THE INVESTMENT ASSOCIATION

FCA consultation on implementing asset management market study remedies and changes to Handbook

CP17/18

Response from the Investment Association

28 September 2017

EXECUTIVE SUMMARY

1. This response is in six parts, following the broad structure and responding to the questions in the FCA's consultation paper CP17/18:

   - Part One – Introduction and wider context
   - Part Two – Enhancing fund governance
   - Part Three – Moving fund investors to alternative share classes
   - Part Four – Treatment of box profits
   - Part Five – Extension of scope
   - Part Six – Cost Benefit Analysis

Part One – Introduction and wider context

2. The Investment Association (IA) supports the overall objectives of the Market Study to ensure that the UK asset management market operates in a highly competitive and transparent manner. With respect to the core proposals in CP17/18, we agree that this operating environment should be characterised by robust, investor-focused governance mechanisms. Our response below outlines in detail how we suggest this can be best achieved, together with other practical proposals to facilitate the policy intent behind CP17/18.

3. With so much concurrent regulatory change, we stress the need to consider more holistically both the implementation process and potential effectiveness of demand and supply-side remedies. Specifically, we suggest a set of criteria and a framework to deal with the need for greater clarity about interaction with forthcoming regulation (MiFID II in particular) and ongoing competition analysis, especially in areas likely to affect retail market disclosure. We would also welcome a composite analysis across both the Asset Management Market Study and the Platform Market Study to assist the FCA in fulfilling its stated objective of a consistent and coherent framework of interventions.

Part Two – Enhancing fund governance

Value for Money (VfM)

4. We agree that fund governance processes need to ensure a focus on the quality and cost of the service provided, noting that the supply side on its own cannot determine overall value. We support a framework that facilitates consistency while allowing AFM Boards to reflect their own operating model and product set. We encourage the FCA to minimise divergence between fund VfM and pension scheme VfM assessment and reporting.

Detailed definition

5. The proposed definition should be revisited. There needs to be a core focus on value, defined as the quality of service provided, in the context of fees and other costs. Value would cover both the delivery against investment objectives and other aspects of service as experienced by investors. The draft regulation currently works against this, focusing disproportionately on cost. A combination of reordering and a broader approach to value would help to lay the basis for a consistent and rigorous approach to VfM. We do not consider that a 'cost plus' definition of pricing should be the starting point for VfM assessment of the level of charges. The regulator should not be seeking to determine pricing strategies across a whole market. A value-based approach, which considers whether costs are proportionate and reasonable in light of the service delivered to investors, is entirely legitimate.

6. While it is reasonable that economies of scale are considered as part of a VfM assessment, the proposed regulation as currently drafted is unclear and unduly prescriptive in key areas particularly related to pricing structures. There are a number of different ways in which economies of scale may be assessed and delivered commercially, and this should be accommodated within the new rules.

Implementation

7. An implementation period of twelve months is insufficient, particularly given the wide range of significant regulatory issues currently requiring the attention of AFM Boards, notably MiFID II, SM&CR and Brexit.

8. The FCA needs to consider recruitment for independent directors and the development of VfM assessment and reporting as a series of processes that are partly sequential and not running in parallel.

9. Recruitment (identification, interviewing and onboarding) of independent directors across the industry will require a significant amount of time, particularly as their responsibilities will encompass more than VfM. In practice, this process is likely to require at least 12-18 months.

10. The independent directors' role on VfM will not be confined to providing input to and challenge of the assessment. Their role is likely to extend to shaping the VfM assessment process and developing the reporting. This needs to be accommodated in the implementation timetable, as does time to put in place any relevant system and contractual changes.

11. The prescribed implementation period therefore needs to be based more clearly on an assessment of the various activities required and the appropriate sequencing (from the recruitment phases into the VfM assessment and reporting).

12. Consideration also needs to be given to the fact that many firms are likely to undertake significant restructuring ahead of Brexit in March 2019 and this should be factored into the transitional time allowed.

Reporting

13. Public reporting should be primarily a high-level, qualitative summary of the conclusions of the VfM assessment, providing a broad line of accountability. This would reflect the reality that the assessment of VfM will involve consideration of commercially sensitive information that may be the subject of conversations with supervisors but would not be appropriate for the public domain.

Independent Directors

General Role

14. We are generally supportive of the role that independent directors can play, but note the need for the new proposals to be proportionate as well as congruent and not in conflict with existing business models.

Proportion and other requirements

15. The proposed representation is reasonable, but a more proportionate approach is required for smaller firms where a single independent director should be sufficient, with the option to have more. We agree with the approach that independent directors may serve on more than one board as we think that setting a limit of one directorship per individual would be unnecessarily prescriptive and may work against sharing of best practice.

16. We argue that the criteria for appointment are too restrictive, and will exclude candidates who would ordinarily be considered independent from the AFM. More flexibility is required to enable firms to appoint candidates with the requisite knowledge and experience.

Implementation

17. We outline in paragraphs 7-12 that the timeline and implementation process need to be considered holistically across both the new independent director requirements and the VfM process. Twelve months is insufficient given the scale of change and other forthcoming regulatory changes.

AFM Chair

18. It should be for the firm to determine if the AFM Chair is an independent or one of the executive directors, particularly in light of the new prescribed responsibility that is to be allocated to the Chair of the AFM board as proposed in CP17/18. In this respect, we note an apparent disconnect between CP17/18 and CP17/25, as the former proposed that firms could decide whether the Chair would be an independent or executive function whilst the latter defined the SMF9-Chair as a non-executive function without particular reference to Executive Chairs. We would welcome further clarity in this area.

Wider interface with SM&CR

19. The requirement in COLL 6.6.23E for the AFM board to take 'sufficient' steps to address instances of poor VfM may be disproportionate in that what is sufficient can only be assessed on an ex-post basis. We believe that this requirement should be aligned with the prescribed responsibility under the SM&CR standard of 'reasonable' steps.

20. Although CP17/18 has deferred to CP17/25 all formal consultation on the prescribed responsibility to act in the best interests of investors, we note that the former pre-allocates this responsibility to the Chair of the AFM board while the latter leaves it to firms to consider which Senior Manager is the best person to hold each of the prescribed responsibilities. We would welcome further clarity as to the regulator's expectations on this point.

Business model considerations

21. The FCA's proposed requirement for AFMs to appoint independent directors on their boards fails to recognise the diversity of business models in the UK. The IA, in principle, welcomes and supports proposals for independent representation. However, firms should not have to restructure in order to implement the proposed changes. We have suggested ways to introduce flexibility into the requirements while still meeting the FCA's aim of independence.

22. Currently, the scope captures UK-domiciled Super Management Company entities, and therefore effectively extends proposals to non-UK schemes. A risk of regulatory arbitrage arises since the proposed rules will not apply to non-UK Super Mancos using a management passport to manage UK-domiciled UCITS. In the long-run, this may have adverse effects on UK competitiveness.

Part Three – Moving fund investors to alternative share classes

23. The IA welcomes proposals by the FCA to modify the guidance relating to mandatory conversions in FG14/4 and to revisit the issue of a sunset clause on pre-RDR commission payments to UK retail advisers. Both of these changes were called for in the IA response to the interim report of the market study.

24. We agree that AFMs should be able to undertake mandatory conversions to another share class provided the appropriate powers are set out in the prospectus, and the AFM is satisfied on reasonable grounds that there will be no detriment to unitholders. However, it should not be necessary for firms to issue multiple communications, including general communications such as press adverts.

25. The IA has, since before the implementation of RDR, advocated a consistent retail fund distribution regime, which aligns the post and pre-RDR regimes. The majority of our members agree that the FCA should consider the issues involved in stopping trail commission payments on the pre-RDR model. However, this should involve careful consideration of the practical ramifications for both investors and industry participants.

Part Four – Treatment of box profits

26. We welcome the FCA's formal consultation which now sends a consistent signal across the market on the regulator's policy intent on box management. We agree with the proposal to distinguish between risk-free and at-risk profits, and that the manager should be allowed to retain box profits earned through an at-risk exposure.

27. However, we have concerns that the proposed rules, as currently drafted, will not deliver the FCA's policy intent. Under certain circumstances, they will require AFMs to pay at-risk profits into the fund when box losses are incurred. Therefore the effect of the FCA's proposals will be to restrict the operation of dual pricing to the potential detriment of transacting investors. We explore this in detail and suggest an alternative approach to deliver the FCA policy intent while reducing this threat.

Part Five – Extension of scope

28. As a general principle, we believe that there should be consistent standards of governance, oversight and transparency across the retail investment market, taking account of specificities of delivery models. Additional analysis would be required by the FCA into existing governance arrangements and disclosure requirements for specific products before implementing any further rules.

Part Six – Cost Benefit Analysis (CBA)

29. The CBA may underestimate the amount of resource that will need to be dedicated both in implementing the requirements for independent directors and the ongoing preparation and review of the VfM assessment.

PART ONE: INTRODUCTION AND WIDER CONTEXT

30. The IA supports the overall objectives of the Market Study to ensure that the UK asset management market operates in a highly competitive and transparent manner. We have sought throughout the Study to provide both evidence and concrete proposals to assist the FCA in delivering this outcome. Our response to CP17/18 continues that approach.

31. With respect to the core proposals in CP17/18, we agree that the investment fund market should be characterised by robust, investor-focused governance mechanisms. Our response below outlines in detail how we suggest this can be best achieved. In some areas, notably trail commission and how most effectively to deliver the policy intent behind box management, further work will be needed by both regulator and industry.

32. With so much concurrent change, we stress the need to consider the potential effectiveness of demand and supply-side remedies more holistically. Looking both at CP17/18 and the wider conclusions of the Asset Management Market Study (AMMS), the FCA's intention to deliver a consistent and coherent package of interventions could be significantly challenged by two key issues: lack of clarity about interaction with forthcoming regulation, and ongoing competition analysis, not least where it touches upon consumer research and the disclosure of objectives, costs and performance.

