Knowledge based solutions

Research Update: December 2013

Clean and Super Clean Share Classes

Unit-Linked Funds

George McCutcheon MSc FIA discusses clean and super clean share classes

Background

Regulatory (Retail Distribution Review) and fiscal changes (HMRC Brief 04/13) for rebates have resulted in the introduction by fund providers of clean and super clean share classes. This research note is relevant for life companies (both UK and non-UK) who invest in collective investment schemes. In this research update, George McCutcheon discusses this important issue in more detail.

Background (regulatory and fiscal)

RDR has resulted in the introduction of new share classes within collective investment schemes (CIS). These post-RDR 'clean' classes bear a lower annual management charge, excluding the portion of the charge that was formerly rebated to advisers, in line with the RDR ban on commission payments.

In April 2013 the FCA published Policy Statement PS 13/1. This followed on from the June 2012 Consultation Paper (CP) 12/12 'Payments to platform service providers and cash rebates from providers to consumers'. It consulted on changes to how platforms[1] used by both advised and non-advised consumers would be paid. It set out the FCA intention to prevent platforms from being funded by payments from product providers[2]. It also proposed preventing platforms in the non-advised market from passing on rebates to consumers in cash and sought views on a possible read-across of platform rules on payments for services to non-platforms markets.

The key rules (with transitional arrangements for legacy business) are:

- A platform service provider is to be remunerated solely (with some specified exceptions) by a platform charge disclosed to, and agreed by, the consumer.
- A ban on cash rebates[3] for both advised and non-advised platforms.

The new rules will come into effect on 6 April 2014 with the rules in relation to legacy payments to come into force on 6 April 2016. The objectives of the rules are:

- To support the FCA objectives of securing an appropriate degree of protection for consumers and promoting effective competition in the interests of consumers.
- To restrict the influence that product providers and platforms have on the promotion of one fund over another.
- To promote effective competition in the market by removing product provider influence over the distribution of products and adviser remuneration and improving the clarity of services offered by firms to consumers. The distribution of funds will also not be influenced by rebates from product providers to platforms.

The FCA said that it believed that there is a strong argument for the application of similar rules to adjacent markets and particularly in the execution-only and self-invested personal pension (SIPP) markets. The FCA will consider these markets as part of its ongoing work and will aim to consult later on any rules, where necessary.

HMRC Brief 04/13[4] dramatically altered the position for retail investors because the status quo of fund prices with a typical annual management charge (AMC) of 1.5%, which allow for a proportion of the AMC to be rebated to the consumer, could give a potentially poor outcome for consumers from a tax perspective. Given the tax treatment[5] of rebates as clarified by HMRC, it would be more efficient for retail investors for fund prices to strip out most of or the entire rebate built into fund prices. Consumers could then buy a share class with no rebate or a minimal rebate, since they would be paying upfront charges for advice and the platform service. This would lend support to an industry move towards clean share classes and fully transparent pricing.

[1] 'Platforms' are internet-based services used by retail intermediaries and retail clients to view and administer investments. In the UK, as well as acting as distributors of collective investment schemes and other financial instruments (receiving and transmitting orders as well as executing orders on behalf of clients), platforms are also involved in the provision of services for the safekeeping and administration of financial instruments for the account of clients.

[2] 'Product providers' is a general term used by the FCA and in this note it generally is referring to fund management groups providing collective fund 'products'.

[3] The ban on cash rebates is to ensure that the platform's charges are not hidden or obscured by cash rebates to retail clients.

[4] HMRC Brief 04/13 sets out the position regarding the tax treatment of rebates from product providers and intermediaries to consumers (in both cash and units)

[5] Rebates are subject to Income Tax in accordance with S683 Income Tax (Trading and Other Income) Act 2005.

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Retail Investors (Personal Taxation)
The assessment for a UK retail investor of whether a retail share class with rebate is better or worse than a clean share class needs to allow for the effect of taxation. This is because the income tax rate and the capital gains tax rate differ for a UK retail investor.
The aggregate net cost to a UK retail investor of the AMC is the net (of CGT) cost of the CIS AMC less the net (of income tax) rebate. The formula is (1-[CGT Rate]) *[CIS AMC] – (1-[Income Tax Rate])*[Rebate].
The formula for the clean share class is (1-[CGT Rate]) *[CIS Clean Share Class AMC].

