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# FURTHER REFORM FOR THE ASSET MANAGEMENT INDUSTRY

A year after it launched its market study into the asset management industry, the FCA has published its interim report. The report focuses on how well competition works in the industry and the resulting outcomes for retail and institutional investors. Given the recent debates over cost disclosures and value for money for investors, it is unsurprising that, under the auspices of its competition role, the FCA proposes a package of reforms that it believes will improve the experience of retail and institutional investors. In this briefing we consider the changes the FCA is considering and why. Some of these changes could radically alter the landscape of transparency and reporting to investors for all asset managers, including hedge fund and, potentially, private equity managers. Asset managers should consider their impact and respond to the consultation if appropriate. The FCA will consider comments on its proposals before publishing amendments to its rules by the second quarter of 2017.

**PROPOSALS IN BRIEF**

- Strengthened duty on asset managers to act in the best interests of investors
- All-in fee approach to quoting charges
- Provide investors clarity about the objectives of a fund and report against these on an ongoing basis
- Clarify and strengthen the appropriate use of benchmarks
- Provide tools for investors to identify persistent underperformance
- Make it easier for retail investors to move into better value share classes
- Clearer communication of fund charges and their impact at the point of sale for retail investors
- Increase transparency and standardisation of costs and charges information for institutional investors
- Explore the potential benefits of greater pooling of pension scheme assets
- Greater clarity on disclosure of fiduciary management fees and performance
- Consult on a potential market investigation reference to the Competition and Markets Authority (CMA) on the institutional investment advice market
- Recommend bringing institutional investment advice within the FCA's regulatory perimeter
- Further FCA work on the retail distribution of funds and the impact that financial advisers and platforms have on value for money

### THE MARKET STUDY

The FCA launched its asset management market study in November 2015, following concerns that came to light during its wholesale sector competition review. The interim report was published on 18 November 2016. In brief, during its study, the FCA found that:

- there is limited price competition for actively managed funds, meaning that investors often pay high charges. On average, these costs are not justified by higher returns;
- there is stronger competition on price for passively managed funds, though the FCA found some examples of poor value for money in this segment;
- fund objectives are not always clear and performance is not always reported against an appropriate benchmark;
- despite a large number of firms operating in the market, the asset management sector as a whole has enjoyed sustained, high profits over a number of years with significant price clustering; and
- investment consultants undertake valuable due diligence for pension funds but are not effective at identifying outperforming asset managers. There are also conflicts of interest in the investment consulting business model which require further scrutiny.

As a result, the FCA suggests a number of reforms, which we consider in this article.

### A STRENGTHENED DUTY ON ASSET MANAGERS TO ACT IN THE BEST INTERESTS OF INVESTORS

The FCA believes that fund governance bodies do not robustly consider value for money for fund investors. It focused its work on the board of authorised fund managers (AFMs) of authorised funds where a group structure is common. The FCA found that AFM boards often lack the authority and independence to challenge the group commercial strategy.

This highlights the risk of a conflict of interest which the FCA believes is likely to be common among management companies of UCITS, NURS and AIFs marketed to retail customers. In many cases, the board does not adequately consider the reasonableness of a manager's fees and the FCA also found that AFM boards often fail to take appropriate and timely steps to address fund underperformance. The FCA considers that if the majority of investors are unlikely to drive value for money, they need strong governance to look out for their interests. Consequently, the FCA proposes strengthening the duty on AFMs of UCITS and AIFs marketed to retail investors to act in the

best interests of investors. It highlights the following options for consideration:

1. Keep existing governance structures but clarify their duties so, for example, expecting the governance body to demonstrate how it has complied with the strengthened duty to act in investors' best interests.
2. Strengthen the requirements on senior managers of the management company. The FCA will achieve this through the extension of the Senior Managers and Certification Regime (SM&CR) and possibly by requiring senior managers to consider value for money as part of this new regime.
3. Change the composition of existing governance bodies to create more independence, for example by mandating that there must be a majority of independent members and an independent chair.
4. Create an additional governance body, modelled on the Independent Governance Committees for DC pension funds, to carry out the new duties and extend the SM&CR to apply to the new body.
5. Replace existing governance structures with majority independent fund boards, similar to the US Mutual Fund structure, with their responsibilities underpinned by the SM&CR.
6. Enhance duties on trustees and depositaries to assess whether the asset manager is delivering value for money.
7. Introduce a statutory duty of care or fiduciary duty between asset managers and their investors.

