Consultation on implementing asset management market study remedies and changes to Handbook

Consultation Paper
CP17/18**

June 2017

How to respond

We are asking for comments on this Consultation Paper (CP) by 28 September 2017.

You can send them to us using the form on our website at: www.fca.org.uk/cp17-18-response-form.

Or in writing to:
Karen Northey
Asset Management and Funds Policy
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Email:
cp17-18@fca.org.uk

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1 Summary

Why we are consulting

1.1 This consultation paper proposes changes to the way we regulate authorised fund managers. It also discusses whether and how we might apply equivalent provisions to other similar retail investment products. Our proposed changes arise out of the findings of the Asset Management Market Study (AMMS). The final report of the market study is being published at the same time as this consultation paper.

1.2 In summary, as set out in the AMMS final report, we found that:

- evidence suggests that there is weak price competition in a number of areas of the asset management industry. This has a material impact on investment returns for investors through the charges they pay for asset management services
- despite a large number of firms operating in the market, our sample of firms showed the asset management industry has seen sustained, high profits over a number of years
- investors are not always clear what the objectives of funds are, and fund performance is sometimes reported against an inappropriate benchmark
- there are a wide range of investors in the institutional market. This includes many small pension schemes which rely heavily on the advice of consultants. We found concerns about the way the investment consultant market operates.

1.3 This consultation proposes changes to implement some of the remedies identified in the market study. It focuses on three areas:

- governance
- moving investors into better value share classes
- risk-free box profits

1.4 In other areas we want to do more work. We have set out our current thinking on issues including fund objectives, use of benchmarks, performance reporting and the transparency of fees and charges in the final report that sits alongside this consultation. We plan to consult on these further issues, where relevant, later on this year.

Who this applies to

1.5 This paper will interest investment managers, management companies including authorised fund managers (AFMs) and depositaries of UCITS and other authorised funds. It will also interest representative industry bodies, consumer groups, advisory firms and financial advisers.

1.6 Some of the matters covered in this paper are technical and unlikely to be of direct interest to retail or professional investors. However, we welcome any feedback from investors and their representatives and draw attention to the following areas which are likely to be of particular interest to them:

- our proposals to strengthen requirements on AFMs to act in the best interests of investors by considering value for money in Chapter 3
- our revised guidance to the way in which AFMs can move investors between different share classes in the same fund in Chapter 4
- the discussion on whether it should be made easier for fund managers to switch off trail commission in Chapter 4

1.7 In Chapter 6 we consider whether we should extend some of our proposals to retail investment products other than authorised funds. This will be of interest to life insurance companies and closed-ended investment companies.

The wider context of this consultation

1.8 The Financial Conduct Authority (FCA) published its Asset Management Market Study interim report in November 2016 which looked at how asset managers compete to deliver value for money and the resulting outcomes for investors. The interim report set out findings which suggested that there is weak price competition in a number of areas of the asset management industry. This has a material impact on the investment returns of investors through their payments for asset management services.

1.9 The interim report identified several ways in which asset management products and services could work better for investors and outlined a package of remedies to address the issues. In consultation with the industry and other stakeholders we have further developed those remedies, some of which we are now consulting on.

1.10 The proposals put forward in this CP complement other FCA and European work in the asset management sector including the recast Markets in Financial Instruments Directive (MiFID II) and the Packaged Retail and Insurance based Investment Products Regulation (PRIIPs). In considering what we should do to respond to the findings of the AMMS we have been mindful of changes which will be brought about by these initiatives. In some instances, these initiatives aim to address similar concerns outlined in the AMMS and where we think upcoming changes will adequately address our concerns, we are not intending to take further action.

What we want to change

1.11 We propose to strengthen our rules requiring AFMs to act in the best interests of their investors and propose governance reforms which in conjunction with the forthcoming Senior Managers and Certification Regime (SM&CR) will hold asset managers to greater account. We set out our thinking on this in Chapter 3.

1.12 In Chapter 4 we clarify our existing guidance on the approach AFMs should take to move retail investors in pre-Retail Distribution Review (RDR) share classes into better value classes. In response to feedback, we also seek views on whether the FCA should consider introducing an end to the payment of trail commission.

1.13 In Chapter 5 we propose changes to rules on box management in the Collective Investment Schemes sourcebook (COLL) to require AFMs to pass box profits that have been generated without taking any market risk back to the fund.

1.14 In Chapter 6 we consider whether some of the proposals discussed in this CP should be extended to include other retail investment products. Although we are not consulting on rule changes for these sectors at this stage, we set out some early thoughts on the issues and we invite stakeholders, particularly life insurance companies, investment companies and consumer groups, to comment on the discussion in Chapter 6.

Outcome we are seeking

1.15 Our proposals aim to improve competition in the asset management sector. If they work, we should see lower prices, better value products and more choice for investors. Improved competition should also increase the efficiency of the asset management industry and its attractiveness to international and domestic investors. We consider that overall this will help us to deliver public value through a better functioning asset management sector in the UK.

What do you need to do next?

1.16 We welcome comments on our proposed changes to our Handbook and on the questions raised below. Please respond to the consultation questions by 28 September 2017. You can use the online response form on our website or write to us at the address on page 2.

1.17 Following this consultation, we will consider feedback before finalising our rules. We will also take into account any other relevant legislative developments.

2 The wider context

The harm we are trying to address

2.1 As we have set out in the final report published alongside this CP, the asset management industry plays a vital role in the UK's economy. Asset managers manage the savings and pensions of millions of people, making decisions for them that will affect their financial well-being. Asset managers generate returns for their clients by investing clients' money in a wide variety of enterprises, both in the UK and internationally. More broadly, by directing funding to firms they think are most likely to grow, asset managers support businesses that provide jobs and drive economic growth. Asset managers also have an important role in the corporate governance of the businesses they fund.

2.2 The UK's asset management industry is the second largest in the world, managing £6.9 trillion of assets. Over £1 trillion is managed for UK retail (individual) investors and £3 trillion on behalf of UK pension funds and other institutional investors. The industry also manages around £2.7 trillion on behalf of overseas clients.

2.3 The service offered to investors comprises a search for return, risk management and administration. The investor bears virtually all the investment risk. About three quarters of UK households are saving for, or receiving, occupational or personal pensions that rely on these services directly or indirectly. This includes over 9 million individuals saving for their retirement through defined contribution pension schemes and approximately 1.4 million savers currently building up pensions in defined benefit pension schemes.[1] There are also around 11 million savers with investment products such as stocks and shares ISAs. These investors are willing to put their money at risk to generate potentially greater returns than they can get through cash savings.

2.4 We looked at this sector because we want to ensure that the market works well and the investment products consumers use offer value for money. Even relatively modest improvements in charges and value for money could have a significant impact on pension and saving pots.

2.5 We have found evidence suggesting there is weak price competition in a number of areas of the asset management industry. This has a material impact on the investment returns for investors through their payments for asset management services. We found that retail investors do not usually negotiate with asset managers and that fund governance bodies acting on their behalf do not typically focus on value for money. We consider that fund governance bodies can have a more defined role in driving better outcomes for investors. Our package of proposals set out in this and subsequent consultation papers, alongside the other remedies outlined in the final report, seeks to address this problem. We want to boost competitive pressure for investors and ensure a minimum level of protection.

1 The defined benefit figure excludes approximately 5 million deferred members of private defined benefit schemes and several million who are building up benefits in funded and unfunded public sector schemes.

2.6 While the proposed rules would only apply directly to AFMs, the concerns the market study highlights around value for money and governance in authorised funds may also exist for other types of investment products. In this paper we also raise for discussion whether and how we might apply equivalent provisions to other similar retail investment products.

How it links to our objectives

2.7 The proposals set out in this consultation are primarily intended to advance the FCA's objectives of protecting consumers and promoting effective competition in the interest of consumers.

2.8 Our proposed remedies are designed to address some of the competition concerns identified in the market study and drive better value for investors. With more effective competition in the asset management sector, we would expect to see investors being better able to find the best investment product for them at a reasonable price.

What we are doing

2.9 In this document we are **consulting** on three sets of proposals:

- measures to improve fund governance, including strengthened obligations to act in the best interests of investors (Chapter 3)
- changes to existing guidance to enable investors to be moved into better value share classes (Chapter 4)
- changes to box management practices (Chapter 5)

2.10 We are also seeking views on two areas under **discussion**:

- whether the FCA should consider introducing an end to the payment of trail commission (Chapter 4)
- whether remedies outlined in the consultation should be applied to other retail investment products (Chapter 6)

2.11 When the consultation closes, we will consider the feedback we have received in any future policy development.

2.12 This consultation proposes changes to implement some of the remedies identified in the market study now. In other areas we want to do more work. We have explained our current thinking on issues like fund objectives, use of benchmarks, performance reporting and the transparency of fees and charges in the final report that is published alongside this consultation. We plan to consult on rules around these issues at a later date.

Equality and diversity considerations

2.13 We have considered the equality and diversity issues that may arise from our proposals.

2.14 Overall, we do not consider that the proposals adversely impact any of the groups with protected characteristics under the Equality Act 2010. But we will continue to consider the equality and diversity implications of the proposals during the consultation period, and will revisit them when publishing the final rules.

2.15 In the meantime we welcome your input to this consultation on this topic.

3 Measures to improve fund governance

3.1 This chapter outlines our proposed changes to strengthen and clarify our rules requiring authorised fund managers (AFMs) to act in the best interests of their investors. It also sets out proposed changes to the governance structure of AFMs.

3.2 Existing FCA rules require AFMs to act in the best interests of their investors and to prevent undue costs being charged to the scheme or unit holders. These obligations should be overseen by the board of the AFM – the senior committee made up of the directors of the AFM. It is their role to set the overall direction of the firm, and to do so in a way that complies with our rules and considers the best interests of investors in the funds.

3.3 AFMs are not currently required to appoint any independent members to their boards. In the majority of cases the members of the board are employees of the AFM or the wider group companies.

3.4 However, the asset management market study, coupled with our supervisory experience, has raised concerns that our rules are not working as we expect. We found examples in a range of funds where the costs and charges investors pay appear unjustifiably high, and where communications with clients were unclear. We have found that AFM boards:

- generally do not robustly consider value for money on behalf of fund investors[2]
- occasionally fail to take appropriate and timely steps to address underperformance
- can lack the authority within the group structure to challenge the commercial strategy set by more senior boards and executive committees

3.5 In the interim report, we considered five options to reform the structure of fund governance and help ensure firms fully consider the best interests of their investors:

- keep existing governance structures but clarify the duties they are expected to discharge
- strengthen the individual requirements on senior managers of the AFM
- change the composition of existing governance bodies to introduce greater independence from the firm
- replace the existing governance structures with a new body
- impose greater duties on trustees and depositaries

2 See Chapter 5 of the asset management market study report.

3.6 We considered these options carefully, taking on board feedback from the interim report and through roundtables hosted earlier in 2017. We also further investigated existing models of governance, both in the UK and internationally.

3.7 As with most company boards, we recognise that there is an inherent tension in the role of the AFM board. The board needs to balance the competing interests of investors and of the AFM and its shareholders. On the whole, the better competition works in investors' interests, the less reliance is needed on regulation. However, the asset management market study showed that competition was weak in some areas of the market, particularly with respect to value for money.

3.8 We propose a package of remedies to make competition work better in this market and to improve protection of the interests of investors. The key elements of the package that relate to fund governance by AFM boards are intended to:

- clarify how we expect the board to act in the best interests of fund investors and explicitly consider value for money
- increase the robustness of scrutiny through the introduction of independent members
- increase the accountability and influence of the board
- allow for greater scrutiny of how boards are discharging these important obligations

3.9 We also think our proposed changes will be important in underpinning future development in this market. The issues which we are planning to consult on at a later date, such as fund objectives, reporting performance and the use of benchmarks all require robust scrutiny. The AFM boards will have an important role to play in ensuring that the interests of investors are considered properly when dealing with these competing interests, and all other aspects of the management of their firm and funds.

Our Approach

3.10 We examined the issues raised in the market study in the light of our existing rules. In designing the proposals in this chapter, we took onboard feedback from submissions and roundtables and considered a wide range of alternative approaches, including those set out in the interim report. We have also taken into account the proposals of the SM&CR, which we will consult on later in the year. We consider that, collectively, our proposals on governance represent an effective and proportionate approach to the issues identified. However, we will keep this approach under review. Based on the evidence already gathered in the market study, if the measures we plan to introduce prove to be insufficient to bring about improved outcomes for investors, we will consider whether further changes are needed.

Current Structure

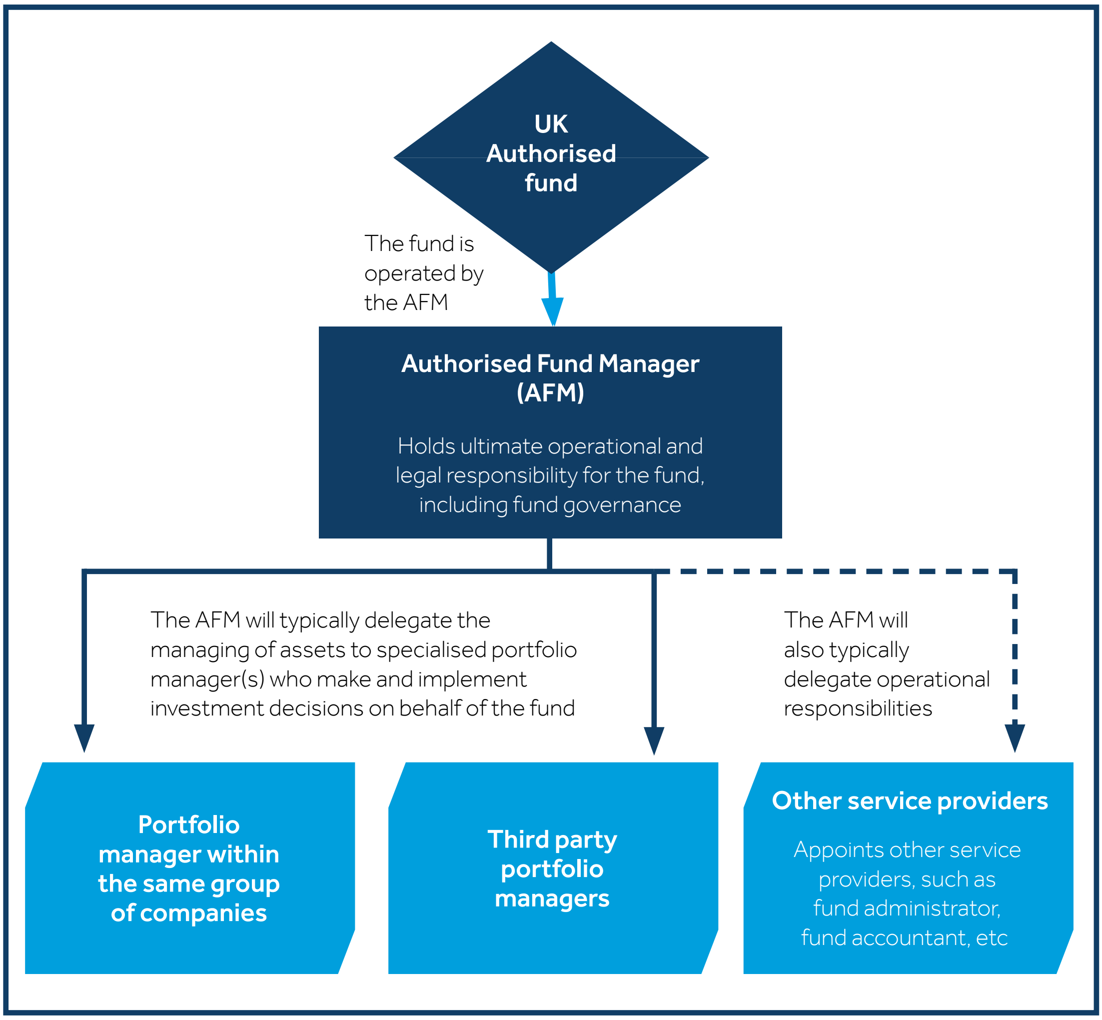
3.11 UK authorised collective investment schemes (funds), irrespective of their legal structure, are required to have an AFM. The AFM is the body responsible for the fund, both for statutory purposes and under FCA rules. The AFM is a company which is authorised and regulated by the FCA in its own right. Like other companies, the AFM has shareholders and is governed by a board of directors.

