Wednesday, 23 November 2016

FCA Asset Management Market Study – Interim Report

A year after announcing the launch of its Asset Management Market Study, the FCA has now published its interim report (MS 15/2.2). This contains its preliminary findings and proposals and invites the industry to submit further observations. As we outline below, the proposed measures may have a significant impact on the UK asset management market.

The purpose of the study, undertaken under the FCA's competition powers, was to understand how competition works within the asset management market and whether the FCA should introduce measures to remedy any failings. Firms have until **20 February 2017** to submit any comments on the initial report.

SUMMARY OF KEY PROPOSALS FOR ASSET MANAGERS

Although many of the key proposals below may seem on an initial reading to be more relevant to retail investors, the FCA has not expressly confirmed which categories of investor would be caught by each proposal, except where otherwise indicated. In addition, the FCA has adopted a very wide definition of the concept of a retail investor for these purposes, which we explain under the next heading below.

The key proposals are:

- A strengthened duty for asset managers to act in the best interests of investors, potentially involving a statutory duty of care or a fiduciary duty being imposed on asset managers in favour of their investors;
- The introduction of an "all-in" fee - i.e. a single charge designed to make the charges taken from the fund more visible to investors and to impose greater costs discipline on asset managers exceeding their charging estimates;
- Requiring clearer communication of fund charges and their impact both at the point of sale and in ongoing communications with retail investors;
- Measures designed to help retail investors identify which fund is most appropriate for them, including requiring greater clarity in relation to fund objectives and potentially increasing the focus on fund underperformance;

- Making it easier for retail investors to move into better value share classes;
- Requiring increased transparency and standardisation of costs and charges information for institutional investors; and
- Requiring greater and clearer disclosure of fiduciary management fees and performance.

We discuss certain of these proposals in more detail below.

MEANING OF "ASSET MANAGEMENT" AND "RETAIL INVESTOR" FOR THE PURPOSES OF THE INTERIM REPORT

The FCA's market study has adopted a very broad definition of "asset management". It covers a wide range of industry sub-sectors including collective portfolio management, segregated mandates, wealth management, investment advisers and providers of ancillary services (such as custody or fund administration) and third party products and services (including, for example, stock lending services and benchmarking data). Although the FCA had specifically carved certain industry sectors out of its scope (for example, private equity), the interim report nonetheless makes some observations in relation to certain sectors which were originally excluded. This suggests that the scope of the FCA's study may be growing as the market review continues. Due to the very wide nature of the study, the FCA makes certain proposals in the interim report which appear to be general in nature, while others are targeted to specific industry sectors.

Throughout the interim report, the FCA refers frequently to "retail investors". For the purposes of the report, the FCA has adopted a wide definition of retail investor, meaning any investor that is not an institutional investor. An "institutional investor" for these purposes is defined as "*any legal entity which pools money from various sources to make investments*". The result of these definitions is that when the FCA's proposals refer to retail investors, they appear to be referring to a very wide population of investors, including certain investors who would not typically be classified as retail according to either a standard industry or a regulatory definition. Therefore, for example, in addition to including sophisticated or high net worth individuals, the definition would also appear to capture companies, even if they are very significant in size, if they are not considered to be "pooling money from various sources". In responding to the report, firms and industry associations may wish to seek further clarification on this definition and its interaction with the proposals relating to retail investors set out below. References to "retail investors" in this briefing are to the wide FCA definition set out in the interim report.

STRENGTHENED DUTY FOR ASSET MANAGERS TO ACT IN INVESTORS' BEST INTERESTS

The FCA expresses concern that authorised fund managers ("**AFMs**"), while being under a duty to act in the best interests of investors, are not currently under an explicit obligation to seek value for money for those investors. The FCA suggests that it may be appropriate to impose a duty on asset managers to demonstrate how their funds deliver value for money for investors and to implement enhanced governance standards for authorised funds to hold their managers to account in this area.

In the interim report, the FCA has not clearly defined what it means by an AFM in this context. Under the FCA's rules, the term "authorised fund manager" would include UCITS managers, as well as managers of other authorised funds such as NURSs and QISs. However, the report appears to distinguish between AFMs and their authorised funds on the one hand and UCITS funds on the other. In particular, it states that "*similar standards of governance*" to those proposed for AFMs should apply to UCITS funds and also to AIFs where the AIF is distributed to retail investors. The proposals do not explicitly state that this should be limited only to authorised AIFs. It is therefore possible that similar but modified proposals could also apply to all types of AIFs.

