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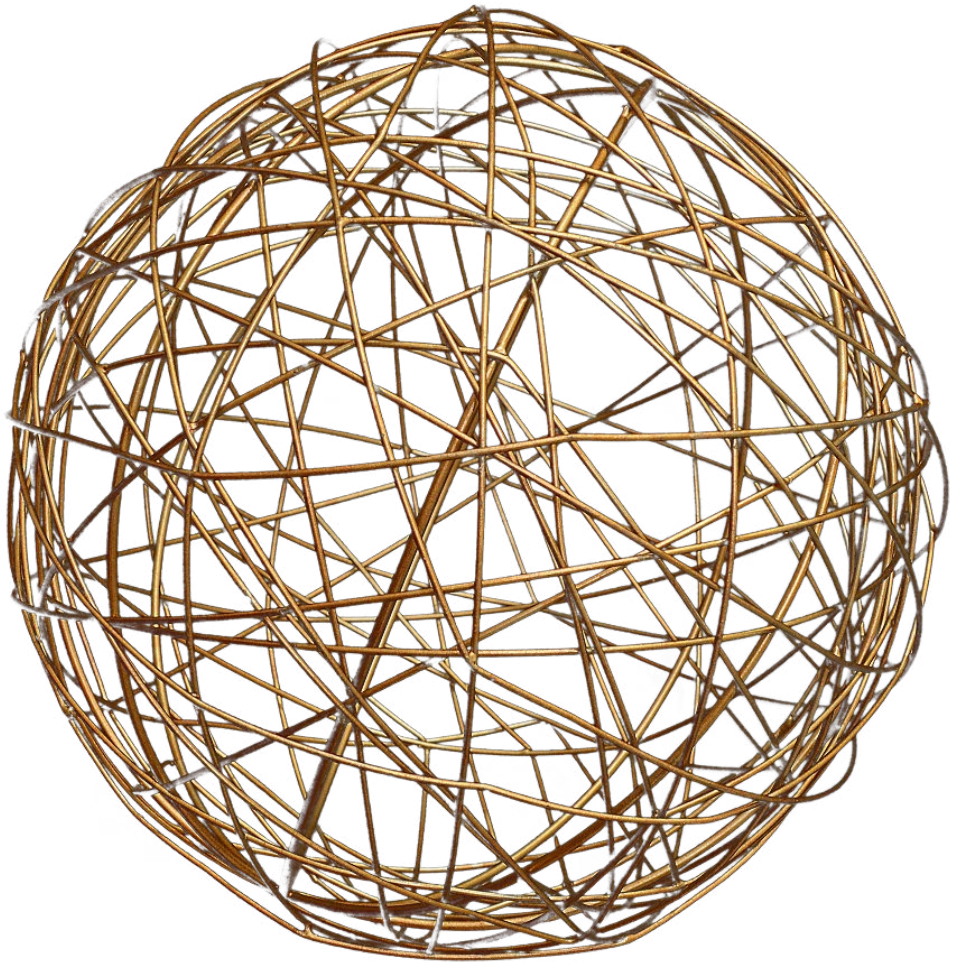

Assessing the value that investment funds deliver to investors

Navigating the challenges

CENTRE *for*
REGULATORY STRATEGY
EMEA

Contents

Executive summary

"The asset management market study and our supervisory work have shown that in general, AFMs have not considered robustly the value they offer to investors under our existing rules. We believe that this is leading to harm to investors through poor value products." – FCA PS18/8

The Financial Conduct Authority (FCA) has introduced new rules requiring UK authorised fund managers (AFMs) to assess the overall value that their authorised funds deliver to investors, and to publish a summary of these assessments annually. These rules are driven by concerns that retail investors may be getting poor value for money, as there is evidence that retail investors can often pay twice as much as institutional investors for similar products, and may unwittingly invest in poor value products such as 'closet index-tracking funds'.[1] Nearly 200 AFMs will be subject to the new rules, which come into force in September 2019 and require the first summaries to be published in January 2020.

This will be the first time that AFMs have had to justify their pricing and consumer outcomes publicly, and it will be highly important from a reputational, as well as regulatory, perspective to produce a credible assessment. This comes at a time when the industry is already facing pressure on pricing, and it could result in more fund closures or mergers where funds are performing poorly.

Importantly, and as a possible harbinger for other financial services sectors, this is the first time that the FCA has made an individual accountable under the Senior Managers and Certification Regime (SM&CR) for a firm assessing value for money.[2] AFMs will need to consider their pricing model for each element of their service, possibly to a much greater level of detail than has been attempted hitherto. Assessing value will, moreover, be challenging due both to the subjective nature of what constitutes good value and to limitations in the data available. To produce a robust assessment, AFMs will need to go through a comprehensive and hence resource-intensive process that is subject to close scrutiny and oversight from the AFM Board. While the market will only see the summary report, it is likely that the FCA's supervisory work will involve more detailed scrutiny of the internal assessments. This paper explores the critical challenges firms face in assessing overall value and how firms can best respond to these, taking into account our work and dialogue with clients on this topic.

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In summary, our view of the principal good practices and potential pitfalls are shown in the following table.