3.12 The UK has not adopted the fund governance model found in some other jurisdictions, where the fund itself has a board of directors who may be individuals acting in executive or non-executive capacities. Instead, when a UK authorised fund is established as an open-ended investment company, the AFM typically acts as its sole corporate director. Where the fund is constituted as a unit trust or contractual scheme, the AFM performs an equivalent function. Our rules therefore rely on the AFM to carry out the responsibility of considering and acting in the best interests of investors, as set out in COLL.

3.13 In the vast majority of cases, AFMs do not themselves manage the assets of the fund, but delegate the management of these assets to another firm that carries out portfolio management. There are two common business models for this arrangement:

- delegation to another portfolio manager within the same group of companies
- delegation to third-party portfolio managers

Figure 1: Overview of how AFMs can delegate responsibilities



3.14 For firms in the first model, the AFM is typically a subsidiary company within the wider investment management business. The directors of the AFM may be employees of the portfolio manager, or directors of the parent company. This creates an inherent tension between the interests of shareholders of the AFM or the wider group and the investors in the fund. The desire of the AFM and its ultimate owners (the shareholders) is to make money from managing the funds entrusted to it, while the interest of the end investors is to get the maximum risk-adjusted return possible (for example through paying low fees and charges). AFMs have various responsibilities under the law and under FCA rules but our findings in the market study, and from supervisory experience, show that the boards of AFMs in this business model may not always take action in the interests of investors, where to do so might go against the group's wider commercial interests.

3.15 Firms in the second model operate in various ways. Some AFMs select one or more portfolio managers to manage all or part of a fund's portfolio, and then market themselves as providing independent challenge and scrutiny of the managers they have appointed. Others 'hire out' their services as a 'host' AFM to portfolio managers, who are generally smaller firms. This allows the portfolio manager to package its services in a fund structure without having to set up its own AFM. However, in commercial terms the portfolio manager may see itself as the principal and the AFM as its agent, providing it with the service of operating funds.

3.16 In host AFM structures, the AFM's board members are unlikely to be employed by the portfolio manager and so might be expected to act with greater independence than the board of an in-house AFM. However, although the portfolio manager is appointed as the delegate of the host AFM, in practice it is the portfolio manager that decides on the selection and ongoing relationship with the AFM it wishes to use to run its fund. This means the host AFM is commercially reliant on the portfolio manager, which can undermine its notional independence. This may result in similar competing interests to the in-house AFM model. Our supervision work indicates that host AFMs are no more likely, for example, to assess value for money robustly than AFMs using the in-house model.

Scope

3.17 The remedies proposed in this chapter will apply to all UK-authorised firms that carry out the function of an AFM for collective investment schemes that are authorised and domiciled in the UK, as well as a UK UCITS management company managing EEA UCITS schemes. They will not apply to UCITS management companies domiciled in the European Economic Area (EEA) that are accessing the UK market through the UCITS management passport, nor to full-scope Alternative Investment Fund Managers that operate UK funds, or market funds domiciled in the EEA in the UK.

3.18 We have considered whether our policy could have unintended consequences, for example whether AFMs who wish to avoid requirements for robust governance might seek to move their operations elsewhere. Although we recognise that the proposed package of remedies will increase costs for some firms in the UK, we expect that the benefits will outweigh any costs. We also expect that any improvements to outcomes for investors will lead to the UK asset management industry being a more attractive place for investors and therefore improve the relative competitiveness of the UK market.

3.19 We have also considered the costs of our proposals in comparison with the requirements in other jurisdictions with large fund domiciles. Luxembourg and Ireland, for example, have introduced comparable fund governance proposals over recent years including independence requirements. The US mutual funds model also has detailed independence and value for money requirements. Overall, we consider the risk for regulatory arbitrage to be low but will keep this under review.

3.20 As explained above, the board of the AFM is responsible for ensuring the robust governance of the relevant authorised funds. The board has an essential role in ensuring the wider interests of investors are considered and protected. Responsibilities of the AFM under our current rules include:

- initial communications
- selecting and managing the assets
- setting and keeping under review the fees and charges investors pay for these services
- ensuring that asset managers are taking all reasonable steps to obtain the best possible results for their clients when executing orders
- the ongoing communication of how the fund is performing
- ensuring proper management of conflicts within the investment process

3.21 So, while this consultation deals in detail with our expectations around value for money, we will continue to consider the role of the board in a wider context. For example, we will consider in future whether additional, specific requirements should be imposed on the board for areas such as the use of benchmarks, how the objectives of funds are set and communicated and how performance is measured and explained.

3.22 Respondents to the interim report have suggested that the AFM boards can lack the authority within the group structure to effectively challenge the commercial strategy set by more senior boards and executive committees. As part of the SM&CR, we will consult on the introduction of a new prescribed responsibility on the chair of the AFM board to act in the best interests of investors, and we consider that this should increase the board's effectiveness to influence decisions made within the group structure towards considering investors' interests.

3.23 We are not calling the role of the depositary of authorised funds into question. Depositaries continue to play an important role in the governance of authorised funds, but the value for money issues we are aiming to address with this proposal are outside their remit.

A new value for money rule

3.24 We expect that AFMs, as part of their existing obligations to act in the best interests of investors, will assess whether the products and services they offer provide value for money. However, the market study has shown that this is not happening consistently.

Some firms who responded to the interim report suggested that this is because assessing value for money is a complex topic and that they were unclear about their obligations. These firms stated that they would welcome further clarity from us about of our expectations.

3.25 We therefore propose to introduce a new rule to require the AFM to assess whether value for money has been provided to fund investors. This assessment must take place on an ongoing basis and must be formally documented at least once a year. We propose that this assessment must consider at least the following points:

Economies of Scale

3.26 Economies of scale are achieved when funds reach certain levels of assets under management. Our supervisory work has found that AFMs do not typically question whether these economies are shared with retail investors. This contrasts with the way that break points are routinely used in institutional and segregated mandates.[3] We propose that AFMs be required to identify economies of scale in the direct and indirect costs of operating funds and consider the introduction of break points. They must further consider whether any savings should be shared with investors, and explain their decision if savings are not being passed on.

Fees and charges

3.27 We propose to require AFMs to assess whether charges are reasonable in relation to the costs incurred. In doing so, they may wish to consider comparable products available for sale, including similar sized institutional mandates. This should include an assessment of the appropriateness of charges paid for performing investment services when considered against the quality of service, comparable market rates and any ancillary services provided by the asset manager and third parties.

Share classes

3.28 We propose to require AFMs to consider the different share classes available to investors and whether these offer value for money. Where multiple classes are available for a given fund, the AFM must assess and explain why some investors are in more expensive classes, with substantially similar rights and conditions. In Chapter 4, we propose remedies which would make it easier to switch retail investors into better value share classes.

Quality of services

3.29 We propose to require AFMs to assess the quality of services investors are or have been receiving. We propose guidance to clarify what should be considered in assessing quality of services. For example, where the AFM delegates asset management services, it may consider how well the asset manager is delivering any additional services which are promised in marketing materials and are paid for out of the fund. AFMs must set out and explain the criteria used to assess quality of service and provide an explanation of the conclusion of that assessment.

Transparency

3.30 We propose to require AFMs to publish, at least annually, a report on the findings of the assessment and the actions they have taken, or will take, to discharge their obligations under the new rule. This should be done either as part of each fund's annual report or through a separate dedicated report published by the AFM on behalf

3 A 'break point' is a level of assets under management which separates two different charging tariffs. For example, assets under management of up to £100 million might bear an annual fee of 0.5% whereas assets above that value might pay a lower amount.

of the range of funds it is legally responsible for. The report must include an analysis of the assessment, address each aspect of the requirement set out above; describe the considerations made and the tasks undertaken and the outcomes achieved to discharge their obligations under the rule. Actions taken may involve renegotiating the asset management contract to obtain better fees and services for investors. If poor value for money practices were identified, the report must explain the action taken to address the situation and a failure to take sufficient steps may be relied on as tending to establish a contravention of the relevant rules.

3.31 This increased transparency will enable better access to information for those looking for it. Investors and analysts will be able to assess better how the fund's decisions were taken, platforms will be able to check that funds are well scrutinised. By requiring AFMs to be transparent about their value for money assessments, we would expect that firms would compete to demonstrate that they are delivering value for money, particularly where this is picked up by market commentators or intermediaries.

3.32 We are proposing that these requirements will enter into force 12 months after rules have been finalised.

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

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

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

Q4: **Do you agree with the proposed requirement for the AFM to publish a report on the findings of the assessment and the steps taken?**

A prescribed responsibility to act in the best interests of investors

3.33 As set out above, a key aspect in addressing the harm identified in the market study is for the AFM board to have sufficient accountability and influence within the firm and the wider group.

3.34 We are required to extend the SM&CR which currently applies to dual-regulated banks and building societies, to almost all financial services firms, including asset managers. The SM&CR is a key part of the FCA's Culture & Governance Priority. The overarching aim of the SM&CR is to reduce harm to consumers by increasing senior managers' accountability. We want to achieve this by raising the standards of conduct and by making senior people in firms more responsible and accountable for their actions.

3.35 The SM&CR will introduce a number of 'Prescribed Responsibilities' for which senior managers in firms will be personally accountable. As part of this we will propose a new specific Prescribed Responsibility under the SM&CR to ensure that asset management firms comply with the obligation to act in the best interests of investors. This includes assessing value for money in accordance with our rules. This Prescribed Responsibility should be allocated to the chair of the AFM board, who will be a Senior Manager under new regime.

3.36 Introducing a Prescribed Responsibility for protecting the interest of investors will signal the value we place on firms to:

- consider this as a key part of their internal governance
- ensure there is individual accountability when that is currently not the case

3.37 The chair of the AFM board would be responsible for taking 'reasonable steps' to ensure the AFM and its board adheres to our current and proposed rules. This would provide an individual incentive for the chair to ensure the firm properly discharges its responsibilities to consider the interests of investors. As a Senior Manager, the chair would also require our approval before taking up their role. This would allow us to assess whether or not these individuals are fit and proper for these important roles.

3.38 We plan to consult on our approach to extending the SM&CR to all FSMA firms later this year. We will consult on the scope and applicability of this specific Prescribed Responsibility as part of that consultation.

Rule requiring independent directors of AFM board

3.39 Several respondents to the interim report have stated that independent directors often increase the level of scrutiny at board level. So as part of our fund governance package, we are proposing a rule requiring AFMs to appoint a minimum of two, and at least 25% of the total board membership, independent directors to the AFM board who meet the requirements set out below.

3.40 The board may choose to task independent directors with other additional responsibilities, while meeting existing remuneration and conflict of interest rules.

3.41 The AFM must ensure that its directors have the resources to perform their duties effectively and that requests for information reasonably made by the independent directors to assist them in their work will be met in a complete and timely manner in line with existing SYSC requirements. This includes data and other information which may be considered commercially sensitive or confidential. We also propose that an independent director may be appointed for terms of no longer than five years, with a cumulative duration of ten years. We also propose that independent directors are not eligible for reappointment to the same AFM board until five years since the end of their last appointment have lapsed.

3.42 We are aware that issues could arise from sharing potentially market sensitive and confidential information if independent directors serve on more than one board. However, a series of controls exist in many sectors. In particular as we expect firms to comply with the existing laws, including competition laws, we do not think that it is necessary to introduce a rule to limit the number of AFM boards on which a non-executive director may serve.

3.43 One respondent to the interim report raised a concern that an independent director would be subject to company law, which would require them to promote the success of the company, just as much as an executive director. They argued that this maintains the inherent competing interest we are trying to address. We acknowledge this point and we recognise the legal duties of independent directors to the shareholders of the AFM are the same as those of executive directors. However, we consider that these duties require the assessment of the best interest of a company beyond measuring financial success. Independent directors will bring in an external perspective, which will support executive directors to meet these duties.

Q5: Do you agree with our proposal to require AFMs to appoint independent directors to the board? If not, what alternative(s) would you propose?

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

Q7: Do you agree with our approach that independent directors may serve on more than one board, provided that they comply with existing rules? If not, do you think a ban on serving on more than one board is necessary?

Requirements for appointment of independent directors

3.44 Some respondents to the interim report have argued that it might be challenging to appoint suitable candidates with the right skill and expertise. Based on our proposals, we expect approximately 480 independent directors to be required. Independent directors need to have sufficient experience and expertise to fulfil their role effectively. Nevertheless, we consider that previous financial services expertise is not necessarily a pre-requisite for becoming an independent director of an AFM. Relevant expertise and experience for this role may have been gained in other professions, academia, public service or otherwise.

3.45 To be eligible to serve as independent director, individuals should meet the following requirements:

- They 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. This includes participating in any share option or performance-related pay scheme of the AFM or the AFM's group.
- They may not have been an employee of the AFM or of another company within the fund group within the five years before their appointment
- They may not 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.

- They may not 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.

3.46 For host AFMs, the above requirements would apply to any commercial relationship the independent director has with the portfolio manager to whom the host AFM has delegated the portfolio management functions. In addition, independent members of host AFMs must not have been employed by the host AFM company for at least five years before their appointment.

3.47 We recognise that recruiting approximately 2-3 independent directors per AFM will create a challenge across the industry.[4] We are proposing an implementation period of 12 months following the finalisation of these rules, but welcome representations on how feasible these timings are.

3.48 Our experience is that the chair of a board typically sets the agenda of issues the board considers. The chair may also have greater influence over the board's discussions and decisions. We have considered mandating whether the chair of the AFM board should be an independent director or an executive director employed by the firm. On the one hand, we believe that an independent chair might allow the AFM board to be more robust in its challenge of the executive of the AFM, particularly on issues where the commercial interests of the asset manager compete with those of investors. On the other hand, there is also a case for having an executive director as chair. An executive director will have day-to-day access to a wider range of information on the firm's activities, which they can use to take responsibility for the management of the fund. An executive director contributes to shaping the values embedded in the culture of the firm and therefore it might make more sense to hold them accountable for any failings as chair of the board. Overall, we have concluded that these points are finely balanced. We want AFMs to appoint independent directors with the right background, most suitable to their needs, and we propose that AFMs should decide themselves whether to appoint an independent director as chair.

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

Q9: **Do you agree with an implementation period of 12 months? If not, how much time do you think AFMs will need to appoint suitable independent directors?**

Q10: **Do you agree that it should be up to AFMs to decide whether to appoint an independent director or an executive director as chair?**

4 FCA Supervision experience indicates that AFMs generally have boards with five to eight directors, with typically no independent directors. Under the proposed requirement to have 25% of their boards comprising of independent directors, and a minimum of at least two, an AFM Board with six members will need two independent directors, while AFMs with seven (to nine) would need three independent directors.

Threshold for requirement to appoint independent directors

3.49 We consider that enhancing independent governance to ensure the interests of investors are protected is an important principle and should equally benefit investors regardless of the size or complexity of the AFM's business. However, some stakeholders have commented on the potential cost of appointing independent directors and suggested that smaller AFMs might be affected disproportionately by these costs.

3.50 However, rather than creating barriers of entry to the market, we consider that independent directors are likely to have an impact on the overall efficiency of AFMs and will contribute to a more robust consideration of value for money. This increased focus should also increase the incentives for AFMs to effectively control ancillary costs paid for by the fund to third party providers. This increased scrutiny would be of value to all AFMs and as a result, we do not think applying our proposals to smaller AFMs would be disproportionate in light of the anticipated benefits.