Options that the FCA has proposed include:

- Imposing specific duties on fund governance bodies to consider the fees and charges imposed by the fund, as well as to perform an annual arm's length reassessment of the investment management agreement with the fund manager;

- Clarifying the duties of the board of an AFM so as to require it to demonstrate how the AFM has complied with the enhanced duty to act in the investors' best interests;
- Imposing specific duties on senior managers of the AFM to consider value for money as part of the extension of the Senior Managers and Certification Regime to asset managers in 2018;
- Requiring AFM boards to have independent members and an independent chair;
- Creating a separate independent governance body, modelled on independent governance committees for defined contribution pension funds, which would carry out the new duties relating to ensuring value for money so that the AFM board could focus on other duties; and/or
- Imposing additional duties on depositaries to assess whether the fund manager is delivering value for money.

Alternatively, the FCA has suggested that it could ask the government to introduce legislation to impose a statutory duty of care or a fiduciary duty owed by asset managers to investors. If this alternative proposal is adopted, this could result in less guidance being available about how asset managers should discharge the relevant duties and less flexibility to review and amend the requirements in the future, if appropriate.

INTRODUCING AN "ALL-IN" SINGLE FEE TO BE DISCLOSED TO FUND INVESTORS

The FCA considers that some fund charges are not adequately disclosed to investors in advance. In addition, where some costs are estimated in advance, the investors bear the risk of the actual charges varying from the estimate, even though they cannot control the charges incurred.

In order to address these issues, the FCA is proposing to introduce a requirement for a single charge, which it considers will be more transparent and may lead to better costs discipline. It has put forward four separate models for a single charge, at least one of which would involve the asset manager itself bearing the risk of a difference between the estimated and actual costs. However, the FCA also recognises the risk that in requiring a single charge, this could result in asset managers increasing their charges and/or trading less, so it is seeking further input on this issue.

ASSISTING RETAIL INVESTORS WITH IDENTIFYING THE MOST APPROPRIATE FUND

In order to assist investors in developing more accurate expectations in relation to the performance of funds, the FCA is considering requiring fund managers to:

- Set clearer and more specific objectives for the fund;
- Provide a timeframe over which the performance of the fund should be measured;
- Provide information to allow investors to assess whether the performance objectives are being met, including disclosing any benchmarks used by the fund manager; and
- Explain the performance of any funds that have merged or closed.

The FCA is undertaking further work to consider if there is a pattern of funds underperforming their objectives in the UK market. If it identifies that this is the case, it may seek to introduce measures to assist investors with switching from underperforming funds to other options. Such measures could include:

- The FCA identifying funds with long-term underperformance;
- Requiring fund managers to inform investors when their funds are underperforming relative to the fund's objectives; and

- Requiring fund managers to compare their performance to a relevant benchmark.

CLEARER COMMUNICATION OF FUND CHARGES AND THEIR IMPACT

In relation to any investment vehicles which are available to UK retail investors, including UCITS funds, NURSs, listed funds, insurance investments and investment trusts, the FCA is considering requiring clearer communication of charges both at the point of sale and in ongoing communications. In particular, it is considering:

- Requiring greater use of pounds and pence figures in order to allow investors to understand the cumulative impact of charges more easily;
- On an ongoing basis, explaining the impact of charges on gross returns more clearly; and
- Including more information on the total costs of investments.

The report notes that there are currently various other ongoing initiatives relating to increasing costs transparency, including MiFID II, the PRIIPs Regulation and the FCA's current proposals in relation to transaction cost reporting to workplace pension schemes. It states that the final policy package will "*bring together a consistent and coherent framework of interventions*", taking all relevant legislation into account. However, the FCA has not provided any detailed explanation of how the various requirements are expected to interact at this stage.

INCREASED TRANSPARENCY AND STANDARDISATION OF COSTS AND CHARGES FOR INSTITUTIONAL INVESTORS

The FCA recognises that certain industry associations, such as the Investment Association, are working to develop a standardised disclosure framework for asset managers to disclose investment costs and is supportive of market-led efforts for improvement in this area. The FCA suggests that it could work with industry to set clearer expectations about what the standardised disclosure template should cover.

