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Assessing the outcome of the FCA's Asset Management Market Study

April 2018

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With the outcome of the FCA's Asset Management Market Study now published, UK authorised investment fund managers should consider how best to implement changes in their organisation – and generally seek to understand the mind-set of the FCA with regards to the regulation of, and expectations from, UK authorised investment funds.

The central theme from the FCA is taking action in respect of UK authorised funds in order to improve competition in this industry for consumers.

The key focus is on improving matters for consumers, and specifically in the light of the FCA's view that there is evidence of weak price competition in a number of areas of the asset management industry.

April publications

April 2018 saw the publication of a number of documents.

We now have details of the FCA's plans to implement changes pursuant to their Asset Management Market Study. We have an eighteen page set of amendments for the first set of final rules and in a further consultation on further remedies.

Pursuant to the Final Report on the Asset Management Market Study and the preceding Interim Report, we now have:

- Policy Statement PS18/8 of April 2018 which sets out feedback and final rules to CP17/18

  This Policy Statement covers fund governance, moving investors between share classes and dealing profit issues.

  In addition, it includes Finalised Guidance – FG18/3 on changing clients to post RDR unit classes, so that it is easier for AFMs to move investors from more expensive share classes to cheaper but otherwise identical share classes (which makes changes from the FG14/4 publication).

- a second Consultation (CP 18/9) proposing various additional changes

  This Consultation sets out proposals for improving fund objectives and use of benchmarks.

There is also a third element to note– although not one set out in these papers. As the FCA point out, MiFID II and PRIIPs have recently introduced greater disclosure of all costs and charges, including transaction costs. Whether of course the way in which these require presentation of information is helpful is another matter but, for the moment pre Brexit, there must be compliance with these new disclosure requirements. The FCA published results of some behavioural testing alongside PS18/8 in Occasional Paper 32 – "Now you see it: drawing attention to charges in the asset management industry." Firms are asked to consider the results when thinking about how their disclosures are working.

Finally, there is a separate Institutional Disclosure Working Group which is seeking to agree a disclosure framework to support consistent disclosure of costs and charges to institutional investors.

All of these initiatives are distinct from the Reference of the Investment Consultancy market to the Competition and Markets Authority ("CMA") for a market investigation which is now underway. The CMA is issuing a series of consultative working papers as part of their investigation, the most recent April one being on trustee engagement.

New provisions pursuant to PS 18/8

Policy Statement 18/8 includes alterations to the governance arrangements for UK authorised investment funds, and also gives feedback on how the FCA's proposals about how the changes would work together with the Senior Managers regime discussed in CP17/18 but on which the formal consultation was covered in CP17/25.

These measures are designed to strengthen and clarify the duty on authorised fund managers (AFMs) to act as agents for their underlying investors and focus on fund managers' governance arrangements and the value they deliver for investors.

First, and perhaps foremost, improving fund governance

- **Acting in the best interests of investors**

  The unit trust model with independent manager and trustee, each of which would be an authorised firm,

has endured well. The replication of that for the authorised corporate director and depositary of an ICVC has similarly served its purpose. But now it seems both the time to move on and to improve matters so that the arrangements are demonstrably seen to work better in the interests of investors in funds of which AFMs are the appointed fund managers. Rather than changing the parties involved, the idea is to strengthen the way in which the AFM operates and, in particular, the AFM board composition.

COLL 6.6.24G is to indicate that COLL 6.6A.2R applies to AFMs of UCITS schemes and in broad terms requires AFMs to act in the best interest of unitholders. COLL 6.6A.2R(5) requires AFMs to act in such a way as to prevent undue costs being charged to any scheme it manages and its unitholders and COLL 6.6A.2R(6)(b) requires an AFM to act solely in the interests of the scheme and its unitholders. In addition COLL 6.6.24G refers to the COBS 2.1, the clients' best interest rule: COBS 2.1.4R(2) already requires a full scope UK AIFM to act in the best interests of the AIF it manages or the investors of the AIF it manages and the integrity of the market, and COBS 2.1.4R(3) requires the AIFM to treat all investors fairly which in turn refers to AIFMs to act in the best interests of the AIF it managers or the investors of the AIF it manages and the integrity of the market and requires the AFM to treat all investors fairly.