In cases where the [Income Tax Rate] exceeds the [CGT Rate], the rebate must exceed the excess of the retail share class AMC over the clean share class AMC in order to compensate for the tax disadvantage arising from the rebate being taxed as income whilst the CIS AMC is tax relieved at the CGT rate.

For example, for a 1.5% retail share class, a UK 40% higher rate taxpayer paying CGT at 28% would require a 0.9% rebate to be no worse off than the alternative of a 0.75% clean share class as the net cost of the retail share class would be (1-0.28)* 1.5 – (1-0.4)*0.9=0.54% equating to the net cost of the clean share class of (1-0.28)*0.75=0.54%.
The excess of the 0.9% over the AMC differential of 0.75% is represents a tax arbitrage cost of 0.15% and clearly represents a major disincentive to the use of retail share classes with rebates because the tax arbitrage cost would be borne by the retail investor, the product provider or a combination of both. It would not be in the interest of the various parties to use the retail share class structure.
The necessary rebate rises to 0.98% for a UK 45% higher rate taxpayer at 28% CGT.

This shows that there is a major tax disadvantage for UK higher rate taxpayers in using retail share classes with rebates and so clean share classes will become the norm (even before factoring in the elimination of the administrative costs and burden of the associated tax compliance paperwork of the retail share class).

Possible extension of platform rules on payments for services to non-platform markets[6]?
A large majority of respondents to the consultation believed that the FCA should read these rules across as otherwise a non-level playing field would be created. A small number of respondents, essentially made up of life companies and execution-only brokers, felt there was no need to read any rules across. A significant number of respondents felt that distribution arrangements between life companies and fund managers could give rise to the potential of providers buying distribution. Given the overwhelming number of respondents who felt that the FCA should read across similar standards to all markets, the FCA believe this issue merits further consideration and will consider these markets as part of its ongoing work and will aim to consult on rules at a later date, where necessary. As in the platform market, the FCA believe that it is important for firms sitting between a product provider and a consumer to be able to negotiate a competitive price from the product provider, but it expects the consumer to benefit from this negotiation and the FCA will ensure that any rules introduced in this area take this into account.

Relevance for Life Companies

- Collective investment schemes are available in either clean or super[7] clean share classes to various categories of investors including life companies. However there is no current ban on payments of rebates to life companies and so the existing alternative of retail share classes with rebates is still available for life company investments. However collective investment schemes may wish to phase out retail share classes (because of the administration costs of maintaining multiple share classes).
- Life companies, making new investments into external collective investment schemes, need to compare the relative attractions of their existing retail share classes with rebates compared to the alternatives of clean or super clean share classes
- For some funds (e.g. mirror funds), the life company might be charging an all-in AMC (inclusive of the AMC cost of the external collective) in which case any change in the net AMC cost of the external collective arising from

[6] CP12/12 defined non-platform adjacent markets as those offerings typically provided by Self-Invested Personal Pension (SIPP) Operators; life companies offering life wrappers; discretionary fund managers, and those execution-only brokers and ISA managers that were not caught by the platform service definition.
[7] Super clean share classes have a lower AMC and are intended for institutional and large investors.

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share class conversions will impact on the life company's profit margin. This arises where the life company product specifies an overall AMC for the policyholder and any external fund manager AMC costs are to be borne by the life company e.g. suppose the external fund manager costs were 1.5% less rebate of 0.8% and the life company was charging an all-in AMC of 1.2% (i.e. the life company charges a 0.5% AMC in the unit pricing). If instead a clean share class of 0.75% was used, the life company would need to change its AMC to 0.45%. Thus any variation in the external fund manager costs would impact directly on the life company's profit margin.

