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# Updating and improving the UK regime for asset management

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*An important paper to review is the FCA's [Discussion Paper 23/2: Updating and Improving the UK Regime for Asset Management](#) which was published in February 2023. In it, the FCA sets out a range of options for change both in the regulation of fund management and asset management in the UK.*

*All might agree that we wish to look at modernising the current position and to further the likelihood of the UK as a world leading centre of asset management – both for portfolio management and as a fund domicile. Over a long number of years now, the UK has lost out as a funds domicile, and one question will be whether that position can be recovered and, if so, how. The challenge is agreeing how to progress these aims.*

The FCA's Discussion Paper provides no answers but does set out a list of questions for industry comment: We attach an extracted list of those questions in the Appendix to this Briefing Paper.

The Discussion Paper discusses what the Future Regulatory Framework means for the UK rules for asset management and what should be prioritised. The FCA are also open to considering other aspect of the rules that need changing – consulting if it is within the FCA's powers or working with HM Treasury if action is required outside of the FCA's remit.

By way of three high level introductory points:

- The first step is to be consideration of what amendments should be made to the UK regime for funds and asset managers as they incorporate elements of retained EU law for funds and asset managers into the FCA Handbook. This is subject to the Future Regulatory Framework changes going ahead as proposed and the Treasury's timelines for repealing the relevant areas of EU law. (See our Briefing Paper on The Edinburgh Reforms and the Future Regulatory Framework: the impact for asset managers.)

- Given that major asset managers often operate globally, it is good to note that the FCA acknowledge that the UK regulatory regime should work effectively with other international regimes and that the FCA Rules should interact effectively with the requirements to which other firms are subject in other jurisdictions so as to avoid unnecessary complexity for international businesses.
- Also the FCA rightly makes the point that change should only be made where there is a purpose in doing so, as any regulatory change is a costly and time consuming business for firms.

**Having though set out these broad parameters, it is discouraging that the Discussion Paper itself seems to be quite specific in its initial suggestions – rather than proposing any radical rethink.**

The areas for discussion are broken down into structural changes, improvements and technology and information, and investor engagement.

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## Structural changes

- **Common regulation of fund managers and portfolio managers?**

The Discussion Paper covers:

- **fund managers** – firms that manage funds subject to rules derived from the UCITS Directive and AIFMD as fund managers; and
- **portfolio managers** – covering firms subject to rules derived from MiFID.

A key challenge is to decide how best to deal with all of the UK provisions which derive from the UCITS Directive, the AIFMD and MiFID, plus some Technical Standards and provisions for certain fund types such as the Money Market Funds Regulation. The FCA seek to identify the slightly different ways in which certain matters are covered in the three European Directive derived texts. Topics identified in Chapter 3 of the Paper include conflicts of interest policies and organisational requirements.

One question is whether the FCA should prefer to have consistency – which can, to be fair, offer a cost effective approach for asset managers - or whether some differences between regulation for fund managers and portfolio managers are justifiable because it is the fund itself which drives the need for the particular area of specification regulation. The FCA asks whether some of these fund derived issues ought to be applied to direct portfolio management generally. But we suggest that one should look carefully at each of the issues and decide whether they are justifiable.

Interestingly, the differences in rules which the FCA identify as being material ones seem more to be a result of the provisions being designed to suit the particular the fund product wrapper and so are particular to those fund products. Notably:

- **investment due diligence**

Even if not in the formal specific due diligence requirements, having sound investment due diligence is implicit within a portfolio manager's regulatory obligations so it may be inappropriate to overcomplicate matters by trying to set out more detailed standards to apply to portfolio managers derived from fund regulation.

- **managing liquidity**

For open-ended funds there are particular concerns at the fund level. The liquidity rules for open-ended funds are designed to ensure that the fund can remain properly open-ended. Liquidity management for AIFs will need to suit the particulars of the dynamics of the relevant AIF. Liquidity management for funds therefore likely has its own particular dynamics which are distinct from those which can be determined on an individual client basis for a segregated mandate in discussion with a client.