4 Moving fund investors to better value share classes

4.1 One of the concerns identified in the interim report was whether some retail investors in authorised funds were holding more expensive share classes even though cheaper, but otherwise identical, classes in the fund were available.

4.2 In response, asset managers told us that there are regulatory barriers which make it difficult for them to switch investors to new, better value share classes, even though this would be in investors' best interests. We also heard that the continued payment of trail commission might be preventing some investors from receiving value for money. This may be because advisers are reluctant to advise investors to switch away from products that pay trail commission or because ongoing charges for investments that pay trail commission payments are significantly higher compared to other classes.

4.3 Most AFMs typically offer multiple classes of units within the same fund to meet the needs of investors with different requirements. Classes can differ based on the currency of the assets, the distribution channel (there may be a different class for each intermediary), the type of investor (institutional or retail) or the arrangements for paying or accumulating income. The annual management charge (AMC) of different classes in the same fund may also vary.

4.4 Some funds also have pre-RDR classes that pay 'trail commission' to advisers on behalf of investors. Trail commission is an annual (or monthly) payment to financial advisers by AFMs over the lifetime of an investment to cover the cost of the initial advice or the provision of an ongoing service. The RDR banned trail commission on new investment products, but advisers can continue to receive trail commission for advice on investments sold before 2012.

4.5 The market study concluded that while there were legitimate reasons why the AMC may vary between classes, there were cases where investors would be demonstrably better off in a cheaper class than the one they hold. We have identified below two separate scenarios where we think this might be the case:

- investors that are in pre-RDR classes that no longer pay trail commission, and
- investors in pre-RDR classes that continue to pay trail commission

4.6 In this chapter, we consider some of the barriers faced by fund managers in moving investors to better value classes. Where firms have pointed to specific areas where we can minimise barriers, we are taking on board the feedback and consulting on modifying our guidance to reduce regulatory barriers.

4.7 Feedback on the interim report also raised concerns about the continued payment of trail commission and suggested that we should consider further action. However, this specific issue was not considered in the market study and we did not collect any evidence. We therefore wish to gather more evidence to support a decision on whether to intervene and, if appropriate, develop an appropriate policy response. We are seeking specific evidence and information from asset management firms, advisory firms, industry bodies and other relevant stakeholders so that we can design an appropriate response.

Investors in pre-RDR classes that no longer pay trail commission

4.8 The interim report found that some investors remain in expensive pre-RDR classes even though the AFM no longer pays trail commission. Firms have said this is due to our guidance that AFMs should get express permission from investors before moving them to classes with no trail commission ('clean share classes').[5]

4.9 Firms told us it can be difficult to obtain specific consent from every unitholder. When this has been attempted in the past it has been only partially successful. While many firms received consent from some unitholders in a pre-RDR class, they were not able to get responses from all unitholders. As a result, investors that remain in pre-RDR classes pay higher fees by not converting to clean classes and the small sizes of the old classes make them uneconomic for firms to run. Firms have asked us to provide clarity about our expectations.

Our proposal

4.10 We propose to clarify and re-issue our previous guidance (FG14/4) on dealing with hard-to-reach unitholders. We will clarify that the AFM can undertake a mandatory conversion, if the required conditions are met i.e.:

- the power to undertake a mandatory conversion must be set out in the prospectus in line with COLL 4.2.5R 5(d)
- the AFM must have made all reasonable attempts to inform unitholders to enable them to give alternative instructions, and
- the AFM is satisfied on reasonable grounds that the change will not result in detriment to investors

4.11 The power to undertake a mandatory conversion must be exercised in accordance with the client's best interests rule (COBS 2.1.1R(1)).

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

5 *Changing customers to post-RDR unit classes (FG14/4)* May 2014. In 2014 we issued guidance setting out what we expect from firms that are involved in the transfer of investors from pre-RDR unit classes to post-RDR unit classes in which the trail commission was switched off.

Investors in pre-RDR classes that continue to pay trail commission

4.12 Some investors are in pre-RDR classes that are more expensive because the AFM continues to pay trail commission. The interim report found that, of those firms surveyed, 21 asset management firms reported paying around £1.4bn in commission in 2015.[6] An industry report suggests 31% of all UK-domiciled fund assets (or £245bn) remain in classes that can pay trail commission.[7]

4.13 In the interim report we said that we do not currently intend to revisit the decision to allow AFMs to continue paying trail commission. Our position is that trail commission arrangements entered before 2012 can continue under certain conditions.[8] However, some respondents to the interim report strongly recommended us to consider introducing a 'phased sunset clause' on paying trail commission to financial advisers (i.e. stop the payment of trail commissions). Firms told us that that while it was reasonable for advisers to be remunerated over a period of time for advice given at the start of the investment, these payments should not be indefinite. This is particularly the case if the investor is no longer receiving a service from the adviser. They therefore recommended that these commissions be switched off at some future date.

4.14 We recognise some of the concerns with continued trail commission payments. Investors may be paying for trail commission without receiving any service in return. Under our current rules, advisers do not have to provide an ongoing service for the trail commission. There can be a situation where the investor is paying for trail commission on an investment product but may still have to pay separately for financial advice.

4.15 Asset management firms told us that trail commission payments acted as a barrier to investors receiving value for money. Trail commission may be a high amount, both cumulatively and/or on an annual basis. One industry report suggests that the ongoing charges for some pre-RDR share classes are 90% higher than for classes that do not pay trail commission for similar types of funds.[9] As these are typically a contractual arrangement between the provider and adviser, investors may not be able to re-negotiate payments or demand that the adviser changes or improves the service offering, or even provides them with a service at all.

4.16 It may also be the case that some investors do not remember from the point of sale disclosure that they are paying for trail commission or are unaware of the adviser who is receiving the payments. This is because advisers can sell their legacy books without the investor being informed. Investors will have limited options even if they do discover that they are paying trail commission. For some investors, the only way to get out of paying trail commission is by selling their investments. This is not cost-free, as investors may also incur charges or tax liabilities on those transactions.

6 Of the 30 firms that provided data, 21 asset management firms reported paying around £1.4bn in commission in 2015 and 9 said they made no commission payments. This figure includes payments made to UK and non-UK distributors and some payments which have since ceased. It does not include rebates back to investors. In addition, the figure does not capture investors that are in classes where commission has been turned off.

7 Analysis undertaken by Ignitus Europe on Morningstar data www.igniteseurope.com/c/1568203/182373/more_than_still_share_classes?referrer_module=issueHeadline&module_order=0

8 Our rules permit commission to continue to be paid in limited circumstances, such as when there is no change to the client's product. See COBS 6.1A.4A R, COBS 6.1A.4AB R, COBS 6.1A.4AC G and COBS 6.1A.4B R for further details.

9 According to the fund fee research firm Fitz Partners, the average ongoing charges for actively managed equity funds is 0.88% for share classes that do not pay trail commission. Pre-RDR classes have ongoing charges of 1.67%, which is 90% higher. www.igniteseurope.com/c/1568203/182373/more_than_still_share_classes?referrer_module=issueHeadline&module_order=0

4.17 While asset management firms have asked us to intervene, there are no regulatory barriers preventing asset management firms from stopping trail commission payments. The main barrier for firms is likely to be the contractual arrangements between the manager, adviser and investor which allow for these commission payments and the terms and duration of those arrangements. Some firms have also told us they fear advisers will not recommend them for future clients if they unilaterally switch off trail commission. One firm told us they had experienced this after switching off trail commission, although they were not particularly reliant on advisers in their business.

4.18 On the other hand, we recognise that re-opening a debate around payment of trail commission could have a significant impact on the advisory market. We also recognise that banning trail commission payments could potentially affect self-employed advisers who were relying on that trail commission for future income, including after their retirement. Entitlement to trail commission could be an important element of the value of a business when an adviser retires or sells their business. In the past, we have heard that banning trail commissions could have a disproportionate impact on smaller advisory firms. However, we are not clear on the extent to which smaller advisory firms receive trail commissions. Some industry sources suggest that the firms charging pre-RDR fee levels are still most commonly life insurance companies and banks.

Our approach

4.19 Although we have not taken steps to introduce an end date for trail commission on legacy business for product providers including asset managers, we have said we may consider it in the future.

4.20 In light of the concerns raised by respondents to the interim report we are open to exploring this issue in more detail. However, in order to consider some of these issues further we need to be presented with clearer evidence of harm. We welcome information that will help us understand the magnitude of the issue and the number of investors that are affected. The evidence provided by firms will help us assess the scale of the issue, the barriers which allow the issues to persist and our appropriate response. Where we receive evidence of investor harm through continued trail commission payments, we will feed this information into our further policy work in this area.

4.21 As mentioned above, stopping the payment of trail commission could have a significant impact on the product providers, and particularly on self-employed advisers who rely on that trail commission for future income. We welcome information from advisory firms and asset managers to better understand this issue

4.22 We want to continue to engage with stakeholders on this issue and collect evidence which will help frame our thinking.

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

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

4.23 Trail commission to advisers for investment products is not only a feature of the asset management sector. Other providers, such as life assurance companies, also pay trail commission to advisers. Some advice firms use trail commission to continue to provide an ongoing service to clients. This is particularly the case in life and personal pension products, where funds can often be switched within the product wrapper without triggering a need to move to adviser charges. In this market, it was also the case that trail commission was sometimes paid in lieu of initial commissions. So as well as considering removing trail commission in the asset management sector, it may be appropriate for us to also consider consumers invested in other retail investment products that pay trail commission. In particular, the potential concerns identified in paragraphs 4.14-4.16 apply equally in other circumstances. We seek further information on the role that trail commission still plays in adjacent markets and the consequences of stopping trail commission payments.

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

5 Ensuring fairer treatment of dealing profits

5.1 The asset management market study identified a particular practice that supports our findings that there are significant weaknesses in the demand side for retail asset management products.[10]

5.2 The way in which unit prices are calculated in dual-priced funds means that fund managers dealing in their own units are able to make risk-free box profits. In a competitive market these would be shared with or passed through entirely to investors. This chapter outlines the changes we are proposing to our rules and guidance for AFMs on box management.

What is box management?

5.3 Some AFMs, especially those offering dual-priced funds, may operate a 'manager's box'. The 'manager's box' is a mechanism whereby an AFM, using its own capital, stands between the fund and those investors who are entering or leaving the fund, rather than the investors transacting directly with the fund. For example, investors wanting to leave the fund sell their units to the AFM, who pays them the amount due. The AFM instead of cancelling the units, holds them in the manager's box and can subsequently sell these units on to other investors.

5.4 In dual-priced funds there is a difference between the price investors pay to buy units in the fund ('offer price') and the price to sell units ('bid price'). There is opportunity for the AFM to make a profit in operating a manager's box. One way in which an AFM can make a profit is if they own the units over a valuation point in the fund. These units are subject to price fluctuations and the AFM may make a profit or loss, depending on changes in the valuation of units. We consider these to be 'at-risk' box profits.

5.5 Another way in which an AFM may make a profit using the manager's box is when the AFM buys units at the offer price and sells them at the bid price at the same valuation point. In this scenario, the AFM makes a profit from the difference between the bid and offer price. The AFM's capital is never at risk in this process as matching is instantaneous. So, the profit generated from this activity can be described as a 'risk-free' box profit.

Our concern

5.6 The use of a manager's box can be compatible with acting in the best interests of investors. For example, it can be an efficient way of dealing that avoids generating transaction costs within the fund. An AFM is also entitled to commit its own capital to its funds and participate in their risk and return, on the same basis as investors.

10 See Chapter 7 of the asset management market study interim report.

5.7 Our concern is whether AFMs might be profiting unfairly from box management. Whether an AFM will be able to make risk-free box profits at any particular valuation point is entirely arbitrary. It depends on how many matching orders there are from buying and selling investors on the same day and the size of those orders. It is therefore not possible to tell, either from forecasts or after the event, if the price any one customer has paid for their units covered the costs of their transaction or contributed to the AFM's box profit. There is thus no opportunity for investors to scrutinise this.

5.8 There is no explicit rule in the COLL sourcebook that allows profits to be made from box management, although the language used in COLL 6.2.9G implies that the manager could keep risk-free box profits.[11]

5.9 Risk-free box profits arise not because of any risk-taking or value added service that the AFM is providing. Rather, they are a by-product of the AFM's ability to match transactions instantaneously with little risk to itself. In our view, the benefits of this activity should be passed on to investors.

5.10 Our supervisory work and the market study's focus on box profits have resulted in some firms changing their practices. The diversity of industry practices shows that taking risk-free box profits is not a widespread norm and that some firms share our view that the practice is hard to justify from a Treating Customers Fairly perspective. However, we are not satisfied that this will address our concerns. In our view, rule change is the best way to ensure that all firms take a consistent approach to the treatment of box profits.

Our proposal

5.11 We are proposing new rules which would require

- AFMs to pass 'risk-free' box profits (i.e. profits generated by netting off transactions) to the fund
- AFMs to disclose their policy on operating a manager's box and how any profits will be treated in the prospectus

5.12 AFMs will be permitted to retain any profits made from holding positions between pricing points when using their own capital ('at risk box profits'). AFMs should, if they wish, be able to deal as principal in the units of the funds they manage. We do not consider that there is a case for prohibiting AFMs from retaining the profits of this activity in all circumstances.

5.13 The proposal to redirect risk-free box profits to the fund benefits ongoing unitholders, even though they are generated through the actions of subscribing/redeeming unitholders. We considered whether we should require AFMs to pass on box profits to subscribing/redeeming investors instead. We decided against this approach because in our view, there is likely to be considerable operational complexity around how the AFM would decide which redeeming investors should get a 'netting off' discount and how that discount would be calculated. However we would like to hear from firms on this.

11 COLL 6.2.9G(4) says 'where the authorised fund manager operates a box with the principal aim of making a profit...'

5.14 Following the publication of the interim report, a number of firms have told us that they no longer retain risk-free box profits. While this is encouraging, we are keen to ensure that our rules prevent a return to this practice. We would like to hear from firms if our proposed rules could be further modified to achieve that and prevent any ambiguity on our policy intent.

5.15 When complying with our proposed rules, AFMs should also consider the client's best interest rule (COBS 2.1.1R(1)). When supervising compliance with the rules proposed here, we will be mindful of whether the AFM has adequately considered the client's best interests as part of its box management policy.

> **Q15:** **Do you agree with our proposal to allow box profits to be retained by the AFM when they have been earned through an 'at risk' exposure, but not when they are achieved risk-free?**

> **Q16:** **Do you have any comments on whether risk-free profits should be passed on to investors in the fund or given back to subscribing/redeeming investors?**

5.16 Firms that responded to the interim report raised concerns that paying box profits into the fund may enhance the performance record of the fund, even though that is not attributable to how the assets are invested or managed. Firms argued that there is a risk that an AFM could, potentially, widen the dealing spread on a dual-priced fund to materially enhance the performance of the fund. We note this concern, however, we are not convinced that a requirement to pass on risk-free box profits to the fund will have a detrimental effect on dealing spreads. The maximum permitted dealing spread is already limited by our rules as part of the methodology for calculating fund prices, which is checked by the depositary. The AFM then makes a commercial decision, considering a range of factors, whether to use the maximum spread or set a narrower spread. In our view the proposed rule change on risk-free box profits will not significantly impact that decision. Nevertheless, we note this concern and will consider it as part of any future supervisory work in this area.