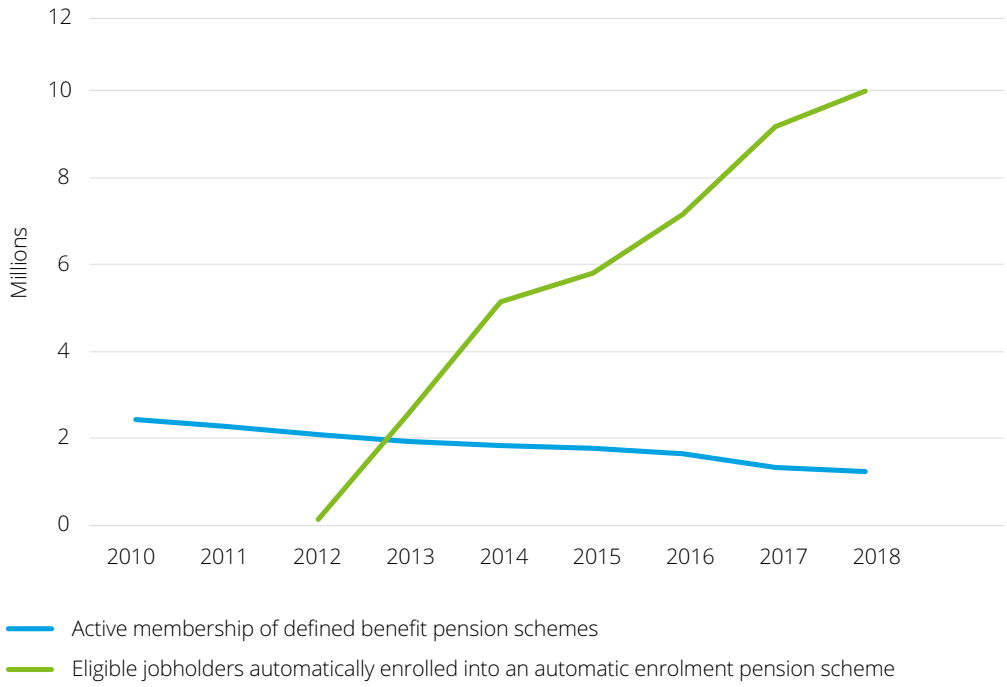
We recommend you	Potential pitfalls include
Engage with the AFM Board early and throughout, including on the development of the assessment methodology to ensure they are comfortable with it.	**Appointing someone as the responsible individual under the SM&CR who has joined too late to influence the methodology:** if a new independent director is going to take this role, they need to be appointed sufficiently early to understand and challenge the assessment methodology.
Expect scrutiny from the FCA: the FCA expects AFM Boards to provide robust challenge in order to provide evidence that the assessments are rigorous.	**Making the assessment too high-level:** the assessment needs to be detailed enough to provide meaningful results, taking into account the specificities of different types of fund and charging structure.
Focus on value, not just cost: good value of course does not necessarily mean 'cheap'.	**Using inconsistent methodologies for different funds:** while the methodology will need to allow for the specificities of different types of fund, the overall approach needs to be consistent across the firm's fund range to avoid the appearance of 'cherry-picking' to improve the results.
Be prepared to be challenged on funds that have high fees and offer little value: the FCA is likely to be particularly critical of expensive funds that closely track an index and of instances where retail investors are charged much more than institutional investors without good reason and clear benefit.	**Including jargon or excessive detail in the published report:** to be accessible to retail investors, the report should be concise and use consumer-friendly language.
Consider whether there are any cross-subsidies between funds that create poor value: if some funds are loss-making over the long term, this may indicate a cross-subsidy which is causing investors in profitable funds to get poorer value.	
Take meaningful actions where funds do not provide overall value. This may include lowering fees – where this is sustainable – or explaining how you intend to improve performance or service quality. Model the impact of these actions on the AFM's revenues and costs for business planning purposes.	

Introduction

In the UK, the increased regulatory focus on value for money in the asset management industry has gone hand in hand with a dramatic increase in the number of retail investors becoming direct clients of this industry. The latter is due in large part to the rise of defined contribution pensions and auto-enrolment into pension schemes (see Figure 1). In its asset management market study, the FCA found that asset managers earned an average profit margin of 36% over a six year period – amongst the highest in the UK economy – with margins still higher if the profit sharing element of staff remuneration is included (see Figure 2).[3] The FCA did not, however, find any clear relationship between fund charges and fund performance.

The FCA concluded that regulatory 'remedies' were needed to improve competition in the asset management market. It put in place a package of measures, including new requirements for AFMs to assess the overall value that their authorised funds are delivering to investors, and to publish a summary of these assessments on an annual basis. In addition, AFMs will be required to have at least two independent directors on their Board, and independent directors must comprise at least 25% of total Board membership. The regulatory expectation is that these directors will boost the amount of independent scrutiny within firms' governance, including when the AFM Board signs off the fund value assessments. The FCA will continue to monitor competitiveness in the sector, including publishing annual aggregated figures on asset manager profitability, price clustering, and performance after fees (including for long-term underperforming active funds).[4]

Figure 1: Membership of pension schemes in the UK[5]

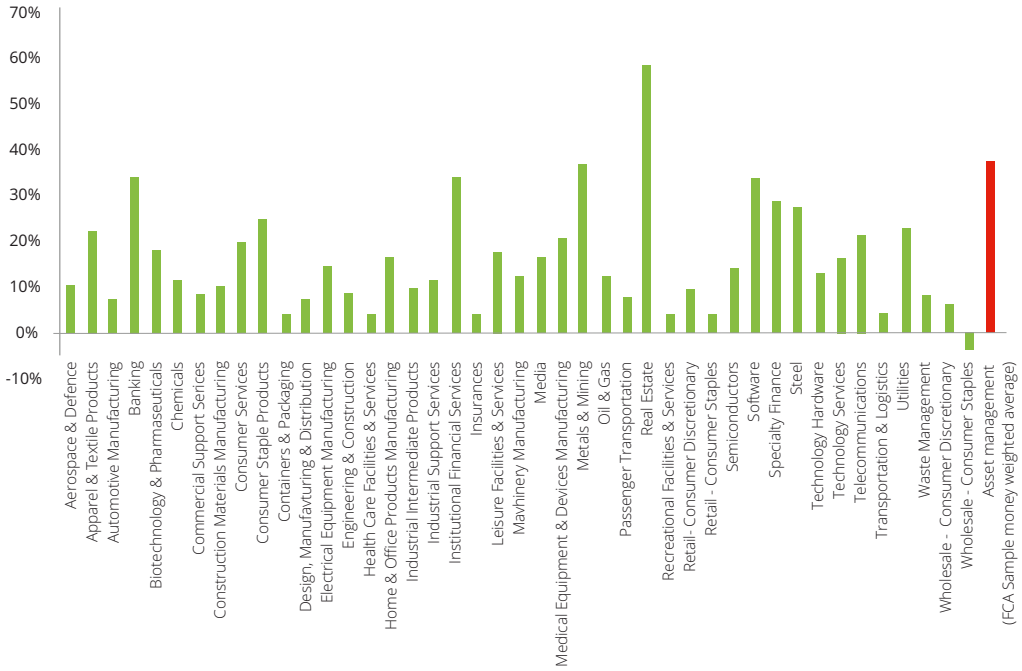


Source: The Pensions Regulator.

