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What effect will the new IMA/NAPF code on transparency of fund manager charges have on schemes? This will inevitably benefit schemes at the cost of fund managers. Is the code likely to become statutory and why/why not? What are the legal implications of this "voluntary" code?

IMA Pension Fund Disclosure Code

Jonathan Berman, Head of Sacker & Partners' Investment Unit, reviews the new code on transparency of investment costs and the legal implications for UK pension schemes.

Introduction

The new code has been produced by a joint working group of the Investment Management Association (IMA) and the NAPF. Its purpose is to promote greater transparency of investment costs, and through disclosure of costs help trustees monitor the costs incurred for their funds and compare these with the approach of other managers.

It is important to note that the IMA has no legal authority to impose standards or reporting requirements and that the code itself only sets out minimum standards.

Historical context

The Myners review contrasts the visibility of fund management charges with the relative lack of transparency for comparable sums spent on brokers' commissions. There is no tradition in the UK of calculating the aggregate cost of commissions over a period. Charges are paid directly by funds without the active involvement of trustees. The effect of this has been to encourage the outsourcing of research by managers who have been permitted to pass on part of their overhead costs to their pension trustee clients through soft commissions.

The Government's response to Myners recommended greater transparency and produced a series of 10 penetrating questions on transaction costs for trustees routinely to ask their managers.

Two level approach to disclosure

The code proposes a two tier approach. Level One Disclosure addresses company wide policies of the manager and is to be provided annually. Level Two Disclosure contemplates client specific data to be provided at least six monthly. Managers may only claim compliance with the code if they comply with all aspects of both levels.

Timetable for implementation

Level One Disclosure is to be brought in by the end of 2002 or earlier. Level Two Disclosure is to be introduced for reporting periods beginning in the first half of 2003. This timetable recognises the need for managers to install or amend their systems.

Most of the information to be disclosed is already available to managers to comply with FSA requirements, but managers have not hitherto been required to collect data on a scheme by scheme basis.

More than just transaction costs

The code goes well beyond transaction costs to cover all costs incurred directly or indirectly in the fund management process. This means that the code is not only concerned with *explicit* costs, such as brokers' commissions and stamp duty, but is also concerned with *implicit* costs incurred through spreads, market impact and opportunity costs.

Difficulty in measuring implicit costs

The code recognises that trustees will want numerical disclosures in a standardised format. However, the code also recognises that there is no accepted methodology to measure implicit costs reliably. In these circumstances, the code only requires quantitative disclosure of costs that can be measured with certainty, and does not prescribe any particular approach to measuring implicit costs, although the manager should state its approach.

Scope of code

The code applies to portfolios of listed securities including cash and pooled funds/collective investment schemes. The code addresses all explicit costs including brokers' commissions, fund management fees, foreign exchange charges and taxation (stamp duty and VAT) and also all the implicit costs referred to above. It does not apply to real property or private equity. For in-house pooled vehicles, total costs are to be disclosed in monetary terms or as a percentage of the fund.

Effects on pension schemes

- The code will help trustees comply with this aspect of the Myners review and their ability to address the Government's list of recommended questions to managers on transaction costs.

- When investment returns are under pressure, the code will help bring all the components of investment costs into sharper focus.

- The code will hand a useful tool to trustees to assist their monitoring of managers more effectively at a time when trustees are likely to be legally required to be familiar with the investment issues. Trustees will be able to challenge managers with higher dealing costs and enquire more readily whether their dealing process has added value.

- Areas previously neglected will come under review. For example:

  - trustees should be able to check more easily whether their funds are receiving best execution;

  - managers will be required to clarify the amount traded with associates, and how they deal with the inevitable conflicts of interest;

  - a new spotlight can be shone on foreign exchange transactions, and whether these have just been conducted with the trustee's custodian or with a range of counterparties. This should lead to greater visibility of the applicable exchange rates.

- The disclosure of the manager's justification or, more likely, the lack of justification for soft commissions should accelerate the decline of such arrangements, at least in the UK.

- The code should promote greater understanding of the dealing process and how this can add or lose value through the choice of dealing venues and methods, for example, when managers choose to arrange internal crossing or use external crossing networks to minimise costs.

Will the code be legally binding?

The code is voluntary and is not intended to be legally binding. One could foresee a potential impact in the attitude of the FSA to potential rule changes in the light of the disclosure of managers' practices. At this stage it is too early to tell.

The substance of the code and, in particular, the recognised absence of an accepted methodology of measuring the implicit costs involved, means that legislation in this area would be inappropriate and extremely unlikely.

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