Impact of the FCA's Asset Management Study Final Report and Consultation Paper

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Introduction

The FCA recently published the Final Report of the Asset Management Market Study which sets out its findings and proposed remedies. Overall the Final Report reflected the FCA's Interim Report which we have previously covered. Key findings from the Final Report were:

- weak price competition;
- no clear link between a fund's performance and its charges;
- lack of clarity of investment objectives;
- concern regarding the role of investment consultants and other intermediaries.

To address these concerns, the FCA details a number of remedies in the Final Report including several areas which it regards as requiring further work. The FCA has also issued a Consultation Paper CP17/18 which sets out proposals for remedies in the following areas:

- improving fund governance;
- ensuring investors are in appropriate share classes;
- changes to the box management rules.

This article focuses on CP17/18 and the implications for the asset management industry.

Fund governance and the new value for money rule

What concerns did the FCA raise?

As far as fund governance issues are concerned, the FCA focuses on achieving value for money for investors and strengthening the board of the authorised fund manager (AFM). The FCA notes that existing rules require AFMs to act in the best interests of their investors, however the FCA believes that the existing rules are not working as they would expect, and there is inadequate consideration of investors' interests –

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particularly at board level. For example, the FCA found that AFM boards do not robustly consider value for money from an investor's perspective and evidence was also found that certain boards failed to address underperformance issues in a timely manner.

The FCA is of the view that part of the issue lies with the commercial realities underpinning the AFM business model. As the FCA noted, most AFMs do not actually carry out the investment management for the fund themselves. This function is generally delegated, either to an investment manager within the AFM group or to an external investment manager. This can give rise to conflicts of interest because of the risk that the AFM is either a relatively low profit subsidiary of the group or acts as a host AFM and is dependent on the external investment manager for its appointment. Linked to this is one of the findings of the Market Study which was that AFM boards can easily be in a position where they "lack authority… to challenge the commercial strategy set by more senior boards and executive committees".

What remedies are being proposed?

In order to address these concerns, the FCA is consulting on the following proposals:

A new value for money rule and reporting obligation

The FCA is proposing that AFMs must assess whether value for money has been provided to fund investors on an ongoing basis. The process must be documented at least annually. The proposed assessment should cover the following five areas:

- Economies of scale – AFMs can achieve economies of scale when funds under management pass certain thresholds. Under the proposal, AFMs will be obliged to identify such economies of scale and share these with investors, possibly through the introduction of break points for retail investors. Institutional investors already frequently benefit from such break points.
- Fees and charges – AFMs will be obliged to consider whether their fees and charges are reasonable, for example by comparing similar products – including those available to institutional investors.
- Share classes – AFMs should consider the different share classes available to investors and ensure that they are offered the class that offers the best value for money for them. Where multiple classes exist and investors are placed in an expensive class with similar rights to cheaper classes, the AFM will need to explain the decision to put the investors into the expensive class in the annual long report.
- Quality of services – AFMs will be obliged to consider the quality of services received by fund investors, especially where services have been delegated to others.
- Transparency – AFMs will be obliged to publish on an annual basis a report on the assessment, its findings, and any actions it has taken or will take to fulfil its obligations under the new rule.

A prescribed responsibility to act in the best interests of investors

As part of the roll out of the Senior Manager and Certification Regime (SM&CR) across the industry, the FCA is proposing the inclusion of a prescribed responsibility to act in the best interests of investors, which will include assessing value for money in accordance with the new proposed rule. The FCA intends to allocate this prescribed responsibility to the chair of the AFM board, who will be a senior manager under the SM&CR.

As a result, the chair would be responsible for taking "reasonable steps to ensure that the AFM and its board adheres to [the FCA's] current and proposed rules." The FCA's view is that introducing this prescribed responsibility will "incentivise" the chair to ensure the AFM discharges its obligation to act in the best interest of the fund investors. As the chair will be a senior manager under the regime, the FCA will also need to approve the appointment which the FCA believes will allow them to assess whether the individuals are fit and proper for the role.

This proposal will be further considered in the forthcoming consultation paper on the extension of SM&CR.

