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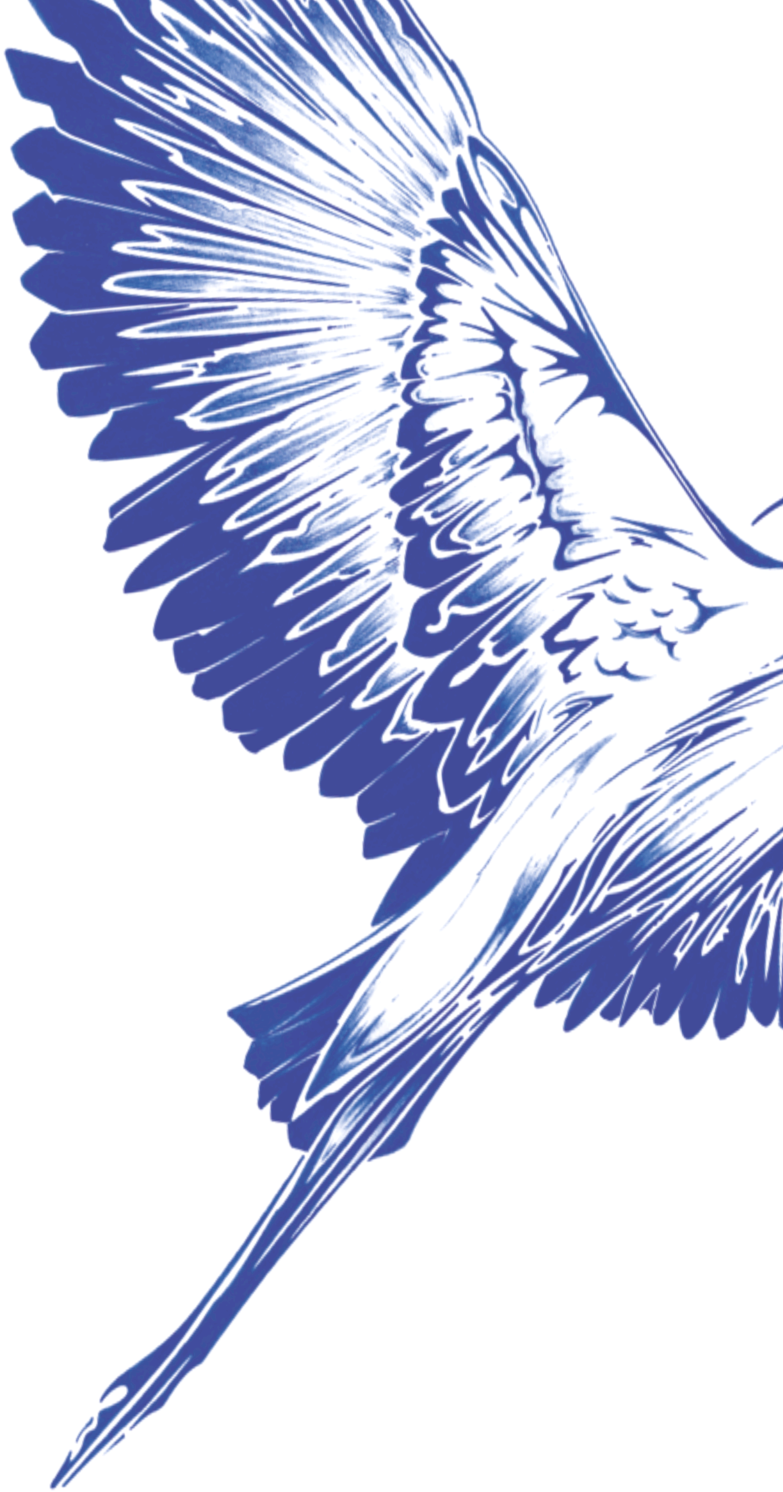
OUTCOMES AND REMEDIES FROM THE FCA'S ASSET MANAGEMENT MARKET STUDY

April 2018



The Financial Conduct Authority ("**FCA**") has recently published a consultation paper and policy statement regarding the findings of the Asset Management Market Study ("**AMMS**"). This Guide outlines the remedies and outcomes from changes to the FCA Handbook through:

- the Policy Statement ("**PS18/8")**; and
- the Consultation Paper ("**CP18/9**").

