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Conflicts of Interest

Corporate Governance and Financial Markets

Edited by

Luc Thévenoz and Rashid Bahar

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Chapter 11

Conflicts of Interest in the Distribution of Investment Funds

*Luc Thévenoz**

> 'Open architecture provides greater choice but introduces the possibility that customers will be sold the funds that pay the highest commission rather than those that are most suitable.'
>
> *The Financial Times*, 18 July 2005

While in the next chapter Tamar Frankel mostly discusses conflicts of interest arising from the relationship between the manager of an investment fund and the brokers executing securities transactions on behalf of the fund,[1] this paper focuses on the relationship between the manager of an investment fund and the firms distributing its shares to the public. To incentivize distributors, the manager agrees to share revenue by retroceding to distributors part of the fees obtained from its activity. I shall examine in greater detail retrocessions paid to distributors out of the management fee charged to the fund and the conflicts of interest that result from them, as well as possible approaches to preventing or managing these conflicts.

In this paper, 'investment fund' refers to any variety of collective investment scheme, whether in corporate form (SICAF, SICAV, investment trusts and so on), based on a contract (*fonds de placement, fonds communs de placement, Anlage-fonds*), or based on a trust arrangement (unit trusts). 'Fund provider' refers to a

* Professor, University of Geneva, Director, Centre for Banking and Financial Law, Commissioner, Swiss Federal Banking Commission. This contribution expresses the author's personal opinions.
1. See below, page 370ff.

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financial institution that designs, creates and promotes an investment fund. The provider does not necessarily manage the assets of the funds, a task which is often partially or totally outsourced. 'Fund distributor' refers to the firm or person controlling the relationship with the individual investor and acting as an intermediary in the investment process. Distributors vary widely in types and sizes, from a bank to an independent licensed or unlicensed[2] financial advisor, including securities brokerage firms, insurance companies, tied agents, etc.

While this paper concentrates on policy issues rather than on any specific legal system, I shall often refer to the European Union legal environment as well as to Swiss laws and regulations. Reasons for the first choice are fairly obvious. On this side of the Atlantic, investment funds are a major area of financial services where governments, regulators and the industry are seeking to achieve closer and more efficient integration while maintaining a high degree of investor protection.[3] The second choice is prompted not only by the institutional context in which this book originated, but also by the fact that revenue sharing between fund providers and distributors has recently attracted a great deal of attention in Switzerland. Over the past three years, the regulator (the Swiss Federal Banking Commission) has questioned the extent and practicalities of retrocessions out of the management fee, which in turn prompted the industry association (the Swiss Funds Association) to a adopt self-regulatory disclosure standard sanctioned by the regulator.

I. GENERAL CONTEXT

The volume of assets in EU-regulated investment funds[4] is estimated at EUR 4 trillion.[5] The figure for Switzerland is CHF 505 billion, or approximately EUR 330 billion.[6] It is no wonder that the distribution of these funds to retail and private-banking customers has become a major line of business and source of revenue for

2. Unlike in the European Union, the provision of financial advice or portfolio management services in Switzerland is not *per se* a regulated service.
3. See recently the public consultation initiated by the EU Commission on its Green Paper on the Enhancement of the EU Framework for Investment Funds of 12 July 2005, SEC(2005) 947, COM(2005) 314 final. It is supplemented by a valuable Background Paper published as a Commission Staff Working Paper. Both are available at <www.europa.eu.int/comm/internal_market/securities/ucits/index_en.htm>.
4. Such investment funds (known as UCITS) are subject to national legislation implementing the Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations, and administrative provisions relating to undertakings for collective investment in transferable securities, OJ L 375/3, 1985, (hereafter: UCITS Directive). This directive has been modified by several subsequent directives. A current, consolidated text is available at<eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:01985L0611-20050413:EN:NOT>.
5. Annex (p. 12) to the Green Paper (no. 2 above).
6. Swiss Funds Association, *SFA fund statistics – Q3 2005*, 30 October 2005, <www.sfa.ch>.

most financial services providers such as banks, securities brokers, independent financial advisors, etc. Unlike in the USA and the UK, the distribution of collective investments in continental Europe is largely dominated by universal banks. At the same time, banking groups are the most significant providers of funds. Traditionally, banks used to distribute almost exclusively their own products through their proprietary network. Over the last several years, however, 'open architecture' has gained in popularity. European banks and other funds providers are trying to distribute their funds through other, non-captive channels such as regional banks, securities brokers, insurance companies,[7] and independent financial advisers. At the same time, European banks are opening their own distribution networks to funds created and managed by other providers.

However significant, this trend toward open architecture (or cross-distribution of investment funds) is still at an early stage. A study by PriceWaterhouseCoopers published in 2002, for example, found that non-proprietary channels contributed 14 per cent of the inflow of new assets from the home market, but 82 per cent of the inflow of new assets from export markets.[8] Data published by the EU Commission confirms the progressive opening up of proprietary distribution channels to funds provided by third parties. In 1998, cross-border funds accounted for 11 per cent of all EU regulated funds. This figure was 13 per cent in 2002 and 16 per cent in 2003, indicating a significant speeding up of the process.[9]

Conversely, Europe is characterized by an extremely large number of funds of sub-optimal size: EU data indicate that the 28,830 EU (regulated) funds have on average five times fewer assets under management than the corresponding 8,046 US investment funds.[10] This makes it difficult for the industry to reap economies of scale. A number of reasons may explain this excessive fragmentation of the European fund industry. Cross-border funds (funds sold in several or many EU Member States) are increasing sharply, but remain difficult and costly to launch. Administrative barriers, differences in tax regime, obstacles to cross-border fund mergers and pooling techniques, client preferences varying from one country to another, all contribute to an offer of funds which is fragmented and biased towards national products.[11]

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7. Life-insurance companies typically distribute investment funds through 'unit-linked policies' (premium buys life insurance plus investment in funds) or 'with-profit funds' (policyholders share in the return on the fund), see Commission staff's Background Paper (no. 2 above), p. 10 at footnote 16. Other intermediaries may also repackage investment funds, e.g. through private labelling, by incorporation into a certificate or other derivative or structured financial instrument, or by way of a fund of funds.
8. PriceWaterhouseCoopers, *Eurofunds Survey 2002: Challenging Markets: Distributing Too Many Products to Too Few Clients* (Luxembourg), <www.pwcglobal.com/lu/eng/ins-sol/publ/pwc_eurofunds_flyer.pdf> (03 January 06), p. 23.
9. [EU Commission's Directorate of General Internal Market and Services, *Financial Integration Monitor 2005* : Background document (June 2005) p. 45, Figure 11.
10. Ibid., p. 46, Table 5.
11. Commission's staff Background Paper (note 2 above), p. 9.

The still prevailing state of high fragmentation of European investment funds inevitably impacts on the costs of funds distributed cross-border in Europe. A recent study of investment fund expenses highlights the fact that the Total Expense Ratios (TERs)[12] of US and European funds diverge widely.

