FCA ASSET MANAGEMENT MARKET STUDY 2017

FINAL REPORT

Introduction

In November 2015, the Financial Conduct Authority ("FCA") launched its asset management market study. In November 2016, the FCA published an interim report which provided industry participants with an opportunity to comment on proposals which it made.

On 28 June 2017, the FCA published its final report along with a consultation paper on remedies. The final report incorporated the feedback which the FCA received in 153 written responses and discussions with close to 200 stakeholders. The final report confirms the findings of the interim report. The focus of the study is on the UK asset management industry and asset managers regulated by the FCA but it will also have an impact on Irish domiciled funds. The proposed remedies will impact both UK and non-UK asset managers selling Irish domiciled funds into the UK. A summary of the key findings of the study and the proposed remedies which will impact Irish domiciled funds are outlined below.

Key Final Findings

Lack of Price competition

- Weak price competition in a number of areas of the asset management industry. In addition, prices seem to correlate negatively with the size of the mandate, with the lowest prices not being accessible to smaller retail funds.
- The FCA found that an average profit margin of 36% existed at investment firms and that investment firms do not typically lower prices to gain a competitive advantage, which leads to the conclusion that there is room for significant improvement in terms of price competition.

Performance

- Both actively managed and passively managed funds underperformed relative to their benchmarks.
- Fees are not an accurate indicator of performance. Actively managed funds with higher fees do not necessarily perform better than funds with lower fees. In fact, there is evidence of a negative correlation between charges and performance.
- The way past performance information is presented to investors can be inconsistent across different funds and can make it difficult for investors to interpret and compare.

Clarity of objectives and charges

- Room for improvement in how asset managers communicate their objectives to clients. The FCA noted that many active funds track the market similar to passive funds but charge significantly higher fees.
- There is often very little awareness among retail investors of the fees they pay for the investment management services, which they receive.

Investment consulting and other intermediaries

- Institutional investors such as pension funds rely on investment consultants to a higher degree when negotiating charges with asset managers.
- There are low levels of competition in the investment consulting market with three firms dominating the market and consistently low levels of switching between the consulting firms being prevalent.

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Proposed Package of Remedies

The FCA recognises that there are a number of recent regulatory changes in the industry which will effect asset managers and they state that the remedies which they propose should sit within this wider policy context. These regulatory changes noted by the FCA include the second Markets in Financial Instruments Directive ("MiFID II") and Packaged Retail and Insurance-based Investment Products ("PRIIPs"). The main objectives of the proposed remedies are to increase investor protection, increase competitive pressure on asset managers and improve the effectiveness of intermediaries.

Increase investor protection

There are a number of remedies suggested which UK managers selling Irish domiciled funds in the UK will need to comply with if implemented. Non-UK managers selling Irish funds into the UK will likely face competitive pressures to comply with the same practice. A number of these remedies are outlined below.

- The FCA has reviewed fund manager risk free "box profit" practices for unit trusts. Box profits are generated through the typical dual-priced fund structures whereby the difference between the spread in a fund's offer price, at which investors buy in, and the bid price, at which the manager buys units back, can be kept as profit by fund managers. The FCA is consulting on whether to require fund managers to disclose any box profits to investors and that any box profits are for the benefit of the fund and not the fund manager/asset management firm.
- The FCA is proposing to require fund managers to assess whether overall value for money has been provided to fund investors taking account of fees and charges, quality of service and level of transparency.
- The FCA is also consulting on ways to make it easier for investors to switch to cheaper share classes.

Increase competitive pressure on asset managers

There are a number of remedies suggested which UK managers selling Irish domiciled funds in the UK will need to comply with if implemented. Non-UK managers selling Irish funds into the UK will likely face also have to comply with a number of these remedies as outlined below.

- The FCA is in favour of the disclosure of a single all-in fee to investors which would include asset management charges, an estimate of transaction costs and any intermediary fees. This FCA remedy is consistent with similar disclosures required under MiFID II and PRIIPs.
- The FCA is in favour of the consistent and standardised disclosure of costs and charges to institutional investors. This is consistent with disclosure requirements under MiFID II.
- The FCA proposes that when fund managers present their past performance, they must do so against the most ambitious target they set out to investors.
- The FCA is chairing a working group with the aim of consulting on rules on how objectives and benchmarks will be more clearly described in performance reporting and marketing material to enable retail investors to make investment decisions based on this information.
- The FCA is considering consulting on rules requiring performance fees to be permitted only where a fund achieves a level of return above the fund's most ambitious target.

Improve the effectiveness of intermediaries

There are a number of remedies suggested by the FCA which aim to improve the effectiveness of intermediaries such as platforms and investment consultants. Many Irish domiciled funds distributing into the UK market use UK investment platforms and will likely benefit from improvements in the effectiveness of these platforms. Two of these remedies are outlined below.

- The FCA recommends that HM Treasury bring investment consultants into the FCA's regulatory perimeter. The investment consultant market is dominated by three players who make up 60% of the market. They are currently unregulated.
- The FCA will launch a market study to assess competition within the UK investment platforms market. With increased competition within the market, Irish funds may benefit from reduced UK platform fees.

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The majority of the remedies outlined above are relevant only to retail fund managers, however some remedies will also impact managers of private equity and hedge funds, particularly the remedies relating to the disclosure of costs and charges to institutional investors.

Next Steps

A number of the remedies (including in the areas of box management and share class switching) are the subject of a consultation exercise ("CP17/18") which ends on 28 September 2017. Other remedies are subject to a future consultation exercise (later in 2017) and some of the remedies require no further consultation.

KB Associates' Services

KB Associates offers a range of services to investment funds including:

- The provision of UCITS/AIF management company services.
- The provision of designated persons to perform UCITS business plan and AIFMD programme of activity managerial functions.
- The provision of UCITS/AIF operational support.

If you would like to discuss any issues raised in this article or related to KB Associates' services in general, please feel free to contact Mike Kirby (+353 1 667 1980), Peter Northcott (+44 203 170 8813) or Mike Parton (+1 345 946 4224).

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