The FCA indicates that it believes option 7 to be unnecessary, but is open to thoughts on whether a statutory duty offers any advantages over its other non-statutory proposals. It also seeks feedback on particular questions, including how firms can demonstrate they are acting in the best interests of investors.

**ALL-IN FEE APPROACH TO QUOTING CHARGES**

The FCA found that around half of non-advised retail investors are unaware they are paying charges. In addition, the availability of charging information to investors is variable. Since charges can significantly affect the net return investors receive and the lack of information upfront hinders the ability of investors to compare investment returns, it is desirable to make a change in this area. The FCA notes that even the ongoing charges figure (OCF), which UCITS (and, effectively, NURS) fund managers must disclose to investors, does not include 'one off' fees, such as entry and exit charges or performance fees. While these are disclosed separately on the Key Investor Information Document (KIID), there is no disclosure of transaction costs, dilution levies and adjustments. The FCA is also concerned that, where the asset manager does estimate transaction fees in advance, the investor bears the risk of an increase in these fees. This could impact price competition particularly for active fund managers and risks asset managers being less effective at controlling complex costs.

To address these concerns, the FCA proposes an all-in-fee approach to quoting charges so that investors can easily see what managers deduct from the fund. It does not go so far as introducing a cap on fees as was rumoured earlier in the review; instead the FCA proposes four alternative approaches:

1. The current OCF becomes the actual charge taken from the fund. Asset managers would have to cover any variation between the OCF, which is currently an estimate, and the actual ongoing charges taken from the fund. Transaction costs (stamp duty, dealing commissions paid to stockbrokers and the 'bid-offer spread') and other charges not currently in the estimated OCF would not be included in the single charge taken from the fund. This option would require the least change from the present way of deducting charges.
2. The current OCF becomes the actual charge, with managers providing an estimate of any implicit and explicit transaction costs. This would be similar to 1, above, but would oblige asset managers to provide an estimate of the transaction costs the fund will incur. This option would enable easier comparison of the likely total charges across different funds.
3. There is a single charge which includes all charges taken from the fund, including both implicit and explicit transaction costs, but with an option for 'overspend'. The single charge would cover all costs. However, to compensate asset managers for trades in exceptional circumstances, managers could have discretion to take additional transaction charges from the fund but must explain these to investors in the annual statement.
4. There is a single charge which includes all charges taken from the fund, with no option for overspend. The single charge figure would bind the asset manager who would have to pay any additional investment-related or administrative expenses occurred (including transaction costs). The asset manager would bear all the risk of a difference between forecast and actual trading costs.

Where the FCA transfers the risk of added expenditure from the investor to the manager, it recognises the risk that managers may increase the costs to investors or trade less than may be ideal to act in the investors' best interests. As well as seeking feedback on such unintended consequences, the FCA specifically asks if it is appropriate to extend this single charge remedy to other types

of investors and not just retail. The FCA considers the possibility of prohibiting retention by managers of box profits.

#### CLEARER COMMUNICATION OF FUND CHARGES AND THEIR IMPACT ON RETAIL INVESTORS

As discussed above, in some cases the disclosure of charges is regulated and standardised. However, this can depend on the type of fund and the disclosures are not always full, or easy for investors to understand or compare. In particular, the FCA notes that investors find percentages harder to understand;the format used in many disclosures. As well as being concerned with information given to investors at the point of sale, the FCA recognises that investors can find it hard to get an estimate of the charges taken from the fund on an ongoing basis. The introduction of the key information document (KID) under the PRIIPs Regulation will not fully resolve these issues and the FCA's research indicates that only 25 per cent of non-advised retail investors look at the current UCITS KIID when choosing a fund.

The FCA would like feedback on the following proposals, which it envisages will apply to all types of investment vehicles available to UK retail investors, including UCITS, NURS, listed funds, insurance investments and investment trusts:

- making greater use of pounds and pence charging figures in point of sale documents, beyond the KIID; and
- illustrating the impact of charges in ongoing communications with the investor.

In both cases, the FCA wants to ensure that the investor can readily see the total cost of investment.