Requirement for independent directors on the board of the AFM

In order to increase the level of scrutiny at board level, the FCA intends to introduce a requirement that 25% of the board of an AFM are independent directors, subject to a minimum of two independent directors for each AFM. In addition to providing such scrutiny, such directors can carry out additional responsibilities provided the AFM continues to meet the requirements of its conflicts and remuneration obligations. Independent directors should be given sufficient resources and requests for information (including commercially sensitive information) should be met in a "complete and timely manner" to ensure that they can provide an appropriate level of scrutiny. The FCA is also setting out requirements for the appointment process. Prospective independent board members must:

- not be employed by the AFM or any member of the AFM's group or remunerated by them in any capacity other than that of an independent director;
- not have been employed or remunerated by the AFM or member of the AFM's group within the previous five years;
- not have had a material business relationship with the AFM or a member of the AFM's group within the previous three years;
- not have been an employee of any portfolio manager the AFM has delegated to within the previous five years or had a material business relationship with such a portfolio manager within the previous three years.

In addition, it is worth noting that the new rule proposes that independent directors can only be appointed for a maximum five year term, and that they are subject to a cumulative maximum duration of 10 years which cannot be consecutive. Draft COBS 6.6.25(5) states that independent directors are not eligible for reappointment to an AFM board they have served on until five years have elapsed since the end of their previous appointment. The FCA has not included a requirement that the chair of the AFM board is an independent director, leaving that decision up to individual firms. Further, the FCA is not proposing to limit the number of AFM boards an independent director may sit on. Although given the maximum limits on directorships, including non-executive directorships, the FCA is introducing for MiFID firms under its MiFID II implementation programme it will be interesting to see whether this position changes.

Implications and considerations for asset managers

The above proposals require significant investment from asset managers in terms of time and processes as well as the additional cost of independent directors. In particular:

- the ongoing assessment of value for money may require additional resources and firms should plan how to document such an ongoing assessment and how they intend to report the findings to fund investors;

- while additional scrutiny of AFM board decisions may be useful for fund investors, ensuring that the right people are appointed could take up significant management time and the FCA estimates that on average each AFM will incur one-off costs of £25,000 which it expects the AFM to absorb;

- the ongoing financial costs of appointing independent directors should not be underestimated. The FCA estimates that the average fees for an independent director will be £40,000 per year and that on average AFMs will spend £140,000 per year on independent directors; this will be an additional cost that the AFM will need to factor in (although it can be passed onto the fund).

It is also worth noting the time pressure on AFMs to meet these proposed requirements. While the FCA appreciates that the recruitment of the almost 500 independent directors estimated to be required by the rule will take time, the transitional period offered in CP17/18 is only 12 months following the rule coming into force.

Share classes

What concerns did the FCA raise?

The FCA noted in its interim report that there were several cases where retail investors were sitting in expensive share classes when there were cheaper but otherwise identical share classes available within the fund. It is common that fund managers have several share classes in funds, for example, a currency class, institutional share class and sometimes share classes for a specific intermediary who distributes the shares. In particular, certain funds continue to have pre-RDR share classes which can still pay trail commission to advisers. Trail commission involves AFMs paying financial advisers a fee over the life of the fund to cover the cost of the advice given by the adviser to the investor at the time the investor purchased shares in the fund. RDR banned trail commission on new investments in 2012, but it can continue to be paid out on investments made prior to 2012 provided certain conditions are met. During the course of the study, AFMs in particular highlighted the regulatory barriers to switching clients between classes and some firms also asked the FCA to consider whether a sunset rule on pre-RDR trail commission should be introduced.

What is the FCA proposing?

In terms of investors who are currently in expensive share classes, the FCA divides such investors into two distinct categories:

- investors in pre-RDR share classes that no longer pay trail commission;

- investors in pre-RDR share classes that continue to pay trail commission.

In relation to investors in the first category listed above, the industry has highlighted that the FCA requirement to obtain express consent from investors prior to switching is a regulatory barrier to moving investors to the cheaper fund classes. Further guidance has been requested by the industry on this point. The FCA proposes to amend its guidance on switching share classes to give AFMs greater clarity that they can carry out mandatory switching of share classes provided the necessary conditions are met. These conditions are:

- making sure the power to make a mandatory conversion is set out in the fund's prospectus;
- the AFM has made all reasonable attempts to inform investors prior to the conversion to allow them time to give alternative instructions (ie to sell their holding);
- the AFM is satisfied on reasonable grounds that the change will not cause detriment to the investors.

Of course the power to make a mandatory conversion must still be exercised in the client's best interest.

