MS15/2.3 WHAT YOU NEED TO DO NOW

INTRODUCTION

Well, that was fun. After much anticipation, the *Asset Management Market Study Final Report* (AMMS final report) landed on 28 June. By now you've probably read it and, if you work in the City, been down the pub to celebrate. The initial reaction seemed to be that the industry had got off lightly, with the Financial Conduct Authority (FCA) stepping back from a full competition review. We see things differently. Whilst the pace of change might not be as rapid as we would like, the changes are coming, and we think they will be a lot harder hitting than you might have first thought. Many of the actions and recommendations contained in the final report will take months, if not years, to work through. But, if you are a fund manager, platform, financial adviser or investor, there are steps you can (and should) be taking now. The first of which is reading this paper, so you're off to a good start.

THE HIGHLIGHTS

Eighteen months of market study, interim findings, industry feedback and the FCA's considered response to that, effectively boils down to the package of 10 remedies contained in the final report. We've numbered them (our numbers, not the regulator's) for ease of reference later.

A INCREASE PROTECTION FOR CONSUMERS WHO ARE LESS ABLE TO FIND BETTER VALUE FOR MONEY

- **A1** Strengthening the duty on fund managers to act in the best interests of investors and introduce independent scrutiny of this.
- **A2** Requiring fund managers to return risk-free box profits to the fund and disclose box management practices to investors.
- **A3** Making it easier for fund managers to switch investors to cheaper share classes.

B DRIVE COMPETITIVE PRESSURE ON ASSET MANAGERS

- **B1** Supporting the disclosure of a single all-in fee to investors.
- **B2** Supporting consistent and standardised disclosure of costs and charges to institutional investors.
- **B3** Chairing a working group to provide investors with clearer and more useful objectives. Consulting on how benchmarks are used and performance is presented.
- **B4** Recommending that the Department for Work and Pensions (DWP) remove barriers to pension scheme consolidation and pooling.

C IMPROVE THE EFFECTIVENESS OF INTERMEDIARIES

- **C1** Proposing to reject the undertakings in lieu of a market investigation reference to the Competition and Markets Authority (CMA) on investment consultancy services and seeking views on this proposal. Make a final decision on making this market investigation reference to the CMA in September 2017.
- **C2** Recommending the Treasury considers bringing investment consultants into the FCA's regulation, depending on the outcome of the provisional market investigation reference to the CMA.
- **C3** Launching a market study into investment platforms shortly.

PUTTING INVESTORS FRONT AND CENTRE

Each of the 10 remedies has the potential to drive positive change in the market. As you would expect, investors – and developments to ensure the market works more effectively in their interest – feature across the three categories, but are the sole focus of section A. The proposals outlined there are detailed in *Consultation Paper (CP)17/18: Consultation on implementing asset management market study remedies and changes to our Handbook,* which was released on the same day as the AMMS final report.

Rather than talking about what has (or hasn't) been said within the wider AMMS final report, the rest of this paper will focus on the specifics of this consultation – since it represents those areas the FCA has prioritised for immediate action – and will assess what might happen next. Let's start by taking a closer look at the three core themes from section A, all of which are covered in the consultation, and what they mean in real terms.

REMEDY	THE LANG CAT VIEW
A1 Governance: where fund groups will be compelled to act in the best interest of investors and introduce independent scrutiny.	The combination of increasing accountability through the Senior Managers and Certification Regime (SMCR), and the new proposed requirement to appoint a minimum of two independent directors to Authorised Fund Manager (AFM) boards, is perhaps the most significant change contained within the AMMS final report. What this really means is 'Do whatever we decide, and ensure your customers are treated fairly, or you'll find yourself up in front of the beak'.
A2 Risk-free box profits	Risk-free box profit is the behind-the-scenes bunce that fund managers take from operating dual-priced funds (so effectively a bid-offer spread). It's been a small but welcome source of profits for many firms for a long time, although some have moved to single-priced funds as part of their cleaning-up-the-store activity. And, unlike in coalition politics, there is no magic money tree, so these profits are simply a charge on investors. The FCA would like these returned to investors. It's important to note that box management is a key part of running mutual funds, and fluctuating markets can mean that a box can be profitable or loss-making in its own right – that's not what's under fire here.
A3 Moving investors into better value share classes.	One area the new AFM boards (with added independent directors) will be on the hook to assess will be the issue of legacy share classes. The consultation includes a few proposals to make the process of converting to clean share classes easier. Clearly the firm will need to act in the customers' best interests. But providing they can be reasonably confident there is no client detriment, and reasonable steps have been taken to obtain client approval, under these new proposals the conversion could take place. This is softening the current stance where client approval is required. Combining this with the new tightened governance requirements, we would expect to see a number of conversion exercises taking place during 2018.

GOING DEEPER ON GOVERNANCE

Each of these proposed remedies is significant, and collectively they start to pack a real punch. We think the key to it all is likely to be the combination of the SMCR and the increased obligation to act in the best interests of your customers. It says a lot about the current state of the industry that this is needed. In some cases the measure of success will start from a pretty low base, however all market participants will be required to improve their governance and reporting.