- For UK life companies, there is no change in taxation arising from HMRC Brief 04/13. Hence the existing position pertains i.e. because the rebates are taxed as trading income for the life company; the rebate amounts should continue to be included in the tax charge computations in unit pricing for its taxed funds.
- In other jurisdictions, the tax treatment of rebates is likely to be similar and so life companies in these jurisdictions should also be including the rebate amounts in their tax charge computations in unit pricing
- The move to clean and super clean share classes will reduce administration costs for both fund providers and life companies because it will eliminate the costs involved in computing and reconciling rebates and processing rebate payments and the costs of drafting associated legal agreements
- From the life insurance industry competitive perspective, the charging basis of platforms is relevant

Existing Holdings of Life Companies in Collective Investment Schemes

- In respect of existing CIS holdings, should life companies switch their holdings into clean or super clean share classes?
- From a purely administrative perspective, the FCA's understanding is that in most cases the move to clean unit classes will be accomplished by converting units (replacing one unit with another of a different unit class) rather than switching (which involves cancelling one unit and issuing another).
- HMRC have indicated their intention that conversions to 'clean' share classes will not create a liability to corporation tax on capital gains for companies. A share conversion rather than a switch might be necessary for this.
- Subject to the provisions of the prospectus, the life company has the right to convert into clean or super clean share classes (as established in COLL 6.4.8R.[8]). This legislative right doesn't fit with the concept of separate clean and super clean share classes (because a logical investor would opt for a conversion to the share class with lowest AMC) and so prospectus provisions would seem to require to be amended if the two separate share classes are to co-exist.
- With no tax complications (with common income and capital tax gains rates for UK life companies and no withholding tax) and assuming a prospectus right to transfer, the comparison of the share classes can ignore tax and would simply be on the basis of the retail AMC less rebate compared to the clean or super clean class AMC

Other Implications for Life Companies

- HMRC Brief 04/13 does not apply to payments made to life assurance companies as rebates are deemed to be trading income of the life company and so are not annual payments. However the only effective difference between whether HMRC Brief 04/13 applied or didn't apply to life companies is that if it did apply then the rebate payments to UK life companies would have to be made net of UK basic rate income tax.
- Life companies (both UK and non-UK) should check that they are receiving rebates from UK collectives with no withholding tax applied.
- Non-UK life companies will need to check whether switches to 'clean' share classes will be accepted by their tax authorities as share reorganizations and hence not subject to capital gains tax

Explanatory Note

[8] COLL 6.4.8R Where there is more than one class of units offered for issue or sale, the unitholder has a right to convert from one to the other, provided that doing so would not contravene any provision in the prospectus

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The bundled share class (which includes commission) of a CIS typically has an AMC of 1.5 per cent charge for equity funds. This charge covers, inter alia, the fees paid to the asset management firm, the platform rebate and any adviser commission. Clean share classes have dropped this annual management charge to 0.75 per cent on average. Some life company internal unit funds have investments in such UK collectives but typically receive rebates on the bundled share classes. It is the net cost (i.e. 1.5% less rebate) which is compared to the 0.75% of the clean share class to determine which share class is cheapest for the unit fund. To complicate things further, super clean share classes (intended for institutional and large investors) have a lower AMC and are intended to consolidate charges at about 0.65%. In some cases the clean or super clean share class would be cheaper – in others the bundled share class with rebates might be cheaper. For example, Hargreaves Lansdown point out that the super clean share class level is in fact more expensive than some of its current agreements with fund groups.

Rebates are treated as part of trading income. Thus the difference in tax terms for a life company in respect of a CIS investment between

- Incurring an AMC of x+y% and receiving a rebate of y% or
- Incurring an AMC of x%

is that in the former it pays income tax at 20% on the y% rebate and pays CGT at 20% on an investment return net of a x+y% charge and in the latter it pays CGT at 20% on an investment return net of a x% charge.
In most cases these will give the same tax result (i.e. tax at 20% on the gross investment return net of x%) but if the life company has capital gains tax losses carried forward, the latter would be preferable as neither tax on income nor capital gains would be immediately payable.

Taxation (HMRC Brief 04/13)
HM Revenue and Customs (HMRC) Brief 04/13 published on 25 March 2013 sets out the position regarding the tax treatment of rebates from product providers and intermediaries to consumers (in both cash and units). The brief explains HMRC's view on the tax treatment of payments of 'trail commission' passed on to investors in CISs and other associated investment products including life insurance policies. However, the Brief doesn't apply to rebates received by life companies as investors in CISs.

