MACFARLANES

FCA ASSET MANAGEMENT MARKET STUDY FINAL REPORT – A CLOSER LOOK

"[W]e are proposing an overall package of remedies to make competition work better in this market, and protect those least able to actively engage with their asset manager. We consider that this will increase efficiency, lead to the UK asset management industry being a more attractive place for investors and so improve the relative competitiveness of the UK market."

There was relief amongst asset managers last week when the FCA published the final report on its market study into the asset management industry. Whilst there is work to be done by the industry and the FCA is proposing yet further regulatory changes, these changes are not immediate and are largely open to consultation. This presents the industry with an opportunity to provide further input and to consider the interaction with other regulatory initiatives in the pipeline already, including PRIIPs, MiFID II and the extension of the senior managers and certification regime (SM&CR).

The FCA concludes that there is weak price competition in a number of areas in the industry and carries forward a number of proposed remedies from its November 2016 interim report. However, as a result of extensive lobbying from the sector, the FCA is generally proceeding with some of the less controversial approaches to addressing its concerns. These include a strengthened duty on asset managers to act in the best interests of investors, enhanced governance (including a requirement for a minimum of two independent directors for fund managers), and standardised disclosure of costs and charges.

The FCA stops short of proposing a market investigation reference (MIR) to the Competition and Markets Authority (CMA) for the entire asset management sector, which was rumoured as one possibility. However, there will be a market study into investment platforms, and a formal recommendation that HM Treasury considers bringing investment consultants into the FCA's regulatory perimeter. The FCA will publish a final decision in September on whether it will make an MIR to the CMA in relation to the market for investment consultancy services to the CMA.

We published an initial summary of the final report on 28 June 2017. In this briefing, we consider and comment on the FCA's findings and proposed remedies in detail. Most of the remedies do not apply to managers of private and alternative funds, please refer to our previous briefing for these managers.

THE MARKET STUDY FINDINGS

In brief, the FCA found among other things that:

- there is weak price competition in a number of areas of the asset management industry. This is evidenced by price clustering on the asset management charge for retail funds, broadly stable active charges over a 10-year period, and average profit margins of 35 per cent;
- there is no clear relationship between charges and the gross performance of retail active funds and some evidence of a negative relationship between higher charges and fund performance;
- fund objectives are not always clear, and fund performance is not always reported against an appropriate benchmark;
- investor awareness and focus on charges is mixed and often poor;
- it has concerns about the investment consultancy market, including the relatively high and stable market shares for the three largest providers, a weak demand side, relatively low switching levels and conflicts of interest; and
- retail investors do not appear to benefit from economies of scale when using investment platforms.

As a result, the FCA proposes a number of remedies. These are considered further on the following pages, although a number remain the subject of consultation. While the FCA recognises that its proposed package of remedies will likely increase costs for some firms, it believes that the benefits will outweigh the costs. The concerns of the industry regarding reduced competitiveness in an uncertain post-Brexit market appear to have held little weight: *"We also expect that any improvements to outcomes for investors will lead to the UK asset management industry being a more attractive place to invest and therefore improve the relative competitiveness of the UK market."*

WHAT IS HAPPENING NOW?

- Recommendation that an independent chairperson convenes a stakeholder group of industry and investor representatives to agree a standardised disclosure of costs and charges to institutional investors and to consider whether any other actions are necessary.
- Launching a market study into direct-to-consumer and intermediated investment platforms.
- Recommendation that HM Treasury considers bringing investment consultants into the regulatory perimeter (subject to the outcome of the proposed MIR).
- Recommendation to the Department for Work and Pensions (DWP) to remove barriers to pension scheme consolidation and pooling.

PROPOSED REMEDIES UNDER CURRENT CONSULTATION

- Strengthened duty on asset managers to act in the best interests of investors (CP17/18).
- Requiring fund managers to return any risk-free box profits to the fund (CP17/18).
- Facilitating switching investors to cheaper share classes (CP17/18).
- Consultation on whether trail commission should be subject to a sunset clause (final report).
- Proposing to reject undertakings from investment consultants in lieu of an MIR to the CMA on the institutional investment advice market; the FCA intends to publish its decision in September 2017.

