

# Consultation on further remedies – Asset Management Market Study

**Consultation Paper**

CP18/9\*\*

April 2018



## How to respond

We are asking for comments on this Consultation Paper (CP) by Thursday 5 July 2018.

You can send them to us using the form on our website at: [www.fca.org.uk/cp18-09-response-form](http://www.fca.org.uk/cp18-09-response-form)

### Or in writing to:

Karen Northey  
Financial Conduct Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

### Email:

[cp18-09@fca.org.uk](mailto:cp18-09@fca.org.uk)

### How to navigate this document onscreen



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# 1 Summary

- 1.1** This consultation paper (CP) proposes changes to our rules and guidance for Authorised Fund Managers (AFMs). This is the second consultation paper proposing changes following the findings of the Financial Conduct Authority (FCA)'s Asset Management Market Study (AMMS). We published the first consultation on 28 June 2017, and the final rules from that consultation have been published today in a Policy Statement (PS18/8).

## Why we are consulting

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- 1.2** We presented evidence that there is weak price competition in a number of areas of the asset management industry in the AMMS 2016 Interim and 2017 Final Reports. This matters to millions of investors. We estimate that over three quarters of the UK population rely on the asset management sector either directly, or via their pensions. Given that even small differences in charges can have a significant impact over time, there is a significant amount of harm to be addressed.
- 1.3** This consultation paper proposes measures to improve the quality, comparability and robustness of information available to investors. They seek to address our concern that fund objectives are not as clear or specific as they could and should be. This makes it harder for investors to exercise choice, as they may not be able to work out what they are ultimately investing in.
- 1.4** This package of measures aims to improve clarity where funds are benchmark-constrained, that is, limited as to how far their holdings can differ from the weightings of a particular benchmark index. Without proper disclosure of these constraints, investors will be unaware of the fund's policy, which may affect its riskiness and the possible return. Where benchmark-constraints are not clear, investors may be unable to make adequate price comparisons.
- 1.5** We are consulting on proposals to ensure benchmarks are used appropriately. We propose that if a fund has benchmarks, their use must be explained and referenced consistently in consumer facing documents. This includes a proposal to ensure that benchmarks are shown appropriately and consistently against fund past performance as our behavioural research has shown that where investors look at past performance, the use of a flattering benchmark can have a powerful effect.
- 1.6** These measures will complement the final rules and guidance in PS18/8, published today, which strengthen and clarify the duty on AFMs to act as agents for their underlying investors and focus on fund managers' governance arrangements and the value they deliver for investors.
- 1.7** The proposals related to objectives have been informed by a working group, which included a wide range of stakeholders, including asset management firms and investor



groups. We are grateful for the time and expert input of this group, which has helped to shape our proposals.

## Who this applies to

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- 1.8** The proposals apply to UK AFMs, in respect of their management of authorised funds (open-ended collective investment schemes (CIS)).
- 1.9** This paper will be of interest to other firms in the investment management industry, such as entities acting as delegated portfolio managers and the depositaries of authorised funds. It will also interest industry representative bodies. Given the number of consumers affected by the asset management industry, it may also be of interest to consumers and their representative groups.
- 1.10** Insurers running unit-linked and with-profits funds and UK listed investment trusts will be interested in our commentary on the potential for the extension of the AMMS remedies to those sectors.
- 1.11** We welcome any feedback from retail and professional investors (including advisers) and their representatives as the proposals aim to provide more useful information to investors.

## A note on benchmarks

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- 1.12** The term 'benchmark' is widely used in the asset management industry as a broad 'catch all' term covering the use of indices. The AMMS shows that investors would benefit from more precise and consistent use of 'benchmarks'. Our behavioural research suggests that the use of a flattering benchmark can have a powerful effect on investors and how they are used is therefore important. The consideration of benchmarks and their uses in this CP is distinct from the new EU Benchmarks Regulation (BMR). The BMR regulates a narrower set of uses of indices than the ones we consider in this CP and references in this CP to benchmarks, or the use of indices, do not refer to those concepts as defined in the BMR<sup>1</sup>.

## The wider context of this consultation

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- 1.13** These proposals and the final rules and guidance in PS18/8 form part of a wider package of remedies to address the findings of the AMMS. Please see Annex 5 for an overview of progress on all of the AMMS remedies.
- 1.14** The AMMS highlighted the importance of clear disclosure of what asset management services cost through the presentation of a 'single charge'. The recast Markets in

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<sup>1</sup> The BMR defines indices used in certain ways as 'benchmarks' and regulates the provision and use of these in the EU. The terms 'benchmark' and 'use' have specific meanings under the BMR. Our proposals are entirely separate from, and have no bearing on, the BMR. Unless otherwise stated, references to benchmarks, or the use of indices, do not refer to those concepts as defined in the BMR. Some uses of indices will fall into both a BMR definition and a definition used in this CP but the definitions will remain unrelated. This CP does not give guidance on, nor represent the FCA's views on, the BMR.

Financial Instruments Directive (MiFID II) and the Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs) have recently introduced greater disclosure of all costs and charges, including transaction costs. Consumers should now see the full costs and charges, expressed as a single fee, for most transactions in investment products, and on an ongoing basis.

**1.15** This is a significant step forward, but how the new information is presented will be important if it is to help consumers make more informed choices. To better understand this we conducted behavioural testing. It reinforced the importance of disclosing costs and charges in a clear and meaningful way. We have published the results of the testing alongside this CP in an Occasional Paper.<sup>2</sup> The findings are consistent with a significant body of previous work. Firms should consider the results when thinking about how their disclosures are working. We will consider changing our rules and guidance to mandate certain forms of disclosure in light of the outcome of our Investment Platforms Market Study.<sup>3</sup>

**1.16** This consultation complements other work to improve the transparency of costs, charges, service and performance of the products investors buy. We are supporting an independent Institutional Disclosure Working Group (IDWG). The group is seeking an agreement among industry stakeholders on a disclosure framework to support consistent disclosure of costs and charges to institutional investors<sup>4</sup>. We have also referred the investment consultancy market to the Competitions and Markets Authority for a market investigation.

## What we want to change

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**1.17** To deliver improved fund disclosures we propose to:

- publish guidance reminding AFMs how they should express fund objectives and investment policies to make them more useful to investors. Firms should, when describing the objectives of their funds:
  - explain clearly what they are looking to achieve and how
  - explain the constraints that the fund's portfolio construction may be under
  - explain any non-financial objectives they have, for example the environmental or social objectives of an investment, and how they will measure and report progress against these objectives

(see paragraphs 3.2-3.29)

- make new rules so that AFMs must explain why they use benchmarks, or if they do not, how investors should assess the performance of the fund (see paragraphs 3.30-3.38)

<sup>2</sup> [www.fca.org.uk/publication/occasional-papers/occasional-paper-32.pdf](http://www.fca.org.uk/publication/occasional-papers/occasional-paper-32.pdf)

<sup>3</sup> [www.fca.org.uk/publications/market-studies/ms17-1-investment-platforms-market-study](http://www.fca.org.uk/publications/market-studies/ms17-1-investment-platforms-market-study)

<sup>4</sup> [www.fca.org.uk/firms/institutional-disclosure-working-group](http://www.fca.org.uk/firms/institutional-disclosure-working-group)



- require that, if an AFM uses benchmarks, the benchmarks must be referenced consistently across the fund's documents and, wherever the AFM presents the fund's past performance, benchmarks used as a constraint on portfolio construction or as a target must be presented alongside the past performance (see paragraphs 3.39-3.43)
- amend our performance fees rules to provide that performance fees must be calculated on performance net of other fees in all cases (see paragraph 4.5)

**1.18** In addition, the Investment Association (IA) has proposed working with consumer representatives to promote the use of consistent terminology.