HMRC understands through its discussions with industry that industry have generally considered such payments to not be taxable in the hands of the (retail) investor. However HMRC considers that these payments are taxable and the brief sets out HMRC's views on how payments from trail commission should be taxed.

The payments made to investors are (in tax terminology) 'annual payments' and therefore subject to Income Tax in accordance with S683 Income Tax (Trading and Other Income) Act 2005. A consequence of this is that the payers are under an obligation to deduct basic rate Income Tax, in accordance with Chapter 6 Part 15 Income Tax Act 2007, from the payment of trail commission and to account for this to HMRC. The investors should then account for any higher or additional higher rate tax due through their Self-Assessment tax return. This tax compliance burden for both payers and payees should accelerate the move to clean share classes.

As was the case prior to the start of the RDR changes, if payments are made to investors in the form of additional units (or cash), then the value of the additional units (or cash) is an 'annual payment' and the payer should account to HMRC for an amount in respect of basic rate Income Tax on the 'grossed up' value of the additional units (that is the amount that, after deduction of basic rate Income Tax leaves the net value of the additional units provided).

As regards past payments, HMRC has said that it will not seek to collect tax for earlier years from either the payers who should have deducted tax at source from the payments or investors who should have declared any higher or additional rate liability in past year's tax returns, where they have not already done so.

Taxation for Offshore Investors

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An unintended consequence of HMRC Brief 04/13 was the legal position that tax should be withheld on rebates paid to offshore investors. This meant that the correct tax treatment as prescribed by legislation, and explained in the Revenue & Customs Brief, was not in line with general tax policy for other payments from collective investment schemes made to non-resident investors (e.g. offshore investors are not normally subject to withholding tax on either interest or equity distributions). The perspective was that 'rebates' paid to investors are economically similar to additional distributions from the fund and that collecting withholding tax for offshore investors might therefore create distortions in how different forms of distribution from the fund are treated for tax purposes.
The UK Government therefore decided to ensure that this unintended consequence of the law as clarified by Revenue Brief 4/13 did not create inconsistencies in the tax system or impact on UK competitiveness and thus published two short statutory instruments amending the Authorised Investment Funds (Tax) Regulations 2006 and also The Offshore Funds (Tax) Regulations 2009. These removed the duty to withhold tax from 'rebates' of the annual management charge in most cases where these payments are made to investors who are not UK resident for tax purposes. Such investors should check that their rebates are received gross.

How Platforms are funded
In CP12/12 the FSA set out its intention to prevent platforms from being funded by payments from product providers. It was concerned these types of payments hindered the clarity of relationships and charges paid by consumers who accessed the services of platforms, either directly or through an intermediary. The FSA was concerned that the way some platforms were currently funded could lead to product bias persisting in the market and restrict competition.
The research commissioned as a result of PS11/9 concluded that the initial concerns were justified for both the advised and non-advised platform markets. Consequently, the FSA proposed to introduce rules that meant a platform service provider could not receive any remuneration for its platform service (or any other related services) except through platform charges agreed with and paid by the retail client.

Following the consultation, the FCA is proceeding with the core proposal that requires a platform service to be paid for by a platform charge disclosed to, and agreed by, the consumer. However, the FCA has agreed to amend the rules to allow:

- Payments for the work incurred correcting a pricing error by the product provider;
- Payments for the work incurred in dealing with a corporate action by the product provider;
- Payments for the work incurred in providing the product provider with management information regarding the consumers who are invested in the product; and
- Payments in relation to advertising products on the platform.

The FCA recognises that allowing the above payments gives rise to the possibility of abuse so that providers may still have the potential to influence distribution. The FCA expect any charges made to be reasonable and proportionate, reflect the service being provided and not vary inappropriately between different product providers.

The FCA is extending the timescale for when a platform charge should become payable for legacy business until 6 April 2016. To avoid operational challenges for platforms as well as the potential for any undesirable tax consequences for consumers, the FCA has included a transitional provision allowing platforms to continue to retain legacy payments from product providers for existing business on the platform, subject to a two-year sunset clause (expiring on 5 April 2016). At the end of the two-year transitional period, platforms would not be able to retain any rebates for legacy business, but would have to be funded by platform charges only.