The FCA's new rules for AFMs reflect its increasing focus on economic outcomes for consumers and whether these are creating harm. Recent interventions to make value more transparent in the financial services sector include a requirement for general insurers to publish value measures and a requirement for providers of annuities to inform customers of market-leading quotes before they take out enhanced annuities. Where the FCA considers that the increased transparency will not produce the outcomes it desires, it has shown a willingness to intervene directly on price. For example it has imposed a price cap on rent-to-own products and is considering introducing a basic savings rate in the cash savings market.

In its asset management market study, the FCA found that asset managers earned an average profit margin of 36% over a six year period – amongst the highest in the UK economy

Figure 2: 10-year operating margins by industry (H2 2006 – H1 2016)

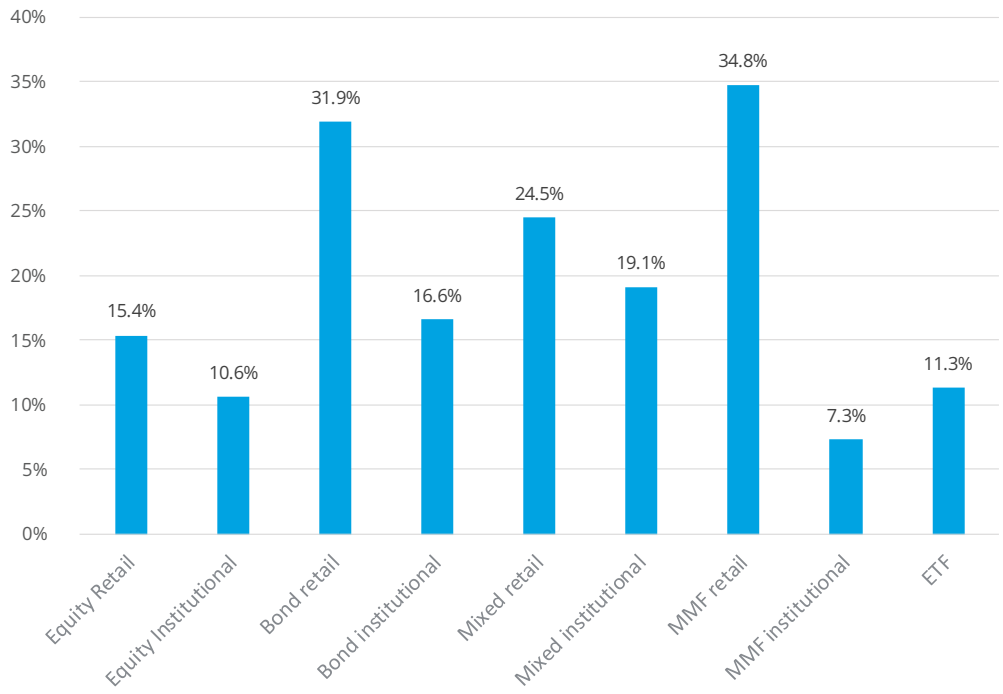


Source: FCA's Asset Management Market Study Interim Report (2016), using Bloomberg data.

The FCA is not alone in focussing on value for money. At EU level, the European Securities and Markets Authority (ESMA)'s 2019 report on costs and past performance in retail investment products found that, on average, Undertakings for Collective Investment in Transferable Securities (UCITS) fund charges reduce returns by 25% and retail investors in UCITS funds pay twice as much as institutional investors.[6] Figure 3 shows how charges affect investment returns for retail and institutional investors across a range of fund types. Recent interventions at EU level have focused on improving transparency to help investors better assess which funds offer good value.[7] ESMA is also carrying out work to identify potential closet indexing practices, and is expected to issue guidance on performance fees later in 2019.[8] In the United States (US), mutual funds registered under the Investment Company Act of 1940 (ICA) are required to publish the factors they considered when entering into or renewing the advisory contract, including factors related to value for money (see page 18 for further detail).

On average, retail investors in UCITS funds pay twice as much as institutional investors

Figure 3: Reduction in relative return on investment due to charges



Source: ESMA's report on impact of charges on mutual fund returns (2017). Investment return is measured net of expenses, sales and redemption fees.

Overarching considerations

Scope: A number of AFMs have funds both in and out of scope of the rules. We suggest that firms consider whether the value assessments would be beneficial for all their funds. It is possible that distributors and institutional investors may want to use the value assessments in their fund selection process. In the retail market, not having a value assessment could place a fund at a disadvantage as advisers could find it harder to justify suitability for funds without value assessments if the peer group has them, although it is likely to take one or two full cycles of the reports being published before we see if there is an impact on new inflows. We have seen reports suggesting that EU management companies are closely watching market developments in response to these rules, particularly where they have a large UK investor base. Platforms could use the value assessments as part of their selection criteria, disadvantaging funds that do not have value assessments. When the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation was introduced, we saw non-compliant funds (e.g. US funds) being removed from platforms. Moreover, carrying out the value assessments could provide useful commercial insights for firms in relation to their pricing and product marketing strategies.

Governance process: Firms' existing product governance process is likely to be a good starting point for the fund value assessment frameworks. A common approach we have observed is for the Product Team to lead on the development of the assessment frameworks with the close involvement of staff from across the firm, including from the Compliance, Risk, Finance, Distribution and Governance teams. The assessments will then be approved by the AFM's Board.