PROPOSED REMEDIES SUBJECT TO FUTURE CONSULTATION

- Costs and charges disclosure to retail investors, supporting the MiFID II approach.
- The appropriate use of benchmarks and performance reporting.
- Convening a working group on objectives and (subject to the outcome of the working group) consulting on any rule changes at a later stage.

WHAT SHOULD ASSET MANAGERS DO NOW?

None of the remedies proposed by the FCA require action to be taken immediately to implement them. However, asset managers would be well-advised to take on board the final report and start to consider how they will respond to the new requirements. The FCA comments in the final report that the engagement process with the industry identified a lack of understanding of how competition law impacts the asset management industry. Asset managers should therefore ensure that all relevant personnel have received appropriate training on competition. It is highly likely that the FCA would take a dim view of any asset manager engaging in anti-competitive behaviour following the outcome of the market study.

Asset managers should also consider engaging with relevant trade bodies and / or lobbying the FCA directly on those points which are of crucial importance for their respective business models.

IMPROVE FUND GOVERNANCE

The FCA found that boards of authorised fund managers (AFMs):

- do not robustly consider value for money for fund investors;
- occasionally fail to take appropriate and timely steps to address fund underperformance; and
- can lack the authority and independence to challenge the group's commercial strategy.

The FCA considers that if the majority of investors are unlikely to drive value for money, they require strong fund governance measures to look out for their interests. It proposes, therefore, a number of measures to improve governance and consults on these in CP17/18: Consultation on implementing asset management market study remedies and changes to Handbook.

A strengthened duty on asset managers to act in the best interests of investors and increased accountability through the SM&CR

As part of the extension of the SM&CR, the FCA will consult (later this year) on the introduction of a new "prescribed responsibility" for the chair of the board of an AFM to ensure that the firm acts in the best interests of investors.[1] The FCA believes that this role should increase the board's effectiveness to influence decisions made within the group structure towards considering investors' interests. In addition, as the chair will be a "senior manager" under the new regime, they will be personally

[1] The FCA makes a point of stating that it is not calling into question the role of the depository of authorised funds. It merely believes that *'the value for money issues we are aiming to address with this proposal are outside their remit'* (paragraph 3.23 of the final report).

accountable for their prescribed responsibilities. Accordingly, the FCA hopes that this will ensure the board and the chair takes the obligation seriously. The new prescribed responsibility to act in the best interests of investors will include assessing value for money for investors (which is considered further below).

The FCA makes clear that it will continue to consider the role of the board in the wider context of its monitoring of the asset management industry. For example, the FCA will consider in future whether it should impose additional, specific requirements on the board for areas such as the use of benchmarks, how the objectives of funds are set and communicated and how fund managers measure performance and explain it to investors.

This proposed remedy is interesting. Experience with the SM&CR in the banking industry has demonstrated its powerful ability to ensure the minds of relevant senior management are appropriately focused on areas of concern to the FCA. We may well see this remedy used in relation to other governance issues in the future.

Value for money for investors

Although AFMs have an existing obligation to act in the best interests of investors, the findings of the market study indicate that they do not always do so. Therefore, in CP17/18, the FCA details its proposal to introduce a new rule requiring an AFM to assess whether fund investors are receiving value for money. The assessment must be ongoing for each class of units in a scheme, but the AFM must formally document it at least once a year. The proposed rule provides a (non-exhaustive) list of factors that the AFM should take into consideration in this assessment. These include:

- economies of scale, e.g. whether there are any savings and benefits, if they should be paid into the scheme property, and whether break points should be introduced or modified;
- reasonableness of fees and charges in relation to costs necessarily incurred – this requires the AFM to take into account charges for comparable products, including for institutional mandates of a comparable size, and comparable rates for any delegated services;
- whether it is appropriate for unitholders to hold units in classes with higher charges; and
- whether charges and other payments are commensurate with the quality of services provided.