Table 1. TER of US, UK, and European Cross-border Funds

	Equity funds (overall)		Bond funds (overall)	
	Asset-weighted average TER	Average fund size (USD mil.)	Asset-weighted average TER	Average fund size (USD mil.)
USA	0.92%	3,238	0.86%	1,883
Europe (cross-border Ucits)	1.79%	1,221	1.35%	992
UK	1.68%	687	1.24%	233

Source: Lipper[13]

While the fund size significantly affects the TER, it does not explain the difference between US and European funds of similar size, as can be seen from a comparison between midsize funds (USD 100 million to 1 billion of assets under management).

Table 2. TER of midsize US, UK and European Cross-border Funds

	Equity funds between USD 100 mil. and USD 1 bil.		Bond funds (overall) between USD 100 mil. and USD 1 bil.	
	Asset-weighted average TER	Average fund size (USD mil.)	Asset-weighted average TER	Average fund size (USD mil.)
USA	1.25%	432	0.93%	407
Europe (cross-border Ucits)	1.86%	413	1.30%	382
UK	1.69%	426	1.25%	295

Source: Lipper[14]

This paper does not purport to explain why European investment funds, particularly those distributed in more than one country, are significantly more costly than US funds. Whatever the number of factors, my point is that costs are significant to

12. According to IOSCO's Technical Committee, 'the Total Expense Ratio of a fund is equal to the ratio of the fund's total operating costs to its average net assets,' calculated at least once a year. It includes all recurring and non-recurring costs, except transaction costs of asset purchases and sales. See Annex 2 of the Technical Committee's Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds, November 2004, available at <www.iosco.org>.
13. Lipper, *A Comparison of Mutual Fund Expenses Across The Atlantic*, 26 September 2005, Tables 1 and 2.
14. Ibid., Tables 3 and 4.

investors because they directly affect the performance of their investments. This also applies to distribution costs as well as to other costs.

Obviously, distribution is not only a matter of costs, but also of quality of service. By focusing on the conflicts of interest in the distribution of investment funds, I will show that both are closely connected. The fact that, in the retail market, funds distributors are significantly, and often exclusively, remunerated by fund providers creates conflicts of interest that may increase the costs ultimately borne by investors without promoting a choice of the funds best suited to the interests and needs of the individual investor.

II. REMUNERATION OF FUND DISTRIBUTORS – AN OVERVIEW

Depending on its contract with the investor, the distributor may or may not receive a fee directly from the investor. Financial advice paid for by the retail investor is not yet very common, while discretionary management of portfolios most certainly is. Nonetheless, under its contract with the provider of the fund, the distributor will in most cases obtain some form of remuneration from the fund provider, in one or more ways:[15]

– The investment in the fund may be subject to an entry (or load) fee paid by the investor to the provider. Most of the fee is typically paid back by the provider to the distributor. A 2002 survey shows that the average retrocession for equity funds varied between 79.5 per cent of the entry fee in France to 95.6 per cent in the UK and 95.8 per cent in Switzerland.[16]
– Whether or not the investment is subject to an entry fee, the distributor receives a retrocession (a so-called trail fee) on the management fee paid to the provider in accordance with the fund regulations. The same survey shows a wider range of retrocession on the management fee of equity funds, from 45.8 per cent in the UK and 56.8 per cent in Switzerland to 106.7 per cent in Spain.[17]

I use the word 'retrocession' here to refer to revenue sharing arrangements by which some part of the remuneration paid to the provider by the investor, directly or out of the assets under management, flows back to the distributor as a remuneration for its services to the provider and/or the investor.

Both types of fees and retrocessions differ in their source and periodicity. The entry fee is paid once by the investor to the provider as a percentage of (and

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15. This paper discusses only retrocessions from entry fees and management fees. Similar issues may arise in connection with retrocessions from other (redemption, switch, etc.) fees charged by the fund provider to the investor.
16. *Eurofunds Survey 2002* (no. 8 above), p. 32.
17. Ibid. A figure above 100 per cent indicates that the provider spends all of the management fee plus money from other resources to distribute the fund

in addition to) his investment. The management fee is charged by the distributor directly to the fund, paid out of the assets managed, in accordance with the fund rules;[18] its cost is borne by all investors in the fund since it is deducted from the net asset value (NAV).

It is worth noting that retrocessions are also paid by funds providers to fund distributors within the same firm or financial group.[19] There are at least two reasons for such intra-firm or intra-group retrocessions. First, whether they operate as separate legal entities in the same financial group or as separate business units within the same legal entity, assets management (typically responsible for providing funds), private banking, and retail banking are different profit centres. Each is accountable for its own revenue and profit. The distribution of investment funds must be profitable to the profit centres in charge of the distribution. Secondly, the number of products offered to private investors is steadily increasing; pushing an investment fund all the way through to the ultimate investor requires incentives comparable with those offered on substitute investments, be they investment funds provided by other firms or other financial products such as structured products. This is true not only from the perspective of the managers of the distribution units, but also from the financial perspective of the employee managing the relationship with the customer.

The above figures[20] show that retrocessions are a substantial part of the management fee. Increased competition for 'shelf-space' is driving them up rather than down. This is particularly true of cross-border distribution. Alan Ainsworth, deputy chairman of Threadneedle Investment Services, was recently quoted by the *Financial Times* as saying that cross-border funds based in Luxembourg or Dublin 'have made progress over the last few years by paying higher retrocessions.'[21] Though I do not have any chronological data on retrocessions, this affirmation matches well with the constant increase in management fees observed over more than 10 years.

While the total volume of funds has been increasing sharply, management fees are also on the increase. The most likely explanation, and the one which is offered informally by many actors, is that retrocessions to distributors drive up the management fee out of which they are paid.

The above mostly applies to funds distributed to (retail and private banking) individual investors. Institutional investors (including high net worth individuals) usually have direct access to the provider of the fund and thus need not pay the cost of a distributor. If they do not, and employ an asset manager or a financial advisor to invest in a fund, the terms of the contract will almost always require the advisor to pass on to them any remuneration received from a third party.

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18. In this paper, the term 'fund rules' includes the instruments of incorporation of an investment company.
19. Page 32 of the *Eurofunds Survey 2002* (no. 8 above) reads: 'For manufacturers [funds providers] that have access to proprietary channels, rebates [retrocessions] offered to the latter are higher than those offered to external partners. For the vast majority of respondents, the rebates offered to the proprietary channel are the upper limit. No external [distribution] partner gets more.'
20. See no. 17 above.
21. *Financial Times*, 18 July 2005.

Table 3. TER and Management Fee

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 (prov.)
Total Expense Ratio (%NAV)	2.20	2.00	2.00	2.00	1.89	1.90	1.87	1.84	1.93	2.08	2.05
Management fee including distribution (%NAV)	1.15	1.17	1.19	1.21	1.23	1.25	1.29	1.31	1.34	1.36	1.37
Managed assets in EU (billion EUR)[22]						2,262	3,070	3,333	3,487	3,200	3,599

Source: Fitzrovia International[23]

The scope of this paper is thus limited to conflicts of interest in the distribution of funds to individual investors. These clients have neither the sophistication nor the commercial clout to make their financial advisor or manager agree to pass on to them any remuneration received from third parties in connection with their own investment.

