THE INVESTMENT ASSOCIATION

THE INVESTMENT ASSOCIATION

15(C) PROCESS FOR US MUTUAL FUNDS

CURRENT PRACTICE

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CONTENTS

EXECUTIVE SUMMARY

The requirements and legal interpretation of the section 15(c) process for 1940 Act mutual funds in the US have provided an explicit reference point for new FCA policy[1] requiring value assessments and reporting by UK fund manager boards. While much has been written on the history of the US requirements, there is less material available on industry practice. A key focus of this paper is to outline what a typical assessment process looks like in the US, what information is included in the public reports, how granular it is and to what extent it is comparable or differs across firms.

Given the significant differences in regulatory history and legal culture between the UK and the US, this paper is for **background information only** and does not recommend a specific course of action for value assessment and reporting in the UK. Rather, the analysis aims to provide insights into what is a well-developed regime, characterised by a long-running legal, regulatory and industry debate around fiduciary duty and appropriate advisory fee levels.

The paper is in three main parts. Part One looks at history of the 15(c) process, Part Two looks in detail at the current assessment and reporting process, and Part Three discusses the similarities and differences between the US and the UK regimes. We provide a full list of US funds analysed in the Annex. Examples of reporting practice are presented separately in the accompanying Appendix.

There are five key points that emerge from Parts One and Two about the US regime:

- Origins in competition concerns. The origins of US requirements can be traced back to the 1960s where two prominent reports concluded that there was not enough price competition leading to very high fees particularly for retail investors. However, the subsequent regulation has been primarily shaped by case law related to the introduction of a fiduciary duty in respect to investment advisory fees.

- Similarities across assessment procedure. Practice has evolved over time and now the market appears to be in a place where the assessment procedure is very similar across firms. The assessment involves a very detailed and (for the investment manager) resource intensive information request by the fund board. However, the content of this request and the weight placed on each piece of information will depend on the board.

- Rigorous governance frameworks. Good governance is crucial for ensuring robustness. For this reason, there is meticulous record keeping and the independent directors on most fund boards have their own legal counsel. This reflects significant litigation concern, borne out by the case law driven evolution of the process.

- Gartenberg as a foundation, but some go wider. This information is centred on the Gartenberg factors, to which the FCA value criteria are closely aligned. Profitability or the comparability between investment advisory fees for retail and institutional clients

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[1] FCA, Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/18, Policy Statement PS18/8, April 2018. See page 13 for FCA response to feedback received.

are discussed separately by some. Some processes cover broader points, such as the investment manager's business model and retention of investment professionals.

- Varied reporting formats with core common themes. The reports across the fund range within each firm follow the same format but there are differences in the presentation across firms and some boards go into more detail than others. The report always provides a high level summary of the main factors that had been taken into consideration and how the board concluded in each case. Fund performance, price and economies of scale are always addressed and peer group comparisons are used very widely.

The main conclusion from the comparison between the US and UK regimes, discussed in Part Three, is that although the UK rules have been deliberately aligned to the US model, they are the outcome of a different process that was not attached to a fiduciary duty and did not involve litigation.

In light of the differences, the lessons learnt from the US experience relate to process rather than substance. The main points on process are:

- Governance is key in evidencing the robustness of the process and the outcome. This is relevant because even though there is no corresponding fiduciary duty in the UK, the UK rules do attach a prescribed responsibility for the value assessment and reporting process.

- The public statement in the shareholders' report is a high level summary of a very detailed and commercially sensitive internal document.

- This is a resource intensive exercise. Firms in the UK should be mindful that resource constraints may be particularly pertinent given the limited time period that the FCA rules allow for reporting, i.e. within four months of the accounting year end.

We hope that this paper will provide useful background information and we will wish to explore further with members some of the implications of the US experience for the development process in the UK, particularly the finding around similarity of procedure, but variety of content and reporting approaches.

We would like to thank IA members and ICI for their useful comments and feedback to this paper.

PART ONE: HISTORY OF THE 15(C) PROCESS[2]

The debate around the level of fund charges has existed in the US at least since the 1930s. Following a number of cases of investor harm in the 1930s[3], the SEC carried out an investigation into the fund management sector and found a number of abuses. The 1940 Investment Company Act (ICA or 1940 Act) aimed to address all these malpractices. However, almost twenty years later, a study by Wharton School of Finance and Commerce (the Wharton Report)[4], commissioned by the SEC, and a subsequent report by the SEC[5], concluded that:

- there was insufficient price competition resulting in high fund charges
- there were conflicts of interest
- retail clients were being charged significantly more than institutional clients whilst having lower expenses
- although the cost of managing funds decreased as assets increased, the ensuing savings were not reflected in lower fees

The congressional hearings that followed these two reports resulted in legislation amending the ICA in 1970 by introducing a fiduciary duty for the investment adviser (fund manager) with respect to advisory fees and, equally importantly, introduced the right for shareholders to initiate a court action against an adviser for breach of that fiduciary duty.[6] This amendment is now known as Section 36(b) of the 1940 Act and it should be noted that this fiduciary duty is connected only to the advisory fees.

At the same time, section 15(c) was amended to specify that the board must request and evaluate *"such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company"*.[7] This annual assessment process whereby the board receives 'reasonably necessary' information, to assess whether the contract with the investment adviser will be renewed, is known as the 15(c) process.