In addition, the FCA proposes that AFMs publish an annual report on the findings of this value for money assessment and any actions taken as a result of it. If the AFM identifies poor value for money practices, the AFM must explain any remedial action it has taken. Failure to take sufficient steps may be indicative of a failure to comply with the AFM's duty to treat unitholders fairly and / or to act in the best interests of the investor. Therefore, it is essential that AFMs understand what the FCA expects of them in carrying out this value for money assessment and seek clarity from the FCA at this consultation stage, if necessary.

If the FCA pursues this proposal following feedback, these rules will enter into force 12 months after being finalised.

Minimum level of independence in governance structures

The FCA proposes a new rule to require that 25 per cent of an AFM's board comprises independent (non-executive) directors and, in any event, a minimum of two. At this stage, the FCA is not suggesting that the chair of the board must be independent, leaving this decision to the AFM. In CP17/18, the FCA produces draft rules which detail the requirements a candidate must meet to qualify as "independent".

To be eligible to serve as independent director, individuals should satisfy the following criteria:

- They may not be an employee of the AFM or of a company within the AFM's group or remunerated by them for any role other than as an independent board member. This includes participating in any share option or performance-related pay scheme of the AFM or the AFM's group.
- They may not have been an employee of the AFM or of another company within the fund group within the five years before their appointment.
- They may not have received any sort of remuneration from the AFM's group within the five years before their appointment. Also, they may not have had any sort of material business relationship with the AFM or with another company within the AFM's group within the last three years.
- They may not have been an employee of any portfolio manager the AFM has delegated to within the five years before their appointment, or have had any material business relationship with that portfolio manager within the last three years.
- For host AFMs, the above requirements would apply to any commercial relationship the independent director has with the portfolio manager to whom the host AFM has delegated the portfolio management functions. In addition, independent members of host AFMs must not have been employed by the host AFM company for at least five years before their appointment.

In recognition that such expertise may be hard to find, the experience required of the independent director "may have been gained through professional experience, public service, academia or otherwise, and does not need to relate to the financial services industry" (draft COLL 6.6.26G, CP17/18).

The appointment of an independent director must be for no longer than five years but can be for a cumulative duration of ten years. Thereafter, a five year period must have lapsed before a person is eligible for reappointment to the same AFM board. There is no limit on the number of AFM boards that an independent director may serve on.

The FCA proposes that, once the rules are finalised, AFMs will have a 12 month implementation period. However, it indicates that it is open to representations from the industry on how feasible this is. Clearly, it will be a challenge for a large number of AFMs to find suitable candidates at the same time and AFMs are likely to want to respond to this consultation accordingly. The FCA estimates that approximately 480 independent directors will be required for the 192 AFMs authorised by it. It does not believe there should be a threshold below which smaller AFMs do not have to appoint independent directors.

ALL-IN FEE APPROACH TO QUOTING CHARGES

The FCA found that firms do not disclose all charges to investors, particularly transaction charges, which are difficult to predict with accuracy. However, in a reprieve for the industry, the FCA has not pursued its suggestion for a capped single all-in-fee, which it was previously considering could apply to all investors.

The FCA acknowledges that both PRIIPs and MiFID II will require firms to calculate and disclose indirect costs such as transaction costs. Under these initiatives, firms should present these charges to investors as cash amounts in cost disclosure documents, allowing the investor to see the overall impact of the charge as well as the cumulative effect on the return of the investment. The FCA notes that MiFID II will require firms to provide aggregated and ongoing information to clients on all costs, including transaction costs and intermediary charges. The firm must give this information to the client at least annually and firms must provide an itemised breakdown of costs when the client requests it. These disclosures, combined with the enhanced MiFID II obligations around best execution and reporting, and the new FCA proposal that governance bodies act in the best interests of investors (including by considering value for money) seem to satisfy the FCA for now. Therefore, having previously focussed its attention on possible approaches to introducing a capped single all-in-fee, the FCA is now concentrating on supporting the changes being implemented under MiFID II. This is a welcome outcome.

