

July 2017

Practice Group:

*Investment
Management, Hedge
Funds and
Alternative
Investments*

UK Asset Management Study - FCA's Final Report and Package of Remedies

By Andrew Massey

On 28 June 2017 the UK Financial Conduct Authority (FCA) published the [final report](#) for its study into the UK asset management market. The report describes the FCA's final findings and sets out the regulatory changes and remedies the FCA proposes to implement to address the concerns identified. This briefing note provides an overview of the findings, the evolution of the package of remedies, and the roadmap for implementation of the remedies.

Background

The objective of the asset management market study was to determine how UK asset managers compete to deliver value to retail and institutional investors. The intention was to identify perceived deficiencies and the interventions that could be made to improve the efficiency of the market and the outcomes for investors.

In November 2016 the FCA published an [interim report](#) describing its provisional findings and proposed a range of remedies intended to improve the competitiveness of the UK market. Following publication of the final report, we consider which of the proposed remedies identified in the interim report are to be taken forward (see 'Proposed remedies vs 'final' package of remedies' below). Since the package of remedies interacts with a number of other initiatives (including forthcoming regulatory changes such as MiFID II¹ and PRIIPs KIDs², the Investment Platforms Market Study, and the market investigation reference affecting investment consultations), we set out the likely roadmap for implementation of the remedies (see 'Roadmap for implementation of final package of remedies' below).

FCA final findings

The FCA's final findings broadly affirm those identified in its interim report. The key findings include the following:

- **Weak price competition** - Evidenced by (i) asset management fee price clustering, (ii) the stability of active management fees over the last 10 years, (iii) differential pricing between institutional investors and equivalently-sized retail funds, and (iv) the high levels of profitability of asset managers.
- **Investors paying for underperformance** - Evidenced by (i) the failure on average of actively managed and passively managed funds to outperform their own benchmarks after fees, and (ii) the absence of a clear relationship between the level of fees/charges and the gross performance of retail actively managed funds in the UK.

¹ The revisions to the current European Union Markets in Financial Instruments Directive known as "MiFID II" effective 3 January 2018

² The key Information document (KID) for packaged retail and insurance-based investment products (PRIIPs) being introduced in the European Union effective 1 January 2018

UK Asset Management Study - FCA's Final Report and Package of Remedies

- **Closet-tracking** - Evidenced by many active funds offering similar exposure to passive funds whilst charging significantly higher fees.
- **Concerns regarding the effectiveness of intermediaries** - Evidenced in relation to institutional investors by the high market share of the three largest investment consultants.

Overview of FCA's package of remedies

The tables below summarise the evolution of the remedies (i.e. which of the remedies proposed in the interim report are being pursued) and the expected steps for implementation of those remedies. Those that will be of particular interest to UK authorised fund managers (AFMs) include the following:

- **Governance and cultural changes** - With the aim of impacting decision-making within firms, the introduction of an independence requirement is to be pursued, but at the AFM level and not the fund level. In addition, the existing proposal to extend the Senior Managers and Certification Regime to all authorised firms may incorporate obligations on senior managers designed to ensure value for money.
- **All-in-one fee** - The FCA remains supportive of the concept of an all-in-one fee, but this proposal is on-hold pending MiFID II implementation, which will enhance costs disclosure for investors using intermediaries.
- **Further investigation into investment consultants** - Following the FCA's proposal in the interim report to make a market investigation reference (MIR) to the Competition and Markets Authority (CMA) in respect of investment consultancy services, the FCA considered whether to accept undertakings in lieu of the MIR proposed by the three major investment consultancies. The FCA proposes to reject the undertakings in lieu and to persist in making a MIR. The FCA expects to make a final decision in September. Assuming the MIR goes ahead, there will be a two-year investigation requiring detailed input from market participants and stakeholders. The investigation may culminate in the imposition of remedies by the CMA intended to change the behaviour of firms and the wider market and, if anti-competitive behaviour is identified, a further investigation into the conduct of relevant parties.

Proposed remedies vs ‘final’ package of remedies

The following table describes the remedies proposed in the interim report and identifies whether these form part of the FCA’s ‘final’ package of remedies set out in the final report. The final remedies will impact UK authorised fund managers — principally in relation to UCITS schemes³ and non-UCITS retail schemes (NURS) established in the UK, and UCITS schemes established in the European Economic Area (EEA) with a UCITS management company in the UK — but there will also be some broader impact on UK asset managers and distributors/intermediaries.

