HOW REGULATION IS DAMAGING COMPETITION IN ASSET MANAGEMENT

Structure and culture vs. regulation

THE NEW CITY INITIATIVE

The New City Initiative serves as an independent expert voice in the debate over financial reform, with the aim of restoring society's trust in the financial sector. It promotes the values and practices of European owner-managed firms who align their interests with those of their clients. It raises awareness of the positive, stabilizing contribution small entrepreneurial firms make to the economy and society as a whole.

"If I had to do it again, I couldn't start-up today". [1]

[1] Interview with managing partner of a wealth management firm, 20 August 2014.

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Key Findings

1. The UK SME asset management sector has traditionally been vibrant and strongly growing, but it is now stagnating, as new start-ups cannot support the financial cost resulting from increasing regulation.

2. Boutique asset and wealth management firms find the burden of regulatory compliance increasingly onerous.

3. New financial regulations from the EU and UK are applied equally to the very biggest and smallest asset management firms, disregarding their ability to shoulder the consequent financial and legal burdens.

4. If financial regulation is not imposed more proportionately on large and small asset management firms, the NCI is convinced that many fewer start-up firms will come to market. This arrest of competition will damage all, but especially the consumer, as choice will become much more limited.

5. The legal complexity of and the potential financial punishment for infringements of regulation pose massive obstacles to the growth of competition in this sector.

6. A new 'priesthood' – compliance officers – has emerged from the financial crash. As the regulatory regime becomes ever-complex and continually evolves, and the scale of potential punishments so damaging to small firms, the temptation is for compliance officers to engage in 'gold-plating' to avoid any possibility of failure to comply.

Source: FCA, Controlled Functions for Investment Managers

Executive Summary

- The UK investment management industry generates about 1% of GDP and remains Europe's leading centre for fund management. It earns an estimated £12 billion a year for the UK. London is the hub of specialist boutique firms.

- The financial crash of 2008 was exceptionally damaging, perhaps the most serious long-term cost being the death of trust.

- Excessive regulation in the UK has led to a substantial rise in compliance costs and personnel. Compliance officers are the new 'priesthood' of the financial services industry.

- The increased regulatory burden has substantially damaged the competitive landscape through increased costs, time spent on compliance, and the imposition of unsatisfactory client suitability measures. The number of compliance officers in the UK has more than doubled since 2001, while the number of asset managers has declined by around 20% over the same period.

- The NCI advocates structural and cultural changes ahead of regulatory ones, to drive better alignment of interests and outcomes for investors and the market in general.

The NCI's Recommendations

1. **A faster reaction time:** It is difficult to get authorized by the FCA. There appear to be two underlying problems, a lack of resources or staff, and that everything has to be up and running from Day One – i.e. you must set up a fund first of all and then apply to be authorized. The application process is time-consuming and complex; it's necessary to have a business plan, investment plans, and compliance procedures in place. And then you wait, for up to nine months. You cannot phone the FCA to ask how your application is faring. As one applicant for authorization put it: "a helping hand along the way, that just doesn't exist. If your application fails you may well have spent up to £30,000 on outside consultants to help you draw up the necessary documentation – quite an outlay just to put in your documents – and you may end up going to the back of the queue to get authorized."[2] Nine months is a long time. As one manager put it: "I would never attempt to set up on my own – months and months of enormous costs when you can't put yourself out there as an investment manager, when you can do no active marketing on behalf of your new fund, when what few clients you may have drift off to somewhere else. It's all just too risky."

2. **Less determination to be seen as tough:** In the post-trust world, where the FCA can sometimes be seen as intimidating – the FCA head, Martin Wheatley, told the Association of British Insurers in a speech in 2013 that the FCA had the power to "shoot first and ask questions later" – firms are nervous to go on the record about how they see the FCA and their experience of dealing with it. This does not help build open and constructive relationships. The apparent determination of the FCA to be seen to administer stern justice is an understandable swing of the pendulum away from a *laissez-faire* approach but it has arguably gone too far and is a discouragement of the entrepreneurial spirit that is vital if London is to remain a centre of financial excellence.[3]

[2] This is a common view. David Kenmir, director of financial services regulatory practice with PwC, commented in May 2014: "The capacity of the regulators has never been as strained as it is now. The sheer range of things the regulators are now expected to do – they now have an issue with bandwidth. What happened to the customer in all this? The FCA told financial institutions to put the customer at the heart of their strategy, but where is the caveat emptor? What about consumer education? Are the regulations proportionate? There are huge issues still to be resolved and I am not sure where it will all end up". *Banking Technology*, 8 May 2014.

[3] The imposition of a record £16.8 million fine on Invesco for failing to disclose derivatives transactions between May 2008 and November 2012 is a case in point. Invesco's 'crime' was that it failed to disclose in its simplified prospectus the transactions – it did disclose them in

3. **Appoint dedicated FCA managers allocated to firms, and enable them to give advice:** The FCA will only refer any enquiries to their handbook, a massive document that is not easy to navigate unaided. The FCA will not advise a firm directly. This one-sided communication is unhelpful and it is not clear why it need be like this.

4. **The FCA should explicitly encourage and nurture new start-ups and could do so by dropping the restriction that a new fund cannot be set up and/or running prior to applying for authorization, by allowing pre-authorization marketing, and by lowering the capital requirements, which seem arbitrary:** This would stimulate competition and ease the way for start-ups.

5. **An explicit recognition that the NCI emphasis on encouraging a better practitioner model is far better than imposing further regulation:** Regulation cannot replace culture. The creation of employee-owned businesses, whose interests are firmly aligned with those of their clients, provide staff with a strong incentive to generate good performance while discouraging actions that could lead to the business' demise. With the correctly structured culture, risk diminishes and performance improves. No law or accounting firm collapsed in the crash, and no private bank; their culture and structure is different.

6. **With effect from April 2015 the investigation and enforcement powers of the FCA are to be dramatically extended to cover anti-competitive behaviour.** The FCA will be given the power to impose fines for infringements of competition laws of up to 10% of the relevant group's turnover, and to apply for a court for a disqualification order against a person who is a director of a company which has infringed competition law. The NCI believes that action to stimulate greater competition is equally important as action to punish anti-competitive behaviour.

its bigger prospectus. The FT commented on 4 May 2013: "this looks like a clerical or administrative error rather than an attempt to cover up losses." The losses were also relatively small (£5.3 million) and – most important – were reimbursed to investors.

