New City Initiative

Response to CP17/18: Consultation on implementing asset management market study remedies and changes to the FCA Handbook

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Introduction

The active asset management industry was the subject of a tough interim market study by the UK regulator – the Financial Conduct Authority (FCA) - in November 2016. At the time, many in the industry interpreted the AMMS interim report as suggesting that the FCA had a preference for lower cost passive fund products such as exchange traded funds (ETFs) and index trackers compared to active management.

New City Initiative (NCI) was reassured to read in the final FCA AMMS report that the regulator clarified its position on this matter, stating that it was never its intention for there to be any preference for passive products. This was a very welcome development for NCI, which had pointed out in its response to the AMMS report that passive products – whilst having a place within some investor portfolios – were not without flaws.

Although offering lower fees, NCI highlighted that passive products are more exposed to equity market corrections than active management. We also articulated that while passive funds had delivered strong performance, these returns had been generated in highly favourable macroeconomic conditions (i.e. a 10-year equity bull run).

“The obvious benefit of active management is that it gives asset owners the opportunity to generate returns above and beyond the market. Good active managers can do this by applying thoughtful insight into market dynamics, an ability to identify discrepancies in the wider universe of opportunities and through effective execution. These elements are not something which passive providers can offer,” said an emerging markets equity manager.

The general tone of the FCA’s latest paper was positive and pragmatic and many in the active management community welcomed the decision not to refer the industry to the Competition and Markets Authority (CMA). “My outlook on the final report was that it was far more of a comforting read than the interim publication. It appeared far less antagonistic, and was broadly fair in what it was saying,” said an NCI member. Another NCI member concurred. “By and large, it was a very comprehensive report,” he said.

In this paper, NCI outlines its recommendations in response to the main points raised in the FCA report. As part of this paper, NCI has consulted with members that represent different investment management strategies, encapsulating the diversity of our constituents, in order to obtain their feedback on the FCA’s report. This paper has been submitted to the FCA.

Jamie Carter
Chairman, New City Initiative
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Governance

Governance is central to the FCA's report. The FCA said it would use the Senior Managers & Certification Regime (SMCR) as a tool to ensure fund managers are adhering to their duty to act in accordance with the interests of the end investors. "Owner-managed boutiques have a strong culture embedded in their fabric to work in the best interests of clients. As many boutiques are owner managed and have alignment with their clients, through co-investment and strict capacity limits, we feel this gives them an edge," said an NCI member.

The FCA also recommended enhanced independence of fund boards, advising managers to appoint at least two independent directors, or have such individuals comprise 25% of the board's membership. A handful of asset managers have expressed concern that qualified, independent directors are in limited supply, and those that are tend to be expensive. "There is a shortage of directors, certainly in onshore European fund markets such as Ireland," said one member.

NCI believes in robust governance. A strong board can ensure business interests are aligned with investors' needs. Institutional investors are increasingly scrutinising manager and fund boards in due diligence, and many operations teams veto investments if they feel corporate governance is subpar. As such, NCI believes a more independent and strengthened governance set-up can only be an advantage for the fund management industry. Achieving this, however, will require action on part of the industry, and certainly changes in how directors are trained and sourced.

A large number of independent board directors – while highly trained and motivated – are selected from a pool of familiar service providers including custodian banks, fund administrators, law firms, auditors and consultants. In other words, they possess expertise, but not generally from a fund management perspective. The industry needs to encourage more buy-side professionals to consider professional directorship roles at the end of their careers, or as part of a portfolio career. The current method of sourcing directors relies on networking and referrals within the industry, which may bring into question the independence of appointments.

If the FCA seeks truly independent directors and wishes to encourage diversity of thought and experience (which it has indicated by suggesting that directors do not necessarily need experience within the fund management industry), it could play a proactive role. For example, the FCA could encourage and work with the industry to create a repository of candidates with an interest in fund directorships at UK OEICs and ACD structures.

This central list would contain a comprehensive CV of each candidate, details of any fund directorships they already have and confirmation of whether they are currently registered with the FCA. NCI suggests the details would not include the name, sex or age of candidate in order to prevent potential bias at the initial stage. This would encourage fund managers and fund boards to source candidates outside of their traditional network.