The persistent reference in the papers to AFMs acting as agents of investors is perhaps somewhat unfortunate, as it is not appropriate to impute a formal agency relationship. Technically this only fits well with the basic unit trust notions whereby investors have beneficial interests in the trust property, and trustees have to have regard to the interests of beneficiaries. Given that unit trusts are trusts, investors do have a beneficial interest in the underlying assets which cannot exist in the corporate structure and what the FCA is now writing in to the rules is that fund managers owe duties to the underlying beneficiaries/investors. The FCA's wider purpose is though to seeking to look through matters where there is any formal fund structure so that it is more akin to the AFM having a discretionary mandate over the investor's money and taking responsibility accordingly as a service provider to the investor. It is perfectly fair to comment that AFMs already should be acting in the best interests of fund investors, both for UCITS and, under AIFMD, for AIFs and this can be better formalised in regulation.

- **VfM**

The FCA's particular focus is that they take the view that AFM boards are not generally considering sufficiently robustly enough whether they are delivering value for money or, to use the FCA's new phrase "VfM" to their investors.

COLL 6 is amended by the introduction of an assessment of value obligation under a new COLL 6.6.20R:

"An authorised *fund manager must conduct an assessment at least annually for each scheme it manages of whether the payments out of scheme property set out in the* prospectus *are justified in the context of the overall value delivered to unitholders."*

Thankfully the FCA have changed tack from talking solely about assessing fund charges to assessing overall value provided, including quality of service, performance and potential to deliver value in the future. There has always been **a concern that the cheapest option is not always the best option. The FCA have now acknowledged this in PS18/8.**

The FCA have accepted that the draft rules that they put forward focussed too much on AFMs **costs** rather than the **full value proposition** of funds, which was not their intention, and so have redrafted COLL 6.6.20R to clarify that fund charges should be assessed in the context of the overall service delivered.

Assessment of VfM of each fund is to be undertaken against relevant elements to this issue. There is a non-exhaustive list of prescribed elements in a new COLL 6.6.20R but there might be other elements. The list set out picks up on key features of the widely accepted Gartenberg principles derived from US case law to which the board of a US mutual fund must have regard when assessing a fund management contract.

The AFM must separately, for each class of unit in the scheme, consider at least the matters in COLL 6.6.21R which set out minimum considerations for the assessment of value:

– *quality of service*: the range and quality of services provided to unitholders;

- *performance*: the performance of the scheme after deduction of all payments out of scheme property as set out in the prospectus.

  Note that, somewhat confusingly, such payments are defined as "charges" for the purposes of COLL 6.6.23E and COLL 8.5.19E.

  Performance should be considered over an appropriate timescale having regard to the scheme's investment objectives, policy and strategy. Fund performance can be assessed over a time period appropriate to the fund's particular position – past and reasonably expected future performance – and it should not be solely based on actual past performance, short term or otherwise.

  The opportunity for AFMs to explain why their fund is currently underperforming if they think it will help investors to understand the strategy is useful. This goes back to preparing a more useful annual report with a commentary rather than the prescribed annual report format – an idea first raised in the FCA's Smarter Communications initiative. This could be a step forward.

- *AFM costs generally*: in relation to each "charge", the cost of providing a service to which the charge relates and, when money is paid directly to associates or external parties, the cost is the amount paid to that person;

- *economies of scale*: whether the AFM is able to achieve savings and benefits from economies of scale, relating to the direct and indirect costs of managing the scheme property and taking into account the value of the scheme property and whether it has grown or contracted in size as a result of the same and redemption of units.

  The FCA indicate that the requirement 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. Interestingly though, firms will have to explain these decisions in annual reports (on which see below) and show how these decisions, along with others flowing from the assessment, are in the best interests of investors. It would seem curious to have to disclose wider business initiatives of a firm to the public but we will see how AFMs choose to formulate these in due course.

