THE UK FCA PUBLISHES FINAL REPORT ON ASSET MANAGEMENT MARKET STUDY

The FCA has issued its much anticipated Final Report on the UK asset management sector, presenting its principal findings and proposing a wide-ranging 'package of remedies' to address the concerns it has identified and to increase the efficiency and competitiveness of the UK market.

Background

The Final Report, issued on 28 June 2017, is the latest step in a process which began in November 2015 when the FCA launched a study into the asset management market following a review of competition in the wholesale sector in 2014. The FCA issued an Interim Report in November 2016, giving the industry an opportunity to comment on its proposals to address a number of issues, including weak price competition, a lack of transparency around charges and fees, the strength of fund governance, the ability of asset managers to control the costs of ancillary services and the role of investment consultants.

The Final Report

The Final Report gives a detailed analysis of the FCA's findings and a framework of proposed remedies.

Following on from the Interim Report, the final findings relate to four main areas: price competition, performance, clarity of objectives and charges, and investment consultants and other intermediaries. These are summarised in Table 1 below.

The remedies the FCA is proposing are summarised in Table 2 below. Described as a 'wide-ranging framework', they have three main objectives:

- To help provide protection for investors who are not well placed to find better value for money
- To drive competitive pressure on asset managers
- To help improve the effectiveness of intermediaries

The proposed remedies will be introduced in phases. Those which do not require further consultation will be 'taken forward' straight away. Some proposals will require further consultation, so alongside the Final Report the FCA has published a Consultation Paper (CP 17/18) focussing on the remedies related to governance and technical changes to promote fairness to investors, as well as a consultation on rejecting 'undertakings in lieu' (UIL). CP 17/18 closes on 28 September 2017 and the consultation on UIL closes on 26 July 2017.

Some remedies will require further analysis in light of other regulatory initiatives, MiFID2, SMCR and PRIIPS in particular, so there will be further consultation on issues such as cost and charge disclosure to retail investors later in the year.

Final findings

Price Competition

The Final Report confirms the interim finding of weak price competition in a number of areas of the asset management industry. The FCA notes that firms do not typically compete on price, particularly in the retail sector, and that there is 'considerable price clustering', with active charges remaining broadly stable over the last 10 years. Responding to feedback, the FCA acknowledges that this does not necessarily mean that prices are above their competitive level, but remains of the view that 'competition is not working as effectively as it could be' based on their findings of high levels of profitability (of the firms sampled, the average profit margins were 36%) and a tendency not to lower prices to attract investors.

Proposed remedies

- Improved governance, including through SMCR
- Making it easier to switch to cheaper share classes
- Disclosure of a single 'all-in fee'
- Disclosure of costs and charges to institutional investors through a standardised template
- Working group on how best to clarify objectives for investors
- Consultation on benchmarks and performance
- Remove barriers to pension scheme consolidation
- Proposal to bring investment consultants within regulatory perimeter
- Market study on investment platforms

Performance

The FCA found that, on average, active and passive funds did not outperform their benchmarks after fees, this being the case both for retail and institutional investors. Furthermore, based on analysis undertaken since the Interim Report, the FCA found that 'there is no clear relationship between charges and the gross performance of retail active funds in the UK', citing evidence of a negative relationship between net returns and charges, so that 'when choosing between active funds investors paying higher prices for funds, on average, achieve worse performance.'

The FCA found that investors found it difficult to identify out performing funds as well as some evidence of persistent poor performance, although these funds were more likely to be closed or merged into better performing funds. The outcome for investors was found to be mixed, as the poorer performing fund tend to perform better after the merger while the performance of the recipient fund deteriorates slightly on average. However, the FCA noted that not all poorer performing funds are merged or closed and it could take a long time for merger or closure to take place, culminating in poor returns for investors.

Clarity of objectives and charges

The FCA cite concerns about how asset managers communicate their objectives to investors, particularly retail investors, finding that many active funds offer similar exposure to passive funds, despite charging a higher fee.

Furthermore, retail investors were often found to be unaware or did not fully understand the fees they were paying, although many institutional investors and some retail are becoming increasingly focused on charges.

Investment consultants and other intermediaries

The FCA has indentified concerns in the investment consulting market, typically used by pension funds and smaller institutional investors, where the market is dominated by a few big players. These include relatively high and stable market shares for the three largest providers, a weak demand side, relatively low switching levels and conflicts of interest.

Aside from investment consultants, in the retail sector there are concerns about the value intermediaries add. In addition, the FCA's analysis indicates that retail investors do not appear to benefit from economies of scale through 'direct-to-consumer' platforms.