Interaction with forthcoming regulation

33. AMMS remedies in key areas, notably transparency and governance, are being developed in parallel to significant other regulatory events and MiFID II specifically. We identify two areas that illustrate the challenge of joining these up, as well as the difficulty of assessing the effectiveness of MiFID II ahead of new (Market Study driven) measures:

   - How consumer testing of disclosure of fund charges, i.e. *cost of investment,* that arose from the AMMS and will conclude in Q4 2017, links to MiFID II aggregated disclosure on total *cost of ownership* (investment plus distribution and advice). The exploration of decision-making drivers and accountability needs to reflect the reality of an intermediated retail delivery chain.

   - How fund governance proposals in CP17/18 link to forthcoming MiFID II-derived product governance requirements. These will introduce, inter alia, an explicit consideration of charging structures for funds. Specifically, the regulation requires that the level of costs and charges should be such that does not undermine return expectations and is compatible with the needs, objectives and characteristics of the target market.

34. There is also a wider question to consider, which is the industry capacity for *simultaneous implementation* given how much change is currently occurring, not least in the context of wider preparations for, and the uncertainties of, Brexit.

Ongoing Competition Analysis

35. The Investment Platforms Study is closely connected to core competition questions being posed in the main AMMS. As we set out in our response to the Platform Study Terms of Reference[1], a joined-up approach is needed to establish an efficient 'critical path', given some AMMS remedies are already subject to implementation ahead even of the Interim Report from the Platform Study.

36. We have identified several areas where disconnects are already apparent as AMMS remedies move to consultation and which we consider are highly relevant. The industry is keen to work with the FCA to address these:

- Announced consumer testing in Q4 2017 of fund charge presentation (total cost of investment) pre-empts the outcome of the Platform Study looking at competition through key parts of the distribution chain which affect total cost of ownership (see also point on MiFID II above). Consumer testing should include information and decision making in the context of total cost of ownership as well as in the context of the likely method of disclosure. For example, online disclosure may well be delivered through platforms, while other distributors such as advisers may disclose information in a paper-based manner, with fund managers having a range of alternative approaches. These different channels need to be taken into account in any consumer testing.

- New policy on communication of fund objectives, performance and benchmarks (planned for Q4 2017) is being developed, which may have significant implications for communication and competition through the value chain that are currently under consideration in the Platform Study. How competition works through the value chain is likely to have implications for the most effective methods of communication.

- New governance requirements are being developed in CP17/18 for fund products that are not just competing against each other, but against functionally comparable services offered by others in the value chain that are currently under competition scrutiny.[2]

Creating a Holistic Approach

37. Putting this together, we suggest that there would be benefit in considering a series of criteria for planning and assessing the impact of remedies from the two Market Studies:

- *Proportionality*. Cognisant of the Principles of Good Regulation, this should recognise particularly the impact of regulatory change (both CP17/18 itself and the cumulative effect of CP17/18 and other measures) on smaller (and not so small) firms.

[1] For further details please see here.

[2] This can be seen particularly in the area of asset allocation products, where multi-asset funds compete with others who provide asset allocation (for example, Discretionary Fund Managers operating model portfolios). How value, costs and performance are assessed and communicated needs to be considered in the wider context of how the retail market is increasingly operating.

- *Interconnection*, assessing how different aspects of analysis and remedies overlap both in the Market Study approach and in relation to existing regulatory change (e.g. MiFID II product governance).

- *Sequence*, looking again both at the interaction within the Market Study process and the wider regulatory landscape from an optimal timing perspective.

38. We would urge the FCA to issue a short report on these criteria in tandem with its final response on CP17/18. We raise a number of practical suggestions on all three criteria as part of our detailed response on the new governance proposals.

39. We recognise that the FCA has considered a number of these factors, notably proportionality, as part of the Compatibility Statement. However, there would be benefit from making this process more explicit and extensive and account for the proportionality and cost of the cumulative impact of all changes.

40. We further encourage the FCA to publish a composite analysis at the time of the publication of the Platform Study Final Report that looks across the retail investment market, bringing together the two studies and any plans for future work in connected areas. This would be a single assessment point that takes account of issues such as the conclusions of consumer testing work, and puts in place a coherent overall disclosure framework through the retail market that works across the whole value chain and associated range of business models.

41. While this has implications for the timing of certain AMMS remedies, we would stress that, particularly on transparency, MiFID II will result in a transformation in accountability from the beginning of 2018. A composite analysis of AMMS and the Platform Study would also allow the FCA to draw lessons from the initial MiFID II implementation period.

PART TWO: ENHANCING FUND GOVERNANCE

42. The governance proposals put forward in CP17/18 are far reaching and will bring about a threefold requirement: (a) a new definition of acting in investors' best interests which connects to an assessment of, and reporting on, VfM; (b) a prescribed responsibility under SM&CR to act in the newly defined 'best interests' of investors; and (c) the appointment of independent directors on AFM boards.

43. This combination of changes is a significant package in its own right. As we stress in the previous Part, it is critical that this is developed and seen in the context of the wider competition analysis of the retail market as well as regulatory change.

44. Our response focuses on the specific questions asked in CP17/18, but also considers these wider points, particularly in the context of implementation of the proposed remedies. This section on governance discusses the issues within the following three areas:

    - Value for money
    - Independent Directors
    - Business Model Considerations

Value for Money

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

45. We agree that fund governance processes need to ensure a focus on the quality and cost of the service provided, but make four general points on VfM before looking at the specific definition:

    a. *Good value for consumers is critical for any industry, but value is ultimately a utility judgement by users of a service*. In all retail markets, that judgement will involve key quantitative elements such as price and performance alongside other factors that may be less tangible. For retail investment funds, these factors will include: the depth and quality of the investment management process; the support infrastructure available to the investment manager; brand reputation; quality of customer experience; and the uniqueness and desirability of the product. Too heavy a focus on price, to the exclusion of other factors, could lead to distortions and a disincentive for firms to invest in product quality, technology and innovation.

    b. *A well-functioning market means that demand side behaviour responds to perceptions of poor value*. Enhanced fund governance can help to ensure access to good value products. This needs to operate in conjunction with others in the delivery chain, including advisers, who have a central role in ensuring their clients ultimately get value for money from their investment experience.

c. *High-level criteria for the fund VfM assessment will help to strike the balance between a need for consistency while avoiding prescription*. There needs to be sufficient flexibility so the AFM board (or representative body) can determine the appropriate assessment criteria with regard to the nature of the offering, the investor base, etc. [3]

d. *The approach to pension scheme VfM differs from that proposed for funds*. This may not assist savers or their representatives in addressing a question that arises at multiple points in the retail investment product chain, namely whether a product or service has met the objectives which it set out for investors and whether the associated cost is considered reasonable in the context of the service delivered. Moreover, using the same core terminology (VfM) in different processes may lead to confusion and undermine confidence. Regulators should seek to minimise the risk of divergence either through the use of a distinct term or by better alignment of the factors behind the VfM assessment.

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

46. We do not agree with the detailed approach. We set out below a range of detailed considerations, and also draw on experience in other jurisdictions. Our proposals for amendment are set out in paragraphs 68-71 below.

47. A central observation is that the specific requirements proposed in COLL 6.6.21R and the Guidance focus disproportionately on cost, almost to the exclusion of all other key determinants of value. A VfM assessment should start with a holistic definition of value, and then consider this value in the context of the cost.

48. Value should reflect, in the first instance, the delivery of outcomes against stated investment objectives and it is surprising that this has been excluded from the proposed assessment criteria. Notably, an investment delivery focus appeared to be the direction taken in the Final Report, which defined VfM as *"some form of risk-adjusted net return"* which *"can be broken down into performance achieved, the risk taken to achieve it and the price paid for the investment management services"*.[4] Although this definition may not apply fully across the entire product set, it appears to be different to the stated requirements in CP17/18.

49. Investment outcomes are a critical component of value, particularly in the context of meeting investor expectations. Namely, the key question is whether the product is delivering what it set out to deliver. For example, has an index fund been managed within the target tracking error? Has the risk-adjusted performance of an active fund been in line with reasonable expectations with regard to the objective?

50. An important aspect when assessing delivery of outcomes, and reporting on value, is the anticipated investment horizon and recommended holding period. This is particularly pertinent

[3] In this regard, we note that the guidance for COLL 6.6.21R, rather than merely clarifying the requirements, effectively provides further prescription through being phrased as a direction, e.g. *"…the AFM board should…"*.
[4] Final Report, para 1.16, p.5.

given the proposal that the VfM assessment takes place on an "*ongoing basis*" and is formally documented *"at least once a year"*.[5] Funds are usually intended to be medium to long term investments, and investment strategies which take a long term view may underperform in the short term. It may not be appropriate to tie reporting to the most recent short-term performance but rather best practice would consider delivery of the investment objective against the recommended holding period as well as the potential to do so in the future. As such, the rules should make explicit reference to the need to assess VfM over an investment period that is appropriate given the investment objectives of the fund and in the light of other economic indicators.

51. Additionally, consideration of value should include criteria relating to the wider quality of service. These would not be defined in regulation but may include:

- Quality of the investment management process, capturing factors such as team quality (seniority, expertise); how intensive the investment approach is; and the performance record of the individuals concerned.

- Support infrastructure: the quality of risk management, compliance and operational capabilities.

- Customer service: information and reports provided to investors, telephone and online services available, etc.

52. That quality will contribute in turn to the brand value that is a critical determinant of customer behaviour across many consumer markets. This assessment of outcomes and quality will not necessarily be directly in relation to the cost of the product, but rather in relation to how these measure against to what was communicated to investors in pre-investment marketing and disclosure.

Charges and economies of scale

53. Looking at the assessment of the 'money' side of VfM, we have two significant comments with respect to how economies of scale and level of charges are approached:

- The assessment of value appears to favour a definition based on a measure of charges relative to cost of production, as opposed to charges relative to delivery of a given product or service and other criteria, such as its quality, uniqueness, desirability, capacity, etc.

- The consideration of economies of scale is unclear, and potentially restrictive.