Since the introduction of the fiduciary duty and the shareholder right to start a court action for breach of that duty, the courts have been more involved in this space and the ensuing case law defined the key parameters of this fiduciary duty[8]. At the time of its introduction, it was not defined what would constitute a breach of the fiduciary duty nor what criteria

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[2] This section draws from Hubbard et al, "The Mutual Fund Industry; Competition and Investor Welfare", Columbia University Press, New York, 2010.
[3] Many were connected to closed-end funds and included cases of embezzlement, misleading accounting practices and generating commissions by shifting investors between investment companies.
[4] Wharton School of Finance and Commerce, "A study of mutual funds", 1962.
[5] SEC, "Public policy implications of investment company growth", 1966.
[6] Before then, only the SEC had the power to take legal action against investment advisers.
[7] Section 15(a) of the 1940 Act required that the contract with the investment adviser is subject to an annual renewal process.
[8] See for example Brown, "Mutual Fund Advisory Fee Litigation: Some Analytical Clarity", Journal of Business & Securities Law, Vol. 16, Iss. 2, Art.2, 2016.

courts should use to determine this. This clarity was provided by the Gartenberg case[9] where it was concluded 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"*. The same case established what are now commonly referred to as 'Gartenberg factors' that are used to determine this:

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

It is interesting to note that although the fiduciary duty is connected to advisory fees and the ensuing litigation has been based on some aspect of the advisory fee structure, the determination of a breach of fiduciary duty, as established in the Gartenberg case, considers it in the wider context of the fund delivery to investors.

These factors have proven to be the standard in many subsequent cases and disclosure rules based on the factors were adopted by the SEC as part of a wave of new regulation for mutual funds in the early 2000s.

NEW RULES ON 15(C) DISCLOSURE

In the aftermath of the 2003 late trading and market timing scandals, the SEC proposed three key changes: the majority independence requirement for fund boards (subsequently vacated); that the board chair is an independent director (subsequently vacated); and enhanced disclosure in respect to the 15(c) process[10]. Specifically, rules introduced in 2004, and effective since 2005, established a requirement for funds to outline in 'reasonable detail' in the shareholders report the factors that were material in the board's consideration of and conclusion in favour of the approval (or otherwise) of the investment advisory contract[11].

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[9] Gartenberg v. Merrill Lynch Asset Management Inc., US Court of Appeals for the Second Circuit – 694 F.2d 923 (2d Cir. 1982).

[10] Although the two SEC proposals on the majority independence and the independent chair were subsequently vacated and Section 10(a) of the 1940 Act requires at least 40% of the Board to be independent, the Independent Directors Council recorded that, in 2016, 84% of fund complexes (voluntarily) had boards consisting of 75% or more independent directors.

[11] SEC, Disclosure regarding approval of investment advisory contracts by directors of investment companies, Final rule, 5 August 2004.

The SEC outlined a slightly edited version of the Gartenberg factors as a minimum consideration of what would relate to both the board's selection of investment adviser and the approval of the advisory fee:

- a discussion of 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
- whether fee levels reflect these economies of scale for the benefit of Fund investors

Although several court cases revolved around the question of advisory fees for retail versus institutional investors, the SEC required funds to indicate whether the board relied on comparisons of the fees and services, and if so, to describe the comparisons and how they assisted the board in concluding that the contract should be approved.

SIGNIFICANCE OF JONES V HARRIS

The next milestone was set by the Jones v Harris case that was brought forward in 2004 based on the allegation that Harris had breached its fiduciary duty by charging retail clients twice as much as institutional clients and failing to provide sufficient details around remuneration.

Initially this was unsuccessful as the district court ruled that the fees were fully disclosed and comparable to those of similar funds[12]. On appeal, it was again unsuccessful (Seventh Circuit) on the basis that fees were set by market forces as *"investors can and do 'fire' advisers cheaply and easily by moving their money elsewhere"*.[13] Eventually, it was heard by the Supreme Court which reaffirmed the Gartenberg standard but also made two key observations.

First, it highlighted the importance of good governance by stating that *"a court's evaluation of an investment adviser's fiduciary duty must take into account both procedure and substance"* and that *"where a board's process … is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process"*.[14]

Second, it noted that there could be significant differences between retail and institutional business that could render a comparison of the respective charges meaningless. Specifically, it stated that the difference in services are attributable to *"the greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and higher marketing costs"*. The

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[12] 694 F. 2d at 928.
[13] 527 F. 3d 627, 632 (7th Cir. 2008).
[14] See 08-586 Jones v. Harris Associates L. P. (03/30/2010) – Supreme Court of the United States.

opinion also added that courts should take into account the similarities and differences between the services that the clients require and cautioned against courts relying too heavily on comparisons between challenged fees and fees charged to mutual funds by other advisers as there is no guarantee that the latter are the product of negotiations conducted at arm's length.

Although seminal in shaping the 15(c) process considerations, the Jones v Harris case was by no means the last case of fiduciary duty breach litigation. ICI Mutual report[15] that in the six years since the Supreme Court's decision, 26 new section 36(b) lawsuits associated with 23 different fund groups had been initiated. A number of reasons behind this proliferation of cases are outlined including procedural ease for filing such lawsuits and disproportionate litigation costs between the two sides[16]. It is also notable that these cases are most commonly filed against investment advisers and only very rarely against independent directors. Nevertheless, the latter's role is scrutinised in each case.