**1.19** The remedies set out in this CP are potentially relevant to unit-linked and with-profits business. In the PS published alongside this CP, we have given feedback on extending the proposals in CP17/18 to those markets. The ongoing diagnostic work into with-profits and unit-linked products referred to in the PS will improve our view of any harm that exists in these markets. It will allow us to make proposals for intervening to address this if necessary. When this work is completed, we will decide whether further intervention is required, and the most appropriate way for us to do this. We will communicate a view on whether to consult on the extension of the remedies in this CP, and the extension of the rules preventing retention of risk-free box profits, at the same time, in the first half of 2019.

**1.20** We are keeping the issue of whether to consult on applying the relevant remedies in this CP to UK listed investment trusts under review. At this time we do not plan any immediate action on this.

### Outcome we are seeking

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**1.21** Our proposals aim to make it easier for investors to choose the right fund for them. This should help them better achieve their investment aims. Additionally, our performance fees proposal promotes fairness in how such fees operate.

### Next steps

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**1.22** Please respond to this consultation by 5 July 2018 by emailing us at: [cp18-09@fca.org.uk](mailto:cp18-09@fca.org.uk).

**1.23** 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

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- 2.1** The asset management industry plays a vital role in the UK's economy. Asset managers look after 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. They support jobs and drive economic growth by directly or indirectly allocating funding to businesses they think are most likely to grow. Asset managers also have an important role in the corporate governance of the businesses they invest in.
- 2.2** The UK's asset management industry is the second largest in the world, managing £8.1 trillion of assets overall. Over £1 trillion is managed for UK retail 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. There are also around 11 million savers with investment products such as stocks and shares individual savings accounts (ISAs).
- 2.4** Firms acting as AFMs are a key component of the UK asset management industry. AFMs operate authorised funds, a major product type within the asset management industry. As noted in Chapter 1, other investment products, for example unit-linked insurance, serve a similar function and similar issues may exist as those we uncovered in the AMMS. We are keeping the potential application of these remedies to these products under review. In the case of unit-linked and with-profits insurance, we will consider the relevance of these remedies and others following future diagnostic work.
- 2.5** AFMs either take portfolio decisions themselves, or choose to delegate this to another firm. Either way, AFMs are the agent of the investors in the funds they operate and owe them duties. They are more than just product providers.
- 2.6** The AMMS presented evidence of weak price competition in a number of areas of the asset management industry. Given the pivotal role the industry plays in the lives of individual consumers, and its impact on the wider economy, these weaknesses matter. We believe that there are several underlying drivers of weak competition in this market. As part of PS18/8 we are confirming a package of measures to strengthen the duty on AFMs to act as good agents for their underlying investors and address the supply side weaknesses identified.



- 2.7** On the demand side of the market, many investors choosing between different asset management products and services have the ability to make good decisions, if properly informed, or have advisers who do this for them. To make good decisions, all investors need and expect certain minimum standards in the quality and scope of the information they receive from the industry.
- 2.8** We want improved information for investors to explain what a fund does, how it does it and how performance is measured. This would help investors exert greater competitive pressure on AFMs and better look after their own interests. The remedies package in this CP seeks to deliver this, principally in the areas of fund objectives, use of benchmarks, and the way past performance is presented. We are also consulting on rules related to fund performance fees.
- 2.9** The proposals complement other FCA and European work in the asset management sector. This includes MiFID II, which came into effect earlier this year, and the PRIIPs Regulation, which also came into effect for most investment products earlier this year, but is due to apply to funds on 31 December 2019. In our response to the findings of the AMMS we have taken into account the changes being introduced by these initiatives. For example, MiFID II and the PRIIPs Regulation have recently introduced greater disclosure of all costs and charges as explained in Chapter 1. In addition, the PRIIPs Regulation requires providers to set out a recommended holding period to investors. We do not think it is proportionate to introduce our own rules to do this before the PRIIPs Regulation applies to funds from 2020.

### How it links to our objectives

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- 2.10** Our proposals are primarily intended to advance our objectives of protecting consumers and promoting effective competition in the interest of consumers.

### What we are doing

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- 2.11** In this CP we set out our proposals to improve the information that AFMs disclose to investors and potential investors.

#### Fund Objectives

- 2.12** Fund objectives and investment policies are often not explained clearly. Because of this, it can be hard to understand what a fund is trying to do in practice, or to compare different funds. It may not be clear to investors that an active fund is constrained by a benchmark, or by how much (so called 'partly active funds'). To help inform what we might do to address this, we set up and chaired a working group to discuss fund objectives. The group included a wide range of interested stakeholders ranging from asset management firms, platforms and investor and consumer groups. Summaries of discussions in the meetings are available on our website<sup>5</sup>, and the discussions have helped to shape the proposals in this paper. We would like to thank all of the participants in the group, and other stakeholders who worked with us for their time and expert input.

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<sup>5</sup> [www.fca.org.uk/firms/fund-objectives-working-group](http://www.fca.org.uk/firms/fund-objectives-working-group).

- 2.13** We propose to publish guidance on how we expect funds to make their objectives more useful to investors. This sets out what we expect when funds disclose their objectives, and reiterates that descriptions of objectives in key information documents should avoid jargon. The guidance also explains when we expect a fund to disclose that its portfolio construction is in practice constrained relative to a benchmark.

### **Benchmarks**

- 2.14** AFMs rarely explain to investors why they have selected a particular benchmark (or where they have not selected a benchmark, how investors should assess the fund's performance). We have seen examples where AFMs present benchmarks inconsistently in different consumer-facing documents for the same fund. AFMs appear to use the term 'benchmark' for 3 different things that may overlap – as an index or similar factor used as a constraint on a fund's portfolio construction, as a target or as a comparator. As referred to in paragraph 1.12 this is distinct from (and wider than) the definition of the term used in the EU BMR.
- 2.15** We propose rules that require AFMs to explain in a fund's prospectus and other consumer facing communications that include fund-specific information<sup>6</sup> ('relevant communications') why they have set one or more benchmarks as a constraint, target or comparator for a fund. Where an AFM has not done any of these, we propose to require the AFM to explain to investors how they should assess a fund's performance. We also propose new rules and guidance to make sure that benchmarks are referred to consistently across each fund's prospectus and relevant communications<sup>7</sup>. Where a fund does not have a benchmark the AFM should be consistent in not referring to one.
- 2.16** Some AFMs present past performance in some of a fund's documents against benchmarks lower than or different to those used in other disclosures for that fund, including benchmarks used as a target. We are proposing to require that where a fund is constrained by and/or targets a benchmark, any presentation of past performance must be compared to that benchmark (or benchmarks, if more than one is relevant).
- 2.17** Under our current rules, AFMs need to make sure that their performance fee structures are fair. As part of this, our existing guidance sets out that AFMs should have regard to whether a benchmark used in a performance fee is reasonable and consistent, given the objectives of the fund<sup>8</sup>. We are consulting on amending our performance fee rules to clarify that we expect performance fees to be calculated on performance net of other fees in all cases.

## **Equality and diversity considerations**

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- 2.18** We have considered the equality and diversity issues that may arise from our proposals. Overall, we do not consider that the proposals adversely impact any of the groups with protected characteristics under the Equality Act 2010. 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. In the meantime we welcome your input to this consultation on this.

<sup>6</sup> Therefore this does not include general 'brand only' adverts or communications, known as 'image advertising'.

<sup>7</sup> This will not apply in respect of comparator benchmarks in communications used in the course of a personal visit, telephone conversation or other interactive dialogue, or in any scenario in which a client has specifically requested that a particular comparator is used. See chapter 3.

<sup>8</sup> COLL 6.7.6 G (2)(b)



## 3 Helping investors choose the right fund for them – objectives and benchmarks

- 3.1** In this chapter we explain our proposals to help investors understand which fund (authorised CIS) might be right for them. We plan to do this by clarifying how AFMs should describe the objectives of their funds. We also propose to require firms be consistent in the way they use benchmarks for funds, including when benchmarks are part of presenting a fund's past performance.