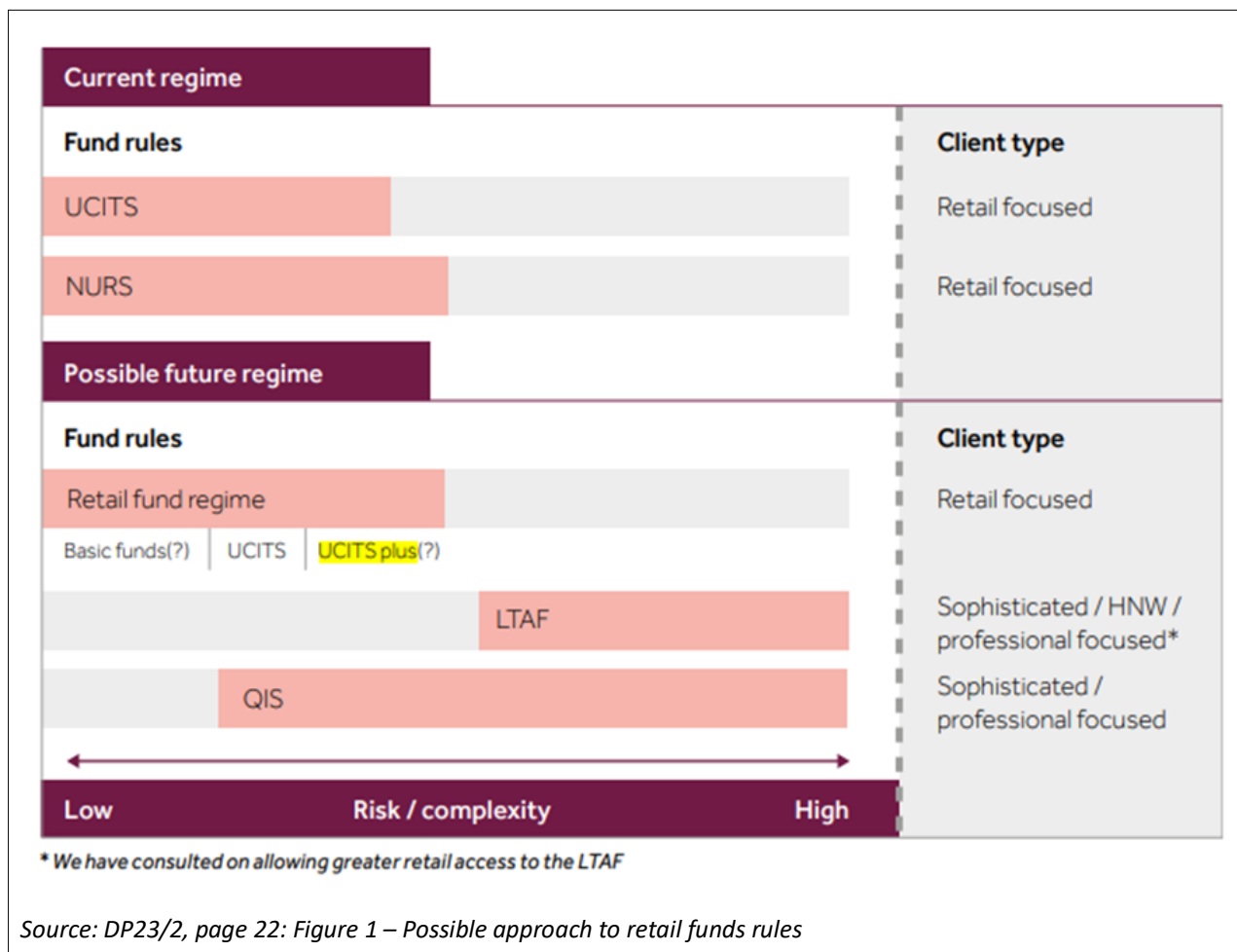
And indeed, one could take a contrary view and ask the question whether some of the additional fund Directive derived rules ought to remain? For example, is the EU approach on fund liquidity requirements the best approach to take.

