SORP for financial statements of authorised funds on how transaction costs should be accounted for have explicitly removed the reference to transaction costs being included as part of the consideration but state that these costs should be deducted from capital. Other examples of undisclosed costs can be the charges deducted in other layers of investments such as charges by funds in a fund of funds investment product.
[3] This point is equally applicable where funds are 'wrapped' for regulatory and tax purposes, and include other charges and costs, e.g., for administration, the use of a platform, etc. An example of a wrap is a pension scheme.

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demonstrated that little had changed since the OFT first highlighted the problem of schemes' costs and charges in 1997.

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

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

1.2 Summary of Key Findings

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

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

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

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

   Fund structures are highly complex.

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

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

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

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

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

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

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

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

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

Service providers do not usually have a fiduciary duty to act in the best interests of customers. Fiduciary duties do exist in the governance of investment funds but can be conflicted and therefore devoid of adequate challenge. Consumers sometimes refer to UK investment managers having a fiduciary duty, but this is usually not the

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case. The regulatory requirement for firms to 'treat customers fairly' (TCF) is not synonymous with fiduciary duty[4].

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

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

7. Performance reporting can be very misleading

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

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

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

Asymmetry of information in the principal-agent relationship between investors and managers allows investment managers to exploit retail investor behavioural biases, such as investor inertia. Investment fund boards may not be able to remove or replace an investment manager. Moreover, even where investors do successfully sue a manager, they may still have to pay for the manager's defence. There are therefore significant problems with the way contractual arrangements on funds can be structured.

9. Consumer protection lacks clarity and certainty

No compensation may be available on some investment products, depending on how the investment is made, or may be severely limited, depending on the investment structure chosen. The arrangements are complicated, lack clarity and can have uncertain outcomes. Current consumer legislation on unfair contract

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

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terms is weak in relation to challenging insurance contracts (which include 'unit-linked' funds) and securities transactions. Consolidation and updating of this legislation is currently underway but appears to continue to exclude insurance contracts. The regulators also have limited powers under these laws.

10. **Regulatory arbitrage is possible to manage risks**

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

1.3 Background to the Key Findings

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

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

Problems relating to structures and transparency are exacerbated by the use of incorrect terminology and misleading shorthand descriptions – for example 'contract based' and 'trust based' in relation to DC pension schemes. 'Contract based' pension funds can sometimes be trusts in structure, and in some 'contract-based' schemes there may actually be no contract between the investor and investment manager. As a result of the confusion that arises from the use of this type of terminology, failings within funds can be incorrectly attributed to the legal or regulatory structure, when in practice the root problem lies in the inherent conflicts of interest in the structure and the way these conflicts are managed.

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

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

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

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

A key problem identified in this report is that the governance of retail investment funds can be weak and conflicted, resulting in inadequate challenges to the actions of investment managers and in poor manager accountability. For example, it can be difficult (and in some cases constitutionally impossible) to replace the investment manager of a fund. If the investment manager – or one of its affiliated companies – selects (or strongly influences) the appointment of members of the governance body, this can compound the issues. This can be the case even where there are independent directors on the governance board, as the same 'independents' might perform a similar role across a range of the investment managers' funds and be remunerated accordingly.

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

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

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

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

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

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

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

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

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

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

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

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

In any event, trying to categorise assets into retail and institutional assets can be difficult. The Investment Management Association (IMA) estimates that of the £4.5 Trn of assets under management in the UK with its members, 81% are institutional with the balance being represented by retail and private clients. But in the UK funds market, which the IMA estimates has assets of £660Bn, retail funds account for 66% of the industry total.[13]

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

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

In theory the regulators should have the power to address some of the concerns outlined above. However, it can be argued that multiple regulators weaken their regulatory reach. They are weakened because differences in objectives, functions and powers of

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

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

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

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

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enforcement between them create loopholes. The need for liaison between them creates bureaucracy and delay. These weaknesses create the potential for regulatory arbitrage. For example, three regulators police DC pension schemes and the financial services firms that provide investment funds for them: the Prudential Regulation Authority (PRA), the Financial Conduct Authority (FCA), and the Pensions Regulator (TPR). Each regulator has different powers in terms of intervention and fines. In particular, while the FCA and TPR share the role of regulating DC pensions, the former appears to have much wider powers than the latter. Despite the memorandum of understanding (MoU) between the FCA and TPR in relation to DC pensions, this asymmetry in power might tempt providers of automatic enrolment pension schemes to 'choose' what they perceive as a 'regulation light' 'trust' structure regulated by TPR rather than the FCA. Furthermore, the level of fines the regulators can impose – even by the FCA – might not be considered punitive by firms. With regulators having to abide by principles of proportionality, fines may be treated as no more than 'the cost of doing business'.

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

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

1.4 Summary of Key Recommendations

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

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

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

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whistle-blowing duty to report poor practice to the regulators.

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

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

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

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

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

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

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on consumer rights should look at the impact of the proposed exclusions for contracts of insurance given the importance of unit linked products and financial transactions.

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

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

1.5 Background to the Key Recommendations

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

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

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

To establish strong and independent governance, it is recommended that an independent professional group of individuals look after the interests of the consumer in the principal-agent relationship with the fund's investment manager. This recommendation requires a

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

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

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

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

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

In order to give strength to the regulatory concept of treating customers fairly, it is recommended that investment managers are subject to the duty of a fiduciary in relation to retail investors. This would be separate from the existing fiduciary duty requirements of the governing body of the investment fund. This could operate in a manner similar to the way in which the US ERISA laws treat service providers of ERISA[18] plans (equivalent to DC pension schemes) as 'plan fiduciaries'. The Law Commission has examined the case for investment intermediaries to have fiduciary duties based upon the recommendations of the Kay Report.[19] The Commission has consulted on this and has concluded by recommending a strengthening of the regulatory requirements rather than a substantive change in the law, despite recognising that the law is complex, inaccessible and poorly understood. It has recommended a strengthening of the regulatory requirements including guidance for trustees and others on their duties and appears to have taken the view that an understanding of these duties by providing guidance to those responsible for governance should be sufficient. It appears to give insufficient consideration to the substantial influence and role that investment managers have in the investment management process and how that principal-agent role is accounted for, concluding that they can rely on the current regulatory structures to deliver good outcomes for investors. A fiduciary duty imposed on an investment manager creates different obligations that go beyond the regulatory requirements of treating customers fairly. For a fiduciary duty to

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[17] *The author was a member of the OFT's expert panel for its September 2013 market study on DC pensions*
[18] *Employee Retirement Income Security Act (1974)*
[19] *The Kay Review of UK Equity Markets and Long-term Decision Making, July 2012*

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take full effect in the complex UK investment market, it would be essential to consider a change in the law in the context of retail investors.

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

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

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

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

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

There may be occasions when an investor wishes to challenge an investment manager's conduct. In order to facilitate this right, it is recommended that the Law Commission's 2005 proposals on unfair contract terms legislation be implemented. The Law Commission recognised that consumer rights in this area were hard to understand because there were inconsistent overlapping pieces of legislation. It proposed a unified legislative regime that preserved the consumer protections afforded in the legislation and also proposed a strengthening of the legal grounds on which a consumer could bring a complaint. In particular, it argued that consumer contracts of insurance (which would include unit-linked funds) and contracts for the transfer of an interest in land and for the creation or transfer of interests in securities, should not be exempt under the unfair contracts legislation, as

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

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currently appears to be the case. It also proposed that the subject matter and price of a contract should be subject to challenge if it was substantially different from what a consumer could reasonably have expected. The Law Commission made further recommendations in 2013 and based on this there is a current Bill on consumer rights making its way through Parliament which consolidates the legislation in this area. However there continue to be exemptions in relation to contracts of insurance and other areas in financial services that may weaken the effectiveness of the proposed legislation and should be looked at in the context of the importance of unit linked funds which are treated as contracts of insurance.

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

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

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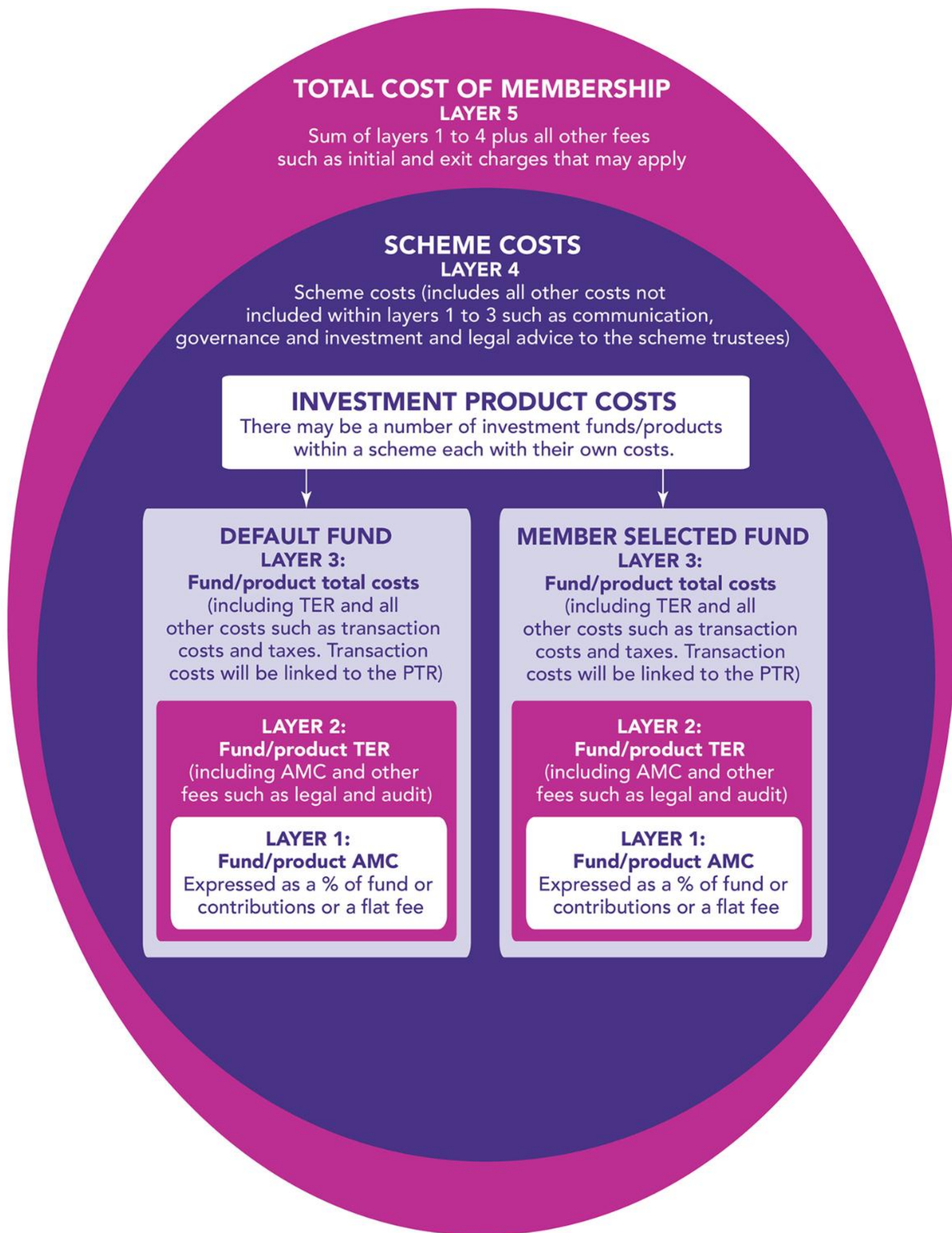

Figure 1 The different layers of costs and charges on a pension scheme prepared by the Pensions Regulator [21]

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

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2. The Importance of Costs and Fund Structures

Key Points

- Costs are an important determinant of investment outcomes
- Costs of investment funds are not well understood
- Investment fund structures are complex and not well understood
- Pensions play an important role in savings and use investment fund structures
- Funds can be offered as products by either investment managers or insurance companies, each of which can be quite different in the way they are managed, exploit investor biases and can have different outcomes for investors
- The product or wrapper an investor buys is not necessarily the format in which those investments are managed creating complicated layers of intermediation and conflicts of interest
- Pension products have historically been offered by insurance companies but the range of offerings has widened with other investment managers offering products with different implications for consumers

2.1 Why is the Panel looking at collective investment scheme charges?

The Panel is aware that a significant proportion of savings in financial securities and instruments in the UK retail market use collective investment schemes whether for pension provision or otherwise, as the preferred vehicle through which savings are made. Collective investment schemes are often referred to as 'funds' by the general public but these funds can be quite different in characteristic and in how they are regulated and therefore the term needs to be used with care.

There has been considerable interest recently in relation to costs and charges and whether these are operating fairly in the interests of consumers. The market study by the OFT in September 2013 noted the importance of defined contribution (DC) pension schemes in meeting government policy on automatic enrolment. The OFT highlighted its concerns about pension scheme members not receiving value for money and in particular it found that the buyer side in these pension schemes was one of the weakest it had ever seen. DC pension schemes predominantly use collective investment scheme products as their preferred structure for investing.

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These concerns have prompted the Panel to look more widely at collective investment schemes and how costs, charges and expenses are managed on them and how they are governed. The Panel's objective is to influence the development of more effective policy and regulation to protect the best interests of consumers.

It is perhaps useful to add a note on some commonly used terminology in the report (a glossary is also provided at the end of the report.) Some commonly used terms are explained below:

- Collective investment schemes refer to a number of structures that are sometimes referred to as 'pooled' investment funds or sometimes as funds. For our purposes in this report we have used the term in its broadest sense rather than limiting it to its statutory definition so that these can include unit trusts sold by an investment manager or a unit linked fund sold by an insurance company. The differences in these types of 'funds' can be important and are discussed later in this report. These funds can also be referred to as products or fund products. Fund products are a subset of investment products.
- Asset management refers to the act of managing assets such as financial securities in a pooled investment fund. Investment managers and Insurance companies both provide asset management services – but usually with different types of funds or products. These days the distinctions between investment managers and insurance companies has become more blurred as large asset managers provide both investment management and insurance through affiliated companies and can therefore offer products traditionally offered by both investment managers and insurance companies. General references to investment managers in the report apply to asset managers managing assets within investment management companies and insurance companies.
- Wraps and Wrappers typically refer to tax and regulatory structures through which investment funds or product can be distributed e.g. Pension schemes and investment platforms. Different investment structures that offer the same investment strategy but are structured differently because of regulatory requirements for different customers are also referred to as wrappers in the context of the discussions in this report. E.g. if a manager offers a UK equity investment strategy through a number of different structures such as an Undertaking for Collective Investments in Transferable Securities (UCITS), a Non UCITS Retail Scheme (NURS) and a Qualified Investor Scheme (QIS) then each is referred to as a wrap for that strategy as the investment management is likely to be aggregated for all those structures.

2.2 Costs are important

For most people, savings in addition to cash deposits and mortgaged property is generally achieved through investing in equities, corporate bonds and gilts. Some invest directly, but the vast majority use collective investment schemes ('funds'). The rationale is that these funds are managed by full-time investment professionals, who act in accordance with a predetermined investment mandate, dictated by the risk appetite and the time

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horizon of the investor. The asset manager typically pools the money of different savers into a single scheme from which the money and investments are handled collectively.

Institutional investors, such as pension schemes and insurance companies, also use collective investment schemes.[22] They are a good way for investors to pool resources and in doing so, achieve economies of scale that they would not otherwise achieve on their own. However as we will see later in this report – these economies of scale appear to operate more to the advantage of the investment service providers than to the investors.

In section 2.5 we look in more detail at the types of collective investment schemes but the primary definition of a collective investment scheme is set out in section 235 of the Financial Services and Markets Act 2000 (FSMA) which describes them as *"any arrangement with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income."*

Millions of people are not saving enough for retirement.[23] Collective investment schemes play an important role in long-term savings. It is therefore of fundamental importance that there is confidence in the products that are offered to the general public.

There is a growing body of research, which suggests that there are three critical factors that impact on the value of any savings product:

1. The amount and length of time for which it is saved;
2. The costs charged; and
3. The investment returns.

While investment returns are important – the costs charged represent a significant factor in determining the outcome of an investment. During the long equity bull markets of the late twentieth century, this issue appeared less important because the comparatively high levels of returns disguised the true costs extracted. More recently, falling markets, financial scandals, and the global financial crisis of 2008, have increased distrust of financial markets and drawn attention to the real costs of investment[24], lack of clear accountability and investment fiduciary responsibility, misperceptions of consumer protection, and also to the remuneration of managers and the management of conflicts of interest in financial services firms.

The CFA Institute 2013 report on Packaged Retail Investment Products said:

"*Among many retail investors, the impact of costs on investment returns is not well under-stood. Consequently, fees and costs are often overlooked or are not given sufficient weight*

[22] *There are also other types of funds used by institutional investors, such as commodity funds, hedge funds and other alternative classes of investment.*
[23] *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/261675/854summ.pdf*
[24] *This includes hidden costs, such as opportunity costs, which are discussed later.*

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in the investment decision-making process. Inadequate attention to costs can result in sub-optimal investment decisions or the selection of unsuitable products.

The importance of costs lies in the effect of compounding. Over long time horizons, fees, expenses, and other costs can significantly diminish returns as wealth is transferred from investors to intermediaries."[25]

There is a body of evidence that shows that apparently relatively small differences in charges can have a big impact on the value of savings over time. The DWP in their report - Reinvigorating workplace pensions, highlighted that an annual management charge (AMC) of 1.5% p.a. reduced a final pension pot by 22% after 40 years because of the lost compound growth potential whereas an AMC of 0.5% reduced the pot by 9%.[26]

It is important to note that investment transactions and related intermediation[27] are not costless and that it is entirely reasonable for these services to be paid for. It is also entirely reasonable for the businesses that provide these services to make profits. The purpose of this report is to understand and explain how the industry is organized and how these costs arise in order to make the process of charging for investment services more transparent and fairer for consumers.

However, transparency is unlikely to be sufficient on its own to ensure customers are treated fairly. A 2010 report commissioned by the European Union: Consumer Decision-Making in Retail Investment Services: A Behavioral Economics Perspective[28], concluded that the characteristics of the retail investment market may make consumer decisions particularly prone to biases and errors because of their lack of product knowledge and their lack of understanding of the inherent risks of the products. The report found that a wide range of products characterized the market with complex pricing structures. An online survey of 6,000 consumers in eight EU member states showed that consumers were often confused by the true nature of their investment products and that nearly 40% of investors in stocks and shares (wrongly) believed their initial investment was protected. Yet the impact of disclosing conflicts of interest to the participants was minimal and depended on the context in which the disclosure was made.

The financial services industry often responds to criticisms about costs by emphasizing that all that matters is performance. The industry argues that performance measures reflect the charges as results are usually quoted net of all costs. This response overlooks the significant conflicts of interest that may exist in relation to costs and the opportunity costs of lost income. Many consumers (and even advisers) do not understand the structures and 'wraps' in which these savings are placed and how these affect total costs. To be effective this sort of scrutiny would need to be performed by independent individuals or bodies whose role it is to represent investors' interests. The response also ignores the common practice for investment managers to disguise poor performance by merging older

[25] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2013.n10.1
[26] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214603/reinvigorating-workplace-pensions.pdf
[27] *Intermediation in this context means where different platforms may have been used to access a security*
[28] http://ec.europa.eu/consumers/archive/strategy/docs/final_report_en.pdf

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funds with newer funds, which makes it difficult for an investor to track the impact on their original investment.

The industry further argues – and it is supported by independent research, that the level of contributions could be the most significant factor affecting the outcomes of savings.[29] However, value for money is not and should not be dependent solely on the amount invested.

Risk is a key issue for retail investors as the investment management contract can be one sided. These agreements are not necessarily negotiated at arms length with the investment manager, and are skewed to the interests of the investment manager. The investment manager bears virtually no risk for making incorrect investment decisions while the investor bears all the risks for poor decisions and also pays significant fixed costs over the life of the investment to the investment manager. Industry argues that to present the risks as one sided is unfair because the industry is highly competitive and poor performance would result in a failure to attract and retain investments. It is true that assets under management can reflect investment performance success but there are also a number of other biases that come into play because of asymmetries of information and understanding that means a manager is able to continue to extract rents from the assets under their management despite poor performance.

These risks were illustrated in an example used by Dr.Chris Sier in a presentation to the Department for Work and Pensions (DWP) on what was wrong with pension costs[30]. Dr Sier drew an analogy between investment risks and the risks incurred when purchasing a fridge. I have extended that analogy:

i) The fridge comes with no guarantees on whether it is fit for purpose and can keep items cool,
ii) Although payment for the fridge will result in a purchase, the use of the fridge is dependent on additional running costs,
iii) The running costs of the fridge are linked to the value of the fridge in the market and increase if the value of the fridge increases, but
iv) It is not possible to ascertain all the running costs of the fridge,
v) The running costs may exceed the costs of purchase,
vi) These running costs will also be charged and received by the vendor and its associates,
vii) The customer cannot control or have any say on the nature of costs and charges incurred on the fridge and its upkeep,
viii) The vendor undertakes to provide the customer with regular information required by regulation on how the fridge is performing with reference to its value at the start and end of each year,
ix) Any attempt to change the fridge to another, perhaps better performing fridge, will result in the purchaser having to sell the fridge back to the vendor at a price the vendor determines and which includes extra charges payable to the vendor for

[29] *Pensions Policy Institute, 2012, Closing the gap: the choices and factors that can affect private pension income in retirement*
[30] *Dr. Christopher Sier, Slide Pack 26 November 2013, Better Workplace Pensions: Response to DWP Consultation on Charges*

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doing so; and

x) The vendor, if it so chooses, can call the fridge back at any time if it is no longer profitable for the vendor and replace it with another fridge with different terms and running costs.

Of course the example is stated in the extreme because it would not be possible for an investment manager to guarantee investment returns and the sales and purchases of investments to retail investors are regulated, but what it highlights is that the investor/purchaser carries all the costs and risks of purchasing the fridge/investment while the vendor/investment manager is positioned to benefit regardless of how the fridge/investment performs (so long as they are able to sell it), and can determine what and how much is charged as running costs and where even changing the fridge/investment carries financial penalties.

In such a market the incentive for the vendor is to sell as many fridges as possible, as each fridge provides certain income for the vendor. Competition is determined by the value the fridge retains at the end of each period with scant attention being given to the income generated by the vendor and its associates through the running costs of maintaining that fridge.

To carry the analogy a little further, the purchase of a fridge generally involves a number of factors – the brand reputation for reliability, a guarantee of performance for a specified period of time and the likelihood of service for a considerable period of time after the guarantee expires, consumer protections if the fridge is not fit for purpose, freedom to dispose of poorly performing fridges (albeit with a poor second hand value), energy efficiency and information on ongoing running costs and an opportunity to use these factors to assess whether a purchase would be good value for money. The difficulties in assessing value for money on investment products due to their lack of transparency on a number of these 'fridge factors' have made it more difficult for investors to differentiate between the offerings available.

The investment industry may argue that the rate of return is most important because that is what attracts money into their funds i.e. investors tend to buy performance history. But is that what motivates them to remain in the fund?

One line of argument is that so long as performance is adequate to remain within the bounds of a range of average returns produced by the universe of managers, and investor capital has not been noticeably eroded, the manager is then in a position to exploit other factors. These include the annuity-like nature of the income that fixed costs generate[31] and investor inertia which increases the likelihood that investors will do nothing in the face of apparently average returns.

It is possible to hypothesise that investors' attitudes towards funds might be explained in behaviour terms by the motivational theories that Maslow[32] and Herzberg[33] developed in

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[31] *Annuity in this context relates to the fixed and repeating nature of the charge that provides a regular stream of income to the manager*

[32] *Maslow A.H. (1943) A Theory of Human Motivation, Psychological Review, 50 370-396*

[33] *Herzberg .F (1968) One More Time: How Do You Motivate Employees, Harvard Business Review*

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relation to employee motivation at work. In investment terms Maslow's hierarchy of needs might include asset safety, risk or low volatility, adequate performance, respectable brand reputation, costs that are not out of line with other funds etc. Herzberg's hygiene factors come into play on this hierarchy of needs. So long as assets are safe and performance is adequate (satisfiers), investor inertia will prevail because of the emphasis on the long-term nature of investment, which suggests that the investor needs to be patient. Even in the face of losses, investors may remain optimistic and remain in the fund in the hope of recovering those losses. However a stream of bad news about a fund that affects asset safety or perceptions of risk, publicized losses, poor customer service such as mistakes made on customer instructions, may risk triggering Herzberg's hygiene factors and upsetting investor inertia causing the investor to withdraw their investments. In such a scenario, risks of loss and costs become an issue (a dissatisfier). Fund managers arguably exploit these behavioral biases by ensuring through fund closures and mergers and changes in investment personnel that performance is at least comparable to the averages in the industry, so as not to trigger any hygiene factors that would cause them to lose the annuity-like income stream they have captured through investment in their funds. Costs and charges therefore are important factors in an investment decision because of these biases that an investor might display.

Are there differences between retail and institutional investors in attitudes towards investments? Retail investors are arguably generally risk averse and do not want to see the capital they have invested eroded away. They do not appear to react to small differences in missed fund performance. Institutional investors and family wealth offices[34] often invest with institutional funds that have stated objectives of capital preservation and low volatility and are prepared to pay for those objectives. The rise of hedge funds was predominantly to cater for these needs of capital preservation and low volatility. Indeed some of the 'riskier' unleveraged institutional funds are probably 'safer' (at least in volatility terms) than some of the authorised retail funds that have 'long only' mandates and are therefore exposed to market risk and higher ranges of volatility.

Ricciardi explains investor inertia through biases they display including what he describes as "the anchoring effect". He believes that investor behavior is influenced through their perceptions of risk – heuristics. He describes financial decision makers as 'satisficers' and not 'optimizers'. This may help explain how in institutional investment management, career risk management can play a big part in the way investment decisions are made.[35]

The causes of retail investor inertia and inattention are perhaps most significant when it comes to examining why investors remain in funds despite high costs and charges. It may be that:

- capital invested does not appear to have eroded away,
- there is a reputable brand name,
- there are connotations of safety through regulatory wrappers,
- there is optimism that investing is a long-term strategy and

[34] *In the United States High Net Worth individuals can pool family assets for investment management*

[35] *Ricciardi .V (2008) Chapter 10 "The Psychology of Risk: The Behavioral Finance Perspective" in The Handbook of Finance, Volume 2: Investment Management and Financial Management Edited by Fabozzi F.J. John Wiley & Sons, Inc*

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- the generation of some performance draws attention away from costs.

In the face of this inertia, costs are a hidden erosive factor that disclosure alone will not solve. This inertia also helps explain why investors may not be as rational in their decision making as is assumed in conventional economic theory.

Reports by the Pensions Ombudsman and Financial Ombudsman Service suggest that the level of complaints around charges is very low. The Pensions Ombudsman reports that only 3.7% of the cases it deals with relate to charges and fees.[36] The Financial Ombudsman Service reports that only 3% of the cases it dealt with related to pensions and investments and of these it can only be assumed that complaints on fees and charges would be included in the 8% dealing with "other complaints" as they do not feature on their own.[37] This suggests that charges and fees do not feature heavily as an area of concern in the minds of the retail investor.

Costs, charges and expenses therefore need to feature as a major consideration at all stages of the investment product life cycle and should form the basis of any value for money considerations when investors, or others acting on their behalf and in their interests, review investment decisions.

The Cooper Review of the Australian Superannuation System (the Australian compulsory work based pension scheme) said costs were one of the guiding principles through which policy was developed:

"*Fees and costs matter; they detract from members' retirement savings and need to be managed as diligently as the generation of investment returns. Technological improvements, and innovation generally, should be encouraged to help lower costs and benefit members.*"[38]

2.3 Recent interest in costs and charges in investment products

The problems with costs in investment products feature regularly in the press. Prior to the financial crisis of 2008 the existence of bull markets meant that investment products were generally able to report levels of performance, which meant that an examination of costs charged to the products did not feature as a significant concern in the minds of investors.

Since 2008 with investment products facing difficulties and reporting poor performance, the impact of costs in those products have begun to be highlighted as an area of concern and a number of investigations in the media and by academics have highlighted the problems associated with the way costs in investment products are charged and disclosed to investors.[39]

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[36] *http://www.pensions-ombudsman.org.uk/Publications/docs/PO_AnnualReportAndAccounts_2013-14.pdf#zoom=100*
[37] *http://www.financial-ombudsman.org.uk/publications/ar14/about.html*
[38] *Cooper J 2010*
http://www.supersystemreview.gov.au/content/downloads/final_report/part_one/Final_Report_Part_1_Consolidated.pdf
[39] *Observer Newspaper campaign on costs 2010 and Which Magazine August 2010 are examples.*

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Although many attempts have been made at tightening up disclosure requirements on costs, these never quite succeed because elements of costs are excluded from the disclosure requirements. This has been a problem with transaction costs which have until now been largely excluded from disclosure requirements and which we will later see are one of the examples used in this report for why self-regulation has not worked.

UK government agencies have also investigated costs and cost disclosure, as have European regulators.[40] These investigations have led to regulatory reform through the imposition of disclosure requirements but it is by no means clear that these reforms have achieved the desired outcome of full disclosure and understanding on costs and charges.

There have also been a number of campaigns for disclosure of costs. These campaigns sometimes need to be understood in a wider context. An example is that of the True and Fair Campaign, which has undertaken valuable work in highlighting a number of failings in the disclosure of costs in investment funds and whose findings are quoted in this report. But the campaign needs to be understood in the broader context that it is sponsored by a firm that offers competing products in the form of exchange-traded funds (ETFs).

Interest in costs and charges is likely to remain following the 2014 budget announcements, as more DC drawdown fund products are developed. Income for the providers on these products will be delivered through charges.

2.4 The importance of collective investment schemes for different types of pensions

An important area of collective investment saving is through the use of these funds in pensions saving.

There has been a lot of research published recently on pensions as a form of saving particularly because of the government policy to introduce automatic enrolment of all eligible employees into pension schemes by 2018. Pension schemes often use forms of saving that are collective investment schemes. These collective investment schemes have been the subject of much examination in recent times but some of the conclusions made in relation to them can be fundamentally wrong because the structures are often misunderstood.

The Office of Fair Trading (OFT) conducted a market study on pensions which was published in 2013 (and updated in 2014)[41] and which resulted in the DWP issuing a consultation on charges. It is important to note that this was in fact the second report by the OFT on the subject. The earlier report published in July 1997[42] identified five causes of consumer detriment in DC pension products that were available to schemes at that time:

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[40] *The DWP conducts an annual survey on charges in defined contribution pensions schemes but the survey results are limited to charges that are disclosed and therefore do not address some of the issues that this paper tries to address on disclosure and conflicts of interest.*
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/281132/rr859-defined-contribution-pension-schemes-summary.pdf

[41] *http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/shared_oft/market-studies/oft1505*

[42] *Office of Fair Trading (1997) Report of the Director General's Inquiry into Pensions, Volume I, July.*

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- level and variability of investment returns;
- level and incidence of expenses;
- cost of purchasing the annuity;
- level of contributions that were sustainable, including the contribution that could be expected from employers in the current regulatory framework; and
- continuity and rate of growth in earnings.

In 1997 the OFT concluded that the resulting consumer detriment could be minimized or even eliminated if a set of proposals was adopted which included:

- passive management of fund portfolios,
- expenses fixed as a proportion of fund value with no hidden element,
- a structure which enabled economies of scale to be exploited and gearing in respect of individual consumers to be aggregated, and
- unbiased and objective recommendations on the levels of contribution needed for consumers of different ages and with different levels of accumulated savings.

Therefore the 2013 OFT report suggests that the causes of detriment have not changed in the last 17 years.

Moreover the latest OFT report (in both its original and revised versions)[43] concluded that the buyer side of the DC workplace pensions market was one of the weakest it had analysed in recent years. It attributed this to a lack of engagement and understanding by employees and employers in such schemes. This weakness combined with the complexity of costs and charges meant there was reduced competition.

The OFT noted that there were a wide range of charges which appeared small in percentage terms but whose impact was only felt over time.

Many of these charges were indirect and consumer detriment arose because of:

- poor comparability of charges
- lack of switching and the persistence of legacy schemes and
- two-tier charging structures.

Part of the problem here is the widespread misunderstanding about the different types of pensions schemes and their structures even by those involved in developing policy in these areas. Any policy development on pensions can only be carried out properly if the individuals involved in policy making and regulation understand the implications of these different structures. Because an understanding of these different types of pensions is central to our discussion a brief explanation is provided below.

[43] *Office of Fair Trading September 2013, Defined contribution workplace pension market study* http://www.oft.gov.uk/shared_oft/market-studies/oft1505

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The Investment Management Association set out the pensions landscape in the table below using some of the conventional short hand descriptions of the different types of pensions:

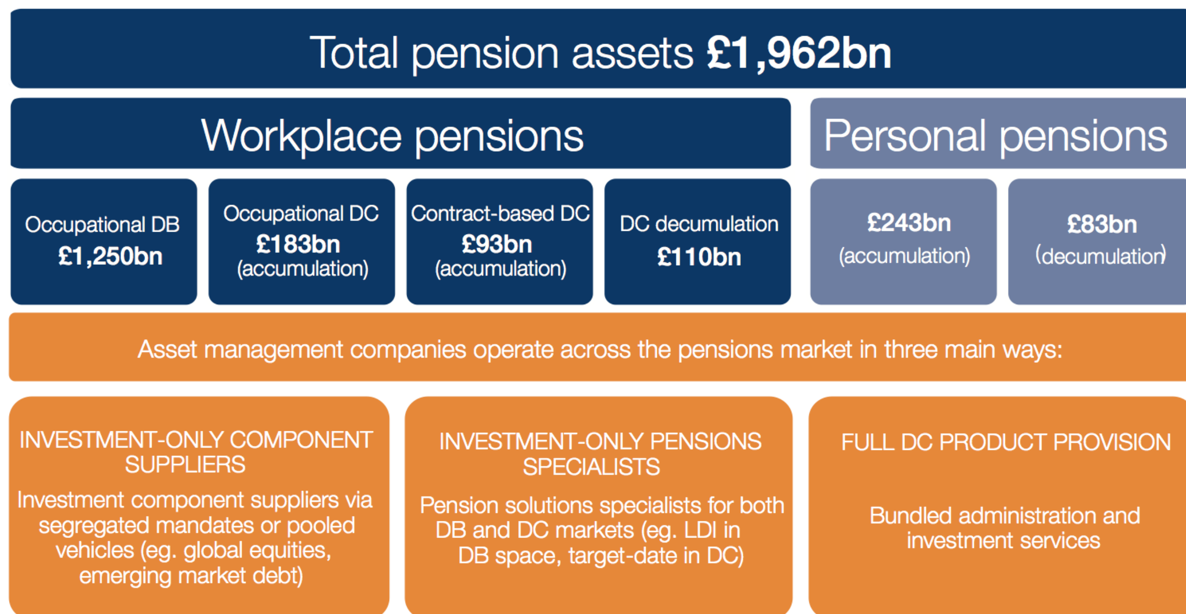

Figure 2 The UK Pensions Landscape[44]

At its most basic there are two types of pensions:

- Work based[45]
- Non Work based

Work based pensions are generally of four different types:

- Statutory (such as NEST and Local Government Schemes)[46];
- Occupational;
- Personal Work Based; and
- Stakeholder Pensions (These can in turn be of two types: Personal Work Based or Occupational depending on how they have been set up – most structure them as Personal Work Based Schemes)

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[44] *Investment Management Association – The Industry in Figures 2012* *http://www.investmentfunds.org.uk/research/ima-annual-industry-survey/industry-figures/*

[45] *Pensions Act 2004 defines what is a work based pension. This has now been replaced through common usage to references to 'workplace' pensions - but this term is technically incorrect.*

[46] *These pensions should not be confused with the State Pension – these are pensions arrangements set up by government under statute for employment-based pensions in the private and public sectors and can include unfunded schemes..*

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Non Work Based pensions are personal pensions and stakeholder pensions taken out by individuals and include self invested personal pension (SIPP) products.

Statutory and occupational pension schemes are generally one of two types: Defined Benefit (DB) or Defined Contribution (DC, also referred to as money purchase schemes)[47]. Personal, stakeholder and Non Work Based pensions are typically DC schemes.