Altogether, case law has affirmed the application of the Gartenberg standard and has significantly shaped the 15(c) process which now covers both an assessment of how well the adviser has delivered and reporting on the content and outcome of that assessment. In this respect, the FCA's newly introduced rules, for Authorised Fund Managers (AFMs) to assess and report on value delivered, bear a strong similarity to the 15(c) process. This is not only in regards to actual assessment criteria but also relates to the content of the ensuing report, although a greater degree of flexibility seems to be allowed in the US.

Nevertheless, this Part highlighted one important difference between the US and the UK regimes. The US rules trace their origins in the Wharton Report (and the subsequent SEC report). These reports covered many of the topics addressed in the FCA Asset Management Market Study and reached distinctly similar conclusions about price competition in the market. But today's US rules reflect the outcome of extensive litigation experience which stems from the fiduciary duty provisions in respect to the advisory fee and which has not existed in the UK. The parallels and differences between the two regimes in terms of assessment criteria and wider process are discussed in more detail in Part Three.

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[15] ICI Mutual, "Section 36(b) litigation since Jones v. Harris: an overview for investment advisers and fund independent directors", 2016.

[16] Anecdotal evidence would suggest that a 36(b) lawsuit costs as much as four times more for investment advisers than plaintiffs.

PART TWO: CURRENT PRACTICE[17]

This section outlines what is the existing practice for the 15(c) process in terms of both assessment and reporting. Anecdotally, it would seem that the market, with time, has moved to a place where there is a common understanding of what the procedure should involve while boards have the flexibility to determine what information to request and how much weight they place on it, resulting in more divergence in reporting content.

ASSESSMENT PROCEDURE

The board, including the majority of independent directors, provides oversight on an ongoing basis and the investment adviser (fund manager) reports regularly on the fund's performance, risk etc. Once every year the board needs to approve the renewal of the contract of the investment adviser – this is the 15(c) process. In order to do so, the board requests a long list of data points and other relevant information from the adviser which it receives in due course. Then the board processes this information, follows up where necessary and takes a decision. A report of the process and conclusion is published in the shareholder report and filed with the SEC, marking the end of the cycle.

The 15(c) process involves a significant interaction between the board and the investment adviser and reflects communication that occurs throughout the year. It follows a lifecycle that can be very roughly split into three stages: information collection, assessment and decision, publication.

INFORMATION COLLECTION

At the beginning of the 15(c) process, the board will usually send a request for information, including specific data points to the investment adviser. There is no specific checkbox list that is commonly used across the industry. The rules require that the board has the reasonably necessary information to carry out its judgement and that the adviser provides it, however, it is up to the board to decide what would be needed and the rules stress that the request should be reasonable. There is room for negotiation here in that if there is reason to believe that this 'reasonableness' line is crossed, the adviser can discuss and, indeed, negotiate this with the board and reach a common agreement as to what information would have to be provided.

Given the nature of ICA Section 36(b) which introduced a private right of action against advisers for breach of fiduciary duty with respect to fees, fund boards consider proactively what could give rise to such a breach in the first place. As such, the content of the request for information covers not only data points that would seem directly connected to the Gartenberg factors such as level (and structure) of charges, existence of breakpoints, performance, risk etc. but also may consider operational risk relating to the adviser itself, wider risk management processes, business continuity plans, qualifications and compensation of key staff, compliance etc. This reflects the fact that as part of the 15(c)

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[17] The assessment analysis is based on a series of bilateral conversations that the IA had with members that have operations in the US. The reporting element is based on IA analysis of publicly available shareholder reports.

contract renewal process, the board is trying to assess the adviser as an entity. As stressed earlier, this request is a consolidation of all the information the board would normally receive throughout the year.

Usually one or more people within the adviser firm will be allocated responsibility for delivering the information requested and firms have stressed that the amount of time and resource it takes to collect the evidence and then double-check all points should not be underestimated[18].

Responding to this request will usually include a combination of internal and external data. Although the bulk of the information tends to come from within the adviser firm, external data tends to be required for peer group comparisons on different aspects including charges and performance. In some cases, external data also involved surveys from third party service provider looking at aspects such as client servicing.

Firms have stressed that the identification of the appropriate peer group can be challenging, requiring a very careful construction of an appropriate peer group of funds, based on factors such as size, performance, number of accounts, investment objectives, investor redemption patterns and fees charged directly to investors outside of the fund. Dependencies with data vendors and other third party service providers can arise as part of this comparison.

ASSESSMENT

The board's assessment and consideration of all the information received happens 'behind closed doors'. The general view was that this part of the process is much more extensive than going through a checklist and ticking a box. Contrary to the UK rules, boards in the US do not have to weigh all Gartenberg factors nor treat all information and data points equally. The board is allowed the flexibility to take a view of what is more important which may result in one or more factors not being considered at all. This will have to be explained in the shareholder report. It should be noted that although this is technically allowed, in reality it is extremely rare for boards to not consider all Gartenberg factors.

Unsurprisingly, considering the amount of information that boards require, the ensuing 15(c) document, often called a "board book", is very lengthy and highly sensitive and only the adviser and the board see it. These board books are updated and revised each year and may often run to 1,000 pages or more.

The board meets separately to discuss the document. This is done without the adviser to ensure that the assessment has been carried out at arm's length. As part of this process the independent directors on the board often have an independent counsel advising them and helping identify challenging questions, as discussed in more detail below. Following this the independent directors will meet and discuss this with the adviser.