The new policy contained with the PS18/8 applies to UK Authorised Fund Managers ("**AFMs**") in respect of their management of authorised funds, i.e. authorised open-ended collective investment schemes. The PS18/8 will be of interest to other firms in the investment management industry, such as entities acting as delegated portfolio managers, the depositaries of authorised funds, financial advisers and industry representative bodies. The CP18/9 clarifies the remedies set out in the PS18/8 over what a fund is offering, what it aims to do, how it intends to do it and how performance is shown. The papers aim to help investors, and their advisers make better use of the information available to choose the right funds.

The key findings of the PS18/8 and CP 18/9 respectively are set out below.

Remedies	Key findings	New rules

I. PS18/8

A. MEASURES TO IMPROVE FUND GOVERNANCE

Remedies	Key findings	New rules
a) Strengthening the duty of AFMs to act in the best interest of their investors	There is an existing duty on AFMs to act in the best interests of fund investors (COLL 6.6A.2R and COBS 2.1.4R). AFMs should therefore assess and justify to their fund investors the charges taken from the funds they manage in the context of the overall service and value provided. This is because AFMs play an active role in the management of funds, not just being product providers but acting as agents for the investor. The FCA considers this as being 'value for money' (**"VfM"**). The FCA believes that AFMs have not considered	The FCA has confirmed in its final rules in COLL, their expectation for AFMs. It expects that in order to act in the best interests of investors, AFMs must assess and demonstrate that value is being delivered for investors. This has been achieved by clarifying the detail of assessment the FCA requires AFMs to carry out. To avoid focusing too much on AFMs' costs rather than the full value proposition of funds, the FCA has redrafted COLL 6.6.20R to clarify that fund charges should be assessed in the context of the overall service delivered. The FCA has also refined the non-exhaustive list of elements prescribed for assessment. This redrafting clarifies that AFMs can assess performance over a time period appropriate to the fund's investment objective, policy and strategy.

Remedies	Key findings	New rules
	robustly the value they offer to investors under the existing rules. This is potentially leading to harm to investors through poor value products. The FCA want to hold agents accountable to their underlying clients on how they deliver value. In particular, AFMs must assess the VfM of each fund agent against a non-exhaustive list of prescribed elements and decide whether each fund offers VfM or, if it does not offer VfM, to take affirmative and explain why in an annual publicly available report. The FCA comments that this will help with transparency and scrutiny of the assessments across the industry.	However, a consideration of AFMs' costs and of economies of scale, remains part of the assessment. The AFM must also consider market rates for comparable services, whether the AFM provides the service itself or receives it from another supplier. AFMs can consider additional elements as part of their assessment, and report on these, but the FCA clarifies that they must set out the basis on which these additional elements are considered. The list of elements sets a minimum basis for the assessment, but it does not constrain the exercise of judgement by AFMs on other elements of their service that are relevant, or prevent innovation in their offering to investors. The provision to consider economies of scale does not prevent AFMs from, for example, reinvesting savings achieved through economies of scale into the business, subsidising other parts of the business or covering development costs. However, firms will have to explain these decisions in the annual report and show how these are in the best interest of investors. For a fund set up as an umbrella, the value assessment will take place on a sub-fund-by-sub-fund basis, with each sub-fund described individually. While AFMs can choose the means by which they communicate quantitative and qualitative information, they must comply with FCA rules for communications to be fair, clear and not misleading. **Implementation period:** The FCA has extended the implementation period for this proposal. The new rules will now come into effect approximately 18 months from the date of publication of the PS18/8 on 30 September 2019. A statement setting out a description of the assessment of value, either in the fund's annual report or in a separate composite report must be published. In either case, the statement must be published within 4 months of the end of the relevant annual accounting period. For an annual accounting period that ends before 30 September