Encourage growth

The UK asset management industry – particularly in the SME sector – makes an extremely valuable contribution to the British economy. That contribution is likely to grow in importance, given the financing gap that has emerged as a result of bank lending drying up in the wake of the financial crisis. Increasingly, asset managers are likely to play a key role between investors looking for yield, and a private sector looking for sources of investment. Asset management will increasingly provide the necessary liquidity.

Thus it is natural that encouraging the growth and diversity – for the minnows of today's asset management world could become tomorrow's mighty – of the investment management industry is a specific government aim. According to the Treasury, the investment management industry "needs a stable, responsive and fertile business environment in which to thrive and compete. This has not always been the case over the past decade. Despite its position as the leading centre for fund management in Europe, the UK has lost ground as a fund domicile, with a consequent loss of jobs and growth especially in the UK regions…[some of this decline] has been the direct result of failing to adequately address concerns over rules and processes here…the Government has taken note, and is determined to improve the UK's competitive position with a comprehensive strategy to enhance the UK's position as a global leader in a global industry." The Treasury promised to enhance the UK's IM industry, and to make "our new regulatory system [the Financial Conduct Authority] as nimble as it is rigorous."[4] This paper attempts to capture some of the difficulties faced by those who may be considering starting a new boutique asset management firm, or who are perhaps nurturing a recently-started firm through the difficult early years.

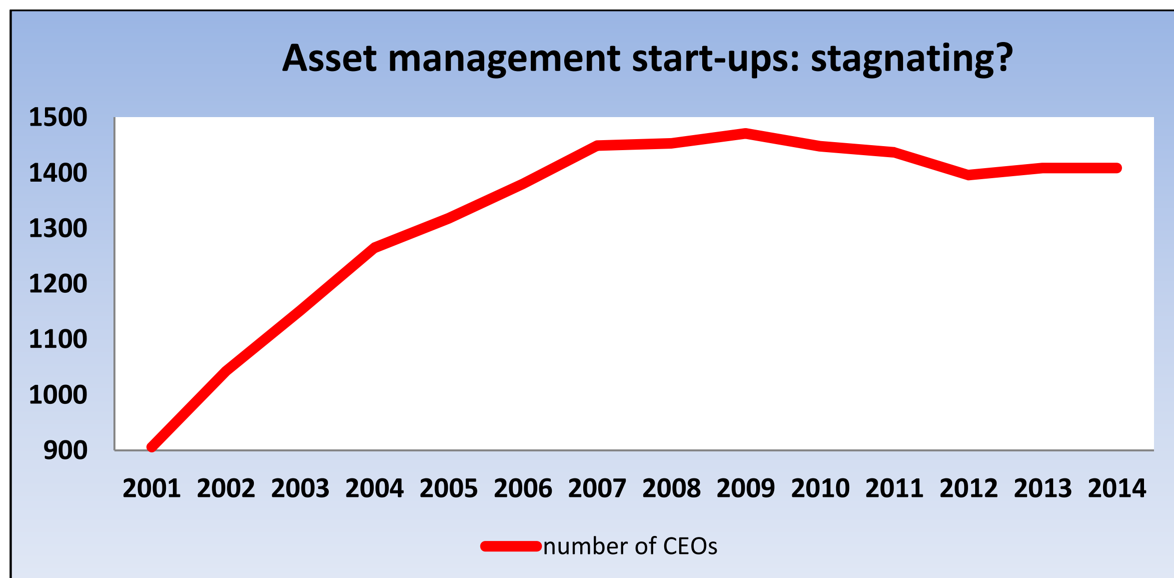
It is important to stress that the FCA is a relatively young body that was brought into being on 1 April 2013. As such it is natural that it is keen to demonstrate its effectiveness and determination to prevent the kind of financial disaster that happened in 2008 – for which the asset management industry bore no responsibility. The NCI is keen to work in collaboration with the FCA and ensure that new regulations work to the benefit of customers, firms, and the country as a whole by promoting a strong ethical culture. To that end the NCI promotes to government and regulators our business model, which is based on boutique firms that represent no systemic risk and present vital competitive dynamics for the savings and retirement markets. Much of what the FCA seeks to do – increase transparency, reduce unfair costs, and foster greater care in the treatment of clients – are

[4] The UK investment management strategy: HM Treasury, March 2013.

ambitions that NCI members share. Our members are concerned however that ill thought through regulations are a serious deterrent to new start-ups, and hamper the growth of fledgling small firms.

The UK has several competitive advantages when it comes to the asset management industry. The objectivity of its legal system is a tremendous boost, as is the English language, through which much of the world's business is conducted. The UK has a large array of innovative, experienced, skilled and trusted investment management firms, with a critical mass in assets under management. The UK investment management industry generates about 1% of GDP[5] and remains Europe's leading centre for fund management, but in the past decade the UK has lost market share for domiciled funds to Luxembourg and Ireland, slipping from 34% in 2000 to 20% in 2011.[6] How much of this loss of business and revenue can be attributed to the costs of additional regulation in the UK is extremely difficult to quantify.

Asset management is nationally important: the investment management industry in the UK manages £6.2 trillion[7] of funds and earns an estimated £12 billion a year for the UK, and accounts for a third of all investment in UK equities. The total of funds under management is almost 50% higher than the pre-crash level. The overall sum increased by 14% during 2013 and another 5% in the first half of 2014. It is notable that about a third of the total is invested by foreign nationals.



Source: FCA, Controlled Functions for Investment Managers; number of CEOs taken as a proxy for number of firms

[5] HM Treasury, The UK investment management strategy, March 2013.
[6] Ibid.
[7] The CityUK, as reported in Cityam.com on Monday 29 September 2014.

The UK and European economies need good returns on their investments to support and maintain an aging population. Within reason, anything that can encourage growth in this sector, and increase competition and enhance the ability of new small start-ups to flourish, is of great importance to the future of the nation's economy. Equally, anything that acts as a drag on growth is to be resisted, unless there are other and higher priorities.