Assessing the information received and reaching a conclusion require a significant time commitment from the board as this usually involves several communications with the

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[18] For an example of what factors could be taken in consideration only on the investment performance, see "Investment Performance Oversight by Fund Boards", Independent Directors Council, October 2013.

adviser as well as multiple meetings over the course of the year. Moreover, firms have indicated that there is a lot of emphasis on process and recording proceedings.

IMPORTANCE OF GOVERNANCE

One essential aspect of this process is governance and the importance that is given to ensuring the robustness in the assessment. The role of the board is not to run the adviser's business but to provide oversight, ask questions and, where needed, request additional information. To ensure robustness, all points raised need to be addressed to the board's satisfaction and this discussion should be documented. For example, even in the information collection part of the process, if the adviser considers that the request is too onerous, there is the flexibility for them to discuss this with the board and reach a mutually agreed level of granularity. However, this should be carefully documented to ensure that the board has received all the 'reasonably necessary' information to reach a conclusion.

The board itself is initially set up by the adviser but once in place, only the independent members can nominate new independent board members. Board members can have multiple positions but there is an annual board self-assessment required by SEC rules.

It is also worth stressing that any director appointed by the adviser does not take a formal part in reviewing the information provided to the independent directors. For example, they would not attend executive meetings to consider the information provided.

The regulator (SEC) can do ad hoc checks and look into the process, however this tends to be part of broader inspection visits covering different aspects of supervision. Robust governance seems to be a key determinant of the validity of the outcome for both the regulator and the courts in the case of class actions. Notably, the Supreme Court decision on Jones v Harris stated that: *"a court's evaluation of an investment adviser's fiduciary duty must take into account both procedure and substance"* and indicated that courts *"must take a more rigorous look of the outcome"* where a board has deficient process or the adviser withheld important information. So effectively, it is less likely for a court to doubt the outcome of the 15(c) assessment if the board can demonstrate that they were well-informed and carried out a robust process.

THE ROLE OF THE COUNSEL

A key function in this process is fulfilled by the independent directors' counsel. Boards as a whole will typically be advised by 'fund counsel' but in recognition of the specific duties imposed on independent directors and the fact that the fund counsel is often counsel to the adviser too, it is becoming increasingly common for independent directors to be advised directly by a separate legal firm. Although there is no regulatory requirement for the independent directors to have their own counsel, this function evolved from the case law around the 15(c) process. Indeed, the market has moved to a place where different law firms represent the board and the fund. Recent research[19] has shown that the percentage

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[19] Independent Directors Council and Investment Company Institute, "Overview of Fund Governance Practices, 1994-2016", October 2017.

of fund complexes whose independent directors are represented by a dedicated counsel or a counsel separate from the adviser's has increased from 64% in 1998 to 96% in 2016.

The counsel advises the board throughout, from sending the board's request for information to the adviser, to educating board members on challenging questions, to assessing and discussing the information received, to producing the summary of conclusions for the shareholder report. Importantly, the counsel is viewed as a key part of the internal governance and critical for evidencing due diligence both to regulators and the courts.

REPORTING

The assessment process is concluded with the production of a summary to be included in the shareholder report. This is usually a two- to four-page long document that provides a high level summary of the main factors that have been considered as part of the 15(c) process as well as a brief note of the conclusion.

The IA has looked in detail at the shareholder reports of the 50 largest[20] US open-end funds[21]. This sample included 33 active and 17 passive funds run by 12 companies, and although predominantly equity, covered the main three asset classes – equity, fixed income and allocation. For a full list of the funds that were included in the analysis please see the attached Annex. A sample of reports are provided separately in the accompanying Appendix for illustrative purposes.

MAIN POINTS

The reports across the fund range within each firm tend to follow the same format, but try to address the specificities of each fund, with a particular focus on the precise objective. For example, the board of one firm refers to *"objectives of providing conservation of capital, current income and long-term growth of capital and income"* for one fund and the *"primary objectives of providing a level of current income that exceeds the average yield on US stock and a growing stream of income over the years"* for another fund.

Reporting across firms varies both in terms of format and in terms of what is actually covered and discussed. As an example, among the sample of reports included in Annex 3, one is over 3,800 words long and others count approximately 1,120 and 600 words. Moreover, the board of funds for one firm includes charts on the peer group price and performance comparisons in its reports while other boards do not. In some cases, there is an additional section on factors like ancillary benefits whereas others choose to provide specific details on the fund's investment approach.

Some firms have a separate shareholders report for each fund where a section on the 'approval of investment advisory agreement' is included while others have a composite report for all funds. In case of the latter, some factors are commonly treated across all funds while others go over the details of each fund. An example of a composite report

[20] Based on fund size as reported in Morningstar.
[21] Although the text refers to "funds" the legal structure is open ended investment companies.

covers common aspects across funds such as quality of services once, whilst performance and fees, which are fund-specific, are discussed on an individual basis.

These differences in presentation and content notwithstanding, all firms discuss in some shape or form the governance structure, performance, level of charges, economies of scale and quality of services.