DB schemes are gradually being phased out in the UK's private sector because the accounting, tax, regulatory and liability regimes are unattractive to most employers who need to carry these liabilities on their balance sheets and which greatly reduce their flexibility in carrying on business. There was initially less concern at a policy level on the costs of such schemes because employers underwrote these liabilities and costs, and ultimately the benefits due to a pensions saver crystallised regardless of the costs of the scheme. In other words, the employer carried the risk of the pension pot being insufficient to meet the benefits promised and therefore effectively underwrote that promise by being responsible for meeting the benefits guaranteed if there was a shortfall in the scheme.

DC schemes on the other hand are increasingly being adopted because the risks of these schemes are borne by the pension savers themselves and they invariably bear the costs of such schemes. The only responsibility that the employer has is to pay the amount of contribution that it has contracted with its employees to pay and to provide pension products to invest that money into. Employers and schemes were generally paternalistic towards their saving members. However with quasi-compulsion (because employees still have the right to opt out) and regulation being introduced into the equation there is evidence that many employers may be disengaged with their pension schemes and may seek to simply comply with their obligations at the least cost to themselves and if so, this is likely to result in greater detriment for pension savers who do not understand what they are being charged and what they are getting back in return for the investments they have made.

Government has also been looking at the introduction of Defined Ambition schemes (DA), sometimes referred to as collective DC schemes.

Understanding these different types of pensions is critical to understanding how they are structured, operate and are governed.

Statutory pension schemes such as NEST and local government schemes are created by legislation. Some such as NEST are set up as trust structures. The Pensions Act 2004 generally requires occupational schemes to be structured as trusts. The trusts will normally include requirements such as the appointment of member nominated trustees to ensure that the interests of beneficiaries are represented and not just those of the settlor of the pension trust – usually the employer. Personal Work Based pensions and Stakeholder pensions structured as Personal Work Based schemes can be set up in one of three ways:

- a trust

[47] *The Government is also considering the introduction of a third type of pension – the defined ambition pension scheme.*

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- deed poll[48] or
- contract

A deed poll is of course just a form of contract but it only needs one party to make the declaration whilst a contract would need two or more parties. The industry often describes Personal Work Based pension schemes in shorthand as contract schemes and occupational schemes as trust schemes, but as we can see above there are three ways that so called contract schemes can be created and therefore some of the generalisations that are made in differentiating between 'contract' and 'trust' schemes can be fundamentally incorrect. Indeed when it comes to 'contract' pension schemes – many believe that there is a contract that exists between the pension provider and the saving member. This is not always true. There are work based personal pensions where the only contract that the saving member appears to enter into is between them and the administrator to the scheme. That contract is simply for the administrator to receive the money deducted (contributions) and to apply it in accordance with the investment choices the saving member has made. The pension scheme member in such a scenario has no contract with the investment manager of the scheme or the investment product.

It is therefore important to recognise the inaccuracies that can creep into these common descriptions and to move away from the shorthand descriptions of 'contract' and 'trust' schemes and some of the automatic assumptions connected to them.

These differences are also critical to understanding how these different scheme structures are regulated and governed.

Generally it is understood that the Pensions Regulator (TPR) is responsible for 'occupational' schemes whilst the Financial Conduct Authority (FCA) is responsible for 'work based personal pensions'. That simplification is not entirely accurate. TPR in addition to its responsibilities for occupational pension schemes also has statutory objectives to protect the benefits under personal pension schemes where the payments are made directly by the employer or where the scheme is a stakeholder scheme. It also has an objective to exercise its functions to promote and to improve understanding of the good administration of work based personal and stakeholder pension schemes.[49]

Although TPR has these vital statutory objectives, it has arguably been given few powers to discharge those functions. The FCA discharges these functions to some extent, and there is a memorandum of understanding between the two regulators which sets out the way they have agreed to divide their responsibilities.[50] Importantly, TPR is powerless to intervene directly in respect of any detriment that might be identified in any authorised investment product that might be used in schemes, as these powers appear to fall within the domain of the FCA. TPR is only able to refer these issues to the FCA.

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[48] *These are creatures of history arising originally from HMRC requirements for registering a scheme for tax purposes, which held assets that were not insurance based products.*

[49] *http://www.legislation.gov.uk/ukpga/2004/35/section/5*

[50] *http://www.thepensionsregulator.gov.uk/docs/mou-fca-regulator.pdf*

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The regulatory structure is further complicated by the fact that consumer problems and complaints in the first instance are directed to the Financial Ombudsman Service[51] (FCA related cases) or the Pensions Ombudsman[52] (TPR related cases) and there can be gaps in coverage as has been recognised in pension liberation and 'unlocking' cases where consumers with DB pensions are persuaded to transfer to DC products.

The regulators also have to respond to evolving markets for the purposes of regulating pensions. For example the FCA introduced the concept of Group Personal Pensions or GPPs for regulatory purposes. GPPs are simply work based personal pension schemes. Similarly TPR have responded to the developing market in Master Trusts – Master Trusts are just occupational trust structures – the only difference being that Master Trusts can have more than one sponsoring employer. Responses to market developments require a high level of coordination between the regulators. For example, Master Trusts combine features that fall within the regulatory remit of both regulators and require joined-up policy making for effective regulation.

There is a significant difference in the nature of penalties and redress that TPR and the FCA can impose on firms they regulate when they identify any wrongdoing. Whilst in professional circles the FCA is regarded as having teeth, TPR's teeth are limited and appear to be rarely if ever exercised. The statutory limits on the fines that TPR can impose mean that the fines are small and are in many ways no more than just an inconvenient cost of doing business for those regulated in that space.

As you will see from Figure 3 – collective investment schemes feature heavily in all the different types of pension schemes as products for investment. But the type of pension scheme structure has a significant impact on how the collective investment scheme is dealt with in the pension structure, and because they are critically different in their form, have implications for the way they are regulated, governed and managed on behalf of members of pension schemes.

Once automatic enrolment has been rolled out to all eligible employees it is expected that even if only the minimum contributions required are made by employers and employees, the savings industry will receive additional annual flows of investment savings of between £7.7Bn and £11.8Bn based on the government earnings figures for 2012/13[53]. Even at the proposed Annual Management Charge (AMC) capped level of 0.75% per annum on the lower estimate of contribution flows - that would result in £57.7m of additional new income for the financial services industry each year from new pensions alone, and is therefore a lucrative prospect for the UK financial services industry.

Towers Watson in a study[54] entitled Global Pensions Assets Study 2014 estimated that the UK at the end of 2013 had US $3.2 Trn in pension assets representing 131% of GDP. DC assets however represented only 28% of the total assets. It is expected that automatic enrolment will change that proportion as more is invested in DC pension schemes.

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[51] http://www.financial-ombudsman.org.uk
[52] http://www.pensions-ombudsman.org.uk
[53] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223031/wpr_digest_0712.pdf
[54] http://www.towerswatson.com/en-GB/Insights/IC-Types/Survey-Research-Results/2014/02/Global-Pensions-Asset-Study-2014

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The FCA estimate that over £900Bn is invested in unit linked funds – another form of collective investment (for the purposes of this report) and that 85% of these funds (£765Bn) represent pension money.[55] This highlights the importance of products offered by insurance companies to pensions.

It is therefore clear that pensions are significant in any policy making in relation to collective investment schemes.

The DWP have published their Landscape and Charges Survey 2013: Charges and quality in defined contribution schemes.[56] The survey based on telephone interviews shows that the average AMC for work based personal pensions was 0.84% while the average AMC for occupational DC schemes was 0.75%. The difference in structures would suggest that there is less bargaining power for those in personal pension schemes and this imbalance needs to be corrected by ensuring that there is someone independent and not conflicted who is responsible for ensuring members receive value for money in work based personal pensions.

The problem with costs and charges is not unique to DC pension schemes. In April 2014 TPR launched its DB pension costs research and comparison tool and published the findings of research examining how DB schemes of different sizes are impacted by administration and other running costs. It found that nearly a quarter of private sector DB trustees could not identify what they were paying in investment charges even though these represented the second largest expense for such schemes. Small DB schemes paid nearly four times as much per member in running costs compared with large schemes.[57]

Finally there is one other important distinction in policy terms that exists between DB and DC schemes. DB schemes in addition to their investment activities are able to place reliance on the employer covenant and also have a provider of last resort in the form of the Pension Protection Fund. DC schemes have no equivalent protections. The members bear the ultimate burden of market risk. In such a scenario it is essential that policy makers do everything to limit unnecessary costs and charges as additional burdens on investors.

[55] http://www.fca.org.uk/static/documents/thematic-reviews/tr13-08.pdf
[56] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/281128/rr859-defined-contribution-pension-schemes.pdf
[57] http://www.thepensionsregulator.gov.uk/press/pn14-10.aspx

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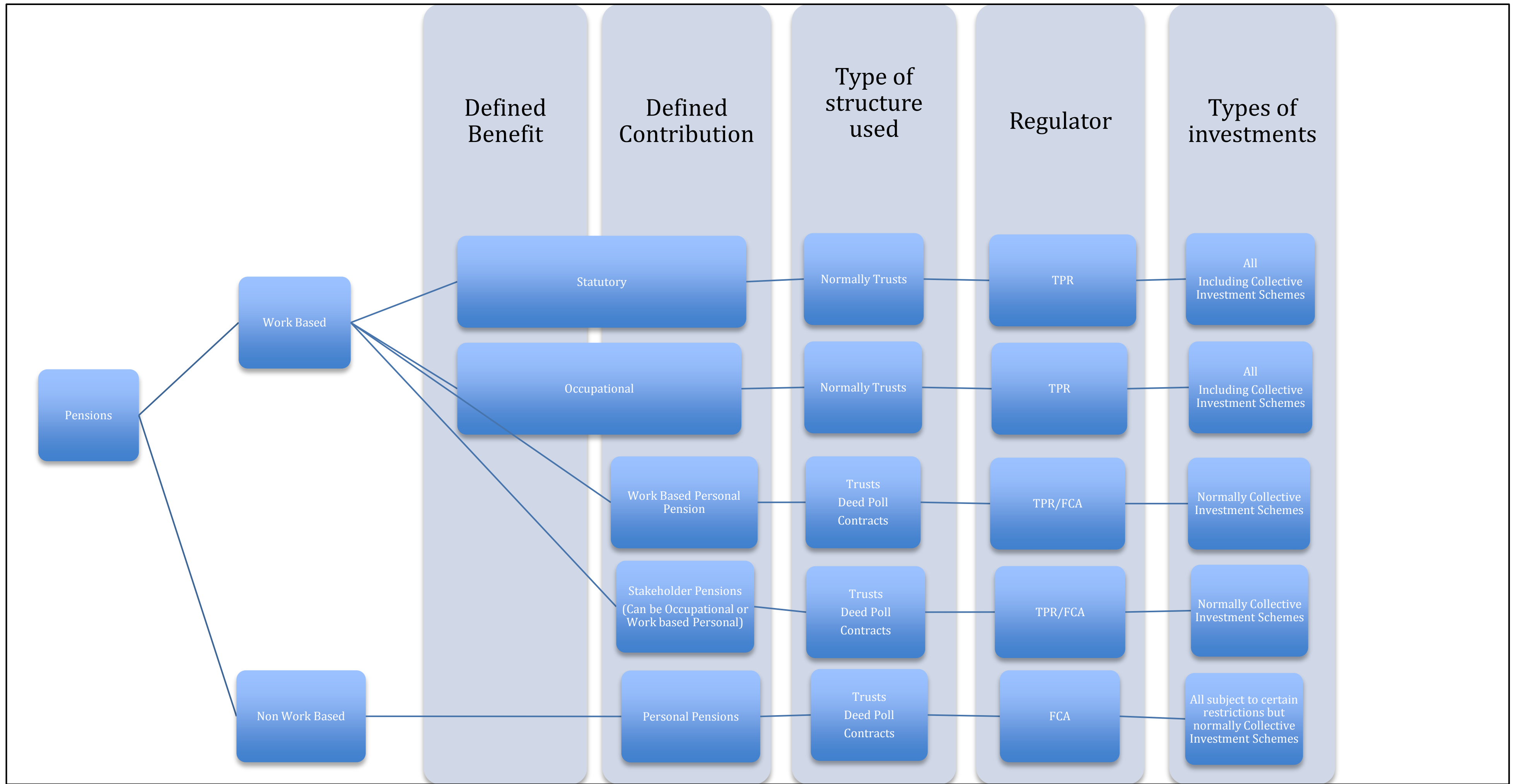

Figure 3 Summary of different types of pensions available in the UK and the importance of funds

2.5 The different forms of funds

As we have seen above – collective investment schemes (or more broadly, funds) are probably the most important savings product used for investment purposes by pension schemes and they are also the most important product used by retail investors when they wish to save through investments in financial securities – whether stocks and shares of companies or bonds issued by companies or governments or other forms of alternative investments such as property, commodities and derivatives.

There are two basic types of funds in the UK:

1. Those offered by investment managers
2. Those offered by insurance companies

The position can be muddied further with some investment managers having insurance subsidiaries and some insurance companies offering products typically offered by investment managers but the general rules that describe these two general types of collective investment saving still apply and are relevant to our discussion. This report deals with both basic types of funds.

2.5.1 Funds offered by investment managers

There are many different names used for funds offered by investment managers but typically these include references to investment funds, investment trusts, mutual funds, unit trusts, investment companies with variable capital (ICVCs) and authorised contractual schemes to name a few. Different regulations can apply to different types of funds although they are all forms of collective investment saving.

Similar to the problems we saw with the naming conventions for describing different types of pension schemes into contract and trust schemes there are anomalies in naming conventions with these types of funds. The most notable of these is the use of the term 'investment trust'. An investment trust is in fact not a trust but a listed company. This confusing nomenclature causes misunderstandings about the nature of the structure and the protections that might be available to investors. The trade association for investment trusts formerly known as the Association of Investment Trusts now refers to itself as the Association of Investment Companies and includes other structures such as Venture Capital Trusts.

Section 235 of FSMA[58] provides a definition of a collective investment scheme. This is a narrower definition referring to specific types of funds and excludes for example investment trusts but it is still relevant to our discussions.

[58] http://www.legislation.gov.uk/ukpga/2000/8/section/235

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The statutory requirements for the arrangements must be such that the persons who are to participate ("participants") do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.

The arrangements must also have either or both of the following characteristics:

(a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;

(b) the property is managed as a whole by or on behalf of the operator of the scheme.

In the UK the operator of a collective investment scheme must be authorised by the FCA. This authorisation is separate from the authorisation of the collective investment scheme.

The FCA through the Collective Investment Schemes Specialist Sourcebook (COLL) governs the regulation of some of these schemes.

Collective investment schemes in the UK regulated under COLL can be:

1. Undertakings of Collective Investments in Transferable Securities (UCITS); or
2. A non UCITS retail scheme (NURS), which can include funds of alternative investment funds, or umbrella schemes with sub-funds[59]. (These schemes are expected to become Alternative Investment Funds under the Alternative Investment Fund Managers Directive that comes into force on 22nd July 2014[60]); or
3. Qualified Investor Schemes.[61]

The first two types of schemes are those used as offerings to retail investors (but institutional investors also invest in them) whilst the third is a type of scheme used only by institutional investors (which for our purposes include investors described as high net worth and sophisticated investors).

UCITS have been one of the most successful ways of distributing fund products in Europe because they can be sold across borders in Europe and they enjoy recognition in many non EU countries. Carne Global Financial Services Ltd has estimated that UCITS funds accounted for assets of US$5.6Trn at the end of 2011. It has estimated that almost 70-80% of publicly sold funds in Asia were UCITS.[62]

UCITS schemes can be of a number of types – they can be investment funds or exchange-traded products such as exchange-traded funds (ETFs).[63]

The arrangements in the collective investment scheme can take the form of a contract, or

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[59] *Umbrella schemes are not restricted to NURS structures and can be found in other scheme structures too.*
[60] *Note that alternative investment funds will not need authorisation under AIFMD but the manager will need to be authorised. Qualified Investor Schemes are also expected to become part of the AIFMD regime.*
[61] *http://fshandbook.info/FS/html/FCA/COLL/1/2*
[62] *Carne Global Financial Services Ltd, UCITS Guide for Alternative Managers, A guide for investment managers, promoters and distributors for establishing UCITS funds*
[63] *The FCA produce a useful fact sheet on ETFs http://www.fsa.gov.uk/static/pubs/other/etp-factsheet.pdf .*

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they can be arranged through trusts, companies or partnerships set up for the purpose.

The fund structures that are used by schemes are:

1. Unit Trusts
2. Open Ended Investment Companies (OEIC) (also referred to as Investment Companies with Variable Capital – ICVC in the UK context)
3. Closed Ended Investment Companies (also referred to as investment trusts)[64]
4. Funds or pooled assets that are not wrapped into a structure but are co-owned by the participants – (referred to as Authorised Contractual Schemes, they can be of two types: co-ownership schemes and limited partnerships. They are tax transparent i.e. any income or capital gains are treated as if they were in the hands of the investor. Accounting for interests within them may however be done on a unitised basis as with unit linked funds).

The primary advantage of closed ended investment companies are that they provide permanent pools of capital as any trading of the shares occurs in secondary markets as investors have no redemption rights on the shares they hold. Listing these vehicles therefore becomes an important aspect because that is how investors can access these investments and realise the value of their investments when they wish to exit from the investment.

There are also other structures that are forms of collective investment, but which are covered under different regulations such as investment trusts, venture capital trusts (VCTs) and investment is also possible into unregulated collective investment schemes (UCIS) although not through offerings to the general public in the UK. Pension schemes and insurance companies are able to use UCIS for investment purposes subject to certain restrictions, such as the application of rules on permitted links.

2.5.2 Funds offered by insurance companies

In the UK, statistical information from the FCA suggests that insurance companies to date have generally offered the most pension savings products – usually in the form of unit linked products.[65]

This appears to be a legacy of history. Pensions were originally designed as insurance products because of two characteristics that they had. Firstly they were generally defined benefit schemes where the employer undertook to pay a defined benefit in the future, for the duration of the life of the employee. Secondly the nature of the benefit was an annuitized stream of income for the life of the beneficiary. Managing these two characteristics fell naturally towards businesses that provided insurance.

Defined contribution products came into existence as employees sought to top up benefits (additional voluntary contributions or AVCs) and these top up arrangements were usually

[64] *Note that Investment Trusts are not regulated through COLL.*
[65] *http://www.fca.org.uk/static/documents/thematic-reviews/tr13-08.pdf*

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provided through existing providers to pension schemes. These providers tended to be insurance companies.

The number of employers offering defined contribution schemes is increasing and other providers are entering the market, which was dominated by the insurance companies. However, insurance companies appear to have continued to provide the bulk of products to service these schemes in the form of unit linked funds.

Although these products are referred to as funds (and are often confused with the pension fund which is a separate structure – it helps to call it something different such as a pension scheme) they are in fact not funds but pooled contracts of insurance. They are also known as life funds or insurance funds. However, they are managed as if they were unitised funds (sometimes referred to as unit-linked funds) and the regulator does not regulate these schemes through its COLL source book but instead regulates them through a different set of rules referred to as the Conduct of Business Sourcebook (COBS) (Rules 19, 20 and 21). In fact COLL exempts from its regulations, pooled arrangements, which are in respect of long-term contracts of insurance.[66] In COBS such pooled contracts of insurance are referred to as linked long-term contracts and in particular COBS 21 deals with permitted links – i.e. the types of investments that are permitted in linked long-term contracts of insurance.

As the market for financial products has expanded some insurance companies have also begun to offer mutual fund products i.e. as funds similar to those offered by investment managers, but the predominance of products are linked long-term contracts of insurance so this classification has been used to distinguish the two broad groups.

These distinctions are vital to understand because they fundamentally change the nature of the investments, the ownership of the assets and how they are managed. The implications for investors in how their interests are looked after are therefore quite different from funds managed on their behalf by investment managers, if the investments are in unit-linked products.

2.6 The impact of automatic enrolment into pensions on the savings industry

The Investment Management Association in its 2012 survey estimated that the UK manages investment fund assets of £1.4Trn of which £660Bn are in UK authorised investment funds (66% of UK authorised funds are classified by the IMA as retail funds). It also estimates that the value of pension assets in the UK was £1.9Trn. (See Figure 2.)

Based on the FCA estimate that £765Bn is invested in unit-linked products used in pensions, it is fair to assume that a significant portion of investment savings use funds, whether through UK authorised investment funds or UK unit-linked funds.

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[66] *There are other collective investment schemes that are also excluded from regulation through COLL such as investment trusts.* *http://www.legislation.gov.uk/uksi/2001/1062/schedule/made*

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On the basis that £7Bn to £12Bn is expected to flow into DC pensions each year once automatic enrolment has been fully implemented by 2018, the size of the asset management industry and significance of funds is going to grow dramatically.

There is already evidence that a number of investment houses are putting together dedicated teams to deal with expected inflows of capital and those firms that are successful in attracting this capital stand to capture significant flows of income. It is imperative that a market that has been created by government policy to be applied on a quasi-compulsory basis over savers is seen to operate fairly and to the benefit of those consumers who have been automatically enrolled in these products.

There is therefore an urgent need to address the unfairness in the market that has been identified by many commentators on the industry and which is supported by the evidence in the reports prepared by the Office of Fair Trading on the Defined Contributions Pensions Market in the UK and the Kay Report commissioned by the Department for Business Innovation & Skills.

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3. Management of Funds, Costs, Charges and Expenses

Key Points

- The two models for managing funds whether by investment managers or insurance companies have significant and different implications for consumers
- Complex structures driven by tax and regulation make costs and charges difficult to track through different layers of intermediation. The existence of conflicts of interest and opacity of costs enables exploitation of investor biases
- Investor information and reporting appears to be designed more for the convenience of the investment manager and requirements of regulation rather than the needs of investors
- There is insufficient management of the conflicts of interests by investment managers; weak governance models can mean that managers are not challenged sufficiently in relation to their actions
- Transparency of costs and risks provided to investors is generally incomplete and difficult to use for decision making

3.1 The basic model of the asset management business

Asset management is a service provided by investment managers and by insurance companies. The investment management model and the insurance model for asset management are the two basic models but they operate quite differently and can have quite different implications. As markets for financial products have expanded, investment managers and insurance companies have started to use both models in their business structures. So investment managers may have an insurance subsidiary and insurance companies may offer mutual fund type products that would typically be offered by an investment manager. This means that distinctions can get blurred but the broad classifications of these two models holds good with asset managers using regulatory and tax considerations to determine how products are offered within these two models.

3.1.1 Asset management by an investment manager

Asset management has a very simple business model. The asset manager gathers money from savers whether consumers or institutions. This money is pooled into investment structures (funds – which as we saw earlier can be structured in a number of ways) and these structures are normally separate from the investment manager's business.

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The investment manager manages these assets in accordance with an agreed investment management mandate, which provides the parameters within which they must operate, but which in reality is usually very broad providing them with a wide range of discretion.

The investment manager charges a fee for its services. This is usually a fixed fee that the manager is able to take regardless of the returns it is able to generate for investors. This one single fact makes the primary focus of any asset manager its asset gathering ability. Its success as a business is driven primarily by the amount of assets it has under management as the bulk of the income it generates is a fixed fee from these assets. Sometimes this is referred to as rent extraction on the capital. Managers argue that investment performance is what attracts investors to their funds but research on investor biases and inertia suggests that this is not necessarily what causes them to remain in the fund.

The manager usually provides no guarantee on the returns that might be generated by it. Sometimes the manager also takes a fee for the unguaranteed returns they generate – referred to as a performance fee.[67] The market has offered guaranteed products[68] but these are generally viewed as being too expensive.

Many retail investors and even some institutional investors incorrectly believe that these disclosed charges are the only charges they pay on their investments.

However the investment manager also incurs costs for conducting its investment management business and the investors are usually required to agree[69] that the investment manager can charge many of the costs of managing their pool of money directly to the investment structure. i.e. they can charge it to the investors. Investors often do not understand that these charges are being made. Costs relating to the running of these collective investment schemes can be charged directly against investors' assets such as audit, legal, custody, trading costs and dealing commissions and the costs of governance.

In theory the manager is supposed to pay the costs of running its own business and to bear its own costs such as property costs, costs of employees and research to conduct its investment management business. As we will see later these distinctions can blur and even some of these costs can indirectly be borne by the investor.

3.1.2 Asset management by an insurance company

Funds offered by an insurance company are normally sold as 'unit-linked' funds.[70] Unit-linked funds have a very different structure from funds offered by investment managers.

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[67] *These may or may not be over a stated target – sometimes referred to as a hurdle or hurdle rate.*
[68] *These products can combine insurance policies and structured products using derivatives and other forms of financial engineering*
[69] *By signing the investment application forms or subscription documents*
[70] *These can include unitised with-profits funds*

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The money that an investor pays into a unit-linked fund is treated as the payment of a premium to the insurance company for a long-term contract of insurance. Each payment made is technically a payment of premium that the company then owns and it is therefore income that it has received in return for making a promise to provide certain benefits.

Upon receiving the money (the premium), the insurance company takes on an obligation to pay the investor a sum of money on the occurrence of an event – usually the investors' retirement. However there are a few complications attached to the payment of this sum of money – firstly, how does one calculate how much this sum of money should be and secondly, what would happen if the insurance company did not have the assets to pay that sum of money?

In order to deal with these complications the FCA and the PRA have a number of rules to ensure that insurance companies 'match' their liabilities with appropriate assets and that they maintain a minimum amount of capital.

The matching of liabilities is achieved by creating virtual investment funds similar to the ones we saw in the asset management model used by investment managers – where money is invested in funds and the value of those funds is tracked and determines the benefit payable to the investor by the insurance company. These virtual funds are referred to as unit-linked funds. However the assets in these unit-linked funds are owned by the insurance company and not the investor. The insurance company can also charge fees against these funds, which are in effect the amount of money that the insurer can take out to reduce the liability it has to match. These fees are disclosed to investors. However the insurance company has the discretion to do a number of things that affect the value of the units and these operate in the same way as a charge would because they reduce the value available to the investor in that long-term contract of insurance and provide a method by which the insurance company can 'extract' the value of income it has received from investors.

From a business perspective therefore the insurance company treats the entire amount it receives as its own and there are accounting rules that determine how it can treat this income by reflecting what the embedded value of that insurance company is. The insurance companies provide governance on these schemes. It is their proprietary capital.

This has a number of implications for the way unit-linked funds are managed in the interests of the investors. The OFT in its 2013 report on the defined contributions pensions market recommended the setting up of an independent project board to conduct a review on legacy (pre-2000) unit-linked products used in pension provision to ensure that customers had been treated fairly. They also recommended the establishment of independent governance committees for each provider to oversee the activities of the insurance companies managing these sorts of products.

The implications in relation to the management of unit-linked products are not restricted to the UK. In 2013 there were press reports in relation to a ruling by the Dutch Supreme Court that customers of Koersplan unit-linked products paid excessive premiums on products sold between 1989 and 1999. Aegon NV the insurer was reported to have been

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ordered to pay £34m in compensation for overcharging 30,000 of its customers for unit-linked products.

3.2 Regulatory structures and the concept of a 'wrap'

Regulation affects the way funds are offered to different investors such as the retail public. As we have seen from the two business models above – the priority for the asset management businesses of investment managers and insurance companies is to gather assets. It does this by offering a variety of funds to the market that target each segment that it is able to offer products to.

The products are methods or vehicles through which investor money is collected and in respect of which reports are produced for investors. They are generally not managed as separate entities. Many managers of investments would not recognise these wrappers although the back office and marketing staff would. Managing investment products by wrapper would make asset management too cumbersome. Aggregating the wrappers for investment management is more efficient and generally makes more economic sense. But the aggregation whether for order execution or handling creates layers of intermediation with cost and governance implications.

Because of the different rules that apply to each regulatory structure and how it is marketed, it is necessary for the investment managers and insurance companies to set up structures that comply with these requirements even though in reality the investment manager may not manage the investments at the level of that structure. That is why these products or marketing structures are often referred to as 'wraps'. A wrap is something that is created for regulatory purposes and does not necessarily reflect how the fund may be managed for investment management purposes. E.g. an asset manager may have an investment management business and an insurance business. The investment manager may offer a UK equities small cap long only investment strategy through a UCITS and NURS structure for its retail and institutional investors a QIS structure for only its institutional investors and through its insurance/life subsidiary a unit-linked fund for its pension investors. When an investment decision is made on that strategy it is likely to be applied to all 4 structures on an aggregate basis and then allocations will be made to each structure in respect of that transaction for accounting and valuation purposes. These 'products' or structures are effectively wraps for that investment strategy.

Specialist investment managers therefore manage these pools of aggregated money (risk capital). These managers may often have little interest in the various wrappers through which investors have made their investments, as their sole interest will be in the aggregated pool of risk capital for which they have responsibility and there will be automated software programmes which will help allocate the trades they execute to the various accounts that comprise the total 'risk capital' being traded.

Management of the wrapper is a job for the sales and marketing teams that face the retail investors and for the middle and back office administration teams that then allocate profits and losses back to each wrapper.

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Financial services use industrial terminology for describing their processes. The process of gathering the money in by the investment manager is referred to as “distribution” and the creation of the wrappers to enable that distribution is referred to as “manufacture”.

Because these wrappers are a means to an end, the industry often does not focus on issues at the wrapper level although a lot of the regulation sits at the wrapper level.

3.3 European and UK Regulation of retail financial products

European and UK regulations have primarily focused on the provision of transparency on the structures used for distributing retail investment products.

Europe deals with offerings through funds to retail investors as packaged products and refers to them as Packaged Retail Investment Products (PRIPs). This is how the Europa website describes them:

“*The retail investment market is largely dominated by “packaged retail investment products”. These provide retail investors with easy access to financial markets, but can be complex for investors to understand. Those selling these products can also face conflicts of interest since they are often remunerated by the product manufacturers rather than directly by the retail investors.*

A complex patchwork of regulation has grown up to address these risks, and inconsistencies and gaps in the patchwork have raised concerns as to the overall effectiveness of the regulatory regime, both in relation to its capacity to protect investors and its ability to ensure the markets work efficiently. These concerns have been further heightened by the impact of the financial crisis.”[71]

In order to address these concerns the European Union has come up with a series of proposals, which include simplifying disclosure of information to investors and how insurance investment products are distributed.

The FCA publishes its own areas of focus, based on its perceptions of risks in the market. It has published its Risk Outlook for 2014[72]. There are a number of areas it has identified that have a direct impact on outcomes for retail savings products. In particular:

- Information asymmetries
- Structures and business conduct features
- Conflicts of interest
- Culture and incentives and
- The growing importance of financial capability

[71] http://ec.europa.eu/internal_market/finservices-retail/investment_products/index_en.htm
[72] http://www.fca.org.uk/static/documents/corporate/risk-outlook-2014.pdf

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A number of forward looking focus areas have been identified by the FCA as creating risks to their objectives and which impact on the concerns expressed in this report, including technological developments, poor culture and controls, large back books leading firms to act against their existing customers' best interests, retirement income products and distribution delivering poor consumer outcomes, and complex terms and conditions.

These concerns will influence how regulation develops in relation to retail products.

3.4 Tax structures

For tax purposes, our fund structures are of two main types – they can be tax transparent or tax opaque.

A tax transparent scheme is one where investors are treated as if they had invested directly in the underlying assets of the scheme and are taxed personally on any income or gains with no tax being imposed at the level of the structure. Authorised Contractual Schemes would be examples of tax transparent structures.

Tax opaque structures are where the structure itself is taxed without regard to the taxable circumstances of the underlying investors. Examples of opaque tax structures would be unit trusts and investment companies with variable capital.

UK pension funds are generally not liable to UK tax on their income or gains although some withholding taxes such as on dividends may be unrecoverable. Non pension funds will be taxed on taxable income and gains. This can influence how a fund is 'wrapped'.

UK investors investing in funds that are based outside the UK need to consider other factors. For example, to only invest in those schemes that have "distributor status" otherwise HMRC taxes any capital gains on those funds/collective investment schemes as if it were income in the hands of those investors. This can have significant consequences for UK investors. UK authorised collective investment schemes can also have other tax advantages.

Managers prefer to manage assets on what is referred to as a tax neutral basis. i.e where they do not need to factor in considerations around taxation. That is why for example insurance companies will sometimes use offshore funds to manage their investments because they do not need to worry about the tax implications if the fund is located in a 'low tax' or 'no tax' jurisdiction. Although the fund may technically be located offshore it is still managed within the UK. These tax neutral vehicles are designed for use by institutional investors but in reality could be aggregating retail investors' money such as through unit-linked products used for pensions. For example within Europe, investment managers like to launch UCITS registered in the Channel Islands, Ireland or Luxembourg for these reasons even though the money is actually managed within the UK.

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Unit-linked funds can also offer various tax advantages and add other complexities. Consultants are often used to advise on appropriate structures for pensions and other types of investments.[73]

Tax has had a profound impact on asset management. Income is generally taxed at a higher rate than capital gains. This creates incentives and focus on value generated through increases in capital value rather than generation of income. Policies around tax such as the taxation of dividends, interest, overseas domiciled investment holdings, tax breaks and tax zones have had a major impact on capital raising, domicile of investment structures, investment strategy, investment products and pension provision. There is also a greater focus on exit strategies for investors such as private equity where capital value as a measure of success can be important. Tax has significant international dimensions too and the existence of double tax treaties can make a huge difference to how an investment is structured and the outcomes on it.

Tax has profound implications for the governance of investment structures too. For example UK investment managers managing UCITS funds that are domiciled outside the UK can create risks for the taxation of the fund, if the directors on that fund are UK domiciled for tax purposes, because the tax domicile of the director and where decisions are taken, can change the tax domicile of that fund. Where a fund has directors that are UK domiciled for tax purposes, the manager needs to ensure that they do not form the majority of directors on a board so as not to impact the 'offshore' tax status of the structure they govern.

Hence tax and its complexities can influence the type of structure selected for the investment management of funds and where the fund is technically located for tax purposes, even if the investment management is done in the UK.

3.5 Differences in the management of products

We have already seen that investment managers and insurance companies are fundamentally different in the way they treat investor money.

The investment manager will usually use the different fund structures discussed earlier. Each fund structure has technical implications for the investment manager. The structure used will for example have implications for how it is governed, as these structures will be separate from the investment managers' businesses. However in reality the investment manager will manage these products as if there is no separation between their business and that of the structure. The separation is technical in nature but not necessarily in reality. For example there may be no requirement to appoint a majority of directors on the investment fund who are independent of the investment manager. Indeed the investment manager will often use their own employees and ex-employees to act on the fund boards and a single director may act on a number of the structures across the manager's entire fund range. This simplifies their processes by taking advantage of the scale benefits that

[73] *Hymans Robertson LLP report for Vanguard (2011) Fund structures for pension funds: Traditional insurance (life) funds may no longer be the most compelling solution*

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having the same people provides. However this can also create conflicts of interest as a director acting on several funds for an investment manager may be unlikely to provide meaningful challenge if it affects their appointment as a source of income or indeed in terms of their careers if they happen to be an employee of the manager. Corporate trustees can face similar conflicts of interest.

Whatever the form of the structure, it is more important to look at the nature of conflicts of interest in the governance provided. Whether trusts or companies are used, governance is sometimes also provided through a corporate entity connected to the investment manager – this could be a corporate trustee or an authorised corporate director for example. The corporate entity is usually a subsidiary of the investment manager and the individuals acting on those boards will tend to be people connected to the investment manager. This status quo is slowly starting to change with some managers seeking to have independent representation that forms the majority on a board – although this may be in the form of an ex-employee, a known 'safe pair of hands'. The directors and trustees of these funds will assume non-executive functions and will typically delegate the day-to-day management of the funds to the investment manager. The effect of this is that there may be little or no challenge to the investment manager about the decisions it takes over these investment vehicles.

The duty of those charged with governing whether as trustees or as directors is essentially that of a fiduciary. But the reality can be that because of the inherent conflicts of interest that can exist in these structures, and accepted market practice (such as individuals having multiple appointments on a manager's fund boards) little may get challenged. The implications are significant because these funds pay a variety of costs and the manager may be more casual towards charging an expense to a fund than they would if that expense was to be charged directly to the investment management business.