- *comparable market rates*: in relation to each service (not defined), the market rate for any comparable service provided (a) by the AFM or (b) to the AFM or on its behalf, including by any person to which any aspect of the scheme's management has been delegated;

- *comparable services*: in relation to each separate charge, the AFM's charges and those of its associates for comparable services provided to clients, including for institutional mandates of a comparable size and having similar investment objectives and policies (at least now there is reference to comparable size);

  The FCA have accepted that there might be differences between retail funds and institutional mandates which are not comparable and, if the AFM believes this to be the case, this can be explained in the annual statement. The FCA confirm: "We do not expect firms to disclose information which is commercially sensitive or competitive"

- *classes of unit*: whether it is appropriate for unitholders to hold units within classes subject to higher charges than those applying to other classes of the same scheme with substantially similar rights."

Having assessed the VfM, the AFM must conclude whether each fund offers good VfM. If it does not, the AFM must take corrective action. The assessment must be explained annually in a report made available to the public.

COLL 4.5.7R(8) is introduced so that the annual long report of an authorised fund must contain a statement setting out a description of the assessment of value required by COLL 6.6.20R. This will clearly need to be a well-considered statement given the points it needs to include to comply with the COLL provision referring to:

- *a* separate "discussion and conclusion" for the matters covered in the indicative list for each matter that forms part of the assessment, covering the considerations taken into account, a summary of the findings and steps taken as part of or as a consequence of the assessment;

- *an* explanation for any case in which benefits from economies of scale that were identified in the assessment have not been passed to unitholders;

- *an* explanation for any case in which unitholders hold units in a class that is subject to higher charges than those applying to other classes in the same scheme with substantially similar rights;

- *the* conclusion of the AFM's assessment of whether charges are justified in the context that the overall value delivered to unitholders in the scheme; and

- *if* the assessment has identified that the charges are not justified in the context of the overall value delivered to the unitholders, a clear explanation of what action has been, or will be, taken to address the situation.

The AFM need not include this statement in its annual long report if it makes a statement available to unitholders annually in a composite report covering two or more funds it manages published in the same manner as the annual long report.

A similar provision to this for UCITS and non UCITS retail schemes is included for Qualified Investor Schemes in a new COLL 8.3.5AR (5) but there are no specifics as to the statements which are thought necessary.

- **Independent Directors**

As expected, the FCA is pursuing its proposal to require AFMs to appoint non executive directors.

A new COLL 6.6.25 is introduced pursuant to which:

- *an* AFM must ensure that at least a quarter of its members of its governing body are independent natural persons (if the governing body comprises fewer than eight, at least two must be independent natural persons).

The AFM must determine whether such a member is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, that member's judgement.

Who is independent? There is no set rule but guidance in COLL 6.6.26(2) will indicate that it is unlikely that a person will be considered independent if any of the following circumstances exists:

- *the* person is an employee of the AFM or an affiliated company or paid by them for any role;

- the person has been an employee of the AFM or an affiliated company within the AFM's group within the five years preceding their appointment;

- the person has or had within the three years preceding appointment a material business relationship of any description with the AFM or an affiliated entity, or with any person to which collective portfolio management of the scheme has been delegated;

- the person received any sort of remuneration from the AFM's group within the five years preceding the appointment; or

- the person has a close relative who is an officer or other senior employee of the AFM or a company within the AFM's group.

The terms of employment must be such as to secure independent members' independence: guidance confirms that there should be appropriate contractual terms so that *"when acting in the capacity of an independent member of a governing body they are free to act in the interests of unitholders and should be able to do so without breaching their terms of employment."*

- *the* aim is to ensure that independent members appointed have sufficient expertise and experience to be able to make judgements on whether the AFM is managing each scheme in the best interests of unitholders.

  The expertise and experience required under COLL 6.6.25R(3) is indicated in guidance potentially to have been gained through professional experience, public service, academia or otherwise and does not need to relate to the financial service industry.

- *appointments* must be for terms of no longer than five years with a cumulative maximum duration of ten years.

  If an independent member is appointed to more than one governing body within an AFM's group, the cumulative maximum duration of ten years is calculated by adding the durations of each separate appointment and discounting the periods during which the appointments overlapped to avoid double counting. Where an independent director is appointed before 1 October 2019, the five and ten year periods run from that date.