Proposed remedies

Governance

The need for improved governance is emphasised, with the FCA proposing to strengthen the duty of fund managers to act in the best interest of investors by clarifying expectations around value for money, increasing accountability through SMCR and by introducing a minimum level of independence in governance structures.

The FCA is consulting (in CP17/18) on these proposals for Authorised Fund Managers (AFMs) and is also considering the degree to which these rules should apply to similar investment products.

It is also intended to introduce a new 'Prescribed Responsibility' under the SMCR to act in the best interests of investors, including a consideration of value for money. This will be covered as part of the wider consultation on the roll-out of SMCR to the asset management sector later in 2017.

Objectives, benchmarks and performance reporting

The intention here is to formulate proposals on how to make fund objectives clearer and to establish requirements on the use of benchmarks and comparators, which, along with increasing transparency of cost and charges, will enable investors to better understand what the fund is trying to achieve, and to monitor performance against targets. However, this is a 'work in progress' and much remains the subject of future consultation.

To address concerns of a lack of clarity in fund objectives, a working group is to be established, chaired by the FCA, to explore different options, including how to make stated objectives more useful to retail investors. It is possible that new rules will emerge in this area, as consideration will be given to whether the working group's output should be turned into new rules on how objectives should be written.

Further analysis is to be done in relation to benchmarks. The FCA does not think that all funds should have to use a specific benchmark, comparator or numerical target return. Further consultation is planned for later this year on an approach to this, so that an AFM that chooses not to set a benchmark, comparator or numerical target return for a fund must, firstly, explain its reasons for so doing to investors and, secondly, is prevented from using any other benchmark, comparator or target in its marketing. In addition, the consultation will cover requirements for those managers that do use a benchmark, comparator or numerical target return to explain their reasons for doing so, and to use it consistently across regulatory and marketing materials.

More work is to be done also in relation to past performance, where the FCA is still

Final Remedies (no further consultation)	
Can move forward immediately	• Bringing investment consultants into the regulatory perimeter • Recommendation to DWP to remove barriers to pension scheme consolidation and pooling • Development of a standardised disclosure of costs and charges to institutional investors • Launching a market study into investment platforms
Remedies subject to on-going consultation	
Consultation on implementing asset management market study remedies and changes into the Handbook (CP 17/18) Opened: 28 June 2017 Closes: 28 Sept 2017	• Strengthen duty of care to act in best interest of investors • Requiring fund managers to return any risk-free box profits to the fund • Facilitating switching investors to cheaper share classes
Consultation on provisional view to reject UIL of a market investigation reference of investment consultancy services Opened: 28 June 2017 Closes: 26 July 2017	• Proposal to reject the undertakings in lieu of a market investigation reference
September 2017	• FCA to publish decision on whether to refer the market for investment consultancy services to the CMA.
Remedies subject to detailed future consultation	
Later in 2017	• Costs and charges disclosure to retail investors • Benchmarks and performance reporting • Convening a working group on objectives and consulting on any rule changes at a later stage (subject to the outcome of the working group)

considering remedy proposals on which it will consult later this year. The Final Report notes that the FCA is considering introducing rules and/or guidance to clarify that where AFMs present their past performance, they must do so against the most ambitious target they set out to investors. Also subject to consultation are rules that where an AFM does not set a specific benchmark, comparator or numerical target return for a fund, the AFM must not present the fund's past performance against any benchmark, comparator or target.

Transparency of fees and charges

In relation to fees and charges there is considerable overlap with the policy objectives of MiFID2 and PRIIPS, which are to take effect in the UK in January 2018. This will affect the way that charges are communicated to investors; for example, MiFID2 will require the disclosure of a single all-in fee to investors using intermediaries, which will include the asset management charge, an estimate of transaction costs and any intermediary fees.

The FCA note that, although this will provide investors with greater clarity about the charges they are likely to face, how the information is presented can have an impact on whether it is effective. In view of this, the FCA are 'testing ways' to improve the effectiveness of fees and charges disclosure, looking at, for example the prominence and formatting of the information, to determine if some methods are likely to be more effective than others in encouraging investors to focus on the impact charges have on their investment returns and enable effective price comparison. The FCA will consult on our proposals on fees and charges communications later in the year.

As regards institutional disclosure, the FCA supports consistent and standardised disclosure of costs and charges and advocates the use of a standardised disclosure template, the purpose of which would be to provide institutional investors with a clear understanding of the costs and charges for a given fund or mandate and facilitate cost comparison.

There is no proposal to require trustees to publicly disclose all cost and charges information. However, with regard to defined contribution workplace pensions, the Pensions Act 2014 will place a duty on the FCA and the DWP to require the disclosure and publication of information about transaction costs, and this has been the subject of recent FCA consultation.

