THE INVESTMENT ASSOCIATION

DP23/2: Updating and improving the UK regime for asset management

Response from the Investment Association

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £10 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 46% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Executive summary

The IA welcomes the opportunity to provide input into this important and timely Discussion Paper (DP) on updating and improving the UK regime for asset management. Our response is broken into two parts. Part One sets out a holistic view of the regulatory framework which looks beyond what is specifically listed in the DP to identify where change is required and Part Two is focussed on the specific questions raised in the DP.

In Part One we set out an ambition to ensure that the UK investment management industry is a world class, tech-driven sector that combines domestic dynamism with a global footprint to deliver the best possible outcomes for our customers. This requires a regime that aims to fulfil six objectives:

- Stimulate innovation
- Facilitate cross-border business
- Focus on the cost of doing business
- Modernise the regulatory process
- Calibrate risk appropriately
- Target regulation effectively

From these objectives flow a series of wide-ranging action points that include both specific policy changes but also changes to the processes by which regulation is formed and the approach taken. Specific deliverables include, for example, putting in place the foundations for digitalisation and Direct2Fund regime, changes to tax and Financial Services Compensation Scheme, clearer demarcation where firms are primarily undertaking institutional rather than retail business and further action on the advice / guidance boundary. These action points sit alongside workstreams on important areas of regulatory reform currently under discussion in parallel, notably sustainability, disclosure and capital markets.

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We recognise that some of our priorities lie beyond the formal remit of the FCA, but we take a holistic view on the future of the UK as an investment management centre, as a narrow focus will not deliver on the potential within the industry.

Part Two of our response explores the FCA's questions in more detail, building on some of the core competitiveness priorities around innovation and technology. While we support incremental measures to improve practice in a number of areas, we do not agree that all of the issues identified – for example, changes to prospectus requirements – are necessary or relevant for the immediate future.

Part One: A regulatory framework fit for the future

The repeal of EU law post-Brexit and the anticipated passage of the Financial Services and Markets Bill presents an opportune time for industry, policy makers and government to work together to create a regime which works in the best interests of consumers and supports well-functioning markets, while delivering on the expected secondary objective for the FCA of facilitating the international competitiveness of the UK economy.

These changes align with a period of tremendous technological change, which has the potential to be transformative for the investment management and broader financial services industries, both here in the UK and across the globe. The nature of our ambition recognises both the scale of the opportunity and the cost of failing to recognise it. We want to ensure that investment management is a world class, tech-driven sector that combines domestic dynamism with a global footprint to deliver the best possible outcomes for our customers.

In the past, the UK has not always moved boldly to embrace and enable innovation in the investment management sector. Now is the moment to change that, which will also bring benefits for the wider economy as we continue to fulfil the vital function of delivering long-term investment returns by investing productively to support companies, essential infrastructure and wider society.

Delivering this ambition does not rest entirely on changes within the remit of the FCA, but many aspects of regulation and public policy are interrelated. Therefore, although DP 23/2 is focused on matters within the perimeter of FCA regulation, the IA and its members believe it is important to set out a holistic framework and future vision for the industry.

Success rests on six objectives which should guide the approach to policy and regulation:

- **Stimulate innovation**: The regulatory regime must enable and promote innovation in process, products and beyond, reflecting the transformational potential of recent technological advances.
- **Facilitate cross-border business**: Our industry is cross-border in nature and the regime must support firms to continue and expand the cross-border delivery of products and services, whether through delegation or the import and export of products and services.
- **Focus on the cost of doing business**: The cumulative cost of doing business must be proportionate and cannot hinder development of the industry to consumers' detriment nor discourage firms from locating business in the UK.
- **Modernise the regulatory process:** Processes to form and execute on regulation need to enable better and more interactive collaboration with practitioners and other stakeholders. Modernisation should also include a formal process for a thorough examination of existing regulation as the FCA moves towards more outcomes-focused requirements.

- **Calibrate risk appropriately:** The culture and regulatory framework must recognise the benefits of risk and accept that not all risk can and should be eliminated. Attempts to remove all risk can lead to poorer outcomes.
- **Target regulation effectively:** Applying over broad regulation, with insufficient targeting, increases costs and fails to deliver benefits to end-consumers. Regulation must be targeted to where a specific harm is identified. Regulation designed to solve a problem in one sector, should not be applied to all sectors and within the asset management industry, rules should take into account the differences between services provided to retail and institutional clients.

Most of these points, and the challenges in delivering them, are not new. The UK Fund Regime Working Group Report (UKFRWG), explored a fundamental question, which is as relevant now as it was in 2019: how can the UK policy, regulatory and tax regime help to ensure the future competitiveness of the UK fund management sector, from both a domestic and international perspective? Its conclusions set out three pillars as pre-conditions for success: a competitive and modern fund range; an optimised regulatory and tax framework; and a clear framework for support and promotion.

While our vision today draws on many of the foundations laid in the UKFRWG report, there is a greater urgency today. In particular, there is a much stronger impetus to embrace innovation, which will underpin the next phase of the industry's development and enable full digitalisation as the technological transformation of the product, distribution and capital markets infrastructure starts to accelerate.

The industry is facing a regulatory environment that is one of the most challenging seen in recent memory. This is a consequence of a diverse set of factors. First, the sheer volume of significant domestic regulatory activity, resulting both from new initiatives such as Consumer Duty and the Sustainability Disclosure Requirements, and from the establishment of a post-Brexit UK regulatory framework. Second, the complexity of some of these new initiatives, especially given the pace of change in the sector. Third, adaptation to the UK's new relationship with the EU in which seamless cross-border trade with the EU has been replaced by significant near-term frictions. Fourth, a UK domestic retail market characterised by high regulatory costs alongside significant impediments to reaching many customer segments who would be well served by greater exposure to long-term investment.

At the same time, the sustainable investment and stewardship expectations on the industry are evolving, be it increasing client demand for sustainable products, asset owner oversight of sustainability and stewardship activities, the FRC's Stewardship Code, the FCA's SDR proposals or expectations in the FCA's ESG strategy that the industry will use stewardship to transition investee companies to net zero. Capital Markets are also undergoing its own period of change with important discussions and consultations ongoing including on listings, T+1 settlement etc.

One critical element which remains unchanged is the need for a holistic approach to ensure UK competitiveness, including the importance of ensuring the UK can be an attractive fund domicile as the industry product set evolves further. In this regard, while the FCA's DP is welcome, without action in other areas, particularly on tax and other costs, this will be an incomplete exercise. We welcome the conversations taking place with policymakers in parallel to the DP to advance many of these points and would encourage further dialogue between all stakeholders to make progress in creating a world leading framework for investment management.

Changes required to deliver the vision

1. Stimulate innovation

In many areas, the UK is a thought leader in both the regulation and delivery of financial services. The IA shares the government's ambition, as laid out in the Edinburgh Reforms, for the UK to be the world's most innovative and competitive global financial centre. However, the UK regulatory regime must transform quickly if this is to become a reality.

The regulatory regime must both enable and stimulate innovation. While the industry recognises its own responsibilities, ensuring the regulatory foundations are in place to embrace the unprecedented technological change ahead is essential. Collectively, we need to avoid a position of looking back in five years and seeing what should have been done, while other jurisdictions were moving fast to recognise the scale of transformation taking place as a result of digitalisation. This leads us to a particular emphasis on tokenisation of the capital market and fund delivery chain, alongside proposed changes such as the Direct2Funds regime, which will offer incremental improvement on a par with structures available elsewhere in Europe.