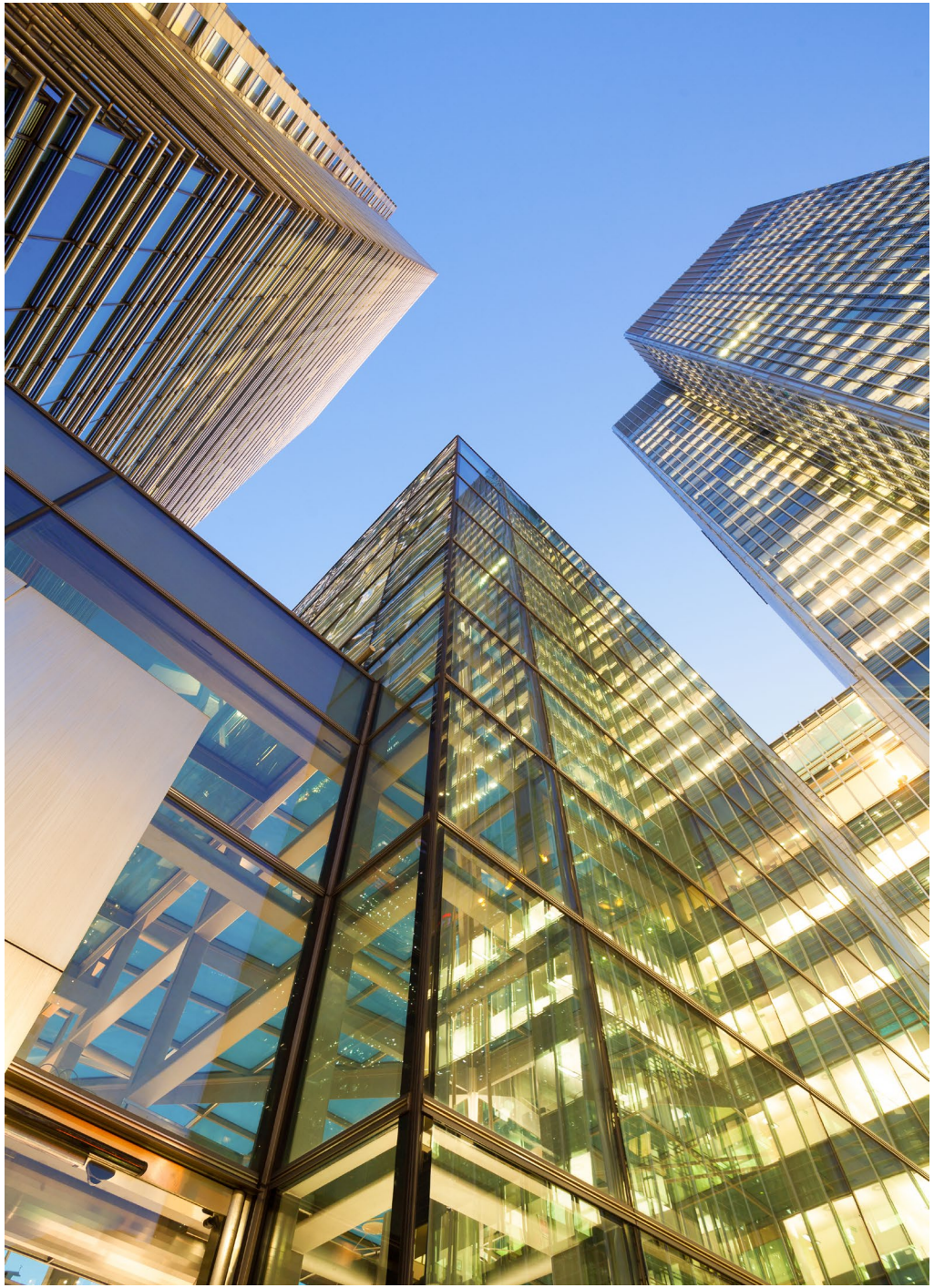
An individual is required under SM&CR to take reasonable steps to ensure that the firm complies with its obligation to carry out the assessment of value. If the Chair of the AFM's Board is an approved person, the Chair should be appointed as the responsible individual. The Chair may be either an executive or an independent director. A number of AFMs are appointing new independent directors to the AFM's Board to comply with the new requirements in relation to governance. However, assigning responsibility under SM&CR to a new board member may mean that the individual is not in place sufficiently early to be involved in the development of the assessment methodology. We think that early engagement by the responsible individual and the AFM's Board is important as it may be difficult to make substantial changes to the methodology late in the day. In our view, effective oversight and challenge from the AFM's Board and the responsible individual is likely to be a key area of focus for the FCA, so it is important for firms to ensure that they have robust governance arrangements.

Consistency of approach: It will be important for firms to develop a framework and methodology that is consistent across all funds, while having enough flexibility to take into account the specificities of different fund types. This will avoid the risk of being seen by the FCA or the market to 'cherry pick' the data or change the assessment process to improve the results for different funds. We have seen that some firms have chosen a scorecard approach with standardised criteria for fund assessment. A lot of firms seem to consider the different assessment criteria to have different levels of importance and are taking this into account in their frameworks.

Published report: Most firms that we have spoken to are planning to include the published report as part of the annual long report for each of their funds rather than publishing a standalone composite report covering their fund range as a whole. Whichever approach is taken, firms should ensure that their format is consistent across all their funds and that they are not seen to be giving more information when the message is more positive.

Firms will also need to ensure that the published information is sufficiently concise and jargon-free to be accessible to a retail investor.[9] The type of language and level of detail included in the PRIIPs key information document could be used as a guide for this. In the US, mutual funds registered under the ICA must set out in their shareholder reports the factors they considered when entering into or renewing the advisory contract. This includes assessing factors related to value for money (see page 18 for further detail). Firms might find it interesting to look at these reports, for comparison purposes, when considering the appropriate level of detail to include. Where a fund is assessed as providing poor value, AFMs will need to include detail on what actions they are taking to address this.

Host Authorised Corporate Directors (ACDs): Independent ACDs providing hosting services are likely to face different challenges from in-house AFMs. They may not have access to information on the cost to the investment manager of providing portfolio management, but they can make interesting comparisons between the fund ranges for which they act as host ACD. If the host ACD decides that the portfolio management charge is too high, this is likely to create a conflict between their commercial relationship with the portfolio manager and their regulatory obligations. However, this issue is not unique to the value assessment process and the FCA expects host ACDs to manage any conflicts of interest that may arise as part of their role.