### Fund objectives and investment policies

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- 3.2** Fund objectives and investment policies, which we refer to collectively as 'objectives' in this chapter, are designed to summarise what a fund aims to achieve, and how it will go about doing this.
- 3.3** Investors rely on objectives to explain to them what a fund will be doing. Fund managers set out a fund's objectives to explain this to investors. But they also want enough flexibility to manage the fund in different market conditions, and in the overall best interests of the investors. This creates a tension between being specific and being flexible that needs to be managed. We do not believe these two aims are incompatible and it is important that firms manage this tension in a way that helps investors. If objectives are clear and helpful this should lead to investors making better decisions about which fund is right for their needs.
- 3.4** The AMMS found that the presentation of fund objectives is not always as useful as it could be to investors. Objectives are often set out in language that, although factually correct, does not explain to an investor, in clear language, what the fund is doing. In addition they are often not specific and may omit important information about how the fund is run. Funds operating quite different investment strategies sometimes explain their objectives in the same overall terms. This makes it hard for investors to compare different funds. The use of jargon and technical language also makes it difficult for a retail investor to understand what a fund is aiming to achieve and how it will go about doing this.
- 3.5** The AMMS also found that some funds are managed in a 'partly active' way but this is not fully disclosed. These funds are limited in how far their holdings can differ from the weightings of a particular benchmark index. Without good information, investors won't be aware of this policy. A fund policy like this has an impact on the way a fund is managed, and on its risk and potential return.
- 3.6** We want it to be clearer to investors what a fund is offering. We want firms to explain succinctly and in plain English what their funds are doing. Key information documents are meant to help investors understand a product, not simply to meet the minimum requirements of regulation. Many investors will also use fund factsheets but key information documents are important for comparability. We expect firms to produce key information documents in such a way as to allow investors and third parties to access and compare information across funds.

## Fund objectives working group

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**3.7** As noted in Chapter 1 we set up a working group to consider these issues. The group met on 4 occasions. It looked at the following topics:

- the meaning and usefulness of objectives
- how objectives might be made more comparable between funds
- how reporting against objectives might be improved

**3.8** The final meeting considered the steps that might be taken to address the issues. The discussions and conclusions of the group are summarised in Annex 3<sup>9</sup>.

## Where and how objectives must be disclosed

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**3.9** Existing rules require that objectives must be disclosed in some standard regulatory documents. They may also be provided in other documents that are subject to regulation.

**3.10** The prospectus of a UK authorised fund must disclose, among other things:

- the investment objectives
- the investment policy for achieving those objectives, including the general nature of the portfolio and any intended specialisation
- an indication of any limitations on that investment policy
- the description of what the fund may invest in
- the proportion of the fund that any asset may make up

Although the constituting instrument of the fund (for example, the trust deed of an Authorised Unit Trust (AUT) or the instrument of incorporation of an investment company with variable capital (ICVC)) is the 'definitive legal document' setting out the fund's objective<sup>10</sup>, the prospectus is the primary disclosure document for investors and other documents must be consistent with it.

**3.11** Key information documents such as the key investor information document (KIID) required by the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and the PRIIPs key information document (KID) must contain a section describing the investment product, including its objectives.

**3.12** Other marketing communications relating to a specific investment product, such as fund factsheets and supporting literature must be fair, clear and not misleading. They must not contradict or diminish the importance of information contained in the prospectus, KIID or KID.

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<sup>9</sup> Supporting papers and summaries of the group's discussions may be found at: [www.fca.org.uk/firms/fund-objectives-working-group](http://www.fca.org.uk/firms/fund-objectives-working-group)

<sup>10</sup> See COLL 3.2.6R, point 7 in the table



## Proposed guidance on fund objectives

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**3.13** We believe that the existing overarching rules on disclosure are sufficient and we do not propose to change them. We also do not propose to make rules to change the way that firms manage their funds in practice. However, to address the problems the AMMS identified we are providing guidance on how we expect firms to meet the existing disclosure rules.

**3.14** This guidance makes clear our expectations for authorised funds already operating. Some firms have expressed concern about departing from the language in fund prospectuses, and this guidance makes clear that firms may depart from the legalistic language used in prospectuses in order to use plain English and should use language that consumers can readily understand. Once finalised, we would also expect an AFM seeking authorisation for a new fund to consider these areas in their application.

### Objectives should explain what a fund is doing

**3.15** The intention of key information documents is to explain to a retail investor in consumer-friendly language:

- the aims of a fund
- how it will achieve its aims

**3.16** In the guidance, we set out what we would expect should be included in the objectives section of the KIID, and the 'what is this product?' section of the PRIIPs KID.

**3.17** There is a requirement for the KID / KIID to be consistent with the prospectus. Consistency does not have to mean identical language. While the substance must be consistent firms should describe the objectives of the fund in consumer-friendly language. This should be different from the language of the prospectus if that isn't consumer-friendly, for example if it is overly technical or uses legal jargon.

**3.18** We also set out our expectation that it is generally necessary to include elements of the investment strategy in the KID or KIID in order to explain how a fund will achieve its aims.

**3.19** The prospectus may allow broad scope for the fund to be managed in different ways at different times. However, where a manager is using a particular strategy to manage the fund this should be disclosed. For example, a manager might have the scope to invest in companies of all sizes. However, the manager's strategy is to weight the fund towards smaller companies. This should be disclosed in the KID or KIID. Another example would be when a manager is targeting a particular level of income for the fund. Again this should be disclosed in the KID or KIID.

**3.20** There are rules that require firms to review and revise their documents at least once a year, and more frequently if things change, to make sure they remain accurate. We expect AFMs to explain their current investment strategy in funds' key information documents, and to update that when necessary. For example if there is a change of manager on a fund, and the new manager will be adopting a different investment strategy, we expect this to be disclosed to investors. However, this does not mean that we expect an AFM to amend a document to reflect every minor change in investment strategy, provided that it still adequately describes how the fund is operating.

- 3.21** We considered whether to change the rules around the disclosure of objectives in the prospectus but decided not to. Our view is that the issues in this area are mainly around how key information documents, and marketing materials which reflect them, talk about objectives.
- 3.22** We recognise that there are some aspects of making objectives clearer where there could be opportunities for the industry and consumer stakeholders to work together. The IA has set out a number of areas where it will look to develop industry guidance, in conjunction with consumer input, as to how objectives may be explained more clearly to investors. We welcome this work.
- 3.23** Some members of the Fund Objectives Working Group asked us to publish examples of what we do not like. We agree that examples can provide colour to the points we are making. But we do not think it would be appropriate to give specific examples. The box below provides generic examples of what we do not think is appropriate.

#### **Examples of poor practice**

##### ***Copying out the prospectus***

Language appropriate for the prospectus may give a comprehensive legal definition but may not be comprehensible to an investor.

Some terms are used by regulations but may not be easily understood by an investor, e.g. "transferable securities" or "collective investment schemes."

##### ***Not explaining the investment strategy clearly***

A KIID may provide a generic description of what the manager is allowed to do. But important information about what the manager is actually doing is only contained in marketing literature.

Example 1: the KIID simply lists the investment powers available under the prospectus, but other marketing materials make it clear that the manager's investment strategy specifically does not involve using some of these powers.

Example 2: the KIID mentions as a possibility that the manager may make use of derivatives, but other marketing materials make it clear that the manager's investment strategy involves systematically using them in a particular way, for example selling call options against portfolio holdings to generate additional income.

- Objectives should explain any constraints on a fund**
- 3.24** We want to improve how firms disclose the portfolio constraints or limits that their funds may have when they decide on the assets they invest in. An example of such a constraint would be a UK equity fund whose portfolio will differ from the composition of an index (such as the FTSE-100) by no more than a set amount. This could be the amount of any individual company share being limited to no more than 3% more or less than the index weighting. Such a fund is more likely to mirror the risk and return of that index than a fund managed without these constraints.
- 3.25** If a fund is restricted in its holdings (index trackers and partly active funds), it is our expectation that this needs to be disclosed in its prospectus and KIID under existing rules.<sup>11</sup> An example of this type of restriction would be when the investment mandate

11 UCITS KIID Regulation Article 7, COLL 4.2.5R (3)(c)



explicitly limits the freedom of the manager to differ from the weightings in a benchmark.