5.17 We want AFMs to state explicitly their policy on operating a manager's box in the fund prospectus and whether they may retain any profits from it. COLL 6.7.16G currently says that an affected person, including the AFM, is not liable to account to another affected person or to unitholders for profits in connection with, amongst other things, dealing in the units of a scheme where it has made a statement to that effect in the prospectus. We propose a rule, to replace existing guidance, which requires the AFM to disclose in the prospectus its policy on operating a manager's box and how any profits will be treated. AFMs will have to account for risk-free profits passed back into the fund, although we do not propose to require the AFMs to disclose any at-risk profits they make.

5.18 COLL 6.6.4R requires the depositary to take reasonable care to ensure that the AFM manages the scheme in accordance with COLL 6.2. We consider that the impact of COLL 6.6.4R is that depositaries will oversee compliance with our proposed rule changes to COLL 6.2.

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

6 For discussion: extending the scope of our proposals to other retail investment products

6.1 As well as authorised funds, investors can access retail investments through other products. Insurance companies offer retail investment products in the form of unit-linked or with-profits insurance products, such as personal pensions, investment bonds or endowments. Currently there are £914bn in assets under management in unit-linked funds and £304bn in with-profits funds, compared to £872bn in authorised funds available directly to retail consumers.[12] We recognise that some unit-linked assets are invested in authorised funds. Consumers can also invest in funds set up as closed-ended investment companies, including investment trusts. It is estimated that investment trusts hold £163.5bn by assets under management.[13]

6.2 The main focus of the market study was on how competition is working between asset managers for retail and institutional investors that use funds and segregated mandates.[14] The asset management market study did not directly focus on unit-linked, with-profits business or investment companies. However, we are aware that the concerns the market study highlights around value for money and governance in authorised funds may also exist for other types of investment products. We seek views from all relevant stakeholders on whether we should consider extending remedies similar to those proposed in Chapter 3 to other types of retail investment products and, if so, whether these remedies would require specific modification to be appropriate in each circumstance.

Unit-linked funds and with-profits business

6.3 In contrast to UCITS and other authorised funds marketed to retail consumers, unit-linked and with-profits insurance products are not FCA authorised in their own right. Instead, regulation focuses on life insurers and other firms involved in the provision and sale of insurance and pensions. Life insurers are dual regulated by the FCA and the PRA. The PRA regulates them for prudential requirements and capital solvency issues. The FCA regulates conduct, including through high-level principles and rules like those set out in the Principles for Businesses, SYSC and general COBS requirements. Life insurers also have to comply with the PRA's Senior Insurance Managers' Regime and the FCA's Approved Persons Regime.

6.4 In addition to rules for designated investment business generally, firms face specific additional requirements when operating with-profits business (COBS 20) and unit-linked business (COBS 21).[15]

12 Sourced from 2015 PRA insurance returns data and the Investment Association Asset Management Survey 2015-16.
13 www.theaic.co.uk/sites/default/files/statistics/attachment/AICIndustryOverview30Apr17.pdf
14 The geographic scope was limited to funds and segregated mandates managed in the UK and/or provided and marketed to UK investors.
15 The 'Permitted Links' rules in COBS 21 limit the type of asset permitted for investment for retail customers (post Solvency II, equivalent to those permitted for UCITS) and include a duty of fair and accurate valuation.

6.5 Insurers will also have to comply with the Insurance Distribution Directive, which comes into force on 23 February 2018. The requirements will apply to all insurance products, including pensions that are structured as insurance products.

Unit-linked funds

6.6 The management of unit-linked funds is also covered by the Association of British Insurers' (ABI) Guide To Good Practice For Unit-Linked Funds (the ABI Code).[16] The ABI Code has been prepared recognising that there is not currently a detailed set of FCA requirements placed on unit-linked fund managers.[17] It recommends that governance arrangements for unit-linked funds should look at various investment and product-related issues. It also recommends that the firm's governing board should have ultimate responsibility for governance, along with ensuring fair treatment of customers, but may delegate duties to senior committees or individuals to support it in carrying out these responsibilities. Insurance companies may have investment committees in place[18] to consider investment and product-related issues, but these do not necessarily focus on value for money and would not typically have independent members.

6.7 We looked at governance arrangements of unit-linked funds in 2013.[19] We identified concerns about behaviours which indicated that firms were not considering the best interests of investors as robustly as we would expect. For example, we had concerns about the application of pricing mechanisms and how well firms were managing conflicts of interest.[20]

6.8 One of the elements of the proposals put forward in Chapter 3 is the requirement to have independent members on governance bodies that oversee the management of investors' assets. We believe this is important because having independent members is likely to contribute to a more robust challenge to firms, especially on issues like value for money where the firms' interests may compete with those of investors. Having independent members reduces the risk that issues are not considered properly. The ABI Code does not currently emphasise independence in governance committees, even though it does give examples where we consider that independence would be important to ensure the issues are considered thoroughly.[21]

With-profits business

6.9 With-profits products have different governance arrangements to unit-linked products. While ultimate responsibility for managing a with-profits fund rests with the firm through its governing body, FCA rules require that firms appoint a with-profits committee (or a with-profits advisory arrangement) for each with-profits fund they

16 ABI 'Guide To Good Practice For Unit-Linked Funds' (May 2014) www.abi.org.uk/globalassets/sitecore/files/documents/publications/public/2014/conduct/abi-guide-to-good-practice-for-unit-linked-funds.pdf

17 'Instead, the FCA set out a framework of principles for business which senior management must apply and interpret, coupled with some specific requirements in particular areas, such as permitted links for investments'. ABI Guide to Good Practice as above, para.1.6.

18 For example, the ABI's 'Guide to Good Practice for Unit-Linked Funds', notes in para.2.5 that firms will typically use committees in their governance structures, with specific names and duties varying by firm.

19 TR13/8 'The governance of unit-linked funds' (2013)

20 Specifically the thematic review raised concerns about the application of 'swinging' prices in dual-priced funds. On managing conflicts of interest, the review found that firms' desire to use existing funds to seed new funds could encourage firms to invest in a manner incompatible with investment mandates, fund objectives or customers' best interests'. The review resulted in six s.166 reports for various governance failings in individual firms but overall we did not find evidence of a 'serious threat to customers' investments'. Following our thematic review in 2013 the Code was updated to reflect our recommendations.

21 For example, paragraph 2.23 of the ABI Code cites that conflicts of interests might arise between the competing interests of shareholders and customers; different customer groups; and employees or directors and customers.

operate.[22] With-profits committees must have clear terms of reference. Our COBS rules set out the minimum parameters of what the committee must consider, including how each with-profits fund is managed and whether the firm is managing conflicts of interests in a way that is consistent with treating customers fairly.[23]

6.10 We require the majority of the members of a with-profits committee to be independent of the firm, or, where there are an equal number of independent and non-independent members, that it is chaired by a person who is one of the independent members.[24] We also expect that, in general, a with-profits committee or advisory arrangement will work closely with the with-profits actuary[25] and obtain their opinion and input as appropriate.[26]

6.11 As a result, these governance arrangements would appear to be better aligned with the aims of our governance proposals for authorised fund managers. However, at this stage, we do not have a full view of whether governance structures in with-profits funds are able to drive better outcomes for investors. There is some alignment between the terms of reference for with-profits committees and what we would expect firms to consider when acting in investors' best interests. However we would like to explore further whether with-profits committees actually consider this as robustly as we would expect. We currently have a thematic review planned which will look at the fair treatment of customers in with-profits funds.[27]

Should we extend governance remedies?

6.12 There are differences in the way that unit-linked and with-profits products are designed and managed, and even more distinct differences in the regulatory regimes for insurance-based investment products and authorised funds. However, from the perspective of investors, these products resemble one another and investors may expect the same or similar outcomes from them. We recognise that the risks and issues for authorised funds, which our proposals seek to address, may similarly affect the ability of unit-linked and with-profits products to achieve the best outcomes for investors.

6.13 In our view, consumers who save or invest through unit-linked and with-profits life assurance products would also benefit from the increased protections that we expect our proposals to deliver for authorised funds. Strengthening requirements for authorised fund managers, without doing something similar for life insurance companies where appropriate, runs the risk of causing unintended consequences for competition between economically similar products. Authorised funds that have to bear the initial costs of complying with our proposed governance changes may become more expensive compared to other products in the short term. Our proposals to enhance governance arrangements for authorised funds aim to improve outcomes for investors. However, if asset managers were incentivised to offer their products through a different vehicle that does not consider investors' interests equally robustly, that could defeat our aim of improving outcomes for investors. In our view, we should seek to apply at least the principles behind our proposed remedies for authorised funds to unit-linked and with-profits products too.

22 COBS 20.5.1R. A with-profits advisory arrangement can be appointed only if appropriate in the opinion of the firm's governing body having regard to the size, nature and complexity of the fund.
23 COBS 20.5.3R
24 FCA Handbook Glossary definition of a 'with-profits committee'.
25 A with-profits actuary performs a PRA controlled function which requires them, amongst other items, to advise the firm's management on key aspects of the discretion to be exercised affecting the classes of with-profits business for which they have been appointed.
26 COBS 20.5.4G
27 FCA Business Plan 2017/18, Annex 1

6.14 We invite views from relevant stakeholders on whether it would be appropriate and proportionate for us to consider extending any aspects of our governance proposals for authorised funds to unit-linked and with-profit products. We would like feedback on the following questions:

Q18: **Are current arrangements, particularly for with-profits business, fit for purpose and can they achieve the same outcomes? If so, please elaborate on how they achieve these outcomes.**

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

Q20: **What would the costs, challenges and resource implications be for firms if we applied the proposals in Chapter 3 to life insurers?**

Q21: **What would the potential benefits be for consumers and firms of introducing any additional governance requirements for unit-linked funds and with-profits business?**

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

Pensions

6.15 Pension schemes were part of the asset management market study, although we did not focus on the interaction between the members and the scheme operators as part of the market study. When considering the governance arrangements in place for unit-linked funds in particular, we know that the majority of these funds are accessed through pensions.[28] In practice, product design may be shaped, to some extent, by equivalent funds being made available in a number of different markets. For example, a particular unit-linked fund might be most commonly available through a workplace pension but, in practice, a highly similar fund may also be available through an individual personal pension or a life product, such as an investment bond. Similarly, we are also aware that unit-linked funds commonly seek to mirror authorised funds.

28 TR 13/8 'The governance of unit-linked funds' (October 2013) para 1.1.1

6.16 In 2015, we introduced rules requiring providers of workplace personal pension schemes, many of which are insurance companies, to establish and maintain independent governance committees (IGCs).[29] A recent review jointly undertaken by the FCA and Department of Work and Pensions found that IGCs were 'generally effective… by influencing, supporting and advancing the reduction in costs and charges that has been achieved so far'.[30] The review found that while there was still work to be done, the industry has made significant progress overall.

6.17 Separately, we have committed to undertake initial discovery work to explore whether the non-workplace pensions market is working in consumers' interests.[31] Because of this, at this stage we are not bringing forward proposals to extend the specific remedies in Chapter 3 to pension products. However, we will consider whether we should be doing more to consider governance as part of the work we have committed to on non-workplace pensions.

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

Investment companies

6.18 Consumers can also invest in funds set up as closed-ended investment companies, including investment trusts. Investment companies, unlike authorised funds, are not directly regulated by the FCA unless they choose to manage their own assets. Alternatively, they may appoint an external investment manager to which the Alternative Investment Fund Managers Directive (AIFMD)[32] applies (in which case that investment manager is regulated by the FCA).[33]

6.19 Investors become shareholders of investment companies, which come under the Companies Act regime with regards to corporate governance and shareholder rights. The board of directors is independent and should represent the interests of shareholders in the company and, where appropriate, take action on their behalf. For example, the board should be able to negotiate improved terms for shareholders by reducing the fees they have to pay to the external investment manager where appropriate.

6.20 Listed investment companies will also be caught by UK Listing Rules which require their board of directors to be demonstrably independent of any investment manager and that a majority of directors are independent.

6.21 Investment trusts will not be in scope of our proposed COLL rules on AFMs to consider value for money. However, some narrow elements of our proposed governance remedies exist. For example, where the investment company has an authorised full-scope AIFM, it is required to ensure that that neither the AIF nor investors are charged undue costs.[34] Listed investment companies are also subject to an

29 COBS 19.5
30 'Remedying Poor Value Legacy Workplace Pension Schemes: Findings from the Joint Review of Industry Progress against the Independent Project Board Recommendations' (December 2016)
31 FCA Business Plan 2017/18 page 64
32 EU Directive 2011/61/EU
33 A self-managed investment company may also be subject to AIFMD and authorised by the FCA for that purpose, unless its assets under management are below a certain value in which case it is subject only to a registration requirement.
34 Subject to the AIFMD level 2 Regulation Art 17 requirement to ensure that neither the AIF nor investors are charged undue costs.

'independence rule'.[35] This existing combination represents a set of rules which are similar to, but narrower than, our proposed governance requirements for authorised funds.

6.22 MiFID II will introduce product governance requirements for MiFID scope products, which may include investment trusts. We will consider the impact of MiFID II with regard to fund governance issues for investment companies.

6.23 Authorised funds and investment companies have many similarities, and we want to avoid applying regulatory standards to one investment vehicle that have no equivalent in the other. Widely differing regulatory treatments might have unintended consequences for product development and distribution.

Q24: What are your views on whether it would be appropriate and proportionate for the FCA to consider introducing similar rules to those proposed for authorised funds for investment companies?

Q25: Is there a risk of investor harm or disruption to the market if we do not extend our proposals for authorised funds to investment companies? If so, how would this risk affect investors?

35 UK Listing rules LR 15.2.11R to 15.2.19R.

Annex 1
Questions in this paper

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

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

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

Q4: **Do you agree with the proposed requirement for the AFM to publish a report on the findings of the assessment and the steps taken?**

Q5: **Do you agree with our proposal to require AFMs to appoint independent directors to the board? If not, what alternative(s) would you propose?**

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

Q7: **Do you agree with our approach that independent directors may serve on more than one board, provided that they comply with existing rules? If not, do you think a ban on serving on more than one board is necessary?**

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

Q9: **Do you agree with an implementation period of 12 months? If not, how much time do you think AFMs will need to appoint suitable independent directors?**

Q10: **Do you agree that it should be up to AFMs to decide whether to appoint an independent director or an executive director as chair?**

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

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

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

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

Q15: **Do you agree with our proposal to allow box profits to be retained by the AFM when they have been earned through an 'at risk' exposure, but not when they are achieved risk-free?**

Q16: **Do you have any comments on whether risk-free profits should be passed on to investors in the fund or given back to subscribing/redeeming investors?**

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

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

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

Q20: **What would the costs, challenges and resource implications be for firms if we applied the proposals in Chapter 3 to life insurers?**

Q21: **What would the potential benefits be for consumers and firms of introducing any additional governance requirements for unit-linked funds and with-profits business?**

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

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

Q24: **What are your views on whether it would be appropriate and proportionate for the FCA to consider introducing similar rules to those proposed for authorised funds for investment companies?**

Q25: Is there a risk of investor harm or disruption to the market if we do not extend our proposals for authorised funds to investment companies? If so, how would this risk affect investors?

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

Annex 2
Cost benefit Analysis

1. FSMA, as amended by the Financial Services Act 2012, requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made'.

2. This analysis presents estimates of the significant impacts of our proposal. We provide monetary values for the impacts where we consider it is reasonably practicable to do so. For others, we provide estimates of outcomes in other dimensions. Our proposals are based on carefully weighing up these multiple dimensions and reaching a judgement about the appropriate level of consumer protection, taking into account all the other impacts we foresee.

Fund governance

3. As confirmed in the asset management market study final report, we found evidence suggesting that there is weak price competition in a number of areas of the asset management industry. In particular, retail and small institutional investors are not adequately informed or organised to drive competition on price, and this has a material impact on the investment returns of investors through their payments for asset management services. We have also found that, although AFMs have a duty to act in the best interest of investors under our existing rules and to treat customers fairly, they do not consider value for money on a consistent basis. These two factors lead to uncompetitive outcomes where the cost of fund management for investors in UK domiciled authorised collective investment schemes is higher than it should be, and in which AFMs capture a higher share of the returns than would otherwise take place.