#### TRANSPARENT AND STANDARDISED COSTS AND CHARGES INFORMATION FOR INSTITUTIONAL INVESTORS

There is less standardisation of costs and charges information for institutional investors and particularly with segregated mandates where, for example, there is no standard definition of annual management charge (AMC). Institutional investors would like better information on costs and charges, although the FCA recognises the impact that price negotiations, confidentiality clauses and Most Favoured Nation (MFN) clauses may have on the true value of such publicly available information. In this context, the FCA seeks further evidence about the impact of confidentiality and MFN clauses on competition. While the FCA does not have enough evidence of harm to propose changes in this area, it is mindful that they may impede transparency and fee negotiations.

To improve transparency for institutional investors, the FCA indicates its willingness to work with industry and investor groups to develop standardised cost disclosure templates. It seeks feedback from stakeholders on the content of this framework, but also on its scope of application. In particular, the FCA is considering whether it should apply to hedge funds and private equity.

#### HELPING RETAIL INVESTORS IDENTIFY THE BEST FUND

The FCA has concerns about how asset managers communicate the objectives and outcomes of a fund to investors. This means that investors find it difficult to know what to expect from a fund and how it is performing against its objectives. In particular, investors may continue to invest in underperforming funds, or expensive actively managed funds which mirror the performance of the market ('closet trackers'), because asset managers do not adequately explain the fund's investment strategy and charges.

For investors who want to look more closely at the performance of their asset manager, the FCA proposes a number of tools which will require managers to:

- set clearer and more specific fund objectives;
- provide a timeframe over which performance should be assessed;
- give investors information which allows them to assess whether performance objectives are being met; and
- requiring managers to explain the performance of funds that have merged or closed.

The FCA intends to carry out further research on funds that are underperforming relative to their objectives and whether the merger of such funds results in better outcomes for investors. If the FCA perceives there to be a problem, it will also consider:

- 'shining a light' on underperforming funds;
- requiring asset managers pro-actively to tell investors when their funds are underperforming; and
- requiring asset managers to compare performance to a relevant benchmark.

The FCA poses a number of questions on these proposals, including whether managers should be required to take action when funds are persistently underperforming.

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

Asset management firms told the FCA that where they create new share classes (typically in response to the Retail Distribution Review (RDR)), 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 need the investors' consent to

transfer them to alternative share classes and many investors do not respond to communications.

The FCA suggests some targeted reforms which could help the investor and the asset manager:

- highlighting differences between old and new share classes;
- testing the effectiveness of different communications in encouraging investors to switch share class;
- making it easier for asset managers to bulk transfer investors to alternative share classes, where it is in their best interests; and
- where appropriate, raising investor awareness of the existence of trail commission and the possibility that they could benefit from switching share class.

**RETAIL DISTRIBUTION**

The FCA proposes further work on the retail distribution of funds, particularly on the impact that financial advisers and platforms have on value for money. In addition, some stakeholders have raised concerns about third party rating providers' business models and the FCA ask for views on whether this is something it should also investigate further.

The FCA acknowledges that the RDR has improved the effectiveness of the fund distribution market. New platforms have launched and market concentration has fallen. However, the FCA's research indicates that best buy lists, third party ratings providers and potentially financial advisers do not give prominence to passive funds, so some retail investors may be overlooking the option to choose a passive fund.

**OTHER PROPOSALS**

The FCA also seeks input on suggestions relevant to pension trustees and investment consultants on the following topics:

- exploring the potential benefits of greater pooling of pension scheme assets;
- greater and clearer disclosure of fiduciary management fees and performance;
- whether the FCA should make a market investigation reference to the CMA on the institutional investment advice market; and
- whether institutional investment advice given by investment consultants and employee benefit consultants should be brought within the FCA's regulatory perimeter.

**NEXT STEPS**

The FCA seeks stakeholder views on its proposed remedies by 20 February 2017. It will set out its confirmed package of remedies in its final report next year. In addition to the feedback received, the FCA will consider its priorities of investor protection, the impact on the UK's competitiveness, and a number of relevant initiatives in the pipeline (for example, PRIIPs, MiFID II and the outcomes of the FCA's consultation on transaction cost reporting to pension schemes and the Independent Governance Committees).

**CONCLUSION**

The FCA found that the asset management industry is not particularly concentrated, with the top ten asset managers accounting for around 55 per cent of the assets under management. However, it has concluded that there is weak price competition in a number of areas of the industry and the FCA makes proposals substantially to tackle this.

Asset managers should assess the impact of the FCA's current proposals and consider submitting a formal response to the interim report, or make representations to their trade associations (which undoubtedly will be mobilised on the issue).


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