**3.26** But there are also situations where there are practical, internal restrictions in place which limit how far a fund can differ from the composition of a benchmark. Examples of such constraints include, but are not limited to:

- the risk management process for a fund causing it to be monitored and controlled relative to a benchmark
- the individuals managing the fund being remunerated based on its performance relative to a benchmark
- the portfolio management system restricting transactions using hard or soft limits relative to a benchmark

Firms should assess whether such restrictions mean that the fund is in practice managed with reference to a benchmark.

#### **Examples of portfolio constraints**

A UK equity fund has an investment policy which permits it to invest in any UK firm in any weighting.

- The investment risk team produces a monthly report on the tracking error of the fund compared to the FTSE All-Share index. If the fund exceeds a certain tracking error, the individual managing the portfolio is asked to buy or sell shares to reduce the tracking error
- When the individual managing the portfolio instructs a trade, the portfolio management system raises a warning flag if a proposed trade would lead to the holding in the fund differing from the index weighting of that security by more than 2%
- The personal bonus of the individual managing the portfolio is linked to the performance of the fund compared to the FTSE All-Share index

In practice the fund is managed with reference to the index

A global bond portfolio has an investment policy which permits it to invest in investment grade bonds in any developed bond market.

- The individual managing the portfolio constructs the portfolio using country weights of the JP Morgan Government bond index
- The country weights relative to the index are monitored on a daily basis by the portfolio management team, and there are limits on how far the investment process allows the fund to deviate from the country weights of the index
- The personal bonuses of the portfolio management team are based on the performance of the fund relative to the index

In practice the fund is managed with reference to the index

**3.27** Our supervisory experience is that AFMs do not always disclose such 'internal' constraints on a fund's portfolio to all of its investors. Investors who are not told of

constraints on a fund's portfolio construction may buy the fund in error, believing its strategy to be different to the one it will employ in practice.

**Funds setting out non-financial objectives should explain these clearly and in full, should not mislead investors, and should measure and report against them**

**3.28** Increasingly funds are setting out non-financial objectives. Examples would include objectives to achieve an environmental or social return or an improvement in the governance of the companies in which the fund invests. These are set out alongside financial objectives. This is recognised by the PRIIPs Regulation, which requires disclosure of specific environmental or social objectives targeted by the product, and reflects our experience authorising and supervising funds. We set out in the guidance what we expect, at a high level, when a fund sets out a non-financial objective. Such objectives should be set out in a way that is fair, clear and not misleading. Funds that set out non-financial objectives should be clear about how they will measure whether those objectives are being met, and should provide ongoing information to investors.

**3.29** The FCA has considered the recommendations of the Law Commission in its report on Pension Funds and Social Impact Investing<sup>12</sup>. We are also aware of other initiatives in this area such as the Social Impact Advisory Group. We are considering the appropriate response to these initiatives and if we consider it appropriate, we may write new rules or provide guidance in due course.

**Q1: Do you agree with our draft guidance on fund objectives?**

## Benchmarks

**3.30** Asset managers generally use the word benchmark to denote indices used to constrain investment, and to target and compare performance. The AMMS shows that investors would benefit from more precise and consistent use of these indices. The proposals in this chapter seek to address this. Please note that this consideration of benchmarks and their uses is distinct from the new EU Benchmarks Regulation. Please see the boxed text below.

### The EU Benchmarks Regulation

The BMR defines indices used in certain ways as 'benchmarks' and regulates the provision and use of these in the EU. The terms 'benchmark' and 'use' have specific meanings under the BMR. The BMR regulates a narrower set of uses of indices than the ones we consider in this CP. The proposals in this CP are entirely separate from, and have no bearing on, the BMR. References below to benchmarks, or the use of indices, do not refer to those concepts as defined in the BMR. Some uses of indices will fall into both a BMR definition and a definition used in this CP as a matter of fact, but the definitions will remain unrelated. This CP does not give guidance on, nor represent the FCA's views on, the BMR.

### Our proposals

**3.31** We have found that fund managers rarely explain why or how they are using particular benchmarks. Examples of how they might be using a benchmark include that a

<sup>12</sup> Original Law Commission report: [www.lawcom.gov.uk/project/pension-funds-and-social-investment/](http://www.lawcom.gov.uk/project/pension-funds-and-social-investment/) The response is here: <https://www.gov.uk/government/publications/pension-funds-and-social-investment-interim-response>



benchmark has been chosen to constrain how they construct the portfolio of a fund; that the fund is targeting the performance of a benchmark; or that the fund manager is inviting investors to compare a fund's performance against a particular benchmark or benchmarks.

**3.32** Some fund managers present their funds' past performance against different benchmarks in different consumer documents. This could confuse investors, and may flatter the performance of a fund. If investors try to choose funds based on confusing or contradictory information they may choose the wrong funds for their needs or have incorrect and inaccurate expectations.

**3.33** Generally, the word 'benchmark' is used across the fund management industry to describe indices (or other similar factors) used by AFMs in different ways. We believe the term encompasses 3 different concepts.<sup>13</sup> The benchmark categories relevant to our proposals are:

- 1. a 'constraint':** an index or similar factor used by AFMs as a constraint on a fund's portfolio construction (see paragraph 3.24 above)
- 2. a 'target':** an index or similar factor that is part of a target an AFM has set for a fund's performance to match or exceed, which necessarily includes anything used for performance fee calculation. Examples would be objectives stating that they aim to 'outperform LIBOR plus 4%', 'achieve a return greater than 6% per year', 'track the return of the FTSE-100', or to 'beat the return of the FTSE All-share'.
- 3. a 'comparator':** an index or similar factor that an AFM invites investors to compare against a fund's performance, such as 'the return of the FTSE All-share' - this type of benchmark may be labelled as a comparator by an AFM, but in many cases it will be identified as falling into this category by the fact that it is neither a constraint nor a target.

**3.34** We propose rules that require AFMs to explain in a fund's prospectus and in other consumer facing communications<sup>14</sup> ('relevant communications') why they have used any constraint, target or comparator for a fund, as applicable.

**3.35** Where an AFM has not set a constraint, target or comparator for a fund, we propose to require the AFM to explain to investors how they should assess the fund's performance in the fund's prospectus and relevant communications. The intention is that investors will gain valuable insight into how the AFM views the fund and how it thinks the fund's performance should best be judged, and that this will promote better informed choices by investors. This 'requirement to explain' should also be a useful discipline when AFMs are selecting benchmarks or considering changing them.

**3.36** We also propose new rules to require that benchmarks - whether constraints, targets or comparators - are consistently cited and described in each fund's prospectus and in relevant communications, or not, if there are no benchmarks. We recognise that there may be times when the use of different comparator benchmarks for different clients may be appropriate and in clients' best interests. We consider that this is the

<sup>13</sup> The same index could be used as both a constraint and target.

<sup>14</sup> Therefore this does not include general 'brand only' adverts or communications, known as 'image advertising'. The term 'relevant communications' used here does not include the UCITS KIID (or KIID equivalent document for a Non-UCITS Retail Scheme) that an AFM may be required to produce.

case in respect of comparators in communications used in the course of a personal visit, telephone conversation or other interactive dialogue, or in any scenario in which a client has specifically requested that a particular comparator is used.