We welcome the focus in the DP on innovation and we strongly believe that this needs to be the priority focus of the FCA going forward. There are examples in the past, notably the development of Exchange-Traded Funds, where the UK did not take the opportunity to capitalise on innovation. Other jurisdictions did see these opportunities and moved accordingly to embrace them. We need to learn the lessons, especially in a post-Brexit context.

Although we warmly welcome the willingness of the FCA to consider wide ranging reform to the regulatory framework for asset managers, we would encourage the FCA to target change to areas which will have a meaningful impact on the competitiveness of the industry and the well-being of investors. We have addressed each of the proposals in the DP in Part Two of this submission but we would highlight the following general points:

- We broadly favour keeping the UK UCITS regime and maintaining close alignment to the EU regime.
- We do not believe significant changes are needed to the NURS regime, though this should be rebranded. Consideration might also be given to carving out NURS from the AIFMD requirements in FUND, given the prescriptive retail regime that already applies to NURS.
- Some refreshment is needed in respect of professional funds, including the QIS and wider question of the onshore professional fund regime. However, overall, we do not believe that significant reforms to the AIFMD are necessary or desirable.
- The LTAF has been a very welcome addition to the UK fund range, although the rules permitting retail access subject to restrictions need to be addressed to fully realise its potential.

The issue of the onshore professional fund regime illustrates a critical question for the future of the UK as a fund domicile. There was no intrinsic reason why there should be a division between centres of excellence for portfolio management and centres for fund manufacture, such as Ireland and Luxembourg. The UK historically had opportunities to do both. Now the decision is not about challenging fund domiciles elsewhere in Europe, the UK should continue its strong commercial and regulatory ties. Rather, it's about ensuring the UK embraces innovation and does not miss future opportunities by repeating errors of the past.

This requires a focus on technology and the regulatory and fiscal foundations that underpin a successful fund regime.

Deliverables:

- The foundations must be put in place for digitalisation as a matter of urgency. This will facilitate the emergence of tokenised funds while recognising the wider importance of tokenisation, notably for the efficient functions of capital markets. Here, we see an important role for the technology working group established under the auspices of the Asset Management Task Force.
- Incremental operational enhancement, notably through the Direct2Funds regime, will send a clear message to firms that the UK is serious about modernisation and more effective delivery that will be relevant both to the fund structures of today and tomorrow.
- While significant changes to the established retail fund regime is unnecessary, there is an opportunity to look again at the professional fund regime to ensure we are fully equipped to capitalise on emerging future opportunities.
- By placing a strong emphasis on digitalisation, the shape of future consumer communication will also start to be resolved. This reflects wider changes in consumer behaviour, as digital forms of managing investments are now sought more often than traditional routes, with our research highlighting that 58% of all investors now use a mobile app to help manage their investments. This number rises to 70% of investors for those aged under 35. We do not think the DP questions on the role of the prospectus, and report and accounts, are the right priorities for now. They are solving for a more traditional model of disclosure and engagement.

2. Facilitate cross-border business

Investment management is a global business, and the UK is one of the most international centres in the world, both in terms of the customers and businesses we serve and the assets that we invest in. As at the end of 2021, overseas clients' assets accounted for 46% of £10 trillion total assets under management in the UK, of which £860bn was from the US and £600bn Asia. The majority of this (59%) is managed on behalf of European clients, with the largest markets in Netherlands, Germany and Sweden.

This brings immense benefits to communities across the UK, as the scale and success of the industry contributes directly to the economy. It provides 122,000 jobs and is responsible for £6.1 billion of net exports in 2020, 3.6% of the total. But perhaps most consequentially, it also means that UK investors – whether retail or institutional - have easy access to the world's best products and expertise. This also means UK businesses and infrastructure projects benefit from having global investors, with their capital and expertise, on their doorstep - IA member firms have invested £1.6 trillion in the UK economy through shares, bonds, property and infrastructure.

To enable our industry to thrive in a global market, we need to ensure international regulatory alignment where practical, while putting in place the necessary incremental changes to support domestic and international competitiveness. The UK's international success is partly founded on high standards of regulation which we support. Standards can be high, while also maintaining proportionality and pragmatism. An appropriate balance is crucial to encouraging people from around the world to trust us with their money, and regulation which recognises the role and international nature of investment management lets the industry thrive.

Critically, a successful domestic market and a world leading international industry are complementary, not alternative choices. Prioritising international competitiveness does not – and should not – come at the expense of lower standards of customer protection. Furthermore, the domestic market is strengthened by access to global expertise (and products) to serve UK investors, while also benefitting from the export of domestic innovation built on serving significant institutional, retail and private wealth sectors.

Deliverables:

- The anticipated objective of international competitiveness and growth must be approached by regulators in a way that makes a material difference. We welcome the government's Call for Proposals on Measuring Success and look forward to contributing to this important discussion.
- Clarity should be delivered on the shape of the Overseas Funds Regime as rapidly as possible, with attention paid to the need to avoid requirements that amount to extra-territorial constraints on cross-border business.
- Delegation of portfolio management activities to the UK from other jurisdictions is an essential feature of our market. The FCA should continue to play an active role in international dialogues and maintain close supervisory ties with counterparts in Europe. Divergence which puts at risk the ability to delegate from the EU to the UK must be avoided.

3. Focus on the cost of doing business

There are many factors which contribute to the cost of doing business for investment management. Some of those factors are within the control of the FCA, but many are not. As set out above, it is critical we look at the regime holistically and addressing some areas of high cost for firms, such as the reform of VAT on funds, have the potential of delivering a significant change with a positive benefit for the wider UK economy. The following impediments must be addressed if the UK is going to be globally competitive and continue to support consumers and the wider UK economy.

<u>VAT treatment of fund management</u>

The tax regime plays a central role in future competitiveness of the UK as a home for investment management. The IA has responded at length to the Treasury's consultation on the VAT treatment of fund management, where we see progress as disappointing. The proposed reforms do not meet their stated aim (on which we strongly agree) of making the UK a home for fund domicile, that is, where investment funds are located from a legal, regulatory and tax perspective. Boosting the UK's place as a home for fund domicile has the potential to bring significant economic benefits, including increasing tax revenues and creating high-skilled jobs across the whole UK.

The UK's internationally anomalous VAT treatment, a topic which is not being addressed as part of the Edinburgh Reforms, is a cost which negatively impacts UK competitiveness. Third party research commissioned by the IA suggests that removing such an anomaly has the potential to increase the UK's total annual tax revenue by up to £693 million after a five-year period, due to the additional economic activity it is projected to generate across the UK.

<u>Reform of the FSCS Levy</u>

The FSCS Levy was founded on the sensible principle that firms which pose the biggest risk to consumers should be liable to pay when things go wrong. This has since been abandoned, with the most secure industries picking up the bill for under-capitalised or poorly managed ones. This is most clear for investment management firms. Investment managers now pay nearly 20% of the total levy (£115 million of £625 million), despite the fact that there has never been a single instance of an investment manager or fund failure leading to a call on the FSCS. This acts as a major drag on UK competitiveness in investment management, as well-run international firms see the FSCS Levy as an unjustified cost of doing business in the UK.

The funding arrangements do not take into account investment managers' stable, well capitalised and tightly regulated nature, as funds are required by law to be held by an independent depositary, meaning that unlike banks customer assets would not be touched in the event that an investment manager had financial difficulties. Additionally, the global coverage of the FSCS has resulted in its significant costs to the industry and the potential that investors are able to knowingly take on excessive risk with the potential to reclaim through FSCS.

Although we welcome initiatives to reduce the overall FSCS Levy through measure to reduce claims, a fundamental review of the FSCS funding structure is now needed as the model has become unsustainable. This would act as a major reassurance to firms that government is focused on removing unnecessary costs and making the UK a welcoming place for world-leading businesses. Reform is something the industry and IA has been championing for a number of years. Yet despite widespread regulatory and governmental agreement that change is needed, nothing has been done to reform this economic drag on the UK.