Assessment of value

54. Although we agree that the level of charges is a central element in the VfM assessment, we disagree with the way the criterion in COLL 6.6.21R (3) is worded: *"whether the level of each charge and other payment taken from the scheme property is reasonable in relation to the* ***costs***

[5] CP17/18, para 3.25, p.14.

necessarily incurred *[emphasis added]"*. This connection between level of charges and costs incurred is part of an economies of scale discussion, not a level of charges discussion.

55. There is a more fundamental issue here. The regulation should allow consideration of whether a charge is reasonable in relation to the outcome and service already delivered as well as the potential to deliver value in the future rather than only to costs necessarily incurred. We do not accept that the regulator should seek to determine the pricing strategy of an entire industry and would point out that value-based pricing is an entirely legitimate approach to commercial operation. Basing price purely on costs necessarily incurred is a very significant constraint on commercial freedoms and we are concerned that the FCA appears to be imposing cost-based price regulation.

56. As a matter of practical consideration, looking at charges relative to costs over a one-year period would not allow the lifecycle commercial experience of a product to be effectively considered. Neither does a restriction to *"costs necessarily incurred"* facilitate experimentation and innovation in delivery. It is also unclear why two areas are identified specifically in COLL 6.6.21R (3): *"the cost of delivering the scheme's investment objectives and policy"* and *"the distribution and marketing of the scheme"*. We suggest that the requirement to consider charges relative to value both delivered and expected is expressed more broadly rather than making explicit references to any specific areas.

Economies of scale

57. While it is reasonable that economies of scale are considered as part of a VfM assessment, there are a number of points arising in the current drafting of the proposed regulation.

58. First, on a technical level, it is not clear what is meant in COLL 6.6.21R (1) as to whether savings and benefits from economies of scale should be paid into the scheme property. We would welcome clarity on the intention, both in terms of areas of activity and the mechanics of payment. We would assume that economies of scale would be reflected in fee levels, covered under COLL 6.6.21R (2). Moreover, once COLL 6.6.21R is translated into reporting requirements, there is an unclear expectation of reporting with respect to *"savings and benefits from economies of scale identified in the assessment which have not been paid into the scheme property*".

59. Second, break points are presented as the only consideration in fee setting. Pricing is ultimately a commercial question for firms and therefore it should be at their discretion whether economies of scale, once identified, are indeed passed on to the investors. Moreover, it should be up to firms to decide in what form economies of scale are passed on, e.g. whether there would be an overall fee reduction, a rebate or the introduction of a tiered fee structure. Equally, it would be for firms to decide whether a resetting of the fee would be automatically triggered or be subject to a further review. It is unclear why the FCA has chosen to suggest a preference for one particular pricing structure above all others.

60. In this context, there are areas where breakpoints may not be appropriate:

- Where a fund has or is reaching its capacity, the manager may consider measures to discourage further investment to serve the best interests of existing investors in the fund.

- Where outflows or unfavourable market movements have a negative impact on fund size, which would then trigger an increase in charges if fund size fell below a certain break point. In this respect, it should be noted that there is an inherent asymmetry in the required steps firms need to take to inform unitholders of an increase or reduction in fees whereby the former is much more onerous than the latter.

61. This raises important broader issues:

- Fee setting and fee adjustments reflect expectations over time. Pricing strategies are typically determined on a long term basis. At the launch of a fund, a target size will be identified – the manager will often subsidise or cap costs for newly launched funds until the fund reaches scale, and it is therefore reasonable for the manager to recover those initial costs (and not be compelled to reduce fees) once the fund has reached profitability.[6] If profits as a result of scale are earned in the future they offset these sunk costs, as well as provide additional capital to launch new products and to invest in people and processes. As such, there is no simple linear relationship between scale profits earned over a period and a single fund's "entitlement" to them.

- COLL 6.6.22G, as drafted, ties the consideration of economies of scale explicitly to the different fee structures encountered in pooled funds and segregated mandates. We do not agree with the drafting of this regulation in that it considers an institutional mandate and a fund as *"comparable products"*. While aspects of institutional pricing may be relevant in some circumstances, the product sets are different in key areas. Notably, this relates to differences in flow expectations such as the level and frequency of fund investments and redemption and administration costs due to the costs of dealing with individual clients. In addition, the cost of distribution (including sales and marketing) and the cost of compliance with the regulatory requirements are much higher for an authorised fund than for an institutional mandate. There is also a risk premium associated with managing a widely held retail fund relative to an institutional mandate. We recommend that the regulation accommodates this.

- Economies of scale may have been achieved in different ways, with different commercial implications. In the case of a merger to increase efficiencies, it may be reasonable to share these with investors. In the case of an increase in fund size achieved through superior investment returns, the AFM board may determine the manager has already delivered added value to investors.

- Investor behaviour should not be disregarded in this context. Prescribing breakpoints may result in unintended consequences whereby investors are no longer willing to invest in new and small funds as they will either prefer to wait until the funds' size exceeds a specific

[6] The alternative would be for early investors, rather than fund managers to bear the risk while funds are small by, for example, paying high initial charges.

threshold or invest in a larger fund that will appear to be cheaper. This could create a barrier to entry as well as expansion for new products and firms thus creating a competition problem in the retail market.

Precedent in other regimes

62. The approach whereby a VfM or VfM-type assessment and reporting is carried out exists in other jurisdictions. While we are cautious about a copy paste approach from other regimes, there are some lessons that we believe can be learnt. Most importantly, we note that delivery against investment objectives features in similar assessments across other jurisdictions.

63. One example is the US fund governance model which provides some useful comparisons. The assessment by US fund boards on the fund manager as required under Section 15c of the US Investment Companies Act 1940 (1940 Act) involves a consideration of a number of factors, based on what is commonly known as the Gartenberg principles. Prominent among those factors is *"the nature, extent, and quality of the services to be provided by the investment adviser"* and *"the investment performance of the fund and the investment adviser"* – see Annex 1 for a full list of the Gartenberg factors.

64. Table 1 shows the Gartenberg principles mapped against the CP17/18 criteria and indicates the sequencing of the different requirements. Although there are distinct differences between the US and the UK models, in our view the Gartenberg principles reflect a more appropriate approach to VfM by first looking at value (investment performance and service quality), and then money in the context of value.

Table 1: Comparison between Sequencing of Gartenberg-Sec.15(c) and CP17/18 Criteria

Criterion	Sec.15(c) 1940 Act / Gartenberg	CP17/18 criteria
Service Quality – nature, extent and quality of services provided	1	4*
Investment Performance – how fund/ investment adviser has performed	2	No explicit requirement
Costs of Services/Charges and Payments – charges incurred and their reasonableness	3	3
Economies of Scale	4 and 5	1
Break Points	No explicit requirement	2
Classes of Units – appropriateness of having higher charge unit classes with substantially similar rights to cheaper unit classes	No requirement	5

* CP17/18 requirement is to assess whether level of charges are commensurate with the quality of service provided to unitholders.

65. The US model also presents a precedent on economies of scale and the treatment of retail vs institutional mandates. In the case of Jones vs. Harris arguments were presented that the difference between the price in retail funds and pension funds constituted a breach of fiduciary

duty. The US Supreme Court reasoned that such comparisons may be *"inapt"* as there can be *"significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to the greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and the higher marketing costs"*.[7]

66. Looking across a different market, the recently introduced Independent Governance Committees (IGCs) in workplace pensions are required, as part of their assessment of ongoing value for money, to consider *"whether the characteristics and net performance of investment strategies are regularly reviewed by the firm to ensure alignment with the interests of relevant policyholders and that the firm takes action to make any necessary changes"* (see Annex 1 for full IGC criteria).

67. In both the US and the IGC models, therefore, this type of 'VfM' assessment and reporting includes consideration of performance and service, alongside cost.

Amending the Definition

68. Drawing together the observations above, we suggest that the FCA should amend its definition in COLL 6.6.21R. Although firms would have to consider all the factors, the sequencing currently appears to give greater weight to cost than quality of service as a starting point for a consideration of value. It also excludes investment delivery as an explicit criterion altogether.

69. There is a straightforward way to begin addressing this issue. The starting point should be to reverse the sequencing such that quality of service is the first and not the fourth criterion. Put simply, a VfM assessment should begin first with 'value' and then consider 'money'. Then quality of service should be extended or more explicitly address the aspect of delivery against investment objectives. Quality of service should be a consideration in terms of the value provided, not merely viewed in terms of the cost of production.

70. Within the 'money' discussion, there should be no prescription on 'cost plus' but rather a value-based assessment of the reasonableness of charges. Although the intention is that firms would consider both levels of charges and economies of scale in their assessment, it is not clear why economies of scale would optically be the first item in COLL 6.6.21R, followed by charges. From a perspective of logical consistency, economies of scale flow directly from a consideration of the level of charges.

71. The requirement to assess economies of scale could be delivered more effectively and clearly by adopting a regulatory language that has one core requirement: to consider and report as to whether there are identifiable economies of scale over a relevant period and whether relevant scale economies are reasonably shared with unitholders. Constraints surrounding the preference for one structure of pricing should also be removed.

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[7] See the US Supreme Court opinion http://www.supremecourt.gov/opinions/09pdf/08-586.pdf

Wider considerations

72. We note the requirement in COLL 6.6.23E for the AFM to take *"sufficient steps"* conflicts with the requirement in SM&CR for Senior Managers to take *"reasonable steps"* in regards to their allocated prescribed responsibilities. In this respect we would argue that 'sufficient' sets a higher threshold and can only be determined on an ex-post basis. For example, the board may take reasonable steps, but the review in the following year may identify that further remedial action is required. In that case, would the steps taken the previous year have been 'insufficient'? COLL 6.6.23E needs to be aligned with SM&CR to ensure consistency of standards and avoid legal ambiguity.

73. Where the assessment identifies that action on VfM is required, this may not always be financial action in the form of a fee reduction, particularly where investment is needed to bring about an enhancement to the investment process or improvement in performance. Alternative forms of action could include changes in personnel, recruitment of additional analysts, increase of research, improvement of processes etc.

