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Briefing note

November 2015

FCA to investigate asset management sector

The Financial Conduct Authority (FCA) has launched a market study of the asset management sector. The scope of the review, which the FCA intends to finish in early 2017, is extensive, covering services provided to both retail and institutional investors as well as ancillary services sourced by asset managers. Active engagement with the FCA is likely to be resource intensive for market participants, but will present opportunities to shape the future regulatory framework for the sector.

Key issues

- What issues will the FCA investigate?
- Which market participants are potentially affected?
- What is the process?
- What are the potential outcomes?

Managing the asset managers

The review is the second market study to result from the FCA's review of competition in the wholesale sector, the first being the ongoing study of the investment and corporate banking services sector.

The study will be carried out, at least initially, using the FCA's powers under the Financial Services and Markets Act 2000, which include wide-ranging powers to impose remedies to promote effective competition.

The FCA has identified numerous issues for investigation, which fall under four broad headings:

- competition between asset managers;
- control by asset managers of costs and quality of ancillary services;
- the role of investment consultants; and
- barriers to innovation.

Competition between asset managers

The FCA intends to explore how asset managers compete to deliver value for money. The focus of the FCA's concern is that, while there are many competitors in the market, competition between them is focused not on pricing, but on factors such as market performance, reputation, marketing and advertising. In the FCA's view, this may not deliver the best value for money for customers, and may also act as a barrier to entry for new funds that have no track record.

The FCA says that it will "map out" charges throughout the sector, and assess, in particular:

- the extent to which differences in charges to certain groups of investors (e.g. between institutional and retail investors, or between active and passive mandates) reflects variations in underlying costs;
- whether entry and exit charges reflect costs and/or inhibit switching;
- the presentation of charges by asset managers and fund platforms, and whether this gives investors sufficient information to compare value for money;
- whether investors' behavioural biases lead them to overlook the importance of charges and/or to remain invested in "closet tracker" funds;
- how the retail distribution review reforms have affected competition between different funds and fund platforms; and
- whether profitability in the sector (which the FCA, from its internal analysis, considers to be "quite

high", at around 35% of revenues), indicates a lack of effective competition.

The FCA will also consider whether there is sufficient competition in certain market segments that are relatively concentrated, such as Liability Driven Investment, and the potential for conflicts of interest resulting from vertical integration, e.g. between asset managers and pension providers or fund platforms.

Control by asset managers of costs and quality of ancillary services

The FCA is looking to understand the extent to which asset managers are willing and able to control and scrutinise costs when purchasing various different services on behalf of the fund, such as custody banking, securities lending, fund administration, market research, benchmarking data and trade execution services. The FCA's preliminary view is that both institutional and retail investors are unlikely to be able to monitor at least some of these costs, e.g. because they cannot isolate the relevant charges from overall fees, and that some may not have the expertise to monitor effectively the way in which asset managers incur them.

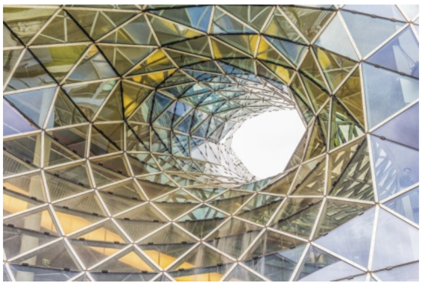
While the FCA will not carry out an in-depth review of the effectiveness of competition for each ancillary service, it will consider certain specific issues such as bundling of services or high concentration levels.

The role of investment consultants

The FCA says it will investigate whether investment consultants suggest or promote investments that are not in the best interests of their customers, e.g. by recommending active or complex strategies to justify the fees paid to them, or when offering their own fiduciary management services such as funds of funds or multi-manager funds.

Other issues that will come under scrutiny include:

- the ability of institutional investors to monitor and assess the quality of advice given by consultants; and
- the metrics used by consultants and the extent to which these help investors to get value for money, act as barriers to entry for new funds, or distort the way in which asset managers seek consultants' recommendations.



Barriers to innovation

The FCA will consider the extent to which innovative new products or technologies are inhibited by regulatory requirements or the conduct of existing firms.

It will also investigate whether some innovation introduces "unnecessary complexity" or is used by firms to charge more for services that do not represent good value.

Scope of the study

Most types of active and passive collective investment funds and segregated mandates fall within the scope of the study, with a focus on those investing in mainstream asset classes (e.g. securities, derivatives and property). However, private equity and venture capital funds are excluded.

As well as asset managers, the study will cover various other market participants, including investors (retail and institutional), investment consultants, platforms and providers of ancillary services, but not financial advisers/IFAs, wealth management firms or stockbrokers.

Process

The FCA will soon begin gathering information and views about the market. This will involve a series of questionnaires and roundtable and/or bilateral meetings with market participants, who will be able to raise with the FCA other issues for discussion that are not expressly covered in its terms of reference.

The FCA is not subject to any statutory deadline for the study, but has indicated that it expects to publish an interim report in summer 2016 setting out preliminary conclusions and any proposed remedies, with an invitation to market participants to comment prior to publication of a final report in early 2017.

If it identifies concerns, it can:

- implement market-wide remedies, through rule-making, general guidance or enhanced industry self-regulation;
- impose remedies on individual firms, using own-initiative variation or requirement powers, cancelling permissions, public censure, financial penalties or filing for injunctions or restitution orders; and/or
- refer the market for an (even more) in-depth investigation by the Competition and Markets

Authority, or accept undertakings from market participants in lieu of such a reference.

Comment

While the FCA has been careful not to prejudge any of the issues it is to investigate, its terms of reference do appear to signpost some possible conclusions. In particular, strengthened obligations on asset managers to disclose charges and costs may be high on the agenda, notwithstanding the existence of various other parallel and impending regulatory initiatives in this respect.

The study also raises the familiar spectre of a UK competition authority concluding that something must be wrong with reference to profitability levels. However, establishing that with sufficient rigour will not be straightforward. The CMA recognises that it faces challenges in gathering suitable data and identifying appropriate methodologies and states that it will invite stakeholders to help with this.

Active engagement with the FCA will provide an opportunity for market participants to shape the future regulatory framework for the sector, and to dispel misconceptions. This is likely to be resource intensive, given the broad scope of the study and the economic analyses that the FCA proposes to carry out, so early preparation and engagement is likely to bring benefits.

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