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		2019, a statement is not required.
b) Independent directors on AFM boards	AFM boards must balance the interests of their fund investors and shareholders. The AMMS suggested that this balance was not always being struck appropriately, with the FCA believing that it is a result of AFMs boards being staffed exclusively by executives of the firm. The FCA has proposed that AFMs appoint a minimum of two independent directors and that they comprise at least 25% of the total board membership. Independent directors can serve for no more than ten years at once, and directors may not be eligible for reappointment to the same AFM until five years from the end of their last term.	Reflecting the changes in the revised corporate governance code (for more information on the corporate governance code, please read our previous newsletter titled “FRC proposes revised UK Corporate Governance Code” published on the 3 April 2018) the FCA has strengthened provisions on board independence. The FCA believes all investors should benefit from independent scrutiny no matter how large the AFM is and how long it has been operating, despite respondents’ concerns on the cost implications for smaller firms. The FCA acknowledges that this will cost money but believes it is proportionate to the benefits independent directors would bring to the running of funds. Independent directors can sit on more than one AFM within a group. However, the time served will be calculated on a group basis. An independent director can serve a term of up to five years (renewed once to a maximum of ten years) within one group, starting from the time of the first appointment. The FCA has also clarified that a director, having already started to serve on the board of one AFM within a group, is not prevented from serving on another board within the same group, as long as the overall time limits are not breached. For AFMs that already have independent directors, prior to the implementation date, can keep the same directors provided they meet the independence requirements set out in COLL 6.6.25R. Once the rules come into force, existing independent directors can serve for a maximum term of five years (renewed once to a maximum of ten years). In terms of independence, there should be no monetary link to the entire company. A person with a close relative employed in a senior position in the AFM, or another firm in the same group, is unlikely to be considered independent under COLL 6.6.25R.

Remedies	Key findings	New rules
		To qualify to serve as an independent director, an individual can't have been paid by the AFM group for five years before their appointment, or had a material business relationship with it for the last three years. **Implementation period:** the FCA has extended the implementation period for this requirement from 12 to 18 months.
c) SM&CR Prescribed Responsibility and the appointment of an independent chair	The FCA have implemented a Prescribed Responsibility (**"PR"**) for fund managers as part of its extension of the SM&CR to almost all financial services firms.	The new PR means that a Senior Manager, usually the chair of the board of an AFM, must take reasonable steps to ensure that the firm complies with its obligation to carry out the assessment of value, the requirement to recruit independent directors, and the requirement to act in the best interests of fund investors. AFMs should decide whether to have an independent chair, but the FCA must approve the appointment of any Senior Managers. The FCA has noted that they will continue to monitor this situation carefully and propose rules if needed. The rest of the FCA's rules for the extension of the SM&CR will be published in summer 2018.
d) Impact of Brexit	The FCA do not believe that the proposals will damage the competitiveness of UK firms. While the FCA acknowledges the proposed package of remedies will increase costs for some UK firms, they expect that the benefits will outweigh the costs. It is vital to the competitiveness of the UK as a global centre for asset management that clients are confident that the UK fund industry offers good value, and provides a more attractive place for investors.	

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e) Cost benefit analysis	The FCA believe that the additional costs should flow through the AFM, i.e. that the AFM would charge the fund an additional amount to cover the payment by the AFM of the salaries and other costs associated with the independent directors. Whether the additional costs of independent directors should instead be passed on to fund investors by the AFM charging the fund a higher management fee, is a decision for AFMs to make themselves.	
f) Making it easier for fund managers to move investors between cheaper share classes	The FCA has made positive changes in this area, making it easier for fund investors to be moved (converted) to cheaper but otherwise identical classes of the same fund. These changes cover AFMs with a direct legal relationship with the fund investor. This would be a significant reduction in administrative burden and time for AFMs-benefiting both the AFM and the investor.	The FCA has made changes to their non-Handbook guidance (FG14/4) by removing the need for the AFM to obtain individual consent from each investor before converting them. This had previously been a barrier to the conversion of fund investors who did not respond to invitations from the AFM. There remains a recommendation that AFMs check whether the mandatory conversions are consistent with the investor's best interests beforehand. AFMs can now make a simple, one-off notification to investors, which does not require a response, a minimum of 60 days before a mandatory conversion. This ensures that notification recommendations are not too onerous. AFMs should not make any other changes to investors' rights as part of a mandatory conversion and depositaries must make sure that a proposed conversion meets the prospectus terms. This is because the prospectus is an important investor protection for the AFM to formally set out, in a document that is widely available, the extent of its right to carry out such transactions without the fund investors' express consent.

Remedies	Key findings	New rules
g) Trail commission	The FCA currently have no immediate plans to bring forward proposals for policy change on whether they should continue to allow the payment of trail commission, despite receiving feedback.	