74. Given the connection of the proposed VfM assessment to aspects of MiFID II product governance requirements (as embedded in the UK funds regime), we note that firms will also be establishing enhanced product governance processes which will overlap with VfM – as touched upon in paragraph 33.

Implementation

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

75. The proposed twelve month implementation period is too short, especially when considered in the wider context of significant and concurrent regulatory change, notably:

    a. The prescribed responsibility under SM&CR in CP17/25.

    b. Implementation of MiFID II, which will require significant focus from AFM Boards.

    c. Preparation for Brexit, where many AFMs may be going through extensive restructuring in the lead up to March 2019. AFMs will require a better understanding of the conclusions of the Brexit negotiations before making extensive structural changes of the kind envisaged in this consultation paper.

76. These wider challenges notwithstanding, a central implementation issue is the relationship between different aspects of the proposals and the required sequencing. This is intrinsically connected to proposals for appointing independent directors (see answer to Q9):

    - The funds industry will need to recruit new independent directors, in large numbers. This involves a process of candidate identification, interview, selection and onboarding into a process of AFM governance that extends well beyond VfM in isolation. This process alone will take at a minimum 12-18 months to bed in.

- The new independent directors will legitimately want to have a role in developing and shaping the VfM consideration and reporting process. Therefore, the overall length of implementation should be appropriately extended to allow both the corpus of new directors to be recruited and the VfM work to begin.

77. One benefit of an extended timetable will be to ensure that other regulatory work relevant to the VfM process (notably on clarity of objectives, use of benchmarks, and the findings from the platform market study) will be further advanced and can be assimilated into the assessment of quality of service and associated cost.

78. An extended timetable will also accommodate the need to develop new management information channels, which in turn will require development of systems, and possible engagement of – or renegotiation with – external suppliers to agree the provision of this information.

79. The implementation period should begin at the time that the final rules are published.

Reporting

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?

80. We agree with the principle of transparency and accountability that these reports aim to deliver. In regards to the content of the publicly available report, this should be a high-level summary of a qualitative nature, recognising that the assessment of VfM will involve consideration of commercially sensitive information, such as activity based costing, margins, price strategies, etc., which for competition purposes should not be disclosed.

81. Here, too, there is precedent in existing regimes requiring reporting on VfM, e.g. for US 40 Act Funds, and IGCs, where reports provide a narrative description of the assessments undertaken, and the conclusions reached. These do not disclose the underlying data or detailed commercial arrangements that have been reviewed as part of the assessment, in recognition of the commercially sensitive nature of this information. Similarly, investment trust reports include a summary of the criteria considered by the board in the assessment of the investment manager and the fee negotiated, and the key decisions made in this regard, while avoiding commercially sensitive information. We would propose a similar approach, whereby the publicly available reports provide a summary of the assessment and its outcome whilst all the underlying information is maintained as part of internal record keeping and made available to the regulator as required.

82. Moreover, we would welcome further clarity as to the level of the reporting, and specifically whether this should be across the range or at the level of individual funds. In this regard, the use of “scheme” and “schemes” in COLL 4.5.7R (8) and (9) is unhelpful. This is likely to be an area where a certain degree of flexibility may be required particularly given the practical implication of costs occurring at different levels across firms. In this respect, reporting should most probably

be at the level at which the criteria (and costs) occur, be it at the level of the range or the level of the fund, but would welcome clarification from the FCA.

Independent Directors

General Role

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?

83. The IA agrees with the general principle of independent representation and supports the overall direction of travel while focussing particularly on a proportionate and effective implementation.

84. In the first instance, a question arises how best to implement independent representation in a way that accommodates different business models. Whilst the introduction of independent directors[8] can be implemented in a relatively straightforward way for incorporated AFMs, it would require extensive restructuring for those with different structures such as LLPs and general partnerships. We would welcome further clarity on the regulator's expectations in this area or for the draft regulation to be amended to address this.

85. We would note that the requirements of independent directors envisaged by the FCA in the proposed requirements in COLL 6.6.25R and COLL 6.6.26G conflict with their duties as directors under section 172 of the Companies Act 2006 (the "Companies Act"). The role and responsibilities of independent directors, assuming they are appointed to the main board of the AFM, will be broader than the assessment of VfM envisaged in COLL 6.6.25R and COLL 6.6.26G – these directors will have accountabilities to the shareholders of the AFM that are enshrined in the Companies Act.

86. The IA does not dispute that the boards of AFMs, including independent directors, who act in the best interests the unitholders in the funds of the AFM, will ultimately be acting in the best long-term interest of the AFM and its shareholders. Delivering for investors in the funds managed by the AFM is clearly important for the long-term sustainability of the AFM. However, COLL 6.6.26G (4) suggests that independent directors must act *"**solely** in the interests of unitholders"* [emphasis added]. This is difficult to reconcile with the duty placed on directors in section 172 of the Companies Act, which requires that *"a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole"*. In doing so, the director must have regard for the interests of various stakeholders including employees, suppliers and customers as well as shareholders (the full text of section 172 of the Companies Act is reproduced in Annex 1).

87. Although the FCA acknowledges this conflict in paragraph 3.43 of CP17/18, given the above, we would argue that a duty to consider the best interests of unitholders would be in keeping with the duty on directors set out in section 172, but a duty to act solely in their best interests is not. The director cannot act solely in the best interests of one stakeholder group under the

[8] When we refer to independent directors or iNEDs, we refer to independent non-executives, recognising there may be other non-executives – these non-independents we refer to as NEDs.

Companies Act, but must consider the interests of a range of stakeholders and ultimately promote the success of the company for the benefit of its members. This conflict will apply in the case of all independent directors appointed to the boards of AFMs, but will be particularly acute for those appointed to the boards of AFMs who do not delegate portfolio management, as outlined below.

88. Moreover, although most AFMs delegate portfolio management as presented in Figure 1 of CP17/18, there are many who don't. Where the AFM is not a subsidiary of a wider group, the AFM board will be the main board and there will be different sensitivities for independents joining the main board. The proposals would then create specific conflicts for these firms in that the independent directors would also be the directors of the portfolio manager in addition to having to represent the interests of unitholders. As such, alternative models of independent governance should be considered for those AFMs to avoid the need for extensive restructuring. For example, one possibility could be that where firms have independent directors on fund boards across their entire range, it would not be necessary to have independent directors at the level of the AFM.

Proportion and Other Requirements

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

89. We broadly agree with the proposal to require two independent directors, to the extent that alternative but consistent forms of independent representation can be permitted in line with our response to Q5. Additionally, we would argue for a proportionate approach particularly in regards to cost for smaller firms and any adverse effects this could then have on competition insofar as it creates barriers to entry. In this context, instead of a one-size-fits-all approach we would welcome consideration of some degree of flexibility whereby, for example, AFM boards can decide what would be the optimal number of independent directors. In particular, AFMs below a specific size, in terms of assets and/or number of funds, with a small number of board executives should not need to appoint two independent directors – such firms could be permitted to appoint only one independent director, or instead adopt alternative proposals in line with those suggested below in paragraph 118.

90. We do not support the inclusion of the 25% threshold. For some this would be equivalent to a minimum of three iNEDs for what in most cases will be a subsidiary board. This would represent a disproportionate cost to those firms, and could result in more challenges across the industry in recruiting suitable candidates. It will also penalise firms appointing NEDs that are not independent – since that will increase the number of iNEDs needed and so gear the diluting effect on executives on the Board. It will be the quality rather than the quantity of independent directors that will determine their effectiveness.

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?

91. We agree with this approach as we do not believe that a ban on independent directors serving on more than one board will be necessary. Although in some cases AFMs are likely to be reluctant to hire independent directors serving on the boards of key competitors and to scrutinise other directorships they hold , some AFMs may benefit from having independent directors serving on more than one board.

92. At the same time, it is possible that there is a natural limit to the number of directorships an individual can hold, although this will be more influenced by the number of hours the individual is required to spend on each AFM (which may vary significantly between different AFMs based on the size and complexity of their business) and the other time commitments of the individual.

93. As evidenced in a thematic review by the Central Bank of Ireland (CBI) on the subject, it is possible for a large number of independent directorships to concentrate across a small number of individuals.[9] To address this, the CBI issued guidance which did not set a cap on the number of positions an independent director may hold but stated that CBI would *"treat high levels of directorships combined with high aggregate levels of annual professional time commitments as a risk indicator"* and once this risk indicator was triggered, it would be subject to additional supervisory attention.[10]

94. In this context, we would agree with allowing independent directors to serve on more than one board but as previous experience in a similar environment has shown that a natural limit exists, we would propose that this is kept under periodic review.

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

95. The IA agrees with having clear criteria to be considered when determining independence. We accept the FCA have sought to do this in the guidance as currently set out in COLL 6.6.26G. Still, we find this criteria too restrictive, in that it will inadvertently exclude a number of candidates who would ordinarily be considered independent. In this context, we note the parallels with the related guidance in the UK Corporate Governance Code[11] which is applied on a comply or explain basis and allows corporate boards to determine if the individual is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The Board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination.

96. More importantly, and as stated in paragraph 90, the quality of independent directors will be the key determinant of their effectiveness. It is important that firms have sufficient flexibility to

[9] Central Bank of Ireland, Review of the number of directorships held by individuals within the investment funds industry, 16 June 2015.

[10] Central Bank of Ireland, Fund management companies – guidance, November 2015. CBI set 20 or more directorships and an aggregate professional time commitment in excess of 2000 hours as the threshold for this risk indicator and stated that these numbers would be reviewed.

[11] Financial Reporting Council, The UK Corporate Governance Code, April 2016.

hire quality candidates with the requisite knowledge, experience and capability to assess detailed technical information and challenge the board.

97. There are several areas where clarification and changes should be made to the criteria in COLL 6.6.26G. First, it is not clear what would apply to former employees of service providers that as an entity had a business relationship with the AFM. The criteria could clarify that such persons can be considered independent if they had no significant personal involvement or connection with the AFM in their previous roles. Here too, the UK Corporate Governance Code is more specific[12].