**3.37** Under Article 7(1) of the UCITS KIID Regulation, we expect AFMs to refer in the KIID's section on Fund Objectives and Investment Policy to any constraint and target benchmarks the fund may have. We are reiterating this point as part of our guidance on the disclosure of fund objectives. We do not consider that the intention of the UCITS KIID Regulation is for comparator benchmarks to be disclosed within the KIID. We appreciate that this will introduce some inconsistency between prospectuses and consumer facing communications on one side and UCITS KIIDs on the other for those funds that use comparator benchmarks. We think this is acceptable because the inconsistency should be temporary, assuming that UCITS KIIDs are superseded at the end of 2019, as is currently the intention.

**3.38** Examples of the implications of the proposals above are as follows. If an AFM references 2 benchmarks in a relevant communication for a fund, it would have to refer to the same 2 benchmarks in another relevant communication for that fund. As another example, an AFM could not, for example, refer to a comparator benchmark in a relevant communication if it had not first updated its prospectus to include that benchmark. This may make it more difficult for AFMs to regularly change comparator benchmarks, which they might otherwise do to show their past performance against a more favourable, different comparator with the benefit of hindsight.

**Q2: Do you agree that we should introduce a 'requirement to explain' with regard to AFMs' use of benchmarks?**

**Q3: Do you agree that we should introduce rules and guidance to require consistency in references to benchmarks across the same fund's documentation?**

### **Benchmarks and the display of past performance**

**3.39** If AFMs produce a UCITS KIID<sup>15</sup>, they must present their past performance in it. They must present it in their prospectus. They can also choose to do so in relevant communications such as fact sheets. Some AFMs present past performance in some of a fund's documents against benchmarks lower than or different to those used in other disclosures for that fund. We have seen cases where AFMs set a target for a fund, but show past performance only against different, sometimes lower, benchmarks. This may exaggerate performance and lead investors to make poor choices.

**3.40** We are consulting on introducing rules so that where an AFM shows a fund's past performance in a relevant communication, it must show it against any constraint or target benchmarks the fund has. This would include, for example, a fund with 2 targets (target benchmarks) - to beat the return on LIBOR, and to beat LIBOR +4%. Our proposed rules would mean that it would not be acceptable for the AFM to show the fund's past performance against LIBOR alone - it must show it against both targets.

**3.41** The UCITS KIID Regulation requires benchmarks to be stated where used, and performance to be displayed against such benchmarks. Funds' constraints or target benchmarks should appear in the Objectives and Investment Policy section of the KIIDs, in light of our proposed guidance on KIID Article 7(1). We are proposing to

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15 Or an equivalent document for a non-UCITS Retail Scheme



confirm our expectation that, as a result of the wording of Article 18(1), AFMs should show their KIID past performance against these benchmarks.

- 3.42** Where an AFM uses comparator benchmarks, we do not propose to require them to show fund performance against these benchmarks. But if they choose to compare their performance against one or more comparator benchmark, we propose that they must do so consistently across all relevant communications.
- 3.43** We do not expect comparator benchmarks to feature or appear in KIIDs. Therefore, our proposals will lead to inconsistency between the KIIDs and the relevant communications (as defined above) of funds that use comparator benchmarks. Given that KIIDs are due to be replaced at the end of 2019, we accept that a small degree of inconsistency will exist with regard to comparator benchmarks and past performance until then.
- 3.44** We are proposing an implementation period of three months for the new Handbook rules and guidance covered in this 'benchmarks' section for new funds, and six months for existing funds.

**Q4: Do you agree that we should introduce rules and guidance on which benchmarks should be displayed against a fund's past performance, where past performance is shown?**

## 4 Performance fees

- 4.1** In this chapter we set out a proposal on performance fees taken by AFMs.
- 4.2** AFMs, in accordance with our existing rules, need to make sure that all fee structures are 'fair'. This includes any 'performance fees' taken only after a fund has achieved a stated objective(s), for example fees taken only once a target benchmark has been exceeded. Performance fee arrangements must be disclosed in full in the prospectus and the existence of performance fees should be indicated in the UCITS KIID.
- 4.3** In the AMMS Final Report we indicated that we were minded to consult on new policy relating to the interaction of the targets a fund may have and how performance fees are calculated relative to such targets. This was in response to our concerns about the fairness of a specific practice, where an AFM might take performance fees before the most ambitious target for a fund has been reached.
- 4.4** There is substantial innovation in fund performance fees in the UK market at the moment, especially the development of more symmetrical performance fee models. These are fees that try to better align AFM and fund investors' interests to the risks and reward of fund performance. For example, such structures reduce the fees payable to the AFM in the case of poor fund performance. We do not wish to inhibit such innovation where it is in the interests of investors. As a result we are not proposing significant rule changes at this time. We remain focused on whether fees are fair to investors and will intervene under our existing rules where we are concerned that this is not the case, for example where it is clear that an AFM is charging performance fees in a way that investors could not understand in advance and would not expect (for example well below a stated target).
- 4.5** We are consulting on one change relating to performance fees. Our current guidance says that an AFM should not charge performance fees on gross performance, i.e. before other charges such as the AFM's fee have been reduced. However, this is not prohibited by a rule. In theory, if an AFM can show that taking fees in this manner is fair, then it could be permitted. In our view it is not in the interests of investors for AFMs to take performance fees on a gross basis. This is 'a fee on a fee' and is unlikely to be understood by investors. We propose a rule to prevent AFMs charging performance fees on a gross basis. This is consistent with the 2016 International Organization of Securities Commissions (IOSCO) Report 'Good Practice for Fees and Expenses of CIS'. 'Good Practice 4' states that performance fees should be taken on performance that is net of other fees.
- 4.6** We are proposing a six month implementation period for these rules.

**Q5: Do you agree that we should remove the possibility that performance fees could be taken on gross performance?**



## Annex 1

### Questions in this paper

- Q1:** Do you agree with our draft guidance on fund objectives?
- Q2:** Do you agree that we should introduce a 'requirement to explain' with regard to AFMs' use of benchmarks?
- Q3:** Do you agree that we should introduce rules and guidance to require consistency in references to benchmarks across the same fund's documentation?
- Q4:** Do you agree that we should introduce rules and guidance on which benchmarks should be displayed against a fund's past performance, where past performance is shown?
- Q5:** Do you agree that we should remove the possibility that performance fees could be taken on gross performance?

## Annex 2

# Cost Benefit Analysis (CBA)

1. The Financial Services and Markets Act 2000 (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 '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 believe it is 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.

### Asset Management Market Study Findings

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3. The key finding of the AMMS is that price competition is not working well in some areas of the asset management industry. We believe that there are several drivers of this weak competition. One of these is that (at least some) investors would be able to exert greater competitive pressure on asset managers if they were provided with better information on the funds available to them. The remedies package in this CP seeks to deliver this.

### Fund Objectives, Benchmarks, and Past Performance

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#### Baseline and our Proposals

##### *Fund objectives*

4. The AMMS identified a number of deficiencies in the way in which fund managers communicate certain fund information to investors. Fund objectives are often written in jargon that makes them difficult to understand and prevents investors comparing funds. We found instances in which a fund's portfolio construction was constrained to a benchmark but this was not disclosed, or disclosed only to institutional investors.
5. We propose to publish guidance on how we expect funds to make their objectives more useful to investors. This will reiterate existing requirements, as described in this consultation, such as the need for objectives to avoid jargon. It will also indicate how AFMs should assess whether the construction of a fund's portfolio is in practice constrained to a benchmark, including due to internal factors within an AFM.
6. When an asset manager is adopting a strategy with limited freedom from an index, they are required to disclose this to investors under our current rules. By the end of last year, we had reviewed 84 potential closet tracker/partly active funds. In 64 funds we have required the manager to make it clearer to consumers how constrained they are. Overall, £34m in compensation has been paid to funds and investors. Separately an enforcement investigation is ongoing against a firm.