Usually the reports will start with a description of the governance structure including the existence of any committees that were involved in the process, and in some cases refer to meetings. The explanation of the governance structure tends to be followed by a statement of the outcome of the assessment. For example, one board refers to a *"Contracts Committee"* while another states: *"The Board has established various standing committees (Committees), each composed of and chaired by Independent Trustees with varying backgrounds, to which the Board has assigned specific subject matter responsibilities in order to enhance effective decision-making by the Board….. Members of the Board may also meet with trustees of other Fidelity funds through ad hoc joint committees to discuss certain matters relevant to all of the Fidelity funds…. At its July 2017 meeting, the Board unanimously determined to renew the fund's Advisory Contracts."*

Broadly, this will be followed by a brief discussion of the main (but not all) points that the board asked the adviser to provide and which were considered in the assessment as well as a brief conclusion on each point. Usually the quality of services and performance are discussed first, followed by the level of charges and economies of scale. Sometimes, profitability is discussed separately.

Boards will look at performance over both short- and long-term, compare it to market movements and, as a general rule, they will not cover it simply from a return perspective but will explicitly refer to delivery against the investment objective. For example, the board of one fund found that the annualised total return for different periods was below the median of its performance universe but concluded that performance was satisfactory given the fund's *"income-oriented objective"* and conservative investment policy.

Both charges and performance are discussed on their own in absolute terms but also in relative terms with reference to peer group. In most cases, a comparison is made against the median within the peer group and sometimes against the average. Generally, a finding that the charge is below and the performance above the peer group median is viewed as positive. Where this is not the case, the board takes other factors into consideration. For example, the 1-year performance of one fund was below the median but the 3, 5, and 10-year performance was above the median and thus the board concluded that performance was satisfactory.

Economies of scale are always commented on. Boards can do a number of things. First, they may have the view that economies of scale are appropriately reflected in the level of charges. Second, they may introduce a tiered structure. Third, where a tiered structure is already in place, they may introduce further breakpoints or lower the existing breakpoints, e.g. as was the case for one fund where the board *"approved an additional 0.005% breakpoint"* once the fund assets exceeded $650 billion. Fourth, they may decide for an outright fee cut without having or introducing breakpoints.

Some boards choose to consider the level of fund charges compared to those for other clients, including institutional investors. However, they make a note that they bear in mind the differences in regulation, operations etc. and specifically that pooled funds as a business tend to be more complex both operationally and from a compliance perspective relative to segregated mandates. For example, in one case the board concluded that where there were differences, these *"appropriately reflected the investment, operational, regulatory and market differences between advising the fund and the other clients"*.

In some cases, the report includes references to the adviser firm itself. This is not only in terms of profitability, which has an obvious connection to the level of charges, but also to other aspects relating to the adviser's viability to continue being successful in the future, experience and expertise of senior management and investment professionals etc. This may include more granular information, for example, one board provided comment on the experience and length of tenure of the fund's investment professionals compared to those of other funds.

It is fairly rare to include charts and/or specific data. Where this is the case, it tends to be a type of benchmarking of the fund price/performance compared to the median levels of the peer group. Although not required by law or regulation, identification of the peer group is typically determined by a 15(c) process consultant based on a careful consideration of competing funds reported in third-party databases (e.g. Morningstar, Lipper etc.) to ensure comparability.

Finally, boards tend to be open about which third party service provider has contributed data and/or further analysis. Examples of such service providers include Morningstar, Lipper, Broadridge and Strategic Insight.

PART THREE: US-UK COMPARISON

Part One outlined in some detail how the US regime is tied to the existence of a specific fiduciary duty with respect to advisory fee levels, as well as the extent to which the current rules reflect a long experience of litigation on this particular issue. The rules that are now introduced in the UK (alongside a wider remedy package) are expressed differently and more broadly.

The value assessment and reporting processes in the UK are the key elements in a new fund governance regime that aims to strengthen the pre-existing duty to act in the best interest of investors. As part of fulfilling this duty, the FCA is requiring AFMs to consider whether the charges taken from a fund are justified in the context of the overall value delivered to unitholders.

When the rules were initially proposed in Consultation Paper CP17/18, they focused on 'value for money' and included a number of criteria that many respondents interpreted as focusing more on cost structure than customer delivery. Following consultation, the FCA redrafted the rules and commented[22] that: *"… agents should be accountable to their underlying beneficiaries on how they deliver value. We accept that our draft rules could be seen as too focused on AFMs' costs rather than the full value proposition of funds, which was not our intention. We have redrafted our final rules to clarify that fund charges should be assessed in the context of the overall value delivered, rather than using the term 'value for money'."*

Despite the different expression and histories, there are parallels between the underlying concerns of US and UK regulators in shaping their respective regimes. The origins of both the US and the UK requirements stem from the same debate around the level of charges, sharing economies of scale with investors, profitability, and investment performance. The focus is on the supply side of the market and making firms think about how they set the level of charges in the context of what they deliver to investors.

The final FCA criteria were explicitly drafted to bring them closer to factors set out in the Gartenberg model in the US, even though the US rules do not make any explicit reference to "value". As a result, both regimes address quality of service, performance, level of charges, and economies of scale.

Table 1 maps the value assessment criteria outlined by the FCA against the Gartenberg factors that the SEC has listed for the reporting against the 15(c) process. A number of specific observations can be made about the drafting:

- Profitability. Profitability is explicitly mentioned as part of the Gartenberg factors. FCA Criterion 3 addresses it less directly through the comparison of the charge level with the cost of providing the service to which this charge relates.