Broader regulatory costs

Over the last decade, the industry has embraced significant change in the interests of driving efficiency, raising standards of governance and oversight, and thereby improving outcomes for our customers across the market. It has become increasingly apparent that the UK retail and institutional markets are some of the most competitive in the world, with retail fund fees in particular falling sharply in the post-RDR period amidst greater diversity of product offering, both active and indexing.

At the same time, the cost of regulatory compliance and implementation has risen steadily. Some of this is inevitable as part of the change process. However, the layering of similar but differing requirements is having an adverse impact on the fund management industry. Cost benefit analysis is a critical process, and we welcome initiatives in the Financial Services and Markets Bill to strengthen these provisions. However, a cost-benefit analysis seen only in the context of a single initiative does not take into account the cumulative layering of costs, which collectively create an unattractive proposition for firms looking to conduct business in the UK. The approach to supervision of a particular initiative can also impact the cost of compliance and must be taken into account.

The Consumer Duty, while clearly a positive development from the perspective of its overall aims, is turning out to be anything but a principles-based transformation. Instead, we are seeing a lack of regulatory clarity on some key issues resulting in complex and increasingly costly bureaucracy.

Similarly, the initial SDR labelling blueprint has illustrated the challenges of an approach that, while widely supported by industry, shows signs of over-engineering in an environment where the regulatory load is already significant. We are encouraged by signs that the FCA will soon take a more pragmatic approach on this dossier to deliver an important innovation for the retail market in a way that will work more effectively.

The industry clearly recognises its continued responsibilities in driving up standards of delivery, particularly in areas which are most challenging, such as customer understanding. Multiple initiatives are in flight to support the direction of travel set by policymakers and regulators. However, we need to find a more cost-effective approach if international investment managers are to be persuaded that the UK remains a 'go-to' destination.

Deliverables:

- The FCA needs to work collaboratively with policy makers and industry to consider the cumulative cost implications for asset management firms of the UK regulatory regime.
- The FSCS and tax regimes need urgent review
- Initiatives to target regulation and remove unnecessary compliance cost should be taken forward though an open dialogue between industry and regulators. Our proposed Investment Management Regulatory Forum (see below) is a key initiative which can help identify areas of regulatory cost which could be eliminated without harm occurring to end customers.

4. Modernise the approach to regulation

The Future Regulatory Framework process, and moving EU rules into a FSMA framework, presents an ideal opportunity to take a more dynamic approach to regulatory creation and execution. Over the past two years, regulatory policy development for investment management has been characterised by four features:

- An unprecedented volume of change, some of which has been inevitable given the wider context of post-Brexit reflection.
- Generally shorter formal consultation cycles and tight deadlines to deliver on regulatory change initiatives
- Some positive developments such as the DLAG framework put in place by the FCA to discuss sustainable investment labels.
- A degree of layering, where new regulation builds on similar but distinct existing requirements, most notably through Consumer Duty. This has been accompanied by scope creep, where retail-oriented regulation impacts businesses who regard themselves as primarily institutional (see below on "targeted regulation").

We see scope for more formal (and permanent) regulatory-industry policy development dialogue to facilitate an open exchange of views outside the formal consultation process and suggest the creation of a permanent dialogue in the forms of an Investment Management Regulatory Forum. This should bring together experts from across the industry and play a key role as we move towards a new framework for regulation. It can enable policy making to break away from the current formal cycle which often surfaces significant issues at a stage in the process when changing direction is difficult or unpalatable.

We must move towards, at pace, an outcomes-focused regulatory architecture. We are currently in a position where Consumer Duty has moved in one direction, while leaving many formal regulatory requirements in place that are prescriptive, including product design, governance and disclosure. There needs to be greater clarity about the long-term direction of travel, which includes removing prescriptive regulation that is no longer required and a clearer differentiation between retail market regulation and the wider institutional market.

Some industry participants have suggested that robust regulatory requirements for asset managers at firm level remove the need for regulatory regimes at product level for new products. The IA is not of the view that significant reforms are immediately necessary or desirable to the structure and regulation of authorised funds. However, looking forward, the suggestion of a fundamentally different approach to firm and product level requirements does merit further consideration by regulators and industry.

This is not just about the substance of policy, regulation and fiscal treatment. It is about the process of working together to establish a common understanding of the opportunities and challenges ahead, and to ensure there is an institutional framework to facilitate focused and technical dialogue on an ongoing basis. Embracing innovation is a cultural change and efforts must be made to embrace change and be willing to take risks to further innovation. Our proposals for a new Industry Regulatory Forum are one example of the need to do things differently and to generate a new energy and sense of shared purpose.

Deliverables:

- We call for the creation of an Investment Management Regulatory Forum to facilitate dialogue between industry and regulators, enable a more collaborative approach to policy formation and deliver a outcomes focused regulatory framework.
- We reiterate our support in principle for a simplification of the FCA rulebooks, although our starting point has been FUND and COLL rather than a wider rationalisation. In terms of simplification, we also suggest looking again at the connection between different aspects of FCA outputs – regulation, guidance, speeches, letters – where it is sometimes challenging for industry to access in one place a clear statement of regulatory expectation.
- We support work to improve the efficiency of the authorisation process, for companies, funds and people. Feedback from member firms consistently suggests significant scope to enhance the business experience in this area, which will help to boost the attractiveness of the UK as a place to establish and operate an investment management business.
- Alongside preparing for tomorrow's opportunities, we are mindful of ensuring that the UK rulebook allows us to ensure that legacy issues are resolved. A decade on from the implementation of the Retail Distribution Review, there is still a need to address cases where clients are currently being underserved, and where firms are restricted in their ability to help them. As previously articulated to the FCA, firms still face barriers in transferring clients into unbundled, lower fee share classes. We should take the opportunity to resolve this.

5. Calibrate risk appropriately

A number of cultural and structural factors are pushing the UK towards a risk-averse framework and this needs to be addressed. Risk is an essential element of investment, and an underpinning of society and the economy. Without exposure to risk, companies would not get the capital they need to grow, and investors would miss out on the opportunity to take advantage of successful growth companies.

At the retail level, taking risk, with the appropriate caveats and protections, is an important part of building an individual's future financial resilience. Times of high inflation are a reminder that volatility is only one source of risk to financial well-being, and one that can be significantly mitigated by investing for the long-term. Our latest research shows that commitment to investing remains solid despite the current geopolitical and economic conditions, with 41% of investors expecting to invest more over the next 5 years. Young investors are particularly ambitious. Our data indicates that those aged under 35 are likely to invest more money, more often, and invest in new products over the course of the next 5 years.

However, with just 8% of the adult population receiving regulated financial advice, 38 million UK adults are not getting formal support with financial decision making. There are still too many obstacles to being able to do this successfully, including the ability of firms to support investors on the journey in areas such as regulated personalised guidance. At an institutional level, there is also an important debate to be had about the approach to risk across the wider ecosystem and the implication for investment into long term assets and illiquid assets.

Deliverables:

- The FCA has recognised the need to increase participation in long-term investment. There is scope to do much more including re-examining the retail journey and ensuring that in the interests of consumer protection, one part of the market (investment funds) is not subject to disproportionate safety barriers.
- One central step forward will be to widen customer access to support, whether through formal advice or regulated personalised guidance. We welcome current steps by policymakers and regulators to make progress in this area, and encourage a balanced view towards risk.

6. Target Regulation effectively

While the UK asset management industry serves an extremely important retail market, its institutional client base both in the UK and overseas is of a much larger scale, accounting for 75-80% of total assets under management in recent years. This needs to be reflected better in the future regulatory architecture.