The FCA conducted a review of asset managers and how they managed conflicts of interest in November 2012 and noted that "*[f]irms regularly spend millions of pounds of their customers' money buying research and execution services from brokers. Only a few firms [they] visited exercised the same standards of control over these payments that they exercised over payments made from the firms' own resources*." [74]

The reasons for this appear to be because of the inherent conflicts of interest. The FCA has taken a much tougher stance since then, requiring the CEOs of asset management firms to confirm that they have proper processes in place to manage conflicts of interest by providing a written attestation that their firm's arrangements were effective and compliant with FSA rules. In late 2013 Clive Adamson, the FCA Director of Supervision stressed to the FCA Asset Management Conference in London what the FCA meant when he said that investors placing their trust in a firm to act on their behalf should have a reasonable expectation that firms would act in a fair way and in their interests which included an expectation "*that asset managers spend their clients' money as though it was their own and manage costs with as much tenacity as they produce returns*"[75]

[74] http://www.fca.org.uk/static/pubs/other/conflicts-of-interest.pdf
[75] http://www.fca.org.uk/news/fair-transparent-and-competitive-the-fcas-vision-for-the-asset-management-sector

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Insurance companies offering unit-linked funds do not need to establish the same governance structures of the sort that an investment manager is obliged to have on their funds although they do have a duty as authorised investment businesses to treat their customers fairly. For example firms need to consider whether a with-profits committee is appropriate for the particular fund or funds they manage, with regard to the size, nature and complexity of the fund in question.[76] Insurance companies can reinvest the money or reinsure the products – they may use similar funds to those used by investment managers but when they make these investments – they do so on their own behalf and not on behalf of investing savers. The money invested in those products belongs to the insurance company – not the saving investors and so the investments do not necessarily have regulatory requirements that would apply to retail investments. Insurers can also offer exposure to other insurance firms' unit-linked products. They do this through a process referred to as reinsurance. Reinsurance does not remove the obligation to ensure that customers are treated fairly.

In October 2013 the FCA conducted a review of the governance on unit-linked funds by looking at a sample of 12 insurance firms.[77] The results of the review were curious because the review concluded that it had found no material issues, yet it required the appointment of skilled persons under s166 of FSMA for serious deficiencies it had identified in respect of three firms - i.e. a quarter of its sample in respect of the way unit prices had been determined on the grounds of fairness and accuracy. It went further and stated that 50% of the sample it had looked at did not fully consider specific unit-linked conflicts of interest even though potential conflicts did exist. Nearly half of the sample was identified as being able to make improvements to their valuation processes for unit-linked funds. Just under half the sample needed improvements in the way they apportioned tax consistently across their funds and fair treatment of losses. However it found that except for one firm, its sample had appropriate governance arrangements, which considered unit-linked funds in sufficient depth and granularity!

We do not know if the sample of 12 gave statistically significant results for the FCA but deficiencies in respect of nearly 50% of the sample and serious deficiencies in respect of 25% of the sample might justify re-examination of the conclusions of that review over the universe of firms offering these products.

Unit-linked products, because of their nature offer a wide range of discretion to the insurer in how they are managed. This is significant in relation to costs charged against these products, which has an impact on their overall value. It is therefore worth devoting a section to unit-linked products in their own right.

It is also worth noting that the Investment Management Association in the UK has merged with the Investment Affairs Division of the Association of British Insurers in June 2014 in order to give them a single, stronger more coherent voice.[78]

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[76] *http://www.fca.org.uk/static/documents/policy-statements/fsa-ps12-04.pdf*
[77] *http://www.fca.org.uk/news/tr13-8-the-governance-of-unit-linked-funds*
[78] *http://www.investmentfunds.org.uk/press-centre/2014/press-release-2014-04-11/*

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Earlier in 2014 concern was expressed that MIFID II, which impacts on collective investment schemes such as UCITS, was being used to regulate insurance products when the proper way was through the European Insurance Mediation Directive (IMD).[79]

What it shows is that regulators are increasingly starting to view the two types of products – those distributed by investment managers and those distributed by insurance companies - as being similar although the use of MIFID II, it was suggested, was because IMD II was moving too slowly.

3.6 Unit-linked funds

The ABI published a consultation in relation to proposed changes to its ABI Guide to Good Practice for Unit-Linked Funds in March 2014.[80] A revised guide was published in May 2014 to respond to the FCA's findings from its thematic review on the governance of unit-linked funds. Firms have till December 2014 to review their operations and begin "making progress towards following them" which suggests there is no firm deadline for changes to be implemented.[81]

This guide is perhaps the most important document in describing how insurance companies in the UK manage unit-linked funds. The guide states that it has been prepared recognising that there is currently no detailed set of rule requirements placed on unit-linked fund managers.

Section 2 of the guide covers the scope of governance at Board level for the insurance company – it does not appear to currently reflect the OFT recommendations for independent governance committees.

Section 3 deals with fund launches, mergers and closures. It lists a number of reasons why mergers and closures might occur including operational considerations, corporate changes, governance reasons, external corporate actions, small fund sizes leading to high total expense ratios for policy holders and lists the considerations that need to be taken into account. There is a requirement for firms to ensure policyholders are treated fairly in exercising discretion.

Section 4 of the guide deals with fund operations including the exercise of discretion, and its opening statement in the section dealing with the use of discretion is that where discretion is exercised 'it is very important to ensure that the firm treats its customers fairly'. It then lists the areas where discretion may be applied:

- Allowing for dealing costs

[79] http://www.out-law.com/articles/2014/january/mifid-not-the-right-place-to-regulate-sales-of-insurance-investment-products-says-expert/

[80] https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2014/Conduct/Consultation%20ABI%20Guide%20to%20Good%20Practice%20for%20Unit-Linked%20Funds.ashx

[81] https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2014/Conduct/ABI%20Guide%20to%20Good%20Practice%20for%20Unit%20Linked%20Funds.ashx

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- Unit Price rounding
- Changes to investment profile or risk assessment of assets
- Application of annual management charges and any ability to alter the definition or level of the charge
- Tax (e.g. how actual charges or credits for tax are calculated, when they are removed from or credited to the fund, how deferred tax provisions are calculated)
- Introducing charges for new or unforeseen types of expense which may not be described or covered under existing policy terms
- Criteria for moving funds between bid and offer bases
- Internal deals between two unit-linked funds
- Management of fund liquidity
- Ability to defer switches/surrenders in adverse market conditions
- Ability to defer transactions by customers seeking to exploit market timing opportunities
- Valuation of assets – especially where market prices do not exist
- Determining, if applicable, distribution rates for income
- Choice of pricing point of the linked fund
- Frequency of pricing
- Addressing breaches of policy conditions or other customer commitments and dispute resolution
- Launching funds and seeding with shareholder capital
- Merging funds
- Ability to close a fund to new business or switches in and the ability to close a fund completely.

As can be seen from this list, the areas of discretion are wide ranging and can have a significant impact on outcomes for customers, particularly if there is no one specifically looking after the interests of the customers. As we have seen from the recent FCA review of the governance of these funds[82] – a quarter of the sample was found to have serious deficiencies requiring a skilled person's report and nearly half of the sample was identified as having deficiencies in managing their conflicts of interest.

Insurance companies need to have flexibility in managing products and it is not unreasonable to expect investors to pay for these services. However what is evident is that despite the requirement to treat customers fairly, because there was no independent challenge to the way these activities were conducted and because there was no one charged with an obligation to look after the interests of consumers, unfairness crept into the provision of investment services, as evidenced by the work carried out by the FCA on conflicts of interests in asset management and on the governance of unit-linked products.

Some of these discretions are examined in more detail as their impact as a form of charge on savings is relevant to consumer detriment across funds.

[82] http://www.fca.org.uk/news/tr13-8-the-governance-of-unit-linked-funds

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3.7 Funds used by Pension Schemes

We saw in Figure 3 that although pension schemes can use a variety of investment products, defined contribution pension schemes tend predominantly to use products that are different forms of funds. We also saw that of UK pension assets of £1.9Trn in 2012 more than £0.7Trn were invested in unit-linked funds. This makes unit-linked funds a significant form of consumer investment which is likely to grow further with automatic enrolment. There is also a significant market in self-invested personal pensions, which can use funds in the form of UCITs. It is therefore essential from the consumer perspective that these funds operate fairly in the interests of the consumers they are supposed to serve. It is also worth noting that insurance companies themselves reinvest and reinsure their liabilities using funds.

3.8 The use of different share classes in products and the impact on retail customers

When investors invest in funds they can be divided into different share classes. Some of the share classes may be offered to retail or institutional investors whilst other classes of shares may be available to institutional investors only.

There can be a number of differences between these share classes. The share classes may provide for different terms such as the size of investment, and most often, different levels of charges.

Recently there has been the creation of 'clean' and 'super clean' share classes to address restrictions on the way certain charges are made in relation to RDR.[83] However there are still a number of charges that can be made even to these share classes that may not always be understood.

The retail share class will typically carry the highest charge. The reason given by investment managers is that the retail investors invest in smaller amounts whilst institutional investors tend to invest in scale and therefore it is more equitable for the institutional investor to bear a lower charge because their proportionate share of the costs is much lower. The reality can be different. Institutional investors have greater bargaining power when they make an investment – they can therefore often negotiate how their investments will be managed and what they are prepared to pay – they will generally be able to negotiate waiver of any initial or exit charges and negotiate a reduced charge for the disclosed AMC. Sometimes they can even negotiate terms so that their portfolio investments are managed slightly differently to the other classes of investment.[84]

These differences can create significant conflicts of interests between the different classes of investors but these are not often challenged by those charged with governance on funds. The response to such an assertion is that it is unreasonable, because there is a

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[83] RDR or the Retail Distribution Review came into effect on 1st January 2013. It banned adviser commission for new sales of investment products, including pension schemes and plans. From this date onwards, all advice relating to the sale of new investment products must be fee-based. However, firms that sell investment funds and products on a non-advice or execution-only basis still receive sales commission.

[84] Examples of different terms of investment could include restrictions on the types of securities invested in.

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fundamental obligation for all regulated investment firms to treat customers fairly. However this fairness is generally considered as between customers within a class – firms appear to be rarely challenged in relation to the varying interests of different share classes and how these have been managed. The retail share class may not however be insignificant in a number of these structures – but because of the fragmented nature of their investments those charged with governance do not appear to seek a better deal for them.

Depending on the way the fund is priced, the activities of the institutional class can effectively be subsidised such as on entry or exit from the fund and their investments can even have an impact on capacity and investment returns of the fund. Therefore although the size of investment by an institutional investor may be significant and contribute towards operational costs being reduced it may also impact on the ability of the manager to generate returns as the manager reaches capacity and may increase risk when an institutional investor decides to exit from a fund by impacting on the liquidity and value of the assets used for redemption. Arguably this would be no different if the institutional investor was invested in the same class as the retail investor but of course the institutional investor is in their own class paying lower fees despite creating these greater risks for the retail share class.

There appears to be little research on the impact of share class differentiation within fund structures, but it is important that there is someone independent of the investment manager charged with the specific responsibility to ensure that retail investors get a fair deal in relation to their share class.

There were similar problems with sub funds in umbrella fund structures where these sub funds were exposed to cross-class liability. However, rules in the UK which require umbrella ICVC companies to segregate the assets of sub-funds (The Open-Ended Investment Companies (Amendment) Regulations 2011)[85] came into force in December 2011 and have gone some way to reducing one aspect of detriment for the consumer which is in respect of their liability for risks taken by other sub-funds within that umbrella structure.

3.9 Cross-class liability

Cross class liability is another concept to which advisers to investors in funds do not give enough attention. There is an assumption that so long as the retail class of a fund structure has the right features required by regulation the structures automatically have the right protections. Sometimes the existence of a share class can create risks for another share class.

In most legal structures the existence of share classes would not be recognised in the event that the structure was wound up in order to distribute the proceeds from the assets to the shareholders – this means that the liabilities of a particular share class, say, for any

[85] http://www.legislation.gov.uk/ukdsi/2011/9780111517239/regulation/3

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borrowing, are shared equally across say both a leveraged and unleveraged share class if there are insufficient funds within a share class to meet those liabilities, thereby creating cross class liability. [86]

Although retail funds have restrictions on leverage and there is no differentiation in strategy between classes permitted under COLL, the following example is a useful way to illustrate the basic concept of cross class liability risk: let's assume there are two investors, A and B, who both invest £100. A invests in an unleveraged class while B invests in a leveraged class where the investment manager borrows another £100 secured against the £100 received from investor B. The manager invests £300 in an asset, which then falls in value to £30. The fund now has two classes of shares. The unleveraged class of shares is valued at £10 and the leveraged class is valued at £20. The liability of £100 owed to the lender will be met by the £30 of assets in the fund and not just the £20 of investor B. In this scenario the investor investing in the unleveraged class of shares is worse off because they get no upside from the borrowing by the leveraged class but carry all the risks if a loss arises from the borrowing. Just because the unleveraged class does not have any borrowings does not mean it is insulated from the risks of borrowing of the other class.

This is cross class liability. We have noted that leverage cannot be applied differently between classes in retail funds so how can cross class liability arise in retail funds?

The actions of investors in other classes can precipitate cross class liability within a fund because these are accounting mechanisms that do not insulate the assets and liabilities of other share classes. Despite paying higher fees the retail investor can be exposed to higher risks by the actions of the institutional investors paying lower fees on a fund because of cross class liability. Examples of these risks on retail funds, through the activities of institutional investors, include reducing the capacity of a fund (the optimal size of a fund at which returns can be generated for investors – if a fund gets too large it may face difficulties in generating returns), reducing liquidity, moving market prices because of the size at which transactions are done, which can in turn, affect the value of the fund. Waiver of certain charges for a class of investor absorbed by the fund can also have an impact. Institutional investors can also be advantageous to retail investors because they bring the benefits of scale to operational costs depending on how investors are charged for these.

Cross class liability between sub-funds in an umbrella structure[87] has been removed through a change in the regulations but not in respect of share classes within a sub fund.

The existence of cross class liability carries additional costs and risks for which the retail investor may not necessarily be rewarded. Because they are not rewarded for these risks, they bear an opportunity cost, which is as important as any direct charge made against their assets.

[86] *In retail structures leverage is regulated and generally restricted to 10% (see COLL 5.1.4)*
[87] *Umbrella structures are more common for retail products*

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Asset managers may create new share classes to accommodate a large investor as a mechanism through which they do not need to vary the terms already given to existing investors. Those responsible for the governance of the fund should consider whether the creation of these share classes create a problem for existing investors, but the governance model may be conflicted, which may mean that proper challenge is not exercised on behalf of retail investors.

3.10 Platforms and segregated portfolio companies

Platform and segregated portfolio companies provide efficient mechanisms for investment managers to distribute investment product. Platforms are also ways to capture capacity with investment managers.

A platform can either comprise a series of funds through which investments can be made with different investment managers from one portal or can be a single structure with a series of sub-funds – typically through a segregated portfolio company, that then holds the investments with different investment managers through those sub-funds.

A platform is a good way to reserve and access limited capacity with a successful manager where the investor would not ordinarily be able to access that investment manager directly, perhaps because they are closed to new investment.

Many insurance companies providing pension products such as unit-linked funds also use platforms as a way of providing access to funds of other insurance companies. The way this is done can have a significant impact on the ability of a retail investor to claim compensation if the insurance company fails and can have significant consequences for the investment because the platform contract can be a contract of reinsurance which may not be covered by the UK compensation regime if things were to go wrong.[88]

The efficiencies in relation to scale and cost that platforms and segregated portfolio companies are able to achieve are not necessarily passed on to retail investors and often the platform structures and their associated risks may not be properly understood with incorrect assumptions being made about their safety because investors think they would be compensated in the event of a problem.

3.11 Fund of Funds

Funds of funds can add additional layers of costs because costs are charged at both a fund of funds level and at an individual fund level. In a paper published by the Pensions Institute in 2012 they noted that in the case of diversified growth funds the existence of sub-funds could add 50% to the headline rate.[89] A number of conflicts of interest can also

[88] *Insurance companies sometimes argue that the risks of insurance companies failing are over-emphasised and remote because of the various regulatory protections, and in some quarters it is argued for example, that although Equitable Life had significant problems, technically it never became insolvent. Nevertheless, investors suffered, and continue to suffer significant detriment.*

[89] *http://www.pensions-institute.org/reports/CaveatVenditor.pdf*

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operate where the fund of funds is investing in funds that are also managed by the same manager. The manager is therefore able to extract rent from that capital at two levels and the investor can often pay two lots of general fund expenses as well. Some managers will waive or reduce fees in these circumstances but these relationships may not be disclosed or highlighted prominently for investors to consider. Other managers argue that if another manager had managed the fund, the investor would have incurred those costs and therefore it should not matter if the manager also offers other funds that the fund of funds is able to invest in with no waiver of fees.

3.12 Charges taken through pricing mechanisms

In order to understand charges in relation to valuations and pricing mechanisms we need to understand how assets are valued and then how units in a fund are priced, bought and sold.

Valuing assets is an area that can pose many problems whether from the perspective of accounting and reporting or for the purposes of dealing to enable investors to buy or sell their holdings in a fund.

The way assets are valued can include undisclosed charges. These arise because the costs of buying and selling an asset may be included in the value of that asset.

In the context of unit-linked funds there is the added potential incentive for the insurance company to opt for a more conservative value because the payments they make come out of their own funds and therefore have a direct impact on their own profit and loss account because they are the legal owners of the assets and the value of the unit-linked fund is only the reference for value payable. We have already seen the wide discretions that insurance companies are able to exercise in this respect. When an insurance company makes a payment to an investor relating to a unit-linked fund, that payment does not necessarily have to come from that unit-linked fund – the insurance company can use any money it chooses to source payments, as the unit-linked fund is simply a reference mechanism to determine value.

Small differences in prices can make significant differences to the profitability for a manager who is paid a fixed fee based on the value of assets because of the scale at which they operate. Managers will often point to this system of remuneration as justification that their interests are aligned with those of the investor because they get paid on the value of the assets and therefore have an incentive to maximise that value. That is not always strictly accurate because in the UK the manager can be a vertically integrated financial services business that not only provides the asset management for these funds but also provides administration, execution services, valuation and custody services in addition to investment management services. This means the manager can (at least theoretically) make money out of the investor by valuing assets slightly differently at different stages for a whole range of services and not just investment management.

A fund can quite legitimately use different methods to value assets for different purposes. To illustrate the point, the value of a unit in a fund for the purposes of buying or selling

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units (dealing) can be different to the price of that unit in the financial statements of that fund depending on the accounting standards and methods for pricing used. This is because the dealing value may not be calculated the same way as it is for accounting purposes although typically it is the same and the financial statements should generally have a reconciliation between the dealing and accounting prices for a unit in the fund if they are different.

It is also possible for assets to be valued using one method for the purposes of dealing but valued in a different way (usually higher) for other purposes such as say taking charges for administration. An example of this might be where an exiting investor is paid proceeds based on the bid (lower) value of the units while administration costs are taken on the mid value of the units, which is higher than the value the investor receives. The use of swinging prices (see below) has tended to remove this anomaly but only because investment houses now tend to use the offer price as the single price and therefore in the main most charges are taken at the higher value – which an investor would never receive if investors were exiting en masse from the fund because the price would then be swung to the lower value for that dealing point. Of course charges would also be taken at that point with reference to the lower value. We look at this in more detail below when we look at the common methods of pricing funds.

Therefore, valuations of the assets in a fund do need to be looked at with care by someone responsible for looking after the interests of investors.

The value of the fund itself also needs to be considered with care.

A fund's value will be determined by the value of the underlying assets. However once that value has been determined it still needs further adjustment to take into account the costs of buying new assets when investors pay money into the fund and to take into account the costs of selling assets when investors leave the fund and to account for the other costs and charges that the investment manager makes.

There are generally three ways that units get priced[90]

1. Bid-Offer spreads (Dual Pricing)
2. Use of Anti-Dilution Levies (Single Price)
3. Use of a swinging price. (Single Price)

Bid-Offer spreads are the basic way of measuring the difference between buying and selling prices of units. The bid price is what the manager will pay you if you want to leave the fund; the offer price is the value at which the manager will allow you to invest in the fund. So if a unit has a spread of 100p – 110p then the bid price, the price the exiting investor will get, is 100p and if you want to buy a unit the price you will need to pay is 110p (its offer price). The spread is 10p but the spread alone does not necessarily represent the costs of buying and selling. Most investors find spreads difficult to understand and so industry came up with a single pricing method referred to as the anti-dilution levy.

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[90] *I have ignored forward pricing and historic pricing methodologies as these are more to do with timing rather than pricing*

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The anti-dilution levy effectively creates a single price. Let us say that the single price is quoted at 105p per unit. The manager in this method takes a view of the general flows on the fund. If the majority of flows on the fund are inward investments with occasional outflows – the manager may be content to use the price of 105p per unit. However if there was an investor that wished to make a large investment in one month – the costs of getting that investor invested in the fund would dilute the profits made for other investors if those costs were paid out of the fund. The manager therefore charges an anti-dilution levy to cover those additional costs. These anti-dilution levies would normally be received by the fund.

The third method, Swing Pricing, is now the most common method used by funds in the UK. This has been accepted as a method that is easier for an investor to understand because they are presented with a single price. Swing prices are where the manager operates a single price based on their view of the flows of the fund. Most collective investment schemes, at least in their accumulation phases, tend to experience inflows into the fund. i.e. the majority of flows are investments into the fund. In this scenario the manager can use the offer price as their single price and an exiting investor in a period where there are generally inflows will benefit because they can exit at that higher price. Charges against the assets of the collective investment scheme will tend to be taken at those higher rates as well. Where this same collective investment scheme suddenly starts to experience outflows the manager can swing the price to the bid price – the lower price. An incoming investor at this stage should be able to benefit from this, as they are able to buy units at a lower price. The manager will carefully monitor flows into a scheme to ensure that it is not operated in a way that would be detrimental to the firm.

The Association of the Luxembourg Fund Industry conducted a survey on Swing Pricing in 2010, which suggested that most funds in Anglo Saxon countries, the US and Switzerland had adopted a form of swing pricing as their pricing mechanism.[91]

Sometimes the swing may not be implemented on the day of the outflows or inflows but on the following day. This has meant that the investors causing the swung price have not been the ones to be affected by it, with those investors transacting the following day being affected instead.

The FCA in its 2013 review of the governance of unit-linked products found that:

"*One firm, that adopted a long-term approach, did not have the ability to swing the price in the event of a material transaction that went against the 'trend'. This could lead to customers receiving an inappropriate price.*

Two other firms, which also adopted a long-term approach, did swing their price in the event of a material transaction which went against the trend – but a delay in their processing timeline meant that the 'swung' price was applied to customers transacting the

[91] http://www.alfi.lu/sites/alfi.lu/files/ALFI_Swing_Pricing.pdf

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following day – and not those customers whose transactions actually caused the price movement."[92]

These problems with swing pricing represented 25% of the sample they tested.

3.13 Charges against the fund

Asset managers are generally paid a fixed percentage of the value of the assets they manage regardless of whether they generate any returns for investors. Some funds have introduced performance fees but even these, unless they incorporate hurdle rates[93], high water marks[94] and claw back clauses[95] can incorporate unfairness for the investor.

So what exactly is the asset manager expected to pay out of their pockets in relation to the services they provide?

The received wisdom on fees is that the fixed percentage management fee is the charge that the manager makes for investment management and the provision of staff with relevant expertise. Because the asset manager is acting as agent for the investor all other costs of the fund are borne directly by the fund itself. Where there is a performance fee, the thinking is usually that the management fee is a fee to cover the fixed overheads of the manager and that the performance fee is the reward that the manager gets for generating returns for the investor. (This could be performance above a benchmark. The benchmark then becomes the hurdle rate.) Most funds accessible by retail consumers only charge a management fee and so the charge also incorporates a profit element for the asset manager.

The fund pays its own transaction costs, the costs of custody, any borrowing costs, audit and legal costs and asset managers can even charge consulting fees to the fund if they can justify direct benefit to the fund. The manager has a wide discretion on the charges that can be allocated against the investment fund.

As we have noted above, the FCA have warned asset managers that they need to treat the allocation of these charges with the same level of rigour as they would to a charge that they would bear themselves. Asset managers tend to be more 'relaxed' where a cost can be allocated to a fund they manage rather than where it affects their own bottom line.

But there are also wider implications to the costs that are charged to the fund. The most notable of these are inbuilt costs for the purchase and sale of securities – referred to as execution costs[96]. It has been traditional in the industry for managers to seek from their execution brokers what are referred to as soft commissions or bundled costs whereby they

[92] *http://www.fca.org.uk/static/documents/thematic-reviews/tr13-08.pdf*
[93] *The rate of performance above which a fee would be payable*
[94] *High Water Mark is the value of investments at which a performance fee has been paid. If the value falls below this level then a subsequent increase in value will not accrue a performance fee until such time as the value exceeds the last level at which a performance fee was paid.*
[95] *Claw backs are used to make managers repay any performance fee they have received if the value of investments fall after receipt of the performance fee*
[96] *Execution costs form part of transaction costs*

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pay a little more for the execution of transactions which are charged to the fund in return for services such as research that the manager receives. The managers argue that this research is used for the benefit of investors and therefore it is justifiable. Regulation has tightened considerably in this area. Whereas in the past even travel and entertainment costs could be covered by these soft commissions this is now largely restricted to research.

Another less understood aspect of costs are the borrowing and credit facility arrangements that the asset manager can enter into on behalf of their funds which are secured by the assets in those funds. The manager can benefit significantly from scale in relation to these arrangements which can extend to their own businesses' credit facilities and it is not clear if regulators examine whether any advantages enjoyed by asset managers from the benefits of scale in this respect are passed down to investors.

Finally there is the question of remuneration of the employees of the asset manager – that is the employment remuneration package, as opposed to the charge the investor pays to the firm as a whole. There has been much regulation in this area – bonuses are usually paid annually to staff members and although the rules have changed requiring employees with the decision making powers on investment management to place their bonuses at risk alongside investors, there is inherently always going to be a mismatch between the time horizons of those employees and the investors on whose behalf they are employed. As with defining charges there can be a problem with defining bonuses. The Sunday Times in April 2014[97] reported how directors of the Royal Bank of Scotland[98] had chosen to do away with bonuses and to award themselves 'allowances' in shares which were not part of their basic pay, nor were they related to performance. This allowance was just a mechanism to ensure that the directors' total pay package did not change significantly. It was reported that the government, as the major shareholder of the company, had not reacted to the implementation of 'allowances' even though it had voted against proposed bonuses. The fate of charges and charge caps may well be similar if the definitions around any rules allow similar loopholes to be exploited.

3.14 Allocation of expenses to funds

In addition to the charges that are deducted from a fund, a fund also incurs a range of expenses. An extract from a large investment manager's description of fund expenses sets it out as follows:

"*The following expenses (being the actual amounts incurred) may also be payable by the Company out of its assets at the discretion of the ACD: broker's commissions, fiscal charges and other disbursements which are properly incurred in effecting transactions for the Company; interest on and other charges relating to permitted borrowings; taxation and other duties payable by the Company or on the issue or redemption of Shares; any costs incurred in amending the Instrument of Incorporation or this Prospectus, including costs incurred in respect of meetings of Shareholders and/or directors convened for purposes*

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[97] *Sunday Times, (2014) Business Section, 27 April 2014 RBS stokes pay row with new 'bonus' scheme for top staff* *http://www.thesundaytimes.co.uk/sto/business/Finance/article1404205.ece*

[98] *Many banks also have asset management businesses.*

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which include the purpose of amending the Instrument of Incorporation or this Prospectus; any costs incurred in respect of any other meeting of Shareholders convened on a requisition by holders, not including the ACD or an associate of the ACD; in relation to a unitisation, amalgamation or reconstruction where the property of a body corporate (such as an investment company) or of another collective investment scheme is transferred to the Company in consideration of the issue of Shares in the Company to Shareholders in that body corporate or to participation in that other scheme, any liability arising after the transfer which, had it arisen before the transfer, could properly have been paid out of that other property provided the ACD is of the opinion that proper provision was made for meeting such liabilities as were known or could reasonably have been anticipated at the time of the transfer; the audit fee and any proper expenses of the auditor; the fees and any proper expenses of any professional advisers retained by the Company or by the ACD in relation to the Company; the fees of the FCA and the corresponding periodic fee of any relevant regulatory authority outside the UK; any sum due by virtue of any COLL Sourcebook, such as cancellation proceeds and reasonable stocklending expenses; the cost of printing and distributing promotional material in respect of the Company or any Fund and of any marketing activities undertaken by the ACD in relation to the Company or any Fund; the costs of printing and distributing annual, half yearly and quarterly reports and any other reports or information provided for Shareholders; the costs of listing the prices of the Funds in publications and information services selected by the ACD including Bloomberg and Reuters; and any other charges/ expenses that may be taken out of the Company's property in accordance with the COLL Sourcebook.

Expenses not directly attributable to a particular Fund will be allocated between Funds as described above."

This suggests that the authorised corporate director (ACD) of the fund exercises these discretions. The ACD is disclosed in those documents as being a related company within the same group as the investment manager and therefore the investment manager for all practical purposes makes these decisions and gives effect to them. The directors of the ACD are also listed and, in some cases, their other directorships are disclosed. Although it states that details of the other directorships can be provided, where these are not listed, there is no sense of whether these are connected entities of the manager or other types of businesses. Where the information is provided, it reveals that the directors also act on other entities of the asset manager. Some of these costs that the funds pay will be payable to other group companies within the organisation and the organisation will also obtain certain services in bulk such as for the audits of the collective investment schemes. While scale will provide benefits for the constituent funds, what is not often disclosed is what other benefits the manager might be receiving from those service providers. For example reduced costs for consultancy and other add on services. Most fund managers these days tend to use separate audit firms for auditing their own business and those of their underlying funds and auditors are required by their rules to disclose the value of other services they have provided. Investors, and those advising them to understand these relationships, appear only rarely to examine these disclosures.

There will of course be strict compliance procedures followed to ensure that expenses are properly allocated, but as we noted earlier, it may be much easier to obtain approval for

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expenses that are charged to a fund than it is to obtain approval for expenses borne by the asset manager. These expenses are rarely if ever scrutinized by independent third parties. Nor are they the subject of independent challenge, other than from periodical regulatory reviews or by auditors verifying and confirming that the expenses were incurred.

A number of firms have been responding to the new requirements for transparency on costs.

A recent booklet from a major platform provider on its investment charges describes a change in its approach to charges. It said that its old approach to charges had been to state a single ongoing charge that was taken from fund assets by the manager (a bundled charge) but that going forward it would unbundle these charges so that the fund management charge would be separate from the service fee. It suggested that it would expect most of its customers to pay less with this new charging approach. However there was no real simplification to the costs that could be charged in the detailed terms and conditions. The charges that the platform could make for the funds it offered included:

- Entry charges
- Ongoing Charges
- Performance fees
- Equity Dealing Charges (for some accounts)
- Administration charges (for some accounts)
- Service fees
- Switching fees
- ETF Dealing fees (on some accounts)

Yet the newsletter suggested that investors would not be paying for fund switching fees, and initial charges for fund dealing. The headlines and the details in the appendix therefore did not match up, while the multiplicity of different descriptions made it difficult to track how real the headline promises were. These charges would still be difficult for most retail customers to understand and with the possible prospect of a decrease in advised sales there is a likelihood that there will be less scrutiny of these charges too by those who understand them.

Another interesting piece of information was tucked away in an explanation as to why tracker or index funds had become more expensive as a result of these changes. It explained that although tracker funds have been priced very competitively historically, many investment companies had been unable to reduce the overall charges enough to offset the introduction of the service fee. This was because regulations now required that platforms must charge the same service fee across all the funds they offered so that cross-subsidisation is no longer possible.

Another large provider's key features document covering charges for a group self invested personal pension scheme stated that:

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"*Charges are regularly reviewed and may be increased to reflect increases in overall costs and/or changes in the assumptions made. Any increases in charges will not increase [the provider's] profit margins above reasonable levels.*

Your illustration shows our charges and the effect they have on reducing the value of your investments over the term of your plan."

What would be a reasonable level of profit margin? Whose perspective would it be and who if anyone would they consult before executing such additional charges?

Another ICVC in 2014 wrote to its customers that that it was changing the way it was disclosing and applying fees. Rather than applying a number of separate fees it would charge a single ongoing charge which would then be applied to discharge the various costs other than in respect of transaction costs.

So firms are starting to respond to the pressure on fees and to provide simplified disclosure of fees but there is a long way to go as best illustrated in a quote in a paper examining fiduciary duties by Johnson and Graaf called Modernizing Pension Fund Legal Standards for the 21st Century where they quote Professor Amin Rajan saying:

"*There is a widespread perception in the pension world that the investment industry is perverse in one crucial sense: its food chain operates in reverse, with service providers at the top and clients at the bottom. Agents fare better than principals. In Europe, average fees have reportedly gone up by nearly 50% in the past four years, as the search for absolute returns has intensified. In the absence of good returns, many clients have felt short-changed. A value-for money fee structure has become an important factor in its own right*."[99]

3.15 The costs of sales and distribution

The retail distribution review (RDR) was heralded as being a major change to the way fees are levied on investments bought through advisers. It was expected to change the shape of the asset management industry.

RDR changed how sales commissions were charged, provided detailed guidance on education and competence thresholds for those operating within financial services, and was expected to bring clarity to charges and how the advice market operated.

Deloittes in a review of RDR in 2011, expected an increase in the number of share classes in products with a separate share class for legacy business, clean share classes that stripped out fees and a hybrid share class.[100] As we have seen, share classes themselves can create additional risks and costs for retail consumers.

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[99] http://www.issanet.org/pdf/Create_DB-and-DC-plans_final_Nov-2008.pdf *Rajan DB & DC Plans Strengthening their delivery, CREATE Ltd and Investment & Pensions Europe quoted in 2009 Johnson & Graaf Modernising Pension Fund Legal Standards for the 21st Century (February) Network for Sustainable Financial Markets.*

[100] http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Images/Industries/FSI/PDF%20thumbnails%20(150)/uk-fs-rdr-shaking-up-investment-management.pdf

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It therefore appears that RDR has introduced additional layers of complications because legacy business continues while sales and distribution are focused on future flows of investments. Legacy products have been moved into separate share classes to preserve the old charging structures.

In July 2013 the FCA published its early review on the implementation of RDR. It noted that they:

"*found that while most firms were providing their generic charges in good time before making a personal recommendation, some were not. [They] were also concerned that some firms, while describing themselves as independent, were not offering a truly independent service. Some firms providing restricted advice were not adequately describing the nature of the firm's restriction.*"[101]

Some observers are concerned that RDR may result in a reduction in advised sales.[102]

3.16 Dealing Commissions - access to management and research

As we have noted earlier, access to management and dealing commissions for research are some of the hidden charges that investment managers can use to reduce their own costs by charging these indirectly to the funds they manage. Dealing commissions are also referred to as soft commissions.

Martin Wheatley – the chief executive of the FCA in a speech in October 2013 spoke about the problems with soft commissions and summarized the issue:

"*Ongoing issues around transparency in this sector are nothing new. In 2003 the FSA looked at the array of services that could be supplied to asset managers by brokers in return for clients' dealing commission.*

The FSA found commission was being used in a way that gave rise to significant conflicts of interest by influencing where asset managers directed trades. There were also concerns over accountability to clients and how their commissions were effectively being spent. At the time dealing commission was used to fund a broad range of services, such as investment research, market data service licenses, phone lines, seminars, external publications and data price feeds.

As a result, in 2006 the FSA introduced a new regime that worked with industry to tackle these shortcomings. The FSA had considered more radical reforms, but as a compromise, the FSA understood an alternative model devised by industry may provide a cost-efficient way of securing the same outcome. The regime, which is still in place today, is principles

[101] http://www.fca.org.uk/static/documents/thematic-reviews/tr13-05.pdf
[102] http://www.cass.city.ac.uk/__data/assets/pdf_file/0016/202336/The-impact-of-RDR-Cass-version.pdf

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based, allowing asset managers to make reasonable judgements when using client commissions.

The rules specify that, in addition to the actual transactional costs linked to execution, commissions can only be used to purchase a narrowly defined range of execution or third party research services. There is also an obligation on asset managers to disclose the use of commissions to their clients. The FSA committed to keep the regime under review, and to consider the case for further intervention if changes did not address the original problems.

Since 2006, supervisors have increasingly come across evidence that the current regime does not sufficiently enhance transparency and accountability. There are two persistent problems. Firstly, services are being 'bundled' together, with eligible and non-eligible services being mixed. Secondly, when this information is provided back to the client, there is a lack of clarity or adequate transparency around how their commissions have been spent.