**Fund benchmarks: constraints, targets, and comparators**

- 7. We have found that the benchmarks used in different client documentation for the same fund are sometimes inconsistent, as is the use of benchmarks in the presentation of past performance. An AFM's reason for using a benchmark for a fund is rarely explained to investors. For clarity, where we use the word 'benchmark' in this context we refer to three different concepts; a 'constraint', a 'target' and a 'comparator'. These 3 types of benchmark are explained in the main paper.
- 8. We are proposing rules that will require AFMs to explain why they have used any constraints, targets, or comparators in a fund's prospectus and relevant communications, and to require that these benchmarks are referenced consistently across these documents. Where a fund does not have a constraint, target or comparator benchmark, we are proposing that AFMs must explain how investors should assess the fund's performance in the same documents.
- 9. We propose to publish guidance recommending that AFMs also refer in the KIID's Fund Objectives and Investment Policy section to any constraint and target benchmarks that are set out in the fund's prospectus and relevant communications.

**The presentation of past performance**

- 10. Some AFMs present a fund's past performance against different benchmarks to those given in other disclosures for the same fund. This could lead investors to conclude that a fund has performed better against its investment objective than it has.
- 11. We are proposing to require that where a fund has constraints or targets, and where an AFM presents the past performance of a fund, the AFM must present the fund's past performance alongside that or those benchmarks.<sup>1</sup>
- 12. AFMs must present their past performance in the UCITS KIID (if they produce one). We propose to consult on guidance that recommends that AFMs should show their KIID past performance against any target or constraint benchmarks.

**Baseline and our proposals – summary**

- 13. Disclosure deficiencies create an information asymmetry between the fund manager and the investor. As a result, investors may find it harder to accurately determine a fund's objectives, the proper context for the fund's past performance (where an AFM chooses to display this), and reference indices. Investors will find it more difficult to compare funds and to later determine if the costs and charges they have paid are consistent with the nature, extent, and quality of the services provided by an AFM. In summary, this makes it harder for investors to identify which fund is likely to meet their investment needs and objectives.

Market Failure	Proposals
<b>Lack of competitive pressure caused by disclosure deficiencies results in an inefficient funds market</b>	Consistent use of benchmarks, explanation of why benchmarks used or alternative method to assess fund performance set out
	More useful Objectives Disclosure (including of constraints on portfolio construction)
	Past Performance disclosure requirements (where past performance is included in documentation)

<sup>1</sup> As noted in the main body of this consultation, we are not proposing to require every display of a fund's past performance to include any comparators the AFM may have indicated for the fund. If an AFM does use a comparator in one instance, they must do so consistently across any other communications for that fund that shows a comparator.

- 14.** For a competitive market to function efficiently the information relevant to the price formation of the products available within the market must be reliable, and if it is to be reliable then it must be consistent. Investors cannot make informed decisions if they are unable to assess the characteristics of the products in the market because they are not presented with consistent information in relation to the funds that they are considering making, or have made, an investment in.
- 15.** The remedies seek to empower those investors able to exert demand side pressure to deliver this by:
- Requiring asset managers to be clearer about the objectives of the fund. This will include where AFMs are required to clearly communicate the constraints – whether implicit or explicit - of a fund’s portfolio construction in relation to a benchmark.
  - Promoting the consistent display of benchmarks in consumer facing documentation, as well as requiring that AFMs explain their use of benchmarks
  - Enabling investors to better identify performance, both before and after sale, against the benchmarks the manager has chosen.

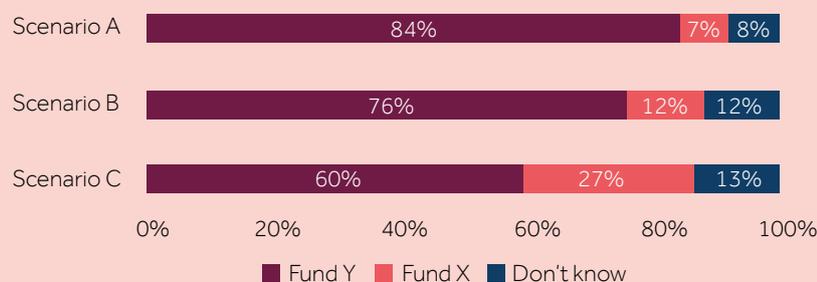
### Investor decision making

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- 16.** Both academic evidence and data gathered on our behalf shows that the specific way in which a benchmark is used by an asset manager for the display of past performance can have a conclusive effect upon investor preference. This is demonstrated in Annex 3 of the AMMS, in which consumer research we commissioned illustrates the ‘Benchmark Framing Effect’. Past performance does not indicate the likely future performance of a fund. But if investors do use past performance to try to assess a fund’s expected future returns, the behavioural research below suggests that the use of a flattering benchmark can have a powerful effect.
- 17.** In the experiment, investors were asked to select one of two hypothetical funds – Fund X or Fund Y - based upon the past performance presented to them both with reference to a benchmark and without. Despite Fund Y outperforming Fund X by 2% every year, the framing of both funds’ past performance with either a flattering or disadvantageous hypothetical benchmark had significant effects upon investor behaviour.

The study gives insight into the behavioural changes that the illustration of past performance and strategic use of benchmarks can bring. In all 3 hypothetical scenarios presented to consumers, Fund X underperformed Fund Y by 2%. In the second of these scenarios (Scenario B), Fund X was shown to have outperformed a benchmark. Fund Y was shown in isolation. The number of respondents who selected Fund Y in scenario B was 8 percentage points lower than those who selected Fund Y in scenario A; the percentage of investors that selected Fund X rose by 5%. In the last scenario (Scenario C), Fund X was shown in isolation, whilst Fund Y was shown to have underperformed its hypothetical benchmark. The number of investors that selected Fund Y fell by a further 16%. The number of consumers that selected Fund X rose by 15% (see Figure 38 in Annex 3 of the AMMS, below). The number of respondents who selected Fund Y in scenario C was 24 percentage points lower than those who selected Fund Y in scenario A.

**Figure 38: Based on the past performance information below, which fund would you choose to invest in? (Q53a).**



Sample base: Scenario A (659), Scenario B (630), Scenario C (636). Speeders (ie respondents who spent very limited time on answering the question) have been removed from sample.

The findings of this controlled trial are reinforced by a significant body of academic research. We think that this empirical data shows that it is reasonable to make assumptions about the likelihood that investor behaviour will change as a result of our disclosure remedies. We accept that that consumer behaviour observed in a controlled experiment will not be perfectly reflected in reality.

18. Where Fund X was shown to have outperformed its benchmark, more investors chose to invest than where the same performance was shown in isolation. Where Fund X was again shown in isolation, but Fund Y was shown to have underperformed its benchmark, yet more investors chose Fund X, despite its explicitly weaker performance. We can infer that had Fund X been shown to have outperformed its benchmark in the latter scenario, the number of investors choosing to invest in the weaker of the 2 hypothetical funds would have increased even further.
19. Empirical data also suggest that the objectives, likely return and performance of a fund are of primary importance (alongside costs) to investors who refer to fund documentation, as are the client-facing documents that describe them most prominently, including the KIID and the Factsheet.
20. Figure 14 in Annex 3 of the AMMS shows that 25% of investors consult the KIID, and that 34% consult either the factsheet or some other form of fund documentation. Behavioural data gathered as part of the AMMS also suggest that the top 3 factors considered by those retail investors that consult fund documentation are all financial.

21. These data suggest that investors who switch funds do so in the majority of cases because of the performance of the fund; less than 10% of investors switched because of poor service. They also suggest that somewhere between 8% and 24% of investors who consult fund documentation may be influenced by the inconsistent use of benchmarks and the display of past performance.