Although the distinction is not always clear in practice (for example, in the DC market), asset managers who seek to provide services and products for institutional investors are increasingly required to comply with investor protection and disclosure requirements designed for retail investors. This unnecessarily increases the regulatory burden and costs that apply to firms seeking exclusively institutional business without an obvious benefit to consumers. For example:

- Requiring authorised funds that are only offered to institutional investors to produce and provide a Key Investor Information Document, which is of no value to institutional investors.
- For Consumer Duty, requiring firms to consider whether products and services intended exclusively for institutional or professional investors fall into the scope of the Duty e.g. those providing investment management services to Defined Benefit schemes.

Furthermore, the regulation and reporting requirements that apply to asset management companies are another area where over broad application of regulation creates disproportionate complexity and additional cost. Such requirements, notably remuneration rules across multiple pieces of regulation, are derived from those introduced to the banking sector, where the activities of key risk takers can threaten the financial position of their firm, and the wider financial system. Asset management activities do not create the same balance sheet risks, and do not create the same risks of government intervention being needed. Regulation should be proportionate to the risks in asset management. Risk taking is inherent in asset management and remuneration needs to be structured so that there is an appropriate balance of risk/reward.

A broader issue on effective targeting concerns the overlap between the FCA and TPR regulatory regimes in the UK pensions market and the impact on OPS firms. The pension scheme clients of these firms are subject to extensive pensions legislation and oversight by TPR, yet this has not always been recognised in the development of overlapping FCA regulation, resulting in the risk of regulatory duplication, with the associated cost this carries. For example, the FCA's initial proposals for firms on TCFD reporting overlapped with DWP requirements on OPS firms' TPR regulated clients which would have resulted in burdensome and duplicative reporting. While the FCA did subsequently amend the proposals to take account of feedback received, a more tailored approach to the initial policy development would have been helpful.

Deliverables:

- A full review of requirements is required in order to explore the scope for a different demarcation between the requirements applying to products and services intended for distribution to retail markets, and those designed exclusively for institutional and professional markets. A thorough review recognises the complexity of the challenge, given that significant parts of the rulebook derive from EU law.
- The FCA should act decisively on areas which are more straightforward to remedy, for example, the scoping issues under Consumer Duty affecting pure institutional business such as DB pension scheme mandates.

Part Two: Response to DP questions

Q1. Do you think that we should aim to create a common framework of rules for asset managers? What benefits would you see from this? What costs might this create? If you do not think we should do this, are there any areas discussed above where we should consider taking action, even if we do not create a common framework of rules? What would we need to consider around the timing of implementing a change like this?

When the concept of a single rulebook was explored in the UKFRWG Report, one key driver for the original idea was the ability to present a clear and accessible set of regulatory requirements for overseas investors seeking to quickly understand and familiarise themselves with the UK approach to investment funds. In this respect, we continue to think that a rationalisation focused on FUND and COLL could be helpful. We are not persuaded that it should be expanded to include wider investment management activity, as proposed in the DP. We also note that there is not a homogeneous set of asset management firms in the UK eco-system, as illustrated by a specific set of rules for those owned by a parent occupational pension scheme which is also their sole client (OPS firms).

We emphasise that without a regime that is intrinsically appealing in terms of the fund vehicles and tax treatment of those vehicles, a single rulebook would risk being a resource drain on the regulator at a time of high work load.

Q2. Do you think we should change the boundary of the UK UCITS regime? If so, do you think we should take any of the three approaches set out here? Should we consider any alternative approaches? What timeframe would be needed to allow firms to change their existing product offering or to develop new products?

The UCITS brand has become a leading brand for retail fund structures and is recognised worldwide as providing a strong investor protection framework. The UK played a leading role in the formation of the UCITS regime, and although no longer part of the EU and not able to market funds within the EU, the UK UCITS remains a valuable and recognised brand within the UK, and UK UCITS are still marketed in jurisdictions outside of the EU, such as Hong Kong. As such, the IA is of the view that the UK UCITS brand should be retained and should remain closely aligned with the EU regime. This will also have the advantage of UK investors understanding that UK UCITS are comparable to UCITS marketed into the UK from the EU.

Overall, the NURS is a strong framework that provides additional investment powers relative to the UCITS while retaining a strong investor protection regime similar to the UCITS. This is particularly welcomed by managers wanting to provide property, diversified funds, multi-asset and fund of funds. However, the "NURS" branding is unattractive – the regime is defined by what it isn't rather than what it is. As such, the NURS regime has never gained any attraction outside of the UK. It is therefore essential that the NURS is rebranded.

In its 2019 UK Fund Regime Report, the IA suggested that UCITS+ could be considered as a branding concept for the NURS. It is important to note this was suggested as a branding concept rather than a brand – the purpose being to reframe how the NURS is considered. We do not necessarily think that UCITS+ is the right brand – this could create confusion in fund and intermediary markets. The IA proposes that a collective group of fund industry and marketing/branding experts be formed to consider an appropriate rebrand for the structure.

The IA is not aware of any significant demand for a "basic fund" regime as described in the DP. We strongly agree with the FCA observation that previous initiatives to create simple products have struggled to be effective. This has partly been because, unlike a basic bank account or core insurance product, there is a lack of clarity about what simple should mean in the investment context. Is it a certain form of investor experience (e.g. a smoothed return avoiding volatility) or a focus on investment outcome (e.g. maximising long-term gain, accepting short-term volatility)?

Certainly, if established, this does not need to be a separate regime – the proposed fund could be established as a label within the existing UK UCITS or the NURS framework. Indeed, the UCITS regime has long been recognised as the gold standard framework for simple retail funds. A separate regime might be confusing, and could result in higher risks for investors – e.g. if a basic fund is unable to utilise currency hedging, this will expose investors to currency risk. A basic fund label is only likely to have value if it is accompanied by an advice/guidance and financial promotions regime with lower requirements than for other products, though the appetite for such a label amongst the industry has not been tested.

Finally, adoption of the QIS has been limited, and overall this is seen as less attractive than competing regimes such as the Irish QIAIF. Feedback from members suggests it is not as a result of the branding, but some aspects of the product itself that is the issue. Specifically, some of the investment powers are more limited than the QIAIF, particularly its ability to originate loans and invest in private credit. Also, and probably more significantly, the perception of the industry is that it is treated as a quasi-retail product, particularly at the authorisation stage. This results not only in significantly longer authorisation timescales, but also a much more intensive authorisation process, with a degree of questioning and scrutiny that AFMs would associate more with a retail product. Overall, this increases the cost of getting the product to market, and along with the more restrictive investment regime, makes this less attractive. The IA recommends that a proper review of the QIS regime be considered.

Q3. Do you think we should work with the Treasury to amend the threshold at which AIFMs must apply the full-scope rules? If so, do you have any comments on the options described above? Are there any other areas we would need to consider if we were to do this?

Overall, the IA does not believe that significant changes are needed to the rules on AIFMD, and we generally regard it as being in the interests of the UK asset management industry and investors to remain closely aligned with the EU AIFMD and international standards. We recognise that HM Government and the FCA will want to make some technical changes to the threshold limits, (e.g. so that they are specified in sterling rather than euro). There may also be a case for considering whether exemptions can capture some AIFMs whose aggregate AUM is above the threshold, but individual AIF AUM are significantly below threshold and whose activities are relatively low risk (e.g. they do not employ leverage). But overall, we do not believe material changes to the regime are necessary, and it is important that there is no perceived weakening of regulatory standards in the UK AIFM regime.