- **The future for UK authorised funds**

Pursuant to the UK Funds Regime Working Group work set up by the Treasury's Asset Management Taskforce, there has already been one completed exercise – the establishment of the Long Term Asset Fund (LTAF). The question is whether other changes proposed by the Working Group are to be advanced or whether additional initiatives should also be undertaken.

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The FCA's possible approach for retail funds is summarised in the following table:



The possibility of rebranding the NURS regime as "UCITS plus" sounds a little odd and could cause confusion.

**Certainly, getting rid of the "NURS" label would be useful. However referring back to the UCITS product and its fixed investment parameters inevitably leads to expectations of a "UCITS plus" product. In fact, one could view it as "UCITS minus", as the current parameters for NURS funds are less restrictive than for UCITS funds.**

**Might it not make more sense simply to refer to "UK retail funds" and, within that term, funds which historically were set up as UCITS continue to be**

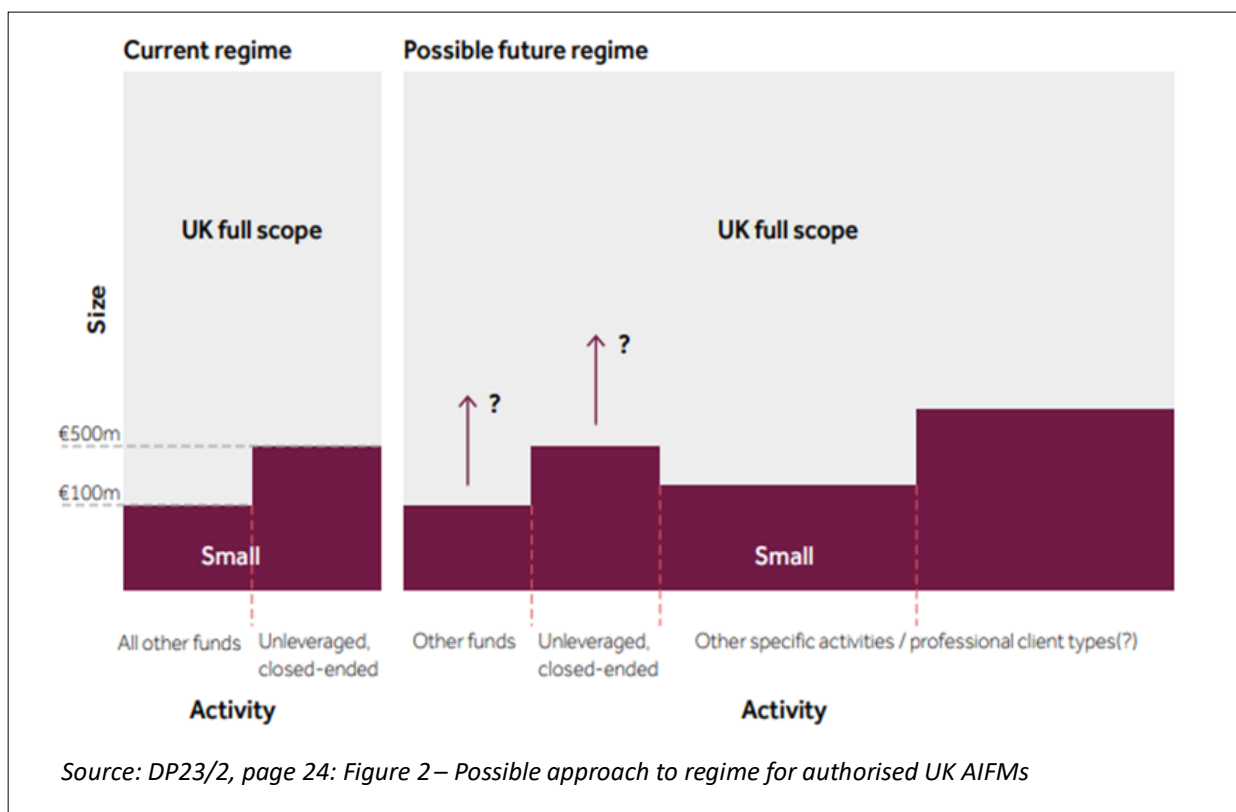
**authorised as UK UCITS? Having a "UK retail funds" regime would probably make more sense and be readily understood by investors.**

The next question of course then is should there be a clear distinction between the products offered for retail investors and professional investors, given that in practical terms retail funds have often had a mix of investor types. It might be good to have a discussion around how qualified investor schemes could be made more popular as a fund structure choice.