In addition to this, the FCA states that it is testing ways to improve the effectiveness of new disclosures, to understand the role of the prominence and formatting of charges information in encouraging investors to focus on the impact charges have on their investments and enabling effective price comparison. It says this work will inform the development of any future remedies in this area.

The FCA is also considering whether to consult on guidance in areas such as the wider use of pounds and pence disclosure on other information sources and the benefits to consumers of consistency between point-of-sale and ongoing disclosures. This was an issue it previously raised in its interim report.

PERFORMANCE FEES

The FCA is considering consulting on rules to make performance fee structures more equitable. For example, it mentions considering permitting firms to charge performance fees only above the fund's most ambitious target they hold out to investors, and also after the deduction of ongoing fees.

FUND MANAGERS TO RETURN RISK-FREE BOX PROFITS TO THE FUND

The FCA has made no secret in recent years of the fact that it does not favour firms retaining risk-free box profits. It has finally taken the opportunity to consult on changes to the rules on this. While it affects a minority of AFMs (as most do not retain the profits), the FCA confirms its proposal in the interim report that fund managers will be prohibited from retaining risk-free box profits. Instead, these should accrue to the fund as it is otherwise hard to justify from a treating customers fairly perspective. Risk-free box profits are those which accrue when the AFM uses a "manager's box" and the AFM makes a profit from the difference between the bid and offer prices but the AFM's capital is never at risk as the matching is instantaneous. "At risk box profits" (i.e. when the AFM is using its own capital) may be retained by the AFM.

The FCA details its proposals in CP17/18. These include an obligation of the AFM to disclose in the prospectus its policy on operating a manager's box and how the AFM will treat any risk-free profits (but not at-risk profits) accruing from it.

Should this rule take effect, AFMs that currently retain risk-free box profits should prepare to change their procedures and prepare for the additional disclosure in the prospectus. The FCA proposes transitional provisions which indicate that a change to an existing prospectus is necessary only when it needs updating for other purposes.

CONSISTENT AND STANDARDISED DISCLOSURE OF COSTS AND CHARGES TO INSTITUTIONAL INVESTORS

The FCA considers that the level of disclosure of costs and charges could be improved for institutional investors, for example those who receive investment services other than through a fund structure, but notes that this aspect of the asset management market will be significantly improved on the implementation of MiFID II:

> *"We consider that the information required by MiFID II will give institutional investors a clear understanding of the costs and charges that they are incurring. If this information is delivered within a well-designed template, it could facilitate more effective competition."*

As indicated in its interim report, the FCA supports work with industry and investor groups to develop standardised cost disclosure templates. It recommends that both industry and investor representatives agree a standardised template of costs and charges. The FCA proposes to ask an independent person to convene a group of relevant stakeholders to develop this further, for both mainstream and alternative asset classes, where appropriate. Following this, the FCA indicates that it will work with these stakeholders to consider whether any other action is necessary to ensure that institutional investors get the information they need to make effective decisions. The Investment Association has already done some work in this regard which may potentially form the basis of discussions on this matter going forward.

OBJECTIVES, BENCHMARKS AND PERFORMANCE REPORTING

The FCA is concerned that investors find it difficult to know what to expect from a fund and how it is performing against its objectives. The FCA continues to believe that more clarity is required around objectives, as well as helping investors compare objectives between similar funds. This has become increasingly clear from interactions with the regulator on fund applications and its thematic review on Meeting Investors' Expectations (TR16/3). However, it has refrained from requiring all funds to have a benchmark comparator, and the FCA's proposals in this area are subject to further work and consultation.

In a further reprieve for the industry, the FCA is not pressing ahead with its initial proposal to require "shining the light" on underperforming funds. The FCA hopes its reformulated package of remedies should expose such underperformance.