The death of trust

The financial crash of 2008 was exceptionally damaging in many ways, perhaps the most serious cost being the destruction of trust. Trust is – or should be – at the heart of the asset management industry. But trust died, crucified in part by the many instances of the financial sector mis-selling products, largely because the deep connection between the seller of products and the customer had broken down. The relationship of trust between financial expert and financial novice disappeared, and the structures of the financial services allowed this to happen. Bluntly, people were mis-sold products because the sellers were well rewarded financially, whether or not their products met the interests of the customer. All kinds of markets were rigged by individual bankers, who benefitted from structures that divorced them from end-users. No wonder that restoring trust is so difficult.

The response of governments to misbehaviour is, usually and understandably, to create new laws, rules, regulations and punishments, to stamp out not only the recognised misbehaviour but to try to prevent future misdeeds – whatever their shape or form. This, essentially, is the function of the Financial Conduct Authority (FCA), the successor regulatory body to the FSA. The Retail Distribution Review put paid to that, and is one instance of a necessary piece of regulation – although, like much regulatory change, it has had unforeseen and adverse consequences. As the trust-based culture disappeared, a rule-based one inevitably rushed to fill the vacuum – even though the proliferation of new rules and regulations is shutting the stable door after the horse has bolted. Government and regulators worry that they cannot anticipate where the next major financial disaster might lurk. The temptation is to be draconian on all fronts, sweeping up both large firms that may potentially pose systemic risks, and smaller firms that – because of their employee-ownership culture – pose no such risk. The lasting legacy of the crisis has been to create voluminous prescriptive rulebooks, in a forlorn effort to eliminate any possible uncertainty. The aggregation of more regulation, requiring more information, more oversight, more people, all imposes a tax on doing business. Perhaps some part of

this tax is necessary, in order to safeguard the financial system from a worse fate. But who knows which part?

The problem is that the regulatory landscape post-2008 is an uncertain place and subject to rapid change. There has been a plethora of new regulation from both the EU and the UK. Many smaller firms have found it difficult to keep up with the pace and financial cost of change, as they have been forced to add layers of bureaucracy (either internally or outsourced) to ensure they are fully compliant. The NCI is concerned that the noticeable stagnation in start-ups since 2009 reflects the additional burdens faced by anyone seeking to join this highly competitive business. It is the era of the unstoppable rise of the compliance officer – even as overall staff levels in the UK asset management industry struggle to return to those seen at the start of the Millennium.

We need the FCA

We all – clients, firms, the nation – need the FCA, to develop good regulation, regulation that will help this vital sector to grow. That growth is not part of the FCA's mandate but perhaps it should be. The FCA is costlier and – so far – tougher than its predecessor, the FSA. By the end of Q1 2014 the FCA Enforcement Division had opened at least 70 investigations into individuals and firms since its inception in April 2013. It has on average been opening more than six cases a month. This compares to a total of 49 investigations begun by the FCA's predecessor, the Financial Services Authority (FSA), in financial year 2012/13; an average of around four cases per month.

The regulators are funded through a levy on the financial services industry, but a National Audit Office (NAO) report[8] acknowledges that this could be passed onto consumers. The combined forecast cost of the FCA and PRA for 2013/14 is £664m; 24% higher than the cost of the FSA in its final year, according to the NAO. The regulators have attributed this increase to additional front-line staff, IT, support and premises costs. More than a third of staff currently employed by the FCA have less than two years' service at either the FCA or FSA, according to the NAO, while 31% of those who resigned last year (2013) were classed as 'high performers'.

The FCA in March this year (2014) made a gesture in the direction that the NCI welcomes, by focusing more on the culture of firms. It said it would engage with investment management

[8] http://www.nao.org.uk/report/regulating-financial-services-2/

businesses to assess their culture and other aspects of firms' operations, so as to "identify emerging risks and work with you to take pre-emptive action where necessary…We are putting a particular emphasis on understanding the culture within a group: the way you conduct your business, what you expect of your staff, and your attitude towards your customers," the FCA said in its new handbook. "Your culture underpins everything you do, setting the tone for the behaviours you promote and reward. You must decide what type of culture is suitable for your group, and demonstrate it from the top down…An effective culture will ensure that you treat customers fairly in everything you do, and that you do not abuse the markets you operate in." The regulator said that it wants to know more about how businesses in the financial services industry are "really run" and not just about how they control risks. It said it wanted to understand how businesses "aim to make money" and their financial health and how organisations' "culture and strategies support fairness for consumers and markets." Crucially, it added: "If we find firms, groups, products or behaviours that could have an adverse effect on competition – for example, a large, established firm making it difficult for customers to switch to a competitor – we will consider the most appropriate action to take."

We also need global rules

It is very important to try to set global regulations. We create an uneven playing field by setting tough regulations in Europe, while the American and Asian markets benefit by enjoying much looser regulations. Some regulation that looks certain to be introduced can be deflected, if sufficient weight of opinion is mustered against it. For example, the European Securities and Markets Authority, Esma, the pan-European regulator, has been assessing proposals by the FCA to ban dealing commissions and it appears to have rejected them, in favour of more transparency from brokers.[9]

Some regulation might be both good *and* bad – it's too early to tell. The Markets in Financial Instruments Directive (MiFID) was first introduced in November 2007 and is the cornerstone of the European Commission's Financial Services Action Plan. A successor Directive, MiFID II, will come into force in January 2017 across the EU. It runs to 800 pages, and while few are willing to speculate precisely what its impact will be, it will certainly significantly push up the cost of advice as a result of

[9] The *Financial Times*, 11 November: 'Europe pulls back on research cost revamp'.

the additional work involved in compliance, such as recording telephone calls, asking clients to sign minutes of meetings, and specifying the time periods for issuing reports to clients and having reviews. MiFID II will also mean a ban on independent advisers taking commission, as with the RDR in the UK. On the other hand the requirement that investment managers reveal all costs and fees – including hidden costs and underlying fees – to consumers in one figure, and that investors should be issued with clear, itemised statements at least once a year, is surely welcome; greater transparency wherever possible is one way of restoring trust. Anything that enhances transparency and enables consumers to have a clear comparison between investment managers will improve competition – even though this carries the burden of wading through an 800 page rulebook and, as a result, taking on board more compliance costs, either internally or externally.