NCI expressed reservations about the use of directors with no fund management experience, something the FCA has hinted may be acceptable. While welcoming the opportunity to get fresh ideas from other industries, NCI believes it could be difficult for two newly appointed independent directors with no experience of fund management to fulfil their roles competently. It would be prudent initially to ensure at least one of the newly added independent directors had fund management experience, given the pivotal governance role the FCA envisages.

Performance, Transparency and Value for Money

The FCA also outlined concerns that performance fees charged by active managers were not always entirely transparent. Performance fees are generally paid provided a fund manager beats a pre-defined benchmark but the FCA argued some managers were still collecting these fees, occasionally against lower benchmarks or targets.

“We currently intend to consult on new requirements to clarify that, wherever AFMs choose or are required to present their past performance, they must do so against the most ambitious target they set out to investors. For example, an absolute return fund’s most ambitious target may be LIBOR +4%. If we bring in such rules, their effect would be to make clear that, where the AFM chooses or is required to display the fund’s past performance, it must show the past performance against LIBOR +4%, and not against LIBOR alone,” read the FCA report.

NCI supports the FCA’s push for clarity and transparency of fees and performance objectives. This can be supported by regular communication with clients through more comprehensive factsheets and disclosures, coupled with a robust standard of corporate governance.

Most significantly, NCI has always been a passionate advocate of equitable fee structures. Investors should only pay fees they believe are justified given the performance potential or specialist nature of the strategy. There is clearly attrition on fees, as investors apply pressure on active managers. Some members of NCI acknowledge that this is inevitable, and one called for a radical realignment in terms of fee structuring.

“In its interim market study report the FCA correctly pointed out that the prevailing model of fees – namely a fixed structure – incentivises firms to chase asset growth, which is not necessarily in the best of interests of clients. This conflict arises because it is well known that larger pools of capital are harder to manage than smaller ones. One solution would be to align the incentives of clients and the manager by linking fees more closely to the investment performance delivered to clients. For example, having managers offer a lower fixed management fee, but a higher performance fee, that is refundable in the event of subsequent underperformance, would mean that managers would be incentivised to generate long-term sustained performance rather than chase assets,” commented one equity fund manager.

Closet trackers cannot be considered part of the active management industry. As such, NCI welcomes further scrutiny of those managers. Firms which routinely hug or mirror indices do not deliver the value that boutiques, such as those represented by NCI, offer to investors. “Closet trackers are right to be a source of FCA scrutiny. There is nothing wrong with a fund that attempts to generate FTSE index returns plus 2%, for example. But it should be priced accordingly otherwise it is not delivering value for money,” said one member.

Value for money was a key phrase in the AMMS report, and the FCA is seeking an explicit requirement that fund boards and managers assess whether a fund offers value for money for customers on an annual basis. This is an admirable objective but in practical terms difficult to comply with because value for money is specific to the circumstances of the customer.

In this case, only the end customer or their adviser can really judge what value for money is to them. NCI strongly believes the key to value for money is transparency and availability of information. In addition, requiring the manager to make a subjective assessment on an annual basis, and to outline the steps it is taking, could result in an increased focus on short-term results, which is against the interests of the investors, the UK economy and The Patient Capital Review.

A Single All-in Fee Structure

Fee transparency has long been an area of interest for the FCA, and it was expected that an all-in-one fee charge inclusive of ancillary and transaction costs would be proposed. Such a charge, argued the FCA, would help investors understand better what they are paying, but also enable them to compare different prices across asset managers more effectively. NCI strongly believes in fee transparency and it is keen to engage with the FCA on the matter.

However, there are some challenges, which were cited by the FCA itself. "Some warned against investors becoming too focused on charges or not understanding the charges. A number of respondents argued that while charges are important they are not the only thing that investors should consider," it read. The paper cited other respondents who complained that incorporating transaction charges into the headline fee would be practically complex, mainly because such costs are difficult to predict accurately ahead of time.

