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FCA publishes final report on competition in UK asset management

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The Financial Conduct Authority ("FCA") published today its final report on its asset management market study.

The report is the culmination of almost two years' work on the UK asset management sector by the FCA, focussing on matters such as weak price competition amongst asset managers (particularly in the active retail sector), perceived high profitability, price clustering for asset management fees and a lack of customer focus on fund charges.

The Final Report sets out the FCA's conclusions on its work, and the FCA will now focus on specific remedies. Because remedies will be the subject of various future consultations, there are no immediate rule changes, although the FCA includes a Consultation Paper (CP 17/18) to set out its proposed specific new rules on a number of areas covered in the final report.

The FCA's work mainly impacts retail fund managers that are established in the UK. Alternative investment fund managers are not directly impacted. Retail fund managers that are established in EEA jurisdictions outside the UK (such as Luxembourg and Ireland) are also not directly impacted, including those that operate in the UK by exercising passport rights.

The FCA's proposals are as follows.

Fund governance and asset manager duties

To address its criticism that fund governance bodies are not independent from the fund manager and do not appear to challenge "value for money" on behalf of investors, the FCA will consult on new rules for authorised fund managers ("**AFMs**") of UK authorised funds. The FCA proposes to require AFMs to appoint a minimum of two individuals, and at least 25% of the total board, as independent directors on the board. An independent chair will not be required this is a matter for the AFM to decide. In its accompanying Consultation Paper, the FCA sets out its requirements for directors to be sufficiently independent to serve on the board, such as that a board member cannot be an employee of the AFM, or a recent employee, or remunerated by the AFM for any other role. The FCA also sets out the factors that the AFM board should consider as to whether value for money has been provided to fund investors, taking into account matters such as whether economies of scale are shared with retail investors, the criteria to assess the manager's performance, and whether the fund management fee and other charges are reasonable (compared to other similar products, or comparable institutional client accounts). AFMs will be required to publish an annual report on this assessment and the actions they have taken to discharge this responsibility. This is a significant development in fund governance.

There are interesting parallels here with the requirement under the US Investment Company Act of 1940 that at least 40% of a US mutual fund's board of directors not be "interested persons" of the fund. That Act sets out strict conditions for assessing a director's independence, and, in practice, independent directors represent a majority, and frequently more than 75%, of many board of US investment companies. There are also similarities between the factors that the FCA sets out for the board's consideration and the factors that must be addressed in shareholder reports for US mutual funds regarding the board's considerations in performing its annual review of the fund's investment advisory contract, including approval of the advisory fee, the extent to which economies of scale are realized as the fund grows and comparisons of the advisory fee with that paid under other advisory contracts."

Separately, the FCA will apply its Senior Managers Regime to all authorised firms in 2018. This regime is to ensure better accountability of senior individuals in firms for their decisions and conduct. Under the regime, firms must allocate applicable responsibilities to relevant senior managers to ensure that there is an individual accountable for all aspects of regulated activity in the firm and, therefore, liable, if the regulator can show that the individual did not take "reasonable steps" to prevent misconduct. To increase the effectiveness of fund boards, the FCA proposes to introduce a new "Prescribed Responsibility" under the regime to ensure that asset managers act in the best interests of investors, including assessing value for money, and to allocate this responsibility to the chair of the AFM board.

These rule changes will also apply to UK UCITS managers, but not EEA UCITS managers that are accessing the UK market through the passport. The FCA points out that the main UCITS jurisdictions of Luxembourg and Ireland have introduced "comparable fund governance proposals over recent years, including independence requirements", but these arguably do not go as far as the FCA's requirement for two independent directors at the manager level and for the board to challenge the value for money provided by the fund's service providers.

Fund objectives, benchmarks and performance

The FCA has earlier expressed concerns on whether investors understand the investment objectives that the fund indicates it will meet, and whether investors can in practice assess that the fund is performing against its objectives. The FCA has also raised concerns on possible investor confusion as to whether a benchmark is being used for comparison or management purposes, and the degree to which a fund's strategy is linked to a benchmark. In its 2016 interim report, the FCA considered requiring a benchmark for all funds, allowing investors to track performance against the benchmark over time.