But a ban on commissions for advice inevitably means that many smaller investors will be unable to afford advice and/or it will not be commercially sensible for advisers to take them on. Thus they will be pushed more towards lower-cost but also lower-performing index-tracking funds, and the 'homogenisation' of the wealth management offerings and industry will relentlessly continue – and smaller firms interested in actively managing funds will struggle to get off the ground. The really wealthy will still be able to afford bespoke advice through private or family offices, while those unfortunately unable to afford such advice will be driven increasingly into execution-only 'pile them high' funds. This will inadvertently help foster a valuation discrepancy in which those funnelled into index funds will only gain average returns – which may be very poor indeed – while those able to afford advice will stand to gain much more. Thus the rich will get richer, thanks to regulatory change.

MIFID II as it stands will require all advisers to disclose all costs relating to the product itself, as well as the advice, and the cumulative effect of this on returns. It is unclear how cost disclosure will work in practice, but many are worried that this mixing of two fundamentally different things – the cost of advice and the cost of the product – will pose definitional problems. MiFID II has been introduced alongside the packaged retail and insurance-based investment products regulation, and the Insurance Mediation Directive II. These three pieces of legislation cover different product types and either the sales or disclosure process, but there is a degree of overlap between them. All this is difficult to keep up with, but for wealth managers who have been in business for several decades and know their clients intimately, there is an inherent absurdity – as well as a cost – in the regulation that requires them to demonstrate that they know their clients.

One wealth manager from a small independent firm, who estimates that 8% of his firm's annual revenues are eaten up by regulatory compliance, argues that "many of the old-fashioned IFAs deserved weeding out, precisely because they sold on the basis of commission received rather than good objective advice for the client; they put their own interests first and those of the client second.[10] The FCA was right to introduce RDR, but the imposition of RDR has afflicted us because the FCA wants, on one side of A4, a demonstration that fund managers *really* know their clients. The IFAs had a very unscientific approach and one can understand why the FCA should want to introduce a more systematic way of proceeding. But it's difficult for us. We really do know our clients well but how do we prove this? It's up to us how we demonstrate this, so we have been given rope to hang ourselves with. Now everybody has to go round to their clients to try to organise this. Putting that paperwork in place is incredibly burdensome. And clients hate having to fill in forms." This firm has three partners, three other fund managers and five support staff. It has £300 million under management. It is a good example of the way in which 'one-size fits all' regulatory requirements inadvertently damages potential growth, discourages others from starting-up a new business, and ultimately may force the firm into consolidation that will see existing clients no longer receive the kind of individual service they require. An unlimited liability partnership, with very tight internal controls, the firm has taken 20 years to build up to 350 clients. "To produce the forms to show 'suitability' takes a month of work for two people over the course of a year," says its managing partner. "We do the compliance, anti-money laundering, and the financial returns to the regulator. Over and above that, there are so many rules and regulations, and so many of them have come so fast, that we cannot understand them without help. We have thus hired a compliance consultant at £15,000 a year, with whom we hold four audits a year, for each of which we need to spend two days to prepare, and half a day actually on the audit. There are a whole series of 'incoming missiles' – new laws and regulations. Of course the compliance consultant has a vested interest in spouting whatever the FCA says. The killer is that the FCA requires us to demonstrate *on an annual basis* that we really do know our clients and, if we don't, the penalties are quite high."

More fundamentally, it is the *de facto* encouragement by the FCA of 'model' portfolios that especially disturbs many wealth managers. One commented: "How can this be right? Each client is different. But if you have two clients who superficially appear similar, yet to whom you have sold a different set of investments, the burden of proving to the FCA that that was the right thing to do is quite substantial. I feel like it's a situation where 'many must suffer for the sake of the few'. Of

[10] Trail commissions – the annual fee paid to financial advisers by their customers over the lifetime of products such as pensions or unit trusts – were banned by the FCA from the start of 2013.

course people in the past peddled rubbish, but this idea that one size fits all is equally inappropriate. We all live under a cloud of fear. If you are a big company and get fined half a million pounds you can probably survive; but if you are our size it will make a material difference and your firm might go under. This fear is a massive barrier to entry. The FCA needs to be able to be more flexible to distinguish between a charlatan and a decent person. It's making everyone very risk averse. It's a kind of painting by numbers approach – it's on the side of the very big companies, making everybody the same by rhetorically asking 'is there too much risk?' There's too much hassle."

The upshot of RDR is paradoxical: rubbish advice has been cleared away – but the costs of getting good advice will become prohibitive, and the ordinary consumer without great wealth will inevitably go to pile them high, sell them cheap index funds, managed by a handful of very big firms who know little of their clients, and whose remuneration is utterly independent of any performance. Says one wealth manager: "RDR has created collateral damage. I think the man on the street is going to get less and less advice. Meanwhile the individual is being required to save on his own for his future. Ultimately this is a monoclonal approach; reducing diversity is a risk in itself."

In Europe today the state pension of one retiree is, on average, paid for by the taxes of four workers. By 2050 a retiree will be supported by two workers. And meanwhile people are living longer – so the state pensions will have to last longer. The response of governments throughout Europe to this problem is to shift the burden of responsibility of retirement planning to the working-age individual. But just as the state is shifting to an expectation of pensioners funding themselves out of savings, and by default is requiring the upcoming retiree to have a level of financial planning sophistication far beyond anything ever seen in earlier generations, that same state is making it ever-more difficult for the upcoming retiree to receive advice from asset managers. Yet the same wealth managers need to better manage increased risk and design products not only for saving towards retirement but also to allow for steady income flow and safeguard the investor against the risk of having insufficient cash flow in old age.

The steady scarcely perceptible shift towards large and often publicly quoted wealth management firms, answerable more to shareholders than clients, and touting a look-alike index product, bought by a mass that needs to fund its retirement yet has insufficient wealth to access good advice, is a nightmare that could be avoided. Why nightmare? Because indexation necessarily forces managers to hold companies in which they do not believe, simply to avoid the risk of under-performance – and under-performance is clearly something that the FCA is watching out for and may deal with harshly if

it feels there is a justifiable case to be made. Large publicly quoted fund managers specialise in marketing, in the attraction of new clients rather than the agile performance offered by boutique fund management firms. And new FCA authorizations have yet to recover their peak, as the chart below shows.