4. We believe our overall package of remedies, once implemented, will lead to better competition in the asset management industry, which will in turn lead to better outcomes for investors.

5. This section focusses specifically on our proposals to amend and enhance the governance of authorised funds. The proposals build on existing requirements in our Handbook for fund managers to act in the best interests of the investors in their funds. They seek to do this through a combination of factors including an explicit requirement to consider value for money; providing individual incentives for this to be done effectively; introducing a greater degree of independence to the relevant decision making bodies to rebalance competing interests, and requiring transparency over the discharge of these duties to allow for great market scrutiny.

6. In summary, these proposals provide that:

- An AFM must assess the ongoing value for money for unit-holders in each relevant fund it runs.[36] Our rules will include a set of criteria we expect AFMs to consider as part of this assessment.
- The boards of all AFMs in the scope of these rules must have 25% by number (and at least 2) independent directors. This rebalances the competing interests on the AFM Board, and aims to introduce a greater degree of independent challenge to discussions about the best interests of investors, including the assessment of value for money.
- The AFM board must publish periodic reports detailing the activity taken to discharge these obligations.

7. As part of the Senior Managers Certification Regime (SM&CR), we will also consult on a prescribed responsibility which will make the chair of the AFM board personally accountable for discharging these obligations. The individual will have a statutory duty to take 'reasonable steps' to ensure that the AFM discharges its obligation to consider value for money according to the new rule. The CBA of this proposal will be considered separately when we consult on those proposed changes.

8. Over time we believe these proposals will lead a number of benefits for investors, through a more consistent and rigorous consideration of their needs. However, we expect one of the principal benefits to accrue to investors through our proposals will be a reduction in the fees and charges they pay.

9. This assessment focusses on the costs of our proposals compared to this specific set of benefits.

Baseline

10. While we already expect AFMs to provide value for money as part of acting in the best interests of investors, the asset management market study has found that AFMs fail to consider value for money on a consistent basis. This has led to the market as it stands today, with investors being charged the current level of fees and charges in exchange for the services provided by AFMs.

The changes in behaviour we expect to see

11. By introducing an explicit requirement for AFM boards to consider value for money, we will remove any potential ambiguity as to our expectations. Setting out in rules and guidance the steps we expect to be undertaken in this assessment should bring about a degree of consistency in these actions across different AFMs. For managers who are already considering some or all of the elements we set out in our new rules, the changes in behaviour will be smaller. For firms not considering these issues at all, we expect them to start doing so.

12. We believe that the introduction of independent members to AFM boards will provide an independent view and challenge to the deliberations of the board. This will help to reduce the tension between the competing interests of the investors and the interests of the AFM's shareholders that are likely to arise as part of assessing value for money.

36 By 'relevant fund' we refer to Collective Investment Schemes that are authorised and domiciled in the UK, plus EEA UCITS schemes run by a UK UCITS management company. However, for the purposes of calculating the AuM and weighted AMC of the funds for this CBA, set out below, we have disregarded such EEA UCITS schemes on the grounds that their overall size is not significant.

This should contribute to a more robust consideration of value for money and reduce the risk that the consideration is unduly biased towards the interests of shareholders. In addition to a potential reduction in annual management charge (AMC), the increased focus on value for money should also increase the AFM's incentive to effectively control ancillary costs paid for by the fund to third party providers.

13. Publishing the results of this consideration will allow third parties to scrutinise this work, providing a further check and balance to ensure the consideration is effective. This provides a further incentive for the AFM board to discharge its duties effectively.

14. Finally we consider that linking the obligations to act in the best interests of investors to the chair of the AFM board provides personal incentives for the chair to ensure this obligation is discharged effectively, for example the prospect that a failure to do so could result in regulatory scrutiny and possible enforcement action. However, as set out above, a separate CBA will follow regarding this proposal.

15. The combined effect of these measures on the average AFM board will, in our view, cause an explicit and meaningful consideration of value for money to be conducted that includes as a minimum a consideration of the fees and charges investors pay.

16. Considered in the context of the market study, where we have found evidence of a broad range of costs and charges for apparently comparable services and sustained high levels of profits, we think it is reasonable to conclude that these assessments will lead to some firms reducing the fees and charges investors pay.

17. We do not believe it would be proportionate for us to attempt to model these effects on a fund by fund or firm by firm basis. However, we can reasonably estimate the expected costs to firms of our proposals, including the on-going costs which we expect to be passed on to fund investors. We can then compare these costs with the reduction in fees and charges caused by AFMs' consideration of value for money that would be required for our proposals to bring, overall, a net benefit to investors.

One-off costs

18. We assume that AFMs will incur costs as they prepare for the implementation of this rule, and that these costs will be absorbed by the AFMs (i.e. these costs will not be passed on to the fund and/or investors). We estimate that each AFM will incur an average one-off cost of £9,800. This is based on estimated costs from two sources. Firstly, we estimate that each AFM will incur five 'person days' of compliance staff work. We have estimated that this sort of compliance work will cost £363.64 per person per day; this is based on an average annual staff cost to the AFM of £80,000 per person, divided by 220 working days. £363.64 multiplied by 5 is £1,818.18 per AFM. Secondly, we estimate that each AFM will incur two working days (16 hours) of external legal advice at an estimated average cost per hour of £500 (£8,000 per AFM).

19. Taken across the 192 AFMs authorised by the FCA[37], this equates to around £1.9 million in one-off costs.

Ongoing costs

20. We assume that AFMs will incur ongoing costs in terms of the time that executive directors will take to prepare for and participate in annual board discussions on value for money, and also in the costs they will incur in compliance /support staff time to help

37 We are referring to firms with the 'managing an authorised AIF' and/or 'managing a UCITS' permissions.

the directors prepare for those discussions.[38] We are assuming that all such costs will be passed on by the AFM to fund investors. We estimate these costs to be £813,000 per year across the 192 AFMs.

21. This is based on the assumption that, on average, each AFM has seven executive directors (i.e. non-independent directors). We assume that, at least once a year, each executive director spends 1.5 hours per meeting preparing for discussions on value for money. We estimate each executive director's hourly rate as £56.82. This is based on an estimated salary of £100,000 p.a., 220 annual working days, and each working day being eight hours long. The total cost of executive directors' time to consider value for money therefore amounts to £596.59 per AFM per year (£56.82 multiplied by 1.5 hours multiplied by seven directors). In addition, we assume the directors will need legal/compliance support which will cost each AFM £3,636.36 p.a. This is based on compliance staff spending ten person days preparing ahead for each meeting, at a cost of £363.64 per person as set out above. Both of these lead to a total cost per AFM of around £4,232.95; multiplied by 192 AFMs, this leads to £813,000 across the industry (rounded).

Costs of requiring the AFM board to have independent directors

22. Our supervisory experience indicates that AFM boards generally have five to eight directors, with typically no independent directors. Under the proposed requirement for at least 25% of AFM boards to consist of independent directors, and a minimum of two independent directors on each board, an AFM board with six members will need two independent directors, while AFMs with seven (to nine) would need three independent directors. In this CBA, we take the midpoint of this range, and assume that each AFM needs to appoint 2.5 independent directors.

One-off costs

23. We assume that AFMs will incur costs in recruiting new independent directors for the first time, and that these costs will be absorbed by the AFMs. We estimate that each AFM will incur a one-off cost of £25,000 on average. This is based on the assumption that each AFM appoints on average 2.5 new independent directors, and that the recruitment cost per individual will be around £10,000. Taken across the 192 AFMs authorised by the FCA, this equates to £4.8 million.

Ongoing costs

24. AFMs will incur ongoing costs for remunerating independent directors and for other miscellaneous staff time needed to support the independent directors in their posts. We are assuming that all such costs will be passed on by the AFM to fund investors. We estimate that the average number of new independent directors will be 2.5 per AFM. For each AFM, we estimate that each independent director will receive £40,000 per year in salary and other payments. In addition, we have estimated the cost for other ancillary services needed to support independent directors at £40,000 per year per AFM. This includes periodic recruitment costs for new independent directors to replaces others leaving the board. We therefore estimate the total costs of independent directors for each AFM to amount to £140,000 per year. Based on 192 AFMs, this will amount to £26.9 million per year across the industry (rounded).

38 The cost of the staff time of the independent directors is accounted for separately below

Breakeven analysis

One-off costs	One-off costs to AFMs of these proposals	£6.7m[39]
	One-off costs to investors of these proposals	None. These are borne by AFMs
Ongoing costs	Ongoing costs to AFMs of these proposals	None. These are passed through to fund investors
	Ongoing costs to investors of these proposals	£27.7m[40]
Annual revenue of all UK AFMs		£7,605m[41] (£7.6 billion)
These ongoing costs as a decimal of the total AuM of the funds in question (£1.17 trillion),[42] expressed in basis point terms, to illustrate the 'break even' point of this policy for investors, as explained below		0.24 basis points (i.e. 24% of 1 basis point)[43]
The ongoing costs as a percentage of AFMs annual revenue, as an alternative way to put the size of the 'break even' point for investors in context		0.36%[44]

25. The policy intervention will be net costly to investors if the reduction in fees (e.g. AMCs) and charges stemming from AFMs' consideration of value for money is less than the direct ongoing costs of this policy that we expect AFMs to pass through to investors in fund charges. Any reduction in fees and charges stemming from AFMs' consideration of value for money that is greater than these direct ongoing costs will be net positive to investors.

26. For the estimated ongoing costs of £27.7 million per year, the 'break even' point is a reduction in the AMC stemming from AFMs' consideration of value for money equivalent to 0.24 basis points per year. This is in the context of a money weighted average AMC of 65 basis points for the relevant funds (active and passive).[45] Put another way, this would mean UK AFMs reducing their AMC by an amount equivalent to 0.36% of their annual revenue.

27. We think that it is likely that the fees and charges will drop considerably more than this low breakeven level, and that our proposals will bring net benefits. This is the case even after taking into account the one-off costs borne by AFMs, which are relatively small.

39 This is reached by adding £1.9m which is the cost to AFMs of preparing to implement the requirement to assess value for money and £4.8m for AFMs' costs in recruiting independent directors for the first time.

40 The sum of the £813,000 per year ongoing costs associated with the requirement for the AFM to assess value for money and the £26.9 million per year ongoing costs associated with the cost of the independent directors, which we expect AFMs to pass through to fund investors via increased fees or charges.

41 This £7,605 million figure has been estimated by taking the money weighted average AMC of 65 basis points for the relevant funds (calculated from Morningstar data for active and passive UK domiciled authorised funds), and multiplying this by the estimated AuM for these funds (£1.17 trillion, taken from Morningstar data, and sense checked against recent IA data). 0.0065*£1,170,000,000,000 = £7,605 million. This figure has been cross checked against an estimation of AFM annual revenue figures arrived at from an analysis of data reported to the FCA by AFMs in FCA Returns, and found to be in close agreement.

42 Figure taken from Morningstar data, and compared with recent IA data.

43 £27.7m ongoing costs to investors divided by £1.17 trillion relevant AuM.

44 £27.7m ongoing costs to investors divided by £7,605m UK AFMs' annual revenue.

45 Estimated from Morningstar data for active and passive UK authorised funds.

Overall conclusion

28. Our proposed policy interventions intend to change the behaviour of the members of the governing body of AFMs, who are tasked with directing the affairs of the firm and the funds they are responsible for. We believe it is reasonable to expect this change will happen in practice. Furthermore, based on the evidence gathered in the market study, we think it is reasonable to conclude that there is scope for a reduction in the fees and charges paid by investors, equivalent to at least the breakeven point illustrated above.

29. We accept that the exact degree to which the expected change in behaviour leads to reductions in fees and charges will differ firm by firm and fund by fund. However, we are confident that, overall, it is reasonable to expect our proposed interventions to result in net benefits for investors.

30. Given the international nature of the sector and the risk of regulatory arbitrage, we have considered the costs of our proposals in comparison with the requirements in other jurisdictions. Other jurisdictions with large fund domiciles, such as Luxembourg and Ireland, have introduced comparable fund governance proposals over recent years including independence requirements. The US mutual funds model also has detailed independence and value for money requirements. We therefore consider the risk for regulatory arbitrage to be low.

Rule change on Box Profits

31. As described in Chapter 5, we propose to implement new rules in the COLL sourcebook to prevent AFMs from retaining risk-free box profits.

32. In summary, the 'manager's box' is a mechanism whereby an AFM stands between the fund and investors moving into or out of the fund. For example, investors wanting to leave the fund sell their units to the AFM, who pays them the amount due, rather than investors transacting directly with the fund. The AFM, instead of cancelling the units, holds them in the 'manager's box' and can subsequently sell these units on to other investors. The AFM holds these 'box' units as principal, not as agent for the fund or investors, and currently it can retain any profit it makes from trading them. This is called a box profit.

33. Funds are either single-priced, meaning that all transactions in units of the fund at each pricing point happen at a single price, or dual-priced. In dual-priced funds there is a difference between the price investors pay to buy units in the fund ('offer price') and the price to sell units ('bid price'), reflecting the price spread of the underlying assets.

34. Box profits can arise from either 'at-risk' or 'risk-free' trading in units. At-risk box profits arise when the AFM, trading as principal, holds units in the box for a period of time which exposes the AFM's capital to market risk and changes in valuation (i.e. the price of the units held in the box can go up or down). As the units in the box are owned by the AFM, its own capital is 'at-risk', and the profits are 'at-risk' box profits.

35. Risk-free box profits arise when the AFM is able to match or 'net off' transactions between investors entering and leaving the fund in the same dealing period. They are typically associated with dual-priced funds, because when the AFM acts as intermediary between investors moving into or out of the fund and the fund itself, it buys units from redeeming investors and is able to sell them on to subscribing investors before the next valuation point, profiting from the difference between the bid and offer prices. In this situation, matching of flows is instantaneous and the AFM has not taken on any market risk.

36. Our proposal is that AFMs should be allowed to retain at-risk box profits but must return risk-free box profits to the fund.

37. The direct cost of a rule change on risk-free box profits is that firms will lose a revenue stream. Our supervisory work across 11 firms found that these firms collectively made £69.74m in box profits, of which approximately £64.90m were from risk-free profits.

38. Following the publication of the AMMS interim report that highlighted our concerns over some asset managers retaining risk-free box profits, from our original sample, over 70% of earnings that were being retained from risk-free box profits either are no longer being retained by the asset manager or are subject to a public commitment from the asset manager to no longer be taken.

39. Our proposed rule change will result in at least £20m in risk-free box profits, that firms currently retain, being transferred in future to customers invested in those funds.

40. Industry reports confirm that most firms will not suffer a material fall in their overall profits by ceasing to take risk-free box profits.[46] We are aware that for a few firms revenue generated from box profits may be more significant. For example, we found that it accounted for 10% of one firm's revenue stream. In our view, this will not result in firms going out of business or having to modify their business models significantly. This should be true for smaller asset managers as well.

41. There may be some one-off costs but we expect these to be minimal (we estimate less than £5000 per firm). We are assuming that there are not any significant systems-related costs. Changes to operational arrangements will require a certain amount of compliance-related costs but we do not expect these to be significant. We do not expect there to be any ongoing costs to firms in complying with this rule.

Table 1: Costs and benefits of box profit rule change

	Benefits	Costs
To firms		Annual loss of risk-free box profit (£20m) One-time and ongoing compliance costs
To 'long-term' buy-and-hold investors	Annual gain of risk-free box profit (£20m)	
To 'short-term' entering and exiting investors	No change	No change

46 www.fnlondon.com/articles/schroders-set-to-stop-taking-risk-free-profits-20170113

42. Our proposed rule change will mean that investors in the fund will benefit from any risk-free box profits generated from investors entering and leaving the fund, because the revenue generated from the AFM's risk-free unit transactions when dealing as principal will be passed back into the fund. We recognise that long-term investors in the fund are likely to benefit from shorter-term investors entering and exiting the fund.