III. CONFLICTS OF INTEREST AT TWO LEVELS

The factual settings of fund distribution and the resulting flows of remuneration give rise to two conflicts of interest: one in the person of the distributor, the other in the person of the provider. These conflicts are legally relevant only if the provider and the distributor are respectively subject to a duty of loyalty to the investor, i.e. a duty to actively protect and promote the investor's interests.[24]

A. FUND PROVIDERS

For investment funds subject to regulatory approval, the fund provider will always be a regulated entity subject to a legal, contractual or regulatory duty of loyalty to investors.

22. The data on assets managed by UCITS investment funds are taken from the Background Paper (no. 2 above), p. 6. Note that it refers to the overall EU market, while TER and management fee refer to equity funds domiciled in Luxembourg and Dublin. The investment fund volume is given here as a proxy for the development of the total market, from which Luxembourg and the Irish Republic profit probably more than other member states.
23. Presentation by Ed Moisson at the Fund Forum International on 8 July 2004. These figures apply to 'mainstream actively managed equity funds domiciled in Luxembourg and Dublin.'
24. See the introductory chapter of this book, pages 3–4; see also V. Simonart, 'Conclusions générales' in *Les conflits d'intérêts* (Brussels, Bruylant, 1997), pp. 303–304.

1. Duty of Loyalty

The law of the European Union imposes a clear duty of loyalty on the fund provider ('management company'). Article 5h of the UCITS Directive[25] requires the provider to try 'to avoid conflicts of interest and, when they cannot be avoided, ensure that the UCITS it manages are fairly treated,' and to ensure that it 'complies with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of its investors.' This wording would seem to distinguish between duties of the provider to the UCITS it manages (to avoid conflicts of interest) on the one hand and its duties to investors in these UCITS (to promote their best interests) on the other. However, Article 5f (1)(b) requires Member States to adopt prudential rules aimed at 'minimiz[ing] the risk of UCITS' or client's interests being prejudiced by conflicts of interest . . . .' It is doubtful whether the interest of a UCIT and the interest of its investors can be distinguished. Losses and other detriments suffered by a UCIT are of necessity borne by all investors in it in proportion to the size of their investments.

Article 12 of the 1994 Swiss Investment Funds Act[26] requires the management company[27] and its agents to safeguard exclusively the interests of investors. As a result, the management company may only obtain and keep the remuneration spelled out in the fund rules; any other compensation or advantage must benefit the fund itself.[28] Conflicts of interest are not specifically mentioned in the 1994 Act. However, the Rules of Conduct adopted in 2000 by the Swiss Funds Association include three general rules dealing with conflicts of interest (adequate organization, employees' compensation policy, regulation and supervision of staff securities transactions).[29] The Swiss Federal Banking Commission, which is also the regulator for the fund industry, has mandated compliance with these rules for all management companies and requires their auditors to report on compliance.[30]

To summarize, both EU and Swiss law impose a duty of loyalty on fund providers and require them to avoid conflicts of interest that may affect the interests

25. See no. 4 above.
26. French, German and Italian authentic versions at <www.admin.ch/ch/f/rs/c951_31.html>; unofficial English translation by KPMG at <www.kpmg.ch/library/gesetzestexte/en/11972.htm> January 2006.
27. Investment funds contemplated by this provision are exclusively contractual arrangements – 'common funds managed by management companies' (see Art. 1(3) of the UCITS Directive) – not unit trusts or investment companies. A new Collective Capital Investment Act is currently being considered by the Swiss Parliament, which will extend this duty to investment companies and other collective investments falling within the (extended) scope of the Act, see *Feuille fédérale* 2005 5993, available at <http://www.admin.ch/ch/f/ff/2005/index0_43.html>.
28. See Arts. 14 (1) and 12 (2) of the Act.
29. Paragraphs 11 – 13 of the Code of conduct for the Swiss fund industry of 30 August 2000, <www.sfa.ch/index.php?setLN=e&site=2&page=13>.
30. See paragraph II.1 of the Annex to the Circular no. 04/2: Self-regulatory rules recognized as minimal standards by the Federal Banking Commission, 21 April 2004, <www.ebk.admin.ch>.

of investors in their funds. If such conflicts cannot be avoided, these interests must be 'treated fairly,' i.e. must not be 'prejudiced.'[31]

2. Retrocession Paid by Fund Providers on the Management Fee

Does the retrocession of some of the management fee by the fund provider to the distributor create a conflict of interest? One might be tempted to answer in the negative. The management fee paid to the fund provider out of the assets under management, in accordance with its contract with the investors, is legitimate compensation that it should be free to use as it wishes. Why should the fund provider's duty of loyalty extend to the use of such compensation? In particular, why should there be any problem in using a (significant) part of its compensation to remunerate distributors?

Though coined as 'retrocession out of the management fee,' the payments only nominally come out of the fees earned by fund providers. In reality, they are commissions negotiated between a fund provider and every distributor, calculated as some fraction (expressed in basis or percentage points) of the net funds invested in the fund by clients of that particular distributor. These commissions are paid out of the assets under management and are then accounted for as part of the so-called management fee. Indeed, the commissions are paid for by the investors collectively. In economic and accounting terms, such payments to distributors flow out of the accounts of the investment funds, not of the fund provider. When negotiating the amount of the distributors' compensation, the fund provider is therefore in a fiduciary position and owes a duty of loyalty to the investors, whose money it uses to pay for services provided by third parties, as it does for custodian banks, asset managers and other service providers.

The provider's conflict of interests comes from the fact that it has a personal interest in increasing assets under management (and its own compensation) by using such commissions to induce distributors to sell more fund shares. While the interest of investors requires compensating distributors for the services investors receive, fund providers have an interest of their own in inducing more sales by paying higher commissions out the investors' assets.

There is an additional component to the provider's conflict of interest, which lies in the potentially corrupting effect of such payments on fund distributors, which may conflict with the best interests of some investors. Compensating distributors for their efforts to bring in new investors or keep current investors in the fund is legitimate up to the point where such compensation induces them to recommend that particular fund in breach of their own duty to the investors. As we shall see below, distributors of funds (unlike distributors of cars or household appliances) are generally under a duty of loyalty to their customers, which is distinct from the fund provider's own duty of loyalty. It should not be the fund provider's responsibility to make sure that the distributor is fulfilling its duty of loyalty, e.g. by second-guessing

31. Comp. Art. 5h (d) and 5f (1)(b) of the UCITS Directive.

recommendations made by distributors to investors. However, the fund provider's own duty of loyalty prevents it from inducing the distributor to act against the investor's interests. After all, an investor induced by a distributor to invest in a given fund is the customer (and principal) of both the distributor and the fund provider.

'Retrocessions out of the management fee,' which are in fact commissions paid out of assets under management, compensate distributors for services rendered to the investors (advice) as well as to fund providers (promotion). When setting the appropriate level for such compensation, a fund provider is serving two interests, its own and its investors'. Retrocessions on management fees thus create a conflict of interest in the person of the fund provider as well as in the person of the fund distributors, as we shall see below.