At this stage, the FCA does not propose any specific rules changes in this area, but will carry out further work to require managers to be more specific when describing the fund's objective (focussing on the language used) and to ensure that managers track performance of the objective over time, including against any benchmark. The FCA will chair a working group on this subject before considering any rule changes.

The FCA does not "currently" think that all funds should have a benchmark, but will consult on rules and guidance that will require managers to be clear about why a benchmark has been used, and require that the use of benchmarks is consistent across marketing materials. Where a fund does not set a benchmark, the FCA will consult on introducing a new requirement that the fund explains the reasons for this to investors.

The presentation of past performance information is already governed by rules in the UCITS Directive and the Markets in Financial Instruments Directive ("**MiFID**"). As an overlay to these rules, the FCA will consult on new requirements to clarify that, when AFMs present past performance, they must do so against the "most ambitious target" communicated to investors. For example, where an absolute return fund's most ambitious target is LIBOR +4%, the effect of the proposed new rule will be to make clear that, where the AFM displays the fund's past performance, it must show the past performance against LIBOR +4%, and not against LIBOR alone.

The FCA has separately raised concerns that investors do not switch away from funds with long-term under-performance. The FCA found that "self-correction" by the industry, such as the closure or merging of under-performing funds, is effective to a degree. However, in light of its proposals for funds to better clarify their objectives and their use of benchmarks, the FCA will not take any further actions to "shine a light" on persistently poorly performing funds.

Transparency of fees and charges and treatment of fund performance fees

The FCA reiterated its concerns in the report that investors do not pay sufficient attention to fund charges or understand what they represent. The FCA acknowledges that the new disclosure requirements under MiFID II and the forthcoming PRIIPs Regulation (as from January 2018) will require firms to provide aggregated and on going information on all costs associated with a fund (including underlying transaction costs), in particular requiring firms to show all costs as a single figure in monetary and percentage terms. The FCA considers that these EU-wide requirements will substantially address its concerns on greater clarity on charges. In light of this, the FCA will concentrate on improving the effectiveness of disclosure, focussing on matters such as formatting and prominence. It is helpful that the FCA acknowledges that the industry is doing much to bolster its efforts to increase transparency, whilst also allowing the time required to see how MiFID II will affect such measures.

The FCA makes some significant comments on funds' use of performance fees. Under current rules, funds may charge a performance fee, but there are no particular rules on how it is operated, other than that the fee must not be unfair to unitholders. The FCA is considering consulting on new rules to permit performance fees to be charged only above the "most ambitious target" that the fund holds out to investors, and only above the "most ambitious target" after deduction of ongoing fees. There is some lack of clarity on what is meant by the "most ambitious target", and there is the possibility that firms will stop publishing any such target in response to the new rule. The FCA also refers to consulting on a possible requirement that losses should be offset before further performance fees are charged (a high water mark, which is currently the norm), and will consider more generally whether additional policy action is required to make UK funds' performance fees more equitable, considering "asymmetric fees" that do not align investor and manager incentives.

In relation to disclosure to institutional investors, the FCA acknowledges that MiFID II requirements means that firms should provide accurate information on costs and charges. The FCA wants to encourage a standardised template for this disclosure, and will convene a group of stakeholders to take this forward.

Box management practices

Currently, fund managers may operate a "manager's box", which is a mechanism for the manager (as principal) to deal with investors in units in a fund and to match transactions between buying and redeeming investors, with the opportunity to make a profit when buying and selling units. There is currently no rule that explicitly prohibits managers from retaining profits from box management, and the FCA's concern is that some managers may profit unfairly, this practice, although acknowledges that this is not a widespread norm.

The FCA proposes new rules to require AFMs to pass "risk-free" box profits to the fund and to disclose their policy on operating a manager's box, and how any profits will be treated. The FCA notes that firms have already appeared to be changing their practice in this area, following publication of its interim report in 2016.

What is box management?

The 'manager's box' is a mechanism whereby a manager, using its own capital, stands between the fund and the investors who are entering or leaving the fund, rather than the investors transacting directly with the fund. For example, investors wanting to leave the fund sell their units to the manager, who pays them the amount due. Instead of cancelling the units, the manager holds them in the manager's box and can subsequently sell these units on to other investors.