Payments and Rebates to Consumers
In CP12/12 the FSA confirmed that, following the publication of PS11/9, it intended to prevent product providers from being able to rebate a share of the product charge to the consumer in the form of cash when an adviser was involved. However, PS11/9 did not deal with cash rebates when no adviser was involved, i.e. when the retail client bought investment products on a non-advised/execution-only platform. CP12/12 set out the FCA intention to read similar rules across to the execution-only market. The FCA is proceeding with its ban on cash rebates for non-advised platforms, in line with the ban previously consulted on in the advised market, to prevent these payments being used to disguise the costs of the platform charge.

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FRS Comment

The new rules are designed to ensure that the platform's charges are not hidden or obscured by cash rebates to retail clients. Thus the FCA are introducing a rule to prevent D2C platforms (where retail clients invest directly via a platform without using an adviser) from arranging for a retail client to buy a retail investment product where the product charges may appear to offset any platform charges that are payable. This means that the FCA will stop D2C platforms from selling products where product charges or other payments are maintained at a level such that a cash rebate is payable to the retail client. Otherwise a retail investor seeing just the platform charge and the cash rebates might perceive the platform service charge to be the net of the two amounts without realizing that there are also inflated product charges. The rules will not prevent platforms from passing on discounts from product providers to retail clients in the form of additional units.

Market Developments

Asset managers, platforms and distributors/advisers have signalled a concern that the ban on rebates will lead to an increase in confusion for customers because of a lack of standardised approaches and terminology for share classes.

There have been intensive discussions between platforms and asset managers on fund prices with platform service providers seeking preferential terms. Whilst platforms have been pushing for super clean share classes, the asset managers in return for such preferentially priced terms have been asking for guarantees over future flows. There have been delays in concluding deals hinting at difficulties in negotiations with some asset managers supposedly digging their heels in on price.

Hargreaves Lansdown has said it will not be carrying out bulk switches of client money from bundled to clean or super clean share classes on the basis that it is an execution-only business and so clients will need to elect to switch out of bundled and into clean share classes.

In August 2013 Standard Life committed to becoming one of the first platforms to operate on a fully 'clean' basis and announced that in November, it would carry out the bulk conversion of all investments in bundled share classes to their unbundled clean equivalent - including available discounted share classes (or 'super-clean').
It gave three key reasons:

- That the income tax liability on rebates from bundled mutual funds is a significant increase in the cost to investing for most advisers' clients - between 0.15% and 0.40% on a typical bundled share class and that the change to unbundled share classes eliminates this additional cost, along with all the associated client conversations and tax reporting
- That clean share classes facilitate ease of comparison and healthy competition and supports the FCA's desire for transparency.
- That the consistent use of the cleanest share class helps advisers demonstrate that they are treating all clients fairly

This change had proved controversial. FTAdviser has revealed that many unbundled funds on Standard Life's two platforms will be more expensive than their bundled counterparts, in some cases due to a temporary rebate the firm has negotiated ending by the end of January. In response, Standard Life has said it is well on its way to converting all funds to new cheaper bespoke share classes, and that the rebate tax would be more damaging to clients.

Fidelity FundsNetwork is to move to a clean-only model by the end of 2013 on all new business. The change - which applies to clients with ISAs or those with unwrapped assets - will be effective from 9 December, giving clients a pricing model comprising a £45 investor fee and an annual 0.25% service fee, which the group said is both simple and transparent.

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He has presented a number of papers at the Life Convention of the Institute of Actuaries and has co-authored a number of papers for the Society of Actuaries in Ireland, including a 2011 paper on placing value on tax losses in unit linked funds.

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Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing and fund accounting software to the Life Assurance and Pensions industries. It was founded in 1999 by actuaries and IT specialists and is one of the leading software providers in its sector. Its Invest|Pro™ product family is a recognised leading benchmark in the investment fund accounting area and customers are some of the biggest brands in Life Assurance and Third Party Administration including MetLife, SEB, IFDS, and Accenture Insurance Services.

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