This very conflict of interest is why, in the United States, SEC Regulation 12b-1 allows a mutual fund to pay distribution and marketing expenses out of the fund's assets provided that this has been approved by a majority of the outstanding voting securities of the investment company and is re-confirmed annually by a decision of the board of directors exercising reasonable business judgment and in the light of their fiduciary duties.[32]

3. Retrocession Paid by Fund Providers on Entry Fees

Entry fees are paid by investors upfront; they are distinct from the money invested in the fund. Who benefits from this entry price is not necessary relevant to the investor. Where the contract between the investor and the distributor does not provide for an explicit advisory fee or brokerage commission, the investor should expect that some or all of the entry fee will serve as remuneration to the distributor. When the investor explicitly pays for the service she gets from the distributor, she may not stop to think that its contractual partner may be getting some additional compensation from a third party, a benefit that the distributor may not be allowed to retain for itself. But this is relevant to the investor's relationship with the distributor, and not to the fund provider.

Do retrocessions out of entry fees raise the same conflict of interest as retrocessions out of management fees? We have just observed that both compensate the same service, viz. the distributor's contribution to the investor's initial decision to invest in a given fund. However, the corrupting effect of sharing the entry fee between the provider and the distributor seems much less problematic because:

– The entry fee is fixed (as opposed to the management fee, the actual amount of which will be determined year on year by the fund provider up to the cap defined by the rules of the particular fund) and easily recognizable by the investor; and

32. Rule 12b-1,'Distribution of Shares by Registered Open-End Management Investment Company,' was adopted by the Securities and Exchange Commission in 1980. The text of the Rule is available at <www.law.uc.edu/CCL/InvCoRls/rule12b-1.html>.

– The entry fee is explicitly designed as the price for being admitted into the fund, a price which reasonably entails the costs of fund distribution about which the investor may seek information from her distributor.

The investor is therefore in a much better position to guess or to find out from the distributor about the compensation the latter will obtain if the investor decides to choose that fund. This largely minimizes the problem from the viewpoint of the fund provider.

B. Fund Distributors

Investment funds can be distributed by various types of financial intermediaries – banks, securities brokers, tied agents, insurance companies and agents, independent financial advisors and portfolio managers, etc. – whose legal status and regulatory duties may differ significantly. Here again, conflicts of interest are legally relevant only if the distributor is subject to a legal, contractual, or regulatory duty of loyalty to the investor.

1. Duty of Loyalty

I shall not attempt here to determine which distributors are subject to such a duty of loyalty and will restrict ourselves to several highlights.

Under EU law, the UCITS Directive does not purport to impose duties on distributors of investment funds. However, the execution of orders or provision of advice in respect of UCITS is an investment service subject to the Markets in Financial Instruments Directive (MiFID).[33] Article 13(3) MiFID requires the investment firm 'to maintain and operate effective organizational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 18 from adversely affecting the interests of its clients.' Article 18(2) provides that if the measures taken 'in accordance with Article 13(3) . . . are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.'

The Swiss Investment Funds Act of 1994 subjects the professional activity of distributing shares in investment funds to licensing by the Federal Banking Commission, unless the distributor is already licensed as a bank, securities house, or insurance company.[34] Apart from good repute, adequate training and experience,

33. Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments . . . OJ L145/1, 2004, (hereafter MiFID).
34. Art. 22 of the Act combined with Art. 23 of its implementing Ordinance, available at <www.admin.ch/ch/f/rs/c951_311.html>. The Swiss Postal Service, which provides certain financial services, is also exempted from this requirement.

liability insurance coverage, and reliable distribution methods, no specific regulatory duties attach to this status except for the requirement of a written contract with funds providers.[35] These few regulatory duties are supplemented by self-regulation adopted by the Swiss Funds Association requiring management companies to include in their distribution contracts a duty for the distributor to avoid conflicts of interest between investors and itself (and its employees) or, where this is not possible, to avoid any detriment to the interests of investors.[36] In fact, the most significant distributors of funds in Switzerland are banks that are also licensed as securities brokers, which Article 11(1)(c) of the Securities Exchange and Securities Trading Act of 1995[37] subjects to a legal duty of loyalty to their customers, including the duty to ensure that the interests of the latter are not adversely affected by potential or actual conflicts of interest. Moreover, a similar duty of loyalty will apply to all distributors of investment funds when the 2006 Collective Investment Act enters into force.[38]

2. Retrocession Received by Fund Distributors

Independent of the fund provider's conflict of interest as described earlier, negotiating for and obtaining retrocession creates a separate conflict of interest in the distributor.

Whether a distributor is required to assess the suitability of the investment for the investor, whether it owes a duty of professional advice or a mere duty of information will depend on its regulatory duties and the nature and extent of the service promised to the investor. As soon as this service includes some use of the distributor's professional judgment, the fact that the distributor receives some level of remuneration from the fund provider, whether as a one-off or periodically, may bias his judgment or appear to do so. The distributor's self-interest in maximizing its income conflicts with its duty to use its professional judgment in the best interests of the investor.

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35. See Art. 22 (1) of the Ordinance. Whether distributors are agents (*mandataires, Beauftragte*) of the management company and therefore subject to the same duty of loyalty under Art. 12 of the Act is controversial, comp. M. den Otter, *AFG: Anlagefondsgesetz* (4th edn, Zurich, Orell Füssli, 2001), p. 58, and M. Küng & M. Büchi, *AFG: Materialien zum Bundesgesetz über die Anlagefonds* . . . , (Kriegstetten: Q Verlag, 1995), p. 148.
36. Para. III.A.3 of the Annex to the SFA Guidelines on fund distribution, 22 October 2001, <www.sfa.ch/index.php?site=2&page=12>. Pursuant to Art. 22 (3) of the Investment Funds Ordinance, the Federal Banking Commission imposes on all licensed distributors the duty to abide by the SFA Guidelines.
37. French, German and Italian authentic versions at <www.admin.ch/ch/f/rs/c954_1.html>, English translation at <www.swx.com/admission/regulation/rules_federal_en.html> (19 August. 2005)
38. See Art. 20 of the Federal Act on Collective Investments of Capital of 23 June 2006, <http://www.admin.ch/ch/f/ff/2006/5533.pdf>.

Indeed, the European legislation implementing the MiFID does recognize that receiving an inducement 'from a person other than the client . . . in relation to a service provided to the client' is a source of conflict of interest.[39]

Recognizing this conflict of interest does not mean that retrocessions should necessarily be banned and distributors be remunerated directly by the investor. This is one of several possible solutions to this conflict, and a radical one. But recognizing the conflicts that retrocessions entail for distributors of funds, as well as for their providers (see above), is a necessary preliminary to the search for possible solutions.

