New City Initiative

By email

18th December 2015

Dear Sirs

The New City Initiative (NCI) welcomes the opportunity to provide comment to the UK Financial Conduct Authority (FCA) pertaining to its asset management market study. At the heart of the study is whether asset management is competitive and delivering fair value to end investors, both retail and institutional. The NCI would like to highlight several areas of concern to the FCA, and potential remedies to these issues, which will hopefully boost competition in the asset management space.

**Barriers to entry**

Section **4.33** of the FCA's "Asset Management Market Study Terms of Reference" says that high barriers to entry and expansion reduce the likelihood that new firms will enter the market or existing firms will expand their businesses. The FCA rightly notes that this dearth of competition can reduce the incentives of existing firms to offer fair value for money to investors. The NCI believes this is an accurate assessment from the regulator.

Competition is crucial in any industry. A failure to evolve or maintain standards is a disservice to the consumer in any sector. In the asset management space, clients will comprise retail and institutional investors, the latter of which will include public and private sector pension funds managing capital on behalf of retirees, for example.

The majority of institutional investors, such as public and private sector pension funds, are bound by strict risk concentration criteria. They are often contractually prohibited from gaining excessive exposure to a single fund management company. This is a sensible policy and avoids a scenario whereby a single investor owns a fund. However, this does mean that these investors cannot allocate to smaller managers. As their ticket sizes are usually substantial, investing into smaller managers can cause institutions to breach their concentration risk thresholds. Instead, these institutions are forced to invest into larger, more established fund houses.

This is evident in the FCA's latest hedge fund survey published in June 2015, for example. The survey of UK hedge fund managers found the 10 largest hedge fund managers in the UK controlled 38% of Assets under Management (AuM).[1]

By concentrating investor assets into a handful of large asset managers, institutions are exposed to enhanced counterparty risk. If a disruptive market event occurs (such as bond liquidity drying up), and one or more of those asset managers suffers adverse performance or worse, those investors will be severely impacted.

[1] Hedge Fund Survey – June 2015 - FCA

Diversification is crucial to ensuring sound returns and protecting assets. Operating in a market which hinders competition and emerging manager development will have an adverse impact on investors' ability to create a diversified portfolio, and therefore minimise their risk exposure to a select few large asset management houses.

A failure to enable emerging managers to grow their businesses is an inhibitor to competition and preserves the status quo of the largest managers. As the FCA highlights, a lack of competition acts as a dis-incentive for established market participants to provide value for money to their clients. The FCA acknowledges that some barriers may be a result of investor activity. For example, a new market entrant will not possess the track record or past performance of one of their more established peers. A lack of a track record is a major disadvantage when soliciting capital.

The FCA also said it recognises regulation can be a barrier to entry or expansion. As such, the NCI would like to address several pieces of regulation, which it feels has stymied the development of smaller and emerging managers in the UK.

Regulation is an essential aspect of financial services and the NCI welcomes any sensible regulation which protects against inherent build-ups of systemic risk and safeguards the rights of investors. Simultaneously, regulation must be proportionate to those entities to which it is applied, and conducive to competition in capital markets.

While regulation was essential following the financial crisis, some rules have disproportionately impacted smaller to mid-sized asset managers, more so than their established peers, which have the resources and human capital to weather the increased workloads and obligations.

A small sample study of the impact regulation had on NCI members found 46% of respondents spent between 10% and 20% of their management time dealing with regulatory compliance. [2] The study found 8% spent in excess of 20% of their management time dealing with regulatory affairs.[3] This sample set covered managers of long-only vehicles, UCITS, hedge funds and private equity/real estate. For managers of small to mid-sized investment vehicles, such costs and overheads are not sustainable. It is not only a barrier to entry, but a barrier to managing money and delivering returns for clients.

A number of regulations have been implemented in the European Union (EU) including the Alternative Investment Fund Managers Directive (AIFMD), the European Market Infrastructure Regulation (EMIR), and the Markets in Financial Instruments Directive II (MiFID II), the latter of which is likely to be introduced around 2018.