The overall value assessment

The criteria set out by the FCA are closely intertwined and essentially filter down to three elements: cost, performance against objectives, and quality of service.[10] Different investors will place different weights on the importance of these three elements. Firms will need to decide how they weight the different criteria and reflect this in both their value assessment framework and in their fund marketing materials so that investors are clear on how the fund is intended to provide value.

Where charges are higher than the comparable market average and performance is at or below the chosen benchmark (or other method used for assessing performance), firms will need to justify how their fund still offers overall value. We think that the FCA will want to see tangible benefits to investors, rather than, for example, arguments that consumers are willing to pay more for a strong brand. Where charges are higher because the firm is smaller and benefits from fewer economies of scale, we think firms will need to demonstrate that they are offering something different from the bigger players, such as access to a niche market, a differentiated investment process or set of objectives.

The criteria set out by the FCA are closely intertwined and essentially filter down to three elements: cost, performance against objectives, and quality of service

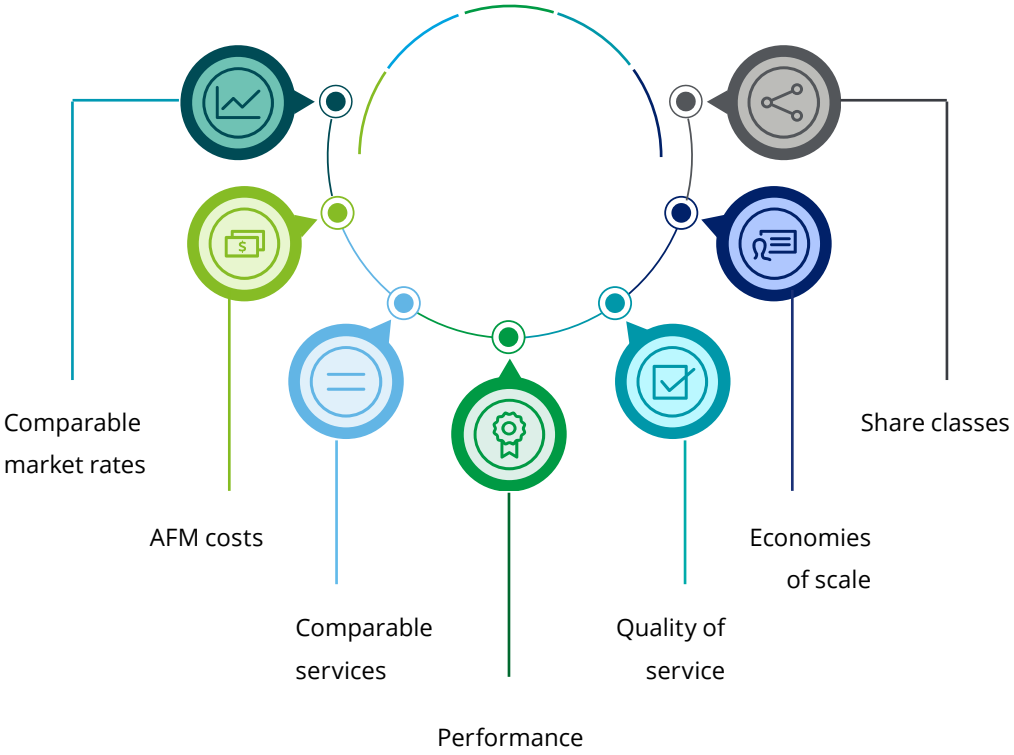
Where a fund is not providing overall value, firms will need to take prompt and meaningful actions as this part of the published statement is likely to receive the most scrutiny from regulators and investors. One obvious option is to lower fees, and the FCA will expect firms to consider this where relevant. Where firms are considering this, they may want to take a long-term perspective as once fees are lowered it may be difficult to raise them again in the future.

Firms may also explain how they intend to improve performance or the quality of service to improve a fund's overall value. For example, some funds seek to outperform the market through carrying out a rigorous investment analysis process and taking a high active investment risk, which typically costs more for the fund manager to administer. If the fund manager makes the wrong short-term judgement calls, the fund may well underperform. In this scenario, rather than reducing fees the firm may decide to explain in its published statement how it intends to improve its investment process (e.g. with enhanced checks and balances) so that the fund can better deliver on its objectives.

Where firms take action to improve overall value, it would be important to model the impact of this on their revenues and costs so that they have an understanding of how this will affect future profits.

Where a fund is not providing overall value, firms will need to take prompt and meaningful actions as this part of the published statement is likely to receive the most scrutiny from regulators and investors

The FCA's 7 assessment criteria



Comparable market rates

In relation to each service, AFMs must assess the market rate for any comparable service provided by the AFM, or by any delegates on behalf of the AFM. This does not explicitly require the use of external data, but most of the firms we have spoken to are intending to use external data as this makes the assessment more credible.

A key challenge for firms will be determining comparative peer groups to compare market rates effectively. Firms need to consider both the investment objectives and the charging structure (e.g. whether the AFM's charges are bundled with the annual management charge, whether there are performance fees etc). In our view, when deciding on peer groups, firms should consider the investment objectives rather than the fund structure per se, as investors are most likely to be interested in what the fund delivers than, for example, whether it is a fund of funds. But any investment restrictions, such as whether a fund of funds is fettered or unfettered, will be relevant in determining peer groups. Finding an appropriate peer group will be particularly challenging for some types of product, such as multi-asset funds. Those individuals signing off the value assessment will need to look carefully at how peer groups have been determined to ensure that they have not been constructed to make certain products look more attractive.

Many of the firms we have spoken to are struggling to find the exact data they would like to use for their assessment. Overall, data is easier to find for retail funds listed on platforms than for institutional funds.

There are also difficulties in cutting the data in the right way to identify the types of fund that are most relevant as a peer group. It is likely that firms will have to make some compromises and judgements because of limitations in the data, but they will need to be able to demonstrate that their peer group is credible and intended to provide a fair comparison.