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- **The AIFM regime**

The UK's AIFM regime is unduly complicated due to the UK regulation of operators of funds which pre-dated the introduction of AIFMD and so the UK peculiarities of small AIFMs and registered AIFMs as well as full scope AIFMs. Possible approaches suggested by the FCA are set out in the following table.



It is certainly true that consumers may not understand the difference between small authorised AIFMs and small registered AIFMs. The possibility of requiring some types of small registered AIFMs to be authorised and removing the registration for others is to be considered. It may well be easier for AIFMs to require FCA authorisation generally and then have different levels of regulation applying to AIFMs depending on some criteria, be it the existing size threshold or another set of criteria. There may though still be the issue of disclosure of the relevant level of applicable regulation to investors.

## Improvements

- **Hosted funds**

Given the cost and expertise barriers to entry for new managers and the popularity of the host AFM route, it will be worth paying attention to the proposals for host AFMs.

The FCA suggest that there should be:

- clearly articulated contractual provisions so as to reduce the risk of the portfolio manager misunderstanding the obligations of the fund manager or

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- alternatively, industry guidance developed to set appropriate standards and act as a guide of host AFMs.

These two options may not however address all of the issues most recently evident in the case of the Woodford fund? Certainly, a key issue is to ensure that the fund manager is resourced in order to fulfil, and in fact does fulfil, its role as the AFM but arguably that role is in fact already clear. What is less clear is accommodating and satisfactorily recording the sponsor's role?

In practice, some portfolio managers can assist in the good governance framework because they wish their branded products to work well. This however does mean they are doing more than portfolio management, whilst always respecting the clear obligations of the fund manager to manage the fund.

**Ironically, one of the issues with the better ranges of hosted funds is that the portfolio managers do in fact wish to do portfolio management and also be an active sponsor of the product – not least as their name is on the brand of the product and they are probably selling it to their clients. Recognising the particular dynamics of hosted funds and building on the experience of the better ranges might be valuable?**

- **Liquidity management**

This is inevitably an ongoing hot topic. It could be good that the FCA wish to have some consistency and indicate that they expect firms to comply with the liquidity stress testing guidelines issued by ESMA which they plan to convert into FCA Rules but this should not be assumed. It maybe that a

UK regulator may wish to follow its own preferred approach rather than always adopt the ESMA position?

- **Investment due diligence**

As mentioned above, given that, even if not in the form of specific due diligence requirements, having sound investment due diligence is implicit within a portfolio manager's obligations, it would

seem inappropriate to overcomplicate matters by trying to set out more detailed standards that apply to all asset managers.

- **Depositaries**

The word "clarification" might sound alarm bells, as it usually means making matters more onerous.

Within the Discussion Paper, it appears that the FCA are not questioning the scope of the Depositary's role but the way in which a Depositary performs its role, and the level of intervention and challenge of fund managers it provides. But is this in fact the case?

It may quite legitimately be the case that the FCA wishes to increase the role of the depositaries but that should need to be undertaken as a detailed consultation and, should the role be increased, the scope of depositaries appointments and the level of commensurate fees etc would need to be reviewed. The question is whether any "clarification" is to go so far as to make substantive changes.

- **Improving fund rules**

It is inevitable that fund rules should move on as markets move on, and as client requirements move on. The question is how fund rules should be "improved".

Examples which the FCA are volunteering to look at include:

- **eligible assets**

Various ideas are floated:

On the one hand flexibility might be offered where the FCA do not want the rules to force managers to sell investments for example where, for circumstances outside of the managers control, the 10% rule will be breached.