Retail and institutional intermediaries – investment consultants and platforms

Simultaneously with the Interim Report, the FCA consulted on making a market investigation reference to the CMA with regard to investment consultancy services. This prompted the largest investment consultants to provide UIL of the reference, offering commitments to disclose charges and performance information in a standardised format, as well as introducing changes to address conflicts of interest and strengthen internal processes. However, the FCA has provisionally concluded that the UIL may not provide a comprehensive solution and have indicated that they propose to reject the UIL. A final decision on whether to make a market investigation to the CMA will be made in September 2017 following a consultation, launched alongside the Final Report, on the FCA provisional view to reject the UIL.

In addition, the FCA is recommending that the Treasury bring investment consultancy services into the regulatory perimeter, so that the regulator has the authority to set performance standards and assessment criteria in this sector.

In relation to platforms, and in response to feedback received, the FCA will be launching the Investment Platforms Market Study, to assess the significance and scope of the issues raised in this area. The study will consider how investment platforms (and firms offering similar services) compete to win new customers and retain existing customers. The terms of reference for the Investment Platforms Market Study will be issued shortly.

Share class switching

Another topic for consultation is share class switching, which includes a proposal that the FCA modify their guidance to clarify that when dealing with unresponsive unitholders the AFM can undertake a mandatory conversion, provided the power to do so has been set out in the prospectus, the AFM has made all reasonable attempts to contact unitholders and is satisfied, on reasonable grounds, that the change will not result in detriment to investors. The FCA believe that these changes will remove the barriers that make it difficult for asset managers to switch investors into new, better value share classes.

Box management practices

The same consultation covers proposals to require firms to return any risk-free box profits to the fund and to disclose box management practices to investors in the fund prospectus.

Pension pooling

The FCA is recommending that the DWP continues to review, and where possible, remove barriers to pension scheme consolidation and pooling. It is seeking to minimise the barriers as it believes that some schemes will benefit from pooling assets.

New Prescribed Responsibility under SMCR for Asset Managers

- It is proposed that the Senior Managers and Certification Regime (SMCR) will be extended to all authorised firms including asset managers during the course of 2018. The expectation is the FCA will publish a consultation paper and draft rules in relation to the extended SMCR this summer.
- Under SMCR, all authorised firms will be required to appoint Senior Managers who will be pre-approved by the FCA (subject to grandfathering provisions). Senior Managers will be allocated certain prescribed responsibilities for which they will be personally accountable. The overall aim of SMCR is to increase the accountability of senior managers within authorised firms in line with the FCA's Culture & Governance Priority.
- In CP/17/18, the FCA has proposed to introduce a new specific prescribed responsibility for individuals identified by asset managers under the extended SMCR '*to ensure that asset management firms comply with the obligation to act in the best interests of investors*'. The FCA proposes that this new prescribed responsibility will be allocated to the Chair of the AFM Board, who will be identified as a Senior Manager under the extended SMCR. As a Senior Manager, the Chair of the AFM Board will be responsible for taking reasonable steps to ensure the AFM and its board adhere to current and proposed rules.
- In practice, asset managers will need to: (i) consider the steps to be taken to ensure they can clearly identify individuals such as the Chair of the AFM Board who will become Senior Managers under the extended SMCR; (ii) undertake a mapping exercise to ensure that the relevant prescribed responsibilities (including the new prescribed responsibility to act in the best interests of investors) are allocated to the relevant Senior Managers; and (iii) consider implementing a framework to ensure Senior Managers have a clear understanding of what reasonable steps they need to take to adhere to the current and proposed rules.

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Insights for Asset Managers

'Insights for Asset Managers and Funds', a series of calls offering a practical overview of the issues faced by the asset management and funds sector in today's international legal, regulatory and commercial environment. Each call lasts for around 30 minutes and focuses on a specific topic, with participants able to submit questions in real time via Webex during the call.

The FCA's Final Report on the Asset Management Market Study – What next?

The FCA has issued its much anticipated Final Report on the UK asset management sector, presenting its principal findings and proposing a wide-ranging 'package of remedies' to address the concerns it has identified and to increase the efficiency and competitiveness of the UK market. On this call, the panel outlined the FCA's principal findings and proposed remedies, discussed what is likely to happen next as the process unfolds and went on to assess what this may mean for the UK's asset management industry.

Please **click here** to view the online recording of the session.