IV. POSSIBLE SOLUTIONS

Having established that, in most cases, retrocessions create conflicts of interest for fund providers as well as for distributors, we can start looking for solutions. As noted above, the most significant conflict arises out of sharing the management fee. For practical purposes, I shall focus largely on solutions in respect of retrocessions out of the management fee. A number of potential solutions can be envisaged, ranging from the most radical and undifferentiated to preserving the status quo. I shall go through them under three headings: prohibiting retrocessions, regulating retrocessions, and disclosing retrocessions to investors.

A. Prohibiting Retrocessions

The most radical and undifferentiated option would be to partially or entirely prohibit the payment of retrocessions by fund providers to distributors. Full prohibition would avoid all conflicts of interest arising out of such payments. This is the least liberal remedy: prohibition prevents market forces from applying. It is not *per se* unacceptable, but should only be considered if no other, lighter approach equally avoids conflicts of interest, or at least enables them to be managed so as not to disadvantage investors. A prohibition approach need not be absolute. It can differentiate between entry fees and management fees, which do not raise identical problems. It may also be subject to waiver by the investor as the party whose interests are endangered by the conflict.

Retrocessions on entry fees actually compensate the distributor for a service provided to the investor: information, transmission of order and payment, and quite often some form of advice. The provision of such services is useful and beneficial to investors. If they are not adequately remunerated, they will not be provided. At the same time, the remuneration creates an incentive to recommend (or limit the proposal of) funds based on the amount of remuneration received through retrocessions rather than on suitability to the needs of the investor. This is a problem

39. See Art. 21(e) and 26 of the Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC . . . as regards organizational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L241/26, 2006.

faced by buyers of complex goods and services. It is legally relevant when the distributor is subject to a duty of loyalty; a situation that does not generally apply to the sale of washer-dryers, automobiles or home cinemas. However, this conflict of interest might be effectively managed by other measures such as disclosure, as considered below.

Retrocessions on management fees can also be considered additional, deferred and periodic compensation for the same services performed at the time of investment. This does not imply that they should receive the same treatment as retrocessions on entry fees. Because retrocessions on management fees are periodic, their aggregate sum is not measured according to the extent or quality of the service provided to the investor, but according to the duration of his investment. This can also be construed as compensation for the loss on retrocessions on entry fees forfeited because the investment in the original fund is maintained. The incentives so created are not aligned with the interests of the investor.

In addition, informal discussions and queries show that individual investors are generally aware that the entry fee they are charged is used, at least partly, to compensate their distributor. The vast majority, however, are not aware that part of the yearly management fee represents regular payments to distributors. The mere words 'management fee' certainly do not suggest that a significant part of it is used to compensate and incentivize distributors.

Straightforward prohibition is nonetheless an unattractive solution. If the competitive market for distribution services ('shelf-space') calls for retrocessions, then their abolition is unlikely to achieve an efficient solution and is likely to be evaded in more obscure ways.

As an alternative, prohibition of retrocessions could be designed as a *default rule* which an *investor may agree to waive*. This in fact is the basic rule in a number of legal systems. In English and American law, fiduciaries – including financial advisors and wealth managers – are not allowed to make a secret profit out of their office.[40] Under Swiss law, the duty of loyalty includes the agent's duty to account to the principal for any benefit received from third parties in connection with his services.[41] In both systems that rule may be waived by the principal. To be valid, a waiver is generally conditional on full prior disclosure by the fiduciary. Whether or not the waiver can be implicit is a separate question; one that will be discussed later in connection with disclosure.[42]

The significance of this default rule is evidenced by the fact that experienced investors – such as institutional investors, high net worth individuals, and family officers – do not usually waive it in their relationship with their financial advisor or asset manager. They negotiate the whole remuneration structure for which they are going to be charged and therefore include in their contracts an explicit duty for

40. Rather than focusing on fiduciaries and fiduciary obligations, this paper approaches the issue through the duty of loyalty, the core equitable obligation of fiduciaries. As discussed in pages 247–248 above, most funds distributors owe a duty of loyalty to investors.
41. Art. 400 of the Swiss Code of Obligations.
42. See pages 352ff below.

the advisor or manager to account for compensation received from third parties, including brokers and fund providers.

A similar policy can take the shape of a menu approach requiring financial advisors to offer investors an explicit choice between options. This was the approach taken by the UK Financial Services Authority in its recent move towards 'depolarization'. The regulation used to oblige each financial advisor either to be 'independent' and offer products from the whole of the market, or to be 'tied' to a single provider whose products it was distributing. In 2004, FSA changed its policy and authorized advisers to offer products from a (limited) number of providers.[43] This policy is linked to a significant improvement in disclosure about the services offered and their price. It is interesting, from the perspective of this study, that 'independent financial advisors' (IFA) are now required to offer their customers a choice between a fee-based and a retrocession-based[44] approach. Customers must be free to compensate their advisor directly and exclusively if they wish, in which case they will benefit from any payments or other advantages received by the adviser from third parties.

B. Regulating the Level of Retrocessions

We have seen that the conflicts of interest that retrocessions create for fund providers and for fund distributors are not identical. Fund providers negotiate retrocessions with distributors to increase investment in their funds, which serves their own interest in maximizing revenue, but not necessarily the interests of investors, who nonetheless are charged for it. At the other end, distributors negotiate and obtain a financial incentive which may bias their professional judgment in advising investors.

The distributor's conflict of interest arises from the fact that, for any class of funds (equity, bonds, money-market, etc.), a distributor is unlikely to negotiate the same level of retrocession from different providers. This is the normal consequence of fund providers competing for 'shelf space' and privileged access to investors. One simplistic answer would be for legislation or regulation to fix a uniform level of retrocessions for each class of funds. This would suppress the incentive for distributors to advise their clients based on any other consideration than the intrinsic quality of the funds and their suitability for individual investors. By the same token, the provider's conflict of interest would be avoided because fixed retrocessions dispense providers from the need to balance their own interests with those of investors when negotiating distribution agreements.

However, it is widely accepted that regulating the price of services in a competitive industry should generally be avoided. However carefully determined, regulated

43. See Financial Services Authority, *Reforming Polarisation: Implementation*, November 2004, Policy Statement 04/27, <www.fsa.gov.uk>.
44. The FSA uses the terms 'commission' or 'product charge' for the compensation paid to the distributor by the provider of a financial product.

prices are likely to be less efficient than competitive prices. They do not readily adapt to market changes, and may create wrong incentives or disincentives.

In addition, price regulation is politically unacceptable. Financial markets are supposed to be the epitome of, or at least the best approximation to, a perfect market. Regulated prices, in so far as they used to exist in the guise of maximum interest rates or no-interest no-fee checking accounts, have become anathema and have been systematically dismantled.[45] Even central banks, which enjoy a legal monopoly, have moved towards implementing monetary policy mostly through open-market mechanisms.