On the other hand, and a contrary concern, the FCA are concerned that some UCITS managers see the 10% rule as a general permission to do what they like with that part of the fund without considering

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implications for suitability or risk management. Also they rightly raise the linkage with liquidity issues.

This is quite a difficult area to get right.

## – prudent spread of risk

There has always been the overall requirement for a prudent spread of risk for authorised funds except for QIS where there is to be a spread of risk. Deriving from the UCITS requirements though, there have always been the comprehensive specific set of restrictions on UCITS investments which obviously follows through in reinforcing how that spread of risk is accomplished. The position is not dissimilar for NURs except for a couple of areas of latitude on wider investment possibilities – such as 20% in unlisted unregulated assets rather than 10%.

The FCA say they are thinking of changing the rules although they are not currently minded to remove quantitative restrictions.

Certainly with the UK UCITS model, it seems inappropriate to diverge from the general European UCITS model as it would cause confusion in the market place should UK UCITS be different.

However, for other UK retail funds (by whatever name they might be called), there might be more scope to introduce flexibility going forwards so long as the basic principle of prudent spread of risk that is not excessively high risk can be achieved.

**There is an argument that application of prescriptive investment parameters is not the only way to devise retail funds: it just happens to be the way that EU UCITS funds were devised.**

## Technology and information

Use of new technologies is clearly an important area and where some modernisation is perhaps now overdue.

It is welcome that the FCA in Chapter 5 of the Discussion Paper emphasise the FCA's willingness to support technological changes that could modernise fund

propositions. This could be

- in the area of – almost inevitably – driving better consumer outcomes;
- but also in fund operations (where they mention the Direct to Fund (D2F) proposition which the IA is seeking to progress);
- fund tokenisation – meaning the way of units in a fund being bought and sold being simplified.

There could also be wider issues considered including:

- Tokenised portfolio assets where existing assets could be held in the underlying portfolio of the fund and traded in a secondary market in tokenised form, with fully digitised clearing and settlement.
- Also some might be interested in investing in crypto assets within a fund, which are not currently permitted investments. The Government's consultation on regulating crypto assets probably needs to be progressed before this notion could be advanced.

## Investor engagement

A chapter of the Discussion Paper is given over to investor engagement.

Given the UK regulator's focus on ensuring good outcomes for investors – and indeed in the asset management space of course the Asset Management Market Study which has already led to the introduction of various changes with this in mind - investment engagement is an important topic.

The FCA Discussion Paper does cover the topics of how drafting a fund prospectus should be approached, improving reports and accounts, and encouraging unitholder meetings.

Certainly it will be valuable to try and encourage better engagement so that manufacturers of products can better understand the underlying client's perspective. This would enable the manufacturers to meet the FCA's expectations on delivering good outcomes to consumers as manufacturers will be better aware as to the nature of consumers and their concerns. However it should be

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debated as to how this is best achieved. And indeed as part of the discussions manufacturers are currently having with distributors as part of the plans for implementation of Consumer Duty, some of the issues here are being reviewed.

Oddly, the FCA seem to be focussed on interaction and investor engagement through unitholder meetings being an important fund governance mechanism.

**Given the apathy when many unitholder meetings were held over a long number of years, it may be simply unrealistic to think that unitholder meetings might be the way to encourage more engagement?**

Also, it should be remembered that when OEICs were first introduced, they had to have an annual general meeting and, due to the cost and lack of attendance at these, the requirement for these was removed.

If however the FCA decide to pursue encouragement of the unitholder meeting route, it might be that managers should have the option of convening an annual discussion forum - and perhaps in a virtual format - rather than making them formal unitholder meetings. Certainly the FCA rightly raise the issue, given the prevalence of platforms now, that customers of platforms should be enabled to attend and take part in such discussions/meetings.

Somewhat oddly, the Discussion Paper does not focus on investor engagement in the sense of effective communications with investors by way of notices and other communications and interactions.