At a general level, we do not think that the AIFM discussion in the DP captures the wholesale / professional dimension of what is missing from the UK fund regime. Again, without seeking to automatically replicate the views expressed in UKFRWG 2019[1], the industry view has been that when seeking to compare opportunities to domicile funds in the UK with those, for example, that exist in Ireland or Luxembourg, one critical problem for the UK has been the weakness of the offer in the area of unauthorised, professional funds. There are also issues with respect to the QIS, which have led historically to firms preferring other jurisdictions to serve UK customers who otherwise would have been keen to use a UK-authorised fund vehicle.

Our views specifically on AIFMs therefore should be seen in the light of these general points, noting that this is a conversation that requires Government action to remedy rather than sitting in the legal and regulatory reach of the FCA.

Q4. Are there aspects of the current AIFM regime that professional investors do not value? Would there be benefit in us removing any of these?

While the AIFMD was challenging and very costly to implement, overall the industry has adapted well to the AIFMD regime. The final compromise of the original AIFMD text achieved an appropriate balance between enhancing investor protection and improving oversight of financial stability risks while avoiding overly burdensome requirements. As such, we do not feel that significant revisions are needed to the AIFMD.

We remain cautious on proposals for a two or multi-tiered framework for AIFs. While this approach has been adopted in some domiciles such as the Channel Islands, these are largely exporters of funds and unlike the UK do not have a sizeable investment market. A two-tiered framework would make for a significantly more complex compliance regime for UK asset managers, but even more so for UK investors, who would have to investigate which tier each product was being managed under. Most significantly, this could impact on how the robustness of the UK regulatory regime is perceived to be.

Calls for either elements of the AIFMD to be abolished, or for a two-tier system to be applied, have at their heart a perception that parts of the AIFMD introduce investor

[1] https://www.theia.org/sites/default/files/2020-04/20200330-ukfrwgfinalreport.pdf

protections that are not required, such as the depositary requirement. This is not a position the IA shares. Depositaries play a critical role in ensuring AIF assets are genuinely segregated from those of the manager, either through holding these assets themselves or ensuring that they are properly registered on behalf of the AIF, independently monitoring key activities of the manager such as its compliance with investment policies and valuations, and importantly, the daily cash flow movements in and out of the fund, ensuring these are properly accounted for. This independent daily oversight, in particular of cash flows, was absent in the Madoff scandal, which sadly impacted many professional investors as well as individuals.

There are some areas that would benefit from amendment or clarification. For example, we recommend that the unlimited liability on external valuers for negligence be reconsidered. This requirement has largely resulted in firms refusing to act as external valuers for AIFs, particularly in real estate, resulting in additional layers in the valuation process that are not beneficial for certain AIFs. We are therefore supportive of the position of the Association of Real Estate Funds (AREF) that this requirement be revised. As mentioned previously, the remuneration regulation and reporting requirements for UCITS management companies and AIFMs are derived from banking sector requirements which are ill-suited to the business models of management companies and should be revisited.

Q5. Do you think that we should amend our fund rules or add guidance either to make clearer the requirements on portfolio managers of funds, or to set minimum contractual requirements between host AFMs and portfolio managers? Do you think this would lead to any other consequences that we need to consider?

We would encourage a reframing of terminology here to use the term independent AFM. Overall, we do not believe specific rules are needed for independent (host) AFM arrangements, such as minimum contractual requirements – the COLL rules already provide for a strong governance and risk management regime, which in recent years have been strengthened by the requirement to have at least two independent directors on the AFM board and to perform an assessment of value. It is notable, for example, that the events that led up to the suspension of the Woodford fund in July 2019 occurred prior to the requirement to appoint independent directors to the AFM board. Overall, these requirements have strengthened the position of the AFM relative to the portfolio manager, not just in the case of independent AFMs, but also internal AFM arrangements.

It is important that the role and responsibilities of AFMs are properly understood by portfolio managers – historically, the AFM was at times perceived as an operational entity by portfolio managers, providing a support function, rather than the entity with regulatory responsibility for the fund. While the governance changes introduced in PS18/8 have significantly changed this perception, some additional guidance by the FCA may be beneficial in further emphasising the role of AFMs.

Q6. Do you have any comments on us potentially amending the rules and guidance around liquidity stress testing?

In response to observations made by the UK Financial Policy Committee, drawing on insights from both the Bank of England and FCA, the IA has consistently been supportive of further exploration of the three principles set out in 2019. These concern liquidity measurement, pricing mechanisms and use of notice periods. While our view continues to be that on liquidity stress testing and pricing, it is guidance rather than new rules which would be most helpful, we recognise both the need for more consistency of approach and the opportunity for regulators to set out a more precise set of expectations. We encourage the FCA to continue its approach of aligning stress testing requirements with international standards - the IA has consistently advised its members to follow the ESMA Guidelines on Liquidity Stress Testing, and understands these have been widely adopted, so welcomes the FCA's explicit endorsement of these guidelines in the DP.

Q7. Do you have any comments on whether we should make our rules on liquidity management and anti-dilution clearer?

Regarding anti-dilution mechanisms, we conducted an in-depth analysis of following the Bank of England and FCA joint review of liquidity practices and published our findings in October 2022.[2] We concluded that swing pricing and other anti-dilution mechanisms are effective investor protection tools that work well in normal conditions. We recognise that the onset of the global pandemic in March 2020 highlighted different practices and responses to extreme stress conditions and areas where operations could be enhanced. We made recommendations aimed at ensuring these mechanisms are sufficiently responsive to changing market conditions.

Nevertheless, it is important to recognise that the appropriate application of an anti-dilution mechanism will depend on a number of factors in a particular circumstance and the significance of each factor may be quite different for different firms or funds. Therefore, it is essential that rules facilitate a range of approaches for securing the best outcomes for investors without being prescriptive about the mechanics so as to stifle the ability to act according to the particular circumstances at hand. In this respect, the IA would recommend that any clarifications focus on the design of the mechanisms rather than their application.

Q8. Do you have any comments on the benefits or costs associated with public disclosure of fund liquidity?

To the extent that the current regulation of investment funds sets a robust architecture for the maintenance of liquidity in normal conditions, and provides tools for managing through exceptional conditions, we would wish to see a clear analysis of how the potential benefits associated with further public disclosure of liquidity outweigh what could be significant risks. We support providing investors with clear information about the nature of the portfolio in which they are invested. However, in an environment of more concentrated fund buying/selling, and faster information exchange through tools such as social media, it is easy to see how poorly-designed disclosure could have the reverse effect of that intended, and instead reinforce run risk.

A critical pre-requisite of public disclosure of fund liquidity is therefore identifying a liquidity classification framework that is appropriate to the structure of open-ended funds and gives an accurate picture of fund liquidity. If not, there is a risk that fund investors are given an inaccurate picture of the liquidity of their assets, which then risks incentivising behaviours that are detrimental to fund investors both individually and collectively.

Assessments of open-ended funds' liquidity positions should reflect how redemptions are managed in practice, and recognise that liquidity of individual securities is relative to trade

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[2] Investment Association (2020). *Enhancing Fund Pricing*.

size and market capacity – which will vary over time. A liquidity profile based on static ex-ante classifications of individuals securities in the portfolio will not be appropriate.

The way fund liquidity is measured and classified is currently subject to ongoing discussions at FSB/IOSCO level. We encourage ongoing participation by the UK in those discussions and international consistency as far as is possible in the application of recommendations and guidance.

Q9. Do you have any comments on us making our expectations on investment due diligence clearer for all asset managers?

It is not clear to us that further rules are needed in this area, and prescriptive rules on due diligence could be counterproductive. The identification of supervisory failings in some firms does not necessarily mean that the rules themselves are inadequate, rather that standards in some firms need to be raised.

