

Next Steps in the Asset Management Market Study

FCA publishes final rules and further consultation on outstanding remedies under its asset management market study.

Key Points:

- The FCA has published a [Policy Statement \(PS18/8\)](#) setting out final rules and guidance concerning the governance and duties of fund managers. The final Handbook provisions set out in PS18/8 will come into force on 1 April 2019 and 30 September 2019, and the finalised non-Handbook guidance is effective immediately.
- The FCA has also published a [further consultation \(CP18/9\)](#) on proposed rules and guidance concerning the provision of information by funds to investors, specifically relating to fund objectives and the use of benchmarks. Feedback is requested on CP18/9 by 5 July 2018.

Background

Alongside the publication of the FCA's final report in its asset management market study in June 2017 (see Latham's related [Client Alert](#)), the FCA launched a consultation (CP17/18) on the proposed remedies it considered required full consultation (other remedies not requiring further consultation were confirmed in the final report, and some ideas were merely put forward for further discussion). Both PS18/8 and CP18/9 include an overview of all asset management market study remedies, set out in an Appendix.

CP17/18 covered three main areas: measures to improve fund governance; moving fund investors to better value share classes; and ensuring fairer treatment of dealing profits. The FCA has now provided feedback to that consultation, along with a further consultation concerning the information that funds make available to investors, and how that information is presented.

Most of the rules and guidance consulted on in CP17/18 are being introduced with only minor changes from the proposals, although the FCA has pushed back several of the proposed implementation dates. This is despite the FCA having received quite a substantial number of responses to the consultation — in particular, it received 106 responses to its proposals concerning fund governance.

Some of these respondents highlighted how the changes might damage the UK's competitiveness or lead to regulatory arbitrage following Brexit. The FCA recognises that the changes will increase costs for firms, but sticks steadfastly to its view that its reforms will make the UK asset management sector more

attractive for investors, and more competitive. The industry will no doubt feel that the FCA was resolved to introduce these changes, regardless of the feedback received.

Since completing the market study, the FCA has been focused on addressing the “weak price competition” and lack of transparency around costs that it identified. This signals the FCA’s move towards thinking more and more like a competition regulator, with the FCA focusing on how it can meet its statutory objective of promoting competition in the interests of consumers. The final measures will, amongst other things, require asset managers to consider the value experienced by investors, and will break “unfair” practices such as the retention by firms of risk-free box profits.

Governance

Value for money (Effective date: 30 September 2019)

The FCA consulted on introducing a controversial new rule requiring fund managers to assess whether value for money has been provided to fund investors, as part of managers’ duty to act in the best interests of investors. This stems from the FCA’s view that asset managers are the agents of their investors, not simply product providers. The FCA proposed that this assessment would need to take place on an ongoing basis, and the results would need to be formally documented and published at least once a year. The FCA proposed that the assessment would need to cover certain prescribed areas, such as fees and charges, and quality of services.

The FCA reports that although respondents to the consultation generally supported the objective of this measure, many queried the way in which it was drafted, raising concerns that it was unduly focused on fund managers’ costs, rather than the overall value provided by a particular fund. A number raised issues with the term “value for money”, and the idea of adopting a measure in rules that requires a subjective judgment to be made.

Consequently, the FCA has redrafted this measure to clarify that fund charges should be assessed in the context of the overall value delivered, and has refined the list of elements to be taken into account as part of the value assessment. Although managers must still consider costs, fund performance has been added, and performance can be assessed over a time period appropriate to the fund’s investment objectives.

Independent directors (Effective date: 30 September 2019)

To help ensure that the best interests of investors are subject to greater scrutiny and challenge at board level, the FCA proposed that asset managers should include a minimum of two independent directors on their boards, and that these should make up at least 25% of the total board membership. The FCA proposed that this requirement would apply regardless of the size of the fund manager.

The FCA reports that, although many respondents were supportive of this proposal, a number also raised concerns about the costs for smaller businesses and the potential for this to create a disproportionate barrier to entry for new market entrants.

Despite this feedback, however, the FCA is going ahead with its proposals as consulted on, and will apply this requirement to all asset managers. The FCA believes that firms will not struggle to find independent directors, and emphasises how firms can use the opportunity to increase diversity on their boards.

The one concession for firms is that the requirement will take effect on 30 September 2019, giving them 18 months rather than 12 to make the necessary changes. This is not the end of the story, however, as

some elements will remain under review. For example, the FCA states that it did consider going further on board independence, and will consider introducing a higher threshold of independence at a later stage if needed, depending on how the rule change beds in. The FCA has also maintained its position that independent directors may sit on multiple boards, but states that it will monitor the situation.

Prescribed Responsibility (Effective date: expected to be mid to late 2019)

The FCA stated in CP17/18 that it would consult on introducing a new Prescribed Responsibility specifically for fund managers under the Senior Managers and Certification Regime (SMCR). The FCA consulted on this specific Prescribed Responsibility as part of its consultation on the extension of the SMCR (CP17/25). The Prescribed Responsibility would make clear that a Senior Manager must take reasonable steps to ensure that the firm complies with its obligation to carry out the assessment of value, the duty to recruit independent directors, and the duty to act in the best interests of fund investors. The FCA indicated that it would usually expect this Prescribed Responsibility to be assigned to the Chair, and CP17/18 proposed rules that would allow asset managers to decide whether their Chair would be an executive or independent board member.