In practical terms, whilst sophisticated investors may refer to a fund prospectus, generally investors should expect a comprehensive prospectus but will not really be expected – and encouraged - to read it from cover to cover. Likewise with reports and accounts. Investors might though be expected and encouraged to read, for example, quarterly updates or fact sheets: succinct and readable communications about changes to funds, performance of funds and perhaps the results of the annual value assessments?

Perhaps more reliance should be put on easy to understand communications which come within the notifiable and significant notification category for COLL 4 purposes? This would fit well with the Smarter Consumer Communications previous work from the FCA as to how communications are drafted and presented to investors so that investors do understand more about the products

and changes to them. And of course all of this work which fitted within the TCF area will now be subsumed under the wider banner of the Consumer Duty and putting investors' interests at the heart of managers' decisions, which is a key regulatory initiative.

## Facilitate a radical rethink?

There is a risk that the work within this welcome initiative could lose sight of the wood for the trees. Many of the initial discussion points in the Discussion Paper pick on particular details of current regulation.

**We would submit that this is a valuable opportunity to undertake a wide ranging review. It is vital that the UK regime for both fund managers and portfolio managers is reviewed from first principles – a blank sheet of paper.**

In this connection, some initial thoughts include:

- **Aim for clarity and understandable terminology**

We are not sure we are convinced by the Working Group's suggestion of "UCITS plus". Whilst we may be stuck with the UCITS name, given its global brand awareness, may be the time has come for a simpler approach with UK authorised retail funds and UK authorised professional funds? That is not to say of course that professional investors could not invest in retail funds should they wish to do so but that certain funds might simply be reserved for them.

More generally, it would be useful to avoid jargon which is not readily understandable. Clear descriptions which are understandable by investors are to be preferred.
- **Avoid over-prescriptive regulation**

Whilst there is a temptation to see an issue and then specify an answer for it, it is often better to allow the market to find their own solutions, which may differ depending on the particular product concerned and the particular manager concerned rather than overprescribe the position in standard rules.

Especially for professional investors, it is unnecessary to have over-complex regulations such as sometimes now applies for full scope AIFM standards.



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- **Allow flexibility**

It would be a shame if the FCA Rules became even more prescriptive. When COLL Rules were introduced in 2007, an effort was made to simplify the rules but set out a principled approach.

Inevitably with UCITS funds, the specifics have had to be included because of the specific prescription for UCITS funds. Now though the UK has an opportunity to set the rules at the level we wish, which need not be so prescriptive. An example might be the proposal to make rules clearer around dilution adjustments when the purpose of the dilution adjustments is clear and different practices may well be supportable.

This is an ideal opportunity to undertake a radical rethink of the way in which the UK authorised fund rules are set up and the options available within them. Some of the FCA's suggestions seem to be more tinkering around the edges than suggesting anything fundamental.

Whilst it is really helpful that the FCA is taking this initiative to launch a wide ranging discussion forum, one question for the industry is whether the questions raised indicate a rationalisation plus a few improvements rather than something sufficiently radical for international competitiveness. Will the indicated direction of travel offer a way of improving the UK's position as a fund domicile? Should the proposals, particularly for fund categorisation, form a new debate on what forms of retail funds should be made available, and should they all be fully open-ended? Is there a role for an authorised retail vehicle which has elements of closed-endedness?

Even when a new product has been recently introduced in the UK such as the Long Term Asset Fund (LTAF), it is arguably too constrained to ensure its viability. It is vital that the current plans to try and widen out its marketability are progressed in order to ensure its success.

**It may be too late to look at the international competitiveness of the UK as a fund domicile but surely there are strong reasons for trying to improve the range of investment funds made available to the UK market and UK investors.**

The FCA is promising to engage widely in forums and roundtables as well as individual meetings and, when developing specific policy proposals, may convene groups to consider potential options and understanding consequences of certain options.

Given that this is the first time in a long while that we have the opportunity to participate in a discussion looking at the new rules from the point of view of a "blank sheet of paper", it is important that all contribute their views and that all issues are aired with the FCA.