C. Disclosing Retrocessions to Investors

It is generally agreed that where financial markets are concerned, it would be inefficient to avoid conflicts of interest absolutely. There is arguably no financial market without intermediation. Intermediaries often deal for the account of numerous clients, whose interest may conflict, and often for their own account as well. Conflicts of interest that would be perceived as unacceptable in other professions, such as the law, are not yet perceived as such in the financial industry. Because they cannot be completely avoided, conflicts of interest are tolerated provided that, when they occur, clients are 'treated fairly,' or in a manner that is 'not detrimental to their interests.' When this cannot be achieved 'with reasonable confidence,' a financial services provider 'must clearly disclose the general nature and/or source of conflicts of interest to the client before undertaking business on its behalf.'[46]

Disclosure differs from other approaches because, where conflicts of interest cannot be avoided and the interests of the client are even potentially at risk, the decision on whether that risk is acceptable is left to the client, who is empowered to take his interests into his own hands. Disclosure enables the client to either accept the risk or withdraw from the contract and, if at all possible, try to secure better terms for himself with some other intermediary.

Disclosure is the approach adopted by the Swiss Funds Association (SFA) in its Directive regarding transparency in management fees of 7 June 2005.[47,48] Partly inspired by SEC Rule 12b-1[49] this self-regulation is (to my knowledge) the first

45. See recently the European Court of Justice judgment of 5 October 2004 that legislation prohibiting banks from remunerating sight accounts in euros is contrary to the EU Treaty, case C-442/02, *CaixaBank France v. Ministère de l'Economie, des Finances et de l'Industrie.*
46. Article 18 (2) MiFID.
47. This directive was reviewed by the Federal Banking Commission and designated as a minimal standard applicable to all management companies. See no. 27 above.
48. After the finalization of this chapter, the SFA was authorized by the Federal Banking Commission to delay the enforcement of its Directive of 7 June 2005 while it is trying to identify an alternative approach move in line with the European Standards, especially as set out in the Market for Financial Instruments Directive.
49. See above, no. 32 and accompanying text.

of its kind in Europe, including the UK.[50] It is in the line with the IOSCO's *Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds* of November 2004,[51] as well as with the *Asset Manager Code of Professional Conduct* adopted by the Center for Financial Market Integrity in 2005.[52]

The SFA regulation applies to investment funds marketed to the public, not to funds (or classes of shares) restricted to institutional investors. The regulation deals with two different issues:

– Retrocessions paid to distributors out of the management fee[53] are admissible provided that their existence and their actual or maximum level are disclosed in the fund rules and in the prospectus. When that is the case, the fund rules and the prospectus must indicate the actual or maximum levels of the following three components of the management fee: administration of the fund, management of the assets, and distribution. When (as should almost always be the case) maximum levels are disclosed, then the total sum of the three components may not exceed 150 per cent of the maximum management fee. Obviously, the sum of the actual components may not exceed the maximum management fee. This *ex ante* disclosure by way of maximums is meant to allow fund providers to negotiate retrocessions with distributors without divulging to them the actual overall level of retrocessions.

50. Schedules A (under 1.18) and C in Annex 1 to the UCITS Directive, as amended in 2001, set a rather vague standard regarding disclosure of remuneration payable to third parties. Commission Recommendation 2004/384/EC of 27 April 2004, OJ L 144/44, 2004 recommends that the simplified prospectus should give' an indication of the existence of fee-sharing agreements and soft commission' (point 2.2.1 (f)). Fee-sharing agreements are defined in pt. 2.2.2.1 as 'those agreements whereby a party remunerated, either directly or indirectly, out of the assets of a UCIT agrees to split its remuneration with another party and which result in that other party meeting expenses through this fee-sharing agreement that should normally be met, either directly or indirectly, out of the assets of the UCITS.'
51. Report adopted in November by the Technical Committee of the International Organization of Securities Commissions, <www.iosco.org>; see above footnote 12. Payments to distributors out of funds assets are only marginally discussed, see para. 12 on page 3 with footnote 3 and Annex 1 (Examples of a fee table).
52. It recommends the disclosure of conflicts of interest with brokers resulting *inter alia* from 'soft or bundled commissions, referral and placement fees, trailing commissions, sales incentives . . . 'as well as 'management fees and other investment costs charged to investors, including what costs are included in the fees and the methodologies for determining fees and costs.' See Appendix I, under F.4.a and d, at p. 17–18. Available at <www.cfainstitute.org/cfacenter/positions/pdf/asset_manager_code.pdf>.
53. Notwithstanding the need for some international convergence of terminology, the SFA directive uses the German word *Bestandespflegekommission* and the French neologism *commission d'état. Literally translated, Bestandespflegekommission* means a commission paid [to the distributor] for maintaining the assets [invested in the fund].

– *Rebates*[54] on the management fee in favour of certain classes of investors are admissible provided that they are implemented in one of two ways. For investment funds open to the public, certain classes of share may carry lower management fees provided that their eligibility requirements are transparent for all investors. Rebates are also admissible for funds restricted to certain qualifying institutional investors. In both cases, the maximum management fee for every class of shares must be disclosed in the fund rules and in the prospectus. Rebates to investors are different from retrocessions from distributors because they entail no conflict of interest but they violate the equality of treatment among investors. I shall not discuss them further here.

The SFA regulation is the result of much discussion within the industry and with the Swiss Federal Banking Commission. Since its enforcement has been postponed,[55] it is impossible to assess the impact of this solution. In the next two parts of this paper, I will discuss the pros and cons of the disclosure approach and some alternatives in its design.

The Market in Financial Instruments Directive (MiFID) is mostly based on disclosure. Article 26 of the Commission Directive 2006/73/EC implementing the MiFID deems investment firms receiving such payments not to be acting 'honestly, fairly and professionally' unless two requirements are met:[56]

> '(i) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service;
> (ii) the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the firm's duty to act in the best interests of the client.'

Two differences between the Swiss and the proposed EU approaches are worth noting. The former relies on disclosure by the providers of funds while the latter, which applies to all investment firms, relies on disclosure by the distributors. In addition, the latter requires that the payments received by the distributors must enhance the quality of the service provided and not imperil its duty of loyalty.

Why has the Swiss Funds Association opted for disclosure by fund providers rather than by fund distributors? Part of the answer lies in Switzerland's regulatory

54. Unfortunately called 'retrocessions' in French and 'Rückvergütungen' in German.
55. After the finalization of this chapter, the SFA was authorized by the Federal Banking Commission to delay the enforcement of its Directive of 7 June 2005 while it is trying to identify an alternative approach move in line with the European Standards, especially as set out in the Market for Financial Instruments Directive.
56. OJ L241/16, 2006.

approach to the distribution of financial products. Unlike the European Union, where MiFID complements the UCITS Directive by mandating licensing, supervision and conduct of business rules for all distributors of investment products, the Swiss 1994 Investment Fund Act deals marginally with the distribution of funds. Distributors must be licensed, but they are subject neither to substantive prudential supervision nor to specific conduct of business rules.[57] While not entirely impossible, it would have been more difficult – and probably ineffective – to impose disclosure regarding retrocessions on fund distributors rather than on fund providers. Another reason is that disclosure at the fund provider's level (as implemented by the SFA) does not pursue the same objectives as disclosure at the distributor's level (as required by the British FSA or by the draft EU directive implementing MiFID). The former allows investors to make choices based on the distribution costs of various funds; the latter allows investors to discriminate among financial advisors based on their prices. I shall discuss this further in Section VII.