The FCA has confirmed that it will introduce this Prescribed Responsibility as consulted on, although it reports that some respondents queried the introduction of a sector-specific Prescribed Responsibility and whether the person assigned this responsibility could be unduly left open to retrospective criticism. The FCA also has not heeded calls for further guidance on its expectations of individuals charged with this Prescribed Responsibility. The new Prescribed Responsibility will apply as and when the extended SMCR comes into effect, which is currently expected to be mid to late 2019. The rest of the rules relating to the extended SMCR are due to be published by the FCA during the summer.

The FCA also received a number of responses to its proposals concerning Chairs, with mixed views as to whether or not the FCA should mandate an independent Chair. The FCA has confirmed that it will leave this decision to asset managers.

No doubt this new Prescribed Responsibility will make candidates for Chair positions think more carefully about taking on the role, particularly while the FCA's enforcement capabilities under the SMCR remain somewhat unknown (the first enforcement cases under the SMCR have not yet been concluded, to provide some form of precedent).

Extension to other investment products

Although the FCA did ask for views in CP17/18 as to whether the proposals relating to governance should be extended to other investment products (unit-linked and with-profits insurance products, and investment trusts), it has decided not to apply the governance changes more widely at this stage. The FCA explains that ongoing "diagnostic work" is taking place in relation to these products, and it will aim to communicate a view on any intervention work it considers appropriate during the first half of 2019.

Other issues

Conversion (Effective date: 5 April 2018)

The FCA also consulted in CP17/18 on recast guidance to facilitate the conversion of investors into cheaper but otherwise identical classes of the same fund, by clarifying that a fund manager can undertake mandatory conversion in certain circumstances without needing individual consent. The FCA reports that responses were all supportive of the intent of the proposal, but a significant number of respondents thought the notification recommendations consulted on were still too onerous, and likely to prevent fund managers from carrying out class conversions in practice.

Therefore, the FCA has amended the final guidance accordingly. It now recommends that fund managers make a simple, one-off notification to investors, which does not require a response, a minimum of 60 days before a mandatory conversion takes place. The FCA has kept the recommendation that fund managers check that mandatory conversions are consistent with investors' best interests before going ahead, and has also maintained its position that mandatory conversion should only be possible when permitted by the prospectus. The recast guidance (Final Guidance 18/3) is effective immediately.

Box profits (Effective date: 1 April 2019)

The FCA also proposed to prohibit fund managers from retaining risk-free box profits (requiring these profits to be passed to the fund, for the benefit of investors), and to require fund managers to disclose their approach to box management in the fund prospectus, in order to increase transparency for investors.

Concerns were raised in the feedback process about the practicalities of implementing the rules as drafted, and possible unintended consequences. The FCA received over 40 responses on this aspect of the proposals, showing the level of concern with the drafting.

Some were concerned that the proposals would be too complex to implement, and that the FCA had not understood pricing structures and what is risk-free correctly. Some thought that the FCA was impliedly suggesting that there is not a future for dual pricing.

The FCA is proceeding with its proposals, but has made some technical amendments to address the concerns raised by respondents. In particular, the FCA has adjusted the rules to require managers to allocate risk-free box profits in a way that is fair to unitholders, rather than having to pay them to the fund, which allows more flexibility. Guidance articulates what might constitute fair allocation.

The FCA stresses that it maintains the view that that use of a manager's box can be compatible with acting in the best interests of investors, and that it has no plans to review the fund pricing regime. The FCA has also included some technical commentary on the new rules in Annex 2 to PS18/8.

Trail commission

The FCA did also raise some discussions about the payment of trail commission in CP17/18. The FCA reports, however, that it is still considering issues concerning the payment of trail commission and has no immediate plans to bring forward policy proposals at this stage.

Investor information

CP18/9 proposes measures to improve the quality, comparability, and robustness of information available to investors. The measures seek to address the FCA's concerns that fund objectives are not as clear or specific as they ought to be. In particular, the proposals address:

- **How fund objectives can be expressed more clearly and be more useful to investors.** The FCA is proposing guidance to remind firms that they should explain clearly what their funds are looking to achieve and how, explain any constraints relating to the fund's portfolio construction, and explain any non-financial objectives. The FCA also proposes to set out what it would expect to be included in certain sections of a PRIIPs KID.
- **The use of benchmarks.** The FCA is proposing new rules to require asset managers to explain why they use benchmarks, and to reference benchmarks consistently across the fund's documents.

- **Ensuring that use of benchmarks as a constraint or as a target is explained.** The FCA is proposing to require asset managers to clarify for investors when funds are benchmark-constrained, or when they are limited in how far their holdings can differ from the weightings of a benchmark index.
- **The use of performance fees.** The FCA is proposing to amend its rules on performance fees to provide that they must be calculated on performance net of other fees, in all cases.

The FCA also notes how this work fits in with its general concerns around the disclosure of costs. It explains how the costs and charges disclosure requirements under MiFID II and the PRIIPs Regulation represent progress in this area, but stresses that the presentation of this information is important in terms of the real benefit to investors. The FCA has carried out behavioural testing and encourages firms to consider the results — which are set out in an [Occasional Paper](#) — when thinking about how their disclosures are working.

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