Source: FCA (up to end of October 2014)

The main criteria for being judged a success in this world is that more funds come in through the front door than leave through the back; and by inadvertently encouraging this world the FCA is doing a disservice for precisely those it claims to protect. Big firms meanwhile gobble up smaller in the mission to add assets and acquire even more firepower in the hunt for achieving beta. This gobbling invariably results in the placing of the acquired clients into one of a few crudely defined risk categories, and their money is invested into the 'appropriate model' which is designed by an investment committee at the centre. Unsurprisingly the investment outcome to the client is largely uniform across the board. Average input = average output.

Bigger asset managers have grown very fast and these firms are more able to absorb the costs of regulation (more people, more technology) than smaller. But the big players were once small companies, providing the kind of keen competition necessary to keep asset managers competitive and more likely to better serve clients. Under the subtle but palpable pressure from regulators, asset managers are discouraged from doing anything that might be perceived as incurring unusual risk. From another direction comes another pressure – the need to reduce costs and lower fees. Together

these two pressures result in an inevitable slide towards investment in index funds, which is nothing more than an acceptance of average performance.[11]

Portfolios and funds are increasingly geared towards what are perceived as 'risk-free' or 'risk-minimal' strategies. The assumption by the regulators is that if risk is to be incurred, it ought to be spread as widely as possible. Fund managers, encouraged to crudely segment their customers into 'low/medium/high risk' categories, are tempted to steer clients towards 'model' portfolios, pleasing the regulator who wishes to be seen to diminish or at least 'regularise' risk. Power and control is increasingly concentrated in a shrinking asset management world, where the product-pushing Big Asset Gatherers dominate. The heavy hand of regulation will inevitably result in financial advisory firms advising clients on the basis of the rules – both formal and informal – as laid down by the regulator, rather than any investment case customised for an individual client.

In the UK, a monoclonal culture of massive investment houses, all offering remarkably similar products at commoditised prices and delivering commoditised returns, is threatening to overwhelm small and medium-sized firms, and stifle new start-up firms. The cult of the index – even though it negates any better return to the investor than the mean – seems firmly established, with unspoken regulatory approval. If you go for beta, you cannot be blamed; going for alpha means going out on a limb. In today's post-trust world, where investors can never be seen to be risking losing money, to do that could mean trouble with the regulator.

Acronym soup

Acronyms pepper the financial services' world. MiFID II, AIFMD, RDR in the UK, the Dodd-Frank Act and FATCA in the US, FOFA (the Future of Financial Advice) in Australia – all are designed to protect customers, prevent financial crime, increase transparency (particularly over fees), and bring about market stability. We applaud and support these aims; but the unintended consequence of these regulatory changes is that competition is being reduced, and performance is not being improved.

Adhering to all these new rules is complicated and costly. Achieving full compliance involves tracking and understanding the evolution of new rules, realigning policies and procedures, upgrading

[11] The average did very well between January 1982 and September 2007 – the total dollar return from the MSCI World Equity Index was an annualized 11.8%/year. But in the 18 months after September 2007 that same index fell 56% - well over half the gains of the previous 25 years were wiped out. Relying entirely on beta for returns is dangerous.

platforms and technologies, developing and implementing plans, training employees, and documenting and reporting to regulators on compliance. Not doing this could mean a heavy fine – crippling for a smaller firm – and a ban on business activity, as well as legal bills, reputational damage, and correctional costs. Compliance officers are the new priesthood, who in case of doubt prefer to gold-plate their standards, for fear of falling short.

Nor is it merely formal acronyms. Informal legalistic binds have been put in place. The FCA for example now routinely asks the CEO or other members of a firm's senior management to certify in writing that the firm is compliant in a particular area, or that it has carried out an agreed remediation action within a specified timeframe. The FCA explicitly regards this 'attestation' as making it easier to take enforcement action; the attestation is regarded as having a legal affirmation status, crystallizing the idea of personal accountability. The trouble is that, like the binding of female feet in ancient China, the end result is neat but crippling.

As a consequence of the time and money costs involved the rise in the demand to comply, there has been a concomitant rise in the supply of outsourced compliance expertise. There have always been rules and regulations surrounding asset management, but in the past they did no more than supplement trust; it's worth noting that, despite the existence of regulatory safeguards, the Madoff scandal still happened.

Regulations provide no more than a comfort blanket. In themselves, they are insufficient to prevent a determined fraudster from committing crime. Gaining and retaining investors' lasting trust requires greater transparency, better communication, and better management of expectations. Above all, asset managers demonstrably need to abide by their promises of putting clients' first and foremost. This can only be done through having the right culture, one where the asset management firm's employees co-invest their own capital alongside that of their clients.

Under a cloud

According to a wealth manager consulted for this paper, today's regulatory environment is intimidating: "We all live under a cloud of fear, a fear of doing the wrong thing without perhaps even realising it." Perhaps this is intentional, *pour encourager les autres*. In any case, it is not only that the regulatory burden has become much heavier; it is also the fact that it is subject to frequent