### **One-off and on-going costs**

22. Our new rules and guidance on benchmarks, fund objectives and past performance will in almost all cases require a change in the information already presented in investor marketing material, such as KII documents and Factsheets. They will require firms to undertake a comprehensive internal review of their marketing material, and may result in them having to re-issue written documentation relating to the objectives, benchmarking and past performance for all of their funds. AFMs will also need to update their prospectuses with a mention of and an explanation of why benchmarks have been used. We expect that the one-off costs to AFMs of our proposed rules (i.e. excluding the fund objectives disclosure clarifications) would be small, but not negligible.
23. Firms' review of fund documentation will involve compliance and legal departments, as well as internal sales staff. While the resources required to undertake the review will vary depending upon the number of funds that an AFM manages, we are assuming an estimated average of 35 funds per AFM<sup>2</sup>; many AFMs will have only a couple of funds, and some may have more than 100. We are establishing our estimate at the AFM level, rather than the fund level. This is because we are assuming that AFMs will review all of their funds in a single batch, rather than reviewing them on an individual basis. On an industry basis, we estimate that it would take approximately 280 hours per AFM at an aggregate level for the firm to review the existing fund documentation that may need to be re-issued across its fund range.
24. This is roughly equivalent to 3 weeks review by a member of the sales team, 3 weeks review by a member of the compliance team, and 2 weeks for legal review and executive sign-off. This is equivalent to a total of 8 hours to identify and review each affected fund. We do not expect that entry-level personnel will be undertaking this work – a combination of senior sales, compliance and legal staff will be required.<sup>3</sup>
25. Were the implementation period of our rules to coincide with the regular updating of documentation performed by firms, the costs to firms would be incurred only for the formatting changes required in relation to benchmarks, objectives and past performance. This would require significantly less time than if an ad hoc review of all outstanding fund documentation was undertaken, and as such both one-off and ongoing costs would be negligible (see below).
26. We consider that this is primarily a one-off change, and that any ongoing cost when an AFM changes a benchmark will not be material. Because customer facing documentation is already subject to periodic review, we anticipate that the ongoing costs to firms of our disclosure remedies in respect of these documents will be zero. Firms may face negligible ongoing costs in making minor adjustments to the prospectus in line with any changes in benchmark use.

2 Approximately 100 AFMs run UK authorised funds. There are circa 3500 UK authorised funds associated with these AFMs that will be impacted.

3 Wage assumed to be £60,000. Total cost to firm is wage x 1.25 (wage, buildings, N.I.), which is £75,000. Days worked per year assumed to be 220. Effective net working hours per working day assumed to be 7. Therefore the cost per 1 hour is £48.70, rounded to £49.



27. We are not treating any transaction or tax liability costs incurred by investors who choose to switch investments due to these better fund disclosures as a direct 'cost to consumers' of our proposals. Our proposals do not require investors to switch funds. This decision will be made by the investor, in light of their circumstances and specific needs. We assume that investors will not choose to switch investments where this would be net costly to them.

<b>One-off costs</b>	One-off costs to AFMs of these proposals	280 hours x £49 = £13,720 £13,720 x 100 AFMs = <b>£1,372,000</b>
	One-off costs to investors of these proposals	0
<b>Ongoing costs</b>	Ongoing costs to AFMs of these proposals	Immaterial
	Ongoing costs to investors of these proposals	0

### Possible unintended consequences

28. One potential consequence of our proposals could be that AFMs stop setting specific targets, eg 'to beat x + 2%', or any targets, for their funds. An AFM could alter the investment objective of a fund so where it once targeted to outperform the FTSE All-Share by 2%, for example, it now simply targets to outperform the FTSE All-Share (or remove the target entirely). It could do this so that the fund would be held to a lower standard.
29. There is currently nothing to stop AFMs removing discreet targets from their funds and being held to a lower standard as a result. If a firm ceased to identify discreet targets, the service that is offered may appear less ambitious. This may make it more difficult for the firm to show the merits of its product offering against a rival firm.
30. Certain clients have specific investment aims, for example, liability-driven investment objectives, and may therefore require a fund that aims to achieve a certain target.
31. For these reasons, we do not anticipate that our remedies will cause many if any AFMs to remove discreet targets from their funds where they already have them.

### Benefits from the changes in behaviour we expect to see

32. We believe that our disclosure remedies will allow some investors to more successfully identify the product that best suits their investment needs. Key components of investors being able to choose the right fund for them is their ability to:
- understand what it aims to do and how
  - reasonably estimate the possible future performance of a fund (the extent to which a fund's portfolio is constrained to a benchmark is relevant to this)
  - understand the relationship between a fund's performance and any benchmarks placed against it.

We anticipate that this will drive competitive pressures amongst asset managers and increased competition in this market generally, resulting in better investor outcomes.

- 33.** One possible example of how improved information may lead to benefits would be where a fund previously described as fully unconstrained discloses in its fund documentation that it is subject to a partial constraint in relation to a benchmark. In this situation, we anticipate that a range of outcomes may occur<sup>4</sup>, including:
- i.** Divestment and other investor pressures resulting from the previously undisclosed partial constraint prompt the AFM to reduce the annual management charge (AMC).
  - ii.** Divestment prompts the closure or merger of the fund.
  - iii.** The AFM removes the partial constraint from the fund and maintains, or increases, the AMC.
  - iv.** The AFM maintains the partial constraint on the fund and maintains, or increases, the AMC. This may be the case where some investors do not consult fund documentation, or the AFM increases the value that it offers to investors.
- 34.** We note that unconstrained funds do not necessarily outperform constrained funds, and accept that all investors will have different investment objectives and requirements. This example is indicative of the changes that we expect our 'improved disclosures' remedies to bring: increased competition between funds leading to a more direct relationship between the overall value proposition of a fund, including the reasonable expectation of future performance, and the price paid for it.
- 35.** This competitive pressure can materialise in many forms and is not necessarily demonstrated by investors switching funds. We expect that increasing the accuracy with which investors are able to compare funds may result, for example, in some funds offering better value. These benefits are not dependent on the form in which these competitive pressures materialise. It does not matter, for example, whether investors have switched funds, prices have fallen, or quality of service has improved. Different investors have different priorities when identifying the most suitable fund for their investment needs<sup>5</sup>. Even where investors are not price-sensitive and instead prioritise intangible qualities associated with a given fund, better information for that fund that result in a change to the status quo may tip the balance and cause the investor to re-evaluate their investment options. A fund's 'value' will be determined at the level of the individual investor, and a fund may be deemed 'competitive' by one investor and uncompetitive by another.
- 36.** The net effect is the same – a transfer of surplus from firms to consumers, as the quality of service and value proposition offered by funds more closely reflects the price paid for those funds. There is also the increased benefit to investors driven by their choosing and holding funds that more closely meet their needs as a result of these proposals.
- 37.** The charge taken by an AFM, and overall service delivered, in relation to a specific fund depends upon many commercial, strategic, and operational considerations, some of which will depend upon areas of investment behaviour that will not be affected by our

4 These outcomes depend upon a number of assumptions; these include: 1. Some investors notice disclosures; 2. Some investor's behaviour is affected by disclosures; 3. The number of investors affected is significant enough to affect AFM behaviour, even if this does not prompt material changes.

5 There are legitimate reasons why a constrained fund may charge an AMC associated with unconstrained management and still represent a competitive proposition. Constrained funds offer their own benefits, such as the risk management inherent in their approach – they offer investors the ability to cap their exposure and thus cap their risk, versus a benchmark. Effective price formation will occur where investors are able to compare funds offering similar overall propositions.



proposals. Because of this, it is not possible to reasonably estimate in monetary terms the transfer of surplus that we anticipate will take place from AFMs to investors as a result of the competitive pressures driven by our disclosure remedies. Similarly, we do not believe that it is possible to reasonably estimate the monetary benefits associated with some investors making more informed investment decisions.

- 38.** Mitigating disclosure deficiencies may also have secondary effects upon the UK fund market that are relevant to our objectives. A more transparent and competitive fund market would increase the trust and agency of investors. This may increase the attractiveness of the UK funds industry to international and domestic investors.

### ***Conclusion***

- 39.** We believe the positive benefits that may arise for investors as above (which is a transfer of surplus from AFMs to their investors) sufficiently justifies the overall one-off cost of £1,372,000 and negligible on-going costs.