Issues to consider:

- *Striking a balance*

  With any corporate business, there is always a balance to be struck between interests of shareholders and, typically, employees. The challenge for fund managers though is somewhat different because it is trying to balance the interest between shareholders and their product consumers – investors or, as now reinvented, beneficiaries.

  The requirement to appoint independent directors on AFM boards is intended to help boards strike the right balance when considering the interests of investors and shareholders. The FCA appreciate that appointing independent directors will involve additional costs for AFMs but believe that this is proportionate to the benefits which they expect independent directors to bring.

  The requirement is to apply to all AFMs, including start-up AFMs because an independent director's perspective can be particularly important in formative years during which, for example, its strategy and culture are set.

- *Whistleblowing and SYSC 18*

  There was a request for independent directors to be protected under the FCA's whistleblowing provisions among other protections. There was a concern that, without these measures, independent directors might become more easily "captured" by the AFM. The FCA's response is that specific recent provisions from European legislation such as the UCITS Directive and MiFID II will apply to many AFMs and the Public Industry Disclosure Act 1998 in its provisions is applied to essentially to all UK firms. Whilst the majority of provisions in SYSC 18 will not apply to AFMs, firms can consider the appropriate arrangements in the light of their structure and business model and so firms may find it helpful to consider SYSC 18 when determining the appropriate measures in their circumstances.

- *Link to Senior Managers regime*

  Of course this proposal needs to be considered alongside the application of Senior Management Conduct Rule 4 (SC4-COCON 2.2.4R) to non-executive directors even where they do not require FCA approval to carry out their roles – which category will include the independent directors considered for AFMs. These rules (to be introduced pursuant to CP17/25) have not yet been finalised but application of SC4 would impose a requirement for prospective NEDs to disclose any information to the FCA of which the FCA could reasonably expect notice, which may include any relevant reports to whistle blowers.

  All senior manager conduct rules would apply to individuals approved for senior management functions such as the chair – on which see below for more information regarding the new PR.

– *Directors' duties generally*

The aim is for independent directors to bring an external perspective and support executive directors. Fortunately the word "solely" in COLL 6.6.26G(4) has been deleted from the final guidance in the rules but nonetheless there will be an obligation on independent directors as part of an AFM's board to act in the best interests of investors.

As mentioned above, new guidance in COLL 6.6.24G. More specifically in relation to director's duties, the FCA acknowledges the fact that a director's general duties generally are not limited to shareholders or financial success alone. They have deleted the word "solely" in COLL 6.6.26G(4) and deleted it from the final guidance

– *Extent of the role*

Guidance in COLL 6.6.26 indicates that the role of the independent members *"should include providing input and challenge as part of the AFM's assessment of value in accordance with COLL 6.6.20R. Independent members may be tasked with additional responsibilities, taking into consideration remuneration and conflict of interest rules."*

Not surprisingly, guidance in COLL 6.6.26 specifically indicates that "an AFM should consider indemnifying the independent members of its governing bodies against liabilities incurred whist fulfilling their duties of such members." It should be expected that those who volunteer for the independent member role will require such indemnification.

There is no specific provision on independent directors serving on the AFM boards of different groups and this will be left up to AFMs to decide if they accept independent directors who also serve on other boards, and the FCA will monitor this situation.

Overall the outcome of the consultation seems to provide a balanced way forward for introducing such independent directors to AFM boards. As ever though, the value delivered will depend on the value contributed by those who volunteer for the task. It is not just a case of, as the FCA seem to suggest, there being a "pool of capable financially literate candidates". In order to provide an incisive and constructive challenge, non-executives on AFM boards really need to know about an AFM's role and details of how UK authorised investment funds operate.

- **New prescribed responsibility**

  The FCA is implementing the prescribed responsibility for AFMs without further changes as part of the extension of Senior Managers and Certification Regime ("SM & CR"). The Final Rules should be published in the Summer of 2018.

  COLL 6.6 is amended so that an AFM must allocate responsibility for ensuring its compliance with the new provisions explained above – to act in the best interests of fund investors, to carry out an assessment of overall value and to appoint independent directors - to an approved person.