The SMCR is already upping the ante here. We regularly hear talk of just how under pressure those subject to the SMCR are, and how hard their life is compared to their colleagues who aren't. In fact, being subject to the SMCR is generally accompanied with danger money. Good job asset managers aren't being told to cut costs!

We are especially interested in how the proposed 'value for money' rule[1] will be implemented. Value is subjective, but as a result of these changes an AFM board (with added independent directors) will be required to assess the following:

1. **Economies of scale.** AFM boards will be required to identify economies of scale in the costs of operating funds, and consider the introduction of break points. They must consider whether any savings are being passed on, and explain their decision if not.
2. **Fees and charges**. AFM boards will need to assess whether charges are reasonable in relation to the costs incurred. This should include an assessment of appropriateness, considered against the quality of service and comparable market rates and products.
3. **Share classes.** An assessment of the different share classes available will be required, focusing on whether these offer value for money. Where multiple share classes are available for a given fund, the AFM board must assess and explain why some investors are in more expensive classes.
4. **Quality of services.** AFM boards will be required to assess the quality of services that investors are, or have been, receiving. They must set out and explain the criteria used, and provide a conclusion of that assessment.
5. **Transparency.** The above criteria will have to be assessed on an ongoing basis, with a formal documented assessment once a year. This report is to be published, together with the actions the AFM board has taken, or will take, to discharge its obligations under the new rules. If poor value for money practices are identified, the report must explain the action(s) taken to address the situation. A failure to take sufficient steps may be considered a contravention of the relevant rules.

So, AFM boards will soon be taking on a load of extra obligations and reporting. The good news – as we've already noted – is they will (whether they like it or not) be getting some help in the form of a minimum of two independent directors. These roles are required to make up at least 25% of the total board membership and must meet several requirements. Specifically independent directors may not:

- be an employee of the AFM or of a company within the AFM's group or remunerated by them for any role other than as an independent board member.
- have been an employee of the AFM or of another company within the fund group within the five years before their appointment.
- have received any sort of remuneration from the AFM group within the five years before their appointment. Also, they may not have had any sort of material business relationship with the AFM or with another company within the AFM's group within the last three years.
- have been an employee of any portfolio manager the AFM has delegated to within the five years before their appointment, or have had any material business relationship with that portfolio manager within the last three years.

The FCA recognises that recruiting at least two or three independent directors who not only meet these criteria, but also know their onions will 'create a challenge across the industry'. It is proposing an implementation period of 12 months, but even so, with its research indicating around 500 directors will be required, this feels like an area in which some fund managers will want to make their moves quickly.

WHAT YOU CAN DO

Having outlined the three measures under consultation, it's time to give you some immediate homework.

	A1 GOVERNANCE	A2 BOX PROFITS	A3 SHARE CLASSES
IF YOU ARE A FUND MANAGER	Bite the bullet, and implement the new governance structure now. We believe there will be a first mover advantage here, not only to recruit the best independent directors, but also to make a statement to your customers, shareholders and employees that you are serious about it. Don't fight the changes, embrace them.	Move to single-priced funds. You'll all be doing it soon anyway, and you might find there starts to be some pressure from your 'distribution partners' (a.k.a. customers) to do so. Do you want to lead the market, or follow?	Again, bite the bullet and get on with this. These legacy share classes are going to move soon, it's just a case of when. The sooner you do it, the sooner you can be sure you have retained the customers' assets. You might even be able to close those old legacy share classes and reduce some operational costs along the way.
IF YOU ARE A PLATFORM	The proposals to appoint independent directors to the firm's board are aimed at asset managers, however you should consider implementing them as a platform. Responsible governance is a big theme for the industry, so demonstrate your commitment to your customers by going the extra mile. We suspect you'll end up here anyway, especially if you're a vertically integrated firm.	Again, not so much for you to do here as this is down to the fund managers. Ensure any in-house funds are operating best practice, and if you have a company stance then by all means pressure external fund managers.	Ensure your customers are in the lowest cost share class. Make the process of selecting funds for new business and switching/top-ups as clear as possible, to ensure customers always select the lowest cost version. Follow the leaders and remove barriers wherever you can in terms of dealing with the re-registration problems of Superclean™ funds.