Some firms are also looking at comparable market performance based on the same peer group that they are using for comparable market rates. While this can be an interesting exercise, it is important that this does not replace the assessment of performance against any benchmarks or other criteria set out in the fund's objectives, if these are different from the peer group comparison.

AFM costs

The FCA's rules require firms to compare the charges they levy on investors against the cost they incur in providing the services to which the charges relate; in other words, their gross margin. This includes ongoing charges, initial charges and performance fees but not transaction costs. Where charges are paid directly to third parties, the cost is the amount paid to that party. Firms should be able to use existing data from their UCITS, PRIIPs and/or Markets in Financial Instruments Directive II disclosures to identify the charges that need to be considered.

It is not always straightforward to determine the cost of providing the services to which each charge relates. Some of the AFM's costs will be fixed overheads that are shared across funds and they may not have historically allocated costs down to an individual fund level. Firms will need to find a consistent methodology to allocate costs between funds, such as allocating building and maintenance costs to funds based on their assets under management (AUM).

A higher profit margin could indicate that a fund provides less value to investors. However, what is a justifiable profit margin will depend on the type of fund – for example, a fund that takes a lot of investment risk may have a higher but more variable profit margin than a passive fund.

The FCA does not prescribe a level of charges that it considers to be acceptable. However, the cap of 0.75% per year that it has imposed on default funds in auto-enrolled workplace pension schemes gives an indication of the level of charges it considers reasonable for a type of fund that is likely to be relatively non-complex.

Some of the firms we have spoken to have already begun re-negotiating fees with third party providers – both fees paid directly by unitholders and those absorbed by the AFM – in an attempt to drive down overall costs. In our view, any cost savings from these should be passed onto investors, as firms will find it difficult to justify additional fees on top of third party fees unless they can demonstrate that they are adding additional value.

Comparable services

Firms need to assess each charge against their charges for comparable services provided to clients, including those for institutional mandates of a comparable size and with similar investment objectives and policies. The clear regulatory intention is to ensure that retail clients are not paying substantially higher fees, where the size and service offering to funds are similar to institutional mandates.

Where retail clients invest directly, there may be more justification for a higher fee than when they invest through a nominee account via a platform, which can significantly reduce the cost to the asset manager. Where higher charges are justified by providing additional services to retail clients (such as website and app services), firms will need to justify how these services provide value to clients. This is likely to be one of the FCA's key focus areas, particularly given ESMA's finding that retail investors in UCITS funds pay twice as much as institutional investors on average.[11]

Performance

Performance needs to be measured and judged against a fund's objectives. Many firms are going through a process to clarify the objectives of their funds, both for the value assessment and to comply with the FCA's new rules in PS19/4.[12] The clarity of fund objectives is an area where the FCA is placing greater scrutiny, with many firms being challenged to be more specific and to use consumer-friendly language. Where a fund has a stated benchmark, it is relatively easy to judge whether it has under- or over-performed after charges. Where funds have no benchmark, firms will still need to find a method to monitor performance. For example, they could create a temporary composite comparator benchmark based on the asset allocation of the fund at that time.

Performance will need to be judged in the context of the level of risk that has been taken, in line with the fund's objectives. Many of the firms we have spoken to are intending to use risk-adjusted performance measures. For absolute return funds, performance in good market conditions might be unimpressive but the fund may still have met its objective of capital protection.

Performance should be measured over an appropriate time period, having regard to the fund's investment objectives, policy and strategy. This should link back to the fund's recommended holding period. Some firms are looking at performance across a longer-term horizon, such as 10 years, in addition to the recommended holding period, since they see the recommended holding period as a minimum rather than a maximum. Where the recommended holding period is short, firms might consider providing some contextual information about recent market conditions to avoid giving investors an unrealistic picture of what future returns might be. For an absolute return fund, it might be necessary to go back far enough to include the last major market downturn.

The FCA's policy statement notes that firms can assess reasonably expected future performance as well as past performance. Expected future performance will be particularly relevant to newly launched funds, which may not have a long performance history. For other funds, it is worth considering whether there are any reasons why future performance is likely to be different from past performance. Examples may include the on-boarding of a new fund manager, or a fund growing to a size where there may be diseconomies of scale associated with the investment strategy.

Quality of service

AFMs are required to assess the range and quality of services provided to investors. This includes the quality of portfolio management, regardless of whether it has been delegated. It also includes factors such as the incorporation of environmental, social and corporate governance (ESG) considerations into the investment process in the context of the fund's objectives, as well as services such as access to call centres, website and app services, and a self-assessment by the AFM of its own oversight. Assessing whether minimum quality standards are being met may include consideration of areas like complaints, delays, breaches, and compliance with Service Level Agreements for delegated or outsourced services. Firms may distinguish between essential services and additional services which may justify a higher charge.

Quality of service is the most subjective element of the assessment and many firms have been grappling with quantifying how much a good quality of service is worth to clients. Firms need to demonstrate that the services they provide are services that investors genuinely want and make use of i.e. that they are not simply 'add-ons' used to justify charging customers more. In this context, it may be useful to track how frequently services are used.

Where firms charge more for additional services that are not available to all of their clients it is not always clear how much more they should be charging for such facilities. Ultimately, this will be largely driven by how much these extra services cost to provide. It is important for firms to be clear in their investor communications on what additional costs investors are paying for enhanced services, so that each investor can make an informed decision about whether this offers overall value to them.

Economies of scale

The FCA expects firms either to pass economies of scale onto investors (e.g. through break points)[13] or to reinvest savings into the business. The FCA specifically mentions AUM per fund as being a driver of economies of scale. The number of clients per AUM may also influence economies of scale, but the FCA has questioned whether the difference in cost is sufficient to justify charging retail investors significantly more than institutional investors.[14] The overall size of the firm is also relevant, since a larger firm will spread their fixed costs over more funds.

Firms that are considering introducing break points will need to think carefully about how they structure these to minimise situations where a fund repeatedly crosses a break point threshold. If ongoing charges per AUM fall as the fund grows but then subsequently rises again this may be a difficult message to communicate to investors, particularly if the fund's AUM has fallen due to poor performance. Firms may, for example, consider lowering charges per AUM only if a fund stays above a particular size for a certain period of time.