Examples of this poor practice include firms allocating significant sums of their Bloomberg and Reuters subscriptions, not all of which could be justified as viable research. Or a firm we looked at that paid nearly double the amount of commission it had paid for research than the year previously, simply because it had traded more year-on-year. The amount of research received, however, had remained relatively the same.

Of most concern is that firms are pushing the definition of 'research' by using client commissions to cover non-eligible costs and services.

This includes a significant chunk of clients' commission being paid for 'corporate access' services from investment banks and brokers. We estimate that anything up to £500 million of dealing commission was spent in 2012 to facilitate corporate access. As an example, last year we discovered a firm that was rewarding brokers predominantly based on the corporate access they provided. This averaged out to each individual investment manager paying over £100,000 just to gain access to the management of companies they wanted to invest in. We believe this is just one area where firms are allocating commission to ineligible services and paying more for services than they would if they had to pay for them out of their own money.

This practice transfers the firm's costs onto the client, which clearly works against the client's interests. This raises a concern because asset managers do not control these costs with the same rigour as costs they incur directly. These costs are indirectly borne by the client and do not affect the manager's profits. Likewise, on the other side of the transaction, Chief Executives and Investor Relations officers have learned, sometimes to their surprise, that their time is being billed to the industry by brokers.

As a result of these findings, industry members and representatives, including the Investment Management Association (IMA), have recognised that certain practices need to change. This recognition will also need to extend to the sell-side providers of these services.

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But let me be clear, we accept that investors want to engage with the businesses they invest in and practise good corporate stewardship. We have no particular concerns with the purchase of corporate access. And we need a market for good quality research that benefits both the asset managers and their clients. But asset managers should be using their own funds if they wish to purchase access.

The prevalence of bundled services, combining eligible with non-eligible services, can also disguise overpayments for eligible services. This cross-subsidises services that asset managers should pay for from their own funds. And, in turn, it sustains business models that would quickly fail under increased global competition.

Besides, the link between volume of trading and research expenditure appears to be flawed. It creates 'pots' of research commissions the fund manager is then incentivised to spend regardless of the added value of the services. This creates a potential conflict of interest.

And we are not seeing great value in regards to domestic competition either. Investment banks appear to sell or provide additional services such as corporate access to the highest bidder. This favours high degrees of trading. This also distorts the market and causes asset managers to pay increasingly more for 'research' even if they receive very little value from it.

In a nut-shell, this type of outdated bundled charging system and use of dealing commissions to purchase research lacks the transparency that has attracted a global consumer-base, distorts competition, and supports unsustainable business models.

As mentioned, the FSA committed to keep the regime under review if it failed to address shortcomings it was designed to tackle. We have now reached a point, evidenced by our supervisory work where we need to think again. The system is not working as intended. Wider reform is now required to address these flaws that cannot simply be addressed by incremental improvements to the existing rules."[103]

The UK regulator has therefore recognised that there is a serious issue that needs to be resolved with industry because the system is not working as intended.

Money Marketing reported a debate where it was suggested that more than £14.3Bn was raised by asset managers in 2011 to spend on research costs and corporate access by opting for bundled trading rather than execution only dealing. In that report an estimate was made that 33% of the bundled charges went on execution costs with the balance being diverted to commission sharing arrangements some of which ended up paying for research or corporate access.[104]

The FCA has now banned the use of dealing commissions for corporate access. The rules came into effect in June 2014 as the FCA is treating this as a clarification of the rules

[103] http://www.fca.org.uk/news/shaping-the-future-in-asset-management
[104] http://www.moneymarketing.co.uk/fund-managers-spent-143bn-through-bundled-commissions-in-2011/1074872.article

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that investment managers should have been observing.[105] MiFID II is likely to introduce further rule making in this area.

Martin Wheatley also makes the point that is repeated consistently through this report, on market practices where asset managers are paying far more for services using investors' money than they would if they had to pay for these services themselves. This repeated theme suggests that asset managers cannot be relied upon to police their own activities when it comes to charging costs against client assets.

The IMA published a paper in early 2014 on Dealing Commissions.[106] This is a useful discussion on possible models that might be used for using dealing commission for the purchase of research. The paper lists a number of benefits for the use of dealing commissions but also notes a number of challenges including:

- Embedded conflicts of interest
- Lack of price transparency
- Inability of clients to assess the value of third party research for which they have directly paid
- Risk of cross-subsidy benefitting one cohort of clients to the detriment of others
- A risk of over production of low and no-value research; and
- Time and effort required on the part of investment managers to ensure fairness, value for money and transparency for all clients

Many institutional clients ask for disclosure on commissions but retail clients are neither in a position to demand to see this nor indeed to do anything meaningful with that disclosure if it was received.

3.17 Providing information and reports on funds

The way information and reports are provided on funds also has an impact on the nature of transparency provided over costs, charges, expenses. Performance reporting is important in the context of a discussion on costs and charges because costs and charges have an impact on the returns of a fund.

Reporting on fund products can create difficulties for investors in funds who wish to review the performance of their manager.

There are a number of problems with reporting.

The most important of these are complicated sets of offering documents (including the prospectus) and reports on funds. These documents appear to be prepared more for the convenience of the investment manager and not the investor. Because a number of the

[105] http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-07
[106] *Investment Management Association (2014) The Use of Dealing Commission for the Purchase of Investment Research, February*

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funds offered by large investment managers are formed within an umbrella company or as sub-funds of a larger fund, the documents for these funds can be very large and it is sometimes difficult even for a reasonably financially literate person to work their way through this documentation trying to isolate the bits of information relevant to them.

Take the example of a large investment company that appears fully compliant with all its reporting requirements and provides information on the funds available through one of its investment companies with variable capital. Dated early 2014, in a single document it lists 26 different funds in the same prospectus. Some information is generic but does not apply across the entire fund range. One has to plough through 74 pages of information to extract the relevant information relating to a particular fund all of which is not provided in one place.

The performance information that is provided is for the five previous years only, as is required. Currently that is convenient because it hides the effects of any disastrous results that may have occurred in 2008.

The ICVC, which has since changed its name to reflect that it is an OEIC, (it also reports that the ACD has changed its name) prepares a long-form annual report. Its latest financial statements are available for 2013 and comprise 414 pages covering 25 funds. The accounts, which have been signed off by its auditor, comply with the COLL sourcebook and the Statement of Recommended Practice for Authorised Funds.

The document however is not designed for an investor to easily digest the information that is contained in respect of a fund that the investor might be invested in. Combined with name changes, mergers and closures and opening of new funds it makes it very confusing for an investor to track their investment fund through this morass of information.

Each fund report details the portfolio held by that fund at the end of the year, performance is detailed for the previous five years. Cumulative performance since the inception of the fund is provided as a single number, there is a statement of total return, a statement of change in net assets attributable to shareholders, a balance sheet, and notes to the financial statements which include notes on a range of expenses paid by the fund, fees charged on each class of shares, portfolio transaction costs and dividends distributed. The notes to the accounts show that an institutional share class pays no fees because the investors have a contract with another company within the investment manager's group. There are also other institutional classes, which pay lower fees than those paid by the retail class but which have a higher minimum investment threshold. Information on costs and charges does not provide a complete picture.

In order to address these issues European regulators came up with the idea of a simpler document for investors referred to as the key investor information document (KIID) but this document does not detail the various share classes and the nature of expenses charged against fund assets – because the document is designed primarily for retail investors who might not understand this detail.

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Although information on performance since inception is provided as a single number in the notes to the financial statements it is difficult to get a sense of how the fund has performed except over the previous five years.

There is no information about the cumulative values of the flows that are represented by the fund value that is reported. There is no information about whether the fund is an aggregation of earlier funds and the history of mergers and closures of funds that the net asset value might represent. This is information that should be important to someone advising a customer as it gives a better sense of how the manager has really performed by linking the money the manager has received over the life of the fund and what the manager has achieved with it.

All these issues make it difficult for investors to track their investment funds and the design of this reporting although meeting all the regulatory requirements does not seem to help investors navigate their way through all this information and why it may be relevant to them.

3.18 Expenses in buying products directly or through intermediaries

Prior to RDR if an investor tried to cut out the middleman by investing directly with an investment manager they would pay more than if they were to go via an intermediary such as a fund platform because the manager would not discount the entry fee or initial charge and the investor would still be required to pay the full ongoing charges for the investment even though an element of that ongoing charge would have represented payments to intermediaries had they been used. If the investor used an intermediary then the initial charge would typically be discounted or waived and the investment manager would have paid the platform an ongoing commission referred to as a trail commission, which would have been made from the ongoing charges that the investment manager charged. Most investors did not understand these arrangements – so even though it was possible to pay less by going through a platform the true charges were hidden from the view of the investor.

With RDR the FCA required platforms to come up with a new charging structure by April 2014 and banned the use of commissions for new sales and will do so for existing sales by April 2016.

Investment managers are now required to come up with new share classes that charge lower fees – or so-called clean share classes - and the platforms have had to devise charging structures that charge the customer directly for the services of the platform. Although cash rebates are banned it is still possible to give rebates using units.

Therefore although RDR will make charges more transparent, there will continue to be investors in existing investments, who may be paying hidden costs for at least another two years.

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In fact the True and Fair Campaign in a 2014 two year anniversary report entitled Legalised Looting, suggests that the unbundling of charges has increased fees by 28% on a like for like basis.[107]

3.19 Governance and accountability on funds

Governance and accountability on funds goes to the very heart of the issue in relation to the costs and charges that investors bear.

We have seen in the earlier descriptions of funds that their governance can have significant conflicts of interest that are rarely understood by retail investors.

Although governance should look after the interests of all investors, the issues discussed in this report suggest that retail investors' interests are not looked after as well as the interests of the management firm and institutional investors.

The financial services industry usually points to the regulatory requirement that it has to treat investors fairly, as providing adequate safeguards, but there are a number of reasons why governance does not always work effectively in the interests of retail investors:

- The pool of resources available to provide independent governance on these products is limited;
- The resources used for independent governance can sometimes be provided by organisations set up for commercial gain and who therefore may not have an incentive to challenge the investment managers if appointed to multiple roles by them;
- Governance can be provided by an associated group company whether a corporate trustee or an authorised corporate director or by employees and ex-employees or individuals who have other conflicting connections with the investment manager such as serving on a significant number of their governance boards. (In the example of the ICVC used earlier, the ACD was responsible for 26 funds and the disclosures suggested that the directors of the ACD also sat on other company boards of that manager's group.)
- Regulatory reviews consistently find that firms have failed to treat their customers fairly even after the significant regulatory actions arising from the failures of the markets in 2008;
- Even trust structures can carry these conflicts. Fund providers can use trust structures where the corporate trustee is part of the group and where the directors may be employees and other connected parties to the provider;[108]
- Governance comes as part of the structure and may not be valued as a service by the investment manager. Indeed remuneration of fund boards can be an issue and

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[107] *http://www.trueandfaircampaign.com/wp-content/uploads/2014/03/true-and-fair-campaign-2nd-anniversary-report-legalised-looting-march-2014.pdf*
[108] *Connected parties for these purposes include independent directors sitting on a number of entities managed by the same investment manager.*

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involve fee waivers by employees of the managers, and low fees for independent members on the basis that they act on a number of funds for the manager;

- Although many governance structures require those who govern to apply fiduciary standards whether as company directors or trustees the concerns expressed by regulators on the management of conflicts of interest suggest that governance on funds can be weak when it involves examining the actions of the investment manager (the recommendations of the OFT on unit-linked funds for example, support this view). Investment managers influence the selection of members of fund boards; and
- Insurance providers' unit-linked products do not require independent governance to look after the interests of unit holders. Therefore funds used in personal pensions may have no independent oversight to look after the interests of the pension savers.

Regulatory authorities have tried to respond to these issues by introducing new rules and requirements such as through the implementation of the OFT's recommendations arising from its 2013 review of the pensions market for an independent project board and for independent governance committees but these will only work if there is true independence on these committees with people prepared to challenge what the investment managers do in relation to collective investment schemes' costs and charges.

3.20 Self Regulation and the impact of industry associations

Self regulation by the financial services community – for example through trade bodies - has been slow to protect the interests of retail consumers. An example of this is how the Investment Management Association (IMA) has dealt with the issue of transparency and disclosure in costs.

In February 2012 the IMA in its newsletter carried a headline that its chief executive considered the claims of hidden pension costs to be wildly exaggerated.[109]

In May 2012 the IMA issued another paper "Fund Management Charges, Investment Costs and Performance".[110] This paper contained a study which had been conducted as an analysis of fund charges by looking at charges publicly disclosed in fund literature and comparing these with the difference between realised net fund performance and the cost-free return on the relevant benchmark across the largest index tracker funds - a 'realised annual shortfall'. The idea was that the difference between this realised annual shortfall and the disclosed costs should show the extent of hidden costs. The study reached the conclusion that the 'realised annual shortfalls' were marginally higher than the figures of expected shortfall based on information in the fund accounts, which suggested there was no significant negative impact from the costs that were 'hidden' or not displayed in the fund literature. It then went on to say that:

"*The returns on active funds depend on the quality of their managers' stock selections. Given that transaction costs are an integral part of the implementation of these selections,*

[109] *IMA Insight February 2012*
[110] *IMA Statistics Series Paper:3 Chris Bryant and Graham Taylor May 2012*

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they cannot be looked at in isolation. The realised shortfall in active fund returns compared to the benchmark is substantially less than the expected shortfall based on information in fund literature, reflecting the fact that, overall, the trading costs resulting from fund managers' active investment decisions are more than compensated by the extra returns generated compared with general market returns."

By September 2012 the IMA issued its guide "Enhanced disclosure of fund charges and costs". This recommended practices in relation to the disclosure of fund charges to complement the existing regulatory requirements including an explanation of the purpose of any entry or exit charge, an explanation of the types of charges included the ongoing charges figure[111], a statement whether the fund was subject to a performance fee and recommended additional disclosures about the portfolio transaction costs incurred in the buying and selling of investments for the fund with three year average figures for broker commissions and transfer taxes such as stamp duty reserve tax (SDRT).

Although the IMA recommendations were voluntary it expected its members to adopt the recommendations. Of course not all investment managers are members of the IMA.

By 2014 the position had altered with the new chief executive of the IMA being quoted in the press:

"*The notion that fund managers hide costs is one of the most corrosive issues we face. We are working on proposals for a simple, comprehensive statement of return and costs to be included in reports and accounts, which would incorporate all the costs incurred by a fund over the course of a year and provide full accountability to investors in a simple, pounds and pence figure.*"[112]

One of the arguments used by industry in relation to transaction costs is that they are difficult to establish and are backward looking in nature because transaction costs can vary year on year. Some firms use the portfolio turnover rate as a proxy to estimate transaction costs. But other firms have come up with methodologies to calculate them.[113]

The IMA research contrasts with other evidence that suggests undisclosed transaction costs could, for example, add almost 1.5% per annum to the disclosed costs of a collective investment scheme.

For example a 2007 US academic study by Edelen, Evans and Kadlec: 'Scale effects in mutual fund performance: The role of trading costs', suggests that annual trading costs for a large sample of equity funds were comparable in magnitude to the expense ratio, that they have higher cross-sectional variation that is related to fund trade size and that they have an increasingly detrimental impact on performance as the fund's relative size increases. It went on to suggest that relative trade size subsumed fund size in regressions of fund returns, which suggested that trading costs are the primary source of diseconomies of scale for funds. It identified the negative impact of trading costs to three clear factors:

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[111] *Ongoing charges is the term that replaces Total Expense Ratios (TERs) as a disclosure of costs incurred by a fund annually*
[112] *http://www.moneymarketing.co.uk/news-and-analysis/investments/the-imas-daniel-godfrey-the-corrosive-issue-of-hidden-costs/2005589.article*
[113] *http://blog.brightscope.com/wp-content/uploads/2009/05/brightscope-transaction-cost-algorithm.pdf*

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scale diseconomies, operational trades (i.e. flows) and agency related trades (i.e. soft dollars).[114]

Inevitably trade organisations are set up to represent the interests of their members and it is therefore important that in critical areas such as retail financial services there is adequate independent review of investment management activities and that control in areas such as governance and the charging of costs and expenses is performed in a manner that is independent of the financial services provider and its industry organisations.

3.21 Expenses and risks of custodial services

Regulated investment funds are required to appoint a custodian to safeguard assets. The costs of custodial services are deducted from the fund. The costs for custodial services are generally disclosed and are usually a few basis points on the value of assets held. However charges can also be transaction based and these transaction costs can be over and above the basis point fee on the value of assets held. Even these services can have additional hidden costs, the most notable of these being in relation to foreign exchange services and cash management. These hidden costs arise because the custodian offers rates that are not competitive and is therefore able to benefit from lower interest rates and poorer exchange rates at which it transacts business which are an opportunity cost for investors who lose the potential income from these transactions.

Custodians can also use the assets they custody to lend those assets to third parties such as hedge funds that wish to go short on those securities for a fee (stock or securities lending). (See 3.25 below) Although there is starting to be greater awareness of these practices many trustees of pension schemes and corporate directors have historically not questioned the custodial businesses on their securities lending programmes and practices.

In 2005 an American academic study of custodial costs[115]looked at the factors that affect custodial fees and identified five factors related to portfolio management that can affect fees:

- Number of securities held can impact on the custodial fee if the charges are based on the number of securities held. The number of securities held can also expand the range of securities the custodian is able to lend for securities lending programmes and therefore the amount of money it can make from this activity
- Portfolio turnover can increase custodial fees
- Fund Yield – dividend and interest paying investments can result in additional custodial fees for collection of payments
- Percentages of foreign securities held

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[114] *Scale Effects in Mutual Fund Performance: The Role of Trading Costs, March 2007, Edelen, Evans and Kadlec* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951367

[115] *The Journal of Applied Business Research – Winter 2005, Vol 21, Number 1 An Analysis of Mutual Fund custodial Fees, Cullinan, Bline, Bryant College* http://cluteonline.com/journals/index.php/JABR/article/viewFile/1496/1476?origin=publication_detail

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- Percentage of cash held

Activities such as securities lending programmes also carry additional risks – these risks are borne by the investors but are often not risks for which they are rewarded or told about.

Custodians need to be made more accountable for the assets under their care and to disclose the risks that they place those assets in through their activities. The income that they generate from holding these assets and how this is shared with the investors who own those assets should be disclosed.

3.22 Trade execution on funds

There is a general assumption that assets invested on behalf of retail customers enjoy the greatest protections in financial services. The intention of the regulations is to meet this objective but this may not always be achieved depending on how the investments are made and managed. Investment decisions on funds can result in transactions being executed in a variety of ways. Trades or orders can be aggregated prior to a trade and an investment manager may execute a trade using different trade venues which can be regulated markets, multilateral trading facilities or other financial institutions.

UK regulation requires that a firm must take all reasonable steps to obtain, when executing orders, the best possible result for its clients taking into account the 'execution factors'.[116] This is referred to as best execution. The criteria applied to determine the relevant importance of the execution factors include the characteristics of the client which require the categorisation of the client as retail or professional. (COBS 11.2.6) Where a firm executes an order on behalf of a retail client, best execution is the best possible result determined in terms of the total consideration. i.e. the price of the financial instrument and all the costs related to execution.

The IMA state in their 2014 report on dealing commissions that: "*While execution cost is always important, it is only for retail clients that it is the determining factor in achieving best execution. In all other cases, the investment manager has the flexibility to subordinate cost to other factors such as execution quality.*"[117]

A retail investor investing in a fund is treated as a retail client for the purposes of the purchase and sale of units or shares in the fund.

The best execution rules are disapplied to a firm when, acting in the capacity of operator of a regulated collective investment scheme, it purchases or sells units in that scheme.[118]

[116] *COBS 11.2.1* *http://fshandbook.info/FS/html/FCA/COBS/11/2*
[117] *Investment Management Association (2014) The Use of Dealing Commission for the Purchase of Investment Research, February*
[118] *COBS 11.1.7* *http://fshandbook.info/FS/html/FCA/COBS/11/1*

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The investment manager in managing the investments has another client – the investment fund. For best execution purposes therefore the first thing necessary is to determine what type of client the fund is. COBS 3 sets out the rules for categorisation.

There are 5 types of clients under the FCA rules:
1. Retail clients
2. Per se professional clients
3. Elective professional clients
4. Per se eligible counterparties
5. Elective eligible counterparties

For example, per se professional clients include investment firms, insurance companies, collective investment schemes or the management company of such a scheme, a pension fund or the management company of a pension fund, trustees of an occupational pension scheme or small self administered scheme or a trustee or operator of a personal pension scheme with at least 50 members and assets under management of at least £10 million etc (COBS 3.5.2 R). It is possible for all clients to change their categorisation subject to the rules.

Per se eligible counterparties also include investment firms, insurance companies, collective investment schemes authorised under the UCITS directive or its management company but only in respect of eligible counterparty business which includes execution of orders on behalf of clients. [119]

An investment manager must for each UCITS fund it manages, act in the best interests of the fund when directly executing orders to deal on its behalf or when transmitting those order to third parties. The investment manager is expected to take all reasonable steps to obtain the best possible result for the scheme on a consistent basis taking into account price, costs, speed, likelihood of execution and settlement, size and nature of the order or any other consideration relevant to the execution of the order. (COBS 11.2.5).

Investment managers document their order execution policies. These invariably list the execution factors but interestingly do not appear to disclose the type of client the fund will be categorized as by the investment manager and whether or not it has elected to be treated differently.

Best execution operates on the principle that the firm must identify the type of client it is dealing with. Every client is either a customer[120] or an eligible counterparty. – i.e. whether the client is a retail or professional client or an eligible counterparty.[121] (The FCA announced in a Market Watch publication that it intended to conduct a thematic review of best execution in different markets.[122])

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[119] http://fshandbook.info/FS/glossary-html/handbook/Glossary/C?definition=G156
[120] *A customer is either a retail of professional client*
[121] *FCA Conduct of Business SourceBook COBS 11.2.6 Best Execution Criteria*
[122] http://www.fca.org.uk/static/documents/newsletters/market-watch-45.pdf

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Where transactions are aggregated for different 'clients' of the investment manager and different venues are used to fill the orders the client is likely to be identified as the investment manager - a professional client or eligible counterparty.

Even where the relationship is clear, there is not necessarily any guarantee that a client would receive best execution as was demonstrated in a recent investigation by the FCA where it fined an FX broker, Forex Capital Markets Ltd, £4m for failures in best execution. The broker had kept the profits from favourable market movements between the time the orders were placed by it and executed, while any losses were passed on to clients in full - a practice known as 'asymmetric price slippage'.[123]

Investment managers should have a better understanding of the markets and the prices they are receiving and many investment managers monitor 'slippage' to ensure that they are receiving the best possible prices in the market using external suppliers and monitoring systems that track prices and execution.

Best execution does not apply to insurance-based products, i.e. unit-linked products. It also may not apply to firms managing a UCIT for a third party. Non-UCIT collective investment schemes such as alternative investment funds can contract out of best execution.

In 2004, Edhec Risk conducted a European survey on Best Execution and reached the conclusion that the "*industry ha[d] reached a clear maturity point with regards to the understanding that best execution [wa]s an important objective to achieve in order to better align organisations with the most successful houses. However, the ultimate interest of the investors would appear not to be the most important reason for this*."[124]

Understanding aggregation and transaction resourcing is essential to any analysis of how the line between retail and institutional investors can be blurred. Most investment houses do not transact on a transaction by transaction basis for each individual fund that they act for. It would be too cumbersome. If a manager handling UK equities has determined a general house view that it would be a good idea to sell the shares in ABC Plc and buy XYZ Plc instead, it aggregates the positions it has in ABC Plc in order to sell them and looks to source a purchase of XYZ Plc. The execution teams will source these orders, which may involve aggregating or disaggregating the trades for different venues or to ensure that they do not have an impact on the market. It is then the job of the investment managers' back and middle office teams to allocate these sales and purchases back to the ultimate funds to which these trades belong. These days it is often an automated process with the manager's execution system doing the trade allocations.

These trades would be unrecognisable in the market from the theoretical transactions by an investment fund when an order is being worked. Equity transactions for example can happen in a number of ways or venues: they can be transacted on exchange, off

[123] http://www.fca.org.uk/news/fca-fines-fxcm-uk-4-million-for-making-unfair-profits-and-not-being-open-with-the-fca
[124] *Edhec-Risk Advisory Best Execution for Buy-Side Firms, A challenging issue, a promising debate, a regulatory challenge, European Survey on Investment Management Practices (2004) June* http://www.edhec-risk.com/features/Best%20Execution%20Survey/attachments/Best%20Execution%20-%20A%20challenging%20issue,%20a%20promising%20debate,%20a%20regulatory%20challenge.pdf

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exchange such as in an OTC or private trades, as a cross agency trade (where the manager sells ABC Plc to another fund they manage and buys from that fund shares in XYZ Plc, (perhaps because there are two managers with opposing views in that investment house or where the manager wishes to release some liquidity on a fund). The transaction could also occur in what are now referred to as dark pools so that there is less visibility that the manager is in the trade or it could be on an electronic trading platform or a mix of all of these. The parties may only know the manager as the transacting party operating through an omnibus account and treat the trade as one with a professional client or 'eligible counterparty'.

Once an order is complete the manager will then generally average the price of these multiple transactions to allocate them back to the relevant funds.

Just because an investor is a retail investor does not mean that the fund structure is treated as a retail client. This means that price may not be the sole determinant in the execution of a trade and conflicts of interest such as those arising through the use of dealing commission can come into play.

3.23 Managing liquidity and credit facilities

The management of credit facilities and liquidity may also create additional conflicts of interest that operate as costs to investors because they reduce the value of investments owned by the retail investor.

Most investment managers require credit facilities so that they can manage any mistiming in flows of money that are required for investment purposes. The investment manager will negotiate these terms for their fund ranges. What is not necessarily disclosed is that the same bank may also provide the investment manager with credit facilities for its own business. These facilities might be provided to the manager at a slight discount if the manager is prepared to accept that no interest or lower rates of interest will be paid on cash accounts operated in the names of the funds. These balances may be sizeable and depending on the settlement periods between receipt of cash and the execution of trades to get invested, the bank can earn significant sums of money on these cash deposits. These opportunity costs operate in a similar way to soft commissions as they benefit the managers' businesses at the expense of the investors' savings but are not necessarily disclosed.

The provision of liquidity by investment managers in their fund ranges is another hidden cost that investors can bear because investment managers' activities in this regard often go unchallenged.

This is best highlighted by two examples.

Firstly, phenomena such as the retailisation of hedge fund strategies into UCIT structures may be a ticking time bomb in relation to liquidity issues. This problem was highlighted when a UCITS had to suspend redemptions from their funds in 2008. In order for hedge

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fund strategies to be offered by investment managers to achieve distribution, a requirement for the UCIT structure is to provide investors with regular liquidity or dates on which the investor can exit the fund. The FCA in 2013 expressed concerns over the ability of funds promising to provide daily liquidity that would be unable to deliver it at something close to the daily price.[125] The problem is of particular concern in those funds that have share classes which include institutional investors as these investors are more likely to exit a fund as soon as they smell trouble, causing the investment manager to sell the most liquid assets to meet the liquidity requirement while retail investors who are less likely to be as reactive to market news and market conditions may be left with illiquid securities such as small cap equity investments or unquoted securities. Even where liquidity is met by selling the portfolio on a proportional basis there may well be mispricing of the portfolio because those prices may be affected by the size of the collective investment schemes' holdings in relation to the daily trading volume in the markets which can affect the realisable value of those securities.

Secondly there is the issue of cross-agency trades. The first thing to note is that when fund assets are held in custody – the account is often in an omnibus account in the managers name (i.e. XYZ Manager Client Account) and not that of the fund to which the assets belong (i.e. XYZ UK Equity Fund Account). It makes it easier for the manager and custodian to move assets around just reconciling everything from a paperwork point of view to fund level but without formally having to change title to holdings at fund level because of the omnibus account.

Lets say an investment manager has two funds. Fund A has received subscriptions for £1000 and Fund B has received redemption requests for £1500. Lets assume that fund A has a highly liquid portfolio and the manager earns 0.5% p.a. as an AMC on it. Fund B has a less liquid portfolio and the manager earns 1.0% p.a. as an AMC. Let us assume that the manager is unwilling or unable to sell assets in Fund B to raise the £1500 – it may be that the stock that he would want to sell is trending away from his target price or he just does not have the liquidity and cannot sell it. What the manager decides to do is to sell £1000 of the illiquid stock or even the units of fund B to fund A. Fund A pays for it with the new subscription of £1000. Fund A has now acquired an illiquid investment from fund B (on which the manager is earning a higher fee). Fund B now has £1000 in cash to meet the redemption requests and the manager may borrow £500 against its credit facility to meet the redemption request as a short term timing requirement. So far as the custodian is concerned there are a few book entry adjustments because the assets are in the manager's name rather than specific to the fund. The manager preserves their reputation by having met the liquidity requirement of the redemption request and a month later if all goes well and fund B receives some more subscriptions the investment made by fund A can be quietly reversed with some careful wording for the compliance team that the transactions were in the clients' interests and everyone at the investment manager is happy.

[125] http://www.investmentweek.co.uk/investment-week/news/2303943/fca-we-are-concerned-over-funds-ability-to-meet-liquidity-promises

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There are rules set by the FCA that require that these transactions are conducted only in the best interests of the clients but there is regulatory evidence that this does not always happen.

These practices can also occur when an investment manager runs funds of funds and needs to manage liquidity between them.

Conflicts of interest can arise between funds managed by the same firm. Martin Currie Investment Management Ltd and Martin Currie Inc were fined £3.5m and $8.3m respectively by the FCA and the SEC in relation to how they had managed similar sorts of conflicts of interest in May 2012.[126]

3.24 Box Management for transacting in units

Box management in relation to units in funds is not well understood outside the investment industry. When transactions occur on the buying and selling of units in collective investment schemes these units need to be created in order to be sold or to be cancelled when an investor wishes to redeem from the product. This can be a cumbersome process. On many funds there will be a number of buy and sell transactions on any given day. In order to manage these transactions it makes sense for the manager to match buys and sells (referred to as creation/cancellation of units) and to only cancel or create new units for the net difference. So if on one day there are purchases of 600 new units (creation) and requests for 400 units to be sold (cancellation) the manager only needs to create 200 new units to meet the requirements for that days trading. If these units are sold based on a single price the manager will not make any profit or loss. Because the net requirement is creation units and if the units are sold using a dual price system then the manager will make box profits on 400 units. This is because the 400 units matched for the day will have been bought at the higher offer price while the 400 units sold by investors will have been cancelled at the lower price. The manager can also make a loss on the box if they also maintain a float of units in the box because these are then units that the manager technically owns in the box and which can sustain losses in value but the manager will closely monitor the position and will be able to minimise losses by cancelling units that it is holding in the box that are losing value.

These box profits can be an additional source of income for the investment manager that investors may be unaware of because some of the units they have paid for on the grounds that they need to be created are not used for that purpose, these additional costs of creation are saved by the manager using units in the box and contribute towards its own profitability. The box can also make losses but the manager is in a better position to minimise these by cancelling units that are making losses.

In March 2013 the Financial Times ran a story on how the profits from box management were pocketed by investment management firms.[127] A number of large investment

[126] http://www.fca.org.uk/static/pubs/final/martin-currie.pdf
[127] http://www.ft.com/cms/s/0/334ffcea-8d9c-11e2-9a8a-00144feabdc0.html#axzz2yxO8wM00

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managers had confirmed to the newspaper that they took capital from some of their dual priced unit trusts in the form of box profits, a permitted practice that is open to all dual priced unit trusts.

3.25 Shorting, stock lending and collateral management

Although we have looked at custody and discussed its importance from a cost perspective, it is also necessary to understand how managers use certain investment techniques and what their implications are for investors.

Managers of funds can go short on securities when they form a view that the value of those securities is likely to fall. They borrow the securities from a party able to lend the securities, such as the custodian of a pension scheme or a fund and sell those securities in the market. When they decide to return the investments they go into the market to buy them – hopefully at a lower price. The difference is pocketed by the fund as profits from that investment and the custodian or other lender of those securities receive a fee for having lent those securities – referred to as short interest. In the past the custodian receiving these fees has not always shared them with the owners of those securities and the owners have also been largely unaware of the risks that their assets have been placed under by the organisations that are supposed to be safe keeping them. Even today the fee that the custodian retains can be quite sizeable from these activities.

The investment manager that borrows these stocks also needs to put up collateral, which is provided to the custodian or lender of these securities. This collateral is generally the cash realised from the sale of the borrowed security. In order to manage the risks the lender will normally require the investment manager to put up more collateral if the price of the short starts to move against him. If the manager is unable to do so then the fund they are managing may be deemed to be in default and the collateral can then be realised for the benefit of the lender.

Another problem with short lending is that of course the fund or pension fund who originally owned the assets, may decide for its own reasons that it wishes to sell the securities its custodian has lent. The custodian is able to demand the repayment of those securities from the borrower in order to settle the transaction of the original owner. This may not suit the investment manager who has borrowed the securities and the manager may not be able to borrow those securities from anywhere else. In these circumstances particularly where the market is trending against the borrowing investment manager they then face what is referred to as a ‘short squeeze’ because they are being forced to return assets at a time when the price has risen.

Shorting of stocks requires specialist skills, including understanding how collateral is managed, and not all investment managers from long only investing backgrounds fully understand the risks and how they need to be managed.

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3.26 The operation of liens, rights of set off, indemnities and exculpation of liability

Another area of fund management that receives little attention by investment advisers are the rights that investment managers create over client assets through the operation of liens[128], rights of set off[129] and exclusions of liability in the contracts they enter into for investment management with the fund. The exercise of these rights could have significant implications for investors. These rights are common terms in contractual arrangements but they have implications for investors that are rarely challenged because these terms are viewed as standard or boilerplate terms. 'Generic Risks' as one investment manager dismissively put it.

Through these terms the manager reserves the right to exercise liens and rights of set off over investor assets for amounts owed to it. It also sets out what it is prepared to be liable for and what the investors indemnify it for (normally most of its expenses incurred in or arising from the performance of its duties).

For example, where a manager is sued by virtue of them being the manager of a fund, they are entitled to an indemnity for those costs from the assets of the investors in the fund. In a worst case scenario an investor suing an investment manager may in effect have to pay for the manager's defence. Even where an investor succeeds in a claim against the manager the manager may nevertheless be entitled to an indemnity from those assets unless that particular type of action was contemplated as an exclusion from that indemnity.

Admittedly such a cost is a contingent cost but where a manager chose to exercise it – it is likely to make the other costs and charges pale into insignificance.

A retail investor is unlikely to ever be able to negotiate changes to indemnity exclusions or even exclusions of liability in contractual terms in an investment management agreement but an independent governance body should be able to do so and should flex its muscles where it has the bargaining power to do so in the same way as some institutional investors would when considering investment decisions. The power of the investors' cheque book needs to be exercised by governance bodies that are independent of the manager.

These rights are generally written into contracts, with the balance of advantage firmly in the managers' favour rather than being arms length transactions negotiated by parties with equal bargaining power.

3.27 Implications of market structure on costs and charges

The purpose of Chapter 3 was to provide an understanding of how various aspects of the workings of markets and investment managers' conduct can have a potential impact on the costs of a fund.

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[128] *A right to hold assets until amounts owed to the manager are discharged*
[129] *The right to net amounts receivable by a manager against amounts payable, so that only the difference between the two amounts is payable or receivable*

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As the FCA point out in their reports, not all asset managers conduct themselves in a manner to actively exploit some of the issues discussed here, but acceptance of many of these issues as market practice gives them a cloak of respectability that needs re-examination. An understanding of investment structures and operations place regulatory policy makers in a better position to analyse processes and identify where potential detriment for retail investors and consumers of investment management services may arise, whether in respect of direct charges, costs, expenses or opportunity costs of lost income and how potential conflicts of interest might arise.

The investment markets are complicated and the differences between retail and institutional investors are sometimes artificial because of the way assets are aggregated and managed in funds. Asset managers have to struggle with a myriad of regulations that do not always reflect and neatly fit with market practice and structure. The principal-agent relationship and the associated potential conflicts of interest require a real willingness in culture to manage them properly and independently of the asset managers. Failures in this respect appear to occur regularly as evidenced through regulatory enforcement actions by UK regulators.

The regulators do respond to issues of detriment as they arise, in order to maintain fair markets, but due to a combination of powers and resources available to them they are often only able to respond reactively to issues.