B. ENSURING FAIRER TREATMENT OF DEALING PROFITS

a) Requiring AFMs to return risk-free box profits to the fund and disclose box management practices to investors	Managers of some dual-priced authorised funds, by matching the units of incoming and outgoing investors, were making a risk-free profit on the difference between the dealing prices for those matched transactions. The FCA felt that these profits should be repaid to the fund, for the benefit of investors. AFMs will now be able to retain box profits which they have earned through an 'at risk' exposure but not when they are achieved risk free.	The use of box profits can be compatible with acting in the best interests of investors, as the AFMs commit their own capital to a fund and participate in its risks and returns. The key adjustments the FCA have made in the final rules are: – to require the AFM not to retain risk-free box profits and to allocate them in a way that is fair to unitholders, while removing the obligation to pay them to the fund. Guidance indicates that profits could be allocated fairly by paying them to the fund or to individual investors who have bought and sold units; – to recognise situations where risk-free profits are offset by losses on some transactions, when the dealing spread is narrower than the maximum permitted spread; and – to change the frequency for making payments to the fund. The FCA notes that this may disincentivise AFMs from offering investors narrower dealing spreads. An AFM that sets dealing spreads to the advantage of transacting investors should not be penalised for doing so, compared to one that charges the maximum

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possible spread between sales and redemptions. To address this point, the FCA has expanded COLL 6.3.5DR to, recognising situations where the AFM's risk-free profit made on matched sales and redemptions is offset by a loss on certain sales and redemptions. Specifically, the rule amendment should allow a loss to be recognised where:

- unmatched units from sales must be met by creation of new units, when the creation (issue) price is above offer (sale) price; and
- unmatched units from repurchases are cancelled immediately and not held on the box, when bid (redemption) price is above cancellation price.

The effects of the rule are that:

- losses on sales cannot be offset if it would have been possible to cover the sale from units held on the box or redeemed at the same valuation point (this is purely for the purpose of calculating the amount due to the fund under this rule; it does not prescribe how the AFM actually chooses to allocate old and new units from the box);
- the amount of profit the AFM must give up is not reduced to take account of any adjustments made to correct dealing errors relating to previous valuation points; and
- where the offsetting of losses against risk-free profit results in an overall box loss, this loss cannot be carried forward to offset a net risk-free profit on day two and reduce the amount the AFM must give up – it must be reset to zero after each valuation point.

This amended rule is not intended either to force the AFM to set a narrower dealing spread, or on the other hand to protect it from ever suffering a loss. However, it should treat AFMs more equitably when they commit their own capital to the box by assuming at-risk positions and setting dealing spreads to benefit the investor over the

Remedies	Key findings	New rules
		AFM itself. **Implementation period:** The commencement date is being deferred for 12 months to allow firms to make the necessary changes.
b) Role of the depositary	The FCA has included the changes on risk-free box profits as part of the existing monitoring requirements on depositaries. The changes are broadly compatible with the depositary's current duties and should be no significant additional burden.	The FCA has confirmed that they do not expect depositaries to carry out daily checks on whether an AFM is correctly calculating its dealing profits and has made some changes to the rule. It should be enough that the amount determined by the AFM is reflected in the price calculation where it is material, that payments accrued for in the fund valuation are regularly received into the fund's account and that if there are any breaches that these are reported as usual. However, the FCA expects the depositary to regularly review the AFM's processes as part of its wider testing of the effectiveness of the AFM's controls over valuation and pricing. These checks might include sample testing of the calculations performed by the AFM to ensure they are complete and accurate.
c) Extending the scope of FCA governance proposals to other investment products	Feedback on whether the FCA should extend any aspects of their governance proposals for the authorised funds market to other investment products, specifically to unit-linked and with-profits insurance products and investment trusts (otherwise known as investment companies) was mixed. Diagnostic work has therefore been planned into with-profits and unit-linked products that will provide more evidence if any harm exists in the market. The FCA will communicate their findings in the first half of 2019 commenting whether any further intervention is needed.	The FCA is keeping the possibility of further changes to investment trust government arrangements under review, but do not plan any immediate action on this. As a result of the feedback received, the FCA will not bring forward any proposals on extending the government proposals to pensions, but will consider the issues as part of an assessment on non-workplace pensions.