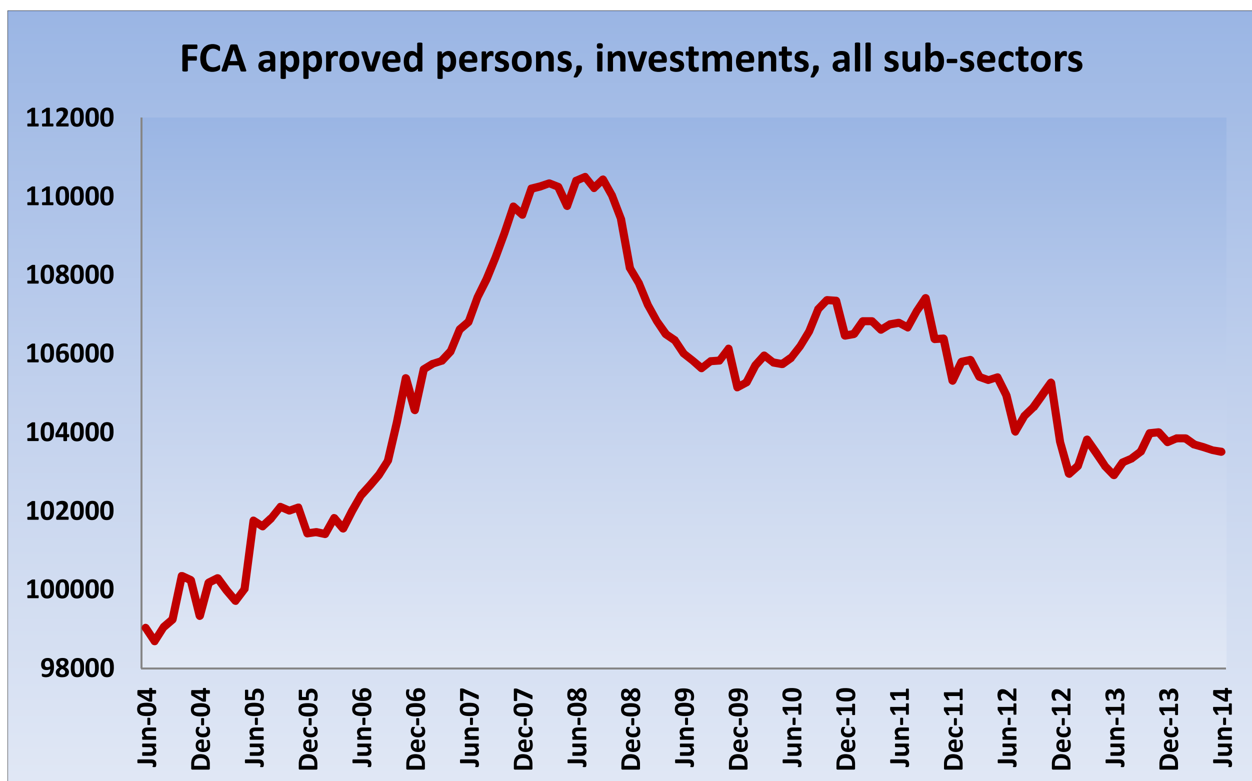
adjustment and change. On occasions the legislation has proceeded in advance of the rules carried by that legislation being specified. In the case of AIFMD there was such a short timeframe to implementation that the regulators had not worked out the precise rules – so firms had to get started on implementing AIFMD, and make assumptions about what those rules would eventually be.

As a case study we spoke to the COO of a small (AUM <$2 billion) asset management firm based in London. It specialises in Asian equities. He detailed the complexity of running his business within a regulatory framework that lacks global harmonisation. "We have to be aware of not just all the relevant compliance regulations in the EU, US and Asian markets – and of course there is no globally uniform regime – but also changes in the taxation prevailing in each of those jurisdictions, and so on. No one has all that expertise on tap so naturally we have to seek legal advice each step of the way. I am pleased we started when we did, just before the crash. I don't know how anyone gets going today without significant backing. Start-ups are going to have a really serious struggle unless they have a serious pool of cash, which they will quickly burn through. It's not just that the regulators are indulging in a belt-and-braces approach, as if terrified that a fresh crisis is just around the corner. It's also clients who, in a post-Madoff world, are inclined to believe that everyone they meet is determined to rip them off."

This COO estimates that he spends 90% of his working week dealing with compliance, regulatory, and risk management issues. "I couldn't really put a monetary cost on it; we rely upon expert external advice from consultants and legal advisers. The lawyers are the only ones who have done really well out of this new world of regulatory tripwires; we are trying to run a business, investing in long-term under-valued companies on behalf of clients. The business of the legal advisers, on the other hand, is precisely telling us what we can and cannot do. They have a vested interest in erring on the side of caution." Some have attempted to put a global cost on compliance. According to KPMG[12] the world's hedge fund industry costs as a result of regulatory requirements are currently $3 billion. It comments: "this rising cost of compliance is squeezing margins...Smaller funds, in particular, are paying the price...For new funds launching in the market, the story may be of greater concern with the cost of compliance quickly becoming a significant barrier to entry." KPMG estimates that compliance costs represent on average more than 7% of total operating costs, with managers "overwhelmingly absorbing the cost of compliance rather than passing it on to their funds."

[12] The cost of compliance: 2013 KPMG/AIMA/MFA Global Hedge Fund Survey.

Boutique firms are often forced to seek expert out-sourced legal consultancy for the compliance functions. One NCI member firm comments: "We cannot afford to hire people with the multinational legal expertise. It might be possible for very large institutions to have 30 people in a back office function doing that, but not for us. At one point we got rid of our cleaners to keep the lights on. There are various absurdities. For example, when AIFMD was introduced we had to re-apply for approval with the FCA, despite the fact that we had been doing the same thing for the previous five years. This was at huge cost and inconvenience, filling in an application pack of hundreds of pages, and we are just a plain vanilla firm. We spent easily over 200 man hours and incurred a financial cost of £30,000-£50,000, simply to continue doing something we had been doing for years."



Source: FCA, Approved Persons

One partner of a London-based asset management firm told us that "new firms, launching with investment teams that may not have already built up a pot of capital to work with, will struggle. The capital requirements imposed by regulatory authorities to start a new asset management firm in the UK have more than doubled in the past decade. They are considerably more onerous than in the US. A US-based asset management firm is required to have just a small amount of capital, less than

$100,000 if it works only with non-ERISA[13] institutional clients; if it wants to manage money for ERISA clients, it needs to have $1 million capital. That's the *maximum* amount needed. Contrast that with the UK. Ten years ago, in 2005, we established a new associate UK firm with £445,000 of capital; our most recent associate firm was required to have £1 million of capital. New UK firms are required to have an increasing amount of capital in place right from the start, for working capital requirements, regulatory minimums, and stress-tested capital resulting from conservative ICAAP[14] shut-down assumptions."

Nor is it a matter solely of one-off costs; there are regular, on-going costs and here too the UK seems to impose more onerous requirements than the US. One asset manager commented that UK and EU regular reporting requirements "have grown considerably in recent years. When our firm started in the mid-1990s, we needed to produce three IMRO[15] reports on a quarterly/six-monthly basis. This has now grown to more than eight FCA reports (and counting) on a six-monthly basis, annual fee submissions, EMIR reporting, AIFMD reporting, etc. Most managers will not be able to prepare AIFMD reports internally; gathering the data is not difficult but the EU template is subject to regular change. Hiring an external consultant to do the AIFMD reporting will cost at least £3,000 per fund per quarter."