1. FCA CP17/18, section 3.2.4

	A1 GOVERNANCE	A2 BOX PROFITS	A3 SHARE CLASSES
IF YOU ARE A FINANCIAL ADVISER	Consider whether you want to include adherence to the new governance structure as part of your research and due diligence process. Do you only want to work with firms who are embracing the changes, or is this less of a concern to you and your clients?	It's up to you, but if you're interested in maximising transparency then you have a platform from which to pressure fund managers. The quickest way to get them to move to single pricing is to vote with your feet.	The share class conversion proposal is aimed at funds held direct with asset managers, however there is also a section on whether there should be a 'phased sunset clause' for trail commission. If/when this happens remains to be seen, but if you're a financial adviser with a decent proportion of your revenue coming from trail commission (and FCA data show this is 26% of all investment fee revenue[2]), now might be the time to start planning to move assets away from commission to adviser fees.
IF YOU ARE A CONSUMER	Ask your fund manager for its response to the AMMS final report. Is it embracing the change, or fighting against it? If it's the latter, is this *really* the best company to trust with your hard-earned?	There's not much you can do here other than pressuring your fund managers to move to single-priced funds. This is one for the future – if you're already in dual-priced funds then you'll be suffering the charge and you'll have to wear it for now. If you want to pressure a fund manager, ask about its box profit stance, and make your displeasure felt.	If you are invested direct with a fund group, especially in funds you have held for over a decade, ask whether you are in the cheapest share class. If not, state that you want to be. If it won't transfer you, consider moving elsewhere, but watch out for any exit charges, tax impacts, and ensure the new home with a platform fee plus fund costs is not more expensive than your current situation.

2. www.fca.org.uk/publication/data/data-bulletin-issue-9.pdf

FINAL THOUGHTS

1 – The role of platforms. The AMMS final report suggests that platforms should be doing more to help investors benefit from economies of scale. Basically, platforms should be beating up the fund managers to secure discounts. We have some sympathy with this view, but as easy as it sounds, the reality is very different. Discounts, when secured, are usually only a few bps, are normally only available via platforms with a higher than average charge (thus rendering the discount irrelevant in total cost of ownership terms) and often create a barrier to exit. We'll be doing more work in this space over the coming months. So keep your eye out for it or call us if you're interested.

2 – The future of trail. A new proposal that hadn't already cropped up in the interim report was the announcement that the FCA is 'seeking views on whether we should consider introducing a phased-in sunset clause for trail commissions'.

The scope and details of any trail switch off are as yet unknown, but it's safe to say it would be a huge change, especially if it were extended to include trail from legacy life/pension products. The latest FCA data show advisers were still getting 26% of their investment revenue from trail commission in 2016[2], so if this disappears most firms would feel the burn. Any indication of this becoming a reality would almost certainly see a big swing of legacy assets away from commission towards a fee structure.

However, this is fraught with unintended consequences. The platform sunset clause resulted in around two thirds of clients being worse off, albeit only by a few bps. This is not the outcome or direction of travel the FCA wants, and that was for ISA/GIA business where there are virtually no product/tax charges to overcome. Again, this is an area we'll be working on during the coming months as we assess the exact impact on all market participants of such a move.

3 – Communication and awareness. Ok, so here's the thing. What's the use of a single all-in fee if – as the research accompanying the AMMS final report found – around a quarter of investors don't think they are paying *any* charges?

Figure 1: Do you pay fund charges on your most recent product? (split by investment product)

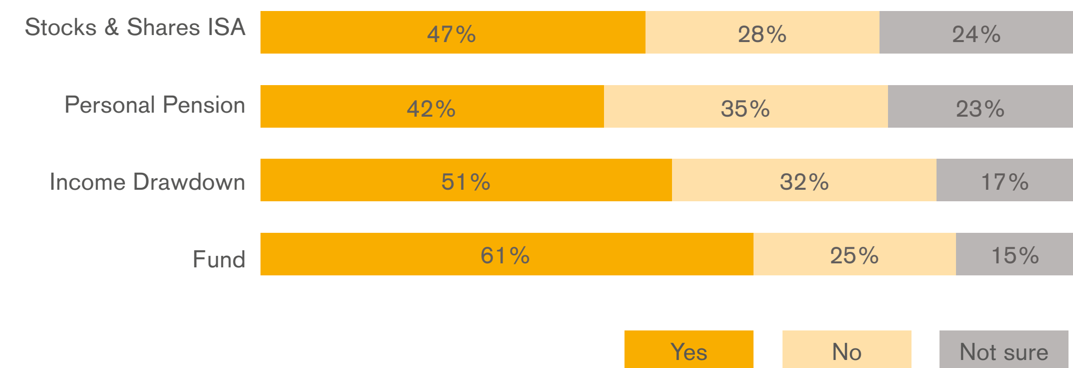

Figure 1 Source – https://www.fca.org.uk/publication/market-studies/ms15-2-3-annex-1.pdf

The AMMS final report doesn't specifically address the issue of consumer awareness, understanding and education, but it's clear that there is a big problem. People simply don't understand what is happening to their investments and how they are charged. This allows providers to hide expensive product features in plain sight. The industry must do better here. It's not just a case of meeting the requirements of the AMMS final report. Whoever you are, you need to improve the way you communicate with your customers.

NOT SURE WHERE TO START?

There has been some frustration expressed about the pace of change. With this first stage of the consultation period ending on 28 September 2017 and the rules to follow in 2018, we have some sympathy with that view. The reality is that the FCA was never going to punch an immediate hole in a £6 trillion industry, especially with all the other change going on around us. The cat is well and truly out of the bag though, and we are firmly of the view that firms who embrace this reality, and are able to demonstrate that they genuinely are treating their customers fairly, will have a competitive advantage as a result. We'd love to help you navigate these changes – call us!

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