The FCA proposes to chair a working group to conduct further work on options to improve the usefulness of objectives for investors. This work could result in new rules or guidance in the future. In addition, the FCA intends to consult on:

- rules requiring an AFM which has chosen a specific benchmark, comparator or numerical target for a fund to make the reasons for this choice clear to investors;
- requirements that, wherever AFMs choose or are required to present their past performance, they must do so against the most ambitious target they set out to investors; and
- rules requiring an AFM that does not set a specific benchmark, comparator or numerical target return for a fund, to make clear the reasons for this to investors. Also, the AFM must not present past performance against a benchmark, comparator or target in regulatory and marketing materials for that fund.

AFMs should liaise with their trade association regarding feeding into the proposed working group, and watch out for future consultations from the FCA on these issues.

In the meantime, industry participants are encouraged to take heed of the requirement to ensure that all client communications and fund documentations are fair, clear and not misleading (for example, ensuring that fund naming conventions do not mislead investors about a fund's objective) and ensuring all product literature is consistent. Providers should also consider which communications may be helpful for their investors.

MAKING IT EASIER FOR RETAIL INVESTORS TO MOVE INTO BETTER VALUE SHARE CLASSES

During the study, a number of asset management firms told the FCA that where they create new share classes (typically in response to the Retail Distribution Review), they find it difficult to switch existing investors to these new, cheaper share classes even if this would be in their best interests. This is for a number of reasons, but one major factor is that managers currently require the investors' consent to transfer them to alternative share classes and many investors do not respond to communications.

This issue has been a huge challenge for a number of asset managers but finally the FCA is consulting on rules (in CP17/18) to allow an AFM to undertake a mandatory conversion if it is in the client's best interests and the following conditions are met:

- the power to undertake a mandatory conversion must be set out in the prospectus;

- the AFM must have made all reasonable attempts to contact unitholders to enable them to give alternative instructions; and
- the AFM is satisfied on reasonable grounds that the change will not result in detriment to investors.

The FCA also proposes to clarify its guidance (FG14/4) on dealing with hard-to-reach unitholders.

CONSULTATION ON PHASED-IN SUNSET CLAUSE FOR TRAIL COMMISSIONS

Respondents to the interim report raised concerns with the FCA about ongoing trail commission payments. Therefore, in the final report, the FCA is consulting on whether it should consider an end to the payment of trail commissions on the distribution of asset management products and, if so, over what time period. It also requests input on the impact of other markets in which advisers are paid trail commission, such as those relating to life and personal pension products.

INVESTMENT PLATFORMS MARKET STUDY

Building on the proposal in its interim report for further work on the retail distribution of funds, the FCA has announced that it will conduct a market study into "direct-to-customer" and intermediated investment platforms.

In particular, the FCA indicates that the study is likely to examine (i) how direct-to-consumer and intermediated investment platforms compete to win (and retain) new customers and (ii) whether and to what extent these types of platforms enable retail investors to access investment products that offer value for money.

This announcement follows on from the FCA's 2017 / 2018 Business Plan which identified *"assessing the market for investment platforms and what can be done to improve competition"* as one of the FCA's sector priorities. The FCA went on to note that in its interim report on the asset management market study, it *"identified a number of potential competition issues in the investment platforms market"*, including:

- complex charging structures;
- if platforms' investment tools enable effective choice; and
- whether platforms have the incentive(s) and / or the ability to put competitive pressure on asset management charges.

The FCA will give more details on the precise terms of reference for the market study, which the FCA intends to publish "shortly". Asset managers will be required to engage with the market study either as users of these platforms or where they operate platforms within the same legal entity or group. The FCA has the ability to conduct the market study under either its competition or financial regulatory powers. However, we anticipate that, as with the asset management market study, this will be conducted under the FCA's FSMA powers, not least as it allows for a more flexible time scale than the statutory deadlines which apply to market studies under competition law.

CONSULTATION ON INVESTMENT CONSULTANCY MARKET INVESTIGATION REFERENCE

In its interim report, the FCA provisionally decided to make an MIR to the CMA in relation to the market for investment consultancy services as the FCA considered that it had reasonable grounds to suspect that there are a number of features of this market that may distort competition.