In relation to the second class of investors (those in classes which still pay trail commission) the FCA approach is less clear cut. While the industry told the FCA that trail payments are a barrier to changing share classes, the FCA's current view is that it does not intend to end such payments. The FCA believes that re-opening the debate on such share classes could have a "significant impact on the advisory market". In addition, such a change could adversely affect self-employed advisers who were planning to rely on that income as part of their pension. The FCA also stresses that there is no regulatory barrier to prevent AFMs stopping such payments; as such obligations are generally contractual. However, the FCA has not ruled out revisiting this area, provided that the industry provides it with clearer evidence of the harm caused to investors by the ongoing payment of such trail commissions.

Implications and considerations for asset managers

The FCA's further guidance on mandatory switching is helpful to the extent that it foresees situations where AFMs will carry out this action and reflects what has already happened in the market. However, AFMs considering this route will still need to ensure the fund's prospectus provides for mandatory conversion in such circumstances and, if not, amend the prospectus accordingly (while considering what type of change event this constitutes). The AFM will also need to consider (and document) what steps it has taken to contact the fund's investors and how it has satisfied itself on a reasonable basis that there is no detriment to investors. Initially such conversions are likely to involve significant input from the compliance and legal advisers.

It is also worth noting the inconsistency in the approach from the FCA. Clearly the FCA is concerned that investors are being overcharged, which is why it has introduced the value for money obligation, yet the amount of trail commission paid each year is not insignificant (calculated at £1.4 billion by the FCA in 2015) and the FCA is currently comfortable leaving these payments in place. It will be interesting to see whether this approach can last.

Box management

Box management is a term used to describe the mechanism whereby a fund manager (using its own resources) inserts itself between the fund and any investors who wish to buy or sell units in the fund, rather than the investors dealing directly with the fund. In dual priced funds there are two circumstances identified by the FCA where AFMs can make profits:

- **"At risk" profits** – these profits arise in a dual priced fund where there is a difference between the bid and offer price for units in the fund. The AFM has the opportunity to hold the units over a valuation point and potential to make a profit by selling them at a subsequent valuation point. However there is a risk that the unit price may go up as well as down and therefore these profits are regarded as "at risk" profits.
- **"Risk free" profits** – these profits also arise because there is a difference in the bid and offer price for units in the fund. However in this instance the AFM is able to match buyers and sellers at the same valuation point, so there is no risk that the price will change and the difference between the prices in this case provides a "risk free" profit for the AFM.

The FCA's concern is that AFMs are profiting unfairly by a regulatory loophole which allows them to retain profits made in both "at risk" and "risk free" scenarios.

What is the FCA proposing?

As a result, the FCA is proposing that "risk free" profits be passed to the fund. AFMs will be able to continue to retain profits made from at risk box management activities. There are also some additional disclosure changes being proposed; AFMs will be obliged to explicitly disclose their box management policy in the fund's prospectus and in particular state whether they retain any profits from such activities. The depositary will be expected to oversee the fund's compliance with this new rule.

Implications and considerations for AFMs

Following the publication of the Interim Report, the FCA understands that several firms decided not retain "risk free" profits any longer, and as a result the FCA considers that this change should not be a significant burden to the majority of AFMs. It will be interesting to see how the industry reacts. Further, as AFMs will need to account for "risk free" profits that are passed back to the fund and accounted for, there is some additional work required of AFMs. In addition, it is arguable that depositaries will have a further oversight responsibility and may wish to levy a charge for any additional work they have to undertake.

Conclusion and next steps

While it is helpful that the FCA is acknowledging the regulatory change that the industry is already facing, such as MiFID II and PRIIPs, there is no doubt that CP17/18 envisages yet more regulatory driven work. The proposals add potentially significant additional costs to AFMs both in terms of money and time. Recruiting independent directors will involve considerable management time, and remuneration will add to AFM and fund costs. The restrictions on the individuals who can be recruited will mean that recruitment consultants are bound to have a boost to their business with the FCA itself estimating that almost 500 independent directors will be required. Also, the focus on investor value for money sits slightly uncomfortably with the decision not to terminate pre-RDR trail payments which AFMs have raised as a legitimate issue regarding higher cost share classes.

Further, it is worth noting that despite the Final Report title, there is a significant amount of work outstanding by the FCA, with costs and charges disclosure to investors and benchmark and performance reporting consultations expected later in the year. A platforms market study is underway with the Terms of Reference for the study published on 17 July and depending on the outcome of a working group on the clarity of investment objectives, there may be a further consultation on that topic as well. Investment consultants will be awaiting the FCA's final decision whether to refer the industry to the CMA later in the year.

Should firms wish to respond to the CP, the consultation is open until 28 September 2017 for feedback.