"Predicting transaction costs is hard for a number of reasons, mainly because we live in very uncertain macroeconomic times, and a lot of active managers do not know how many trades they will execute. It is hard to predict how liquid the market will be in 12 months, or what spreads will be like on trades. Speaking very candidly, I would be very distrustful of any estimate," said an NCI member.

One risk of an all in one fee inclusive of anticipated transaction costs surrounds conflict of interest at managers. If a manager, for example, went over its estimated cost charge,
it could inappropriately incentivise them not to trade even if it was in the clients' best interests. This conflict of interest situation is obviously a scenario that nobody wants to see emerge.

One of the bigger challenges of the FCA's proposal is that a single figure fee could make it difficult for clients to compare funds accurately, unless a breakdown of the component charges is provided. It also risks undermining competition between boutiques and larger established managers. An NCI member highlighted that major asset managers can exert greater pressure on service provider transaction costs, more so than boutiques.

"A major asset manager or a bank-owned asset manager has enormous scope to apply downward pressure on fees simply because of their size. A lot of big players in the market are unlikely to be paying more than 1 or 2 basis points (bps) for fund execution whereas boutique providers are often facing charges of 5 bps, or even as high as 20 bps purely because of their size. As such, transaction costs under this proposed regime could appear higher for smaller firms than the major asset managers," said an NCI member.

NCI has always been in favour of total disclosure to the end consumer, but some members have expressed concerns that investors – certainly on the retail side – could be confused by this new information. "Reporting an all-in-one fee almost risks confusing investors about what the charges are. Our Total Expense Ratio (TER) charge is about 1%, but if we add trading costs, then it will increase dramatically, potentially doubling or trebling the TER," said one NCI member. Customer education will be critical.

An all in one fee, however calculated, could also dent the competitiveness of the UK asset management industry, as charges may appear higher than their peers in other markets. The UK financial services industry – including fund management – faces huge challenges to its existing

model over Brexit, and now is a difficult time to introduce rules which could undermine its ability to compete internationally.

“An all in one fund fee would be fine, provided it is solely used by UK vehicles aimed at UK investors. However, the UK asset management community is international, and our competition abroad is not going to be subject to these rules. As such, a US manager selling to a US audience could appear cheaper than a UK manager, and this would undermine our competitive edge,” said NCI member. Another NCI member agreed. “I worry the headline numbers could be off-putting to prospective clients,” he said.

One suggestion is to exclude certain components of the cost of doing business from the all-in-one-fee charge, such as brokerage and FX commissions. An NCI member suggested a willingness to disclose FX and brokerage charges albeit not in the headline cost, but in an appendix, going back three or four years for context purposes.

Nonetheless, some NCI members have no objection to the publication of an all-in-one fee inclusive of transaction charges. “I agree with the FCA’s stance on fees, and I do believe charges should be expressed in a single figure. A lot of organisations complain that it is difficult to calculate transactional costs, but firms should be able to provide a figure based on the previous years’ experience. I think it would help incentivise managers to cut their external costs, and seek out best execution, as is required under the Markets in Financial Instruments Directive II (MiFID II),” said one fund manager.

NCI believes any single all-in fund fee must be retrospective, and not based on estimates or projections from the manager. Given the difficulty in predicting costs, particularly those that are transaction-related, any estimated charges should be treated with suspicion. Predicted costs also may not tally in the event of market volatility and this could upset some customers, particularly if returns have not been strong.

However, a single fee which uses historic costs incurred would at least be factual. If the information is provided over a time horizon, it allows for anomalous years to be seen in context. As with fund performance, a disclaimer should be used to make clear that the past costs are not necessarily a guide to future charges.

Other Considerations

In the FCA's AMMS interim report, the regulator criticised the asset management community for making it difficult for retail investors to switch share classes. It identified managers often levied charges on investors looking to switch, and said the process could be an administrative headache. This meant investors – predominantly retail - simply stayed in fund share classes which may not necessarily be in their best interests.