43. There also is a small chance that fund managers might consider dual-pricing to be unattractive if risk-free box profits were transferred to the fund, and so might change to an alternative pricing methodology, such as single pricing. Both dual pricing and single pricing have their relative benefits and limitations, and we do not favour one pricing mechanism over the other. If firms make the commercial decision to move from dual pricing to single pricing, we do not expect this to have a particularly detrimental impact on investors.

44. Firms that responded to the interim report raised concerns that paying box profits into the fund may enhance the performance record of the fund, even though that is not attributable to how the assets are invested or managed. Firms argued that there is a risk that an AFM could, potentially, widen the dealing spread on a dual-priced fund to materially enhance the performance. However, the maximum permitted dealing spread is already limited by our rules as part of the methodology for calculating fund prices, which is checked by the depositary. The AFM makes a commercial decision whether to use the maximum spread or set a narrower spread, so we are not convinced that a requirement to pass on risk-free box profits to the fund will have a detrimental effect on dealing spreads. We note the concern and will consider it as part of any future supervisory work in this area.

45. Our rule change requires that firms modify their prospectus to include their policy on box management, allowing them a transitional period of up to twelve months in which to do so. Firms typically amend their prospectus fairly frequently and have to review the document at least annually. Whilst there may be a cost attached to this it is not likely to be significant. If firms are able to make this amendment at the next scheduled prospectus update, then the cost would be even lower.

46. Depositaries will be required to monitor the AFM's compliance with its stated box management policy. Depositaries have an existing duty under COLL 6.6.4R to oversee the AFM's compliance with the relevant parts of the FCA Handbook. As a result, we expect that monitoring box management policies will be an additional element to this existing duty of depositaries. We expect the additional cost on depositaries to be minimal.

Clarifying existing guidance on share-class

47. As described in Chapter 4, we propose to clarify and re-issue our previous guidance (FG14/4) to reflect more accurately our position on moving investors to better value 'clean' classes of units in the same fund.

48. We will clarify that the AFM can undertake a mandatory conversion from one unit class to another, if the required conditions set out in COLL are met. The power to undertake a mandatory conversion must be exercised in accordance with the client's best interests rule (COBS 2.1.1R (1)).

49. We are not undertaking a cost benefit analysis for this as this is a clarification of our existing position and compliance will not impose new costs for firms. Instead AFMs will now be able to close down expensive pre-RDR share-classes which they told us were uneconomical to run. Firms may face some minor dissemination costs. However bearing in mind the length of the document and our proposed changes (which are a few paragraphs long), we expect these will be minimal.

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

Annex 3
Compatibility statement

Compliance with legal requirements

1. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation, including an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under the Financial Services and Markets Act 2000 (FSMA).

2. When consulting on new rules, the FCA is required by section 138I(2)(d) FSMA to include an explanation of why it believes making the proposed rules is (a) compatible with its general duty, under s. 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, and (b) its general duty under s. 1B(5)(a) FSMA to have regard to the regulatory principles in s. 3B FSMA. The FCA is also required by s. 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.

3. This Annex also sets out the FCA's view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (s. 1B (4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.

4. We also explain how we have considered the recommendations made by the Treasury under s. 1JA FSMA about aspects of the economic policy of Her Majesty's Government to which we should have regard in connection with our general duties.

5. We also include our assessment of the equality and diversity implications of these proposals.

6. Finally, under the Legislative and Regulatory Reform Act 2006 (LRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRA.

The FCA's objectives and regulatory principles: Compatibility statement

7. The proposals set out in this consultation are primarily intended to advance the FCA's operational objective of *promoting effective competition in the interest of consumers*. They are also relevant to the FCA's consumer protection objective.

8. We consider that these proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well because they address the market failure identified in the Asset Management Market Study, which has found that there is weak competition in price between asset managers, and that investors often end up paying too much for their investment products. For the purposes of the FCA's strategic objective, "relevant markets" are defined by s. 1F FSMA.

Promotion of effective competition in the interest of consumers

9. The FCA has had regard to the 5 matters in s.1E(2)(a)-(e) FSMA.

10. We consider that these proposals advance the FCA's objective of promoting effective competition in the interest of consumers because they address the market failure and consumer harm identified in the Asset Management Market Study.

- We have identified products being offered to investors which offer poor value for money. This suggests that competition is not working effectively for these products. Our governance proposals should increase the focus on value for money and so deliver better outcomes for investors. By requiring AFMs to be transparent about their value for money assessments, we would expect that firms would compete to demonstrate that they are delivering value for money.

- Our proposals on share classes will make it easier for asset managers to move investors into better value share classes, where available. This will allow AFMs to close down expensive pre-RDR share classes which are uneconomic to run; thereby improving their efficiency. In a competitive market, these cost savings would then be passed on to investors, driving price competition in the market.

- At present AFMs are not expressly prohibited from retaining risk-free box profits which are made when matching investors' buy and sell orders. This practise is not made transparent to investors. It is therefore not possible for investors to compare which AFMs provide the most competitive practises. By removing the ability to make profits from an activity that doesn't benefit consumers, firms affected by our proposals on risk-free box profits will have to provide more competitive choices for investors. In some cases, they may also have to apply more efficient practises to generate revenue previously achieved from risk-free box profits from activities which are in the best interest of investors.

11. Improved competition should also further increase the efficiency of the asset management industry and its attractiveness to international and domestic investors. We believe that overall this will help us to deliver public value through a better functioning asset management sector in the UK.

Consumer Protection

12. This objective requires us to secure an appropriate degree of protection for consumers. The FCA has had regard to the 8 matters listed in s.1C(2)(a)-(h) FSMA (consumer protection).

13. The proposals in chapter 3 (Measures to improve fund governance) will provide increased clarity of our expectations towards AFMs in relation to providing value for money, accountability for senior managers and independence within an AFM's governance body, which, together, should generate lower prices, better value products and more choices for investors.

14. The proposals in chapter 4 (Moving fund investors to cheaper share classes), are to amend our rules to remove barriers which prevent AFMs from switching retail investors into share classes which provide better value.

15. In chapter 5 (Rule change on box management), we are proposing a new rule which would require AFMs to pass 'risk-free' box profits (i.e. profits generated by netting off transactions) to the fund, rather than retaining them for their own account. The transfer of risk-free profits to the fund will benefit the fund investors.

Compatibility with the need to have due regard to the principles of good regulation

16. In preparing the proposals set out in this consultation, the FCA has had regard to the regulatory principles set out in s. 3B FSMA.

The need to use our resources in the most efficient and economic way

17. We have prioritised the issues we consider pose the greatest harm to consumers. We are taking forward proposals that we consider will have the most meaningful impact in addressing our concerns.

18. Our proposed approach raises standards for fund governance bodies, requires firms to improve box management practices and reduces regulatory barriers. This has no ongoing cost to the FCA.

The principle that a burden or restriction should be proportionate to the benefits

19. We have undertaken a cost-benefit analysis of our proposals which is outlined in Annex 2 of this CP, and consider that the restrictions within our proposals are proportionate to the benefits.

20. With regards to the proposed measures to improve fund governance (chapter 3), we have estimated the costs to firms of our proposals and modelled the benefit required through a reduction in fees and charges paid by investors. While we accept that the exact degree to which the expected change in behaviour leads to reductions in fees and charges will differ firm by firm and fund by fund, we are confident that, overall, it is reasonable to expect our proposed interventions to be net beneficial to investors.

21. Our proposals on share-classes (chapter 4) will enable AFMs to close down expensive pre-RDR share-classes which they told us were uneconomical to run. As this is a clarification of our existing rules which does not impose new costs to firms, this principle is not directly applicable to this proposal.

22. Our proposed rule change on box profits (chapter 5) will result in at least £20m in risk-free box profits that firms currently retain being transferred to customers who invested in the relevant funds. Industry reports confirm that most firms will not suffer a material fall in profits by ceasing to take risk-free box profits, and that our rules will not result in firms going out of business or having to significantly modify their business models.

The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term

23. The asset management industry is a vital source of economic growth and one of the most important providers of liquidity needed for the smooth functioning of markets. We consider that proposed measures will improve competition and efficiency in the asset management industry, thereby contributing to contribute to sustainable economic growth.

The general principle that consumers should take responsibility for their decisions

24. Although our proposals do not remove customers' responsibility for their financial decisions, the market study has shown that retail and small institutional investors are not adequately informed or organised to drive competition on price. We expect the proposals to lead to better value products and more choice for investors; the final responsibility for their decisions will remain with them.

The responsibilities of senior management

25. The proposed remedies in chapter 3 (Measures to improve fund governance) will increase the accountability of senior managers with regards to their requirement to act in the best interest of investors and treat customers fairly.

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation

26. This principle is not directly relevant to this CP as the measures are targeted at a specific group, i.e. authorised fund managers. However, as noted above, we may consider whether further work is needed to look at the related unit-linked insurance with-profits and investment trust markets.

The desirability of publishing information relating to persons subject to requirements imposed under FSMA, or requiring them to publish information

27. We believe that our proposals do not undermine this principle. Our proposed rules would promote greater transparency of information about how AFMs are complying with their duties. One of proposals in chapter 3 will require AFMs to publish all actions taken to discharge their duty to consider value for money. Our proposals do not require AFMs or governance bodies to publish, or make publicly available, confidential or commercially sensitive information.

The principle that we should exercise of our functions as transparently as possible

28. We have engaged with trade associations, consumer bodies, firms and other stakeholders throughout the process of conducting the AMMS and after publishing the interim report. We will continue to engage with stakeholders throughout this consultation process prior to making any rules.

Financial Crime

29. Our obligation to have regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime (as required by s. 1B(5)(b) FSMA) is not directly applicable to this CP.

Expected effect on mutual societies

30. We do not expect the proposals in this paper to have a different impact on mutual societies, as they are not within the scope of this CP.

Compatibility with the duty to promote effective competition in the interests of consumers

31. In preparing the proposals as set out in this consultation, we have had regard to the FCA's duty to promote effective competition in the interests of consumers. As set out above the proposals in this CP are primarily intended to advance this objective. We are satisfied that they also advance our consumer protection and market integrity objectives.

Equality and diversity

32. We are required under the Equality Act 2010 to 'have due regard' to the need to eliminate discrimination and to promote equality of opportunity in carrying out our policies, services and functions. As part of this, we conduct equality impact assessments to ensure that the equality and diversity implications of any new policy proposals are considered.

33. The outcome of the assessment in this case is stated in paragraphs 2.13-2.15 of the Consultation Paper.

Legislative and Regulatory Reform Act 2006 (LRRA)

34. We have had regard to the principles in the LRRA for the parts of the proposals that consist of general policies, principles or guidance.

Transparent and accountable

35. We have involved representatives from the industry, consumer groups, trade associations and others from the beginning of the asset management market study. Stakeholders have been able to comment on the policy development by responding to the interim report, attending roundtables and engaging with us directly. We will take into account feedback to this consultation before finalising any changes.

Consistent

36. As set out in Chapter 6, we consider whether we should extend some of our proposals to retail investment products other than authorised funds, e.g. unit-linked or with-profit insurance products such as personal pensions, investment bonds or endowments, or funds set up as closed-ended investment companies. The asset management market study did not directly focus on these products, however, we are aware that the concerns identified in the market study around value for money and governance in authorised funds may also exist for other types of investment products and are seeking views from all relevant stakeholders on whether the remedies proposed in chapter 3 should be extended to these products.

Proportionate and targeted only at cases in which action is needed

37. The AMMS identified specific areas where action was needed to reduce consumer harm. These proposals are a direct response to these areas of harm. We have considered a range of remedies including more interventionist measures and have proposed approaches which we think are proportionate. Additionally, the proposals put forward in this CP complement other FCA and European work in the asset management sector including MiFID II and PRIIPs. In considering what we should do to respond to the findings of the AMMS we have been mindful of changes which will be brought about by these initiatives. In some instances, these initiatives aim to address similar concerns outlined in the AMMS and where we think upcoming changes will adequately address our concerns, we are not intending to take further action.

Regulators' Code (2014)

38. We have had regard to the Regulators' Code for the parts of the proposals that consist of general policies, principles or guidance and consider that our proposals meet the following principles:

Regulators should carry out their activities in a way that supports those they regulate to comply and grow

39. As set out above, we consider that these proposals advance the FCA's objective of promoting effective competition in the interest of consumers because they address the market failure identified in the Asset Management Market Study, which has found that there is weak competition in price between asset managers, and that investors often end up paying too much for their investment products. Improved competition should increase the efficiency of the asset management industry and its attractiveness to international and domestic investors. We believe that overall this will help us to deliver public value through a better functioning asset management sector in the UK.

40. We have responded to stakeholder feedback and provided additional clarity where stakeholders have raised concerns around understanding our expectations including in the proposed rule on assessing value for money and clarifying guidance related to share class switching. We believe this additional clarity will support firms to comply with their obligations.

Regulators should provide simple and straightforward ways to engage with those they regulate and hear their views, and should ensure that their approach to their regulatory activities is transparent

41. As set out above, we have involved representatives from the industry, consumer groups, trade associations and others from the beginning of the asset management market study. Stakeholders have been able to comment on the policy development by responding to the interim report, attending roundtables and engaging with us directly. We will also take on board any feedback we receive from this CP.

Regulators should ensure clear information, guidance and advice is available to help those they regulate meet their responsibilities to comply

42. As we have set out in the CP, we already consider that the basic concept of value for money should be well understood by AFMs. However, the asset management market study has shown that an explicit requirement to consider this would help clarify our expectations and achieve better outcomes for investors. Our proposals on share classes will make it easier to close down expensive pre-RDR share classes which are uneconomic to run and do not provide good value for investors; this will enable providers to more easily comply with parts of our value for money rules.

Regulators should base their regulatory activities on risk

43. The AMMS identified specific risks to the functioning of this market and we have targeted our remedies to the potential and actual harm identified. The remedies proposed in this CP are based on the research and analysis undertaken through the asset management market study and further work we have undertaken based on the feedback we have received. This has included looking at comparable regulatory models and data from other sectors, such as Independent Governance Committees from the pensions sector. We have also looked at other jurisdictions, such as fund governance models in Ireland, Luxembourg and the US. In some areas, e.g. on trail commissions and extending the scope of our remedies to other retail investment products, respondents have asked us to go further than areas covered by the market study. We have taken this feedback on board and, in order to gather further evidence, have raised these issues for discussion in this CP.

Treasury recommendations about economic policy

44. In the remit letter published by the Chancellor of the Exchequer on 8th March 2017.[47] The Chancellor affirms the FCA's role in ensuring that effective competition in financial services can create the right conditions for access to finance, which is part of the Government's economic objective to create strong, sustainable and balanced growth. The FCA has regard to this letter and the recommendations within. As set out in the CP, we consider that our proposals are proportionate and will promote effective competition, making the UK asset management sector more attractive to domestic and foreign investors. We are confident that the policies proposed in this CP will enhance competition and support growth.