The FCA states that savings achieved through economies of scale can be reinvested into the business, for example to subsidise newly launched funds or cover development costs. However, firms will need to explain how these investments directly benefit investors. Economies of scale should not be used to fund day-to-day operations of the AFM with no benefit being passed on to investors.

If firms have smaller funds that are loss-making because they do not benefit from economies of scale, this may indicate a cross-subsidy which could mean that profitable funds are delivering less value for their investors. Firms will need to keep such cases under close review and consider whether such a situation is likely to be temporary or continue into the longer term.

Share classes

According to research from Fitz Partners, in 2017 a third of retail assets invested in UK funds were still held in legacy share classes that pay rebates to financial advisers.[15] The FCA's guidance in FG18/3 made it easier to move investors out of expensive legacy share classes.[16] Many firms have already been doing work to move investors out of expensive legacy share classes and close them so that they do not have to be included in the value assessment.

However, firms need to consider whether moving investors out of expensive share classes is in their overall best interests. For example, in some cases if an investor is moved into a cheaper share class this may trigger their distributor to put them onto a platform, incurring new platform charges. In addition, some types of transfer could potentially incur tax liabilities. Where firms are not confident that moving investors into a cheaper share class would necessarily be in their best interests, they should ask the investor but not move them automatically if they do not respond.

Where investors remain in more expensive share classes, firms will need to be able to justify that they have considered whether moving them to a cheaper share class would be in the investor's best interests, or justify why there are higher costs to servicing them. In some cases, investors in more expensive share classes may receive additional services. In other cases, cheaper share classes may have a higher minimum investment amount.

Assessing value for money in the UK pensions sector

Workplace pension schemes operated by an FCA authorised firm

Since 2015, workplace pensions operated by an FCA authorised firm have been required to have an Independent Governance Committee (IGC), or a governance advisory arrangement, which must assess the ongoing value for money for policyholders.[17] The minimum assessment criteria include areas such as the level of charges and indirect costs borne by policyholders, the net performance of the investment strategies, and the efficiency of transaction processing. IGCs must publish annual reports setting out, among other things, the IGC's opinion on the value for money delivered by relevant schemes.

IGCs have challenged firms on a number of areas, including early exit fees, initial charges, ongoing charges, the efficiency of administration, the broader customer experience and the inclusion of ESG factors in the investment process.

The remit of IGCs is now being extended beyond workplace pensions to cover investment pathways for non-advised drawdown.[18] The FCA is also considering value for money in the non-workplace pensions market, and it has indicated that it has concerns about the value provided by unit-linked funds which will be addressed as part of this.

Trust-based workplace pension schemes

Also since 2015, trust-based workplace pension schemes providing money purchase benefits have been required by law to calculate at least annually the charges and (insofar as they are able to) transaction costs to which members' funds are subject and to assess the extent to which they represent good value for members.[19] The Pensions Regulator (TPR) has published guidance on assessing value for money to help trustees comply with this legal duty.[20]

TPR's assessment criteria have some commonalities with the FCA's criteria on assessing value for money for investment funds. In its guidance, TPR provides some useful examples of what trustees might consider under quality of service. For example, it divides this into four areas: governance and management, investment, administration and communications. It suggests that trustees assess whether services provided are suitable for, relevant to and valued by members. This could include conducting member surveys or workshops to get feedback on the services provided to members.

On costs and charges, TPR suggests that trustees can source comparative information through competitive tendering, sharing information through an adviser or professional trustee where permitted, commissioning an independent consultant or using an appropriate benchmarking service. It states that trustees should carry out a thorough consideration of costs and benefits, but not use a method that will incur costs which are disproportionate to any likely benefits to members.

The FCA and TPR stated in their joint strategy that they will work together on a broader range of regulatory interventions around value for money for workplace pensions.[21] More recently, the FCA has indicated that this may result in more prescriptive requirements in this area.[22]

Assessing value for money in the US mutual fund sector

In 1970 the Investment Company Act of 1940 (ICA) was amended to introduce a fiduciary duty for fund advisers with respect to advisory fees, and to give fund shareholders the right to bring lawsuits for breaches of this duty.[23] Case law has established principles for assessing whether this fiduciary duty has been breached. A seminal court decision in 1982 set out the 'Gartenberg standard', which held that a breach would be when a fee is charged that 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'.[24] It set out six factors for assessing whether the level of advisory fees is excessive:

- the nature and quality of the services provided to the fund and its shareholders;
- the profitability of the fund to the adviser;
- the adviser's receipt of 'fall-out' benefits because of its relationship with the fund;[25]
- the extent to which the adviser realises economies of scale as the fund grows larger;
- comparative fee structure i.e. comparison of the fees with those paid by similar funds; and
- the independence, expertise, care, and conscientiousness of the fund's board in evaluating the adviser's compensation.

In 2010 the Gartenberg standard and factors were upheld in a Supreme Court judgement.[26] Since then, a further wave of lawsuits has been initiated.[27]

The ICA also requires the advisory contract to be approved by a majority of the fund's independent directors.[28] Since 2005, SEC rules have required mutual funds registered under the ICA to outline in 'reasonable detail' in their shareholder reports the factors that were material in the board's consideration of the investment advisory contract.[29]

The minimum factors that must be disclosed are broadly similar to the Gartenberg factors. They are:

- the nature, extent, and quality of the services to be provided by the investment adviser;
- the investment performance of the fund and the investment adviser;
- the costs of the services to be provided and profits to be realised by the investment adviser and its affiliates from the relationship with the fund;
- the extent to which economies of scale would be realised as the fund grows; and
- whether fee levels reflect these economies of scale for the benefit of fund investors.

The analysis behind these published reports is generally very detailed and resource-intensive. Rigorous governance frameworks and meticulous record-keeping are adhered to, in part because of concerns about potential litigation. While the litigation risk is lower in the UK, individual accountability under the SM&CR is likely to focus minds in a similar way. Unlike under the UK regime, the reports focus exclusively on the contract with the investment advisor and do not involve a self-assessment.