In response, the three market leaders proposed a series of "undertakings in lieu" (UILs) hoping to address the FCA's concerns and fend off a full market investigation.

UILs are commitments (either structural, behavioural, or both) which can be offered by a party (or parties) in the relevant market in order to address a regulator's concerns. If they are accepted, the commitments become binding and removes the need for an MIR. The proposed UILs include, among other things, measures to encourage tendering of investment service contracts, and to increase transparency of costs, fees and performance as well as measures to address potential conflicts of interest.

However, the FCA indicates in its final report that it is provisionally inclined to reject the proposed UILs and is consulting separately on the issue.

The FCA considers that it cannot be confident that the proposed UILs would *"achieve as comprehensive a solution as is reasonable and practicable"* to any adverse effects on competition that it has identified in investment consultancy services. Another relevant factor is that although the UILs have been offered by the three largest players in the market, they only account for less than 60 per cent of the market, leaving the possibility that competition issues for a large segment of the market would remaining unaddressed.

When considering the FCA's provisional decision, it should be noted that UILs are rarely accepted. Regulators often consider that the market study has not given them sufficient information on the competition concerns to properly judge whether the proposed UILs provide an adequate solution and can be concerned about the ability to negotiate UILs with the industry as a whole.

The FCA intends to make a final decision as to whether to accept these proposed UILs or press ahead with the MIR in September 2017. However the FCA's reservations about the UIL package, coupled with press reports of the lack of enthusiasm for the UILs from other investment consultants, suggests that an MIR remains the most likely outcome. More details on the MIR and what this may mean for investment consultants, asset managers and institutional investors such as pension fund trustees can be found in our Competition team's publication.

POSSIBLE REGULATION OF ASSET ALLOCATION ADVICE

Subject to the outcome of the FCA's potential market investigation reference mentioned above, the FCA intends to recommend that HM Treasury considers bringing asset allocation advice provided by investment consultants and employee benefit consultants under its regulation by extending the regulatory perimeter. If the Treasury makes this legislative change, the FCA would consult on how to implement this and carry out a cost benefit analysis to facilitate a proportionate regime.

NON-DISCLOSURE AGREEMENTS (NDAS) AND MOST FAVOURED NATION (MFN) CLAUSES

In its interim report, the FCA asked for further evidence about the impact of NDAs and MFN clauses on competition. After considering responses, the FCA has decided there is no need for it to intervene in this area at this stage.

POOLING OF PENSION SCHEME ASSETS

The FCA found that smaller pension schemes are less likely to be able to benefit from economies of scale. Therefore, the FCA intends to recommend that the DWP continues to review, and where possible, remove barriers to pension scheme consolidation and pooling. The FCA will work with the DWP to explore the feasibility of this.

DATES TO NOTE

- CP17/18, which covers governance, share class switching and box management, is open for consultation until 28 September 2017.
- The closing date for responses to the FCA's proposal to reject the UILs is 26 July 2017 and it intends to publish its decision on whether or not to refer investment consultants to the CMA in September 2017.
- The FCA plans to publish consultation papers on most of the remaining remedies before the end of 2017.

CONTACT DETAILS

If you would like further information or specific advice please contact:

MICHELLE KIRSCHNER
PARTNER
FINANCIAL SERVICES REGULATION
DD +44 (0)20 7849 2227
michelle.kirschner@macfarlanes.com

TIM CORNICK
PARTNER
INVESTMENT MANAGEMENT
DD +44 (0)20 7849 2510
tim.cornick@macfarlanes.com

LORA FROUD
PARTNER
INVESTMENT MANAGEMENT
DD +44 (0)20 7849 2409
lora.froud@macfarlanes.com

MALCOLM WALTON
PARTNER
COMPETITION
DD +44 (0)20 7849 2575
malcolm.walton@macfarlanes.com

JULY 2017

MACFARLANES LLP
20 CURSITOR STREET LONDON EC4A 1LT

T +44 (0)20 7831 9222 F +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com