- Comparable market rates. The FCA criteria include a stronger focus on comparable market rates and the rates of comparable services, i.e. which may involve a peer-group

[22] FCA, Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/18, Policy Statement PS18/8, April 2018, paragraph 1.17, page 5.

comparison of level of charges as well as potentially a comparison between retail and institutional products. These are not part of the Gartenberg factors but as Part Two discusses, both tend to be part of US board considerations for the 15(c) process.

- Retail v institutional. The comparison of charges for retail and institutional clients is one of the more nuanced differences between the two regimes. Even though it formed the basis for some prominent legal actions in the US, it never became part of the Gartenberg factors as outlined by the Supreme Court on its Jones v Harris decision and by the SEC reporting requirements. Still, it is mentioned in the SEC guidance on reporting and, as with all other factors, it is up to each board to decide whether it wants to consider it or not. As covered in Part Two, some (but not all) boards do consider and refer to it. In the UK, it features as an explicit criterion, which was moved from the guidance section in the consultation paper to the rules section in the policy statement. At the same time, the policy statement[23] clarifies that *"AFMs can explain in their annual statement why retail funds and institutional mandates are not comparable, if the AFM believes this to be the case".*

- Unit classes. The FCA 'classes of units' criterion doesn't have a Gartenberg equivalent. This reflects the unique feature of the UK retail market which in a post-RDR environment includes pre-RDR share classes with bundled charges (covering the cost of investment management, advice and distribution) and post-RDR share classes with 'clean' charges (reflecting only the cost of investment management).

Table 1: SEC Gartenberg factors vs FCA criteria

SEC criteria based on Gartenberg factors	FCA criteria in COLL 6.6.21 R
The nature, extent, and quality of the services to be provided by the investment adviser.	Quality of service: The range and quality of services provided to unitholders.
The investment performance of the fund and the investment adviser.	Performance: The performance of the scheme, after deduction of all payments out of scheme property as set out in the prospectus (in this rule, COLL 6.6.23E and COLL 8.5.19E, "charges"). Performance should be considered over an appropriate timescale having regard to the scheme's investment objectives, policy and strategy.
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.	AFM costs - general: In relation to each charge, the cost of providing the service to which the charge relates, and when money is paid directly to associates or external parties, the cost is the amount paid to that person.
The extent to which economies of scale would be realised as the fund grows. Whether fee levels reflect these economies of scale for the benefit of fund investors.	Economies of scale: Whether the AFM is able to achieve savings and benefits from economies of scale, relating to the direct and indirect costs of managing the scheme property and taking into account the value of the scheme property and whether it has grown or contracted in size as a result of the sale and redemption of units.
NA	Comparable market rates: In relation to each service, the market rate for any comparable service provided: (a) by the AFM; or (b) to the AFM or on its behalf, including by a person to which any aspect of the scheme's management has been delegated.

[23] Ibid, page 14.

NA	Comparable services: In relation to each separate charge, the AFM's charges and those of its associates for comparable services provided to clients, including for institutional mandates of a comparable size and having similar investment objectives and policies.
NA	Classes of units: Whether it is appropriate for unitholders to hold units in classes subject to higher charges than those applying to other classes of the same scheme with substantially similar rights.

Moving beyond the assessment criteria, we see similarities and differences across the broader process requirements of each jurisdiction. Table 2 summarises these in detail but three features are specifically worth pointing out:

- Formal responsibility. Perhaps one of the most fundamental features is that a specific type of responsibility and accountability is attached to both regimes. In the US, this takes the form of a fiduciary duty that the investment adviser has in regards to any compensation received for services rendered to the fund. In the UK, the FCA introduced two key changes alongside the requirements for the value assessment as part of its wider Asset Management Market Study remedy package. First, it created a requirement for the appointment of at least two independent directors on the AFM's governing body. Second, under the Senior Managers & Certification Regime, it created a prescribed responsibility that sits with the Chair of the AFM's governing body for the value assessment, the appointment of independent directors and acting in investors' best interests. The nature of this prescribed responsibility, and indeed the requirement to have independent directors, seems to mirror the importance placed in the US on having robust governance structures and processes.

- Assessment and reporting. Both regimes follow a twofold approach whereby the requirements involve not only the actual assessment but also a summary report with the conclusion of that assessment that is publicly available and thus, adds an element of external scrutiny. As Part One discusses, in the US the reporting came much later than the assessment requirements. In the UK, both components were introduced at the same time. This perhaps reflects learnings from the US, but it is also notable that the FCA puts emphasis[24] on the role that an annual public statement will have in *"aiding comparison across the sector*."

- Flexibility around assessment process. In regards to how the different factors are treated and how much weight should be placed on each, technically, the SEC rules allow US fund boards the flexibility to consider those that they view as most relevant. As mentioned earlier, in reality, boards almost always consider all factors. In contrast, the UK rules do not allow any such flexibility as the FCA has listed all criteria as a minimum consideration.

[24] Ibid, page 13.