  The FCA have concluded that, where the chair of an AFM's governing body is an approved person the AFM must allocate the responsibility to that person. However, the FCA has confirmed that whether or not an AFM has an independent chair is a decision for each AFM. The new prescribed responsibility (PR) for AFMs under the SM&CR can therefore be assumed either by an executive or independent member of the board with the position of chair.

Additional Specific Changes

- **Moving investors to better value share classes**

  Given the proliferation of share classes and investor inertia in taking action themselves, it is welcome that the FCA seeks now to make it easier to implement mandatory switches.

  AFMs should ensure that mandatory conversions are consistent with investors' best interests where they have made the notifications simpler: AFMs can make a simple one off notification to investors, which does not require a response, a minimum of sixty days before a mandatory conversion. An AFM should not however make any other changes to investors' rights as part of a mandatory conversion to cheaper but otherwise identical share classes.

  To provide clarity, it would be useful for prospectus documents to catch up with the mandatory

conversion possibilities so that the prospectus documents refer to such a possibility. The FCA indicate that they think it important 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.

No decision has been made by the FCA on whether to continue to allow the payment of trail commission – the FCA is still considering feedback.

A note of caution though: Despite the FCA relaxing its approach on mandatory switches, AFMs should proceed with caution given the technical legal issues which arise on unilaterally seeking to alter investor rights.

- **Fairer treatment of dealing profits**

There was broad support for the fairer treatment of dealing profits because, in a sense, this is an old problem which no longer really exists.

A particular issue arises for dual priced funds where fund managers run a box in their units of the fund on which potentially they could make profits by operating a manager's box and the FCA is following through on its new rules to require AFMs to pass "risk free box profits" i.e. profits generated by netting off transactions to the fund and AFMs to disclose their policy on operating a manager's box and how any profits will be treated in the prospectus.

Box profits on dealings were however essentially abolished years ago and so requiring any managers to return any risk free box profits to the fund and disclose box management practices to investors should not cause any particular new concern. Indeed the FCA acknowledged in CP 17/18 that a number of firms had already told them that they no longer retained risk free box profits.

Part of the issue regarding box management practices is that there is a misunderstanding that dual pricing is actually fairer than single pricing. There is no single right answer on the best method of pricing but dual pricing does at least try to address the needs to balance the interests of ingoing, outgoing and remaining investors and in the fairest way which is practicable.

Fortunately the rule changes do not seek to stop firms operating dual priced funds. Single and dual pricing methodologies are to be allowed to continue and are unaffected.

New proposals pursuant to CP 18/9

Not content with finalising its Policy Statement 18/8 pursuant to the first Consultation Paper from June 2017, the FCA has launched its second Consultation Paper in connection with the Asset Management Market Study entitled "Consultation on further remedies" – CP18/9 in April this year.

The proposals in CP18/9 concern measures to improve the quality, comparability and robustness of information available to investors. The proposals are designed to improve clarity of what a fund is offering (what it aims to do, how it intends to do it and how performance is shown) because the FCA believe that a lack of clarity is another reason for weak competition. It focusses on demand side so that investors are properly informed so they can better choose between different asset management products and services.

The expressed intention of this Consultation is to propose *"measures to improve the quality, comparability and robustness of information available to investors. [The measures] seek to address our concern that fund objectives are not as clear or specific as they could and should be. This makes it harder for investors to exercise choice, as they may not be able to work out what they are ultimately investing in."*

Also a package of measures is proposed with the aim of improving clarity where funds are benchmark constrained – i.e. limited as to how far their holdings can differ from weightings of a particular benchmark index. The FCA take the view that, without proper disclosure of these constraints, investors will be unaware of the fund's policy, which may affect its riskiness and the possible return. When benchmark constraints are not clear, investors may be unable to make adequate price comparisons. And there are proposals to ensure benchmarks are used appropriately.

In its details, this consultation perhaps raises more questions than it does answers. One might sympathise with the issues but perhaps not consider that the solutions proposed are the best way to address those issues. And some solutions proposed could introduce consequential, potentially detrimental, consequences.