47 www.gov.uk/government/publications/recommendations-for-the-financial-conduct-authority-spring-budget-2017

Annex 4
Abbreviations used in this paper

ABI	Association of British Insurers
AFM	alternative investment fund
AIF	authorised fund manager
AIFM	alternative investment fund manager
AIFMD	Alternative Investment Fund Managers Directive (EU Directive 2011/61/EU)
AMC	annual management charge
AMMS	Asset Management Market Study
AuM	assets under management
AUT	authorised unit trust
CBA	cost benefit analysis
COBS	Conduct of Business sourcebook
COLL	Collective Investment Schemes sourcebook
CP	consultation paper
EEA	European Economic Area
EU	European Union
FCA	Financial Conduct Authority
FG	finalised guidance
FSMA	Financial Services and Markets Act 2000
ICVC	investment company with variable capital
IGC	independent governance committee
LRRA	Legislative and Regulatory Reform Act 2006

MiFID II	the recast Markets in Financial Instruments Directive (EU Directive 2014/65/EU)
NURS	non-UCITS retail scheme
PRA	Prudential Regulation Authority
PRIIPs	Packaged Retail and Insurance based Investment Products
QIS	qualified investor scheme
RDR	Retail Distribution Review
SM&CR	Senior Managers and Certification Regime
SYSC	Senior Management Arrangements, Systems and Controls sourcebook
TR	thematic review
UCITS	Undertaking for collective investment in transferable securities (EU Directive 2009/65/EC)

Appendix 1
Draft Handbook text

COLLECTIVE INVESTMENT SCHEMES SOURCEBOOK (MISCELLANEOUS AMENDMENTS) INSTRUMENT 2017

Powers exercised

A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in or under:

(1) the following sections of the Financial Services and Markets Act 2000 ("the Act"):

(a) section 137A (The FCA's general rules);
(b) section 137T (General supplementary powers);
(c) section 139A (Power of the FCA to give guidance);
(d) section 247 (Trust scheme rules);
(e) section 248 (Scheme particulars rules);
(f) section 261I (Contractual scheme rules);
(g) section 261J (Contractual scheme particulars rules); and

(2) regulation 6(1) of the Open-Ended Investment Companies Regulations 2001 (SI 2001/1228).

B. The rule-making provisions listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. Part 1 of the Annex to this instrument comes into force on [*6 months from making*] 2018 and Part 2 of the Annex to this instrument comes into force on [*12 months from making*] 2018.

Amendments to the Handbook

E. The Collective Investment Schemes sourcebook (COLL) is amended in accordance with the Annex to this instrument.

Citation

F. This instrument may be cited as the Collective Investment Schemes Sourcebook (Miscellaneous Amendments) Instrument 2017.

By order of the Board
[*date*]

Annex A

Amendments to the Collective Investment Schemes sourcebook

In this Annex, underlining indicates new text and striking through indicates deleted text.

Part 1: Comes into force [*6 months from making*] 2018

4 Investor Relations

…

4.2 Pre-sale notifications

…

Table: contents of the prospectus

4.2.5 R This table belongs to *COLL* 4.2.2R (Publishing the prospectus).

…

Dealing			
17	The following particulars		
	…		
	(h)	in a *prospectus* available during the period of any initial offer:	
		…	
		(vi)	any other relevant details of the *initial offer*; ~~and~~
	(i)	whether a *unitholder* may effect transfer of title to *units* on the authority of an *electronic communication* and if so the conditions that must be satisfied in order to effect a transfer; and	
	(j)	a statement of the *authorised fund manager's* policy for *dealing* as *principal* in *units* of the *scheme* and holding them for that purpose and, where applicable:	
		(i)	a description of when the *authorised fund manager* may retain any profits it earns and absorb any losses it incurs for these activities; and
		(ii)	a statement of non-accountability as referred to in *COLL* 6.7.16G.

…

…

Guidance on contents of the prospectus

4.2.6 G …

(3) ~~In relation to *COLL* 4.2.5R(27), the *prospectus* might include a statement of the *authorised fund manager's* policy in relation to holding *units* in the *scheme* as *principal*, and in particular whether it seeks to make a profit from doing so. It might also include a prominent statement of non-accountability referred to in *COLL* 6.7.16G (Exemptions from liability to account for profits).~~ [deleted]

…

…

6 Operating duties and responsibilities

…

6.3 Valuation and pricing

…

Profits from dealing as principal

6.3.5D R (1) Where an *authorised fund manager* (*AFM*):

(a) accepts instructions to *sell* and *redeem units* at the same *valuation point*; and

(b) is able to execute those instructions as *principal* by matching *sales* and *redemptions* without placing its own capital at risk,

the *AFM* must allocate to the *scheme property* a sum equivalent to any amount by which the proceeds due to the *scheme* from the *sales* exceeds the payments due to *unitholders* from the *redemptions*.

(2) Any payment required to be made under (1) must be made by the close of business on the fourth *business day* following the *valuation point* at which the *sale* and *redemption prices* were determined.

(3) This *rule* applies to the *redemption* and *sale* of *units* of different *classes* at the same *valuation point*, if those *classes* are treated as one for the purpose of *COLL* 6.2.6AR.

6.3.5E G The *authorised fund manager* may commit its own capital to hold *units* for the purpose of *dealing* as *principal* and may seek to profit from gains in the value of the *units* it holds, when it *issues* or *redeems units* at one *valuation* *point* then *sells* or *cancels* them at a later *valuation point*. However, it should not profit from situations in which it is not exposed to an equal risk of loss if the *units* fall in value, or from the ability to match simultaneous *sales* and *redemptions* at different *prices* at no risk to its own capital.

…

6.7 Payments

…

Exemptions from liability to account for profits

6.7.16 G ~~An~~ Except as provided in *COLL* 6.3.5DR, an *affected person* is not liable to account to another *affected person* or to the *unitholders* of any *scheme* for any profits or benefits it makes or receives that are made or derived from or in connection with:

…

…

8 Qualified investor schemes

…

8.3 Investor relations

…

Table: contents of qualified investor scheme prospectus

8.3.4 R This table belongs to *COLL* 8.3.2R.

…		
13	**Dealing**	
	Details of:	
	…	
	(9)	the circumstances in which direct *issue* or *cancellation* of *units* by the *ICVC* or the *depositary* of an *AUT* or *ACS* (as appropriate) may occur and the relevant procedures for such *issues* and *cancellations*; ~~and~~
	(10)	whether a *unitholder* may effect transfer of title to *units* on the authority of an *electronic communication* and if so the conditions that must be satisfied in order to effect a transfer; and

	(11)	a *statement* of the *authorised fund manager's* policy for *dealing* as *principal* in *units* of the *scheme* and holding them for that purpose and, where applicable:		
		(a)	a description of when the *authorised fund manager* may retain any profits it earns and absorb any losses it incurs for these activities; and	
		(b)	a statement of non-accountability as referred to in *COLL* 8.5.14G.	
…				

…

8.5 Powers and responsibilities

…

8.5.9 …

Profits from dealing as principal

8.5.9-B R (1) Where an *authorised fund* manager:

(a) accepts instructions to *sell* and *redeem units* at the same *valuation point*; and

(b) is able to execute those instructions as *principal* by matching *sales* and *redemptions* without placing its own capital at risk,

the *AFM* must allocate to the *scheme property* a sum equivalent to any amount by which the proceeds due to the *scheme* from the *sales* exceeds the payments due to *unitholders* from the *redemptions*.

(2) Any payment required to be made under (1) must be made by the close of business on the fourth *business day* following the *valuation point* at which the *sale* and *redemption prices* were determined.

(3) This *rule* applies to the *redemption* and *sale* of *units* of different *classes* at the same *valuation point*, if those *classes* are treated as one for the purpose of *COLL* 8.5.10AR.

8.5.9-A G The *authorised fund manager* may commit its own capital to hold *units* for *dealing* as *principal* and may seek to profit from gains in the value of the *units* it holds, when it *issues* or *redeems units* at one *valuation point* then *sells* or *cancels* them at a later *valuation point*. However, it should not profit from situations in which it is not exposed to an equal risk of loss if the *units* fall in value, or from the ability to match simultaneous *sales* and *redemptions* at different *prices* at no risk to its own capital.

8.5.9A R …

…

Exemptions from liability to account for profits

8.5.14 G ~~An~~ Except as provided in *COLL* 8.5.9-BR, an *affected person* is not liable to account to another *affected person* or to the *unitholders* of any *scheme* for any profits or benefits it makes or receives that are made or derived from or in connection with:

…

…

TP 1 Transitional Provisions

TP 1.1

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
…					
47	*COLL* 4.2.5 and *COLL* 8.3.4	R	An *authorised fund manager* is not required to update the *prospectus* due to the amendments made to the following provisions by the Collective Investment Schemes Sourcebook (Miscellaneous Amendments) Instrument 2017 until it is updated for other purposes: (a) *COLL* 4.2.5R(17)(j); and (b) *COLL* 8.3.4R(13)(11)	[making + 6 months]	[making + 12 months]

Part 2: Comes into force [*12 months from making*] 2018

4 Investor relations

…

4.5 Reports and accounts

…

Contents of the annual long report

4.5.7 R …

(8) An annual long report of an *authorised fund* must also contain a statement setting out a description of the value for money assessment required by *COLL* 6.6.20R including:

(a) a separate discussion and conclusion on value for money for each paragraph of *COLL* 6.6.21R, and for each other matter that formed part of the assessment, covering the considerations taken into account in the assessment and the steps undertaken as part of or as a consequence of the assessment;

(b) an explanation for any savings and benefits from economies of scale identified in the assessment which have not been paid into the *scheme property*;

(c) an explanation for any case in which *unitholders* hold *units* in a *class* which is subject to higher charges than those applying to other *classes* of the same *scheme* with substantially similar rights;

(d) an explanation of the criteria used by the *AFM* to assess quality of service and an explanation of the conclusion of that assessment;

(e) an explanation of which charges and other payments taken from the *scheme property* have been reviewed and any case in which cost savings have been achieved and not paid into the *scheme property*; and

(f) if the assessment has identified poor value for money in relation to any paragraph of *COLL* 6.6.21R, or any other matter that formed part of the assessment, the statement must explain clearly what action has been or will be taken to address the situation.

(9) An *AFM* need not include the information required by (8) in its annual long report if it makes the information available to *unitholders* annually, in a composite report covering two or more of

the *schemes* it manages, in the same manner as the annual long report.

4.5.7A G …

(5) An *AFM* which is not subject to *COLL* 6.6.20R as a result of *COLL* 6.6.19R is not required to comply with *COLL* 4.5.7R(8).

…

6 Operating duties and responsibilities

…

6.6 Powers and duties of the scheme, the authorised fund manager, and the depositary

…

Table of application

6.6.2 R This table belongs to *COLL* 6.6.1R.

Rule	*ICVC*	*ACD*	Any other *directors* of an *ICVC*	*Depositary* of an *ICVC*	*Authorised fund manager* of an *AUT* or *ACS*	*Depositary* of an *AUT* or *ACS*
6.6.18G	…					
6.6.19R		x	x		x	
6.6.20R		x	x		x	
6.6.21R		x	x		x	
6.6.22G		x	x		x	
6.6.23E		x	x		x	
6.6.24G		x	x		x	
6.6.25R		x	x		x	
6.6.26G		x	x		x	
Notes:	…					
	(5)	*COLL* 6.6.20R to *COLL* 6.6.26G have a special application as set out in *COLL* 6.6.19R.				

…

Application of value for money assessment and independent director rules

6.6.19 R *COLL* 6.6.20R to *COLL* 6.6.26G apply to:

(1) an *authorised fund manager* (other than an *EEA UCITS management company* or an *EEA AIFM*) of an *AUT*, *ACS* or *ICVC*; and

(2) a *UK UCITS management company* providing *collective portfolio management services* for an *EEA UCITS scheme* from a *branch* in another *EEA State* or under the freedom to provide *cross border services*.

Value for money assessment

6.6.20 R (1) An *authorised fund manager* must conduct an assessment at least annually of whether each *scheme* it manages provides good value for money for *unitholders*.

(2) In carrying out the assessment required by (1), the *AFM* must, separately for each *class* of *units* in a *scheme*, consider at least the matters set out in *COLL* 6.6.21R (Table: considerations relevant to value for money assessment).

Table: considerations relevant to value for money assessment

6.6.21 R This table belongs to *COLL* 6.6.20R (value for money assessment).

Economies of scale	
(1)	Whether there are savings and benefits from economies of scale relating to the direct and indirect costs of managing the *scheme property* and whether any such savings and benefits should be paid into the *scheme property*.
(2)	Whether break points, that is specific fee reductions that apply when assets under management increase to specified levels, should be introduced or modified.
Charges and other payments	
(3)	Whether the level of each charge and other payment taken from the *scheme property* is reasonable in relation to the costs necessarily incurred, in particular in delivering the *scheme's* investment objectives and policy and the distribution and marketing of the *scheme*.
Quality of service	
(4)	Whether the level of charges and other payments taken from the

	scheme property is commensurate with the quality of service provided to *unitholders* relating solely to the administration or the management of the *scheme*.
(5)	Whether the level of charges is commensurate with the quality and range of services provided to *unitholders* which do not directly relate to the administration or the management of the *scheme*.
Classes of units	
(6)	Whether it is appropriate for *unitholders* to hold *units* in *classes* subject to higher charges than those applying to other *classes* of the same *scheme* with substantially similar rights.

6.6.22 G (1) When assessing the appropriateness of charges and other payments under *COLL* 6.6.21R(3), the *AFM* should take into account:

(a) its charges and those of its *associates* for comparable products, including for institutional mandates of a comparable size;

(b) the stated objectives and policy of each *scheme*, and the strategy being pursued by the *AFM*;

(c) the appropriateness of charges paid to any *persons* to which any aspect of the *scheme's* management has been delegated or which provide services to the *AFM* or on its behalf (for example when executing orders on behalf of the *scheme* or placing them with others for execution), in particular taking into consideration the quality of service provided by those *persons*; and

(d) comparable market rates for any services provided by the *AFM* and any *persons* to which any aspect of the *scheme's* management has been delegated or which provide services to the *AFM* or on its behalf.

(2) When assessing the quality of service provided under *COLL* 6.6.21R(4) and (5), the *AFM* should have regard to the quality of service it provides and the quality of service provided by any *person* to which any aspect of the *scheme's* management has been delegated or which provides services to the *AFM* or on its behalf.

6.6.23 E Failure by an *AFM* to take sufficient steps to address any instance where the assessment required by *COLL* 6.6.20R has identified poor value for money may be relied on as tending to establish contravention of *COLL* 6.6A.2R, *COBS* 2.1.1R or *COBS* 2.1.4R as applicable.

6.6.24 G *COLL* 6.6A.2R applies to *AFMs* of *UCITS schemes* and in broad terms requires *AFMs* to act in the best interests of *unitholders*. In particular, *COLL* 6.6A.2R(1) requires *AFMs* to ensure *unitholders* are treated fairly, *COLL* 6.6A.2R(5) requires *AFMs* to act in such a way as to prevent undue costs being charged to any *scheme* it manages and its *unitholders* and *COLL* 6.6A.2R(6)(b) requires an *AFM* to act solely in the interests of the *scheme* and its *unitholders*. *COBS* 2.1.1R is the *clients best interests rule*, *COBS* 2.1.4R (2) requires a *full-scope UK AIFM* to act in the best interests of the *AIF* it manages or the investors of the *AIF* it manages and the integrity of the market and *COBS* 2.1.4R(3) requires the *AFM* to treat all investors fairly.

Independent directors

6.6.25 R (1) An *authorised fund manager* must ensure that at least one quarter of the members of its *governing body* are independent natural *persons*. If the *AFM's governing body* comprises fewer than eight members, the *AFM* must instead ensure that at least two of its members are independent natural *persons*.

(2) The *authorised fund manager*, in appointing an independent member of its *governing body*, must determine whether such a member is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, that member's judgement.

(3) The *authorised fund manager* must take reasonable steps to ensure that independent members appointed to its *governing body* have sufficient expertise and experience to be able to make judgements on whether the *AFM* is managing each *scheme* in the best interests of *unitholders*.

(4) Independent members of the *AFM's governing body* must be appointed for terms of no longer than five years, with a cumulative maximum duration of ten years.

(5) Independent members are not eligible for reappointment to the *AFM's governing body* until five years have elapsed after having served on that *governing body* for the maximum duration of ten years.