NCI acknowledged in its response to the AMMS that switching share classes was operationally straightforward, and could be done "at a push of a button." However, permission must be given by the investor for switching, and this can be surprisingly difficult to obtain and creates administration, which the clients rarely want anyway.

The FCA agreed that switching share classes needed to be simplified, and that it would support removing the obligation of the manager to seek explicit investor approval to do so. NCI is fully supportive of this position, and it looks forward to working with the FCA on remedying this issue.

Box profits were also referenced in the FCA's study. NCI agrees with the FCA that revenues derived from risk-free box profits should be passed back to the investors in the fund, and not retained by the manager.

Conclusion

The next two to five years have the potential to be very challenging for UK asset managers as Brexit negotiations inevitably shape market sentiment and investor flows. NCI is hopeful a competitive UK asset management framework will emerge, supported by robust regulation.

As such, we look forward to engaging with the FCA and other regulatory bodies to ensure that any rules and best practices introduced are proportionate, in the best interests of the consumer, do not infringe on the ability of UK asset managers to compete globally and do not unduly hamper boutique managers from delivering value for money for their customers.

Appendix

NCI Responses to the FCA AMMS Consultation

Q1: Do you agree that we should introduce a specific rule requiring AFM boards to assess value for money?

An issue raised by some NCI members is that while the proposals are commendable, a number of AFMs and investment managers are effectively often combined companies. These proposals could force some managers, particularly boutiques, to split their AFM functions out into a separate company at significant cost if they are to satisfy the independent directorship criteria. One member recommended the FCA create an AUM threshold at which boutiques are obliged to appoint independent directors to oversee value for money requirements.

Whilst the FCA has noted that funds can achieve economies of scale, it must also recognise that this can work both ways. If the value of the fund falls because of a bear market, for example, the expenses will equate to a higher percentage of the value of the fund. In practice, it would be very difficult, both practically and reputationally, to increase fees under such circumstances.

Great care needs to be taken in giving a broad remit to assess "Value for Money" on an annual basis. The reality is that different investors perceive value for money differently and have unique circumstances (for example, in terms of knowledge, objectives, size, time horizon, geographic location, tax domicile, use of intermediary etc). As such, the investor should be the entity determining whether they are receiving value for money.

In addition, requiring the AFM to make the assessment on an annual basis will shorten the time horizon of the AFM, and therefore the portfolio manager, which NCI believes is against the interests of investors and The Patient Capital Review. The time horizon of portfolio managers and their clients has been shortening for years and this would further add to the pressure to focus on short term results.

NCI would like to see clarity from the FCA on which funds would be required to provide this information. Will it just be UK funds aimed at retail investors; UK funds aimed at institutional investors or other funds that are aimed solely at sophisticated international investors? The needs of these groups may differ.

It would be better therefore to require AFMs to ensure transparency and availability of information which then allows individual customers to assess Value for Money given their specific circumstances, rather than making an internal and subjective assessment.

Q2: Do you agree with the specific requirements of the assessment? If not, what additional or alternative elements should be included?

NCI believes AFMs should always act in the interests of investors and provide value for money. On fees, NCI believes investors should only pay fees that they think will give value for money given the returns expected, and we have repeatedly articulated this point. In terms of changing share classes, NCI welcomes this in principle but has pointed out regularly that there are inhibitors that prevent managers from doing this. These include obtaining permission from underlying investors to switch, and this is something NCI would like the FCA to redress.

As noted in the answer to Q1, NCI believes it would be better to require AFMs to ensure transparency and availability of information which then allows customers to assess Value for Money given their specific circumstances, rather than focus on assessing Value for Money annually and publishing their subjective opinion, which will lead to short termism.

Q3: Do you agree with the planned implementation period of 12 months? If not, what alternative timeframe would you suggest?

NCI supports the implementation timing of the proposed rule-changes, providing the FCA gives clarity on exactly what it wants, although we caveat this by recommending the FCA be flexible in its approach, particularly as the industry may be in the critical stages of executing its Brexit contingency plans at this point.

Q4: Do you agree with the proposed requirement for the AFM to publish a report on the findings of the assessment and the steps taken?