98. Secondly, our interpretation of the proposed rules is that, as written, they would preclude a person serving, or who recently served, as an independent director of a fund managed by the AFM or another firm in its group from being considered as independent and available for the AFM board. This would include independent directors who also serve as non-executive directors on the main parent entity board, or other boards and committees of the firm. As drafted, COLL 6.6.26G (1)(a) only allows for persons solely remunerated as independent members of the governing body of the AFM, which is reinforced by the terms of COLL 6.6.26G (1)(d).

99. Given the potential challenges in identifying and recruiting suitable candidates, particularly in the early years of implementation, we do not think this is a desired outcome. Provided individuals serving as independent directors on the main board (or another group board) otherwise have the quality, capability and experience to meet the independence criteria, they should not be excluded from also acting as independent directors on the board of the AFM.

100. Sitting on both the main entity and AFM board may help to provide a broader perspective and therefore an improved level of oversight and challenge to executive management. Firms should therefore have the flexibility to make such appointments, where they deem them appropriate to their specific circumstances, as per COLL 6.6.25R (2), and that COLL 6.6.26G (1) should be amended to allow for individuals who have been remunerated by other Group entities as independent directors:

- COLL 6.6.26G (1)(a) *"…. the person is an employee of the AFM or of a company within the AFM's group or paid by them for any role other than as an independent member of the governing body or of a company within the AFM's Group."*

- COLL 6.6.26G (1)(d) *"…the person has received any sort of remuneration from the AFM's group within the five years preceding their appointment other than as a non-executive director of a company within the AFM's Group."*

101. While supporting the principle that there should be a periodic rotation of independent directors, the IA does not believe the maximum tenure of independent directors should be hardcoded in the rules. Placing a hard limit on the tenure of independent directors deprives the AFM board of any flexibility over the length of term of independent directors in circumstances where it may in the interests of the investors for the term of independent directors to be

[12] See UK Corporate Governance Code provision B.1.1.

extended. For example, if an independent director is reaching their tenth year of service and the AFM is in the process of restructuring its operational arrangements or its fund range, it may be in the interests of the investors concerned to have continued scrutiny of the restructure process by an experienced independent director familiar with the fund range and operation of the AFM, rather than replace them with a new independent director who is unfamiliar with the AFM and its fund range. As such, we would propose that the provisions in COLL 6.6.25R (4) and (5) are moved to the guidance under COLL 6.6.26G.

102. Significant CRD firms are already required to establish independent risk[13], remuneration[14] and nomination[15] committees. These committees must be composed of members of the management body who do not perform any executive function in the firm. The individuals on these committees are in practice non-executive directors according to the definition of non-executive directors in the glossary of the FCA Handbook. The definition of independence proposed by the FCA in CP17/18[16] is likely to prevent individuals serving on the independent risk, remuneration or nomination committees as independent directors of the significant CRD firm from serving as independent directors of the AFM under the COLL rules. Individuals receiving compensation for any role other than as an independent member of the governing body, would, according to the proposed new rules in COLL not be regarded as independent. We disagree with this approach and would suggest to align the requirements in a way that allows firms to appoint individuals currently serving as non-executive directors for significant CRD firms to become independent directors according to the new rules. As mentioned elsewhere in our response there are a number of firms which might perform more than just the AFM function and therefore by definition there may be CRD significant firms which also perform the AFM function.

Implementation

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?

103. We see the implementation of independent directors and the implementation of the VfM requirements as part of the same process. As we noted in our answer to Q3 above, an implementation period of twelve months will be insufficient for many firms. The recruitment of independent directors for the AFM board will be a new process for most AFMs. They will therefore need to develop new policies, outlining the criteria and process that will apply to the selection of the independent directors. Such a policy will need to be developed prior to commencing the recruitment process. This will go beyond considering the requirements in COLL 6.6.25R and COLL 6.6.26G – the AFM will need to consider its business structure and complexity in addition to ensuring the policy is consistent with the wider group's governance and recruitment policies, such as culture and diversity.

[13] SYSC 7.1.18
[14] SYSC 19A.3.12
[15] SYSC 4.3A.8
[16] Proposed amendments to the Collective Investment Scheme sourcebook COLL 6.6.26G (1)(a).

104. There will also need to be sufficient time for the industry to undertake the recruitment. There is not currently an identified pool of suitable independent directors for AFMs – therefore identifying suitable candidates may initially be more challenging. It is likely there will be a large number of AFMs competing to recruit a small number of individuals– those firms that are unsuccessful in hiring those initial candidates will inevitably require more time to identify further suitable candidates.

105. There is a need to consider this not only in the context of the other proposals within CP17/18 and the introduction of the prescribed responsibility under SM&CR in CP17/25 but also in the context of broader developments and particularly the wider implications of Brexit and the fact that many AFMs may be going through restructuring in the lead up to March 2019. As such there is a case for AFMs being allowed to complete this process before finalising their structures and a longer transition period is therefore required.

AFM Chair

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?

106. We agree with the proposal that AFMs decide themselves whether to appoint an independent or executive director as Chair. As acknowledged in CP17/18[17], there are different advantages to having an independent director or an executive director as chair and the AFM board is best placed to decide if an independent or executive chair is most suitable for their structure.

107. The Chair defines the direction of the board and having independent leadership can set a direction for the board which is less influenced by the executive leadership. At the same time, an executive director will have access to wider and more immediate information on the AFM and given the wider role in shaping the culture of the firm, there is a strong sense of accountability which becomes particularly relevant in the context of SM&CR.

108. On that specific point, it is likely that the requirement for the Chair to be an SMF will pose a practical and cost challenge for AFMs seeking to recruit an independent person.

Wider interface with SM&CR

109. The IA agrees with the proposal to introduce a prescribed responsibility on AFMs to act in the best interests of unitholders and we note that the FCA has deferred consultation on this to CP17/25 and we will respond to this paper in due course. In the meantime, we would like to raise three points of discrepancy between CP17/18 and CP17/25.

110. The first point relates to the function of the Chair of the AFM board. CP17/18 is consulting on whether it should be up to AFMs to decide whether to appoint an independent or an executive director as chair and the IA agrees with the FCA analysis that both have merits and it should be

[17] CP17/18, para 3.48, p.18.

up to AFMs to decide this. As such, we would welcome further clarity as to why CP17/25 lists SMF9-Chair as a non-executive function and what this means for Question 10 in CP17/18.

111. The second point relates to whom the prescribed responsibility to act in the best interests of investors would be allocated. According to CP17/25 this responsibility includes the VfM assessment and independent director representation and would be allocated to *"the Senior Manager who is the most senior person responsible for that issue"* and who will *"need to have sufficient authority and an appropriate level of knowledge and competence to carry out the responsibility properly"*.[18] However, CP17/18 clearly states that this responsibility should be allocated to the chair of the AFM board.[19] We would welcome further clarity in regards to the regulatory expectations in this area particularly in the context of whether the chair of the AFM board can be either an executive or a non-executive, independent function.

112. The third point relates to what we already raised under Q4, where there is a misalignment between AFMs being required to take 'sufficient' steps to address any identified cases of poor VfM (as per proposed COLL 6.6.23E) and the chair of the AFM board being responsible for taking 'reasonable' steps to ensure the AFM and its board adhere to FCA rules (as per CP17/18, para 3.37, p.16). As mentioned earlier, what is 'sufficient' could only be judged on an ex post basis and as such we would propose that CP17/18 is aligned with CP17/25 by requiring that the AFMs take 'reasonable' steps in their VfM assessment.

Business Model Considerations

Diversity of business models

113. The IA in principle welcomes and supports proposals for independent representation on the governance arrangements of funds. As such, we want to ensure effective implementation that serves the best interests of investors. In this context, we would welcome further clarity regarding regulatory expectations on extending the proposed governance requirements to a diverse set of business models among AFM firms.

114. Paragraph 3.13 of CP17/18 describes two business models used by the *"vast majority"* of AFMs, both of which involve the AFM delegating the management of the assets of the funds – the first, to another portfolio manager within the same corporate group as the AFM, the second to a third party portfolio manager (i.e. one not part of the same corporate group as the AFM). There is no further discussion in the consultation paper on the non-delegation model (where the AFM itself undertakes the portfolio investment), nor is there any consideration in the consultation paper of the diverse legal structures used by AFMs.

115. Within the delegation matrix, the legal analysis is of course a delegation by the AFM. As stated in paragraph 3.13, it is the AFM which *"holds ultimate operational and legal responsibility for*

[18] FCA, CP17/25, Individual Accountability: Extending the Senior Managers & Certification Regime to all FCA firms, July 2017, para 4.39, p.24.
[19] CP17/18, para 3.35, pp.15-16.

the fund, including fund governance". However, the commercial analysis is different. As identified in paragraph 3.13 of CP17/18, there are in fact three delegation models:

- Model A (paragraph 3.14) – The AFM delegates to an affiliated portfolio manager. Typically Model A is used by larger and longer-established groups and often already have NEDs, if not independent directors. Having independent directors at the AFM level should be straightforward for groups using Model A. Clearly in this model a requirement for independent directors at AFM level would support effective VfM assessments.

- Model B (paragraph 3.15 – first sentence) – The AFM is, say, a wealth manager, selecting third party portfolio managers. Here the AFM is obviously not conflicted in a VfM assessment of third party portfolio manager(s). The AFM would however be a profit centre in its own right and either undertake distribution or be affiliated to a distribution entity. (As such, there are some parallels with Model D (see below). Again, having independent directors at the AFM level should be straightforward where Model B is used.