Initiative	Proposed remedy	To be adopted?
Strengthen the duty on authorised fund managers (AFMs) to act in best interests of investors	Clarify/strengthen duty of AFM board to act in investors’ best interests	Yes
	Require the AFM board and senior managers to consider value for money	Yes
	Impose greater duty on trustees/depositaries to assess whether managers are delivering value for money	No
	Statutory duty of care or fiduciary duty owed by managers to investors	No
Governance changes for UK authorised funds	Require AFMs to have a majority of independent members and an independent chair	Yes
	Create a separate independent body	No
	Require fund boards to have a majority of independent members	No
Improve disclosure of information to retail investors	Require managers to set clear and specific fund objectives	Potentially
	Require specification of timeframe over which performance should be assessed	Potentially
	Require specification of information to allow investor to assess whether performance objectives are being met, including disclosing managers’ benchmarks	In part
	Require managers to compare performance to a relevant benchmark	In part
Clearer communication of fund charges for retail investors	Introduction of an all-in-fee	Potentially
	Require greater use of pounds and pence charging figures in ‘point of sale’ documentation	Potentially
	Require managers to illustrate the impact of charges in ‘ongoing’ investor communications	Potentially
Address persistent underperformance	‘Shine a light’ on funds with long-term underperformance	Unlikely
	Require managers to inform investors if their funds are underperforming relative to the fund’s objectives	Unclear


³ Schemes constituted in accordance with the UCITS Directive (Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 as amended by Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014)

Initiative	Proposed remedy	To be adopted?
	Require managers to explain performance of funds that have merged/closed	Unclear
Make it easier for retail investors to switch to better value share classes	'Shine a light' on differences between old and new share classes	Unlikely
	Experiment with different communications to test effectiveness in encouraging investors to switch	No
	Make it easier for managers to bulk transfer investors where it is in their best interests	Yes
	Raise investor awareness of trail commission on pre-retail distribution review (RDR) share classes	Potentially
Box-management	Require benefits of risk-free box management (i.e. for AFMs of dual-priced funds that make net adjustments to the box on each dealing day and receive the 'box profit' arising on the spread charged to subscribing/redeeming investors) to be solely for the fund's benefit	Yes
Interventions to assist institutional investors	Market investigation reference (MIR) to Competition and Markets Authority (CMA) in relation to institutional advice market	Potentially
	Increase transparency and standardisation of costs and charges for institutional investors	Potentially
	Require better disclosure of fiduciary management and performance fees by investment consultants that provide both fiduciary management and asset allocation advice	Potentially
Economies of scale	Encourage greater pooling of pension scheme assets	Potentially

Roadmap for implementation of final package of remedies

The following table sets out expectations as to how each of the remedies identified in the ‘final’ package is to be progressed.

Initiative	Proposed remedy	Next steps
Strengthen the duty on authorised fund managers (AFMs) to act in best interests of investors	Clarify/strengthen duty of AFM board to act in investors’ best interests	To be considered in FCA consultation on extension of Senior Managers and Certification Regime to AFMs (FCA Consultation Paper 17/25).
	Require AFM board and senior managers to consider value for money	Imposition of requirement to assess value of money being considered in FCA Consultation Paper 17/18. Position for senior managers to be considered in FCA consultation on extension of Senior Managers and Certification Regime to AFMs.
Governance changes for UK authorised funds	Require AFMs to have a majority of independent members and an independent chair	Being considered in FCA Consultation Paper 17/18. Proposed to require a minimum of two independent directors, and at least 25% of total board membership.
Improve disclosure of information to retail investors	Require managers to set clear and specific fund objectives	FCA to chair a working group, which may result in new rules or guidance. FCA supportive of industry-led initiatives to consider language used and naming conventions.
	Require specification of timeframe over which performance should be assessed	The PRIIPs KID will introduce a recommended hold period (albeit UCITS are exempt until 31 December 2019). Working group to be convened by FCA may consider alternative ways to deliver such information to investors.
	Require specification of information to allow investor to assess whether performance objectives are being met, including disclosing managers’ benchmarks	FCA intends to consult on requirements regarding presentation of past performance, including: (i) requiring performance to be presented against benchmark/target (if one is used in marketing materials); and (ii) prohibiting use of benchmarks/target/comparator in materials unless a specific benchmark/target/comparator is set.
	Require managers to compare performance to a relevant benchmark	In part, for funds that identify a benchmark - consultation expected (see above).