(6) The terms of *employment* on which independent members are appointed must be such as to secure their independence.

6.6.26 G (1) A member of an *AFM's governing body* is unlikely to be considered independent if any of the following circumstances exist:

(a) the *person* is an *employee* of the *AFM* or of a company within the *AFM's group* or paid by them for any role other than as an independent member of the *governing body*, including participating in the *AFM's* share option or performance-related pay scheme; or

(b) the *person* has been an *employee* of the *AFM* or of a company within the *AFM's group* or of any *person* to which *collective portfolio management* of the *scheme* has been delegated, within the five years preceding their appointment to the *governing body*; or

(c) the *person* has, or had within the three years preceding their appointment, a material business relationship of any description with the *AFM* or with a company within the *AFM's group* or with any *person* to which *collective portfolio management* of the *scheme* has been delegated, either directly or indirectly; or

(d) the *person* has received any sort of remuneration from the *AFM's group* within the five years preceding their appointment.

(2) The role of the independent members should include providing input and challenge as part of the *AFM's* assessment of value for money in accordance with *COLL* 6.6.20R. Independent members may be tasked with additional responsibilities, taking into consideration existing remuneration and conflict of interest rules.

(3) The expertise and experience required under *COLL* 6.6.25R(3) may have been gained through professional experience, public service, academia or otherwise, and does not need to relate to the financial services industry.

(4) The effect of *COLL* 6.6.25R(6) is that a *person* who serves on the *governing body* should be subject to appropriate contractual terms so that, when acting in the capacity of an independent member of the *governing body*, they are free to act solely in the interests of *unitholders* and should be able to do so without breaching their terms of employment.

(5) An *AFM* should fill any vacancies that arise within the required number of independent members on its *governing body* as soon as possible and, in any event, within six *months*.

(6) An *AFM* should consider indemnifying the independent members of its *governing body* against liabilities incurred while fulfilling their duties as such members.

…

8 Qualified investor schemes

…

8.3 Investor relations

…

Contents of the annual report

8.3.5A R …

(5) An annual report of an *authorised fund* must also contain a statement setting out a description of the value for money assessment required by *COLL* 8.5.17R including:

(a) a separate discussion and conclusion on value for money for each paragraph of *COLL* 6.6.21R, and for each other matter that formed part of the assessment, covering the considerations taken into account in the assessment and the steps undertaken as part of or as a consequence of the assessment;

(b) an explanation for any savings and benefits from economies of scale identified in the assessment which have not been paid into the *scheme property*;

(c) an explanation for any case in which *unitholders* hold *units* in a *class* which is subject to higher charges than those applying to other *classes* of the same *scheme* with substantially similar rights;

(d) an explanation of the criteria used by the *AFM* to assess quality of service and an explanation of the conclusion of that assessment;

(e) an explanation of which charges and other payments taken from the *scheme property* have been reviewed and any case in which cost savings have been achieved and not paid into the *scheme property*; and

(f) if the assessment has identified poor value for money in relation to any paragraph of *COLL* 6.6.21R, or any other matter that formed part of the assessment, the statement must explain clearly what action has been or will be taken to address the situation.

(6) An *AFM* need not include the information required by (5) in its annual report if it makes the information available to *unitholders* annually in a composite report covering two or more of the *schemes* it manages in the same manner as the annual report.

…

8.5 Powers and responsibilities

…

Application of value for money assessment and independent director rules

8.5.16 R *COLL* 8.5.17R to *COLL* 8.5.21G apply to an *authorised fund manager* (other than an *EEA AIFM*) of an *AUT*, *ACS* or *ICVC*.

Value for money assessment

8.5.17 R (1) An *authorised fund manager* must conduct an assessment at least annually of whether each *scheme* it manages provides good value for money for *unitholders*.

(2) In carrying out the assessment required by (1), the *AFM* must, separately for each *class* of *units* in a *scheme*, consider at least the matters set out in *COLL* 6.6.21R (Table: considerations relevant to value for money assessment).

8.5.18 G The *guidance* in *COLL* 6.6.22G applies to interpreting the requirements of *COLL* 6.6.21R as applied by *COLL* 8.5.17R.

8.5.19 E Failure by an *AFM* to take sufficient steps to address any instance where the assessment required by *COLL* 8.5.17R has identified poor value for money may be relied on as tending to establish contravention of *COBS* 2.1.1R or *COBS* 2.1.4R as applicable.

Independent directors

8.5.20 R (1) An *authorised fund manager* must ensure that at least one quarter of the members of its *governing body* are independent natural *persons*. If the *AFM's governing body* comprises fewer than eight members, the *AFM* must instead ensure that at least two of its members are independent natural *persons*.

(2) The *authorised fund manager*, in appointing an independent member of its *governing body*, must determine whether such a member is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, that member's judgement.

(3) The *authorised fund manager* must take reasonable steps to ensure that independent members appointed to its *governing body* have sufficient expertise and experience to be able to make judgements on whether the *AFM* is managing each *scheme* in the best interests of *unitholders*.

(4) Independent members of the *AFM's governing body* must be appointed for terms of no longer than five years, with a cumulative maximum duration of ten years.

(5) Independent members are not eligible for reappointment to the *AFM's governing body* until five years have elapsed after having served on the that *governing body* for the maximum duration of ten years.

(6) The terms of *employment* on which independent members are appointed must be such as to secure their independence.

8.5.21 G The *guidance* in *COLL* 6.6.26G applies to interpreting the requirement for independence in *COLL* 8.5.20R.

Appendix 2
Draft non-Handbook Guidance

Changing clients to post-RDR unit classes

June 2017

Introduction

1.1 This guidance sets out what we expect from firms that are involved in the transfer of fund investors from pre-Retail Distribution Review (RDR) unit classes[1] to post-RDR unit classes. This guidance replaces the guidance in FG 14/4 on the same subject.

1.2 We are setting out our approach as a result of a number of queries from stakeholders and some evidence of uncertainty in the procedure to adopt when converting clients to the new unit classes.

Background

1.3 The implementation of the RDR rules on adviser charging[2] and related rules for platforms have resulted in new unit classes (widely referred to in the industry as 'clean' unit classes) in authorised collective investment schemes. These post-RDR 'clean' classes bear a lower annual management charge (AMC), excluding the portion of the charge that was formerly rebated to advisers, in line with the RDR ban on commission payments.

[1] The term 'unit class' is used throughout this document. References to 'unit' within the FCA Handbook apply to both units in an AUT and an ACS and shares in an ICVC. This document shares that referencing, so references to 'unit class' also include 'share class' in respect of an ICVC.
[2] PS10/6: *Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules*: http://www.fca.org.uk/static/documents/policy-statements/fsa-ps10-06.pdf (March 2010)

1.4 In the case of platforms, Policy Statement 13/1[3] referred to the introduction of clean unit classes and announced the banning of payments to platforms from product providers. These particular rules came into force on 6 April 2014 for new business, with the rules for legacy payments coming into force on 6 April 2016. Changes to 'legacy' business require platforms to have access to clean unit classes or to be able to pass on any continuing payments they receive from providers[4] to clients in full in the form of small cash rebates or unit rebates (COBS 6.1E.10R and 6.1E.11G).

1.5 A rule and guidance setting out how the rules made in April 2013 apply to legacy business in relation to cash rebates to clients were made on 27 February 2014 and came into force on 6 April 2014 (the same date as the rules made in April 2013).[5]

1.6 We have found that there is some uncertainty over whether a conversion to a clean unit class should be treated in the same way as a switch involving cancelling the existing units and issuing new units. Questions have also arisen about:

- whether conversions can happen in bulk rather than individually
- if conversions can happen without the express consent of the client
- whether advice is needed
- the role of advisers in the conversion process
- whether a new disclosure document (e.g. a Key Investor Information Document (KIID) for a UCITS scheme) needs to be issued to the client before conversion

1.7 This guidance answers these questions.

'Converting' unit classes

1.8 Various mechanisms exist to facilitate the move from one unit class to another. It is our understanding that in most cases the move to clean unit classes will be accomplished by converting units (replacing one unit with another of a different unit class). The holder of the units has a right to request conversion from one class to another, as established in COLL 6.4.8R. The AFM may have a right to require the unitholder to convert to another class if certain conditions are met, as explained below

1.9 We would expect the AFM, when undertaking a unit conversion, to have regard to the relevant tax regulations. Under those regulations[6], an exchange of units in a single

[3] PS13/1: Payments to platform service providers and cash rebates from providers to consumers: http://www.fca.org.uk/static/documents/policy-statements/ps13-1.pdf (April 2013)
[4] Reference to payments from providers to platforms in this guidance do not include payments by providers to advisers in the form of trail commission or facilitated adviser charges, as the platform simply acts as a conduit for these payments to advisers. The payments banned from 6 April 2014 were those payments previously paid by the provider and retained by the platform.
[5] Instrument 2014/16 - http://media.fshandbook.info/latestNews/FCA_2014_16.pdf. Feedback on the replies to the consultation in CP13/9 is contained in Handbook Notice 9 [hyperlink]
[6] The Collective Investment Schemes (Tax Transparent Funds, Exchanges, Mergers and Schemes of Reconstruction) Regulations 2013, SI 2013/1400

transaction might have capital gains tax implications, but this will not usually be the case where the client receives only new clean units of the same fund with the same rights as before but a different AMC.

Conversion procedures for nominee arrangements

1.10 We would expect any AFM or other firm (e.g. platforms or discretionary investment managers) undertaking or facilitating the conversion of units to clean unit classes (and any firms providing advice to clients regarding conversions) to consider a number of points before proceeding, as set out below.

Client's best interests rule and Principles for Businesses

1.11 COBS 2.1.1R (1) (the 'client's best interests rule') in the FCA Handbook states:

'A firm must act honestly, fairly and professionally in accordance with the best interests of its client (the client's best interests rule).'

1.12 It is our view that under this provision and Principle 6 of the Principles for Businesses, a conversion initiated by the AFM, platform or other intermediary acting on behalf of a client should normally take place only if it is fair and in the client's best interests.

1.13 This would normally be the case where the clean unit class is exactly the same as the pre-RDR class, except for a reduced AMC. However, it is possible that this may not be the case if the reduced AMC, combined with any new platform charge (or other charges), will lead to an overall increase for clients. It is also possible, depending on the charging structure, that some clients may be better off and others worse off.

1.14 For retail clients, 'clear' disclosure of the platform charge is required in any event by COBS 6.1E.1R, which came into force on 6 April 2014.

Prior notification of a proposed conversion and treatment of investments where the client objects to conversion

1.15 To mitigate the risk that some clients may be worse off, firms should ensure in all cases that clients have sufficient notification of, and information on, the proposed conversion to enable them to seek advice or make an informed decision on whether to transfer their investments to another platform.[7] The notification should include information on whether there is likely to be an overall increase in charges for clients, as a result of the reduced AMC combined with the new platform charge (or other charges).

1.16 If a client objects to the conversion, their investments can continue to be held in the bundled class if the AFM is willing to continue to offer this option. However, payments from providers that (prior to 6 April 2016) were retained by the platform now have to be

[7] Under COBS 6.1G.1R, such transfers must take place when requested by the client 'within a reasonable time and in an efficient manner'.

passed to the client in full in the form of small cash rebates or unit rebates. If a nominee does not intend to offer clients the option of remaining in pre-RDR classes and receiving unit rebates, it should be made clear to the client that this is not an option open to them.

Approach to be adopted by nominees

1.17 A 'unitholder' is defined in our Handbook[8] as 'the person whose name is entered on the register (of unitholders)'. When the underlying investor uses an intermediary such as a platform, that firm's nominee is the registered holder of the units, so the COLL rules permit the nominee to exercise any right to convert from one class to another.

1.18 We expect nominees to ensure the client is given prior notification that the conversion will take place and is given sufficient time to consider other options. For example, the notification could state that the conversion will take place unless the client objects within a reasonable specified timeframe (where retaining the current class is offered as an option) or notifies the firm that they wish to sell their investments or transfer to another platform. Such a notification should be made in a manner appropriate to the nominee's ongoing dealings with the client (for example, if a nominee deals with the client primarily by electronic communication, such as email, the notification should be made by this method).

1.19 Nominees should bear in mind any notification, disclosure or other contractual requirements that may exist in their contractual relationship with the client or the client's chosen financial adviser, concerning the nominee arrangements. This guidance contains our position on conversions, but firms should also bear in mind that the conversion will also be subject to any contractual arrangements firms have agreed with the underlying investor.

Conversion procedures for direct unitholders

1.20 The COLL rules envisage authorised fund managers undertaking a mandatory conversion of units if

- the circumstances in which mandatory conversions will take place are set out in the prospectus of the fund,[9] and
- the client's best interests rule is satisfied.[10]

1.21 If the prospectus does not refer to mandatory conversion, the AFM can amend it to allow such conversions of units. The AFM would need to consider how this change to the prospectus would be treated under COLL 4.3 (Approvals and notifications) to ensure unitholders were properly informed about possible mandatory conversions in future.

[8] http://fshandbook.info/FS/glossary-html/handbook/Glossary/U?definition=G1233.
[9] COLL 4.2.5R 5(d)
[10] COBS 2.1.1R(1) and PRIN 6

1.22 To satisfy the second condition, we expect AFMs to make reasonable attempts to inform unitholders about any planned mandatory conversions, giving them sufficient notice to enable them to redeem their units if they do not wish to be converted, and to alert them to alternative options if available. AFMs should consider general communications, such as press adverts, for hard-to-reach unitholders.

1.23 The AFM can proceed with the conversion if:

- despite best efforts it has not received alternative instructions about the units affected by the proposed conversion, and
- the AFM is satisfied on reasonable grounds, having considered, in particular, the costs to unitholders associated with the old and new classes of units, that the conversion will not result in detriment to the unitholders concerned.

Advice on conversions

1.24 Some questions have focused on whether a conversion would constitute advice. For nominees, issuing a notification that a clean unit class exists to which it is proposed to convert all existing clients' holdings, explaining (where this is the case) why it is in the client's best interests, does not constitute advice.

1.25 For the AFM, notification to direct unitholders that a clean unit class exists (without a specific recommendation to convert to that class) does not constitute advice. Similarly, prior notice of a mandatory conversion is not advice. If the client is given such a notification, they then have the option to seek advice on the matter.

Advisers and their role in the conversion process

1.26 If the client is investing in a fund as a result of the recommendation of a financial adviser and that relationship still exists, then that adviser may have a role to play in the conversion process.

1.27 Legacy payments to platform providers came to an end in April 2016 (unless passed on in full to clients in the form of small cash rebates or unit rebates).

1.28 Additionally, we would encourage platforms and product providers to engage with a client's financial adviser in good time when considering converting holdings to clean unit classes, so the financial adviser has an opportunity to discuss the conversion with their client as appropriate.

Providing a new disclosure document when converting to clean unit classes

1.29 There have been some questions about whether a conversion from a pre-RDR unit class to a clean unit class requires a new disclosure document, such as the KIID, to be provided to the client for the new unit class under COBS 14.2.1R(7).

1.30 Where the move to clean unit classes will be accomplished by conversions, we consider that a new disclosure document, such as a KIID, would not need to be provided as long as:

- The firm has taken reasonable steps to assess whether the conversion is in line with the client's best interests rule and Principle 6 of the Principles for Businesses (treating customers fairly).
- In all cases, where the conversion is initiated by the AFM, platform or other nominee, the client has been given sufficient notification of, and information on, the proposed conversion to enable them to seek advice or make an informed decision on whether to transfer their investments to another platform. The notification should include information about whether there is likely to be an overall increase in charges for clients, as a result of the reduced AMC combined with the new platform charge (or other charges).
- Clients are given the option to request the KIID for the clean unit class or advised how they can access the document electronically.

Pub ref: 005476

FINANCIAL
CONDUCT
AUTHORITY

25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk