Latest remedies from the FCA's Asset Management Market Study: new remedies set out in Policy Statement 18/8

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Earlier this month the Financial Conduct Authority (FCA) published its latest remedies associated with the Asset Management Market Study (AMMS) in a Policy Statement (PS18/8). The proposed remedies were set out for consultation at the time of the Final Report and its associated consultation paper CP17/18 and there are no significant surprises contained in PS18/8, although the FCA has taken on board elements of industry feedback. We have previously discussed the Interim Report here and the Final Report here. This briefing focuses on PS18/8 and the implications for the asset management industry.

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Fund Governance and Assessment of Value

1. Assessment of Value

Throughout the AMMS process the FCA has consistently noted that, despite the existing duty on authorised fund managers (AFMs) to act in the best interests of investors, AFMs did not in the FCA's view "robustly consider whether they are delivering" value for money for their investors. As a result CP 17/18 proposed the introduction of a value for money (VfM) rule.

The original proposal required AFMs to assess VfM against a non-exhaustive list of criteria which included economies of scale, fees and charges, share classes, quality of services, and transparency.

Feedback and final implementation

Overall, the FCA indicated that it received broadly supportive feedback in relation to the intention behind the VfM rule. However, there were some common concerns raised, including:

- the drafting of the proposed rule, which could be read as focusing on cost rather than value in a wider sense which might lead investors to think that "cheapest was always best". Value should be considered in a more holistic manner, and several respondents suggested a rule based on the US approach based on the Gartenberg principles[1];

- how and whether breakpoints should be referred to, some respondents felt that the FCA has underestimated the differences in the pricing mechanisms applicable to retail and institutional funds;

- the requirement to report annually as many respondents pointed out that as most funds were designed to be held as medium to long term investments, annual reporting might indicate that a fund had underperformed in the short term;

- that this reporting might force AFMs to release commercially sensitive data.

Concerns were also raised about the proposed implementation period given the ongoing significant regulatory burden on the industry.

While the FCA believes that the "core of our policy is correct" it has taken on board many of the concerns raised by the industry in relation to the specifics of the proposed VfM rule which is now to be referred to as "Assessment of Value". As a result:

- the FCA has redrafted the proposed rule to encompass a wider interpretation of value, rather than focus on costs. It reflects many of the Gartenberg principles in the new rule and explicitly includes fund performance;

- the FCA also accepted that the direct reference to break points was too prescriptive and has removed it from the final rules;

- funds will be able to assess fund performance over an appropriate timeframe based on the fund's objective, strategy and policy however AFMs will still need to report annually. The FCA believes that an annual report is useful information for investors and will help them compare funds in line with their investment horizons, which may be different to the fund's investment strategy and timelines.

The FCA has also delayed the implementation date to 30 September 2019 and provided a transitional rule so that the value assessment is not required for an annual accounting period which ends before 30 September 2019.

The new Assessment of Value rules are found at COLL 6.6.20R and 6.6.21R. These require the AFM of UK authorised funds to conduct an assessment of value at least annually for each scheme the AFM manages as to whether the payments out of the scheme property are justified in the context of the ***overall value delivered to***

[1] The Gartenberg principles derive from United States case law and relate to what considerations the board of an US mutual fund should have regard to, when assessing the fund management contract (including the fee). The points are as follows:
1. the nature, extent, and quality of the services to be provided by the fund manager;
2. the investment performance of the fund and the fund manager;
3. the costs of the services to be provided and profits to be realized by the fund manager and its affiliates;
4. the extent to which economies of scale would be realized as the fund grows; and
5. the extent to which fee levels reflect these economies of scale for the benefit of fund investors.

unitholders.

In carrying out the assessment of value the AFM is required, for each class of units in a scheme, to consider at least the following matters (an AFM can also consider other matters):

- **Performance** – the performance of the scheme, after deduction of all payments out of the scheme property, over an appropriate timescale having regard to the scheme's investment objective, policy and strategy.

- **AFM costs general –** for each charge the cost of providing the service to which the charge relates, and when money is paid to associates or third parties the costs is the amount paid to that person.

- **Economies of scale -** whether the AFM is able to achieve savings and benefits from economies of scale, relating to the direct and indirect costs of managing the scheme property and taking into account the value of the scheme property and whether it has grown or contracted in size as a result of the sale and redemption of units.

- **Comparable market rates –** in relation to each service the market rate for comparable service provided by the AFM or to the AFM or on its behalf.

- **Comparable services –** in relation to each separate charge, the AFMs charges and those of associates for comparable services provided to clients, including for institutional mandates of a comparable size and having similar investment objectives and policies.

- **Classes of units -** whether it is appropriate for unitholders to hold units in classes subject to higher charges than those applying to other classes of the same scheme with substantially similar rights.

2. Requirement for independent directors on the board of the AFM

One of the key proposals of CP 17/18 was to increase the number of independent directors on the boards of AFMs to ensure that AFM boards balance the interests of shareholders and investors appropriately. Work previously undertaken by the FCA indicated that this was not always the case. CP 17/18 proposed that AFMs appoint a minimum of 2 independent directors and that independent directors comprise at least 25% of the board of the AFM. In order to be considered "independent" an individual cannot have been paid by the AFM group in the previous five years (so old employees of the group will only become "independent" five years after leaving the group). In addition individuals cannot have had a material business relationship with the AFM group for the previous three years. It was also proposed that independent directors can only be appointed for a maximum five year term, renewable once so a cumulative maximum of 10 years, at which point the lose their "independence" and need to be replaced. Following a five year hiatus, such independent directors would regain their independence.

Feedback and final implementation

Again, the FCA noted that the feedback was supportive overall, however concerns were raised in a few areas including:

- whether the requirement should apply to all AFMS including small firms and new entrants to the market as it could be an unfair financial burden on them;

- whether the duty of independent directors to focus solely on the interest of investors conflicted with the general duties of directors;

- the difficulty in finding enough independent directors to fill the expected estimated 480 vacancies.

The FCA plans to implement the independent directors' requirement largely as set out in CP 17/18 with the final rules and guidance to be in COLL6.6.25R and COLL6.6.26G. Under the new rules it will be for the AFM to make a determination as to whether an independent director is "independent in character and judgement" to be suitable for the role.

Further the AFM must take "reasonable steps to ensure that independent members appointed to its governing body have sufficient expertise and experience to be able to make judgements on whether the AFM is managing each scheme in the best interests of unitholders." This slight redraft of the rule indicates that the FCA took account of the concerns raised regarding the independent directors proposed duty in CP 17/18 to act "solely" in the interests of unitholders which some respondents believed clashed with a directors general duties. While the FCA set out in PS 18/8 that it does not believe that there is such a conflict, it has removed "solely" from the final rule.

In relation to whether the independent director requirement should be applied to all AFMs, the FCA stands by its proposal in CP 17/18 to apply the independent directors to all AFMs regardless of size. The FCA's view is that all investors deserve the additional scrutiny that they believe the independent directors will bring. Further, the FCA believes the additional scrutiny may be particularly beneficial for start-ups as it could materially improve the quality of the AFM board's decision making.

Regarding recruitment concerns, the FCA appears confident now that there will be no difficulties in recruiting the requisite numbers of independent directors. The FCA believes that feedback from the investment trust sector indicates that there is a sufficient pool of appropriate candidates. The FCA also makes it clear that such directors do not need to come from the financial services industry and encourages firms to look outside their standard pool of candidates. It will be interesting to see whether this readily available pool of suitable independent directors is as easily accessible to AFMs as the FCA believes. It is also worth noting that:

- the terms of employment on which independent directors are appointed must secure their independence;

- the role of the independent directors is to provide input and challenge to the Assessment of Value;

- independent directors may take on additional duties, subject to remuneration and conflict of interest rules;

- what constitutes a "material business relationship" has been left to be determined by the AFM;

- independent directors can sit on more than one AFM within a group, although their time served will be calculated on a group basis;

- AFMs that already have independent directors on their boards can keep them as long as they meet the independence requirements set out in the incoming COLL 6.6.25 rule, their clocks will starting ticking once the independent directors rule comes into force (due to be 30 September 2019).

3. Prescribed responsibility to act in the best interests of investors

To further improve fund governance, and as part of the rollout of the Senior Managers and Certification Regime (**SM&CR**) the FCA proposed a prescribed responsibility to act in the best interests of investors, (including the responsibility for assessing value for money) in CP 17/18. 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. CP 17/18 asked for feedback on whether the FCA's proposed approach to leave to the AFM to decide whether the chair should be independent or an executive board member.