The time has come to look again at retail fund structures as a whole and to consider whether they remain fit for purpose to meet the requirements of the UK retail financial markets.

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4. Current and Evolving Disclosure Requirements

Key Points

- MiFID II is expected to require the provision of greater transparency to investors on funds
- There is growing recognition that unit-linked funds need to provide higher levels of transparency to investors and there are moves to create more equivalence in transparency between all packaged retail investment products including unit-linked funds
- Reporting practices on pensions are also being tightened but may not succeed because information is likely to remain incomplete. In the charge cap for UK automatic enrolment default funds for example, key costs are being excluded, including transaction costs and variable costs associated with buying, holding and selling the underlying investment instruments
- There is a danger that investment service providers will try to find ways around charge caps and definitions of charges.
- KIIDs will provide more disclosure going forward but this is still likely to be insufficient and only deals with disclosure on one type of fund structure
- The asymmetries of information and understanding are likely to remain between investment service providers and investors

4.1 MiFID II

In October 2011 the European Commission announced its intention to amend the Markets in Financial Instruments Directive. The industry refers to this as MiFID II. For the purpose of this report the relevant requirements proposed included an extension to transparency in relation to instruments such as bonds and derivatives and the provision of additional information. There were also proposals in relation to advice and what constituted advice and a potential ban on the sale of structured UCITS on an execution-only basis.

The European Parliament approved the updated rules in January 2014. Stronger investor protection is proposed through strengthened requirements for client asset protection; product governance; conduct rules for the provision of information to clients; clarity on what constitutes independent advice and limitations on the receipt of commissions and

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inducements. It also covers packaged retail investment products and amends the Insurance Mediation Directive to introduce some rules for insurance based investment products.[130]

On 15 April 2014 the European Parliament approved the legislative texts that will amend MiFID. On 24 April 2014 the Commission sent a mandate to ESMA on possible delegated acts in MiFID seeking technical advice[131]. ESMA have issued a consultation document, responses to which must be received by 1st August 2014.

The 720 page directive will have a direct impact on the distribution activities and value chain of asset managers and distributors of financial products.[132] MiFID II requires better governance by the investment managers over their own businesses and specifies the number of directorships individuals will be able to hold. Firms will have to ensure that each product they manufacture is consistent with the identified target market. Retail clients will need to be provided with a statement of suitability before the transaction and firms providing portfolio management services will be required to carry out a periodic assessment of suitability. Firms providing independent advice will not be able to accept or receive inducements from third parties. Firms providing advice and portfolio management will not be allowed to accept or retain fees, commissions or any monetary or non-monetary benefits paid by a third party in relation to the provision of the service to clients with the exception of minor benefits under certain conditions.[133]

The technical advice requirement includes how investment advice is provided through distribution channels such as the Internet, product governance and how products are reviewed, safeguarding client assets (particularly where Title Transfer Collateral arrangements are entered into. These are not allowed when dealing with retail clients but their use with non retail clients may still undermine the effectiveness of client asset requirements). They have also been asked to look at:

- effective arrangements to mitigate the risks of investment firms agreeing to unsuitable liens and rights of set off over their client's assets,
- conflicts of interest rules to improve this framework,
- inducements,
- independent advice,
- suitability and appropriateness,
- client agreements and reporting obligations,
- best execution,
- order handling,
- product intervention by regulators and
- costs.

In reviewing the information provided to clients and information on costs and charges, ESMA have specifically been asked to provide advice on:

[130] http://europa.eu/rapid/press-release_MEMO-14-15_en.htm?locale=en
[131] http://ec.europa.eu/internal_market/securities/docs/isd/mifid/140423-esma-request_en.pdf
[132] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+20140415+TOC+DOC+XML+V0//EN
[133] http://www.pwc.lu/en/regulatory-compliance/docs/pwc-mifid-230414.pdf

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- "*the costs and charges to be disclosed to clients as well as their aggregation, which could be expressed both as a cash amount and as a percentage;*

- *the format and timing of disclosure (ex-ante and ex-post) of information on costs and charges, including methodologies to calculate ex-ante costs;*

- *appropriate modalities to provide such information to professional clients and eligible counterparties;*

- *the scope of investment firms subject to this obligation bearing in mind the objective to ensure such important information is provided on the broadest possible basis and bearing in mind situations where more than one investment firm provides investment or ancillary services to a client;*

- *the requirements to be met by firms when providing their clients with information on the cumulative effect of costs on return in order to increase the client's understanding and awareness of the cumulative effect of costs and charges on their investments*."

It is interesting to note that the Commission has directed ESMA to take into consideration extending the requirements of disclosure also to eligible counterparties and reminded them that the financial crisis has shown the limits in the ability of even non-retail clients to appreciate the risk of their investments.

These changes are not expected to come into force in the UK until 2016. It is usually 30 months following the entry into force of the Directive and Regulation.

4.2 Packaged Retail Investment Products (PRIP)

PensionsEurope represents the national associations of pension funds and similar institutions for occupational schemes. In January 2014 they published a position paper on the proposal for regulation of KIIDs for PRIPs. Their view was that occupational pensions should fall outside the scope of PRIPs.[134] The European Fund and Asset Management Association (EFAMA) disagreed.[135] On 15 April 2014 the European Parliament approved rules on the information that must be given to small investors. The rules would apply to all investment products intended for small investors but would not apply to non-life insurance products, defined as:

"*life insurance contracts where the benefits under the contract are payable only on death or in respect of incapacity due to injury, sickness or infirmity, or deposits other than structured deposits and securities.*

[134] *PensionsEurope (2014) Position Paper on the proposal for a regulation on key information documents for investment products* http://www.pensionseurope.eu/system/files/2014.01.27%20-%20PensionsEurope%20position%20paper%20on%20PRIPs.pdf
[135] http://www.europeanpensions.net/ep/pension-plans-should-be-covered-by-prips-kids-legislation.php

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Officially recognised pension schemes, pension products which, under national law, are recognised as having the primary purpose of providing the investor with an income in retirement and individual pension products for which a contribution from the employer is required would be also exempted from the scope of the legislation."[136]

This exclusion will be re-examined within four years after entry into force of the regulation. The rules will need to be endorsed by the UK and will take effect within two years.

The text that has been approved applies to all products regardless of their form or construction that are manufactured by the financial services industry to provide investment opportunities to retail investors where the amount repayable to the investor is subject to fluctuations because of exposure to reference values or in the performance of one or more assets which are not directly purchased by the investor. These products shall be known as PRIIPs and will include investment products such as investment funds, life insurance policies with an investment element and structured deposits. For these products, investments are not of a direct kind achieved when buying or holding assets themselves. Instead these products intercede between the investor and the markets through a process of "packaging", wrapping or bundling together assets so as to create different exposures, provide different product features, or achieve different cost structures as compared with a direct holding. Such "packaging" can allow retail investors to engage in investment strategies that would otherwise be inaccessible or impractical, but can also require additional information to be made available, in particular to enable comparisons between different ways of packaging investments.[137]

In other words the disclosure requirements will apply to all fund structures other than pensions as defined above.

The requirements for the KIID include:

- The use of clear, understandable language accessible to retail investors
- Avoiding financial jargon and terminology not immediately clear to retail investors
- Use of investment product calculators that cover the costs and fees charged by various investment product manufacturers together with any further costs or fees charged by intermediaries or other parts of the investment chain not already included by the manufacturer
- Where information is difficult to understand it needs to include a comprehension alert to inform the retail investor of this fact. This will include information on products not commonly invested in by retail investors, use of different mechanisms to calculate the final return and pay offs that take advantage of behavioural biases such as teaser rates followed by a much higher floating conditional rate or iterative formula
- It needs to be separated from any marketing documents and cannot cross reference to them
- Must be kept up to date

[136] http://www.europarl.europa.eu/news/en/news-room/content/20140411IPR43440/html/Key-things-small-investors-should-be-told
[137] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+AMD+A7-2013-0368+004-004+DOC+PDF+V0//EN

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- Must not be misleading, inaccurate or inconsistent with the relevant parts of the contractual documents of the PRIIP

The European proposals include providing retail investors with a right of redress to seek compensation for damages they suffer due to failures on the part of the PRIIP manufacturer. In order to do this it seeks to harmonise the rules relating to liability of the PRIIP manufacturer making them liable where loss is through the KIID being inconsistent with the contractual documents under the product manufacturer's control. The document also refers to proposing explicit mechanisms for prohibiting or restricting the marketing distribution and sale of insurance based investment products giving rise to serious concerns about investor protection. This may require UK insurers and regulators to look at how product platforms and product choice are offered given current restrictions on compensation for reinsured products.

PRIIP manufacturers will be required to give a substantive response to complaints by investors.

Significant changes could therefore come in to play but only in two years time.

4.3 UCITS products and the KIID

COLL 4.7 sets out the current requirements for the key investor information document (KIID) that must be provided to investors that are investing in any ICVC, authorised unit trust or authorised contractual scheme that is set up as a UCITS in the UK.

The KIID must provide comprehensible information written in non technical language without reference to any other document on the following aspects of the UCITS:[138]

(a) identification of the scheme;
(b) a short description of its investment objectives and investment policy;
(c) past performance presentation or, where relevant, performance scenarios;
(d) costs and associated charges; and
(e) risk/reward profile of the investment, including appropriate guidance and warnings in relation to the risks associated with investments in the scheme.

The KIID must also state where and how to obtain additional information including the prospectus and annual and half yearly reports.

It needs to include a synthetic risk and reward indicator and the ongoing charge which must be calculated and disclosed in a particular manner.[139] The ongoing charge does not include the following costs:

[138] http://fshandbook.info/FS/html/handbook/COLL/4/7
[139] http://www.esma.europa.eu/system/files/10_674.pdf

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a) entry / exit charges or commissions, or any other amount paid directly by the investor or deducted from a payment received from or due to the investor;
b) a performance-related fee payable to the management company or any investment adviser;
c) interest on borrowing;
d) payments to third parties to meet costs necessarily incurred in connection with the acquisition or disposal of any asset for the UCITS' portfolio, whether those costs are explicit (e.g. brokerage charges, taxes and linked charges) or implicit (e.g. costs of dealing in fixed-interest securities, market impact costs);
e) payments incurred for the holding of financial derivative instruments (e.g. margin calls);
f) the value of goods or services received by the management company or any connected person in exchange for placing of dealing orders (soft commissions or any similar arrangement).
g) The exclusion in (e) for transaction-related costs shall not extend to:
i) transaction-based payments made to any of the persons listed in (a) or (b), in respect of which the recipient is not accountable to the UCITS; all such amounts shall be taken into account in the published figure;
ii) the costs of acquiring or disposing of units in other UCITS or collective investment undertakings (CIUs), need to be taken into account

Protection from civil liability is provided to the person providing the Key Investor Information provided the KIID and any translation of it is not misleading, inaccurate or inconsistent with the relevant parts of the prospectus.

This information needs to be filed with the regulator.

As we have seen from the earlier discussions there are a number of key items that are excluded from this document and yet it will often be the only document that an investor will see ahead of making an investment decision even though the option to receive more information is available.

The Investment Management Association issued a Statement of Recommended Practice (SORP) for financial statements of UK authorised funds. Its most recent version is dated May 2014[140].

The 2011 update, required disclosure of Total Expense Ratios (TERs) to be replaced with an Ongoing Charges figure. The TER is calculated in accordance with COLL 4 Annex 1R while the ongoing charge is calculated in accordance with European regulations (CESR/10-674).

In the FCA regulations, COLL Appendix 1EU KII Regulation,[141] Article 12 deals with transaction costs and states that where the impact of portfolio transaction costs on returns is likely to be material due to the strategy adopted by the UCITS this needs to be stated

[140] *Investment Management Association (2014) Statement of Recommended Practice Financial Statements of Authorised Funds*
[141] http://fshandbook.info/FS/html/FCA/COLL/Appendix/1EU

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within the ‘Objectives and investment policy’ section. Article 10 deals with ongoing charges.

In the 2010 SORP - Section 2.64 to 2.69 dealt with the disclosure of expenses in financial statements of authorised funds. 2.65 stated that transaction costs were generally recognised as part of the consideration for a transaction. i.e. they are treated as a cost rather than a charge on the fund. The focus on treatment of expenses was generally whether they should be charged against capital or income rather than disclosure.[142] The implications in relation to transaction costs were that where a collective investment scheme purchased shares worth £100 and paid dealing commission of £10 then the accounts showed the cost of purchase of that investment as £110 without a requirement to disclose the £10 dealing commission separately. The 2014 SORP has removed the reference to transaction costs being recognised as part of the consideration in the old 2.65 and states in 2.68 that “*charges arising as a result of investment transactions for the scheme, such as handling charges levied by custodians, should be recognised on an accruals basis as deductions from capital.*”(It also refers to the FCA handbook - COLL 6.7.11G).

In May 2014 the FCA also published the results of its thematic review on Clarity of fund charges.[143] It concluded that using the AMC in some marketing material and ongoing charges figures (OCF) in other documents confused investors and hindered their ability to compare charges. The FCA suggested that using the OCF consistently in all marketing material for UCITS was likely to help investors understand and compare charges.

4.4 Unit-Linked Funds

The European Union commissioned a report in 2009 to look at disclosure practices in the EU on unit linked insurance products.[144] The report was designed as a mapping exercise. It established that with regard to insurance undertakings few European member states make a clear distinction between service related and product related charges. There was a clearer distinction in relation to insurance intermediaries between these two types of charges.

Costs for unit-linked products were typically structured along the following lines:

(i) An initial establishment charge or allocation rate (buying units in funds chosen by the customer) – usually a percentage of the initially invested premium and each additional investment the customer makes, covering, *inter alia*, the setting-up costs;

(ii) An Annual Fund Management Charge i.e. a percentage deducted from each fund in which an investor invests, used to cover charges associated with managing the investment options the customer chooses. This may also include Annual Adviser Remuneration if, for

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[142] *Investment Management Association (2010) Statement of Recommended Practice Financial Statements of Authorised Funds*
[143] *http://www.fca.org.uk/static/documents/thematic-reviews/tr1407.pdf*
[144] *https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/CEIOPS-Report-National-Measures-Unit-Linked-Life-insurance-products.pdf*

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example, an insurance intermediary takes commission for providing initial and on-going advice to the customer. N.B. Such commission may or may not have been agreed with the customer up front; and

(iii) Additional charges such as Early Cash-In/Surrender Charges or due to tax/ regulatory changes.

Items (i) and (iii) tended to be product-related costs as they were directly linked to the type/amount of the investment chosen by the customer, whereas item (ii) contains elements of both product-related costs and service-related costs because they cover costs related to underlying assets and costs related to financial advice provided by an insurance intermediary.

The report said that an insurance undertaking would in many member states be required to give information on costs in connection with service and product as appropriate, in a comprehensible way so that a customer was reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument being offered. MiFID IM Article 33(a) provides that:

"*Member States shall require investment firms to provide their retail clients and potential retail clients with information on [costs and associated charges] that includes such of the following elements as are relevant:*

[the total price to be paid by the client in connection with] the financial instrument or [the investment service or ancillary service], including all related fees, commissions, charges and expenses, and all taxes payable via the investment firm or, if an exact price cannot be indicated, the basis for the calculation of the total price so that the client can verify it".

On an ongoing basis it was common practice for the insurance undertakings to inform the policy holder about specific types of data but the scope of the data was substantially different for different member states

The UK rules for unit-linked funds are found mainly in COBS[145] and relate in the main to the permitted links – i.e. types of investments that the funds can make (COBS 21), with – profits funds (COBS 20) and some pensions supplementary disclosure provisions (COBS 19). The introduction of European rules for Packaged Retail Investment and Insurance Products (PRIIPs) is likely to change the paucity of rules relating to disclosures by unit-linked funds by bringing them more into line with other retail fund products. Whether these additional disclosures will achieve their aims however, remains to be seen.

4.5 Non UCIT Retail Schemes (NURS)

Given the movement of the EU towards classifying collective investment schemes into UCITS and Alternative Investment Funds (AIFs) it is expected that the NURS regime will be subsumed into the rules for an AIF as these non-UCIT retail schemes appear to fall

[145] *FCA Handbook COBS 19 -21* *http://fshandbook.info/FS/html/handbook/COBS*

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within the scope of the Alternative Investment Fund Managers Directive (AIFMD). AIFMD requirements generally follow the UCITS rules regime so it is expected that the changes should not be too dramatic for most investment managers running such schemes. FUND 3.2.2 (9) of the FCA handbook requires a description of all fees, charges and expenses and the maximum amounts directly or indirectly borne by investors.[146] The common requirements for retail funds, which will be placed in FUND 4.1 and 5.1 of the FCA Handbook, have not been issued.

4.6 Retail Distribution Review

The ban on product providers remunerating platforms in cash or in kind came into play in April 2014. Investors now need to pay these charges explicitly. Different platforms have dealt with these changes differently. Some have reduced manager fees or platform fees or moved the charges on to other products or services such as investment trusts and costs for share transactions. The FCA has indicated that fund supermarkets can offer rebates using fund units on legacy investments until there is a switch to 'clean' funds, which is expected in 2016.[147]

4.7 Current reporting practices on pension schemes

In November 2012 The NAPF published the work of a joint working group – Pension Charges Made Clear: Joint Industry Code of Conduct, Telling employers about DC pension charges.[148]

The purpose behind this document was to provide information about charges to employers in a form they could understand as part of good transparent practice, and to allow a more ready comparison of charges and services, so that employers and trustees were able to act as well informed customers.

Disclosure of transaction costs in the template required an average to be disclosed over the past three years for broker commissions and stamp duty and referred to the IMA Guidance on fund charges and transaction costs discussed earlier. However this code has been criticized by the True and Fair Campaign which describe it as a 'fudge' because they argue that the disclosure will tell you what the spread is but not how often the manager has traded and the disclosure will be per unit rather than in absolute terms.[149]

The code is a voluntary code and not all IMA members have adopted it although they are expected to do so.

The Investment Management Association has had a Pension Fund Disclosure Code for some time. The March 2005 edition superseded the May 2002 edition and the current

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[146] http://fshandbook.info/FS/html/FCA/FUND/3/2
[147] *Chartered Institute for Securities and Investment, (2014), Change - The Regulatory Update, April*
[148] http://www.napf.co.uk/~/media/Policy/Documents/0273_Pensions_charges_made_clear_code_of_Conduct.ashx
[149] http://www.pensions-insight.co.uk/ima-single-figure-is-yet-more-fudging/1472478.article

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edition appears to be September 2007. In a 2006 survey by the IMA they asked a question about the take up of the second edition of the code and 48 out of 53 respondents representing 98% of the assets under management in the study said they complied[150]. The DWP feasibility study on charges noted that if pension schemes routinely received detailed breakdowns of explicit transaction costs in accordance with the guidance in this code then their full disclosure to members of the schemes was feasible.

The Pensions Act 2014 has brought in a requirement in section 44 for the Secretary of State to make regulations requiring information about some or all of the transaction costs of a relevant scheme to be given to some or all of the persons mentioned.[151] We will need to see how the DWP will approach this because if the disclosure is only in relation to some of the costs it is unlikely to have the desired effect.

The ABI made much of its published agreement by some of its members on the disclosure of pension charges and costs in January 2013. The signatories to this agreement committed to implement the agreement by the summer of 2014. The purpose of the agreement is to disclose all charges and costs in a consistent way both at the outset and crucially as people build their savings.[152] There appears to be no information on the ABI website of the progress made by the ABI on this initiative since January 2013.

The FCA Handbook perimeter guidance at PERG 10 gives guidance on activities related to pension schemes. Annex 3 tabulates and summarises the regulatory position of pension scheme trustees and service providers. PERG 12 covers guidance for persons running or advising on personal pension schemes.

The FCA Handbook at COBS 13 at Annex 3 sets out charges information to be provided for a packaged product and Annex 4 sets out charges information that should be provided for a personal pension scheme and a stakeholder pension scheme. For example reduction in yield information is not required for stakeholder pension schemes where adviser charges are not being facilitated by the scheme and carry an alternate form of disclosure.

Other organisations also provide information on charges on products such as the Money Advice Service, but the product information is limited.[153]

In March 2014 the FCA and TPR issued a joint guide to the regulation of workplace defined contribution pensions[154] to provide an overview of how DC pension schemes are regulated to protect the interests of consumers (the reference to 'workplace' is incorrect shorthand and should read 'work-based'. The Pensions Act 2004 refers to work-based pension schemes.[155]). It makes some important points. It recognises that although a completely identical regulatory approach across the two types of scheme is not feasible, the regulators do have the same expectations for scheme quality and member outcomes.

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[150] *IMA (2006) Asset Management survey for year ending December 2006 Page 55*

[151] *http://www.legislation.gov.uk/ukpga/2014/19/section/44/enacted*

[152] *https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2013/Pensions/ABI%20Agreement%20on%20the%20disclosure%20of%20pension%20charges%20and%20costs%20January%202013.ashx*

[153] *http://pluto.moneyadviceservice.org.uk/pensions*

[154] *http://www.thepensionsregulator.gov.uk/docs/guide-to-the-regulation-of-workplace-defined-contribution-pensions.pdf*

[155] *Pensions Act 2004 Section 5(3)*

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What it is silent about is that the two regulators have quite different powers to regulate and what they can do in respect of the issues that either may have to deal with. In many respects the document is only an explanation of the memorandum of understanding between the two regulators. There needs to be greater consistency between the regulators and it is troublesome when even the definition of what constitutes an occupational scheme is slightly different as between the two regulators.

Arguably, the regulators incorrectly identify the main regulatory focus of TPR on DC pension schemes. The focus of TPR should not just be on the conduct of the trustees of 'trust based' schemes, as it suggests. The statutory objectives and functions of TPR go much further than just "trust based" schemes under the Pensions Act 2004 – they cover both occupational schemes and work-based personal pension schemes with direct payment arrangements. Based on their memorandum of understanding which does recognise the statutory objectives TPR has, it would appear that the FCA cover all DC schemes that are set up as work-based personal pension schemes or stakeholder schemes set up as personal pension schemes or group SIPPs while TPR cover occupational and statutory schemes. Some of the responsibility that TPR has in terms of its statutory objectives appears to have been delegated to the FCA through its memorandum of understanding, if not just in practice. [156] These nuances can be important, but because of the current use of language that creates shorthand for trust based and contract based schemes, the statements made do not appear to be strictly correct.

Statute as a general rule (with some exceptions) requires occupational schemes to be set up as trusts[157]. TPR as we have noted before does have statutory objectives to protect the benefits of members in occupational and work-based personal pension schemes and to promote and improve understanding of the good administration of work-based pension schemes. The FCA treat the setting up, operation and winding up of a personal pension as a regulated investment activity and through that they regulate work based personal pensions which in practice can include trust based schemes as we have discussed earlier in this report. Even the explanations in the appendix of the TPR/FCA document defining contract based schemes appear incorrect because the member's contract may not be with the product provider but with the administrator of the scheme, and as we have seen some of these schemes may be set up as trusts with the Trustees being the contracting party on behalf of the beneficiaries.

One might ask, so what? The answer must be that generalisations made in relation to these shorthand descriptions can sometimes be wrong and therefore more care needs to be taken. It shows how unnecessarily complicated the pensions universe has become just from a regulatory perspective alone when so much can be open to judgement and interpretation.

4.8 The DWP Command Paper on Better Workplace pensions

[156] *Memorandum of Understanding between the FCA and TPR* *http://www.thepensionsregulator.gov.uk/docs/mou-fca-regulator.pdf*
[157] *Pensions Act 2004 s252*

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In March 2014 the DWP issued its command paper - Better workplace pensions: Further measures for savers.[158]

The paper sets out the government's vision for 'workplace' DC schemes based on the principles that:

- Those running pension schemes are informed, competent and have members' interests as their priority.
- Charges borne by members in default arrangements are fair and only relate to services that add value to their pension saving.
- There is full transparency of all costs and charges throughout the value chain – in a way that enables scheme managers to compare across the market and get the best deal for their members.
- The regulators and regulatory regimes are joined up and focused on member protection.

In order to meet these principles the government is proposing:

- New minimum quality standards,
- Independent Governance Committees (IGCs) on all 'contract-based' schemes (see section 4.7 above for earlier comments about why this classification of schemes does not work well)
- A charge cap for default funds set at 0.75% of funds under management
- Banning consultancy charges on qualifying schemes
- In 2017 the cap will be reviewed with a view to including transaction costs in it
- Member borne charges incompatible with automatic enrolment will be banned from April 2016, such as active member discounts and adviser commissions
- From April 2015 trustees and IGCs will have new duties to consider and report on costs and charges including new requirements to make standardized disclosure of all pension costs and charges mandatory so that they are comparable between schemes

Although the government proposals indicate serious intent to tackle the problems identified, key costs are being excluded from the proposed cap on default fund charges – the transaction costs, variable costs associated with buying, holding and selling the underlying investment instrument, at least until the position is reviewed again in 2017. These costs will of course still need to be considered in relation to the Quality Standards being proposed for schemes and be disclosed. See the figure below for the detail on exclusions.

In a number of areas such as soft commissions and brokerage there is still potential for unchallenged conflicts of interest to exist. The problems with a charge cap per se is also discussed later.

[158] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf

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Excluded from the default fund charge cap on MBD: transaction costs: the variable costs associated with buying, holding and selling the underlying investment instrument
Brokerage commission and fees
Soft commission services included in brokerage fees, e.g. research costs
Transaction taxes, e.g. stamp duty and non-reclaimable withholding taxes on dividends
Spreads, e.g. bid-offer on bonds, FX (and associated costs such as commission)
Other charges embedded in the transaction price, e.g. payments incurred through financial derivative instruments
Entry fees, other initial charges and exit fees for investment in underlying funds
Deductions of expenses or fees from profits such that they are not shared equally with members, e.g. in relation to activities such as stocklending, interest income, foreign currency exchange

Figure 4 Charges excluded from proposed government charges cap[159]

[159] *Page 60 Tackling unfair charges – a cap on charges, DWP Command Paper Better Workplace Pensions* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf

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5. Research and International Developments

Key Points

- Costs play an important role in determining outcomes for investors
- Investors give more importance to performance information than they do to information on charges
- Fee caps are unlikely to help financial services to flourish
- Transaction costs can form a significant proportion of undisclosed costs on investments
- A number of countries and national regulators have focused on investment costs and how they are disclosed but have stopped short of requiring full disclosure on transaction costs
- Disclosure requirements vary between countries
- In order to understand costs on investments it is necessary to understand the scale of transaction costs and the nature of the conflicts of interest that may exist

5.1 Research on costs and charges

The problem with costs and charges of investment funds has been recognised for some time.

In October 2000, the Pensions Institute published a paper by David Blake and John Board on measuring value added in the pensions industry. Their evidence suggested that there was no clear relationship between charges, realised performance and expected performance. They argued that there was no support, either in theory or on the basis of existing evidence, for the argument that high charges could be justified by the promise of the superior investment performance that such high charges might be able to purchase. Their evidence indicated:

"*that strong investment performance, even if it existed for a period in the past, is very unlikely to be sustained over the long investment horizon needed by pension plans to build up sufficient assets for retirement. As a result, it would be much better for policyholders if providers competed on the basis of charges rather than on past investment performance.*"

They went further, recognising that the:

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"*current complex and often disguised charging structures used by providers [wa]s a source of consumer confusion.*" They felt that any "*suitable charging method must improve the incentive for providers to secure the long-term commitment of their policyholders and penalize underperformance as well as reward outperformance*". [160]

In 2000 the FSA also published an occasional paper (no.6) by Kevin James called The Price of Retail Investing in the UK. He examined the use of the Reduction in Yield (RIY) method to capture costs and concluded that since RIYs do not capture implicit costs such as transaction costs, which he demonstrated accounted for about half of the total costs of portfolio management, they were a misleading and biased measure of the true price of investing even for those people who could understand the concept. They failed to convey to retail investors an intuitively meaningful idea of the price for investing and placed actively managed funds at a disadvantage. The paper concluded that retail investors could not measure the price of investing because a significant element of this price is mostly not disclosed at all. But he was also not convinced that even if a retail investor could identify elements of this price that they would place sufficient weight on this information in taking investment decisions. This finding is important because most regulators and policy makers in Europe and most proposals for disclosure of costs continue to skirt around the issues of implicit costs and transaction costs in particular as being too difficult, which means that significant costs continue to remain undisclosed to investors.

In 2003 the Pensions Institute looked at the Polish pension system which showed that over a three year period the system was not cost effective and the incentives produced by the fees and peer based performance measurement frameworks had a detrimental impact on active investment management.[161]

The 2004 Pensions Commission (The Turner Report) also recognised the problem with costs and complexity saying "*both the behavioural barriers to savings and the costs of provision have been made worse by the bewildering complexity of the UK pension system, state and private combined.*" It also quoted a 2000 FSA report which had suggested that the implicit costs for actively managed equity funds could be as high as 1.3% and expressed the view that implicit costs added significantly to the overall costs with implications for post cost returns for savers.[162] Costs could absorb almost 30% of a saver's fund using a reduction in yield figure of 2.1% suggesting that in order for a saver to benefit the risk adjusted returns would need to exceed a minimum break even point of 2.1% on their capital.

The US did a similar review in 2004 in relation to 401(k) plans (which are similar to DC pension plans) forming a working group on plan fees and reporting through the Advisory Council on Employee Welfare and Pension Benefit Plans, which was created by ERISA to provide advice to the US Secretary of Labor. The working group concluded that "*many*

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[160] *http://www.pensions-institute.org/workingpapers/wp0005.pdf 2000 Blake & Board, Measuring Value Added in the Pensions Industry (October) Discussion Paper PI-0005 The Pensions Institute, CASS Business School, City University London*
[161] *Dariusz Stanko (2003) Polish Pension Funds, Does the System Work? Cost, Efficiency and Performance Measurement Issues, Pensions Institute, January Discussion Paper PI-0302 http://www.pensions-institute.org/workingpapers/wp0302.pdf*
[162] *2004 Pensions Commission, Pensions: Challenges and Choices, The First Report of the Pensions Commission.*

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plan sponsors simply d[id] not understand the total fees paid to service providers, nor the revenue streams between them."[163]

In 2008 the DWP commissioned research on the feasibility of researching the costs of pensions schemes. This research concluded that it was possible to research this area through a large-scale study and recommended a study, which aimed to achieve comprehensive coverage of annual third party and internal administration and investment management costs. The research concluded that certain costs should be excluded or reduced in the survey coverage including detailed coverage of costs borne by members of trust based DC and contract based schemes and detailed coverage of the more opaque elements of investment management costs such as transaction costs. The reasons cited were because these were generally not known or the responsibility of a different decision maker and should be the subject of separate surveys.[164] The report included a useful literature review of findings from previous surveys.

In 2008 the International Organisation of Pension Supervisors published a working paper comparing the costs of DC schemes in different countries because of their significant impact on the amount of retirement income delivered to individuals and proposed a Charge Ratio as a basis for national and international comparison.[165]

APRA – the Australian regulator of pensions also looked at costs of large superannuation funds in 2008.[166] They tried to quantify the impact of charges and concluded that retail superannuation funds have lower performance returns and that part of the net retail underperformance is due to embedded fees that are already incorporated by the investment vehicles used by these funds at the gross return level rather than poor investment management skill.

The Financial Services Authority in the UK also commissioned an important piece of research from CRA International in 2008.[167] The report by Fiorenzo Bovenzi and Mark Tilden assessed some of the benefits of regulation in relation to the disclosure of charges. It looked at charges tables and the reduction in yield as measures and their effectiveness for consumers. It showed that customers gave more importance to return information and risk characteristics before charges featured in their decision making.

The FSA had also looked at the quality of advice on pension switching by conducting a thematic review in 2008. They found that a quarter of the sample had provided unsuitable advice. The reasons given for unsuitability were that the switch involved extra product costs without any reasons being given (79% of the unsuitable cases), the funds were not suitable to the investors attitude to risk and personal circumstances (40%), the adviser

[163] http://www.401khelpcenter.com/dol/dol_working_group_report_feedisclosure_5500.html
[164] *DWP (2008) Costs of running pension schemes: findings of a feasibility study, John Leston, Margaret Watmough and Jennifer Ross of RS Consulting, Research Report No 535*
http://webarchive.nationalarchives.gov.uk/20130314010347/http://research.dwp.gov.uk/asd/asd5/rports2007-2008/rrep535.pdf
[165] *International Organisation of Pension Supervisors, (2008) Comparison of Costs + Fees in Countries with Private Defined Contribution Pension Systems Denise Gomez Hernandez and Fiona Stewart Working Paper No 6, June*
http://www.oecd.org/site/iops/41269747.pdf
[166] *APRA Investment Performance, asset allocation and expenses of large superannuation funds*
http://www.apra.gov.au/Insight/Documents/Insight_Issue_3_2008_large_super_funds.pdf
[167] *Bovenzi and Tilden (2008), Benefits of Regulation: Effect of Charges Table and Reduction in Yield, The right decision matters, CRA International, March on behalf of the FSA*
http://www.docstoc.com/docs/27517937/Benefits-of-Regulation-Effect-of-Charges-Table-and-Reduction-in-Yield

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failed to explain the need for ongoing reviews (26%) and the switch involved loss of benefits from the ceding scheme (14%).[168] The FCA have carried out subsequent reviews in 2012 and held a webinar in 2014. They found that the concerns of 2008 remained. The two main concerns were:

- Firms were operating tied advice models that prevented their advisers considering a customer's existing pension arrangements when giving pension switching advice. They considered this to be a breach of their rules.
- Advisers were recommending portfolio advice services with insufficient justification that the additional costs were genuinely adding value for customers.[169]

There has also been a lot of debate that regulation affects performance of pension funds. An academic study in 2008 looking at the performance of Polish and Hungarian pension funds found that this might not necessarily be the case.[170]

In 2009 the Investment and Financial Services Association in Australia commissioned Deloittes to review international superannuation and pension fund fees in selected OECD countries including the UK.[171] This report concluded that comparison presented challenges because there was confusion between fees and costs, non-disclosure of fees and costs – especially investment fees, which tended to be netted off performance fees in some countries leading to significant understatement and difficulties in estimating employer subsidies of costs for stand-alone corporate funds. The report recommended that industry bodies, governments and regulators around the world joined forces to initiate and improve the quality and measurement of fees and costs data.

In 2010 the Australians looked at outsourcing costs on pension schemes. They found that retail funds paid significantly higher fees to related service providers surmising that this was due to a lack of independent challenge of costs on these products. They found that in the more concentrated markets (custody, actuarial and audit) the service providers with high market share were associated with higher fees.[172]

A significant and influential review of pensions in the Australian market was conducted in 2010. The Cooper Review highlighted the need for systemic transparency to increase accountability and availability of information to those who were interested. Its seventh super policy principle was that fees and costs mattered; they detracted from members' retirement savings and needed to be managed as diligently as the generation of investment returns and technological improvements should be encouraged to help lower costs and benefit members.[173] In the Australian context the review concluded that fees were too high and that fees in superannuation had not reduced in line with what could be expected, given economies of scale that were clearly present or available. One of the

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[168] http://www.fsa.gov.uk/pubs/other/pensions_switch.pdf
[169] http://www.fca.org.uk/firms/financial-services-products/investments/pension-switching
[170] *Bohl, Lischewski & Voronkova (2008) Does Regulation hurt pension funds' performance? Evidence from strongly regulated pension fund industries, March* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1101625
[171] https://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/news-research/Press%20releases/Australia%20compares%20well%20in%20global%20super%20fee%20study/IFSA_Deloitte_report.pdf
[172] *APRA (2010) Australian superannuation outsourcing – fees, related parties and concentrated markets, Kevin Liu and B R Arnold, July* http://www.apra.gov.au/AboutAPRA/Documents/SA_WP_ASOFRP_072010_complete.pdf
[173] http://www.supersystemreview.gov.au/content/downloads/final_report/part_one/Final_Report_Part_1_Consolidated.pdf

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reasons it identified for this were the limited opportunities for member vigilance on the one hand and incentives for agency vigilance on the other, to reduce prices. Even where members were engaged there was a lack of contestability at consumer level because of complexity of products, lack of information and transparency of fees. Even if someone was interested in switching, the paperwork and other 'frictions' in changing became too much, causing the consumer to give up. It expressed the view that the earlier Australian superannuation structure had been somewhat optimistic in that it had relied on notions of market forces, disclosure and competition (along with trust concepts) to resolve consumer issues surrounding complex products, structures and conflicts. We seem to be a few years behind in the UK as our policy makers are relying on similar notions of market forces, disclosure and competition to put things right.

In 2010 HM Treasury commissioned a literature review on lessons learned from previous "Simple Products" initiatives, which was undertaken by Professor James Devlin at the Nottingham University Business School.[174] The conclusions and recommendations of this study included clear implications for the imposition of fee caps and why these were not a good idea if financial services was to flourish. The review also interestingly noted that the evidence suggested that levels of trust and perceptions of fairness were not as low as was often assumed but that customers perceived that they received relatively less fair treatment in the areas of charges, terms and conditions and other benefits and that any simple product initiatives must offer particular reassurance in these areas if it is likely to have a substantial positive impact on levels of engagement and provision. This has profound implications for the default products that are being designed for the automatic enrolment into pensions by the UK Government.

Another academic study in 2010 on pensions concluded that although large scale brings cost advantages, liquidity limitations seem to allow only smaller funds, and especially small cap mandates to outperform their benchmarks. Pension fund cost levels were substantially lower than mutual fund fees.[175]

In 2010 the DWP commissioned another report, which looked at how charges were made. That paper notes that in a transaction cost analysis conducted by Bath and North East Somerset Council in relation to their pension scheme that 'implicit transaction costs are likely to exceed explicit ones'.[176]

A report published in 2010 by the Centre for Retirement Research at Boston College looked at how costs could be reduced in 401(k) plans (US structures similar to UK DC pension plans) and concluded that trading costs were a major expense for actively managed funds.[177]

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[174] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81571/lessons_learned_from_simple_products_initiatives.pdf

[175] *Bauer, Cremers and Frehen, (2010) Pension Fund Performance and Costs: Small is Beautiful, Yale ICF Working Paper No. 10-04* http://depot.som.yale.edu/icf/papers/fileuploads/2673/original/ICF_WPS_10-04_Cremers_Frehen_Pension_Fund_Performance_Paper.pdf

[176] *DWP (2010) Charging levels and structures in money purchase pension schemes: Report of a quantitative survey, Adrew Croll, Ed Vergeson and Alex Lewis of Ipsos MORI, Research Report No. 630* http://webarchive.nationalarchives.gov.uk/20130314010347/http:/research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep630.pdf

[177] http://crr.bc.edu/briefs/reducing-costs-of-401k-plans-with-etfs-and-commingled-trusts/ *Vitigliano, Kopcke, Karamcheva (2010) Reducing costs of 401(k) Plans with ETFs and Commingled Trusts, Boston College Centre for Retirement Research*

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In 2011 Deloittes published its second edition of study on fees in defined contribution/401(k) plans, which was commissioned by the Investment Company Institute.[178] Defined contribution plans in the US held $4.5Trn in assets. 84% of all fees were asset based investment related fees.

Oxera published a report on savings in private pension products in January 2013 in which it recognized that for "*all types of private pension scheme, the net performance will depend on the charges applied to the scheme. These charges will in part reflect the cost of providing the pension scheme. Not all costs may be directly visible to the consumer, but ultimately one could expect the costs of providing a pension scheme to be borne by the consumer*."[179] The report goes on to say that while there is an increasing demand for analysis of costs and charges, data on charges and costs has been difficult to obtain and has not been readily available on a consistent basis across countries.

A Canadian study published in 2013 in the Journal of Finance has found that payments to the brokers of mutual funds skew broker's incentives to recommend a fund and that the payments predict worse performance, particularly from sales loads which do not impart continuing exposure to the investment's performance.[180]

This summary of research suggests that in order to get a proper handle on costs we cannot avoid the impact of transaction costs and the interplay of conflicts of interests operating to give retail customers good outcomes on their investments.

5.2 International examples of disclosure

Several studies have compared disclosure regimes on pension products and a number of these compare the US, Canadian, Australian, UK and Chilean systems for comparative purposes. An example is the study by Canadian academics at the University of Toronto.[181] It noted that fee disclosure could be blatantly misleading for example indicating that zero fees had been paid when in fact fees had been bundled and not charged separately for a particular activity. Several types of disclosure were not helpful – some being available only on request, while jargon on expense ratios and loads was unhelpful.

The Australian Regulator – ASIC sets out the disclosure requirements for products in its Regulatory Guide 168 the latest version for which is dated October 2011. It sets out 6 basic principles for disclosure[182]:

- Timely

[178] *Deloitte, (2011) Inside the Structure of Defined Contribution/401(k) Plan Fees: A Study Assessing the Mechanics of the 'All-In' Fee*
[179] http://www.oxera.com/getmedia/d6ade83e-566f-49e4-934e-4cfe3c23f379/Position-of-savers-in-private-pension-products.pdf.aspx?ext=.pdf
[180] *Christofferson, Evans and Musto (2013) What do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives Darden Business School Working Paper No 1393289*
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1393289
[181] *Turner, John. Witte, Hazel A. (November 2008) Fee Disclosure to Pension Participants: Establishing Minimum Requirements; Rotman International Centre for Pension Management, University of Toronto, Canada*
[182] https://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg168-published-28-October-2011.pdf/$file/rg168-published-28-October-2011.pdf

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- Relevant and Complete
- Promotes product understanding
- Promotes product comparison
- Highlights important information
- Has regard to consumer needs

In 2012 the Federation of Dutch Pension Funds issued recommendations on administrative costs and further elaborations on asset management costs. It noted that cost transparency would remain a central issue in the years to come. Their recommendations have aimed towards transparency and comparability of costs. They accept that initially funds may have to provide estimates of costs in order to meet these requirements. While the principles are simple the implementation of the disclosure and what is not required in relation to different products is complicated.

In 2012 the Canadian Securities Administrators issued a discussion paper and request for comment on mutual fund fees.[183] Mutual funds accounted for 73.8% of all Canadian fund industry assets under management. Some of the concerns highlighted in the discussion paper included concerns that sales commissions funded from mutual fund management fees led investors to the mistaken belief that there were no costs to purchasing a mutual fund. Investors had limited understanding of the different kinds of mutual fund costs and only seemed to understand the most visible of the costs. The paper refers to UK efforts in this area through RDR. This has resulted in new disclosure requirements which include annually a summary in dollar terms of what they were charged and any other fees paid to the firm such as trailing commissions and commissions on bond trades and a new annual performance report that included how much they had contributed, deposits and withdrawals for the year and since the account was opened and percentage returns for their account over one, three, five and ten years and since it was opened.[184]

In 2013 the CFA Institute conducted a study of periodic reporting for retail investment funds in Asia Pacific by reviewing the rules of 6 countries: Australia, China, Hong Kong, India, Japan and Singapore.[185] All countries required itemized fee and charges disclosure and a single figure fee for comparison and four countries required disclosure of transaction costs with only India and Singapore not requiring it. Three countries required disclosure of soft commissions, four required disclosure of related party transactions and five required management discussion of changes that affected the investment.

There is also currently a joint project between FASB and IASB on the financial reporting and disclosure on contracts of insurance[186] on which the latest update appears to have been issued in October 2013.[187]

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[183] *Canadian Securities Administrators (2012) Discussion Paper and Request for Comment 81-407 Mutual Fund Fees, December* http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_2012123_81-407_rfc-mutual-fund-fees.pdf

[184] http://www.securities-administrators.ca/aboutcsa.aspx?id=1136

[185] *CFA Institute (2013) Periodic Reporting for Retail Investment Funds in Asia Pacific, An Investors Perspective* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2013.n1.1

[186] http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1175801889812

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The US has stringent reporting requirements on its pension plans – but the detail of the forms on which costs and charges are disclosed makes them difficult to interpret and understand.

It is evident from the work done by academics and regulators around the world that there are consistent concerns around the disclosure of costs and their impact for investors, particularly in relation to pension funds. It is also evident that there appears to be no single satisfactory solution to the problems of non-disclosure because most solutions stop short of requiring full disclosure of all costs.

The international experience suggests many attempts at reforming disclosure requirements for costs and charges. Success appears to have been elusive and the prospects for the latest attempts at reform although improving the position still appear to have issues. In the next section we examine why the options for reform remain problematic.

187 http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175827217882&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=2475707&blobheadervalue1=filename%3DProposed_ASU_Insurance_Contracts_%2528Topic_834%2529.pdf&blobcol=urldata&blobtable=MungoBlobs

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6. Problems with the Current and Evolving Approaches to Charges

Key Points

- The profit motive appears to be stronger than the regulatory requirements to manage conflicts of interest and treat customers fairly
- Regulatory arbitrage and complex structures can create problems for investor decision making, resulting in unequal outcomes
- Regulation can create inaccurate assumptions about asset protection and available compensation
- Asymmetries of information and understanding are difficult to eliminate when dealing with retail investors and it is not reasonable to expect them to overcome these
- Known behavioural biases of retail investors suggest that transparency and disclosure alone are unlikely to result in rational actions by them
- Governance and accountability on investment products is often inadequate and insufficient to look after the interests of retail investors
- The law currently does not adequately assist consumers in obtaining redress for unfair treatment in financial services
- Closet index trackers are unfairly charging higher fees to consumers
- Performance reporting can hide fund losses through fund closures and mergers
- Trade execution methods and order aggregation for efficient asset management makes it more difficult for retail investors to understand how their investments are managed and make costs opaque
- Reported fund performance and investor experience can be different and these reports need to be made more relevant to investors
- Definitions of costs and charges can be manipulated and need to be tightened as they are difficult to understand and will have greater importance if charge caps are to be implemented

6.1 Profit motive is stronger than conflict of interest management

Policy makers sometimes forget that financial services businesses have a profit motive and that investment managers have a duty to maximise profits for their shareholders.

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There is some research that disputes whether this has been the main driver for manager decisions in investment management.[188] Recent developments in regulation around remuneration of employees in financial services firms reflects the view that investment management employees may not always have had profit maximization for the shareholders as the primary driver, but to enhance their own incomes and wealth resulting in short term views for decision making. Under UCITS V it has been proposed that 'identified staff' such as senior management, risk takers, control functions and employees receiving total remuneration in the bracket of senior management and other risk takers whose professional activities have a material impact on the risk profile of the UCITS manager will be subject to a UCIT compliant remuneration policy, but as we have noted this is only one of the types of structures that a retail investor can invest in. Shareholder value versus executive compensation has been the subject of a lot of research by the UK Government and academics generally.[189] Banking and alternative investment funds have had regulation imposed upon them in respect of remuneration. The latest technique reported for getting around restrictions on payment of bonuses in the banking context is to pay 'allowances' instead. When it comes to bonuses and charge caps everything is in the name.

Regulatory requirements for treating customers fairly place managers in a conflicting position with their duties to maximise profits. Managers have a duty to minimise costs for their firm and to maximise their profits, which is inherently at odds with requirements to reduce costs for customers and provide them with value for money despite the regulatory requirement to treat customers fairly. Regulatory findings consistently show that firms find it difficult to manage these conflicts of interest.

Regulators in the financial services area will often say that their role is not that of a price regulator. Even if it were so in the face of extortionate costs, it would be a difficult duty to discharge currently, because not enough is disclosed on costs of funds.

There have been recent reports that the FCA is to investigate exit fees that firms charge their customers, with examples being quoted that some firms are charging fees of 6% of the value of the assets for customers to exit products. These are likely to be designed to discourage customers because of the significant profits that can be made from those customers. The incentives to put the profit motive first are very real, despite regulatory intervention.

It is true that other profit making businesses can also be subject to regulation but these often tend to relate to things such as public safety or products being fit for purpose more so than controlling price. Investment management cannot provide the guarantees you might expect from other purchases and as the mandatory regulatory warning goes – past performance is no guide to the future and so there can be no guarantees that investment products are fit for purpose if that purpose is to generate investment returns for the investor.

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[188] *Simon Wong, (2011) How conflicts of interest thwart institutional investor stewardship, Butterworths Journal of International Banking and Financial Law, September* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1925485

[189] *Robert Lippert (1996) Agency Conflicts, Managerial Compensation, and Firm Variance, Journal of Financial and Strategic Decisions, Volume 9 Number 3, Fall*

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That regulatory warning itself is possibly one of the greatest contradictions in investment management, as there are probably not many investors that would actively invest with a manager with a long history of loss making. Most investors in reality tend to buy past performance and in effect look for successful (or 'lucky') managers. The key warning is that there cannot be any guarantees – that is why, despite all that a sales and marketing team might do to promote a successful product, the investor needs to minimise costs.

Given the profit motive of the investment manager, it can be argued that the controls and disclosure requirements that managers adopt are ultimately designed for 'regulatory correctness' rather than to meet customer needs.

6.2 Regulatory arbitrage, complexity and staff knowledge give advantages

Investment products intended for the retail market tend to be regulated by the Financial Conduct Authority. Other regulators may be involved such as the PRA and TPR, but the products generally come under the umbrella of the FCA. The regulator uses a series of handbooks, codes and guidance to set out the requirements in relation to different products. But there are also anomalies because a regulator may not have full sight of the entire structure. A classic case in point is occupational defined contribution pension schemes. Because the structure is an occupational scheme – the scheme is subject to regulation by the Pensions Regulator.[190] However the products typically used by the scheme will be unit-linked funds, which are regulated by the FCA. Unit-linked funds are products that can be 'wrapped' by insurance companies who in turn are regulated by the PRA. There are of course memoranda of understanding between these regulators but for a member of the investing public it is no mean feat to be able to understand which of these three organisations or the two ombudsmen, they should direct any concerns to. In this respect the number of regulators and ombudsmen make it difficult for a retail investor to know what their first point of contact should be, despite the existence of organisations that aim to help such investors such as the Pensions Advisory Service.

The various regulatory structures are confusing, complex and very often not joined up. The investor compensation regime in the UK is a good example of this, where the choice of a fund structure or wrapper using exactly the same investment strategy could result in extremely different outcomes for investors in the different structures. The structures have nothing to do with the risks of investment but everything to do with the way they are regulated and put together (wrapped). A retail investor cannot be expected to understand these complexities when even professional advisers can struggle to interpret those rules. This complexity provides opportunity and gives advantage to those who have the resources to find ways to navigate through these structures. These complexities create uncertainties and in turn cause unfairness. The rules although well intentioned, do not always work in the interests of the retail investor who will always be a few steps behind in understanding the impact of their investment decisions in relation to these complexities.

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[190] *TPR statutory provisions and regulations tend to focus more on the regulatory aspects of defined benefit schemes than they do on defined benefit schemes*

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In discussions with the pensions industry there appears to be a preference to be regulated by TPR which is generally viewed as being a reasonable regulator. This can sometimes raise the suspicion that this view of reasonableness perhaps arises because TPR lacks the teeth to do anything meaningful in the space it regulates. If the number and quantum of fines was taken as a measure of effectiveness, then TPR would lag behind the FCA quite considerably, but for no fault of its own, because it has not been given equivalent powers and teeth by its sponsoring government agency, the DWP.

By way of example, TPR's ability to impose fines is derived in many instances from section 10 of the Pensions Act 1995 dealing with civil penalties where the maximum amount it can fine is £5,000 in the case of an individual and £50,000 in any other case.[191] In contrast section 206 of the Financial Services and Markets Act 2000 permits a penalty to be imposed without limit, of an amount the authority considers appropriate.[192]

Another area of potential regulatory arbitrage is in the case of fees and charges, as the evidence of higher charges in personal pensions[193] suggests that some may prefer these wrappers because it provides greater freedom in relation to costs and charges and the way contracts can be structured for the provision of services.

Retail funds are generally 'manufactured' to meet regulatory requirements for distribution. That is why investment strategies may be offered through multiple structures. This means that although the individual specialist within the asset manager may not differentiate between the different structures they are managing in an investment strategy – there may also be little transparency at investor level on how their money/investments will be managed even though there may be a headline manager associated with a particular strategy or structure and generic statements on order execution, management and allocation policies may have been provided to an investor (if they understood them in the first place).

The Retail Distribution Review (RDR) ushered in a number of changes in the way financial services in the UK work. It introduced a ban on initial and trail commissions but importantly it also introduced a whole range of changes in the range of qualifications needed in order to conduct various types of controlled investment activities. This used to be referred to as threshold competence in order to perform a particular activity.

It is interesting to note that while the industry is required to comply with these requirements there appears to be no equivalent mandate requiring those who regulate or determine policy in these areas to have equivalent levels of threshold competence. It is therefore inevitable that despite the extensive use of industry consultation and experts there appears to be no evidence that regulators sent in to investigate regulatory issues or determine policy considerations can demonstrate whether they themselves have the threshold competencies to understand the products they are reviewing, recognise problems, develop policies and then enforce them. This lack of grounding can sometimes result in prolonged investigations and policy making of questionable quality.

[191] http://www.legislation.gov.uk/ukpga/1995/26/section/10/enacted
[192] http://www.legislation.gov.uk/ukpga/2000/8/section/206
[193] *The DWP Charges Surveys suggest that the AMCs on so-called 'contract based' schemes are higher.*

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6.3 Inaccurate perceptions on asset protection and investor compensation

As previously shown, European research suggests that investors automatically impute that assets are protected if the products are regulated, such as in relation to compensation when things go wrong.

There can be a huge difference in outcomes when things go wrong, if an investor has made certain decisions, regardless of the fact that they have used regulated products in their decision-making.

Let us take the example of a retail investor wishing to make provision for their retirement by setting up a self invested pension scheme using investment products. They could choose to set this up using for example, a platform that offers a variety of UCITS funds or they could choose to invest in unit-linked funds offered through an insurance company.

Let us look at the outcomes for two investors – A & B saving £3,000 per annum for 30 years. Investor A invests in the XYZ UK Equity Fund which is a UCITS fund managed by an investment manager and investor B invests in the ABC UK Equity Fund which is a unit-linked fund of an insurance company. They are both investing the same amount and the investment strategy is exactly the same.

In year 30 let us assume that the investment manager failed to segregate the assets of XYZ UK Equity fund properly and the manager as a result of a fraud became insolvent and lost all the money. Let us also assume that the insurance company did not match its assets and liabilities properly and became insolvent and hence cannot meet its obligations to investor B.

Investor A and B both apply to the Financial Services Compensation Scheme for the losses they have both suffered of £90,000 each (assuming no investment growth in those 30 years). The compensation receivable by investor A is capped at £50,000[194] so they suffer a loss of £40,000. The compensation receivable by investor B is however quite different because the product they have invested in is a unit-linked product. Unit linked products are considered to be long-term contracts of insurance and therefore investor B is entitled to receive 90% of the benefits under the policy without the amount being capped.[195] Investor B therefore only loses £9,000 compared to investor B who has lost £40,000 for investing in a similar investment strategy.

Both investor A and investor B will have paid costs and charges to their product provider over the life time of the investment but the protections available in respect of the different structures used result in quite different outcomes. That is something that would arguably need to be built into any value for money analysis. Consultants and advisers on products do understand these issues but the complexity of the rules can be difficult even for them to understand and advise upon.

[194] http://www.fscs.org.uk/what-we-cover/eligibility-rules/compensation-limits/investment-limits/
[195] FCA COMP Rules COMP 10.2.1R

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However the problems do not end there.   They are complicated even further.

If investor B had made the investment in ABC UK Equity Fund through a platform say provided by another insurer EFG (which is quite common) then that product, it has been argued, would be considered to be a reinsurance contract and it would not be eligible for any compensation at all.[196] In such a scenario investor B loses £90,000. So even where an investor may have made a choice on the grounds that the investment would be safer – the fact that the insurer reinsures that liability (and may even contractually have passed on their liability in respect of the investor to the reinsurer) means that the investor is left totally exposed.

Investor A's cover is not straightforward either. If investor A invests in a UCITS fund through an employer's DC pension scheme and the employer happens to fall into the category of a large employer, then because the product is not a unit-linked product and the sponsoring employer is a large employer[197] – investor A will be unable to claim compensation for any losses and so will lose £90,000. The automatic enrolment process into pensions for large employers has been completed. Where the products used by them are not insurance-based, no compensation would be available if disaster strikes. Of course most large employers will have sought professional advice in setting up these structures and their advisers should have considered these issues in structuring their schemes.

The Financial Services Compensation Scheme (FSCS) only applies where the authorised firm has been declared insolvent and the FSCS has declared that firm to be in default. What is the position of a DC Pension saver who loses their money perhaps because of fraud? They would not necessarily be eligible to claim under the FSCS, unless the fraud led to insolvency, but would need to seek recovery from the Fraud Compensation Fund. The Fraud Compensation Fund (which is run and managed by the UK Pension Protection Fund) will only entertain a claim once all other avenues of recovery have been exhausted. This means that a pension saver heading into retirement, possibly in frail health, having to deal with complicated financial matters and the stress of financial loss and insecurity is going to have to exhaust recovery processes such as those through the courts before being able to make a claim. This could involve processes taking several years with the individual increasing in frailty. It is difficult to see how such a scheme is fit for purpose in such a disastrous scenario.

But the complications do not end there either, because when an investor receives compensation and it relates to a DC pension arrangement – if the investor uses that money to pay into another DC scheme it is referred to as being a 'relievable pension contribution' and it can trigger the loss of enhanced protection from tax charges. If however the trustees of the scheme seek compensation then the award of compensation to the trustees will mean that the payment would not be a 'relievable pension contribution' and enhanced protection will not be lost.[198] So there are even tax consequences and costs that an investor facing losses in their pension scheme would need to consider in how

[196] *FCA COMP Rules COMP 5.4.2 and 5.4.5*
[197] *FCA COMP Rules COMP 4.2.2(4)(b)*
[198] http://www.hmrc.gov.uk/manuals/rpsmmanual/rpsm03104511.htm

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they claim compensation. This is not something that it is reasonable to expect retail investors to understand.

The costs of these compensation schemes are also costs that investors pay for whether through industry or pension scheme levies and which in fact may be of no value whatsoever to the investors who suffer losses because of the complexities on whether they would be eligible for compensation or not.

Assumptions about regulated products and investor compensation; ignorance about the costs of these and decisions made on the assumptions of asset safety can therefore be inaccurate and have significant consequences for investors.

The Financial Services Consumer Panel conducted research in this area in 2010 when it commissioned a report by David Severn on "Safer" Products which highlighted many of the complexities and issues that have also been raised here and in particular some of the complexities brought in by RDR which was meant to simplify matters.[199]

6.4 Asymmetry of information and asymmetry of understanding

Given the nature of the current proposals for disclosures on costs and charges there is always going to be an asymmetry of information between the product provider and the investor as there is no requirement to provide investors with full disclosure on all costs. The rules provide for certain costs to be excluded from disclosure. Even the DWP command paper shows government intention to maintain the status quo on transaction charges at least until 2018 although the latest SORP issued by the IMA suggests that transaction costs will be shown as deductions from capital in the accounts and this may lead towards better disclosure if adopted by authorised funds.

The agent-principal arrangement requires full disclosure if it is going to work and investment products generally do not provide this full disclosure. The need not to disclose can be strengthened contractually because contractual clauses often excuse the provider from having to provide this information, with contracts simply acknowledging the existence of conflicts of interest and requiring investors to accept these.

The provider has control over the provision of services that support the investment product and the nature of the relationships do mean that the provision of full disclosure on the benefits, costs and impact of all the business arrangements is likely to be onerous and costly to the product provider. Providers are unlikely to undertake such disclosure voluntarily.

As previously noted there is evidence that even if investors are provided with full disclosure, they are unlikely to know what to do with it and that other biases come into play in making investment choices.   If the existence of a history of regulatory actions were criteria to determine investments, a number of large financial services firms would be unable to attract investors to their funds.

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[199] *Financial Services Consumer Panel (2010) "Safer" Products – research by David Severn*

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Industry often argue the case that disclosure would be pointless because it would not be understood or used and it has also influenced European regulators in determining policy on disclosure so that costs such as transaction costs and structural risks have not been disclosure requirements of the Key Investor Information Document.

This leads to another asymmetry – that of understanding. An asymmetry of understanding between the investor and the product provider can be exploited at the expense of the investor who attributes characteristics of safety and reliability to the products they invest in. This may not be supported by the reality of the structures and their relationships. There are assumptions made on safety, because products are regulated, and because of the way information is presented that cannot be relied upon by investors. This is discussed further in relation to conflicts of interest (see 6.7).

6.5 Behavioural biases in investment decisions

These asymmetries in information and understanding are also affected by behavioural biases in investment decision making. It has already been shown that investor reaction to disclosures on conflicts of interest only results in reactions that are contextual. Industry argues that the costs of disclosure are disproportionate because investors would not use or be able to use the information given to them. These biases suggest that the reactions of retail investors in particular and investors generally can be influenced by the way information is presented to them whether it is to do with the risks of investing or indeed the costs associated with an investment creating difficulties in making rational judgments and decisions.

James Montier in his book on behavioral investing refers to a number of pieces of research that support these behavioral biases.[200]

The first of these is a self-serving bias where people are prone to act in ways that are supportive of their own interests. He uses a 2004 unpublished paper in which 139 auditors (trained to provide independent opinions as a profession) are given five controversial accounting case studies and randomly assigned to act either on behalf of the company using those accounting techniques or on behalf of an investor looking to invest in that company. The auditors who were told they were working for the company, were 31% more likely to accept the accounting practices than those who were told they were working for the outside investor.[201]

The second bias was that investors were less likely to evaluate issues if their adviser appeared confident. Montier quotes a 2009 study where neuroscientists recorded subjects' brain activities using an MRI scan while they made simulated financial decisions. In each test the subject chose between a risk free payment and taking a chance in a lottery. In some of the test rounds they were presented with advice from an expert economist on the

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[200] *James Montier, The Little Book of Behavioral Investing, How not to be your own worst enemy (2010) John Wiley & Sons Inc*
[201] *Don A. Moore, George Loewenstrin, Lloyd Tanyu and Max H Bazerman, (2004) Auditor Independence, Conflict of Interest and Unconscious Intrusion of Bias (Unpublished)*

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better alternative (which was not necessarily optimal). They found that the expert advice made the subject's brain switch off some processes required for financial decision making with the subject echoing the expert's advice. The subjects it was suggested could have done better if they had evaluated the options without the expert advice.[202]

The third bias of interest that he speaks about is to do with assumptions on price and their link to utility which can be exploited by many financial services businesses and he quotes a study where participants are asked to taste a wine worth $10 and then asked to taste another wine which they are told is worth $90. Most participants found that the more expensive wine tasted twice as good, even though both wines were actually exactly the same.[203]

The final bias to mention is in relation to holding people accountable for outcomes. Here Montier refers to a 1999 paper which finds that holding people accountable tends to increase the focus on outcomes with higher certainties (known as ambiguity aversion), increase collection and use of all information (which may be useful or useless), increases preference for compromise options, increases selection of products with average features ('career risk management') and increases the degree of loss aversion most people display.[204]

These biases suggest that investors generally, are likely to find it difficult to use information that is presented to them disclosing risks and costs, and can easily impute incorrect characteristics to those decisions, such as in relation to their relative safety and utility.

6.6 Complexity through tax, regulation and intermediation

It was noted earlier that many of the products and wrappers that are developed are to aid distribution in respect of tax and regulatory requirements. However the money that is then converted into assets under management for the investment manager is not necessarily managed within that wrapper or product. The investment manager may manage that money by strategy. Order aggregation and execution can create additional layers of intermediation, with rules and costs that only the manager understands and that may be beyond the understanding of even financially literate investors. Managers should be able to organize their businesses in the way they believe to be most efficient for them, but because these products and wrappers may not reflect the realities of how these assets are managed, it makes disclosure on costs and relationships that the investment manager has in managing their business more difficult, even if their intentions were to provide full disclosure of these arrangements and their associated costs.

[202] *J.B.Englemann, C.M. Capra, C. Noussair and G.S.Berns, (2009), Expert Financial Advice Neurobiologically 'Offloads" Financial Decision Making under Risk, PLoS ONE 4(3): 4957.doi:10.1371/journal.pone.0004957*

[203] *H.Plassman J.O'Doherty, B.Shiv and A.Rangel, (2008), Marketing Actions Can Modulate Neural Representations of Experienced Utility, Proceedings of the National Academy of Science 105:3 (2008): 1050-1054*

[204] *J.S. Lerner and P.E. Tetlock, (1999), Accounting for the Effects of Accountability, Psychological Bulletin 125 (1999): 255-275*

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Industry understands these complications and navigates through them. In its attempts to simplify the issues for their investors the implications of some of the structural issues and details get lost however well intentioned they may be.

6.7 Conflicts of Interest and disclosure policies

Paul Woolley notes that one of the consequences of asymmetric information is the ability of financial intermediaries to capture “rents” or excess profits.[205] Woolley refers to a paper that presents a model, which shows how competitive agents are able to extract progressively higher rents to the point where the agent is capturing the bulk of the gains. This is what appears to have happened with the financial services industry, creating conflicts of interest.

Conflicts of interest as a term, although understood by most, need further categorisation.

For example there are conflicts that exist between the investment firm and the client such as in relation to liquidity, the profitability of a fund or a class and the provision of information. There are also conflicts of interest that need to be managed between clients, such as between retail investors and institutional investors. There are other conflicts that may exist as between the employees of a firm and that firm and/or their clients which often tend to receive more attention from the regulators through their reviews of personal account dealing and hospitality and gift rules which appear to be generally well managed by most firms these days.

An American academic presented a paper at a Federal Reserve of Chicago – Bank for International Settlements conference in 2003 called Conflicts of Interest and Market Discipline Among Financial Services Firms, which provides more detail on how these conflicts can arise, particularly as between retail and institutional investors. The examples he uses are more relevant in American markets but the principles do have application in a UK context particularly in relation to conflicted research.[206]

The most visible evidence of some of these conflicts can probably be seen in the hospitality tents of some British sporting events where financial services industry sponsors can be seen. Who are these people who are being entertained and to what purpose, for whose benefit and at what cost? It is of course entirely reasonable that financial services businesses like other businesses are able to advertise and pursue matters relevant to them and to influence the development of their own businesses. Financial services businesses will argue that they are entitled to do so at their own cost and this must be right as a concept. What makes it more difficult is that ultimately investors do pay for it, as this is part of the overhead that the manager seeks to recover and reflect in its own profitability. Investors may also benefit from the influence that is obtained but the benefits to the

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[205] Adair Turner and others (2010) The Future of Finance: The LSE Report, London School of Economics and Political Science; Chapter 3 Paul Woolley Why are financial markets so inefficient and exploitative – and a suggested remedy
[206] Ingo Walter (2003) Conflicts of Interest and Market Discipline Among Financial Services Firms, New York University *http://people.stern.nyu.edu/iwalter/conflict.pdf*

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business as a whole of such visibility can also be substantial and can be quite hard to quantify.

We noted that research indicates that disclosure of conflicts of interest only elicits a response from investors, which is context dependent. i.e. some conflicts and risks may just be seen as generic rather than real and therefore not treated as seriously.

Most conflicts are disclosed in generic standard template language devised by compliance and legal experts and therefore often have little impact on their readers, who view them as they are intended, i.e. as standard disclosures about which they need not worry. An example from the subscription documents of hedge funds highlights the point about attitudes even though it does not relate to retail investment.

Investors in hedge fund subscription documents typically have to sign a declaration that they are able to lose the entire investment they are making and that they understand the conflicts of interest the investment manager with whom they are investing may have. Professional investors accept these disclosures because they are given in the context of standard disclosures and regularly sign these documents unchallenged because they wish to invest with a particular manager, but they would hardly do so if they really believed that they could lose all their money. That possibility however, if history is anything to go by, can be real.

More recently it has been reported in the Sunday Times that Fairer Finance conducted a survey of 2,000 investors and found that just over a quarter had read the terms and conditions on their investment products in full and only 17% claimed they understood the terms.[207] Reading the terms and conditions in full was a major task and can be greater than the length of a novel. The article went on to compare the terms and conditions for a major bank running at 34,162 words, which it suggested was 5,000 words longer than Steinbeck's novel Of Mice and Men. It also noted that letters marked 'important' from financial services providers are often left unopened. It suggested that financial businesses seek to benefit from information overload in these circumstances. Fairer Finance have launched a campaign called 'Spare us the small print'.[208] Service providers blame the regulators for having to cover various aspects but many of us are guilty of having simply clicked the 'agree' button when accessing internet pages or services on the internet without reading the detail in them. Policy makers have to accept that disclosure on its own will never be enough.

A 2009 paper published by academics at the Said Business School at Oxford University looked at whether transparency overcame conflicts of interest by examining information from UK pension funds on commissions, trading activity, payments for research and other variables. It found that although, following UK regulatory changes to increase transparency, average commission rates had fallen, trading activity had increased significantly resulting in total commission payments to brokers more than doubling between 2003 and 2007.[209] In other words, businesses find a way around the rules.

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[207] *http://www.fairerfinance.com/press-releases/the-worst-banks-and-insurers-for-small-print-revealed, April 2014*
[208] *http://www.fairerfinance.com/blog/spare-us-the-small-print*
[209] *Mark Abraahamson and Tim Jenkinson (2009) Does transparency overcome conflicts of interest? Evidence from investment managers and their brokers.*

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6.8 Inadequacy of Governance and Accountability

If there was just one reason alone that was singled out to explain why disclosures on costs and charges as they currently are, have little meaning and do not work, then it is the inadequacy of governance and accountability on investment funds.

Whether these funds are structured as trusts or companies appears to be largely immaterial despite the duties that trustees and directors have. There are a number of reasons for this.

The constitution of these funds and pension wraps can be constructed in such a way that the investment manager cannot be easily removed from their role. The individuals (or corporate entities) who act on these boards whether as trustees or directors may be connected parties affiliated with the asset manager and may have no incentive and indeed in some cases no power, to challenge their employer's decisions. Investment managers will often point to employee roles that have powers of veto and intervention in trading decisions. The exercise of these powers can be extremely career limiting for the individuals involved and is likely to be exercised only in extremis. Even unconnected individuals on these boards may have little incentive to act against the manager if they also act on their behalf on several other boards and are remunerated for that.

Even where the board is able to challenge decisions it is unlikely to have the full picture on how things are being managed as they will have no day to day connection with the funds' activities, their role being non-executive in nature.

For all practical purposes, other than the strict legal sense (and even in the legal sense because powers can be delegated to it by the boards) the investment manager is the executive decision maker with full day-to-day control over the funds and their management. There is therefore a marked difference between structure and reality.

But however independent you make the board there is still one rather large elephant in the room. The investment manager effectively appoints the board and the investment manager can usually, through the use of various mechanisms, remove any board member it is not happy with.

Investment managers are likely to want to protect their interests by ensuring that products are structured so that they can preserve their commercial interests when sponsoring funds, wraps and other products. However in doing so they may create conflicts of interest including difficulties in sanctioning them if the services are not of an adequate standard.

Even where independent people have been appointed to boards, there may be apparent if not real conflicts of interest, as these 'independents' may act on several of the manager's boards. It is essential that independent boards can act in a truly independent manner. Current approaches on appointing boards tend not to address this issue and disclosures of

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http://ora.ouls.ox.ac.uk/objects/uuid%3Ac3b57c23-5547-48c9-aa14-31be2c99f0cb/datastreams/ATTACHMENT01

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relationships sometimes have to be actively sought before they are given. Investment firms subject to the Capital Requirements Regulations will need to limit the number of directorships that an individual can hold in an investment management firm from July 2014. Similar strictures should apply on the funds themselves where retail investors are involved.

Some issues may be difficult for a fund board to focus on. For example, a manager may decide to use execution facilities that cost an extra penny per share, but which result in the investment manager being able to make significant savings to its research and corporate access activities. Such decisions are unlikely to be challenged as an extra basis point in the cost of investments to investors may not even be noticed by a board. Even where such additional costs or soft commissions are scrutinised by a fund board they are difficult areas to challenge a manager on because of accepted market practice and regulatory acceptance of such practices. The advantages to a manager with high portfolio turnover could however be significant. Only a board that is sufficiently independent of the manager and knowledgeable about wider issues on execution policy, order allocation and handling would be able to challenge a manager perhaps to get a better deal for its investors.

Even where there is a crisis on a fund – there is the possibility that the board is only told about it once the manager has resolved the crisis.

Therefore accountability, which lies with the board, is quite different from the day to day management of the fund. Those accountable for the management of the fund on a day to day basis are investment manager staff and employees and their first loyalty is likely to be to their employer.

These structures make it difficult for a board to independently hold a manager to account.

When you combine these aspects with the fact that these products do not provide any guarantees and results are measured with reference to benchmarks and relative performance this too makes it difficult for a board to make its manager accountable.