First, fund objectives and benchmarks

The FCA have been informally pursuing a number of policies regarding investment objectives and policy statements. This consultation now sets out their proposals for formalising these initiatives.

- **Proposed guidance on fund objectives**

  FCA indicate that they want firms *"to explain succinctly and in plain English what their funds are doing".* The FCA have published a summary of the Fund Objectives Working Group conclusions in this consultation. It includes various useful comments:

  – In fact consumers are far more likely to read fund factsheets than key information documents and in turn a prospectus. However, further regulatory prescription around factsheets was not thought to be a good idea.

  – Clearer definitions would be helpful – although whether this is per group or across the industry is left unclear. There have always been differences, for example with regard to long term or capital growth or mainly or primarily across the industry.

  – Certainly the focus on being clear about time horizons in respect of which investors should assess whether objectives have been made is useful – it is important that investors are not encouraged to look at short term performance.

  Draft non-Handbook Guidance is to be published setting out FCA comments on the description of fund objectives and investment policies. Ironically, some of the examples of poor practice about which the FCA is now complaining have resulted from changes in relevant law and regulation – for example:

  – Reference to the asset classes derives from UCITS III text and was introduced into fund objectives because the FCA asked that the asset classes be named – for example including the words transferable securities and collective investment schemes. If managers can go back to writing comprehensible text describing the investment objectives without technical language this would be helpful.

  – Likewise the reference to various powers but in fact the strategy being only to use certain of these powers, or using some of them in a particular way. There has long been a concern about mentioning all potentially relevant strategies and then losing the real emphasis as to the intended strategy in the lengthy text describing miscellaneous powers.

- **Benchmarks**

Given the concern is to ensure clear disclosure of objectives so that investors can make adequate comparisons, there may be undue emphasis in the proposals on whether or not there is appropriate use of benchmarks. The recent concerns about closet trackers might reinforce concerns about pursuing proposals relating to benchmarks. Nonetheless, the FCA is doing so and we now have details of their specific proposals.

There will be some challenges for funds where there is a possibility that there are restrictions which mean that the fund is, in practice, managed with reference to a benchmark. The FCA point to examples where internal risk reports of tracking errors to a particular index lead to buy/sell corrections; where a warning flag might be raised if a trade might result in diversions from index weighting by more than a certain percentage; or where the bonus of a portfolio manager might be linked to the performance of the fund when compared with a particular index as indicating that the fund is managed with reference to a benchmark. Firms are asked to assessed whether any such restrictions mean that the fund is in practice managed by reference to a benchmark.

This discussion is completely distinct from the new EU Benchmarks Regulation. The proposals in this CP have no bearing on the Benchmark Regulation. In this CP, some of the indices will fall both within the regulation definition and in the definition used in the CP as a matter of fact but the definitions will remain unrelated.

COLL 4.2.5R is to be amended by introduction of new disclosure requirements for the investment objectives and policies of an authorised fund in the prospectus which requires categorising any references to benchmarks in one of or more of three ways – a target, a constraint or a comparator.

The new requirements proposed for prospectus text are as follows:

"*(c)-(b)* Where*:*

(i) *a target for a scheme's performance has been set, or a payment out of scheme property is permitted, by reference to a comparison of one or more aspects of the scheme property or price with fluctuations in the value or price of an index or indices or any other similar factor (a "**target benchmark**"); or*

This is 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. This would include objectives stating that they aim to outperform by a certain percentage or achieve a return greater than 6% per year, or track the return of the FTSE 100, or beat the return of the FTSE All-Share.

(ii) *without being a target benchmark, arrangements are in place in relation to the scheme according to which the composition of the portfolio of the scheme is, or is implied to be, constrained by reference to the value, the price or the components of an index or indices or any other similar factor (a "**constraining benchmark**"); or*

This is an index or similar factor used by AFMs as a constraint on a fund's portfolio construction. An example of such a constraint would be if a UK equity fund whose portfolio would differ from the composition of an index such as the FTSE 100 by no more than a set amount – such a fund would more likely mirror the risk and return of that index than a fund managed without such a constraint.