Take AIFMD. This obliges financial institutions running in excess of €100 million to become AIFMD-compliant, and appoint a depositary/depositary lite, file an Annex IV regulatory report, and have a hierarchically and functionally separate risk oversight. While there are a number of benefits to AIFMD (i.e. the pan-EU marketing passport), the cost of compliance is prohibitive for some firms.

[2] "Regulatory Challenges That will Impact Asset Managers" - NCI
[3] Ibid

A BNY Mellon study in 2013 calculated the average manager would incur between US$300,000 and US$1 million in costs to attain initial AIFMD compliance.[4] This number has probably fallen since, and on-going AIFMD costs are unlikely to be as high. However, it is still costly and does present a barrier to competition.

In a paper – "Asset Management in Europe: The Case for Reform" - published jointly by Open Europe and the NCI in July 2015, we recommended the AuM threshold for AIFMD compliance be increased from €100 million to €500 million.[5] Such a threshold would still capture the majority of asset managers but would spare new launches – many of whom may not possess scalable or reliable investor capital – from burdensome regulation, which could hinder their development. These are – after all – the asset managers of the future, and regulators should encourage their growth as a means by which to bolster competition and investor choice going forward.

The NCI would also recommend that newly launched asset managers (i.e. UCITS/EU managers of non-EU funds) marketing their vehicles to EU investors be excused from some of these regulatory obligations, such as supplying regulatory reports to individual member state regulators. Instead, we advocate that newly launched asset managers only be obliged to submit a single regulatory report to their Member state of Reference, and not to all of the regulatory authorities to whose jurisdictions they are marketing into. We do, however, recognise it is essential that managers register with regulators in countries where they are marketing.

One of the interesting developments to occur within the EU recently has been the Capital Markets Union (CMU), an initiative primarily designed to increase the role of non-bank lending in the real economy. However, policymakers have said that harmonisation around cross-border fund sales will be addressed too. The UK is one of the more straightforward jurisdictions for fund managers to sell into.

UCITS and AIFMD, which theoretically allow for harmonised cross-border distribution, still have a number of flaws. Many EU member states have introduced barriers to UCITS and AIFM distribution including additional tax and regulatory reporting obligations.

Following qualitative interviews with leading law firms across the EU, the NCI estimated a UK-based asset manager marketing and distributing into all of the other 27 EU member states (plus Switzerland) would face initial costs of over €1.5 million. Total on-going maintenance costs – allowing for the continuation of cross-border marketing – could be near €1.4 million per year. [6] We advocate the FCA embrace CMU, particularly around pushing a reform agenda to liberalise UCITS and AIFMD distribution by encouraging other member states to remove barriers to entry for fund managers. This, again, would make it easier for smaller to mid-sized managers to enter into the market. Furthermore, we would advocate easing some of the regulatory reporting and other regulatory requirements applied to those managers which solicit only institutional capital.

[4] https://www.bnymellon.com/us/en/newsroom/news/press-releases/aifmd-will-reduce-choice-and-increase-costs-for-fund-managers-and-investors-according-to-bny-mellon-survey.jsp

[5] Asset Management in Europe: The Case for Reform – NCI and Open Europe

[6] Asset Management in Europe: The Case for Reform – NCI and Open Europe

Another area which could be harmonised under the CMU could include the provisions around investment advice under MiFID II. While we recognise that clients should only be sold products which are suitable for them, the interpretations around prohibitions on inducements are likely to vary across the EU. The UK and Holland, for example, already have legislation in place which goes further and beyond what is outlined in MiFID II. As such, we advise that the CMU revisit the inducement rules and bring more uniformity in its application across the EU.

In closing, asset management plays a crucial role in capital markets. Institutional and retail investment in the sector continues to grow. However, a number of end investors have their assets exposed to a handful of large asset managers and this has not necessarily provided them with best value for money.

It also exposes them to concentration risk, which in turn facilitates counterparty risk. Enhancing competition by easing national and pan-EU regulations on smaller asset managers will help the industry develop. Implementing regulation that is proportionate will encourage new managers to grow their businesses and provide healthy competition to established asset management houses. This will ultimately benefit the consumer by giving the investor good value for money.

Yours Sincerely

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