- Model C (paragraph 3.15 remainder and 3.16) – This refers to a portfolio manager using a host AFM to act as the regulated AFM of a fund range for which the portfolio manager acts as portfolio manager, sponsor and distributor. Host AFMs provide a means of enabling smaller portfolio managers, including start-ups, the means to access the funds market where they otherwise lack the in-house capabilities to act as an AFM themselves. However, we note the conclusion that the commercial reliance of the host AFM on the portfolio manager can undermine its independence and result in similar competing interests to the in-house AFM model. An additional complexity is that the host AFM is likely to act as AFM for numerous client portfolio managers. Identifying NEDs who qualify as independent against all the host AFM's client portfolio managers may be challenging. Typically Model C is used by smaller portfolio manager firms, wishing to focus on the core competence(s) of portfolio management and (distribution).

116. Additionally, there is a fourth model (that of non-delegation), which is not covered in CP17/18:

- Model D – This is where the AFM undertakes portfolio management itself and does not delegate, either internally or externally. In some cases, the AFM also provides portfolio management to other clients, e.g. Pension funds, endowments, AFMs using Model B, etc. For firms using Model D, there are different sensitivities involved in the appointment of independent directors. They have statutory obligations to act for the benefit of the AFM's shareholders, in addition to their regulatory obligations to act in the best interests of unitholders of the AFM's funds. They will also have a wider remit than independent directors on the boards of AFMs who delegate portfolio management. This will particularly be the case where the AFM is the main or only legal entity in the group – being appointed to the main board will involve broader commercial responsibilities and accountabilities for the independent directors. Many smaller firms use Model D, and such firms will be disproportionately affected by proposals that are focused on the multi-entity MiFID investment managers serving UCITS or AIFM AFMs.

117. Each of these models is permitted under the FCA rules and indeed the UCITS and AIFM Directives, and accordingly valid. Model D was specifically introduced as part of the UCITS III changes. It is important that the proposed rule changes do not favour any one model over the others.

118. We do not believe AFMs should be expected to change their business models or restructure in order to implement the changes to governance proposed in CP17/18. Instead, alternative proposals to introduce independent representation should be considered for those firms. The IA would welcome further discussion with the FCA on suitable alternative proposals for such AFMs, although these could potentially include:

- Appointing independent directors at the level of the fund, rather than the AFM. Although it is not possible to appoint independent directors to a unit trust or an ACS, it is possible to appoint independent directors to an ICVC. Given the issues highlighted in paragraphs 3.13 to 3.16 of the consultation paper and in paragraphs 114 to 117 above, we consider that having independent directors at fund level, instead of at AFM level, should facilitate effective VfM assessments at least as well as having independent directors at AFM level. Hence, if all the funds in an AFM range have independent directors at fund level, the IA believes that it should not be necessary for those AFMs also to have independent directors at AFM level.

- Appointing independent directors or representatives to a suitably empowered sub-committee of the AFM's board, tasked specifically with the obligation to act in the best interests of investors and to perform and report on the value for money assessment. This would enable the AFM to assign the appropriate responsibilities to the independent representatives, without them having to take on the wider corporate responsibilities that would be involved with them joining the main board, and the resulting conflicts and sensitivities that would entail.

119. We would welcome further clarity as to whether there is an underlying assumption that all AFMs are limited companies, as this is not stated in the consultation paper. We are aware of AFMs structured as LLPs and conceivably an AFM could be structured as a general partnership. LLPs and general partnerships will not be able to appoint independent directors. Under the current proposals, it is not clear if these AFMs would be expected to restructure so as to become limited companies, or if they would be expected to appoint "independent" members (in an LLP) or partners (in a general partnership). The latter scenario is likely to be highly undesirable, since the implications of appointing a member or a partner are significantly different to the appointment of a director.

Cross border implications for Super Mancos

120. The scope of the FCA's requirements extends beyond UK AFMs. If adopted, the proposals in CP17/18 will apply to the following categories of FCA authorised firms:

- All UK-authorised firms that carry out the function of an AFM for collective investment schemes that are authorised and domiciled in the UK

- UK UCITS management companies managing EEA UCITS schemes

The following firms will not be in scope:

- UCITS management companies domiciled in the EEA accessing the UK market through the UCITS management passport

- Alternative Investment Fund Managers (AIFMs) that operate UK funds, or market EEA-domiciled funds in the UK

121. However, our understanding is the rules will apply to an AIFM which is authorised as an AFM of UK regulated collective investment schemes, e.g. the AFM of Non-UCITS Retail Schemes (NURS) and Qualified Investor Schemes (QIS).

122. Since the introduction of the cross-border management passports in both the UCITS and AIFM Directives, a number of businesses have consolidated their management entities into single management company entities, through which their entire European fund ranges are managed. These consolidated management companies are commonly referred to as “Super Mancos”.

123. The FCA’s proposed rules will apply to UK domiciled Super Mancos, regardless of whether they have UK domiciled funds. Since such Super Mancos will have to apply the FCA’s VfM requirements to their European fund ranges, e.g. those domiciled in Ireland or Luxembourg, there is in effect an extra-territorial application of these requirements and potentially anti-competitive implications.

124. The requirements will not apply to Super Mancos domiciled in other EU member states, including those using the management company passports to manage UK domiciled UCITS. Such firms will be under no obligation to appoint independent directors or conduct a value for money assessment on their UK funds. While we recognise that the FCA’s jurisdiction cannot extend to non-UK Super Mancos, this clearly creates the potential for regulatory arbitrage. It also appears likely that this will weaken the competitiveness of the UK as a domicile for Super Mancos. We recognise that it has been suggested that the proposed remedies will make the UK funds industry more attractive to investors through the introduction of higher standards. Still, feedback from some of our members suggests that the UK is likely to be a less attractive domicile for locating their management companies in future due to a number of factors, including the proposed SM&CR responsibilities and the value for money requirements.

125. The draft rules require those AFMs and management companies in scope of the requirements to conduct and report on value for money assessments for the “schemes” managed by the AFM/management company. It is not immediately clear that “schemes” is limited to UK authorised funds and EEA UCITS – where the AFM/management company entity is also authorised as an AIFM, the draft rules could be interpreted as also applying to any unauthorised AIFs managed by the AFM/management company entity. We do not believe this is the intention of the FCA’s proposed rules, and we recommend the scope is better clarified in the final rules to avoid such unintended consequences.

PART THREE: MOVING INVESTORS TO ALTERNATIVE SHARE CLASSES

Q11: Do you agree with the proposed modification of FG14/4? If not, what alternative(s) would you propose?

126. The IA welcomes the FCA's proposal to modify the guidance in FG14/4 as a step in the right direction. In its response to the Interim Report, the IA highlighted that the existing guidance prevented AFMs from moving investors in pre-RDR unit classes to post-RDR unit classes without an explicit instruction from the investor, even where this was to the benefit of the investor. As stated in the IA response, there is no legal basis for such a restriction. We therefore welcome the fact that the FCA has decided to revisit the guidance in FG14/4 and clarify that, under particular conditions, it will be possible for AFMs to move investors to alternative share classes without their instruction.

127. We agree that the conditions in paragraph 1.20 of the proposed modification of FG14/4 should be satisfied, namely that the circumstances in which mandatory conversions can take place are set out in the prospectus of the fund (and if not, the prospectus is amended to include this as outlined in paragraph 1.21) and that the client's best interest rule is satisfied. However, we disagree with the FCA's guidance on the steps required to satisfy the latter, particularly with regard to the communications which should be issued by the AFM.

128. The conditions set by the FCA in its proposed modification of FG14/4 for an AFM to undertake a mandatory conversion include a requirement for the AFM to *"make all reasonable attempts to inform unitholders about any planned conversions"*, suggesting that *"AFMs should consider general communications, such as press adverts, for hard-to-reach unitholders"*. According to the proposed guidance, the AFM can only proceed with the conversion if, despite *"best efforts"*, it has not received an alternative instruction about the units.

129. This condition will prove a significant burden for AFMs, and could potentially deter AFMs from moving unitholders into unit classes that offer them better value. We agree and support the second condition in paragraph 1.23 of the proposed modified guidance, that the AFM must be satisfied on reasonable grounds that the conversion will not result in detriment to the unitholders concerned.

130. We question why the AFM should be required to make a number of attempts to contact unitholders, and in particular issue costly general communications, such as press adverts if the AFM has already taken the appropriate consideration to ensure there is no detriment to unitholders. This goes far beyond the requirements to communicate other types of changes that can have a material impact on unitholders. For example, where the AFM intends to increase its annual management charge, it is required to issue a single notice in paper or another durable medium, to the first named unitholder, providing 60 days' notice of the intended change. There is no requirement on AFMs making such a change to issue multiple communications or issue press adverts. Further, the FCA has not explained why it believes that the use of general press adverts will be more effective than the personal communication that firms will be required to undertake anyway.

131. The IA would encourage the FCA to further modify paragraph 1.22 and the first condition of paragraph 1.23 of FG14/4 in order to better align it with COLL 4.3. Namely the guidance in FG14/4 could require, that having satisfied itself on reasonable grounds that there is no detriment to unitholders in undertaking the mandatory conversion, the AFM issues a single notice to unitholders of its intention to convert their holding to the new unit class, giving them sufficient advance notice to redeem their units if they do not wish their holding to be converted and alerting them to other options where they are available. Following the expiry of the set period, if the AFM has not received any instructions from the unitholder, they should be able to proceed with the conversion.

Ending Pre-RDR Trail Commission Payments

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

132. The IA has, since before the implementation of RDR, advocated a consistent retail fund distribution regime, which aligns the post and pre-RDR regimes. We set out our views again in our submission to the FCA Interim Report. Our guiding principle is that investors must have a clear understanding of what it is they are paying for and who across the supply chain is advising, administrating and managing their money.

133. Some of our members believe this clarity can be achieved without transferring fund investors into a post-RDR regime and have concerns about potential cost and tax consequences for investors. The majority of our members agree the FCA should consider the issues involved in stopping trail commission payments on the pre-RDR model. Moreover, there is industry agreement that it should be easier for fund managers to move investors to alternative share classes where this benefits investors but that the current regulatory regime does not easily facilitate this outcome. As the FCA recognises, this is a complex subject and needs to be addressed.