The Pensions Institute published a paper in 2014 on assessing value for money in defined contribution default funds which recommended that in order for DC Pension products to be able to measure value for money there needed to be a set benchmark and the benchmark they recommended was the use of 'replacement income ratio'.[210] In other words, a DC pension scheme might be constructed using investment products so that an employee that had saved in that product over a period of time would be able to replace say 40% of their income through their savings in the scheme. Although that could be achieved on a pension scheme, investment products need something similar that boards can review. Boards do of course look at fund performance and performance relative to benchmarks and peers but there is no sanction if there is a failure to do so, other than the risk that assets flow out of the fund. The evidence suggests however, that money in retail funds (and pensions in particular) remains relatively 'sticky' and managers do not often experience large scale outflows, unless there has been a failure of some sort that has received publicity. Fund

[210] http://www.pensions-institute.org/reports/ValueForMoney.pdf

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boards need to be able to place the investment manager at risk of being replaced in order to improve the delivery of service to investors.

A Spanish study in 2009 made two interesting points relevant to this discussion. It found a puzzling fact that funds with worse before-fee performance charged higher fees which it explained as being due to strategic fee-setting by mutual funds in the presence of investors with different degrees of sensitivity to performance. It also found some evidence that better fund governance may bring fees more in line with performance.[211]

In the case of unit-linked funds there is no need to have similar governance arrangements although it is hoped that IGCs will perform a similar independent governance role.

Currently the structure of board governance and accountability provide a manager with few risks or real incentives for them to up their game on behalf of investors.

6.9 Multiple levels of intermediation create complexity and change charges to costs

An example of how a value chain is created in a DC Pension is illustrated in a report by Oxera, showing how each level of intermediation extracts a charge and associated taxation. Figures 5 and 6 show these different levels for an employer sponsored pension product and a private DC scheme provided by an insurance company.

[211] *Javier Gil-Bazo and Pablo Ruiz-Verdu, (2009) The Relation between Price and Performance in the Mutual Fund Industry, Department of Business Administration Universidad Carlos III de Madrid*
http://e-archivo.uc3m.es/bitstream/handle/10016/7474/Therelationbetweenpriceandperformanceinthemutualfundindustry.pdf;jsessionid=FDE24107CCF7F12E4FE6B018DA116DA6?sequence=1

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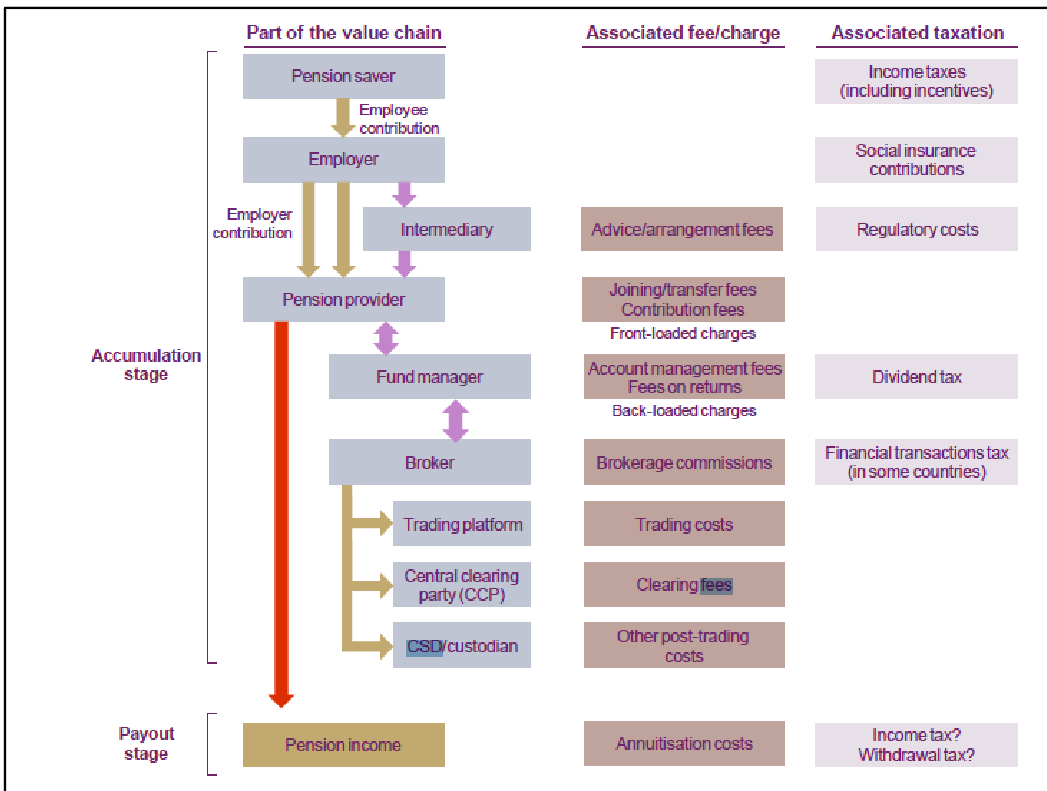

Figure 5 Value Chain of an employer sponsored DC scheme from the Oxera Report – Position of savers in private pension products[212]

[212] http://www.oxera.com/getmedia/d6ade83e-566f-49e4-934e-4cfe3c23f379/Position-of-savers-in-private-pension-products.pdf.aspx?ext=.pdf

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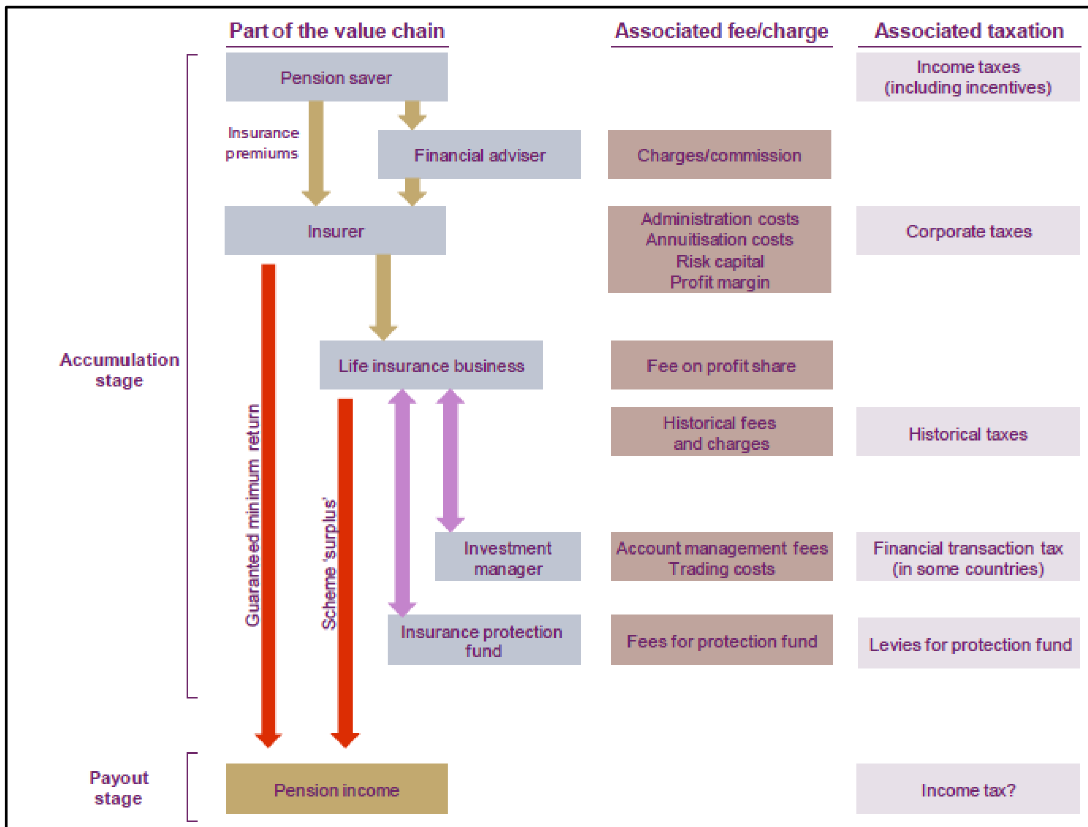

Figure 6 Value Chain of a private insured DC scheme from the Oxera Report – Position of savers in private pension products[213]

In addition to these layers of intermediation, there can be levels of intermediation within an investment manager that also extract charges.

This report has referred a number of times to the way that complexities of regulation and taxation create differences between the product wrappers and how they are managed.

The investment management team may be less interested in the wraps used by the sales and marketing teams to gather the assets the manager is managing.

Lets assume that an asset manager has an offering of three products with £100 of assets in each – of these products one is a UK equity product, another is a European equity product with a 10% exposure to UK equity and the third a global equity product with a 5% exposure to UK equities. The investment manager may have a UK equities team that looks after UK investments. That team will think of its assets under management as being £115. It does not matter to it that the assets belong to three different funds – it manages the money as one lot (if subject to the same investment mandates) and then the execution systems, middle and back office teams will allocate trades by this manager or desk to the three products. There may be a number of teams – some may trade fixed income others might trade other forms of securities or geographic sectors or industries depending on their expertise. Each desk may be required to trade through an in-house execution desk or

[213] http://www.oxera.com/getmedia/d6ade83e-566f-49e4-934e-4cfe3c23f379/Position-of-savers-in-private-pension-products.pdf.aspx?ext=.pdf

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may be allowed to choose their own execution brokers. These brokers will then resource trades through the different trading venues they use which may include electronic order matching systems, exchange based trades, trades in dark pools etc.

There may therefore be no knowledge of the ultimate investor vehicle that is transacting because those allocations take place at investment manager (middle and back office) and custodian level.

This makes tracking investments complicated but can give the manager huge benefits of scale.

Of course scale can also work against a manager. Larger trades are more difficult to disguise in the markets. Managers can therefore also break up or disaggregate trades to avoid attention. An investment strategy may only have a limited capacity and large sizes can make generating returns on trades more difficult. Sophisticated investors understand this and will ask managers to disclose what their trading capacity is and whether it will have an impact on returns. Retail investors may not understand these nuances and work on the assumption that big is beautiful. It is, but in many instances, primarily for the investment manager.

6.10 Remuneration is fixed regardless of performance

This report has looked at the different forms that fees can take on collective investment schemes. The main form of remuneration for the manager is a fixed investment management fee regardless of the performance that the manager is able to generate for the investor. The nature of this one-sided relationship reduces the risk to the manager if it fails to perform (provided they remain within the pack of average performance) as there is little risk of them being fired for lack of performance even if there is a risk that assets might flow out of the fund. If there is to be any change in the management of retail investment products then, at the very least, the boards of the investment structures need to be able to renegotiate fees in the light of performance or have the ability to move the money to another manager.

If the current status quo is maintained, the incentives for the manager to reduce costs in order to act in the interests of the investor are low. The position is made worse given the propensity for retail and pension money to be quite ‘sticky’ once it has been invested in a fund.

Some collective investment schemes do charge performance fees but even these need to be treated with care unless they include hurdle rates and high water marks so that the manager cannot receive multiple amounts of performance fee on the same element of performance.

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6.11 Advice and product choice have inherent conflicts

There has been some interesting research in the US by the SEC in 2011 prompted by Section 913 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. This required the SEC to conduct a study on the effectiveness of legal and regulatory standards in providing personalized investment advice and recommendations on securities to retail customers and whether there were gaps in the standards of care.[214] The study found that although investors were generally satisfied with their financial professionals, investors were confused about the roles, titles and legal obligations of investment advisers and broker dealers. The SEC recommended that investment advisers adopted a uniform fiduciary standard to investors and harmonization of regulation to add meaningful investor protection.

In the UK there are two types of adviser: Independent and Restricted. Some advice in the form of general information is referred to as 'information only' or 'non advice' services

	Independent adviser	Restricted advisers
Will consider all retail investment products	Yes	No
Can focus only on a particular market	No	Yes
Can consider products only from certain product providers	No	Yes
Has to explain to you the type of advice they offer	Yes	Yes
Can use 'independent' to describe the advice they offer	Yes	No
Incentivised to recommend one product over another	No	No

Figure 7 FCA Table on what independent and restricted advisers can advise upon [215]

In April 2014 the FCA published its second set of findings from a thematic review of retail investment firms and adviser charging and services following the changes through RDR. It focused on two particular areas: whether firms who described their services as independent were offering an independent service in practice and how firms were disclosing their service proposition and charging structures to clients.

The FCA found that a significant number of firms understood the requirements for delivering independent advice and appeared to be delivering it in practice[216] but 73% of firms they reviewed failed to correctly provide the required information on the cost of

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[214] http://www.sec.gov/news/studies/2011/913studyfinal.pdf
[215] http://www.fca.org.uk/consumers/financial-services-products/investments/financial-advice/independent-and-restricted-advisers
[216] http://www.fca.org.uk/news/thematic-reviews/tr14-5-supervising-retail-investment-firms

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advice. Amongst other findings, 58% of firms failed to give clients clear upfront generic information on how much their advice might cost and to give additional information on charges such as highlighting that those ongoing charges might fluctuate. 31% of the firms giving restricted services were not clear that they were restricted or the nature of the restriction.[217]

The FCA intends to commence its third cycle of reviews in the third quarter of 2014 and has threatened regulatory action at that stage.

In March 2014 the FCA fined Santander £12.3m arising from significant concerns about the quality of the advice and communications with its retail investment customers. These failings were considered to be systemic and related to a large number of customers. It referred to the response by Santander to the FCA letter to Wealth Management CEOs in 14 June 2011, which it found had been too positive and misleading in relation to its description of its tools and processes and the quality of outcomes they produced for customers. It also referred to an earlier fine of £1.5m in 2012 for providing investors with unclear information on the scope of cover for certain structured products under the FSCS.[218] The FCA also found that 94% of the advisers in its mystery shopping exercise failed to provide customers with adequate disclosure and/or all of the documents required in accordance with Santander's own process. However the revenue that Santander had generated from its actions over the two year period was reported to be £118.2m between January 2010 and December 2012. Santander closed its investment advice arm in February 2013.[219]

As a 'cost of doing business', a fine of £12.3m for revenues generated of £118.2m is not bad going for the shareholders of the business.

Why is it difficult to provide advice properly even in a very large organisation with huge resources? Invariably it is likely to be a combination of many things – changing regulations become confusing both to implement and police; large sales forces will have huge variations in their levels of experience, knowledge and understanding; the business is always more likely to paint a rosier picture of its controls and processes than what reality might be; but most of all the incentives and therefore rewards from the revenues generated are tremendous and the nature of the fines imposed is generally insignificant in relation to those revenues.

This has been a problem for regulators globally, who are required to use enforcement powers based on principles of proportionality. Unlike an individual who can be thrown into prison to prevent further wrong-doing, profitable organisations survive the fines they pay for wrongdoing and individuals' measures of success and reward within these organisations tend to be the revenues they generate.

6.12 Survivorship bias, fund mergers and closures hide performance problems

[217] *http://www.fca.org.uk/news/thematic-reviews/tr14-6-supervising-retail-investment-firms*
[218] *http://www.fca.org.uk/your-fca/documents/final-notices/2014/santander-uk-plc*
[219] *http://www.ftadviser.com/2014/03/26/ifa-industry/companies-and-people/santander-plays-down-potential-payout-on-m-mis-selling-ipKZF4gIIISd6885qBkzEJ/article.html*

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In January 2013 Vanguard published research on the performance of mutual funds identified by Morningstar over 15 years through to December 2011 that had been closed. It found, unsurprisingly, that the primary factors leading to fund closure were poor relative performance, a lack of commercial success or a combination of both. A majority of funds that were eventually merged had underperformed significantly prior to the merger.[220] But were these decisions made for the benefit of the investor? The FT ran a report in 2011[221] in which financial advisers had accused investment managers of continuing to merge their poor performing funds with better offerings in order to hide their true track records. The report noted that one investment house based on data from Lipper in 2010 had merged 39 funds with others run by the same manager while 81 were shut down altogether. In 2009, following the financial crisis, there had been 56 fund mergers and 127 closures.

Mergers, or a slight change to the name of the fund can obscure the history of problematic funds for the manager. Mergers and closures can also be a sign that investment managers are sometimes too quick to launch funds. The purpose of the launch may be to capture assets under management off the back of a particular investing fashion and then to merge it with another fund using investor inertia to keep the assets.[222]

Unless there is a requirement for fund closures and mergers to be tracked it is easy for managers to hide problem funds.

There should be a requirement for all funds to disclose how many funds have been merged into it and what the values of the original investments made into the fund were, so that fund performance is measured against the actual money that was originally received into the fund. With modern systems and information technology, this should pose no problem to investment houses to track this information and to disclose it. That would give a far better measure to advisers on the nature of the funds they are recommending.

6.13 Closet index tracker funds result in higher charges

One of the first decisions someone must make, when seeking to have a manager manage their investments, is whether the approach should be one of active investment management or passive investment management. The problem is that sometimes the distinction is not so clear but the costs of doing so are. Actively managed funds are generally more expensive than passively managed funds. The reasons offered for this are that active management incurs more research costs and then there are the transaction costs that impact on buying and selling decisions, while passively managed funds are less expensive because the manager generally follows an index. Even index funds come in a variety of guises – the index fund may not (for practical or other reasons) replicate the

[220] https://personal.vanguard.com/pdf/s362.pdf
[221] http://www.ft.com/cms/s/0/61de2a44-e05c-11e0-ba12-00144feabdc0.html#axzz2zLf6LVWB
[222] *In one example of investor inertia, a fund had been merged with other funds over the years. The manager itself had merged, and the fund had consequently undergone name changes to reflect the fund and manager mergers; so much so that it was a major task to identify the fund with the original investment, because reports sent to investors covered the entire fund range of that manager with names that were only slightly different from each other. The returns that were reported bore no relationship to the original investment in the original fund and a significant proportion of the growth in those assets had been taken as charges. The returns were better than the compounded returns in a bank account, perhaps justifying the investor's inertia, but did the returns reflect value for money? Arguably the true beneficiary of the sum of money invested was the investment manager.*

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entire index or may replicate it in a slightly different way and, depending on when they rebalance their investments, there will be transaction costs but these are generally expected to be lower than the costs of active investing.

Some managers are accused of charging active management fees while in reality following an index approach. They are referred to as closet index trackers because they should not be charging the fees of an active investment manager.

Academic research updated in 2011 suggests that collective investment schemes in many countries engage in closet indexing. The degree of explicit indexing is negatively related to fees (i.e. the more explicit it is the lower the fees) while closet indexing is positively associated with fees and negatively with performance (i.e. higher fees and lower performance are linked to closet indexing). The most actively managed funds (and not closet indexers), according to this piece of research, charge higher fees but outperform their benchmarks after expenses.[223] Petajisto in a 2010 paper updated in 2013 found that the most active stock pickers outperformed their benchmark indices even after fees and transaction costs whereas closet indexers or funds focusing on factor bets (or systematic factor risks such as market cap or sector rotation) have lost to their benchmark after fees.[224]

SCM Private – the sponsors of the True and Fair Campaign - are also critical of closet index trackers. In a September 2013 paper called Closet Indexation, A UK Epidemic, it claims that 46% of "UK retail funds were found to be potentially misleading the public and breaching the Financial Conduct Authority's (FCA) over-riding principles that fund management companies '*must conduct their business with integrity, and communicate information in a way that is clear, fair and not misleading*'".[225] The paper also found that of the funds they analysed 40% of each fund was identical to the same index the fund was aiming to beat. The paper suggested that had those investors chosen a low cost index fund instead, then over five years those savers could have saved £1.86Bn in UK equity fund fees and £1.17Bn in overseas equity fund fees.

In 2013 The Journal of Investment Consulting published a paper by Aron Gottesman and Menahem Rosenberg.[226] This work concluded that active mutual fund managers are more likely to closet index during down markets because they have an incentive to do so based on their analysis of the inflows and outflows into funds and their correlation to the magnitude of outperformance or underperformance of the manager.

But a discussion on closet index tracking also draws us into the debate of whether funds and pension funds in particular, should focus on passive investment management styles rather than active management styles given the long-term nature of their investment and the associated costs in delivering performance using the two different styles. CalPERS –

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[223] *Cremers, Ferreira, Matos and Starks (2011) The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees, and Performance* *http://depot.som.yale.edu/icf/papers/fileuploads/2700/original/2011_CIF_WPS_The_Mutual_Fund_Industry_Worldwide_Explicit_and_Closet_Indexing_Fees_and_Performance_Cremers.pdf*

[224] *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685942*

[225] *http://www.scmprivate.com/content/file/researchreports/closet-indexation-report-sept-13-full.pdf*

[226] *Gottesman and Rosenberg (2013) Do Active Managers of Retail Mutual Funds Have an Incentive to Closet Index in Down Markets? Fund Performance and subsequent Annual Fund flows, 1997 -2011, Journal of Investment Consulting Volume 14, Number 2, 2013* *http://www.imca.org/sites/default/files/current-issues/JIC/JIC142_ActiveManagersClosetIndex.pdf*

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one of the world's largest pension funds overseeing almost $255Bn in assets has been reported to be considering moving to an all passive portfolio of investments.[227] Even Warren Buffet is reported to be recommending passive funds because stock selection is 'devoid of benefit'.[228] The first OFT report suggested this as a solution too.

William Sharpe, after whom the Sharpe Ratio (a measure of returns per unit of risk) is named, wrote a paper that was published in 1991 called The Arithmetic of Active Management.[229] In it he asserts that if 'active' and 'passive' are defined in sensible ways, it must be the case that:

"(1) before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and

(2) after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar

These assertions will hold for any time period. Moreover, they depend only on the laws of addition, subtraction, multiplication and division. Nothing else is required."

He argued that presented evidence that shows active managers beating "the market" or "the index" or "passive managers" could occur only because of three reasons:

- Firstly the passive manager may not be truly passive e.g. they may only sample the market and some may charge high enough fees to bring their total costs to equal or exceed active managers
- Secondly the active manager may not fully represent the non passive component of the market in question (our closet indexer)
- Thirdly (and, he argued, most importantly) the summary statistics for active managers may not truly represent the performance of the average actively managed dollar.

"*Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement.*

This need not be taken as a counsel of despair. It is perfectly possible for some active managers to beat their passive brethren, even after costs. Such managers must, of course, manage a minority share of the actively managed dollars within the market in question. It is also possible for an investor (such as a pension fund) to choose a set of active managers that, collectively, provides a total return better than that of a passive alternative, even after costs. Not all the managers in the set have to beat their passive counterparts, only those managing a majority of the investor's actively managed funds."

[227] *http://www.investmentnews.com/article/20130619/FREE/130619874*
[228] *Sunday Times, 27 April 2014*
[229] *William F. Sharpe (1991) The Arithmetic of Active Management, The Financial Analysts' Journal Vol 47, No 1, January/February 1991 pp.7-9 Association for Investment Management and Research. http://www.stanford.edu/~wfsharpe/art/active/active.htm*

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A Turkish academic study in 2014 that reviewed a survivorship and selection bias free database of actively managed private Turkish pension funds showed that most managers were not able to provide performance above and beyond what could be earned by passive indexing. Funds with self-declared benchmarks failed to beat them on average.[230]

In 2011 the Netherlands Authority for Financial Markets published a document: 'The status of academic research regarding the results of active and passive investing'.[231] This paper pointed to two shortcomings of the empirical studies it had reviewed. Firstly it compared active funds to a benchmark or index that an investor could not normally invest in and secondly because the index funds investors could invest in directly did not deliver exactly the same results as the benchmark or index used in the studies. The studies would need to be adjusted for these factors but it was not known how much this adjustment should be because there was little academic research on the results of passive investing. Despite these limitations the research showed that it was very difficult for an active manager to achieve persistent outperformance in the medium to long-term.

The UK Department for Communities and Local Government has recently published a consultation document which refers to research conducted on its behalf by Hymans Robertson which suggests that savings of some £420m could be made if the Local Government Pension Scheme moved to passive fund management of all listed assets accessed through a common investment vehicle.[232] The Hymans Robertson report found that although there were some funds that performed consistently well relative to their peers, for the LGPS in aggregate, equity performance before fees for most geographical regions was no better than the index. The report suggested that greater use of passive investments could save £230m without damaging investment performance in aggregate across the LGPS and reduce turnover costs by circa £190m.[233]

More recently, the Pensions Institute has published research which suggests that only 1% of the sample of 516 UK equity open ended mutual funds they studied between 1998 and 2008 were able to deliver outperformance from stock selection or market timing, but that these managers extracted this outperformance for themselves leaving nothing for investors.[234]

The examples of research mentioned show that although the evidence leans against active management, in those instances where active managers perform better it is possibly for the three reasons Sharpe gives. This means that at the very least active managers on retail collective investment management schemes need to be able to justify the higher costs they charge in relation to performance delivered over the long-term by passive investment managers in the same space. There also needs to be some consideration given to the nature of the disclosures that active investment managers make on the extent to which they might be, or become, closet index trackers.

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[230] *Umut Gokcen, Koc University Atakan Yalcin Ozygen University (2014) The Case Against Active Pension Funds: Evidence from the Turkish Private Pension System.*
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2372059

[231] http://www.afm.nl/~/media/files/wetten-regels/leidraad/guidelines-active-passive-investing/literature-review-active-passive-investing.ashx

[232] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/307923/Consultation_LGPS_structural_reform.pdf

[233] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/307926/Hymans_Robertson_report.pdf

[234] http://www.cassknowledge.com/sites/default/files/article-attachments/a-comparison-of-alternative-bootstrap-methods.pdf

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An independent board reviewing the performance of a manager may not necessarily be prone to the biases to which retail investors are susceptible and may be in a position to challenge the investment manager in a way no retail investor on their own would be in a position to do.

6.14 New collective investment schemes perform better than older ones

In the funds of hedge funds (funds that invest in hedge funds) investment community there was a commonly held view that many hedge fund managers performed their best in their early years of operations because they had a lot to prove. As they accumulated wealth, they became more risk averse and performance tended to level off.

The National Bureau of Economic Research issued a working paper in February 2014 called Scale and Skill in Active Management.[235] They reviewed performance on over 3,000 mutual funds between 1979 and 2011. They found that as the size of the active mutual fund industry increases, a fund's ability to outperform passive indices declines. But interestingly it also found that performance deteriorated over a typical fund's lifetime. They noted that funds with an age of three years or less did better than those that were 10 or more years older by almost 1% per annum. They suggested that this result could be explained by decreasing returns to scale and greater competitiveness. This raises questions about whether it is right to remain in a particular product in the long-term as is often suggested to investors, or whether a manager loses the incentive to generate returns in the long-term and whether it is therefore important for investors to switch managers if not the product from time to time. An ability to switch managers would need governance on the product that was independent of the investment manager. Independent governance would also be necessary if costs were to be negotiated down as a fund grew in size and in age.

6.15 Difficulties in differentiating between costs, charges and expenses

When we talk about costs, charges, expenses or fees we all have a rough idea what these terms mean. But what exactly do they mean? One thing is certain: they are never as clear-cut as they might initially appear and can be used interchangeably.

The fund industry, through a whole raft of regulatory requirements, is now used to disclosing charges. Charges for this purpose are explicit disclosable deductions made from investors' savings pots, whether described as a charge, a fee or as an expense of the fund, and will often include a profit element.

But charges still need to be defined. In collective investment schemes there has been a trend towards a single charge referred to as the ongoing charge. Whether a charge is

[235] *Lubos Pastor, Robert F. Stambaugh, Lucian A. Taylor, (2014) Scale and Skill in Active Management, NBER Working Paper No.19891, February*
http://www.nber.org/papers/w19891

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called an ongoing charge or an annual management charge is immaterial. What is far more important is how that term is defined and what is included in it. Even more important is what is not included.

The charge cap that was imposed on stakeholder pension schemes is a case in point. On the face of it, as the OFT noted in its 2013 market study, the AMCs charged on schemes fell with the introduction of the charge cap on stakeholder pension schemes. Arguably, however, the impact on costs overall was just a 'waterbed effect'. Although the AMC (which had never been clearly defined) did fall – other charges and costs against the fund, which were not included in the definition of the AMC, were charged instead and so the cost base did not change significantly and in some cases may actually have gone up.

The industry is generally able to come up with new ways of recovering the profit margin it wants by adding charges to other services or by inventing new charges.

For example a few observers have debated whether charges for so-called 'new services' such as fiduciary management or blending are little more than variations of fees for services that should be provided in any event as part of the investment management service.

Unlike charges, costs are viewed to be more problematic for disclosure. This is because some costs do not need to be an explicit deduction or explicitly disclosed. Because they may not be disclosed, they can hide a multitude of conflicts of interest and hidden profits for investment managers and their business arrangements. These costs are the 'hidden charges' that the media often refer to. Part of the problem arises because a retail investor looking at their portfolio may attribute certain falls in value of their portfolio to market movements when they are in fact charges taken on the portfolio. These are presented as costs the investment manager cannot control, such as the costs of investment or the purchase of a service. The latest SORP on the financial statements of authorised funds issued by the IMA has removed the explicit statement that transaction costs could be recognised as part of the consideration for a transaction and now simply states that these costs should be recognised on an accruals basis as deductions from capital.

Costs can also be hidden because they include opportunity costs. E.g if a custodian pays a lower rate of interest on cash held in the fund than may otherwise be available in the market – the loss in income is an opportunity cost and not captured or disclosed.

We have looked at dealing commissions. These are another example of a hidden cost. The investor is told that execution costs have been incurred which are an expense of operating the portfolio. What they may not know is that a proportion of those costs are paying for services the manager receives such as for research, which forms part of the investment management service it provides and for which it receives a separate fee. Investment managers know precisely how much commission they have paid to execution brokers because they track it to measure the services they receive in return, and because of regulatory disclosure requirements. The debate on whether it is appropriate for an investment manager to obtain these services through dealing commissions goes to the very heart of exactly what a charge on a fund should pay for, if the agent is able to direct

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expenses it would otherwise incur, to the fund. These dealing commissions are part of the transaction costs that are excluded from many disclosure requirements on funds.

The cost of an investment can also be inflated particularly if the manager is a party to the trade or where one fund a manager manages, transacts with another fund also managed by the same investment manager. There are of course rules to manage these conflicts but we must not forget that the governance on these funds can be carried out by connected parties that may not be independent of the manager and the regulator cannot be there constantly looking over the shoulder of the manager.

Where a fund of funds is used i.e. a fund that invests in other funds, the underlying investments and their charges can get subsumed as a cost of that investment. Therefore the fund of funds structure can hide multiple layers of sub fund charges that exist because they are presented as a 'cost' of that investment. In this example the cost of investing in the fund of funds is the disclosed charge at the fund of fund level. The charges of the underlying funds are not specifically disclosed or disclosed more generically as costs that the fund of fund incurs. These additional costs are often not understood by investors.

The definition of what is a cost and what is a charge is complex and can therefore cause its own problems. The investment manager, as previously noted, has a duty to minimise its own costs and to maximise its profitability. The regulators draw attention to this conflict regularly and it is a difficult conflict to manage. Given the wide discretions that a manager has to direct charges and costs to the investors' savings, and the lack of accountability for some of these decisions, it is difficult to see how regulation can work properly in this area.

Expenses are slightly different from costs but just as relevant. Expenses are usually actual payments made against an investor's pot of savings and reflect the actual amount deducted from the savings pot. They can be costs (when they can include a profit element for that service provider) but expenses charged directly to a savings pot have to reflect the actual cost incurred or the fund's proportional share of that cost to be treated as an expense.

TPR has prepared educational material to show how charges and costs can be subsumed through different investment layers.

6.16 Reported fund performance may bear no relationship to investor experience

Investment managers provide performance information for the fund, which sometimes bears no relationship to the investors' investment experience in the fund.

Funds report performance in a variety of ways. They may tell you what £100 would be worth today had you invested with the fund from Day 1. They will also provide you with information on the 1-year, 5-year and 10-year performance record of the fund.

However these performance numbers may bear no relationship to what the investor's experience has been in the fund because timing of the investment is critical to the returns.

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Lets assume that an investor purchases a unit in a collective investment scheme in the middle of the 11th year since its inception when the value of a unit is £1000. The value of the unit at the start of the year was £800, but falls to £700 per unit shortly after the purchase and ends the 11th year valued at £850. Lets assume that things do not go well for the manager and that after costs over the next 10 years the manager's performance on the fund results in a value of £999 per unit.

The performance numbers for the fund for the 11th year that are reported will show performance for a unit of 6.25% and the 1, 5 and 10 year performance record will also look respectable, but the investor's experience is a loss of 15%. Even after 10 years the investor has not recovered their initial investment although fees have been extracted each year. The manager will report that an investor over 21 years that invested £100 on day 1 would have a unit worth £999. It is hard for the retail investor to understand managers reporting success when their own experience is that all they have suffered over a 10 year period are losses from the original investment.

Many fund platforms will provide profit and loss numbers for their clients to track but even these can be quite misleading because where a fund is closed or merged – it shows the money going into the new fund as new money – wiping out the earlier losses as if they had never occurred.

This is why funds need to track and report on investors' investments in the fund. A fund needs to be able to report that its value of £999 per unit generated over 21 years is based on its original investments. In our example if we assume that there was only one other investor that invested one unit on day one of £100 we would be reporting that the fund had received investments of £1,100 and had created value of £1998 but that only one investor had benefitted from an investment in the scheme by £899 whilst the other investor had in fact lost money (£1) over that period net of all charges. The effects of timing on entry and exit are facts of life in collective investing but the funds need to be more honest about who they have made money for rather than the false impression that can be created through reporting numbers over periods of times or even by quietly closing and merging funds and reporting performance to investors that does not bear any relationship to their investment experience.[236]

Only an independent board would be able to review manager performance properly and effectively. The Independent Directors Council in the US has prepared a useful guide in October 2013 on some of the criteria that a board should use in exercising investment performance oversight by fund boards, although additional criteria could be added such as investor experience and an analysis of investor funds received from which performance has been generated.[237]

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[236] *Some fund due diligence teams receiving reports from investment managers have been known to try and guess whether a manager has made returns or suffered losses based on the opening statement of the investment managers' report as a form of light relief. Managers that had made losses tended to open their remarks by pointing to a benchmark and showing how their losses were less than those of the benchmark, i.e. reporting performance relative to some other benchmark to justify the losses. When they had generated returns they tended to report them in absolute terms.*

[237] http://www.idc.org/pdf/pub_13_performance_oversight.pdf

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6.17 Lack of understanding of order management, trade execution and allocation

We have noted that managers may not manage investments within the funds and wrappers sold. It can sometimes be much more efficient to aggregate investments and orders for efficient management and to utilize limited skills and resources within managers' investment teams.

Some of the costs incurred through the process of aggregating and then filling orders have to be averaged so that they can then be allocated across the funds.

Order handling and management, trade execution, trade and cost allocation can all complicate the process – even though many of the processes are automated. This automation can create opaqueness around costs. It also makes costs look immaterial because they are spread across a number of funds and do not draw attention to what may be significant savings for the manager who is able to allocate that cost across all their funds.

It is essential that investment managers are able to order their businesses efficiently but their systems can create opaqueness at the fund level because of their structure and the way transactions are handled.

6.18 Exclusions in Unfair Contract Terms laws prevent challenge in Financial Services

Unfair contract terms in consumer contracts in the UK are dealt with through two pieces of legislation:

- Unfair Contract Terms Act 1977 (UCTA)
- Unfair Terms in Consumer Contracts Regulations (SI 1999/2083) (UTCCR)

In February 2005 the Law Commission and Scottish Law Commission published a report on Unfair Terms in Contracts[238]. It found that the current law embodied in these two pieces of legislation was very hard to understand because they were overlapping inconsistent pieces of legislation. The report recommended a unified legislative regime that preserved the consumer protections afforded by both pieces of legislation.

UCTA is UK legislation, which applies to exclusion and limitation of liability clauses and often applies regardless of whether terms are negotiated or are in standard form but more crucially does not apply to certain types of contracts even when they are consumer contracts. In particular UCTA does not apply to consumer contracts of insurance or the creation, transfer or termination of interests in land or the creation or transfer of securities or any rights or interests in securities. Unit-linked products are contracts of insurance and investment management contracts can deal with the creation and transfer of securities and therefore arguably these products may not be open to challenge on the grounds that liability has been unreasonably limited or excluded.