In dual-priced funds there is a difference between the price investors pay to buy units in the fund ('offer price') and the price to sell units ('bid price'). A manager can make a profit in operating its box. One way in which it can make a profit is if it owns the units over a valuation point in the fund. These units are subject to price fluctuations and the manager may make a profit or loss, depending on changes in the valuation of units. The FCA considers this to be an 'at-risk' box profit.

Another way in which a manager may make a profit using the manager's box is when the manager buys units at the offer price and sells them at the bid price at the same valuation point. In this scenario, the manager makes a profit from the difference between the bid and offer price. The manager's capital is not at risk, as matching is instantaneous. The FCA considers this to be a 'risk-free' box profit.

Retail investors switching share classes

The FCA has raised the concern that some retail investors continue to hold more expensive share classes, where, post-FCA 2012 Retail Distribution Review ("**RDR**"), cheaper "clean" share classes (which do not attract trail commission) are available. Some of these share classes continue to pay trail commission to financial advisers who acted as intermediaries for sales, which is permitted for products sold prior to RDR coming into effect. The FCA points out that in practice investors may not know that they are still paying trail commission, and that some managers are unwilling to stop the payment of trail commission. However, in the report, the FCA does not propose any immediate restriction on the continued payment of trail commission to financial advisers (and is mindful of the impact if it did on small and retired advisors). As an interim measure, the FCA is asking for evidence of scale and investor harm and refers to "future policy work in this area".

The FCA has also stated that, where firms create new share classes, they find it difficult to switch investors to the cheaper share class – primarily because investor consent is required. The FCA has already published guidance (FG 14/4) on changing customers to post-RDR unit classes. As a further step, the FCA will clarify that an AFM can undertake a mandatory conversion of share classes for unitholders, subject to the conditions outlined in its earlier guidance (such as prior notification to the investor).

Further FCA work on competition in retail distribution

Fund distribution "platforms" are responsible for a significant part of retail fund distribution in the UK. In its report, the FCA considers the impact of platforms on fund charges and the total cost of investment, and the barriers that platforms may create to managers gaining routes to market. The FCA states that, since the RDR, distribution costs and intermediary fees have increased, and are often in excess of fund manager fees. In light of the dominance of a small number of such platforms, and a perceived lack of competition in the market, the FCA has announced that it will undertake a market study on investment platforms, to consider how "direct to consumer" and intermediated investment platforms compete to win new and retain existing customers, and to explore whether platforms enable investors to access products that offer the best value for money. This will be a significant new piece of work for the FCA.

Institutional investors and investment consultants

The FCA is mindful that smaller pension schemes have fewer resources to monitor performance of their asset managers, and wants to encourage economies of scale through pooling of their assets. The FCA will not make asset pooling mandatory for defined contribution or defined benefit pension schemes, but recommends that the relevant government department continues to explore how to remove barriers to pension scheme consolidation and pooling.

The FCA has paid particular focus on the competition aspects of the investment consulting market, defined as firms that provide investment advisory services (such as strategic asset allocation and manager selection) to institutional investors and advice to employers on pension schemes. In its 2016 interim report, the FCA made a provisional decision to make a market investigation reference of investment consultants to the Competition and Markets Authority ("**CMA**"). This was prompted by the FCA's findings of "high levels of concentration and stable market share amongst investment consultants", and perceived conflicts of interest in some of their activities.

In response, the three largest investment consultants provided undertakings in lieu of the reference – a mechanism to resolve the FCA's concerns as an alternative to a reference to the CMA. In its final report, the FCA states that it is proposing to reject these undertakings, is seeking views from other interested parties on this proposal and expects to make a final decision on whether to make a market investigation reference to the CMA in September 2017. The FCA also recommends that the Treasury brings advice given by investment consultants on strategic asset allocation, and advice given by employee benefit consultants to employers on establishment of pension schemes, into the regulatory perimeter, allowing the FCA to supervise the quality and independence of advice given.

Extending the proposals to other retail investment products

The FCA's study focussed on the market for retail investors that invest through funds and segregated mandates. It did not cover economically similar products such as unit-linked insurance products and investment trusts, which are not FCA-authorised in their own right. In the FCA's view, and mindful of possible regulatory arbitrage, customers that invest through unit-linked or with-profits life assurance products would also benefit from the protections proposed for authorised funds, and the FCA invites views on extending the new governance rules to these types of products. The FCA also asks for views on introducing similar rules to investment trusts.