(iii) *without being a target benchmark or a constraining benchmark, the scheme's performance is compared against the value or price of an index or indices or any other similar factor (a "**comparator benchmark**"),*

A comparator is 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.

a statement *providing sufficient information for investors to understand the choice and use of any target benchmark, constraining benchmark or comparator benchmark in relation to the scheme;*

(c)-(a) *where no target benchmark, constraining benchmark or comparator benchmark is referred to, a statement to that effect and an explanation describing how investors can assess the performance of the scheme;*

….

(o) *information concerning the historical performance of the scheme, showing in particular historical performance compared against each target benchmark and each constraining benchmark used in relation to the scheme, presented in accordance with COBS 4.6.2R (the rules on past performance);…*"

Note that, in guidance, it is to be clarified that the prospectus might explain, if it is the case, that one index or factor may be used for both the target benchmark and the constraining benchmark in relation to the same scheme.

The proposal is that some disclosures must be explained in a fund's prospectus and other consumer facing communications that include some fund specific information - "relevant communications". (Relevant communications will not include brand only adverts or communications – known as image advertising – and will not include UCITS KIIDs or KIID equivalent document for a NURS.) The proposal is that:

- an AFM should be required to explain in the fund's prospectus and other relecant communications why they have used any constraint target or comparator. This seems sensible.

- likewise, where an AFM has not set a constraint, target or comparator for a fund, the AFM is to explain to investors how they should assess the fund's performance in the prospectus and relevant communications.

The provisions for AFM communications (leaving aside the prospectus issues mentioned above which are dealt with in COLL) are to be set out in COLL 4.5 – new paragraphs 12-15.

- Paragraph 12 will require any communication about an authorised fund to include a short explanation of the choice and use of every target benchmark, constraining benchmark or comparator benchmark used in relation to the scheme. Where there is no such benchmark there should be a statement to that effect and a short explanation of how investors can assess performance of the scheme.

- Under paragraph 13, where in any communication an indication is given of past performance for any scheme it manages, an AFM must include the corresponding past performance record of any target benchmark or constraining benchmark referred to in the prospectus of the scheme – and not include an indication of past performance for any index, indices or similar factor that is not referred to in the prospectus of the scheme. This should ensure a greater consistency of use of benchmarks in future.

- Under paragraph 14, where there is past performance information comparing against any comparator benchmark, the AFM must include a comparison against the same benchmark and no other in every subsequent communication it makes that is also subject to paragraph 13, for the period of 12 months after a one off communication is made or for so long as the communication remains available to the public in durable medium and has not been superseded by a revised version. (This provision though falls away if such a comparison would not be compliant with paragraph 13 as a result of a change to the prospectus of the scheme.)

- Under paragraph 15, paragraphs 12 to 14 do not apply to any reference to a comparator benchmark that is not identified in the prospectus when that reference appears in communications used in a personal visit, telephone conversation or other interactive dialogue; or in response to a specific unsolicited request by a client for past performance to be compared with a particular comparator benchmark.

For UCITS KIIDs, the FCA do not consider that the intention of the UCITS KIID Regulation is for comparator benchmarks to be disclosed within the KIID but constraining and target benchmarks should be included. The inconsistency between the KIIDS and relevant communications (as defined above) of funds that use comparative benchmarks is regarded as temporary, assuming that UCITS KIIDs are superseded at the end of 2019, as is currently the intention.

Already, for a UCITS KIID, there must be past performance within it, and in the prospectus. Some AFMs are criticised for showing past performance only against some different, sometimes lower, benchmarks than other disclosures for that same fund. The FCA plan to introduce rules so that AFM must show a fund's past performance in a relevant communication against any constraint or target benchmarks the fund has, so it would not be acceptable for an AFM to show past performance other than on the disclosed basis.

Relying on Article 18(1) of the UCITS KIID Regulation, the FCA propose to confirm its expectation that AFMs should show their KIID past performance against such benchmarks. For comparator benchmarks, there is no proposal to require showing fund performance against them, but if an AFM chooses to compare their performance against one or more comparator benchmarks, they must to so consistently against all relevant communications. Comparator benchmarks are not expected to feature or appear in KIIDs.