Feedback and final implementation

Industry feedback on this question was mixed, with some respondents suggesting a requirement that the chair be an independent appointment and others believing that an executive chair was more appropriate. The FCA has decided to implement the proposed rule as put forward in CP 17/18, which will mean that it is up to the AFM to decide whether the chair is an independent director or an executive one. More detail will follow when the rest of the SM&CR rules are published, expected to be in summer 2018. The FCA did note that it will review whether these changes trigger the additional scrutiny it expects at AFM board level and if not, appears to be open to imposing a greater level of independence at board level, for example a 50% independent director quota.

4. Share Classes

In addition the FCA proposed changing the non-Handbook guidance (FG14/4) relating to how AFMs can move clients to cheaper share classes. In order to make it easier for AFMs to move investors to cheaper share classes, the FCA proposed that AFMs be allowed to make these changes without having to get individual consent from each investor.

Feedback and final implementation

Industry feedback on this proposal was overwhelmingly positive, and the FCA will be implementing this change, with an amendment to the guidance which will recommend that AFMs make a one-off notification to the investors at least 60 days in advance of the proposed switch into the cheaper share class. In addition the FCA confirmed that it did not think that AFMs should have to use tracing services to find all their investors. However the FCA has confirmed that a fund's prospectus should allow for such mandatory share class conversions. This revised guidance is now known as FG18/3 and was implemented on 5 April 2018.

5. Trail Commission

CP 17/18 also asked for feedback on whether the FCA should continue to allow trail commission to be paid. They are still considering the responses they received and have no immediate plans to change policy on this.

6. Box management

The FCA also put forward a proposal aimed at ensuring a fairer distribution of dealing profits in CP17/18 by proposing changes to rules on 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. As a result, the FCA proposed that "risk free" profits be passed to the fund and not retained by the AFM.

Feedback and implementation

The FCA noted that while most respondents agreed with them as a matter of principle, a number of respondents raised concerns about the operational complexities of implementing such a change. While the FCA has decided to go ahead with this change, it has taken on board a number of concerns. The final rules and guidance are set out in COLL 6.3.5D, COLL 6.3.5E and COLL 8.5.9-B and COLL 8.5.9-A. The key modifications made to the proposed rule include:

- allowing the AFM to decide how to allocate the risk free box profits as between the fund and/or individual investors that have bought or sold units in the fund;

- recognizing that there are situations where the risk-free profits are offset by losses on some transactions although any such losses cannot be carried forward to the next valuation point;

- changing the frequency for making payments to the fund – which should be made regularly and no less frequently than AFM management charges.

The FCA has also included detailed technical commentary in an annex to PS 18/8 to assist firms in implementing the change, and they have also extended the implementation period to twelve months, to reflect the operational requirements of firms. This commentary goes into greater detail about the type of losses that can be offset against "risk free" profits, including for example where "unmatched units from sales must be met by creation of new units, when the creation (issue) price is above offer (sale) price".

It was also noted that while depositaries would be expected to oversee compliance with this rule, the FCA emphasized that it had not been their intention to "expand significantly the scope of depositaries oversight". In particular the FCA made it clear that depositaries will not be expected to carry out daily checks to confirm whether the AFM has correctly calculated their dealing profits.

7. Expanding the scope of the AMMS

The FCA is continuing its work on how and whether the AMMS study be expanded to unit-linked or with-profits businesses and they expect to publish their views in the first half of 2019.

8. Conclusion and next steps

Overall the FCA has maintained its proposed remedies, but has taken onboard a number of industry concerns and made certain changes particularly in relation to some of the technical drafting and timeline as summarised below.

Rule	Implementation Date/Period
Assessment of Value Rules	30 September 2019
Independent Directors – one quarter of the board, subject to a minimum of two	30 September 2019
SM&CR Prescribed Responsibility for AFMs	Final rules to be published in Summer 2018 – implementation expected mid to late 2019
Box Profits Remedy	1 April 2019
Revised Guidance on Share Classes Conversion	5 April 2018

It is worth noting however, that PS18/8 is not the end of the road for AMMS. The FCA also issued a second consultation paper (CP18/9) on further remedies relating to fund objectives. CP18/9 sets out a package of measures which the FCA has designed to make fund objectives clearer and more specific and in particular to ensure that benchmarked funds have appropriate disclosure so that investors know what they are investing in. With an interim report on the Platforms Study also due in summer 2018, it continues to be a time of regulatory change for the asset management industry.