Investment due diligence is a key activity of active asset management, and quality of research and due diligence can be an important differentiator in terms of the standard of the investment process. It is inevitable that some investment teams will identify issues with certain investments that others will not, and that managers may make different judgements on the information identified. While adherence to minimum standards of due diligence is to be expected (and is already required), we would expect there to continue to be differences in the approach to investment decision making between managers.

Q10. Do you agree that we should make our expectations of depositaries clearer? Do you have any comments on the areas where greater clarification would be desirable? Are there any areas where we should consider removing oversight functions from depositaries? Are there areas where the contribution of depositaries is particularly valuable for the interests of investors?

It is our view that the respective roles and responsibilities of AFMs and depositaries, and the boundaries of their respective responsibilities, are already appropriately set out in the Handbook and are properly understood. Other than safekeeping, the responsibility of the depositary in respect of most activities is one of oversight. This can involve the monitoring of hard limits (e.g. investment restrictions, timing of submission of unit creation and cancellation notifications), but in other cases this oversight duty involves making sure the AFM has and is applying the appropriate procedures, processes and controls. In particular, while the depositary may wish to understand how the manager has reached certain judgements, such as in prudent spread of risk and portfolio liquidity, these are professional judgements on which a range of reasonable views is possible – oversight and accountability of these judgements sits more appropriately within the AFM, particularly the Board. We do not believe that it should be considered the depositary's role to make and enforce its own judgements in areas that affect portfolio management, where these do not relate to prescribed investment restrictions.

Q11. Do you have comments on the analysis of the eligible assets rules for UCITS set out here? Do you think we should update or provide guidance on these rules? If we did so, what impact would this have for managers of UCITS funds?

Overall, we do not consider the rules around what is permissible in the 10% unapproved transferable securities limit for UCITS funds to be overly complex or requiring any changes.

In our experience, the majority of AFMs understand the interaction between the investment rules in COLL 5.2 and the risk management rules in COLL 6.12. Where there are exceptions, it is our view that these can be addressed through supervision.

Q12. Do you have any comments on whether we should consider removing or modifying detailed or prescriptive requirements in the rules on prudent spread of risk?

The IA does not consider that the approach to spread rules in COLL 5.2 and COLL 5.6 (for UCITS and NURS respectively) should be fundamentally changed at the present time. For the LTAF, which was designed to invest in a wide range of private market assets, an approach with prescriptive spread requirement would have been much more problematic given the difficulties of rebalancing. For UCITS and NURS that invest in public markets, transferable securities and other readily realisable retail funds, we do not consider that the same challenge exists. The prescribed limits are understood by investors and give them confidence. These are also easier for risk and compliance, and depositaries, to monitor.

Q13. Are there any other areas where you think we should consider removing or modifying prescriptive requirements in the retail fund rules?

Consideration could be given to carving out NURS from the AIFMD regime. The aim of the AIFMD was to capture managers of unauthorised alternative investment funds offered to professional investors, subject to light regulatory regimes, in order to mitigate financial stability and investor protection risks that arose from activities associated with these unauthorised funds. The NURS was already a tightly regulated retail fund regime, and fell into the AIFMD through the latter's broad definitions rather than by design. The effect is that NURS are subject to two distinct regulatory regimes, resulting in heavy duplication and misalignment of requirements, creating additional and unnecessary complexity for managers of NURS. Carving out NURS from the AIFMD may be an alternative approach to achieve much of the desired simplification of UK fund regulation without the more costly and work intensive approach required to merge the COLL and FUND into a single sourcebook.

In addition, we suggest that some requirements related to efficient portfolio management (EPM), including securities lending, should be revisited, particularly regarding the receipt and reposting of collateral.

<u>Securities Lending</u>: Securities lending can be used by managers of UCITS, where they deem it appropriate, under their EPM strategies to generate additional income from the assets held. These can increase the income returns for end investors and/or offset the impact of management fees deducted from the fund for relatively low risk, given the transactions are collateralised. COLL 5.4.6R(1) states that collateral for a securities lending arrangement must be received under a title transfer arrangement. This prevents UCITS from being able to enter into securities lending arrangements where collateral is provided by giving the lender a securities interest ("pledge) rather than transferring title to the assets to the lender. This limitation reduces the potential transactions that a UCITS can enter into and the lending terms they can get from borrowers, putting them at a competitive disadvantage in the market vis-à-vis other securities lenders. This disadvantage may be further exacerbated in the future by forthcoming changes to capital rules by bank borrowers, which could result in borrowing from UCITS becoming prohibitively expensive.

We suggest that the FCA amend COLL 5.4.6R (1) to allow UCITS to receive collateral for securities lending transactions in the form of a pledge, rather than only by way of title transfer. This will increase the transactions available to UCITS managers, enabling investors to benefit from increased revenue. We are not of the view this would increase the risk to UCITS, since security interest collateral arrangements have been structured such that collateral is sufficiently immediate for the purposes of COLL 5.4.6R (2) and can be appropriated and liquidated quickly in the event of a default by a borrower[3].

ESMA Guidelines on ETFs and Other UCITS Issues: on the management of collateral create unnecessary impediments to fund management activities and could be revisited. Paragraph 43e) requires that any collateral received be “sufficiently diversified” and consist of at least six different issues. This level of diversification is not necessary for collateral – the collateral is only being held temporarily by the fund for the purposes of protecting the fund from counterparty risk, it is not part of the investment exposure of the fund. The requirement to receive collateral this way limits the ability of UCITS to use the most competitive counterparties. Paragraph 43 j), which limits the use of cash collateral, prevents the use of repurchase agreements by UCITS to transform assets to cash to meet margin calls. This results in UCITS having to hold greater levels of cash to ensure they can meet unexpected collateral calls. It is not clear that these requirements offer any meaningful investor protection benefits, and we suggest that the FCA consider whether these are necessary.

Q14. Do respondents agree that we should work towards consulting on rules to implement the ‘Direct2Fund’ model?

The Direct2Fund model offers an opportunity for operational simplification that will facilitate more efficient fund manager delivery, providing an optional approach that mirrors what is available in other parts of the European fund market. Many of our members have indicated that they would like to utilise this alternative model.

On the matter of investor protections, our letter of August 2022 set out our analysis of the relevant areas impacted. In our view, investor protection is, at worst, no different overall than that applicable to the current model and is certainly an improvement from the perspective of removing the client money risk to investors upon the insolvency of the AFM.

We encourage the FCA to move ahead with a consultation that incrementally will make a significant difference in demonstrating that the UK is a modernising, forward-looking jurisdiction. To that end we are sending separately our assessment of the areas of existing regulation impacted by the proposals and where new rules may be required. This assessment was produced by seven law firms and supported by a number of our members.

Q15. What benefits would tokenised units in authorised funds provide for investors? What regulatory changes would be needed to enable tokenised units to be issued? How much of a priority should we put on enabling tokenisation of units?

In considering this issue, we make a fundamental distinction between the ongoing controversy surrounding crypto currencies and the digital delivery infrastructure that could transform the modern investment fund as well as the capital markets in which it invests.

[3] See https://www.islaemea.org/gmsla-security-interest/ for details of the Securities Interest (“Pledge”) Global Master Securities Lending Agreement (GMSLA) developed by ISLA.

The immediate benefits for consumers are realised via a reduction in the costs of administering the fund by automating or simplifying many of the back-office functions, and providing visibility and associated efficiencies to other parties involved in servicing the fund. Network effects include federated AML/KYC checks with firms sharing responsibility for assessing investor's credentials, possibly using a Digital ID. However, the benefits will also be seen in the ability to inter-operate effectively with an increasingly digitalised capital markets infrastructure.