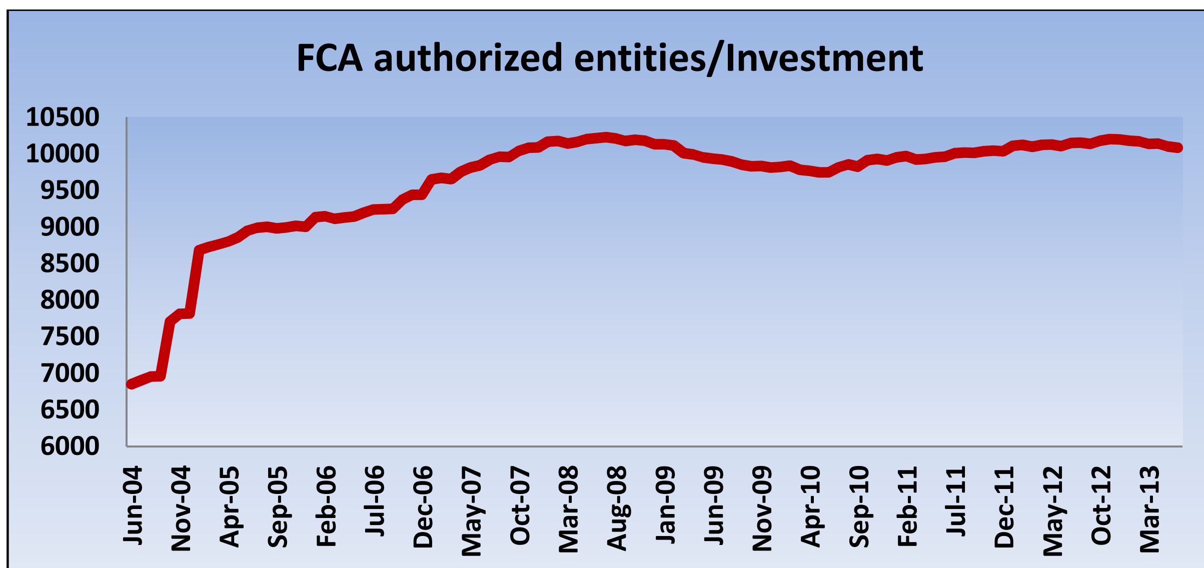
The same fund manager also points out that new firms can get going much faster in the US: "A US investment firm can get started in 30-90 days. But the regulatory and infrastructure requirements demanded by the UK and EU regulators means that a process that used to take 3 months, now takes 6-9 months. As no fees are earned during this period – although costs are incurred – personnel at start-ups need to eat into their own personal capital for a longer period of time.

We have also seen the FCA demand that start-up firms appoint compliance consultants for a period of 6-18 months, resulting in more cost – typically £3,000 per month – as a condition of regulatory acceptance. You can do nothing about this extra burden, only accept it. The sheer amount of paperwork is astonishing. Take the development of a compliance infrastructure. In order to obtain registration today, a UK investment firm needs (at the minimum) a compliance manual, personnel manual, ICAAP, liquidity policy, Pillar 3 disclosure statement, Stewardship Code statement, remuneration code compliance policy and statement, conflicts of interest inventory, "pay to play" and "lobbyist registration" controls, and so on. The ICAAP, liquidity policy, Pillar 3 disclosure

[13] Employee Retirement Income Security Act.
[14] Internal Capital Adequacy Assessment Process.
[15] Investment Management Regulatory Organisation.

statement, Stewardship Code, remuneration code, etc. are all relatively new requirements. Note that that these are on top of normal operational risk, trade allocation, counterparty monitoring and normal compliance procedures that have been requirements for many years. Most firms cannot create these documents themselves and will go to a compliance consulting firm for assistance, which is likely to cost as much as £60,000 for a start-up."

All this means extra staff. In the early 2000s a new firm could get by with one staffer dedicated to compliance, legal, HR and operational risk management (internal audit), in addition to a COO. Today many firms need two full time people involved with this role, in addition to the COO. If it is assumed that a junior compliance person will cost about £50,000-£75,000 in annual salary, plus national insurance, benefits, plus bonus, this is a real cost that must be borne. The chart below reinforces our view that the rate of growth in the number of investment management firms has substantially slowed as a consequence of these additional burdens.



Source: FCA, Total Authorized Entities

The threat to competition following from a post-trust world stretches beyond the costs of the extra burdens imposed by greater compliance. The size of a firm counts for a great deal today, when increasingly minimum relationship sizes dictate whether or not you have a business. Custodians have been moving to work only with firms that can quickly demonstrate that their funds will have $500m

or more in assets, before starting a relationship with an asset management firm. Without a custodian, you cannot launch pooled funds. Brokers today like to see a minimum of $0.5m-$1m of commission flow before they are interested in developing a relationship. The Big 4 accounting firms are focusing more of their attention on larger fund complexes, and have higher minimum fees for audits, tax returns, report reviews, and so on. Smaller asset management firms have to be very selective in their appointment of service providers. If they go too far down the service provider list (particularly with respect to fund auditors), they will face questions from clients and their consultants, and struggle to raise capital. The smaller asset management firms are thus being squeezed in a different direction.

There are also extra demands from client's legal advisers. There has been a dramatic step-change in demands from US institutional clients and their legal counsel on fund terms, side-letter demands, and so on. In addition to terms governing standards of care, lock-up and liquidity provisions, MFN provisions and key man notifications, client counsel are looking to push obligations on firms to underwrite the costs and legal responsibilities for sanctions' monitoring, withholding and capital gains tax liabilities, changes in US and foreign tax legislation; to agree to waive investment management fees in the event of suspensions of a fund's NAV or redemptions, even when the suspension is caused by events outside of the manager's control; to include an ever expanding list of reports, such as estimated daily NAVs, weekly performance data, monthly attribution, quarterly proxy voting, side-letter summaries, attestations of compliance with 'pay to play', and state lobbying registrations. Dealing with these comment letters is typically beyond the ability of a small asset management firm without the assistance of external counsel; negotiating these documents has become increasingly expensive.