One of its suggested expectations is that the relevant template would be provided to all institutional investors as standard and it may provide further information to define which products should be covered by the template. The FCA's initial proposal is that the template could cover pooled funds and segregated mandates, including hedge funds, fund of funds and multi-manager products, and potentially private equity funds (although it is seeking industry views on the latter). In order to aid comparability, the FCA has also suggested that it could require fund managers to publish the relevant templates, suggesting that they may become publicly available documents.

GREATER AND CLEARER DISCLOSURE OF FIDUCIARY MANAGEMENT FEES AND PERFORMANCE

The FCA is concerned that there is very little publicly available information about, or scrutiny of, the fees charged by fiduciary managers and their performance. In this context, the FCA defines fiduciary management to mean circumstances where a service provider advises clients on how to invest their assets and then makes investments on behalf of the client in relation to all or some of their assets. The duties delegated to fiduciary managers may include selecting other asset managers and determining strategic asset allocations. The FCA has particular concerns about the lack of consistency and comparability between the fees of different managers.

The FCA has not put forward specific initial proposals in relation to this aspect of the interim report, but is seeking views on the sort of information that fiduciary managers could be required to disclose, or whether there could be other alternative solutions to the problems it has identified.

OTHER GENERAL FCA OBSERVATIONS IN THE REPORT

The interim report is a lengthy document and at various points, the FCA makes a number of observations which give further insight into its views on certain markets. These include the following (some of which echo criticisms the FCA has made over recent years):

- Costs transparency may be poor in relation to certain hedge funds and private equity funds and some institutional investors may be avoiding those asset classes as a result. The FCA suggests that it has received comments that private equity may be particularly opaque in relation to costs and charges.
- Some hedge funds may be very unclear about the types of assets in which they invest.
- Confidentiality agreements and "most favoured nation" clauses between asset managers and investors could prevent some investors from getting better deals by preventing price transparency or making asset managers less willing to grant concessions due to the fear of those concessions then being offered to all investors. However, the FCA notes that such agreements and clauses may also have a positive impact in strengthening the negotiating positions of some investors. At the present time, it considers that it does not have sufficient evidence of harm caused by most favoured nation clauses to propose changes, but it would welcome further input on this point.
- Many asset managers are still not applying the same appropriate rigour and oversight in relation to how they spend client's research budgets as they would apply if they were spending their own money.
- Firms who manage fixed income products frequently find it harder to demonstrate the steps that they are taking to minimise costs and achieve value for money for their investors. This is in part because limited liquidity in the fixed income markets makes cost comparison more difficult.

OTHER ISSUES

It should be noted that large parts of the report contain detailed econometric analysis which considers issues such as value for money, economies of scale and the economic behaviour of investors. We have not addressed these broader economic issues in this briefing, although it is likely that firms and trade associations will also wish to consider these points in their responses. The interim findings in the report will also be relevant to pension funds and their trustees or operators, firms that provide ancillary services to asset managers (such as depositaries), fund platforms and investment consultants.

The report does not specifically consider the potential impact of Brexit upon the FCA's possible intervention in the UK asset management market. In part, this may be a result of the current uncertainty about the potential outcome of Brexit negotiations. However, the FCA does explicitly state that it will "*consider the impact that remedies will have on the attractiveness of the UK as a place to do business and also the protections offered to UK customers investing in a range of investment products*".

NEXT STEPS

The FCA has published the interim report in order to give the industry an opportunity to provide initial comments on the regulator's preliminary views about the asset management market. None of the proposals are concrete at this stage (although some are more developed than others). Firms should engage with their industry associations in responding to the report. The deadline for responses is **20 February 2017**.

Once the FCA has received the responses and has had time to undertake further analysis, it expects to publish a final report setting out any concrete proposed amendments during **Q2 2017**.

FOR FURTHER INFORMATION, PLEASE CONTACT

10 Snow Hill
London EC1A 2AL
T: +44 (0)20 7295 3000
F: +44 (0)20 7295 3500
www.traverssmith.com

Jane Tuckley
Partner

E: jane.tuckley@traverssmith.com
T: +44 (0)20 7295 3238

Tim Lewis
Partner

E: tim.lewis@traverssmith.com
T: +44 (0)20 7295 3321

Phil Bartram
Partner

E: phil.bartram@traverssmith.com
T: +44 (0)20 7295 3437

Stephanie Biggs
Partner

E: stephanie.biggs@traverssmith.com
T: +44 (0)20 7295 3433