Policymakers should work at pace to establish a framework for tokenised funds to operate in the UK to ensure UK consumers receive the same benefits that investors in the US, Luxembourg, Singapore, Germany, France and South Africa currently enjoy.

Firms have been considering the use of tokenisation for investment funds for some time now, and extensive analysis and preparatory work has been completed. This is no longer a new concept, and as it is already being deployed in other fund domiciles. The time has come for the FCA to enable firms to utilise it in the UK. The risk of waiting too long to address residual doubts about the speed of change, the scale of efficiencies that may be delivered, or the exact shape of the future infrastructure, vastly outweighs the efforts required now to ensure that the foundations are put in place. As such, this ranks as a high priority for FCA engagement and action in the near term.

There are a range of options in this regard, as tokenisation can be seen as a spectrum. Industry appears to have settled for now on using private, permissioned networks over public chains, but this is not a view universally shared. Equally, there is optionality for whether to utilise chains for all elements of fund servicing, or to simply use it for transactions while leaving settlement off-chain. In some jurisdictions, an off-chain unitholder register still operates as the legal register. It is our view that the full benefits will not be realised until full-service models are available that can reduce existing overheads, including the introduction of interoperability across chains and in shared token standards. Nevertheless, there is an increasing risk that the UK is left behind while not utilising even the more basic elements of fund tokenisation.

Regulatory change requirements

Analysis of the existing FCA COLL Handbook, which governs collective investment schemes, identifies a small number of areas which should be considered. These relate mainly to the decentralised nature of the future infrastructure and the inability of the fund entity to unilaterally make changes to the register.[4] Under the DLT consensus mechanism, transactions are generally validated by both parties (the fund and the investor) before they are finalised, something that was not envisaged when the rules were written. We do not consider that tokenised funds would inherently be non-compliant with these rules, and that firms will have alternative options for dealing with such scenarios – as is the case in other jurisdictions and in non-fund shareholder registers. If thought necessary though, COLL could be adjusted for clarity, or alternatively the FCA may consider making an umbrella statement to provide a clear message to industry, in a similar way to the CSSF.[5]

[4] COLL, in particular sections 6.4 (register of holders) and 6.2.16 (sale and redemption) do not seem to conflict with a tokenisation model in which these functions would no longer be fully under the control of a centralised entity. However mandatory transactions such as redemptions, as described in COLL 4.2.5.5 (d), may need to be handled differently.

[5] Commission de Surveillance du Secteur Financier: *FAQ - Authorisation and organisation of entities acting as UCI administrator* *(Q1.2)* June 2022

Aside from these specifics, we would envisage that disclosures would need to be made in scheme documentation for describing the characteristics of the register and the mechanics behind it, as well as any associated risks such as network security and those arising from a reliance on stablecoin or CBDC (if settlement is to take place on-chain).

The use of the terminology 'token' may necessitate some technical changes to regulation, such as where existing rules refer to 'units'. This could be most easily dealt with in the definitions.

Finally, but not insignificantly, the UK Cryptoassets AML/CTF regime covers the issuing and safekeeping of 'cryptoassets' to investors and this captures fund tokens within its scope. Whether or not this was the original intention of the legislation, we would argue that highly regulated investment firms operating permissioned private networks open only to investors who are AML/KYC-checked, and utilising well-established procedures should not be caught by this requirement. Aside from the practical challenge of obtaining authorisation for a new regulated permission, further regulatory oversight for an existing activity seems overly burdensome and unattractive relative to peers in other fund domiciles. It would be helpful if the FCA could at least implement a fast-track process for existing regulated firms/AFMs that can be managed separately from crypto firms from outside the regulatory perimeter.

Q16. Are there specific rules that could impact firms' ability to invest in tokenised assets, where the underlying instrument is itself an eligible asset? How much of a priority should we put on enabling investment in tokenised assets?

There have been multiple recent examples of tokenisation in the bond market, and we see that this will extend into other asset classes in the near term. Investment firms are keen to use tokenisation for traditional assets in order to realise efficiency and operational benefits, and in some cases, to provide greater access to illiquid or high-minimum asset classes, such as private assets.

To facilitate this, regulatory clarity would therefore be appreciated in both the legitimacy of this as an investment approach and the ability of regulated fund structures to hold them. Other enablers are outside the FCA's remit and include the legal status of digital asset property ownership (as recently bolstered by the LawTechUK statement, and separate work being progressed by the Law Commission), the ability of service providers such as custodians to hold such assets, and of the availability of an on-chain UK central bank digital currency or similar digital cash provision.

These moving parts mean that FCA action in isolation is not critical, assuming that the body of work required will be limited to clarification statements on eligibility rather than wholesale change to rules.

In time, it may be appropriate for a small allocation to be permitted to currently ineligible assets within a regulated investment fund as part of a well-diversified portfolio. This could provide a solution to the concerns of regulators for consumers to avoid being over-exposed to asset classes such as cryptoassets, in managing the exposure at a low proportion of the overall portfolio. As the DeFi and CeFi worlds become more interconnected this will become a more relevant consideration.

Q17. How important do you think the different kinds of 'fund tokenisation' discussed above are for the future of the industry? Are there examples from other jurisdictions that could be models for UK fund regulation?

Tokenisation as part of a wider digitalisation of the capital markets is, over time, highly likely to transform fund delivery. The future is unquestioningly digital and should the UK not embrace fund tokenisation there will be a question over the future viability of investment funds as a mechanism to cater for consumer needs in a digital economy.

There are other jurisdictions that are active in this space. However, we are not yet in a position to recommend following the approach offered by other jurisdictions. In Germany, recent legislative interventions enable tokenised assets to be held within tokenised investment funds. As per our answer to previous questions, other major world fund domiciles have or are acting in this area.

Q18. What other regulatory changes, if any, would you like to see to enable fund managers to make wider use of advances in technology without weakening investor protection?

As put forward in our recent response[6] to the disclosure discussion paper, the time has come to move away from prescriptive regulations based on paper-based or near-paper (PDF) towards a form of disclosure and wider communication that reflects the media by which increasing numbers of investors now expect to receive information. Subject to a number of guardrails, based in particular on a prescribed approach to some key data points (e.g. consistent approach to calculation of charges), firms should be able to communicate in the way they see fit for a customer rather than a specific durable medium.

None of this implies weakening investor protection, quite the contrary. Given the low level of customer engagement with prescribed documentation, including both the UCITS KIID and PRIIP KID, technology offers a way to rehabilitate disclosure and facilitate engaging, effective communication techniques.

Looking beyond conventional approaches to disclosure, there is also potential offered by harnessing more advanced technologies. As put forward in our recent response[7] to the joint discussion paper on AI & ML, the supervisory authorities should prioritise areas in which there are benefits for consumers and in increasing the relative competitiveness of the UK. Any future regulatory approach should be proportionate to the level of risk associated with the way in which these technologies are utilised and governed. Focusing on the proper allocation of oversight responsibility through the Statements of Responsibility for particular SMFs is preferable to either creating a dedicated SMF role for AI or making AI a prescribed responsibility.

Q19. Do you agree that improving the content and readability of the prospectus will improve investor engagement? What specific changes would you like to see?

Linked to our answer to Q18, we do not agree and are not yet persuaded that the prospectus is ever likely to be a key document in improving investor engagement. This does not rule out enhancements to the fund prospectus, but such enhancements should

[6] Investment Association: *Response to DP22/6 Future Disclosure Framework* March 2023
[7] Investment Association: *Response to DP22/4: Artificial Intelligence and Machine Learning* February 2023

be framed with respect to the critical role of the prospectus as a core legal and regulatory document for the scheme. Instead, we need to focus on a more engaging approach to fund communication more broadly that provides key information for investors in a simpler and clearer way than traditional approaches have done.