Table 2: 15(c) process vs. FCA value assessment and reporting

US	UK
Origin	
Originally based on the Wharton Report and findings around price competition. Subsequently shaped by case law and the connection to adviser annual contract renewal (15(c) process) and fiduciary duty ICA 1940, Sec 36(b): *"… with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser"*.	Competition study as part of FCA's concurrent competition powers with the Competition and Markets Authority. The ensuing regulation stems from findings around lack of price competition but also reflect findings from the FCA's supervision work.
Criteria weighting	
All factors as a minimum but, technically, there is flexibility to not include a factor if it is deemed to not be relevant and explain why that is. In practice, this flexibility is exercised very rarely.	All as a minimum consideration
Assessment frequency	
Annually	At least annually
Reporting content	
• Discuss in reasonable detail the material factors and the conclusions that formed the basis for the board's approval of the advisor's contract renewal. • Whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (e.g., pension funds and other institutional investors). If the board relied upon such comparisons, describe the comparisons that were relied on and how they assisted the board in concluding that the contract should be approved. • If applicable, any benefits derived or to be derived by the investment adviser from the relationship with the Fund such as soft dollar arrangements by which brokers provide research to the fund or its investment adviser in return for allocating Fund brokerage. • Conclusory statements or a list of factors will not be considered sufficient disclosure. Relate the factors to the specific circumstances of the fund and the investment advisory contract and state how the board evaluated each factor. • If any factor is not relevant to the board's evaluation of an investment advisory contract, note this and explain the reasons why that factor is not relevant.	• Discussion and conclusion for each criterion - including considerations taken into account in the assessment, a summary of its findings and the steps undertaken as part of or as a consequence of the assessment • Explanation why any identified economies of scale have not been passed on to investors • Explanation for cases where investors hold units of high-charging share classes if there are cheaper ones with "substantially similar rights" • Conclusion of the AFM's assessment of whether the charges are justified in the context of the overall value delivered to the unitholders in the scheme • Where the assessment has identified that the charges are not justified in the context of the overall value delivered to the unitholders, a clear explanation of what action has been or will be taken to address the situation.

Reporting detail	
The rules require to discuss in 'reasonable detail' the material factors and the conclusions that formed the basis for the approval.	AFMs can choose the way they communicate quantitative and qualitative information but need to comply with the 'fair, clear and not misleading' rule. No information should be disclosed that is commercially sensitive or anticompetitive.
Reporting frequency	
Annually	Annually
Publication of report	
Shareholder report; prospectus to mention that it is included in the shareholder report. These reports are also filed with the SEC.	Annual long report or separate composite report
Comparison across funds	
Supreme Court opinion on Jones v. Harris not to rely too heavily on comparisons with fees charged by other advisers as these fees may not be the product of negotiations conducted at arm's length.	Yes – explicit assessment criterion
Retail vs institutional	
Although it features in what could be added to the reporting, it is rather to explain that the comparison has taken place and how it has contributed to the conclusion. But this is only to the extent that it had been considered in the first place. No explicit assessment criterion is attached to it and the Supreme Court opinion on Jones v Harris stressed that the comparison may be inappropriate.	Yes – explicit assessment criterion. However, Policy Statement PS18/8 notes: *"AFMs can explain in their annual statement why retail funds and institutional mandates are not comparable, if the AFM believes this to be the case."*
Responsibility	
• The investment adviser has a fiduciary duty with respect to fees as per 1940 Act, Section 36(b). • Wide ranging duties for board and particularly independent directors[25], the main of which is the annual approval of the advisory contract.	• Prescribed Responsibility "za" for Senior Management Function 9 (Chair) introduced by Senior Managers & Certification Regime: *"responsibility for an AFM's value for money assessments, independent director representation and acting in investors' best interests"*. • Independent directors of AFM's governing body to provide input and challenge in the value assessment as per COLL 6.6.26 G (1).

The question naturally arises as to whether the experience garnered in the US and the similarities of the US and UK regimes (notwithstanding their differences) have any implications for the development of the value assessment process in the UK. Even though the FCA stated that the UK rules are closer to the Gartenberg principles in the US, the differences in regulatory history and legal background mean that caution is needed about direct parallels. There are, however, three process points that may be useful in the UK context:

ROBUST GOVERNANCE

Possibly one of the most important lessons from the US involves governance. As discussed in Part Two, the US experience has shown that ensuring appropriate governance mechanisms is a critical indicator of the robustness of the assessment outcome.

[25] For further details see SEC, "Interpretive Matters Concerning Independent Directors of Investment Companies", Release No. IC-24083, 14 October 1999.

This is supplemented by the element of accountability. In the US, this ensues from the fiduciary duty for advisory fees. In the UK it is reflected in the prescribed responsibility that is attached to the FCA value requirements. In both cases, accountability goes well beyond fees and encompasses broader delivery to the investors so that the aim is not to achieve the lowest price but a fair price considering what investors get in return.

ASSESSMENT VS. REPORTING

The assessment in the US is based on the 'board book' that contains extensive, detailed and commercially sensitive information about the investment adviser. The conversations that follow between the board and the adviser are lengthy and equally sensitive. The statement that is then published in the shareholders' report is a substantially summarised version of all this information, providing high-level information around the process and the conclusion. The difference between the substantive internal record and the summarised outward facing statement may well be relevant in the UK context.

Another development in the US that could offer useful insights is that the format of shareholder reports varies even if the requirements have been in place for over ten years. This is a key point for UK implementation given the FCA's reference to the public annual statement *"aiding comparison across the sector"*.

INTENSITY OF PROCESS

As discussed in Part Two, the 15(c) process is a rigorous and extensive assessment of the investment adviser's delivery. Importantly, the requirement for the assessment has been in place for a much longer time than the reporting. This has allowed the industry time to not only develop its internal processes but also to improve before it had to start disclosing any details to shareholders.