134. Our response to the Interim Report stressed the complexity of the retail market, given the different nature of services provided and investor experiences. Clearly, the case of an investor no longer receiving service from the adviser in a pre-RDR bundled share class is in a different category to one who is and any new rules will need to reflect this. The way in which any sunset clause transition process is undertaken needs careful consideration to ensure that any proposal to change the current arrangements does not lead to consumer detriment.

135. We recognise both the practical and commercial challenges of a sunset clause. All parties would need time to plan and implement changes to their business models, and as such we believe that the timetable for a sunset clause could only be determined following consultation among all relevant stakeholders, including distributors and advisers as well as product manufacturers.

136. Furthermore, a sunset clause should apply only to legacy trail payments for retail fund distribution that, all other things being equal, would have been expected to fall under RDR. We would not expect it to cover rebates by product manufacturers to institutional investors

(including life and pension providers), or rebates to overseas advisers (necessary for cross-border distribution purposes).

137. Finally, we would like to highlight that there is a sequencing point that needs to be accommodated in that the powers for fund managers to move investors more easily between share classes should be put in place ahead of any sunset clause. Given the timeframes likely for a sunset clause, we see no reason why this could not be achieved.

Q13: Do firms face contractual or other barriers in switching off trail commission without regulatory intervention? If not, what alternative reasons are there for continued trail commission payments?

138. We have been advised by our members that switching off trail commission unilaterally is challenging without regulatory intervention, since this creates contractual and legal ambiguities – indeed it may be unlawful in some conditions. As stated in our response to Question 12, care needs to be taken in addressing the issue.

Q14: What would be the impact on other financial markets where trail commission payments continue to be paid?

139. As a general principle, there should be a consistency of approach with regard to remuneration of advisers across UK retail investment products but it should be such that it does not distort competition beyond the UK. However, as we indicate in our answer to Q12, the market is currently not subject to a uniform regulatory approach. We therefore suggest a pragmatic response, focusing here on issues arising from RDR implementation.

PART FOUR: TREATMENT OF BOX PROFITS

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?

140. We welcome the FCA's formal consultation which now sends a consistent signal across the market on the regulator's policy intent on box management. We agree with the proposal to distinguish between risk-free and at-risk profits, and agree that the manager should be allowed to retain box profits earned through an at-risk exposure. However, as we illustrate in more detail, in some circumstances the draft handbook text does not deliver this outcome.

141. In general, managers use the box to improve outcomes for investors by minimising the need to change the pricing basis[20] and thereby reducing unit price volatility. Broadly speaking, this can be achieved in a number of ways that are characterised by the size of the spread between sales and redemption prices and the amount of proprietary capital committed by the manager.

142. One way is to set the sales and redemption prices equal to the issue and cancellation prices. This represents the maximum permitted spread that can arise as a consequence of the underlying transaction costs and is illustrated in scenario 1 of Annex 2. It reduces volatility by eliminating pricing basis changes. It requires only minimal proprietary capital to be committed to holding surplus units in the box and therefore it gives rise to only a low level of risk for the manager. However, using the maximum permitted spread means that so called risk-free profits are generated when units are matched.

143. Another way is to set a much smaller quoted spread between the sales and redemption prices, as illustrated in scenario 2 of Annex 2. This approach requires the manager to buy and hold surplus units in order to minimise the need for pricing basis changes. It requires the manager to commit a significant amount of proprietary capital to holding those surplus units in the box and therefore represents a higher level of risk for the manager. The majority of the benefit of matching units flows to the investors transacting fund units. We are aware that, as part of the FCA's supervisory activities prior to the market study, it has been agreed with firms that the quoted spread is a fair return on the capital deployed by the manager and that any profits arising should be regarded as at-risk.

144. This quoted spread is especially relevant where the maximum quoted spread is large (for example, typically greater than 5% in property funds) or there are expected changes in the direction of flows (for example, a monthly direct debit run for subscriptions in a fund that experiences net outflows during the rest of the month).

145. The draft handbook text does not deliver a solution that accommodates the quoted spread approach. Although the FCA's policy intention is to pass only risk-free profits to the fund, the draft handbook text will cause the fair return on the capital deployed to be passed to the fund

[20] The pricing basis results from the direction of net flows into or out of the fund. If the fund experiences net inflows, requiring the manager to issue new units, the fund is on a creation (or offer) basis. Conversely, if the fund experiences net outflows, requiring the manager to cancel units, the fund is on a cancellation (or bid) basis.

in addition to any risk-free profits. In practice, the proposed rule is not aligned with the stated policy intention.

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?

146. Although we welcome that the FCA recognises that dual pricing and the use of a manager's box can benefit investors, we would reiterate that box management does not disadvantage any investors. We do not believe that the Interim Report or the Final Report, as we set out below, are accurate or complete in their exploration of the issue. It is surprising that the FCA's analysis does not make any reference to the issue and cancellation prices or to the transactions that take place between the manager and the fund. These are fundamental to the operation of dual pricing and the manager's box.

147. Indeed, our response to the Interim Report included a detailed technical description of the mechanics of box management which alongside Box 7.2 of the Interim Report explained how box management is a way of sharing the benefits of matching units between incoming and outgoing investors and the manager while never putting existing investors at a disadvantage compared to where no box is operated. Namely, the existing rules ensure that new investors never pay more than the cost of buying the fund's underlying investments, plus any preliminary charge, and redeeming investors never receive less than the proceeds from selling the underlying investments, less any redemption charge. The fund itself is always fully protected from the dilutive effect of issuing or cancelling units.

148. The FCA proposes to prohibit the retention of so called 'risk-free' box profits by requiring AFMs to pass these profits to the fund. However, the new rules set out in the draft handbook text are not fully aligned with this proposal and will work only in certain circumstances. In other circumstances they would require AFMs to pay at-risk profits into the fund and could cause a payment to the fund when box losses are incurred. In practice this will restrict severely the operation of dual pricing.

149. In more detail, the intention of the draft rules appears to be to require a payment to the fund of the amount that represents the proceeds of the spread between the sales price, less any preliminary charge, and the redemption price. The FCA's proposed new rule can be expressed by the following formula:

*Payment to fund = matched units * (sales price – redemption price)*

150. We present in Annex 2 a number of illustrative examples to show the outcome of this proposed new rule and highlight specific cases where a payment larger than the box profit generated would have to be made into the fund. In these cases, AFMs would need to ensure that no at-risk losses occur that they cannot recoup and the way this could be achieved would be to restrict the use of dual pricing. This in turn, could create a detriment to transacting investors.

151. This should not be seen as a rejection of the proposed changes but rather as a point that more detailed consideration is needed on how to treat box profits and we would welcome further

dialogue with the regulator on the best way to facilitate and deliver the policy intent behind the rule change. We suggest alternative handbook text in paragraph 157.

152. An important consideration regardless of the expression of the final rule will be full transparency on box profits, which we support. In particular, it should be necessary to disclose the amount paid into the fund and its contribution to the fund's performance. There are otherwise potential unintended consequences whereby competition over performance is artificially affected by the pricing structure of a given fund. Dual-priced funds, particularly used for property as an asset class, have an important role to play that should not be inhibited.

Operational considerations

153. The FCA's proposal can be achieved operationally but will require significant systems development. The current level of regulatory change makes it extremely challenging to schedule testing and implementation of changes to critical pricing systems in the six months envisaged in the draft handbook text. Daily settlement of the proceeds of the spread is likely to result in many small payments into the fund. It also eliminates the possibility of netting off profits and losses. A simpler operation that has been implemented by some firms already and that would achieve the same objective would be to formulate a policy to pay net box profits to the fund on a periodic basis (such as quarterly), or when the cumulative box profit reached a certain threshold. This would reduce implementation costs, reduce implementation lead times and reduce the risk of errors arising in pricing systems without diminishing the realisation of the FCA's objective.

154. We are aware of firms responding to supervisory pressure from the FCA by amending their practices in respect of the treatment of box profits. We note that the FCA's interventions prior to the Interim Report have led to a decrease in retained risk-free box profits from £63m[21] in 2014 to £20m[22] at the time of the Final Report.

155. Importantly, there are also technical inaccuracies in the draft rules. Firstly, the rule refers to *"proceeds due to the scheme from the sales"* but the existence of a manager's box means sales proceeds are due to the AFM not to the scheme. A payment is due to the scheme only if the AFM decides to cause new units to be issued. As drafted, the rule will fail to cause a payment to the fund. Secondly, the sales price, and therefore the sales proceeds, includes any preliminary charge that may apply. Notwithstanding the first point, the draft rule would cause a legitimate preliminary charge to be paid into the fund instead of to the AFM.[23]

Delivery using an alternative approach

156. The policy objective is clearly to stop managers making risk-free box profits. We think the policy objective could be achieved in a less disruptive way that preserves flexibility in the operation of dual pricing by making a rule that the manager cannot retain risk-free box profits. It is not

[21] Paragraph 7.68 of the Interim Report
[22] Paragraph 39 of the CP17/18 cost benefit analysis
[23] We note also some corrections are needed in 5.5 where buy and sell are back to front; 5.13 where redeemers get a netting bonus not a discount; and 5.18 where they are changing the rules in COLL 6.3 not 6.2.

necessary to dictate which investors should receive the benefit of this rule; the manager should be able to direct the benefit to the transacting investors or the fund as it sees fit.

157. This could be crafted in a similar way to the existing rules in COLL 6.3.8R (5). For example, the following text could be added to COLL 6.3.5BR:

Where the sale price under 1(a), less any preliminary charge, exceeds the redemption price under 1(b), this must not be for the purpose of creating a risk-free profit for the account of an affected person.

If necessary, this rule could be supplemented with handbook guidance about how to deal with any risk-free profits that arise and set a minimum frequency for dealing with them.

158. The effect of this rule in the scenario in Annex 2 would be as follows:

- **Scenario 1.** The outcome would be the same as the FCA's proposal. A payment would be made to the fund because of the prohibition on making a risk-free profit. Therefore the fund would receive a performance boost of £250.