The overall intention that investors should be able to gain valuable insights into how an AFM views the fund and how it thinks the fund's performance should best be judged is to be welcomed. There are

however some new problems which this set of proposals will introduce:

– It is acknowledged that sometimes, different comparator benchmarks might be used for different clients or in different situations.

– Once objectives are extended and benchmarks included, it will be is more difficult to change comparator benchmarks. This could be plus point or a minus point. The FCA assert that fund managers might wish to change comparator benchmarks to show their past performance against a more favourable different comparator with the benefit of hindsight. Just as likely though is that new benchmarks are produced or might become more relevant over time or for different purposes.

What the FCA may achieve with this set of initiatives is to put the brakes on sometimes helpful flexibility for the manager in managing its investment strategy by making the investment policy with which it is obliged to comply overly specific.

There will likely be far less flexibility for managers to respond to changing market conditions without taking purposeful action to change prospectus and other documentation which requires investor consent. There is a risk that this may impose too much of a strait jacket on managers which may put a disadvantage of investors in the longer term.

There can be a clear distinction between achieving clarity of objectives in investors' minds and requiring for managers to set too specific objectives which preclude them from providing timely and responsive active management.

- **Performance fees**

The FCA's focus is on making sure that all fee structures are "fair". Fortunately the FCA do not intend to propose significant rule changes at the moment: remaining focused on whether fees are fair to investors. However they do indicate that they "will intervene" under its existing rules where they are concerned that this is not the case, for example where it is clear that an AFM is charging performance fees in a way that investors could not understand in advance and would not expect (for example well below a stated target).

When fund managers are developing some of the more interesting performance fee models – which seem to be constantly evolving, care should be taken where performance fees are calculated relative to a number of targets.

Nonetheless, the FCA is consulting on one change: a new COLL 6.7.6A rule is proposed:

"Any performance fee specified in the prospectus must be calculated on the basis of the scheme's performance after deduction of all of the payments out of the scheme property."

This is designed to prevent any fee on a fee which is unlikely to be understood by investors. Also, it is designed to ensure consistency with the 2016 IOSCO Report "Good practices for fees and expenses of CIS" – Good Practice 4 stating that performance fees should be taken on performance that is net of other fees.

Impact of new proposals?

The FCA appreciate that new rules on benchmarks, fund objectives and past performance will require changes in information presented in materials. It will require firms to undertake comprehensive reviews of all marketing materials and also update prospectus documents.

Whilst the FCA note in the Cost Benefit Analysis annex that the outcome from their proposals might be that some AFMs will remove discrete targets from their funds, the FCA remain convinced that this will not be the general response and that the disclosure remedies should allow some investors to identify more successfully the product that best suits their investment needs.

What is the timetable?

There is to be staggered implementation:

- governance remedies – requiring AFMs to assess whether their offering is in line with their need on 30 September 2019

  There is a transitional rule so that such a statement setting out an assessment of value is not required for an annual accounting period that ends before

30 September 2019. The statement must be published within four months of the end of the relevant annual accounting period. So there will in effect be a staggered implementation once the rules come into effect approximately eighteen months from the Policy Statement – on 30 September 2019.

The FCA have accepted that *"considering the way to feedback in the context of other pressures on the sector",* the implementation period is extended to allow eighteen months rather than twelve months from the date of the publication of Policy Statement 18/8 with its final rules in respect of value for money assessments.

- final rules for the SM & CR PR for AFMs will come into effect at the same time as the final rules for the extension of the SM & CR in general, which is expected to be in mid to late 2019

- rules on box profits will come into effect on 1 April 2019

- recast Final Guidance 14/4, now known as Final Guidance 18/3 on changing clients to post RDR unit classes will be effective from April 2018

- for the Consultation on further remedies in CP18/9, responses are asked by 5 July 2018. We will need to await the FCA's final rules before knowing their proposed effective timing for those changes.

- Once finalised, there is intended to be a three month implementation period for the new Handbook Guidance covering benchmark proposals for new funds, and six months for existing funds.

Although not all provisions are finalised or yet in force, many fund managers are already planning for, and indeed anticipating, much of the content of the new rules, and seeking to adapt to the FCA's general approach resulting from its Asset Management Market Study.

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