V. THE CASE FOR DISCLOSURE

Disclosure is typically used when conflicts cannot be fully avoided and are not otherwise managed. Disclosure is a necessary basis for the *client's consent* to the risk of being exposed to a conflict of interests and to its potential detrimental consequences. If not explicitly stated, consent may be implied in the client's informed decision not to terminate or renegotiate his relationship with the conflicted party. Thus, disclosure *allows the client to take his interests into his own hands*. Disclosure also *allows market forces to apply* to the management of conflicts and to the pricing of services. Clients may agree to pay more to avoid exposure to certain conflicts of interest, or may want to pay less when they take the risk of some detrimental consequences.

There are significant merits to a disclosure approach for the distribution of investment funds.

On the one hand, disclosure of retrocessions enables investors to factor this cost component, which is ultimately borne by them, into their choice of a distributor (if distributor-specific retrocessions are disclosed) and of one or more investment funds (based on fund-related disclosure). Without disclosure, the investor negotiates direct compensation (fees, commission), if any, with the distributor. Typically, an individual investor will not know of the additional compensation his distributor receives from the fund provider by way of retrocession. He cannot effectively negotiate the total compensation, including the indirect part received as retrocessions, for the service he receives from the distributor. It is true that sophisticated

57. At the time this article is finalised (May 2006), it is still unclear whether the Swiss Parliament will maintain, extend or entirely abandon the (narrow) regulation of funds distributors who are neither banks, securities firms or otherwise regulated entities.

investors who enjoy some degree of bargaining power can, and sometimes do, ask their distributors about retrocessions. In actual fact, only institutional investors and high net worth individuals can do so. When they are not dealing directly with the fund provider, thus by-passing distribution channels, they negotiate with their distributor (typically an asset manager or financial advisor) some form of direct compensation; the distributor undertakes to pass on to the investor any hard or soft compensation received from third parties. This approach does not apply to retail investors because they have neither the necessary information and expertise nor the commercial influence.

Disclosing the level of retrocessions applicable to various investment funds enables the investor to ask the distributor how he benefits from them. Transparency on retrocessions may trigger competition at two different levels:

– Providers of funds might compete on management fees by offering funds with lower retrocessions, and thus lower management fees. With the same gross performance, lower management fee means higher net performance for the investor. Distributors might not like offering funds on which they receive less retrocession, but in a market in which an excessive number of similar, under-sized funds compete for investors, investors might express their preference for such funds.[58]
– If distributors think that these low-retrocession funds do not adequately compensate their services, they may want to negotiate some (additional) remuneration to be paid directly by investors. Investors would then have to negotiate their distributor's total remuneration, something that they do not get a chance to do in the present situation.

For investors, taking their interests in their own hands means, in this context, that disclosure may provide them with more price competition at two levels, *i.e.* management fees charged to the assets of the funds and/or distributor fees and commissions charged to them directly by distributors.

Finally, better transparency on distribution costs might generate more investment in funds by improving investor confidence. A study commissioned by Bank of New York and published in July 2004 under the title *Restoring Broken Trust* strongly corroborates this argument. A survey of a sample of professionals representative of the various participants in the European fund market, it provides an insight into why the industry itself thinks investor confidence has been damaged (more strongly in the UK and in Germany than in other European countries) and what measures could help restore confidence. Among the most frequently cited factors that are important to regaining trust, three of the top four deal with 'increased integrity of promoters' (first, 87 per cent), 'putting client interests before asset gathering'

58. In its recent report (no. 13 above), Lipper notes at p. 6: 'Furthermore, it is interesting that in the U.S. 'low-cost' brands that are perceived to have proactively addressed investor concerns seem to have a competitive advantage in attracting assets. At the very least it seems worth considering whether such an arrangement is feasible for European funds.'

(third, 83 per cent), and 'payment by fees not commission' (fourth, 66 per cent). Seventy-five per cent of respondents agreed or strongly agreed with the proposition that greater transparency in the costs of funds would improve investor confidence in these products.

VI. THE CASE AGAINST DISCLOSURE

There are two main objections to disclosing retrocessions in the investment funds industry.

First, it is often suggested that retail investors do not care how, or how much, distributors are compensated; they look at the fund's performance and are only interested in the total level of costs which impact that performance, not in their components (including distribution). Regulation or self-regulation need not and should not go beyond requiring adequate (standardized) transparency on performance and the Total Expense Ratio (TER).

It is a fact that, at present, most retail investors do not seem to look actively for the best bargain. They typically decide among the funds offered by their long-term financial service provider, their bank in most cases. Since these investors do not compare the performance and costs of a wider choice of funds suitable to their needs, additional cost information is unlikely to affect their behaviour. Nonetheless, a smaller group of retail or private banking investors is indeed pro-active. Their need for information is served by specialized publications, often based on research and tables compiled by firms such as Standard & Poors (Micropal) and Fitzrovia, web sources including multi-funds platforms, fairs, and questions to their usual financial advisors.

Pro-active investors are interested in knowing what part of the management fee is compensating distribution, as opposed to asset management and administration. Research is expensive. If more of the management fee is spent on distribution, less is available for quality research.

Secondly, fund providers fear that disclosing the current level of retrocessions in any format will increase expectations from distributors and drive retrocessions up.[59] Distributors who negotiated remuneration at a lower level than the published data would want to re-negotiate their contracts.

This argument appears wrong-headed. In markets for most goods and services, the remuneration obtained by distributors vary considerably depending on the brand value of the goods or services, the distributor's market share and reputation, volume, etc. Fund providers and distributors are aware of the many factors that determine the level of retrocessions. They are also well aware of the range of retrocessions.[60] Disclosing aggregate figures for individual funds to investors will

59. This is the 'Lake Wobegon effect' referred to in R. Bahar's contribution, Chapter 3, page 118 ff. above.
60. See for example the *Eurofunds Survey* 2002 (no. 8 above), from which most figures in section II are drawn.

not bring new information to distributors. The problem lies not with the principle but with the practice, which should not compromise the capacity of providers to negotiate remuneration with distributors. This is discussed in the next section.

VII. WHO IS TO DISCLOSE WHAT, WHEN, AND HOW?

Disclosure of retrocessions for individual funds can be designed in a number of different ways. The actual design should provide information that is significant enough for investors (i) to discount the bias that retrocessions create for distributors in their selection and advice and, subject to their commercial influence, and (ii) to negotiate the total price they are willing to pay for the distribution of funds.

Who should disclose? Disclosure by distributors fulfils at least the second objective. The investor knows how much the distributor will receive from his own investment and can therefore appreciate the (total) price he is paying for this service. He can thus shop around for his preferred balance between price and extent and quality of service. However, this may not satisfy the first objective if the disclosure relates to a class of products as a whole (investment funds) and not to individual funds. For example, the 'keyfact' disclosure required by the British FSA from independent financial advisors informs investors about the average retrocession paid by investment fund providers to the disclosing advisor, but not about the specific level of retrocession paid by fund providers in relation to various investment funds.[61] It does not, and could never, provide the investor with enough information to discount the incentive effect of increased retrocessions paid by providers to promote specific funds. Indeed, the FSA policy is not meant to achieve this first objective, which is more closely related to the conflict of interest question addressed in this paper.