Regulatory Babel

Almost six years after the financial crash and vast amounts of paperwork, accumulated data, and bureaucratic red tape, regulators still have no real idea which financial institutions pose 'systemic' risk. One thing is certain. By their very structure, member firms of the New City Initiative – small and medium sized asset managers – pose no systemic risk, yet they have been swept up in the regulatory babel that now envelops all. Indeed it is difficult to see how asset managers – whatever their size – can pose systemic risk; any losses suffered by a managed fund flow through immediately to

investors in the fund. The effort expended on bringing asset management under ever-tighter and costlier regulatory control is the result of a false narrative about the causes of the 2008 financial crisis, which argues that the crisis was caused by insufficient regulation of the financial system and which could therefore have been prevented by better and more comprehensive oversight.[16]

At the last count for example on derivatives, national regulators operate around 22 repositories collect data of 11 jurisdictions, each with their own reporting requirements, formats and mandates. Despite all the rulebooks that have been created post-2008, the upshot is that no single authority has a complete view of the obligations that connect financial services' companies around the world. Even where efforts are greatest – at protecting consumers, for example – the result is unwieldy and cumbersome; the Dodd-Frank Act for example consists of 15 million words. The regulatory asymmetry creates an uneven playing field in which rules, tax implications, governance practices, product templates, reporting structures, legal systems and accepted approaches to compliance, all differ in each country. Even the development of a 'passport' scheme for the distribution of UCITS, which has succeeded in creating a pan-European regulatory framework for funds, does not apply in Asia-Pacific, where there is no such passporting. And the idea of a pan-EU passport, a free market without national barriers (in the form of financial costs by national regulatory authorities) is currently a myth.

Thanks to the regulatory burden which hits all asset managers whatever their size, smaller firms are struggling to survive and new start-ups are less commonly seen than consolidation between already existing partnerships. This is a serious threat to competition – and a worrying development for consumers, who will have less choice. And, perhaps most important, it will damage returns for investors, precisely because there is plentiful evidence to show that smaller, newer investment managers outperform larger, older ones.[17]

[16] The crisis was caused by the US government's housing policies which forced reductions in mortgage underwriting standards, primarily through the affordable-housing goals imposed on Fannie Mae and Freddie Mac in 1992. By 2008 58% of all US mortgages were subprime and 76% of these risky mortgages were on the books of US government agencies, principally Fannie and Freddie

[17] See for example *Survival of the Nimble – Why Smaller Investment Managers Outperformed Large Managers despite a Challenging Market Cycle for Fundamentally Based Active Managers*, April 2011, FIS Group, based in Philadelphia.

Boost the boutiques

Our conviction is that the more small and medium sized asset management firms there are, the greater the competition between them will be, and the better the overall average outcome will be for clients. Competition, in other words, keeps firms keenly interested in doing their absolute best for customers, big or small. Less competition means those firms that are left have greater pricing power, which is unhealthy for clients.

The problem of concentration, and the homogenisation of investment management firms and their offerings, is not simply the consequence of the regulatory burden squeezing profit margins of smaller firms and making it more difficult for new independent private entrants. It is also the case that asset management firms that ought to be natural allies (in terms of their culture and size) are neglecting the nurturing of nascent funds.

The FCA's instinctive distrust of investment outcomes' differences mean that the independent boutique firm, which provides a bespoke service to individual clients, is inherently suspicious and is liable to come in for exceptional scrutiny; the level of due diligence and suitability documentation that must be provided for each investment decision is so onerous that it has, in the words of one NCI member firm, "become nigh on impossible to justify the time expended on taking 'non-uniform' decisions for all clients." Yet the bigger an asset manager becomes, the most customers it has, and the more commoditised each one of those customers inescapably becomes. It is surely in everyone's interest that small boutique firms of highly talented individuals keep coming up through the ranks, to counter-act the development of massive asset management firms that do not serve customers as individuals but only see them as part of categories and groups.

In 2011 the pension consultancy Hymans Robertson published a report[18] assessing predictive factors in selecting an investment manager. Based on a study of more than 200 investment managers and 500 investment strategies, and conducted over four years (2006-2010), it reached several conclusions:

- Small is beautiful – large managers underperform smaller, firms earlier in their development perform better

[18] http://www.managerresearch.hymans.co.uk/products/21-identifying-predictive-factors-in-manager-selection.aspx

- Smaller investment teams outperform large ones
- Firms where employees owned a significant direct equity share outperform those without
- Firms with higher personnel turnover had poorer performance

It added: "Clients might, on average, benefit from appointing less established, smaller investment manager teams with fewer clients. This might require a greater acceptance of some of the non-direct investment risks, such as 'key man' or the commercial uncertainty associated with recently formed businesses."

This is completely counter-intuitive and requires courage to subsume the fear of risk from 'going small and new.' But small firms struggle to compete – or even get off the ground – in this changed regulatory landscape, which is putting pressure on profit margins. Big firms, with strong profits and available discretionary spend, are more easily able to absorb the additional costs of compliance, and can invest in building their reputation.

Creating massive rulebooks which try to 'head off at the pass' any and all conceivable wrongdoing is an understandable response to the financial disaster of the past few years – but the risk is that tightening the rules without changing the culture will fail to prevent another crisis. We need to get the culture and structure of financial services right – this is more important by far than the creation of endless rules that require teams of expensive lawyers to understand and advise on. It also hinders innovation and makes the creation of new, more competitive asset management firms much more difficult. The regulatory drive towards trying to eliminate all risk from the asset management industry is that, paradoxically, greater risk is fostered, as investors are funnelled towards so-called 'model' portfolios – including the ubiquitous index funds – managed by a handful of very large players.

As assets are increasingly concentrated, new entrants attempting to break into the fund management industry struggle to find favour with gatekeepers from larger wealth management houses, which – in the new regulatory regime – operate stringent due diligence requirements, such as a minimum three-year track record, or minimum fund size. The industry could and should help its minnows grow by relaxing these tough demands. Much can be done to unclog the processes towards creating new firms, new jobs, to enhance competition and improve consumer choice. For the sake of the UK economy – and the consumer – we need to start this process now.

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- Moneta Asset Management
- Montpensier Finance
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Gary Mead, Executive Director, NCI, December2014.