The published reports are typically 2-4 pages and explain what factors have been considered and the overall conclusion. This may include quantitative information, such as comparing fees and performance to peer groups. One of the most difficult areas is assessing the profitability of a fund, as comparative information is often not publicly available and the profitability of a firm is affected by many factors including the structure of the firm, the types of funds managed and how costs are allocated. In the FCA's assessment criteria, the assessment of charges against the AFM's costs is likely to face similar challenges.

Conclusion

We have already seen firms take a number of actions to improve the overall value delivered to investors in response to the FCA's increased scrutiny in this area and the attention that the published reports may receive from distributers, institutional investors, or journalists producing best/worst buy tables. For example, many firms have already been moving investors out of expensive legacy share classes, where this is in the investors' best interests, to avoid having to include them in the value assessment. Some are also reviewing their contracts with external parties to see whether cost savings can be made. Other firms are challenging themselves on how much the services they provide are in practice worth to investors. As well as improving value for investors, the exercise can give firms a deeper understanding of the value of individual elements of their service, which can provide useful commercial insights for their pricing and product marketing strategies.

Getting the value assessment process and published reports right is likely to be an iterative process, informed by the industry sharing best practices and feedback from the FCA. Firms will need to be prepared to refine their value assessment process over time, and in so doing, to be open and transparent on the rationale for any changes to their methodology to avoid the appearance of re-cutting the data to improve each year's results.

The FCA will expect to see firms making a rigorous and robust assessment of the value that their funds deliver to investors, overseen by strong governance from the AFM Board, including the individual responsible under the SM&CR. If the FCA does not see the industry taking meaningful actions to improve the value delivered to investors, it is likely to consider carrying out additional supervisory work. The FCA has said that it could also consider further measures if necessary, such as requiring a majority of independent directors on AFM Boards.[30]

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Endnotes

1. For example, ESMA found in its 2019 report on costs and past performance in retail investment products that retail investors in UCITS funds pay twice as much as institutional investors on average. See **Performance and costs of retail investment products in the EU, ESMA, January 2019.**

The FCA also continues to **review potential closet tracker funds and closet constrained funds** as part of its ongoing supervision.

2. The FCA states that: "This prescribed responsibility would make clear that a Senior Manager, usually the chair of the board of an AFM, must take reasonable steps to ensure that the firm complies with its obligation to carry out the assessment of value, the duty to recruit independent directors, and the duty to act in the best interests of fund investors." **PS18/8 Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/1, FCA, April 2018.**

3. **PS18/8 Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/1, FCA, April 2018.**

4. **FCA's business Plan 2019/2020.**

5. Most automatic enrolment pension (AE) schemes are defined contribution schemes, however some are defined benefit. According to data from The Pensions Regulator, in 2018 9% of AE schemes used by employers with 30 or more staff were defined benefit, and 1% of AE schemes used by employers with less than 30 staff were defined benefit. Some jobholders may have been enrolled into more than one AE scheme if they have had more than one employer over the period.

6. **Performance and costs of retail investment products in the EU, ESMA, January 2019.**

7. New investor disclosure requirements in the Markets in Financial Instruments Directive II (MiFID II) and the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation are designed to help investors better assess which funds offer good value, while the MiFID II rules on payment for research are designed to improve the value provided to investors in the investment research market.

8. **Supervisory Convergence Work Programme 2019, ESMA, February 2019.**

9. The FCA requires investor communications to be fair, clear and not misleading (see COBS 4.2.1 in the FCA's Handbook).

10. Under the cost element, the FCA includes four different criteria: AFM costs, comparable market rates, comparable services and economies of scale.

11. The FCA also found in its market study that prices for institutional mandates tend to fall as the size of the mandate increases, but these lower prices do not seem to be available for equivalently sized retail funds. **Asset Management Market Study Final Report, FCA, June 2017.**

12. **PS19/4 Asset Management Market Study – further remedies, FCA, February 2019.**

13. A 'break point' is a level of assets under management which separates two different charging tariffs. For example, assets under management of up to £100 million might bear an annual fee of 0.5% whereas assets above that value might pay a lower amount.

14. **Asset Management Market Study Final Report, FCA, June 2017.**

15. **Third of UK retail assets still held in pre-RDR share classes, Fitz Partners, March 2018.**

16. **FG18/3 Changing clients to post-RDR unit classes, FCA, April 2018.**

17. These rules are set out in COBS 19.5 of the FCA's Handbook.

18. The FCA is proposing that, where customers do not take advice on drawdown, firms offer them a range of investment solutions that broadly meet their objectives, known as 'investment pathways'. The FCA intends to extent the remit of ICGs to cover investment pathways. **CP19/15 Independent Governance Committees: extension of remit, FCA, April 2019.**

19. **Regulation 25(1) Occupational Pension Schemes (Scheme Administration) Regulations 1996.**

20. **Guide to Value for members, The Pensions Regulator, July 2016.**

21. **Regulating the pensions and retirement income sector: our joint regulatory strategy, FCA and TRP, October 2018.**

22. **CP19/15 Independent Governance Committees: extension of remit, FCA, April 2019.**

23. Section 36(b) of the ICA.

24. This case was Gartenberg v. Merrill Lynch Asset Management Inc., the U.S. Court of Appeals for the Second Circuit.

25. 'Fall-out benefits' are indirect benefits that the adviser receives because of its relationship with the fund. For example, this could include brokerage fees received by an entity affiliated with the adviser.

26. This was in the Jones vs Harris Associates L.P. case.

27. Further information on these lawsuits are set out in **Section 36(b) Litigation Since Jones v. Harris, An Overview for Investment Advisers and Fund Independent Directors, ICI Mutual, 2016**, and in the ICI Mutual annual Claims Trends Newsletters.

28. Section 15(a) and 15(c) of the ICA.

29. **Disclosure regarding approval of investment advisory contracts by directors of investment companies, Final rule, SEC, August 2004.**

30. **PS18/8 Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/1, FCA, April 2018.**

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