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## The Appendix: List of questions set out in Annex 1 to the FCA's Discussion Paper DP23/2: Updating and improving the UK regime for asset management

- Q1: Do you think that we should aim to create a common framework of rules for asset managers? What benefits would you see from this? What costs might this create? If you do not think we should do this, are there any areas discussed above where we should consider taking action, even if we do not create a common framework of rules? What would we need to consider around the timing of implementing a change like this?
- Q2: Do you think we should change the boundary of the UK UCITS regime? If so, do you think we should take any of the three approaches set out here? Should we consider any alternative approaches? What timeframe would be needed to allow firms to change their existing product offering or to develop new products?
- Q3: Do you think we should work with the Treasury to amend the threshold at which AIFMs must apply the full-scope rules? If so, do you have any comments on the options described above? Are there any other areas we would need to consider if we were to do this?
- Q4: Are there aspects of the current AIFM regime that professional investors do not value? Would there be benefit in us removing any of these?
- Q5: Do you think that we should amend our fund rules or add guidance either to make clearer the requirements on portfolio managers of funds, or to set minimum contractual requirements between host AFMs and portfolio managers? Do you think this would lead to any other consequences that we need to consider?
- Q6: Do you have any comments on us potentially amending the rules and guidance around liquidity stress testing?
- Q7: Do you have any comments on whether we should make our rules on liquidity management and anti-dilution clearer?
- Q8: Do you have any comments on the benefits or costs associated with public disclosure of fund liquidity?
- Q9: Do you have any comments on us making our expectations on investment due diligence clearer for all asset managers?
- Q10: Do you agree that we should make our expectations of depositaries clearer? Do you have any comments on the areas where greater clarification would be desirable? Are there any areas where we should consider removing oversight functions from depositaries? Are there areas where the contribution of depositaries is particularly valuable for the interests of investors?
- Q11: Do you have comments on the analysis of the eligible assets rules for UCITS set out here? Do you think we should update or provide guidance on these rules? If we did so, what impact would this have for managers of UCITS funds?
- Q12: Do you have any comments on whether we should consider removing or modifying detailed or prescriptive requirements in the rules on prudent spread of risk?
- Q13: Are there any other areas where you think we should consider removing or modifying prescriptive requirements in the retail fund rules?
- Q14: Do respondents agree that we should work towards consulting on rules to implement the 'Direct2Fund' model?
- Q15: What benefits would tokenised units in authorised funds provide for investors? What regulatory changes would be needed to enable tokenised units to be issued? How much of a priority should we put on enabling tokenisation of units?

# Appendix 1 (continued)

- Q16: Are there specific rules that could impact firms' ability to invest in tokenised assets, where the underlying instrument is itself an eligible asset? How much of a priority should we put on enabling investment in tokenised assets?
- Q17: How important do you think the different kinds of 'fund tokenisation' discussed above are for the future of the industry? Are there examples from other jurisdictions that could be models for UK fund regulation?
- Q18: What other regulatory changes, if any, would you like to see to enable fund managers to make wider use of advances in technology without weakening investor protection?
- Q19: Do you agree that improving the content and readability of the prospectus will improve investor engagement? What specific changes would you like to see?
- Q20: What changes to the rules for managers' reports and accounts could enable firms to make best use of technology to meet investors' information needs? How else could disclosure of ongoing information to fund investors be improved? For example would there be benefit in us consolidating ongoing annual disclosure reports for funds?
- Q21: Do you agree we should review the rules for unitholder meetings? What changes should we make so that these meetings maximise the participation of fund investors?
- Q22: How could the relationships between fund manager, intermediary and investor be better reflected in rules for authorised funds? Should the FCA do more to enable investors to engage with the manager of their fund?
- Q23: Do you have any comments on the relative benefits of the topics raised in this paper which you think we should consider as part of prioritising our work? How would you rank the areas covered in this paper in terms of priority? (The response form for this question provides a tool for ranking the 10 major topics set out in Table 1 on p.14)
- Q24: Do you have any comments on potential reform of the UK regulatory regime for asset managers and funds in areas that are in scope of this paper but have not been discussed in detail?



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