- **Scenario 2.** Unlike the FCA's proposal there would be no payment to the fund and the manager would retain a profit of £50 as a fair return for putting proprietary capital at risk in order to provide a better outcome for investors.

- **Scenario 3.** Unlike the FCA's proposal there would be no payment to the fund and the manager would be exposed to the loss of £50. This mode of operation is only viable if the manager can net off day to day profits and losses. Therefore any net profits should be paid to the fund on a periodic basis.

Q17: Do you have any comments on our proposed approach to include the proposed changes to risk-free box profits as part of the existing monitoring requirements on depositaries?

159. We do not have specific comments on the role of the depositary.

PART FIVE: EXTENSION OF SCOPE

Q18: Are current arrangements, particularly for with-profits business, fit for purpose and can they achieve the same outcomes? If no, please elaborate on how they achieve these outcomes.

160. The IA does not express a view on whether other models are fit for purpose. As a general principle, we would observe that there is a need for consistency of governance and oversight across the retail market. This does not necessitate consistency of structure. It is perfectly possible, and important, to create similar or equivalent high standards in governance and high levels of transparency without requiring identical oversight and delivery structures.

Q19: Would additional or alternative approaches be more appropriate or cost-effective for tackling the same issues? For example, would the independent governance committees set up by life insurers and used for workplace pensions be appropriate for other products as well?

161. In the DC pensions market, the concept of the IGC has a strong and specific logic, focused on default arrangements. In the retail investment market, fund or fund board level approaches make much more sense with respect to governance. As we stressed in our response to the Interim Report, we strongly believe that it is important to avoid sectoral and/or geographical copy-paste within or across jurisdictions. The IGC model in particular arose from a market with a demand side which is structured in a distinctly different way and so IGCs were intended to address a problem of a very different nature.

Q20: What would the costs, challenges and resource implications be for firms if we applied the proposals in Chapter 3 to life insurers? / Q21: What would the potential benefits be for consumers and firms of introducing any additional governance requirements for unit-linked funds and with-profits business?

162. Life insurers are better positioned to respond on the challenges and resource implications.

Q22: Would there be a risk of investor harm or disruption to the market if we did not extend our proposals for authorised funds to unit-linked or with-profits business?

163. As discussed under Question 18, in principle, equivalent standards of governance, oversight and transparency should apply to all substitutable retail products, regardless of their structure. At the same time, consideration should be given on the particular nature of those products identified to ensure the proposals are appropriate.

Q23: Do you agree with our proposed approach to pension products?

164. We agree with the proposed approach.

Q24: What are your views on whether it would be appropriate and proportionate for the FCA to consider introducing similar rules to those proposed for authorised funds for investment companies? / Q25: Is there a risk of investor harm or disruption to the market if we do not extend our proposals for authorised funds to investment companies? If so, how would this risk affect investors?

165. Investment trusts (ITCs) have a long established governance structure which includes substantial independent representation on their boards. In addition, since the board is at the level of the ITC, and not the management company, the duty of the independent directors of the ITC is to represent the interests of the investors, who are the shareholders of the ITC – independent directors of the ITC therefore do not have any obligations to the shareholders of the management company. The Listing Rules already require the board of the ITC to effectively monitor and manage the performance of its key service providers, including any investment manager appointed, on an ongoing basis[24].

166. A thorough examination of the existing governance arrangements and practices of ITCs would need to be undertaken by the FCA in advance of any proposals to extend these requirements to ITCs.

[24] LR 15.4.7AR

PART SIX: COST BENEFIT ANALYSIS

Q26: Do you agree with the conclusion and analysis set out in our cost benefit analysis?

167. The CBA significantly underestimates the work involved. This concerns particularly the VfM assessment and reporting in both the implementation and the ongoing preparation. Furthermore, we note that no allowance has been made for engagement of external legal counsel, consultants, headhunters, and in general supporting functions that firms may need to implement in order to assist with the VfM reviews and writing/ publication of the annual assessment.

168. We reiterate the need to address the significant new demands on the industry in the context of:

- Significant regulatory change that is already taking place, notably MiFID II
- Preparation for possible structural change brought about by Brexit
- Possible further changes that may be arise from further work carried out in the context of asset management and platform market studies

ANNEX 1

US 1940 Act Funds

1. Requirements of the assessment by US fund boards on the fund manager as required under Section 15c of US Investment Companies Act 1940 (1940 Act):

    a. the nature, extent, and quality of the services to be provided by the investment adviser;

    b. the investment performance of the fund and the investment adviser;

    c. the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund;

    d. the extent to which economies of scale would be realized as the fund grows; and

    e. the extent to which fee levels reflect these economies of scale for the benefit of fund investors

Independent Governance Committees (IGCs)

2. COBS 19.5.5(R)2 – Terms of Reference for an IGC requires the recently formed IGCs in workplace pensions to assess value for money by considering the following:

    - whether the characteristics and net performance of investment strategies are regularly reviewed by the firm to ensure alignment with the interests of relevant policyholders and that the firm takes action to make any necessary changes;

    - the levels of charges borne by relevant policyholders; and

    - the direct and indirect costs incurred as a result of managing and investing, and activities in connection with the managing and investing of, the pension savings of relevant policyholders, including transaction cos transaction costs.[25]

Section 172 of the Companies Act 2006

3. Duty to promote the success of the company

    (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

        (a) the likely consequences of any decision in the long term,

        (b) the interests of the company's employees,

[25] COBS 19.5.5(R)2 – Terms of Reference for an IGC.

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

ANNEX 2

1. This Annex presents a series of scenarios to illustrate the outcome of the proposed rules as currently drafted. Although this is only for illustrative purposes, it describes possible situations where the draft rules would require a payment to be paid into the fund which is larger than the box profit realised or even when a box loss has been incurred. AFMs would need to eliminate the possibility of losses that they cannot recoup and therefore, an unintended consequence of the draft rules would ultimately be a disincentive for AFMs to operate dual priced funds.

2. In our illustrative examples, we make a number of assumptions:

   a. A fund has an issue price of 105p and a cancellation price of 100p. These prices represent the cost of buying and selling the underlying assets of the fund taking into account transaction costs. This spread is wider than would be seen in a securities fund but is typical of a property fund.

   b. There is no preliminary charge so that the maximum sales price is the issue price.

   c. There are subscriptions for 5,000 units and redemptions of 10,000 units.

Scenario 1

3. The manager operates with the maximum permitted dealing spread so the sales price is 105p (equal to the issue price) and the redemption price is 100p (equal to the cancellation price). The manager operates a minimal box so it will be possible to match 5,000 units and necessary to cancel 5,000 new units, as follows:

	Units	Price	Cashflow
Subscription	5,000	105p	£5,250
Redemption	10,000	100p	-£10,000
Units cancelled	5,000	100p	£5,000
Current box profit			£250
Payment to fund			*-£250*
Proposed box profit			*£0*

4. Under the current rules the AFM makes a profit of £250. This is regarded as “risk-free” profit because the manager has committed only minimal capital to maintain the box.

5. Under the FCA’s proposals a payment will be made to the fund in respect of the 5,000 matched units, calculated as follows:

   *Payment to fund = 5,000 * (105 – 100) / 100 = £250*

6. In this scenario the fund would receive a performance boost of £250 due to the benefit of matching and so would be able to present a better performance record than an equivalent single-priced fund.

Scenario 2

7. The manager operates with a narrower quoted dealing spread than in scenario 1 on a cancellation basis by dropping the sales price to 101p in order to pass the benefit of matching units to the subscribing investors. The manager commits capital to the box so it will be possible to match 5,000 units and necessary to cancel 5,000 new units, as follows:

	Units	Price	Cashflow
Subscription	5,000	101p	£5,050
Redemption	10,000	100p	-£10,000
Increase in box units	5,000	100p	£5,000
Current box profit			£50
Payment to fund			*-£50*
Proposed box profit			*£0*

8. Under the current rules the AFM makes a profit of £50, considerably smaller than in scenario 1 due to the lower sales price. In this scenario the subscribing investors receive a £200 matching benefit due to the decreased sales price. However, by committing £5,000 of proprietary capital to hold units in the box, the manager has avoided the need to cancel units. In this scenario the manager has placed its own capital at-risk and therefore the profit arising is not risk-free.

9. Under the FCA's proposals a payment will still be made to the fund in respect of the 5,000 matched units, calculated as follows:

   *Payment to fund = 5,000 * (105 – 104) / 100 = £50*

10. In this scenario it is important to note that the manager is not speculating on the future change in the value of units, but is risking its own capital in order to provide service to investors.

Scenario 3

11. The manager operates with the narrower dealing spread setting the sales price at 103p and the redemption price at 102p in order to share the benefit of matching units between the subscribing and redeeming investors.

	Units	Price	Cashflow
Subscription	5,000	103p	£5,150
Redemption	10,000	102p	-£10,200
Units cancelled	5,000	100p	£5,000
Current box loss			-£50
Payment to fund			*-£50*
Proposed box loss			*-£100*

12. Under the current rules the AFM makes a loss of £50 because the combined proceeds from the sale of units (£5,150) and from cancelling units (£5,000) are not sufficient to cover the cost to the AFM of paying redemptions (£10,200). In this scenario the AFM has paid 102p to redeem units but has received proceeds of 101.5p on average per unit to dispose of those units.

13. Under the FCA's proposals a payment will still be made to the fund in respect of the 5,000 matched units, calculated as follows:

    *Payment to fund = 5,000 * (103 – 102) / 100 = £50*

14. This scenario exposes the flaw in the FCA's proposed handbook text. Despite making a box loss the manager would still be obliged to make a payment to the fund. In this scenario it is the size of the spread and the pattern of subscriptions and redemptions that determines whether the AFM will make a profit or a loss. In practice, this pattern is unpredictable so the AFM relies on the ability to offset losses on some days against profits on other days in order to operate this way.

15. Subscribing investors have received a discount of £100, redeeming investors have received a bonus of £200 and the fund has received a performance boost of £50. Overall the AFM has provided a subsidy of £100 at a loss to itself.