Q20. What changes to the rules for managers' reports and accounts could enable firms to make best use of technology to meet investors' information needs? How else could disclosure of ongoing information to fund investors be improved? For example would there be benefit in us consolidating ongoing annual disclosure reports for funds?

Given the way in which investors engage with all forms of communication is rapidly evolving, particularly towards greater use of mobile devices as a key way to interact with a wider range of financial services, it is difficult to see how the report and accounts in their current format can have a place at the forefront of investor engagement. Instead, there may be a strong case for moving in the opposite direction and recognising the formal accounting and governance role of the audited accounts as distinct from the various other reports and disclosures (for example, assessment of value reports, TCFD reports, remuneration disclosures, disclosures about securities financing transactions and collateral disclosures) that have been added to the annual report. This could leave managers free to develop other means to communicate more effectively with investors on specific topics. For example, investor research suggests that where there is both text and graphics/tables available, investors may look at graphics/tables first before even looking at text. There should be no assumption that they will respond to formal written documentation given a non-linear approach to consumption of information.

The shift from a paper-based generation to a digital one brings benefits in terms of producing and distributing content, but since the manager's report rules were written a generation ago, product complexity and additional regulatory requirements have caused the reports and accounts document to expand from pamphlet to encyclopaedia in terms of volume. Setting expectations about more timely delivery needs to take account of the trade-off between speed and complexity. Nevertheless, we think there is room for better demarcation between the roles of different aspects of the reports and accounts and introducing flexibility in the rules to decouple unrelated reports, eliminate duplicative disclosures, and improve the cohesion between regulatory requirements and accounting standards is worth exploring further.

Regarding the portfolio statement, we are not aware of an unmet investor need that more frequent publication would satisfy.

Q21. Do you agree we should review the rules for unitholder meetings? What changes should we make so that these meetings maximise the participation of fund investors?

There may be merit in reviewing these rules as the highly intermediated nature of the ownership process is not necessarily conducive to strong participation. A greater accommodation of virtual formats for unitholder meetings could be extremely helpful in this context.

Q22. How could the relationships between fund manager, intermediary and investor be better reflected in rules for authorised funds? Should the FCA do more to enable investors to engage with the manager of their fund?

The fund management industry recognises that there are limitations that come with the traditional intermediated relationship between fund managers and retail customers. Some members recall this issue being raised as part of CP 10/29 where there was consideration of a specific rule being introduced in COBS 14 to require intermediaries to pass information up and down the securities chain. With the renewed focus on the role of intermediaries and the access that manufacturers have to their end clients as part of the Consumer Duty, it is a pertinent time to re-examine this issue, however, it is not clear that more rules are the answer. Instead, fund managers should be allowed to develop their own strategies for customer insight and engagement, as appropriate to their own distribution approach. One area that remains a significant challenge here is the 'feedback loop' between distributor and manufacturer, and we are optimistic that progress can be made through the Consumer Duty process.

<u>Stewardship and engagement</u>
We note the specific reference in Q22 to stewardship. Increasingly there are expectations on asset managers (for example, under Principle 6 of the Stewardship Code) to set out how they proactively take account of the views of their clients when discharging their stewardship objectives. Incorporating these views is critical to improving stewardship outcomes. As set out in the IA's joint report with the Pensions and Lifetime Savings Association (PLSA) - Investment Relationships for Sustainable Value Creation, we set out the importance of stewardship as a defining feature of the relationship between asset owners and investment managers, and that understanding and incorporating client views on stewardship should be a key focus for manager selection, contractual arrangements and execution of those rights and ongoing oversight and performance assessments. Through this report, we did not identify any regulatory barriers that needed to be addressed.

There is a growing debate around how stewardship should be conducted on behalf of clients, which has largely focused on institutional clients. This ranges from directed voting in pooled funds, clients providing asset managers with an Expression of Wish[8] and we are also seeing the development of products and services (including from member firms) to facilitate voting choice or pass through voting.[9] Alternatively, there are service providers that are offering a range of services to asset managers to allow asset managers to understand the views of their clients. Clients, in turn, are more likely to select managers based on the alignment of the manager's service offering with their requirements.

While our members have not encountered any barriers to providing these services, so far, we have perceived limited demand and appetite for these products and services. This may partly reflect wider challenges around financial literacy and familiarity with processes that are not necessarily straightforward. With better knowledge and understanding, engagement with investors would be more meaningful.

The market is developing relatively quickly, with some concepts such as expression of wish and voting choice only being introduced to the market in the last year to eighteen months. The IA and our members have not identified any specific regulatory barriers and the market should be allowed to develop further with individual asset managers, clients and

[8] The Occupational Pensions Stewardship Council note that while this is not a formal requirement to be written into contracts, it is a form of communication, similar to sharing a policy or client preference, which clients would expect asset managers to consider. This will help to ensure more open and honest communication between asset managers and asset owners on voting decisions.
[9] Pass through voting enables an investor in a pooled fund to vote their shares in proportion to the AUM they have invested- with voting rights remaining in the fund.

service providers developing products and expectations. If the regulator identified a specific approach, this could stifle this innovation and create a lack of flexibility by putting the focus on one single approach. This could lead to unnecessary cost and administrative burden- particularly where there is a lack of demand from clients. In our joint report with the PLSA, we set out measures to enhance the client voice, but were non- prescriptive in suggesting how to best achieve this. Ultimately asset managers and asset owners need to implement solutions that work best for them, fully cognisant of the strengths and weaknesses of the approaches taken. As such, the IA considers it too early for the regulator to require or promote a specific approach.

Q23. Do you have any comments on the relative benefits of the topics raised in this paper which you think we should consider as part of prioritising our work? How would you rank the areas covered in this paper in terms of priority? (The response form for this question provides a tool for ranking the 10 major topics set out in Table 1 on p.14)

In a broad sense, the objectives outlined in Part One guide our prioritisation. More generally:

- As an industry, we are increasingly clear that the transformative role of technology that is already becoming apparent, should sit at the heart of the FCA's agenda, alongside enhancements that will drive efficiency of delivery, notably the D2F regime.
- At the same time, unless the regulatory and fiscal environment are in the right place today, the UK as a jurisdiction will look much less attractive. This therefore requires a number of changes, some of which are outside the control of the FCA, especially with respect to tax. We reiterate therefore the need for a joined-up policymaker and regulatory approach to UK fund competitiveness.
- We do not regard a number of more BAU items raised in this DP as essential for the future of the UK industry. Given the scale of recent change, we would instead encourage the FCA to be far more selective in its approach.

Q24. Do you have any comments on potential reform of the UK regulatory regime for asset managers and funds in areas that are in scope of this paper but have not been discussed in detail?

As discussed above in Part One, we see a number of areas that may not be directly in scope narrowly for the FCA, but are absolutely in scope for the question of the broader UK asset management and fund regime.

One further area for consideration, not otherwise covered in this submission, is that we believe there should be further review of IFPR thresholds. For a substantial number of member firms, IFPR requires a distinction between whether they are a Small and non-Interconnected (SNI) or non SNI firm Large non-SNI firms (broadly, those with on-balance sheet assets and off-balance sheet items of more than £300 million over the preceding four-year period). Depending on which category a firm falls under the requirements will be vastly different e.g. a non-SNI will be required to establish risk and remuneration committees; comply with pay-out process rules; and provide information on the structure and amount of remuneration awarded to their highest three earners. With inflation having been high over the last 18 months, the threshold risks pulling in a higher number of firms than initially envisaged or believe was the intention of the FCA when it drafted these rules. Some members therefore propose reviewing the £300m threshold to reflect inflation.