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Table 1: Final findings

Price Competition
Weak price competition: Firms rarely compete on price, particularly for retail active asset management services. Prices of segregated mandates, typically sold to larger institutional investors, tend to fall as the size of the mandate increases. However, lower prices do not seem to be similarly available for equivalently sized retail funds.
Price clustering: Considerable price clustering of the asset management charge for retail funds. Charges for actively managed funds have remained broadly stable over the past decade. FCA found high levels of profitability, with average profit margins of 36% in the firms sampled. Firms rarely lower prices to attract new business.
Performance
Price and performance: Substantial variation in performance, both across asset classes and within. Actively managed and passively managed funds underperformed against their benchmarks after taking account of fees, across retail and institutional investors.
Charges and returns: Analysis suggests there is no correlation between charges and the gross performance of retail active funds. However, evidence suggests there is a negative correlation between charges and net returns, thus on average investors paying higher fees achieve worse performance.
Identifying outperforming funds: Investors face difficulty identifying outperforming funds, partly because it is often difficult for investors to interpret and compare past performance information.
Poor performance/closures/mergers: Some evidence of persistent poor performance of funds. Worse performing funds more likely to be closed or merged into better performing funds. Where underperforming funds have merged with a better performing fund, the underperforming fund typically improves and the better performing fund tends to decline. Not all persistently poorer performing funds are merged or closed. It can also take a long time for worse performing funds to be closed or merged.
Clarity Of Objectives And Charges
Communicating objectives to clients: Concerns about how asset managers communicate their objectives to clients, in particular to retail investors. Many active funds offer similar exposure to passive funds, but some charge significantly more for this. FCA estimate that there is around £109bn in 'active' funds that closely mirror the market which are significantly more expensive than passive funds.
Investor awareness of charges: Investors' awareness and focus on charges is mixed and often poor. While many institutional and retail investors are aware of the charges they pay in relation to investment management services they receive, a significant number of retail investors are not aware that they pay charges.
Investment Consulting And Other Intermediaries
Ability to negotiate: Larger institutional investors tend to effectively negotiate the terms of the investment management services they receive, whereas smaller institutional funds such as pension funds, have been less able to do so and rely instead on investment consultants to make decisions on their behalf.
Weak competition among investment consulting providers: FCA has identified concerns in the investment consulting market. These include the relatively high and stable market shares of the three largest providers, a weak demand side, relatively low switching levels and conflicts of interest.
Passing on economies of scale to retail clients: Retail investors do not appear to benefit from economies of scale when pooling money through direct-to-consumer platforms. There are also concerns about the value retail intermediaries provide.

Table 2: Package of remedies

Investor Protection
Strengthen the duty to act in best interest of investors: Strengthen the duty to act in the best interest of investors by clarifying the FCA's expectations around value for money, increasing accountability through the SMCR and introducing a minimum level of independence in governance structures.
Requirement to return risk-free box profits to the fund: FCA is consulting on requiring fund managers to account any risk-free box profits to the fund and to disclose any box management practices to investors.
Switching: FCA is consulting on ways to make it easier for fund managers to switch investors to cheaper share classes and seeking views on introducing a phased-in sunset clause for trail commissions.
Competition
Disclosure of a single all-in fee to investors: FCA wants to see the disclosure of a single all-in fee to investors. MiFID2 will introduce this for investors using intermediaries. FCA testing ways to improve the effectiveness of disclosure, on which it will consult later this year.
Disclosure of costs and charges to institutional investors: Recommending that investor and asset management representatives collaborate, with the assistance of an independently appointed person, to produce a standardised template for costs and charges, following which the FCA will consider next steps to ensure institutional investors obtain sufficient information to make investment decisions.
Working group to clarify objectives for investors: FCA will chair a working group to consider how to make objectives clearer and more useful for investors, before considering any subsequent rule changes. FCA will consult on: requiring managers to be clear about why or why not a benchmark has been used; a requirement that use or otherwise of benchmarks is consistent across marketing materials and where managers present past performance, they must do so against the most ambitious target held out to investors.
Barriers to pension scheme consolidation: Recommending that the DWP review and remove barriers to the consolidation of pension schemes to help those who may benefit from resulting economies of scale that may arise.
Intermediaries
Rejection of UIL of investment consultant investigation: FCA is proposing to reject the UIL of reference to the CMA (provided by the three largest investment consultants) and are seeking views from other interested parties on this proposal. A final decision on whether to make a market investigation reference to the CMA will be made in September 2017.
Extending the regulatory perimeter to include investment consultants: Recommending, subject to the outcome of the provisional market investigation reference to the CMA, that the Treasury bring investment consultants into the regulatory perimeter.
Market study on investment platforms: FCA plans to conduct a market study to assess competition within the investment platforms market.

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