CP18/9	Key findings	Proposed guidance

II. CP18/9

A. HELPING INVESTORS CHOOSE THE RIGHT FUND

a) Fund objectives and investment policies	The FCA is proposing to publish guidance on how they expect funds to make their objectives more useful to investors, emphasising that jargon should be avoided. Further guidance will also be published on how firms should meet existing disclosure rules, funds are now expected to disclose that their portfolio construction is in practice constrained, relative to a benchmark.	Objectives should explain what a fund is doing in clear, consumer friendly language. In the new guidance, the FCA has set what it expects to be included in the objectives section of key information documents such as the key investor information document (**"KIID"**) required by the Undertakings for Collective Investment in Transferable Securities (**"UCITS"**) Directive and the 'what is this product' section of the Packaged Retail and Insurance-based Investment Products Regulation (**"PRIIPs"**) key information document ("**KID"**). This means including elements of the investment strategy in the KID in order to explain how a fund will achieve its aims. Firms are also required to update the KID at least once a year, and more frequently if things change, for example a change of manager on a fund or a new investment strategy. Objectives should explain any constraints on a fund**.** This includes any 'internal' constraints or whether the fund in practice is managed with reference to a benchmark such as the risk management process for a fund causing it to be monitored and controlled relative to a benchmark. Funds setting out non-financial objectives should explain these clearly and in full, should not mislead investors and should measure and report against them.

CP18/9	Key findings	Proposed guidance
b) Benchmarks	The AMMS shows that investors would benefit from more precise and consistent use of the term 'benchmark', as firms are using the term in different ways, in relation to indices, targets or as a comparator. Please note the consideration of benchmarks and their uses is distinct from the new EU Benchmarks Regulation. The FCA has split the term 'benchmark' into three different concepts. The benchmark categories relevant to the FCA's proposals are: – a 'constraint': an index or similar factor used by AFMs as a constraint on a fund's portfolio construction; – a 'target': an index or similar factor that is part of a target an AFM has set for a fund's performance to match or exceed, which necessarily includes anything used for performance fee calculation; and – a 'comparator': an index or similar factor that an AFM invites investors to compare against a fund's performance, such as 'the return of the FTSE All-share'.	The FCA has proposed rules that now require AFMs to explain in a fund's prospectus and in other consumer-facing communications that include fund-specific information, why they have used any constraint, target or comparator for a fund, as applicable. Where an AFM has not set a constraint, target or comparator for a fund, the FCA requires that the AFM explain to investors how they should asses the fund's performance in the fund's prospectus and relevant communications. The intention is that investors will gain valuable insight into how the AFM views the fund and how it thinks the fund's performance should best be judged, and that this will promote better informed choices by investors. The FCA is also proposing on new rules to require that benchmarks are consistently cited and described in each fund's prospectus and in relevant communications, or not, if there are no benchmarks. If AFMs produce a UCITS Key Investor Information Document (**"KIID"**), they must present their past performance in it. The AFM can choose how they wish to display their past performance but must show it in their prospectus. The UCITS KIID Regulation requires benchmarks to be stated where used, and performance to be displayed against such benchmarks. Funds' constraints or target benchmarks should appear in the Objectives and Investment Policy section of the KIIDs, and as a result of Article 18(1) of the Regulation, AFMs should show their KIID past performance against these benchmarks. **Implementation period:** The FCA are proposing a period of three months for the new Handbook rules and guidance for new funds, and six months for existing funds.

CP18/9	Key findings	Proposed guidance

B. PERFORMANCE FEES

a) Performance fees taken by AFMs	The FCA is not proposing significant changes for now, and remain focused on existing rules as to whether fees are fair. However, they are consulting on one change. The current guidance suggests that an AFM should not charge performance fees on gross performance, however, it is not strictly prohibited. The FCA is proposing a new rule to prevent AFMs charging performance fees on a gross basis, consistent with Good Practice 4 of the 2016 International Organisation of Securities Commissions (IOSCO) Report 'Good Practice for Fees and Expenses of CIS'	Any AFMs currently operating performance fees of this type would incur one off costs in discontinuing the practice. They would need to update their prospectus, and may need to update other consumer-facing disclosures. They would also likely incur some operational costs in setting up a new way of calculating their performance fees. The FCA believes this cost would be relatively small and the benefits of the proposal would outweigh any estimated costs. **Implementation period:** A six-month implementation period is expected.

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