[238] http://lawcommission.justice.gov.uk/docs/lc292.pdf

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UTCCR in contrast is European legislation that has been translated into UK law as a fairly literal version of the text of the directive. According to the Law Commission the language, and in some instances, the concepts, are not always easily understood by UK lawyers. UTCCR applies to any kind of contract term other than the definition of the main subject matter and the adequacy of the price. The regulations apply only to non-negotiated terms, although the burden of proving that the clause is unfair falls upon the consumer. This has meant that contracts including investment management contracts or insurance contracts cannot be challenged on adequacy of price unless the language of the contract is written in a manner that is not plain and intelligible to consumers.

UTCCR gave the Office of Fair Trading and the FCA the power to prevent the use or recommendation of unfair terms but the regulators have not been given any power to provide redress or compensation[239].

If one combines the exclusions provided for in the legislation to financial services products, with the inability of the regulators to provide redress – a consumer faces difficulty under these provisions in being able to challenge or rectify any unfair treatment in respect of financial services charges or exclusions of liability, although other channels of redress may be open to the consumer.

The Law Commission in 2005 argued that it was implicit in the UTCCR that the consumer's expectations were an essential part of how 'subject matter' was itself defined. Whether a term related to the subject matter for the purposes of applying UTCCR appeared to depend (at least in part) on how the deal was presented to the consumer. The Law Commission proposed a change to the UTCCR so that the legislation would exclude the main subject matter and the price from the scope of review but only in so far as:

1. the term was not substantially different from what the consumer reasonably expected, and
2. was stated in plain language, and
3. was transparent (which included being readily legible – a concept introduced by the OFT).

This change proposed by the Law Commission is fundamental to introducing fairness in financial services because there can be a mismatch between the broader promises made in financial services and the small print.

The Law Commission in 2005 also proposed that the exemptions provided to consumer contracts of insurance and contracts for the transfer of an interest in land and for the creation or transfer of interests in securities, should be reversed and not be exempt under the proposed new regime.

In 2013 the Law Commission prepared advice for the Department for Business, Innovation and Skills.[240] It again recommended that the exemption for subject matter and price

[239] http://www.fca.org.uk/firms/being-regulated/unfair-contracts/our-powers

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should be reformed and that these terms should be exempt only if they are transparent and prominent. It also recommended sector specific guidance for areas such as insurance on the meaning of transparent and prominent.

The Consumer Rights Bill currently progressing through Parliament makes provision for the reform of consumer law in the UK and to enable consumers and small companies to pursue, through the Competition Appeal Tribunal, private actions under contract law against companies.[241]

Section 65(2) of the Consumer Rights Bill seeks to put a bar on exclusion or restriction of negligence liability merely because a consumer agreed to or knew about the term or notice. However section 66 of the Bill states that section 65 does not apply to any contract so far as it is a contract of insurance. As we have seen previously pension products are often constructed as long term contracts of insurance and therefore it would appear that these provisions would not apply to them. This exclusion appears to perpetuate the difference in outcome for an investor depending on the type of investment product they choose. It is recommended that these provisions are revisited with a view to placing investors in long term contracts of insurance in the same position as consumers challenging other consumer contracts.

Schedule 2, Part 1 of the Bill sets out a list of consumer contract terms which may be regarded as unfair (Grey Terms). Part 2 sets out the scope of Part 1 and in relation to financial services excludes:

- cancellation without reasonable notice (paragraph 8) if it is a term by which a supplier of financial services reserves the right to terminate unilaterally a contract of indeterminate duration without notice where there is a valid reason, if the supplier is required to inform the consumer of the cancellation immediately.
- variation of contracts without a valid reason (paragraph 11) if it includes a term by which a supplier of financial services reserves the right to alter the rate of interest payable by or due to the consumer, or the amount of other charges for financial services without notice where there is a valid reason if (a) the supplier is required to inform the consumer of the alteration at the earliest opportunity and (b) the consumer is free to dissolve the contract immediately

And in relation to the sale of securities and foreign currency excludes:

- cancellation without reasonable notice (paragraph 8), variation of contract without valid reason (paragraph 11), determination of price after consumer bound (paragraph 14) and increases in price (paragraph 15) for (a) transactions in transferable securities, financial instruments and other products or services where the price is linked to fluctuations in a stock exchange quotation or index or a financial market rate that the trader does not control and (b) contracts for the

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[240] *http://lawcommission.justice.gov.uk/docs/unfair_terms_in_consumer_contracts_advice_summary-web.pdf and http://lawcommission.justice.gov.uk/docs/unfair_terms_in_consumer_contracts_advice.pdf*
[241] *http://www.parliament.uk/business/publications/research/briefing-papers/LLN-2014-023/consumer-rights-bill-hl-bill-29-of-201415*

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purchase or sale of foreign currency, traveller's cheques or international money orders denominated in foreign currency.

The Bill excludes TPR from the list of Regulators that can consider a complaint under schedule 3 which relates to the enforcement of the law on unfair contract terms and notices.

Cases on the existing law have created uncertainties. In *Office of Fair Trading v Abbey National Plc* the Supreme Court held that bank charges were exempt from challenge overturning decisions from the High Court and Court of Appeal who had held that the charges were not exempt because they were not part of the essential bargain between the parties. In Europe the courts have also had to grapple with similar issues.[242]

Changes in attitude to the challenge of price in financial services are starting to happen elsewhere too. In 2013 Bloomberg reported on a case in Newark, New Jersey called *Kasilag et al. vs Hartford Investment Financial Services.*[243] In the US there is a 1982 precedent referred to as the Gartenberg Standard where a court will deem a fund's management fee excessive only if it is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining. Legal opinion and Supreme Court rulings suggested that because it was difficult to unbundle the costs of a management fee, challenging a firm on these grounds was considered near impossible but a US District Judge denied an investment manager's motion to dismiss because the customer decided to pursue fees paid to the adviser of a sub fund where the fees paid to that adviser were set out separately in public documents rather than the bundled fees of the adviser to the fund.

[242] *For example see the Kalser OTP case in Hungary.*
[243] http://www.bloomberg.com/news/2013-02-21/lawsuit-shines-a-harsh-light-on-subadvisory-fund-fees.html

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7. Options for Reform

Key Points

- The current incremental disclosure approach to transparency and information on costs and charges and related conflicts of interest is not working in the interests of consumers. PRIPs and MiFID II perpetuate this incremental approach
- Funds targeted at retail investors need to be simplified
- Investment structures need to reflect the reality of how they are managed and need to give the investment manager the freedom to order their business in a way that works to their advantage without creating conflicts of interest with their investors
- Retail funds should adopt a single, simple structure from which only a single investment charge should be made with all other costs being met through that investment charge by the manager
- Investment valuations should strip out the costs of buying and selling to give a true single value
- Governance on funds should be independent of the manager who should play no role in the appointment or removal of the governing body. The governing body should have the ability to remove the investment manager
- The nature of accountability and the duties of the investment manager to retail investors should be set out in statute and should be of a fiduciary nature
- The format of investor performance and cost reporting should be changed so that it is provided with reference to the amounts invested and should be mandatory in nature
- The consumer rights legislation should be revised and consolidated in accordance with the 2005 proposals of the Law Commission and should include exclusion clauses on contracts of insurance.

7.1 'Doing nothing' is not an option

The first option that most policy makers might consider is the case for 'doing nothing'. European initiatives suggest that the current direction of travel in relation to charges disclosure is the right one and there is therefore an argument to let these initiatives embed themselves. The new proposals will strengthen disclosure but for the reasons we have already discussed this disclosure is unlikely to be enough even if it is more than is currently the case and improves disclosure and understanding. The other argument of course is that asset management like so much in financial services is international in

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nature and therefore regulatory action must operate across borders in order to be truly effective; that Europe provides a better mechanism in terms of competitive fairness than any unilateral action by UK policy makers which would place UK asset managers at a disadvantage. However the UK is one of the biggest asset management markets in the world and changes here are likely to precipitate changes elsewhere. The concerns we have discussed are not unique to the UK, and many regulators have attempted to address these issues. The UK, by dealing with the problem head-on is more likely to benefit from first mover advantage than suffer from any proposed changes, because the markets will be seen to be operating more fairly for consumers and that should act as a flag-bearer for change across borders.

The changing regulatory policies on disclosure are welcome but we know that disclosure on its own will not achieve the desired outcomes policy makers seek.

Institutions are usually slow to change and policy makers worry about unintended consequences, but there is mounting evidence of detriment so that delays in change are likely to ultimately work only to the advantage of industry. There is an urgent need to rebuild trust in financial markets; the UK has been leading in this area and there is therefore a very strong case for policy makers to take the initiative and take radical action for change because the incremental approach over the last 20 years has not worked to the advantage of long-term retail savers. The markets are complex and difficult to navigate even for institutional investors. Products need to be simple to understand even if not to manage. They need to be fair, well governed in the interests of those to whom the money belongs, and have consistent outcomes for redress for investors when things go wrong.

Doing nothing should not be an option.

7.2 Single customer charge with all intermediation costs borne by the investment manager

One possible approach for reform is to ban the investment manager from allocating and attributing costs to the fund other than its own charge for managing the fund.

All income and benefits arising from a portfolio would be attributed in full to the investor. For example, stock lending income would not be shared between the manager, the custodian and the investor - it would all need to go to the investor. Any transaction costs or charges for short lending imposed by a custodian would be borne by the investment manager whose sole reward would be the fee they charged the fund.

The investment manager would be permitted to make a single unitary management charge (UMC) per annum to reflect their ongoing costs and fees for running a fund. This would be the sole charge that a manager would be able to make to the retail fund.

All the costs of running the scheme would be borne by the manager, whether in relation to the audits, transaction costs for trading or credit facilities. Even provisions against the value of an investment that is uncertain would be costs for the manager to bear,

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redressing the balance of risk between investor and manager because the risks will be borne by the manager to the extent that they believe that the true value of the asset is different to the value at which the investors' interests are priced. The manager will price these into the single unitary charge. If they are able to achieve benefits of scale, which give them advantages on costs, they will be paying for these services and receiving the benefits directly.

The concept is not problem-free and more thought would need to be put in to it such as in connection with leverage where a manager might argue that unless they can collateralise the assets of the investor, borrowing would not be possible if it meant taking the risk on to their own balance sheet. But it is possible to find solutions for that too and the principle that the costs of the strategy are borne by the investment manager should and can hold good even in such a scenario. Another argument could be that a single charge such as this may also encourage malpractice in other areas such as the way assets are valued for the purpose of the unitary charge, but that too could be addressed.

Asset values would need to be stripped of buying and selling commission so that a pure price for valuation of the investor portfolio was possible because the principle that would be adhered to is that any dilution costs would also be costs of the investment manager and built into the single unitary charge and would reflect what would otherwise be the entry and exit fees.

Entry and exit from the fund should be costs that a manager factored into their charge but it could also be calculated on the basis of a disclosed fixed spread.

This simplifies matters for the investor who is concerned only about three things:

1. Cost of entry and exit from the collective investment scheme if not included in the UMC (there may need to be some regulation to ensure that exit is not extortionate)
2. The value their portfolio is generating
3. The costs (UMC) they have paid the investment manager to do the job

How the investment manager manages the investments, whether through paying transaction costs, commissions or paying for corporate access are matters for the manager's business operations to decide upon in terms of profitability against the single unitary management charge they levy. It should no longer matter to the investor what the manager pays for these services but it will matter to the manager who now has to ensure profitability.

The manager will be judged on the net performance they generate which will be comparable across the entire retail market and a successful manager will be able to demonstrate true value generated for an investor; the investor would not have to worry about hidden or lost profits.

Such a proposal may attract ridicule from industry because it will be quick to point out the difficulties in its implementation and the higher potential costs to the industry that it could

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entail. It is a radical approach but it merits consideration, as other options are not working. Whatever these higher costs are, they are likely to flush out and reflect the true costs of investing and it is for the manager to justify why an investor should continue to invest with them in the light of such costs. The complexity would be for the manager to navigate and resource. That is what they are paid for. It is a simple proposition for the investor. The benefits of any scale through trade execution and order management flow back to the manager only if it has paid for them. The benefits of scale of the investors' money should flow back to the investors, particularly if it is implemented along with the proposals on governance in the next recommendation.

7.3 Change the governance model on retail products

In order to create structures where the interests of investors are protected there need to be some fundamental changes to the governance model.

Governance of these structures is likely to be more effective than any disclosures to investors on costs and charges. This is because those that have the relevant qualifications and experience to do so can perform governance, provided they are independent of the manager and independently appointed.

It should be a requirement that all governance on retail funds requires at least three quarters of the board (whether trustees or directors) to be independent of the manager with a prohibition for those independents to act concurrently on the boards of more than say two OEIC or retail structures of that manager. The prohibition should extend to any 'independent members' that were former employees of the manager in the previous five years with anti-avoidance powers for the regulators.

Investment Trusts have independence requirements not only in their Corporate Governance Guide but also through the listing rules so these requirements are not unusual. The difference here would be the independent process for appointing the board.

The board should have a whistleblowing duty to the regulators and the manager should not be involved in the appointment or removal of a board member (but the investment manager can be represented on the board provided the board wishes to have such representation). The costs of the board could be reflected in any unitary charge made on the fund or be a separate charge on the funds. A board member should not be able to serve more than two consecutive three-year terms on any board.

Finally, in order to have real teeth a board needs to be able to fire its investment manager. Making this effective on older schemes would require legislative change for any contractual terms that create an impediment.

Without these changes in governance the conflicts of interest with the manager will never be fully resolved in the running of retail funds.

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It should be noted that these proposals are similar to the recommendations made by the OFT in its 2013 market study on defined contribution pension schemes where it recommended the introduction of Independent Governance Committees on unit-linked products[244] but the proposal here is to extend this requirement to all retail funds offered to retail investors.

7.4 Discard multiple structures for retail investments

The structures used for retail products are too complex. Tax and regulation drive this. There is no necessity for it to be so. These structures also impact on their governance and there is a lot of confusion about how these products are governed and outcomes can be dramatically different when things go wrong.

Having different structural models for savings vehicles complicates the position for retail investors. The use of trusts is historical in its origins. The trustee model of using amateur upstanding citizens to look after the interests of savers is outdated. The lack of legal personality in trust structures also creates difficulties. Retail investment schemes need professional investment management services and independent professional governance. The OEIC model is best suited to this because it is designed for collective investment and legal personality vests in the OEIC. A requirement for the OEIC to have independent professional governance could mean that the contract to manage the savings within the entity could be changed to another manager instead of relying on investors taking their money elsewhere, as it is the manager who would be fired. This would sharpen the investment managers' game, as the assets will no longer be as sticky as they have historically been due to investor inertia, because governance will act in the investors' best interests, free of conflicts of interest with the manager.

7.5 Justify the existence of different share classes and differential charging

The independent board of the collective retail investment scheme needs to disclose to investors in the KIID any conflicts of interest and how the board manages them. For example the existence of different share classes in any structure and how costs are apportioned between the classes and fees earned should be disclosed. More importantly the board should satisfy itself that these different share classes and differential fees serve the interests of all investors.

In addition, the risks that these classes can create for other investors such as through cross class liability or differential charging need to be explained and their existence justified (other than the existence of accumulation and distribution shares which are just mechanisms for dealing with profits) and why these work in the interests of the collective investment scheme overall.

That will bring greater awareness of the conflicts of interests that can exist between retail and institutional share classes.

[244] http://www.oft.gov.uk/shared_oft/market-studies/oft1505

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7.6 Change the nature of accountability and the duties owed by managers to retail investors

One often reads in the media about the fiduciary duties that investment managers owe to their investors. Although investment managers in some countries are required to behave as if they had fiduciary duties such as in the role of the 'Plan Fiduciary' in the US under its ERISA laws, the nature of the investment managers' duties in the UK to retail collective investment schemes it manages, is essentially one of a contractual nature. This means liabilities to investors are minimised and limited (in part because of the wide mandates that govern their activities) and the contracts create wide indemnities that the manager is able to rely upon out of the assets of the investors. There are usually no fiduciary duties in the contractual arrangements that set up the relationships. There is an overlay of regulation that creates fiduciary-like duties but there is a difference between a requirement to treat a customer fairly (regulation) and a legal requirement to look after the best interests of the customer with a duty of loyalty (fiduciary duty).

The Law Commission closed a consultation on the fiduciary duties of investment intermediaries in January 2014[245] that was initiated as a result of a recommendation in the Kay Report.[246] That document looked at fiduciary duties of investment intermediaries through the lens of pensions. The consultation and its preliminary conclusions appeared flawed, primarily because it appeared to have misunderstood the nature of the structures through which most pension collective investments are made, and hence the role of governance and service providers. It had reached a view on the basis that the majority of pension collective investments were made through OEICs and unit trusts, when the available statistics suggest that unit-linked funds dominate this market as a form of collective investment at the investor level even though insurance companies may then, in turn, invest into these OEIC and unit trust structures. Unit-linked products as long-term contracts of insurance are different in structure and are governed and managed differently to OEICs and unit trusts. The consultations preliminarily conclusion was that the law worked reasonably well in this area and that it was only regulatory aspects that needed strengthening in order to improve outcomes for pensioners. This conclusion appeared to fail to consider the way the market actually worked. Even industry associations such as the ABI recognise the rather light regulatory requirements around unit-linked products. We have also noted the concessions that are provided to long-term contracts of insurance. Even where OEICs and unit trusts are used, if one looks at the contractual relationships of providers to the funds, many service providers seek to exclude liability to the fund and to other contracting parties for losses that might arise or seek to limit these liabilities in some way.

Typical exceptions to the exclusion of liability might be for negligence, willful default and fraud. Firms with American backgrounds may try to introduce language that refers to gross negligence – but English law currently considers this to be a 'vituperative epithet'. These are boilerplate terms commonly found in most commercial contracts, but their effect is watered down because of the wide mandates and the exclusion of liability for many of the services that are performed. Additionally although they may limit or exclude liability

[245] *http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm*
[246] *http://lawcommission.justice.gov.uk/docs/kay-review-of-equity-markets-final-report.pdf*

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they will also seek unlimited indemnities from the assets of investors except (usually) in the event of the three exceptions noted above (negligence, wilful default and fraud). When things go wrong – it is difficult to establish accountability because the contracts often exclude accountability or limit it. Retail investors cannot influence or control how these contracts are entered into, to establish proper lines of accountability. Freedom to contract does not work in the interests of retail investors and there need to be statutory protections introduced through legislation that create fiduciary or fiduciary-like responsibilities and accountability for service providers to retail investments.

The Law Commission published its final report in June 2014. Its conclusion is curious because although it recognises that the law relating to fiduciary duty is complex, inaccessible and poorly understood, it maintained its preliminary conclusion that the law did not require substantive change. The report focused on the position of those charged with governance on pensions and although they considered other intermediaries, insufficient attention appears to have been given to the role of the asset manager and how they contract in relation to the pension products used.

The Law Commission in its report also noted: "*there are serious problems with the law relating to contract-based pensions. The contract model assumes that savers are fully informed autonomous parties, able to make good judgements in the market place. Yet the evidence is that savers fail to engage with pensions. This has now become institutionalised by auto-enrolment, where people are placed in pension schemes by default, without any conscious agreement to the charges or contract terms*."[247] It hopes that the formation of IGCs will contribute towards managing and reducing potential detriment.

Serious problems with the law, complexity, inaccessibility and poor understanding, the ability to contractually exclude liability by service providers, all point to an urgent need for legislative change in introducing fiduciary-like duties for service providers to retail investors.

Accountability and the duties owed by investment managers to retail investors need to be fiduciary-like, particularly if the status quo on costs and charges and governance are retained, otherwise the domination of conflicts of interest can mean that the market may not operate in the interests of investors.

The US experience of the 'Plan Fiduciary' is not problem free, but needs to be studied by policy makers. The lessons of the US experience need to be applied to the UK market. It is necessary to create fiduciary duties for asset managers dealing with retail savings, to protect retail investor interests. Other organisations such as ShareAction (previously known as FairPensions) have also studied the impact of fiduciary duty on pensions and institutional investment and share similar views on the need for change.[248]

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[247] http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties.pdf
[248] http://shareaction.org/sites/default/files/uploaded_files/policy/WhoseDuty.pdf and http://shareaction.org/sites/default/files/uploaded_files/fidduty/FPProtectingOurBestInterests.pdf

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7.7 Require original contributions to be tracked through fund closures and mergers

Fund failures, closures and mergers need to be tracked and disclosed as part of the fund information given to investors. With advances in information technology it should be a relatively simple matter. It will eliminate some of the survivorship biases of fund managers because they will no longer be able to conceal failures and to massage performance numbers that do not tell the true story behind earlier closures and mergers.

If a fund receives investments from another fund it needs to reflect both the value paid in and the original contributions that value represents. The original investments therefore become a part of the DNA of that fund's history and cannot be hidden.

7.8 Change the format of cost and performance disclosure on a mandatory basis

There have been many initiatives to improve disclosure on costs and how performance is reported. Although the regulatory rulebooks require a host of disclosures many of the initiatives by different trade bodies have been voluntary in nature – recommending methodology rather than requiring their mandatory adoption or introducing comply-or-explain procedures to permit organisations to justify why they have not adopted the proposed disclosure standards.

It does not work – because there is too much leeway in favour of the financial services businesses.

In order for comparability to work across products there needs to be a requirement that all products disclose information to a standard that is mandatory and comparable.

7.9 Define charges for any caps that are imposed

The DWP have announced their intention to impose a charge cap of 0.75% on the default fund options that pensions offer for the purposes of automatic enrolment. Charge caps, generally do not appear to work because of the waterbed effect whereby providers find other ways of recovering the costs they would otherwise have charged to maintain their profit margins. Part of the problem has been a definitional one and it is necessary to make the definitions tight so that there is no scope for broad interpretation.

A charge cap is likely to be more effective where the approach to charging is similar to the unitary management charge proposed because the only cost that can be charged to an investor's savings pot is the UMC.

Any charge cap needs to incorporate anti-avoidance provisions to enable the regulators to intervene if the industry discovers and exploits loopholes.

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7.10 Change reporting on fund performance to investors

Reporting on fund performance needs to change. It currently does not meet the needs of investors even though it might be compliant with regulation.

Industry sometimes argues that to present information in a particular way would scare investors away. That should not be a reason for avoiding disclosure. It is incumbent on the investment manager to explain why despite the disclosures it would remain appropriate to continue saving with them.

The starting position on all investment reporting should be to provide five basic numbers:

1. The total amount the investment manager has received for investment over the life of the investment;
2. The total costs that the manager has taken as charges or paid away as costs on those investments;
3. The value added or lost net of those costs;
4. The total realisable value of the investments at the end of the period being reported; and
5. The compounded annual growth rate it represents for that investor.

Once this information has been disclosed the manager is then free to talk about the funds' general performance, to compare it to benchmarks and provide additional disclosures, but these five numbers should be the headlines in all reports to investors.

This information should also be aggregated for the funds' boards.

Reports on funds provided to investors should not be comingled with reports of other funds that are irrelevant to the investors' investments and serve only to confuse the recipients of those reports.

Reports should be designed to enhance the understanding of investors and not for the convenience of the investment manager in compliance with regulation.

7.11 Revision of the Unfair Contract Terms legislation

As discussed in section 6 the insurance and asset management industry have been able to rely on exemptions available to them, which provide a safe harbour from challenge on insurance contracts and investment transactions on the basis that the terms are unfair. The legislation should permit consumers to challenge insurance and investment transaction contract terms that might be regarded as being unfair.

There is an urgent need for reform of this legislation. In particular these exemptions need to be reconsidered so that consumers are able to challenge contract terms on collective investment schemes.

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The Government has introduced a Bill on consumer rights, which is currently progressing through Parliament. As we noted earlier, financial services and insurance contracts in particular continue to enjoy exemptions under the proposed legislation. There are of course other remedies available to consumers, extending beyond unfair contract terms legislation, but these involve expense and time on the part of a retail investor against the considerable resources the manager will be able to bring to bear in defending the position, not to mention the wide indemnities available to them from fund assets. This is likely to deter many investors from pursuing them. Terms on these products need to be negotiated at arms length by people who have duties to their investors in doing so and for these agreements to be open to challenge on the grounds of unfairness.

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8. Conclusions

There have been many attempts by regulators to pin down how disclosure of charges, costs and expenses on funds should be made. Much progress has been made but the inherent conflicts of interest that can exist between manager and investor are difficult to police and exemptions from disclosure mean that the true costs are never disclosed. Caps can work towards inhibiting innovation and lack of full disclosure is likely to impede competition in a market place. Innovation and competition are essential for serving the needs of the investing public.

Policy makers and regulators often seem to shy away from forcing financial services providers to make disclosures that the industry argues may alienate retail investors. But we need to be prepared to grasp the nettle and show why, despite these disclosures, it is in the interests of savers to continue to save using these products.

We need to accept that the saving public is not rational in its decision-making but that much can be done to protect some of the biases we all display; by ensuring that governance on these collective investment schemes is independent of its investment managers, where governance boards have the very real ability to act in the interests of investors and have the ultimate sanction to move the product to another investment manager in the face of unsatisfactory service.

Retail investments are too complicated and the outcomes on products if things go wrong, can be dramatically different based on choices, which even finance professionals find hard to follow. We need to move to a position where a retail investor should have clarity on how well their investments would be protected (whether through regulation, compensation or redress) if things went wrong, so that investment choice does not remain a lottery.

These complexities have also made it difficult for a retail investor to seek redress where they feel they have been treated unfairly because of the exemptions in the way the current law and contractual arrangements are structured. Earlier recommendations by the Law Commission in this respect need to be looked at again urgently and with fresh eyes particularly on contracts of insurance and fiduciary duty.

Finally, there is a real case to move away from tinkering around the edges of disclosure on costs, charges and expenses; to reconsider whether the structures and methods applied in delivering retail investment savings products are fit for purpose; and to consider whether we should discard some of the regulatory and tax complexities that different retail funds have acquired over the years and move to a single structure with a different approach to charging where the asset manager is no longer free to extract unlimited charges from investors' funds entrusted to it.

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9. APPENDIX I - References

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10. APPENDIX II – Glossary of Terms and Abbreviations

ACD	Authorised Corporate Director – a company charged with the governance of an investment company with variable capital.
AIFMD	Alternative Investment Fund Managers Directive.
Annual Management Charge (AMC)	A charge levied against a fund, usually expressed as a percentage on the value of the fund assets. It may cover a combination of charges such as sales, administration and fund management costs. Also see Ongoing Charge.
Asset Management	The act of managing assets such as financial securities in a pooled investment fund. Investment managers and Insurance companies both provide asset management services – but usually with different types of funds or products. These days the distinctions between investment managers and insurance companies have become more blurred as large asset managers provide both investment management and insurance through affiliated companies and can therefore offer products traditionally offered by investment managers and insurance companies
Asymmetric Price Slippage	Practice where broker keeps the profits in a trade arising from favourable market movements while passing any losses on to its clients.
Best Execution	The steps an investment firm must take to obtain the best possible result for its clients taking into account the execution factors. For retail clients the determinant of the execution factors will be the best price.
Bn	Billion.
Box Management	Method used by investment managers to create and cancel units in a collective investment scheme.
Capacity	This can refer to the size of assets under

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management that an investment manager could manage using their investment strategy that would not have a detrimental impact on their ability to generate returns for an investor. It also refers to the reservation of capacity so that if a manager says they have a capacity of £1Bn in a strategy and are operating at capacity, then when an investor redeems from the fund that redemption creates capacity that could be offered to another investor. Some fund of funds make it their unique selling point that they have reserved capacity or access to managers with whom it would otherwise be difficult to get capacity or which retail investors cannot access directly.

Capital Preservation An investment objective that aims not to lose the principal amounts invested by an investor in priority to the generation of returns from that investment.

Charge An amount deducted from an investor's savings to pay for services received. Can also be an aggregation of expenses when the charge may be referred to as an ongoing charge or a Total Expense Ratio. A charge will often include a profit element for the service provider. Charges can include costs and expenses. Current requirements for disclosure mean that not all costs and expenses are included in charges.

Closed Ended Investment Company Also referred to as investment trusts. Investors buy and sell shares in the company on the secondary markets. The investment manager does not need to worry as much about liquidity on their investments as they do not need to meet the redemption requests of investors from the assets of the company.

COBS Conduct of Business Sourcebook, part of the handbook of the Financial Conduct Authority

COLL Collective Investment Schemes Specialist Sourcebook part of the handbook of the Financial Conduct Authority.

Collective Investment Scheme A type of fund where savers pool their money to make investments using a professional investment manager. Section 235 of the Financial Services and Markets Act contains a statutory definition. For our purposes Collective Investment Schemes also refer to a number of structures that are sometimes referred to

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as 'pooled' investment funds or sometimes as funds. These can include unit trusts sold by an investment manager or a unit linked fund sold by an insurance company. The differences in these types of 'funds' are important and are the subject of this report. These funds can also be referred to as products or fund products

Contract Pension Schemes — Shorthand to describe personal pension schemes whether work based or non work based. The term should be used with care, as its literal use is dangerous as many schemes may not be contractual in nature. The term implies that the pension scheme member enters into a contract for the provision of a pension. This is not always true.

Cost — Is an expense or a charge charged against an investor's savings but not necessarily identified separately. It can be subsumed into a value or represent lost income or opportunity costs of not receiving a form of income. For example if £100 is invested and £90 of investments are bought and there is a dealing charge of £10 for that purchase, accounting rules allow the cost of the investment to be shown as £100. Investors do not see the £10 they were charged as a separate expense they have incurred although it is reflected as a cost in the opening value of the investment. They think they invested £100, which is now worth £90. Investors often confuse this with a fall in value of their investments when it is actually a charge that is not visible to them. An example of a cost is transaction costs or charges on an underlying sub fund that is treated as a cost at a fund of funds level. A cost can include a profit element.

Execution — The process by which trades are transacted.

Execution only — When a trade is transacted on the instructions of a client without any advice or recommendation being given.

Expense — Amounts deducted from investor savings in respect of services investor receives relating to their investments. Examples of expenses will include audit and legal expenses. Expenses cannot include a manager's profit element unless they reflect costs

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(which can include a profit element for that service provider). If a deduction is shown as an expense it needs to reflect the actual amount spent by the manager or the share of the actual expense incurred if that expense is allocated across more than one fund. The expense in the hands of the person receiving the amount may represent a profit element for that recipient.

FCA — Financial Conduct Authority.

Fund — A generic name for collective investment savings schemes. Funds can also have a single investor.

Heuristics — Simple and general rules a person employs to solve a specific category of problems under conditions that involve a high degree of risk-taking behaviour and uncertainty.

ICVC — UK term for open ended investment companies. Stands for Investment Company with Variable Capital.

Information asymmetry — Mismatch of information between investors and providers of investment products.

Institutional Investor — An investment firm or professional investors acting on behalf of other investors under a contractual mandate. Usually authorised by a regulator in some way and having the freedom to invest more widely in products that may carry more risk than would be permitted in sales to retail investors. Can in some contexts include sophisticated investors and high net worth individuals.

Investment Trusts — A misnomer, these are closed ended investment companies and are not trusts in structure.

Investor inertia — The lack of reaction that would otherwise be expected of an investor acting rationally in their own best interests.

Leverage — Borrowing. A technique used by firms to magnify the returns on investments. It can also magnify losses.

NEST — National Employment Savings Trust, which is a defined contribution occupational pension scheme backed by government with a public service obligation

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to let any employer use it. Currently there are restrictions on the amounts of contributions that can be made to the scheme and transfers in are currently not permitted.

NURS Non UCITS Retail Scheme.

OEIC Open Ended Investment Company.

OFT Office of Fair Trading – this organisation has now been subsumed into the Competition and Markets Authority. The FCA also has some powers in relation to competition

Ongoing Charge An annual charge based on the value of assets meant to cover a number charges such as the fund management charges, administration etc. Also see AMC.

Opportunity Cost Cost expressed as lost income not received by an investor. For example if an investment manager takes three days to settle a transaction for which they have received cash and they are earning interest on that cash but not paying it over to the customer – that lost interest is an opportunity cost for the investor. They have not been charged a cost but have not received income due to them and therefore benefits that might accrue to them have not been passed on.

Performance The returns generated on an investment. Can be positive (profits or capital gain) or negative (losses).

Platform A mechanism or structure through which investment product managed by different managers can be offered from one point of sale.

Pooling or Pooled Assets The process by which investors' investments in a collective investment scheme are aggregated and invested on their behalf by an investment manager.

PTR Portfolio Turnover Rate.

PRA Prudential Regulation Authority – responsible for the prudential regulation of insurance companies.

Product See Collective Investment Schemes above

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QIS	Qualified Investor Schemes – a type of collective investment scheme for the use of institutional investors.
Short Interest	The fee that the lender of securities for short sales receives.
Short Lending, short sales or securities lending	The process by which an investment manager borrows securities to sell in the market in the expectation that the value of those securities will fall so that when the securities need to be returned to the lender the investment manager can purchase them more cheaply. The difference between the sale price and purchase price to return the securities, where the price has fallen, is the profit that the investment manager makes on behalf of its clients. If the price has increased in the intervening period the manager makes a loss.
Short Squeeze	When a lender of securities for short sales requires the return of the short securities at a time when it is difficult to source those shares and they have to be bought at a time when the borrower will sustain losses because prices of that security have risen rather than fallen.
Slippage	The difference between the price paid for an asset and the best price available in the market.
Soft Commissions	Method by which investors can be charged costs for executing a trade, the benefits for which are received directly by the investment manager rather than the investor.
Stakeholder Pensions	A type of pension created by the Welfare Reform and Pensions Act 1999. It can be an occupational or work based personal pension or even a non work-based pension.
TER	Total Expense Ratio was a measure used to disclose charges on a fund but was misleading because the disclosure excluded a number of costs including transaction costs. It is now often referred to as an Ongoing Charge but still does not include all costs on a fund such as transaction costs.
TPR	The Pensions Regulator.

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Transfer Title Collateral	Borrowers offer security to their lenders as a form of insurance in case they default on the borrowing. This is referred to as collateral. Collateral in the UK can be taken in many ways. Sometimes collateral does not require the title of the asset to be transferred to the holder of the collateral, the borrower instead grants a fixed or floating charge over the asset. If the lender wishes to use the asset, perhaps as collateral for its own borrowings – it needs to have title on the collateral transferred. This process of using the transferred title assets to borrow is also referred to as rehypothecation. Transfer Title Collateral removes some of the fiduciary type obligations a custodian might otherwise have. Not allowed in retail transactions but can have an impact on them indirectly.
Transaction costs	Costs incurred by an investment manager when buying and selling securities. These costs will vary depending on the amount of trading the manager does and the nature of the investment strategy.
Trn	Trillion.
Trust Pension Schemes	Shorthand to describe occupational pension schemes. Occupational pension schemes are generally required by the Pensions Act 2004 to be set up as trusts.
UCIS	Unregulated collective investment scheme
UCITS	Undertaking of Collective Investments in Transferable Securities.
UMC	Unitary management charge – a new method of charging proposed in this report to prevent the manager from allocating any charges to the investment funds of investors other than the investment management charge so that costs and performance become fully disclosed.
Volatility	The variation in returns generated by an investment. It is used as a proxy for risk on an investment and is generally measured as the standard deviation from the average return of the investment.
Workplace pensions	Alternative description for work based pension

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schemes, the term used in the Pensions Act 2004.

Wraps and Wrappers Typically refer to tax and regulatory structures through which investment funds or product can be distributed e.g. Pension schemes and investment platforms. Different investment structures that offer the same investment strategy but through different structures because of regulatory requirements as to how they can target a potential customer are also referred to as wraps or wrappers in the context of the discussions in this report. E.g. if a manager offers a UK equity investment strategy through a number of different structures such as an Undertaking for Collective Investments in Transferable Securities (UCITS), a Non UCITS Retail Scheme (NURS), a Qualified Investor Scheme (QIS) and as a unit linked fund (in order to cater to pension investors wishing to invest in that strategy) then each structure or product is referred to as a wrap for that strategy.

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11. Appendix III - Declaration of Conflicts of Interest

JAITLY LLP is a global risk consultancy that specialises in operational risk and operational and structural due diligence of investment funds generally and hedge funds specifically and in the corporate governance of funds.

The author of this report acts as a non-executive director on funds, has advised the Pensions Regulator on costs and charges and asset protection in pensions and was a member of the expert panel on the OFT's study on defined contribution pension schemes published in September 2013.

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

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