AFMs that are looking at how to implement the new FCA requirements in the UK will need not only to shape and put in place their processes for the assessment within a year – which is going to be a substantial exercise in itself – but they will also be faced with a time constraint[26] to produce the public statement. The US example has shown that given the depth and level of detail of information involved, investment advisers have to dedicate resource to this, which quite often means a number of full time employees working on this. This would imply that firms in the UK may need to anticipate a considerable amount of resource may be required to set up and carry out the assessment as well as produce the corresponding statement on time.

[26] The statement must be published within four months of the accounting year end either in a fund's annual long report or in a separate composite report covering two or more funds. This rule become effective along with the other governance requirements on 30 September 2019 so that the first reports are expected by the end of January 2020.

ANNEX: TOP 50 US FUNDS

Table 3: List of 50 largest US funds[27]

Fund Name	Firm Name	Global Category	Index Fund	Fund Size (in US$ bn)
Vanguard Total Stock Mkt Idx	Vanguard	US Equity Large Cap Blend	Yes	701
Vanguard 500 Index Investor	Vanguard	US Equity Large Cap Blend	Yes	418
Vanguard Total Intl Stock Index	Vanguard	Global Equity Large Cap	Yes	343
Vanguard Institutional Index	Vanguard	US Equity Large Cap Blend	Yes	223
Vanguard Total Bond Market Index	Vanguard	US Fixed Income	Yes	198
American Funds Growth Fund of Amer	American Funds	US Equity Large Cap Growth	No	196
American Funds Europacific Growth	American Funds	Global Equity Large Cap	No	166
Vanguard Total Bond Market II Idx	Vanguard	US Fixed Income	Yes	157
Fidelity® 500 Index Investor	Fidelity	US Equity Large Cap Blend	Yes	152
Fidelity® Contrafund®	Fidelity	US Equity Large Cap Growth	No	129
American Funds American Balanced	American Funds	Moderate Allocation	No	129
PIMCO Income	PIMCO	US Fixed Income	No	113
American Funds Income Fund of Amer	American Funds	Aggressive Allocation	No	109
Vanguard Developed Markets Index Admiral	Vanguard	Global Equity Large Cap	Yes	108
American Funds Washington Mutual	American Funds	US Equity Large Cap Value	No	106
American Funds Capital Income Bldr	American Funds	Allocation	No	106
Vanguard Wellington™	Vanguard	Moderate Allocation	No	102
American Funds Capital World Gr&Inc	American Funds	Global Equity	No	100
American Funds Fundamental Invs	American Funds	US Equity Large Cap Blend	No	100
Vanguard Mid Cap Index Institutional	Vanguard	US Equity Mid Cap	Yes	98
American Funds Invmt Co of Amer	American Funds	US Equity Large Cap Blend	No	94
Vanguard Small Cap Index	Vanguard	US Equity Small Cap	Yes	91
American Funds New Perspective	American Funds	Global Equity	No	84
Vanguard Emerging Mkts Stock Idx	Vanguard	Emerging Markets Equity	Yes	83
Vanguard Growth Index Investor	Vanguard	US Equity Large Cap Growth	Yes	81

[27] Source: Morningstar. Information as of 30 June 2018.

Franklin Income	Franklin Templeton	Cautious Allocation	No	77
Metropolitan West Total Return Bd	Metropolitan West	US Fixed Income	No	75
PIMCO Total Return	PIMCO	US Fixed Income	No	71
Dodge & Cox Stock	Dodge & Cox	US Equity Large Cap Value	No	70
Vanguard Value Index	Vanguard	US Equity Large Cap Value	Yes	67
American Funds AMCAP	American Funds	US Equity Large Cap Growth	No	67
Vanguard Extended Market Index	Vanguard	US Equity Mid Cap	Yes	67
Vanguard PRIMECAP	Vanguard	US Equity Large Cap Growth	No	64
Vanguard Short-Term Investment-Grade	Vanguard	US Fixed Income	No	60
Vanguard Real Estate Index	Vanguard	Real Estate Sector Equity	Yes	60
Dodge & Cox International Stock	Dodge & Cox	Global Equity Large Cap	No	59
Vanguard Interm-Term Tx-Ex	Vanguard	US Municipal Fixed Income	No	58
Dodge & Cox Income	Dodge & Cox	US Fixed Income	No	56
First Eagle Global	First Eagle	Flexible Allocation	No	56
T. Rowe Price Growth Stock	T. Rowe Price	US Equity Large Cap Growth	No	56
T. Rowe Price Blue Chip Growth	T. Rowe Price	US Equity Large Cap Growth	No	56
Fidelity® Total Market Index	Fidelity	US Equity Large Cap Blend	Yes	53
Vanguard Wellesley® Income	Vanguard	Cautious Allocation	No	53
Vanguard Short-Term Bond Index	Vanguard	US Fixed Income	Yes	51
American Funds American Mutual	American Funds	US Equity Large Cap Value	No	51
DoubleLine Total Return Bond	DoubleLine	US Fixed Income	No	50
MFS® Value	MFS	US Equity Large Cap Value	No	48
Vanguard Windsor™ II	Vanguard	US Equity Large Cap Value	No	47
Oakmark International Investor	Natixis	Global Equity Large Cap	No	46
Vanguard Health Care In	Vanguard	Healthcare Sector Equity	No	45