Fund-specific disclosure is better and more efficiently achieved by fund providers. Aggregate, non-distributor-specific figures give an indication as to the incentives offered to distributors. They allow market forces to apply to the selection of specific funds, as well as to the overall level of retrocessions paid to distributors. Both potential effects of fund-specific disclosure must be examined separately.

Comparing the level of retrocession across all investment funds, across investment funds in the same asset type or management style, or across investment funds offered by the same provider would provide the market with signals as to the aggressiveness of promotion and the incentive bias to which distributors are exposed in making their recommendations. This type of information may be used by individual, sophisticated investors. It is likely to be used by financial analysts and to be reflected in fund table-leagues, and will thus be brought to the attention of a larger audience of investors. While the TER impacts the overall performance of funds, its

61. See Tables 1 and 2 of Annex 2 to Policy Statement 04/27 (no. 45 above).

distribution component signals potential bias on the distribution side. Both pieces of information are valuable; neither quite replaces the other.

What, how and when to disclose? What can and should be disclosed obviously depends on who does the disclosing. The FSA requirements applying to independent financial advisors give an example of the degree of disclosure that can be achieved by distributors. It allows investors to make comparisons between distributors and classes of products (i.e. investment funds as opposed to life insurance policies), but not within each class.

The SFA regulation is an example of disclosure by fund providers. The exact design of disclosure will depend on the balance to be achieved between the interests of investors and of distributors. Investors may wish to obtain *ex ante* as well as *ex post* disclosure. Investment funds provide for both types of disclosure: prospectus: simplified prospectus are designed to inform investors before their investment decision; annual and other periodical reports inform investors about the performance of their investments. Since the actual level of retrocession is subject to bargaining between the fund provider and the individual distributor, *ex ante* disclosure on retrocession to distributors must almost necessarily be framed as a maximum percentage or a percentage bracket. *Ex post* disclosure may express the retrocessions actually paid or due as a percentage of the net asset value of the fund. That type of information is however quite sensitive; it affects the bargaining position of providers when setting the level of retrocession with individual distributors, creating a ratchetting effect.

The SFA has opted for *ex post* disclosure of the maximum management fee allowed (as a percentage) and a breakdown into its three components: administration,[62] asset management,[63] and distribution,[64] with a maximum percentage for each component. The total of the maximum percentage of each component must be no greater than 150 per cent of the maximum management fee. The total of each actual component, i.e. the actual management fee, must obviously not exceed the maximum management fee.

The SFA approach gives fund providers flexibility at the cost of some lack of transparency for investors. Comparing the maximums for each component *ex ante* may provide quite a different impression from the real weight of each component in the management fee as disclosed *ex post*. A hypothetical example will show how.

62. Includes administrative functions, risk management, internal control system (ICS) and compliance, monitoring and supervising authorized agents, accounting, controlling, financial statements, valuing fund assets, calculating the NAV, issuing mandatory publications, and all other functions not connected with asset management or the distribution of fund units.
63. Includes research and analysis, making investment decisions and reporting on investment policy to unit holders.
64. Includes working with sales agents/partners as well as institutional investors, marketing, road shows and sales discussions with investors.

Table 4. Hypothetical Disclosure According to SFA Regulation

	Maximum allowed	Relative weight of each component	Actual expense	Relative weight of each component
Management fee	2.0		1.59	
▪ Administration	0.4	13.3%	0.21	13.2%
▪ Asset management	1.6	53.3%	0.41	25.8%
▪ Distribution	1.0	33.3%	0.97	61.0%
Total of components	3.0	100%	1.59	100%

The figures disclosed to investors are highlighted in this table. *Ex ante* disclosure (column 'maximum allowed') suggests that asset management weighs more heavily than the other components, with distribution accounting for a third. *Ex post*, actual expense disclosure indicates that the total management fee remains well under control, below its maximum. But undisclosed component weighting shows that distribution really accounts for three-fifth of the total management fee, quite a different proportion from the one suggested in the disclosed maximum component. This distorting effect results from the rule that the disclosed total maximum for each component may exceed the total management fee by 50 per cent.

VIII. IS DISCLOSURE ENOUGH?

One reasonable approach for the policy-maker designing a legal rule is to look at real agreements negotiated by parties with similar sophistication and market power. Informal enquiries and inspection of a few actual contracts indicate that institutional investors negotiate fee-only remuneration with their asset managers and advisors. Payments and discounts granted by third parties are passed on to these investors. This strongly suggests that the traditional rule prohibiting fiduciaries from keeping secret benefits for themselves is optimal. It is also liberal because it allows the fiduciary and its client to depart from the legal rule and make their own deal.

For retail investors, who are less sophisticated and enjoy less commercial influence, this rule is contracted out in the guise of a general clause authorizing financial advisors, asset managers, and other retail distributors to keep for themselves benefits they might receive from third parties in connection with their clients' investment. Such clauses hide the true extent of the price paid by the investor to her direct intermediary as well as the incentives that may bias that intermediary's professional judgment. This is not acceptable unless some degree of transparency is achieved to allow the investor to take her interests into her own hands.

However smartly designed, can disclosure promote more investor awareness and more competition on distribution costs? It is too early to assess the effects either of the British FSA's depolarization policy or of the Swiss Funds Association's new self-regulation.

Additional arrangements could be devised to make use of the disclosed information on behalf of investors. This is not a new concept in the financial markets,

where debenture trustees and other bondholders' representatives are appointed to monitor the issuer's solvency and behaviour and are usually empowered to make decisions on behalf of all investors (triggering acceleration clauses and the like). The FSA proposes building on the same concept when it suggests that the new requirement to disclose soft commission arrangements between fund providers and securities dealers[65] should include scrutiny by an individual or group representing the retail investors. This representative should have knowledge and experience of investment activity, authority and confidence to discuss with the fund providers, and sufficient incentive to carry out the task diligently. Based on the disclosed information, he would be required to ask questions and request explanations from the provider of the fund, and to express views in general terms or in relation to a particular arrangement.[66]

Whether or not the disclosure of certain information will prove useful to investors is often no more than an educated guess. Are investors better served by the disclosure of significant shareholdings in listed companies, or of management transactions in the same? What will be the value to investors of knowing how much distribution costs affect the performance of their investment? Beyond political arguments, lawyers will be looking for empirical research to verify the relevance of their thinking. Or will they?

65. See Policy Statement 05/9: *Bundled brokerage and soft commission arrangements – Feedback on CP05/5 and final rules, July 2005, available at* <www.fsa.gov.uk>.
66. See Consultation Paper 05/13: *Bundled brokerage and soft commission arrangements for retail investment funds*, September 2005, available at <www.fsa.gov.uk>.

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