Initiative	Proposed remedy	Next steps
Clearer communication of fund charges for retail investors	<u>All-in-fee - option 1:</u> Make current ongoing charge (OCF) the all-in fee (i.e. managers pick-up other costs e.g. transaction costs)	 <p data-bbox="1339 448 2007 545">Introduction of an “all-in-fee” is pending. Proposed to rely on PRIIP KIDs and MiFID II requirements (for time being).</p>
	<u>All-in-fee - option 2:</u> Make current OCF the all-in fee with managers estimating transaction costs	
	<u>All-in-fee - option 3:</u> Single charge including transaction costs with overspend mechanism	
	<u>All-in-fee - option 4:</u> Single charge including transaction costs with no overspend mechanism	
	Require greater use of pounds and pence charging figures in ‘point of sale’ documentation	FCA considering whether to consult on whether to provide guidance.
	Require managers to illustrate the impact of charges in ‘ongoing’ investor communications	Effectiveness of fund charges disclosures being considered as part of FCA’s Smarter Consumer Communications initiative .
	Performance fee operating models	FCA to consider whether additional policy action is required to ensure UK funds with performance fees operate equitably.
Address persistent underperformance	Require managers to inform investors if their funds are underperforming relative to the fund’s objectives	FCA to see whether remedies to improve clarity of objectives and the use of benchmarks/comparators, along with increasing transparency of costs and charges (see above) will better equip investor to identify/understand persistent underperformance.
	Require managers to explain performance of funds that have merged/closed	Unclear whether/how this is to be progressed.
Make it easier for retail investors to switch to better value share classes	Making it easier for managers to bulk transfer investors where it is in their best interests	Being considered in FCA Consultation Paper 17/18. Proposed to permit mandatory conversions if certain conditions satisfied.
	Raise investor awareness of existence of trail commission on pre-retail distribution review (RDR) share classes	May be considered in the future.

Initiative	Proposed remedy	Next steps
Box-management	Requiring the benefits of risk-free box management to be solely for the fund's benefit, which will affect dual-priced funds operating a box that is adjusted on a net basis	Being considered in FCA Consultation Paper 17/18. Proposed to require risk-free box profits to be directed to fund and require disclosure of box management practices.
Interventions to assist institutional investors	Market investigation reference (MIR) to Competition and Markets Authority (CMA) in relation to institutional advice market	FCA consulting on provisional view to reject the undertakings in lieu received from the largest investment consultations and whether to proceed with MIR to CMA.
	Increase transparency and standardisation of costs and charges for institutional investors	FCA supportive of industry-led initiatives to develop templates to facilitate MiFID II costs and charges disclosure requirements. FCA to convene a group of relevant stakeholders chaired by an independent person to seek to achieve a consensus between managers and institutional investors on templates.
	Require better disclosure of fiduciary management and performance fees by investment consultants that provide both fiduciary management and asset allocation advice	To be considered as part of possible MIR to CMA.
	Expand regulatory perimeter to include advice provided by investment consultants to institutional investors	FCA is recommending to HM Treasury to expand the regulatory perimeter to include asset allocation advice.
Economies of scale	Encourage greater pooling of pension scheme assets	FCA will continue to work with Department of Work & Pensions.
Distribution in the retail market	Further work ongoing/required.	FCA undertaking Financial Advice Market Review , launched in 2015. FCA to undertake Investment Platforms Market Study (Terms of Reference MS17/1.1 published 17 July 2017).
Extension to other retail investment products	Further work required on effectiveness of existing regime for other retail investment products e.g. unit-linked or with-profits insurance products such as personal pensions, investment bonds or endowments.	In FCA Consultation Paper 17/18 the FCA requests views on such an extension.

UK Asset Management Study - FCA's Final Report and Package of Remedies

Author:

Andrew Massey

andrew.massey@klgates.com

+44.(0)(20).7360.8233

Contacts to Discuss Issues Raised in This Alert:

If you wish to discuss any of the issues raised in this alert, please contact:

Andrew Massey

andrew.massey@klgates.com

+44.(0)(20).7360.8233

Philip Morgan

phillip.morgan@klgates.com

+44.(0)20.7360.8123

Jacob Ghanty

jacob.ghanty@klgates.com

+44.(0)20.7360.8211

Todd Gibson

todd.gibson@klgates.com

+1.412.355.8315

Scott Megregian

scott.megregian@klgates.com

+44.(0)20.7360.8110

Jennifer Marsh

jennifer.marsh@klgates.com

+44.(0)20.7360.8223

K&L GATES

Anchorage Austin Beijing Berlin Boston Brisbane Brussels Charleston Charlotte Chicago Dallas Doha Dubai
Fort Worth Frankfurt Harrisburg Hong Kong Houston London Los Angeles Melbourne Miami Milan Munich Newark New York
Orange County Palo Alto Paris Perth Pittsburgh Portland Raleigh Research Triangle Park San Francisco São Paulo Seattle
Seoul Shanghai Singapore Sydney Taipei Tokyo Warsaw Washington, D.C. Wilmington

K&L Gates comprises approximately 2,000 lawyers globally who practice in fully integrated offices located on five continents. The firm represents leading multinational corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organizations and individuals. For more information about K&L Gates or its locations, practices and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

© 2017 K&L Gates LLP. All Rights Reserved.