It is correct that information be published on an annual basis, and we feel there should be clear guidelines laid out by the FCA that are perfectly suitable and clear. However, we again stress that it would be better if the decision about value for money were left with individual customers. By ensuring transparency and competition, we believe market forces will work.

The requirement to publish steps taken is likely to encourage 'action' on the part of the fund board. In some circumstances this may be correct, but it will lead to a bias towards action, and will likely shorten time horizons, which as we highlighted earlier is damaging for the market and the UK economy.

We feel publishing key information from which decisions can be made, will be conducive to enhancing trust between the manager and their investors. However, NCI would hope that any further reporting obligations do not create an even greater regulatory burden on the industry which is already dealing with significant regulatory change.

Q5: Do you agree with our proposal to require AFMs to appoint independent directors to the board? If not, what alternative(s) would you propose?

NCI believes in robust governance, as we feel that having a strong board can ensure business interests are aligned strongly with investors' needs. Institutional investors are increasingly scrutinising manager boards in due diligence, and many operations' teams do veto investments if they feel corporate governance is subpar. As such, NCI believes a more independent and strengthened governance set-up can only be an advantage for the fund management industry.

NCI believes the FCA can play a key role in creating a central register of candidates which could improve the diversity of background of directors, attract new ideas to the industry and ensure true independence.

Q6: Do you agree with the proposed proportion of independent directors (at least two and not less than 25% by number)?

A handful of asset managers have expressed concern that qualified, independent directors are not in abundant supply, and those that are tend to be expensive.

Q7: Do you agree with our approach that independent directors may serve on more than one board, provided that they comply with existing rules? If not, do you think a ban on serving on more than one board is necessary?

NCI fully supports the FCA's position that directors be allowed to serve on more than one board. Our experience in offshore jurisdictions is that this encourages the spread of good ideas and best practice. We do not see any merit in a ban or a limit on the number of directorships, but it would be prudent for directors with more than one directorship to be required to justify to the board that their time commitments elsewhere do not impinge on their ability to fulfil their role.

Q8: Do you agree with the proposed requirements for being an independent director? If not, what alternatives do you propose?

NCI agrees with the FCA on a number of the requirements expected for being an independent director, but it is hesitant about imposing an arbitrary time limit on how long directors can serve. This can be restrictive, and may cause business disruption at the point when the directors' tenure ceases.

Q9: Do you agree with an implementation period of 12 months? If not, how much time do you think AFMs will need to appoint suitable independent directors?

NCI supports the implementation timing of the proposed rule-changes, although caveats this by recommending the FCA be flexible in its approach, particularly as the industry may be in the critical stages of executing its Brexit contingency plans at this point. If the FCA plays a meaningful role in creating a central register of interested candidates, this timeline should be easier to hit.

Q10: Do you agree that it should be up to AFMs to decide whether to appoint an independent director or an executive director as chair?

This should probably be considered with reference to the UK Corporate Governance Code.

Q12: Should the FCA consider stopping the payment of trail commissions on the distribution of asset management products? If so, over what time period?

NCI believes an orderly wind-down of trail commissions is commendable in principle, and may be manageable for the asset management industry, but this requires a thorough assessment of the impact on the UK market in terms of fund distribution, the availability of advice for retail investors without trail commission, the impact on IFAs and the impact and influence of platforms. If implemented, it may require a long 'sundown' time period of adjustment, but it would likely provide investors with better value for money, as trail commissions can be extremely high.

Q15: Do you agree with our proposal to allow box profits to be retained by the AFM when they have been earned through an 'at risk' exposure, but not when they are achieved risk-free?

NCI believes that box profits accrued by holding positions between pricing points when using their own capital should be retained by the AFM. NCI agrees with the FCA that revenues derived from risk-free box profits should be passed back to the investors in the fund.

Q16: Do you have any comments on whether risk-free profits should be passed on to investors in the fund or given back to subscribing/redeeming investors?

It is common practice for single priced funds to charge an anti-dilution levy on large subscriptions and redemptions which is for the benefit of the fund, and the ongoing investors. It seems sensible that any dual-priced fund should work to the same principle.

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