### **Performance Fees**

#### ***Baseline***

- 40.** Our current guidance strongly suggests that an AFM should not charge performance fees on gross performance, however, it is not prohibited.<sup>6</sup>

#### ***Our Proposal***

- 41.** We are proposing a rule to prevent this practice.
- 42.** Any AFMs currently operating performance fees this type would incur one off costs in discontinuing the practice. They would need to update their prospectus, and may need to update other consumer facing disclosures. They would also likely incur some operational costs in setting up a new way of calculating their performance fees. We do not believe that it is possible to reasonably estimate these costs, although we consider that they would be generally small. We are not aware of any AFMs that this would affect. If this is the case, costs to the industry would be zero.
- 43.** We do not believe that it is possible to reasonably estimate the benefits that may accrue to investors as result of this proposal.
- 44.** Overall we consider that the benefits of this proposal (which may be preventative) outweigh the estimated small or zero costs.

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<sup>6</sup> An AFM could only do so if it could show that their fee is nonetheless fair to the fund investors.

## Annex 3

# Summary of the Fund Objectives Working Group

1. As described in the main paper, we convened a working group to consider the issues the AMMS identified in relation to fund objectives. Papers and summaries of the group's discussions on the below topics can be found at: [www.fca.org.uk/firms/fund-objectives-working-group](http://www.fca.org.uk/firms/fund-objectives-working-group). The material below is a summary of the matters discussed and should not be taken as the FCA's view.

### The purpose of different documents

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2. There are several of purposes behind existing disclosure documents:
  - the Prospectus is the authoritative document from a legal point of view
  - key information documents<sup>7</sup> are designed to present key information in a consumer-friendly format, and enable comparisons
  - factsheets provide updates about a fund's activities, market context and performance information in consumer-friendly form
3. Consumers are far more likely to read fund factsheets than key information documents. This is partly because key information documents are written in a legalistic style because firms view them as formal documents with heavily regulated content. Many firms take a cautious approach to deviating from the language they use in the Prospectus.
4. Further regulatory prescription around factsheets (the documents consumers are most likely to read) was not thought to be a good way forward.

### The 'what' and the 'how', the 'field' and the 'play'

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5. Fund objectives should describe what a fund is trying to achieve, and investment policies are about describing how it will achieve it.
6. Some felt that the investment policy should be expressed flexibly to describe the broad 'field' in which the manager might choose to operate. Others felt it should be narrower to describe what the manager is actually intending to do (where on the 'field' the manager intends to 'play').
7. Fund managers can feel they need to manage their portfolios in a particular way because of the Investment Association (IA) sector classifications. On the other hand, classifications like the IA sectors are important in helping investors to navigate the

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7 The UCITS KIID / PRIIPs KID



wide range of available funds and work out which fund might be best for them. They are also regularly reviewed.

### Terminology and taxonomy of terms

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8. Firms could describe their funds' objectives more consistently if it was clearer what certain terms mean, for example 'long term' or 'capital growth'. Clearer definitions may also link to industry work done to assess how to describe who the fund is targeting, which is a requirement of the new MiFID II product governance rules.
9. There were different views on whether a more defined taxonomy of terms would help consumers or not. Some members of the group agreed to think about doing further work in this area.

### Time horizons, risk and volatility

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10. Firms should be clear about the time horizon that they would expect investors to use to assess whether their funds' objectives have been met. They should also be consistent with this when they report on fund performance.
11. Fund documents should present objectives alongside risks. But this should be done without over-emphasising risks, or getting investors to focus on them excessively.
12. It is difficult to manage investors' expectations around volatility, particularly in a document like the KIID. But it is important to explain to investors why investments have gone down and whether they might recover. This is done via factsheets and other investor communications. There is scope for innovation in this area which might be in interests of investors (eg online videos are popular with investors).

### What is engaging versus what is useful

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13. Market commentary and performance information engage investors. But this information might not be the most useful for investors to make investment decisions, for example if it gave rise to too much focus on short-term performance.

### Non-financial objectives

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14. Non-financial objectives are important. As with financial objectives it is, and always has been, important that these are presented in a way that is fair, clear and not misleading.
15. There are different ways of reporting on non-financial objectives. There may be scope for common standards in this area.

16. There are a number of existing initiatives focused on this topic, including the Social Impact Advisory Group and the work following on from the Law Commission's report into pension funds and social investment.



## Annex 4

# Compatibility statement

### Compliance with legal requirements

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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.
3. 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.
4. This Annex 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. This duty applies insofar as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.
5. In addition, this Annex explains 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.
6. This Annex includes our assessment of the equality and diversity implications of these proposals.
7. Under the Legislative and Regulatory Reform Act 2006 (LRRRA), 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. Under this Act the FCA is also 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 LRRRA.

## **The FCA's objectives and regulatory principles: Compatibility statement**

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8. The proposals set out in this consultation are 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.
9. We consider that these proposals are likewise 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 (AMMS). The AMMS presented evidence of weak price competition in a number of areas of the asset management industry, and suggested that certain minimum standards in the quality and scope of the information that investors receive from the industry in order to make good decisions are not being met.
10. For the purposes of the FCA's strategic objective, "relevant markets" are defined here by s.1F FSMA.

## **Promotion of effective competition in the interest of consumers**

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### **The FCA has in this consultation had regard to the 5 matters in s.1E(2)(a)-(e) of FSMA.**

11. 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 AMMS by introducing transparency measures that will increase the ability of investors to assess and compare funds. Where investors are able to compare products, they are able to drive competitive pressures amongst product providers.
12. Increasing the competitiveness of the UK funds market may also increase its attractiveness to international and domestic investors.

## **Consumer Protection**

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13. The mandate of the FCA includes the requirement to secure an appropriate degree of protection for consumers. The FCA has in this consultation had regard to the 8 matters listed in s.1C(2)(a)-(h) FSMA on consumer protection.
14. By increasing the consistency and accuracy of disclosures our proposals will assist investors in making informed investment decisions, and will make it more likely that an investor will be able to identify the right product for their investment needs.

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

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15. 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 economical way**

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16. In this consultation, we have prioritised the issues that we consider to represent the greatest potential source of harm to those consumers that consult fund documentation. We are consulting on the disclosure requirements that we consider will have the most meaningful and efficient impact.
17. Our proposals would raise disclosure standards for fund managers and drive the competitiveness of the UK funds market. This has no ongoing cost to the FCA.

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

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18. We have undertaken a cost-benefit analysis of our proposals, which is included in Annex 2 of this CP. We consider that the costs of our proposals are proportionate to the benefits.

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

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19. The asset management industry is a vital source of economic growth and a key provider of liquidity in both UK and global markets. By increasing the competitiveness of the UK funds market, our proposals should contribute towards the sustainability of UK economic growth.

### **The general principle that consumers should take responsibility for their decisions**

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20. Our proposals enable investors to take responsibility for their decisions, by facilitating better informed investment decisions.

### **The responsibilities of senior management**

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21. Senior management remains responsible for conduct rules. The proposals in this CP are part of an overall AMMS remedies package that also includes new specific governance requirements for AFMs under the Senior Managers & Certification Regime.

### **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**

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22. This principle is not directly relevant to this CP as the measures are targeted at a specific group, i.e. authorised fund managers.

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

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23. Our proposals are not relevant for this principle.

### **The principle that we should be accountable and exercise our functions as transparently as possible**

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24. We have engaged extensively 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**

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25. Our obligation to minimise the extent to which it is possible for a firm 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**

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26. Mutual societies are not within the scope of this consultation, and we therefore do not expect them to be impacted by the proposals in this paper.

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

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27. 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 intended to advance our competition objective.



## Equality and diversity

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- 28.** 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.
- 29.** We have considered the policy proposals contained within this consultation in full, and are satisfied that there would be no negative impact upon any of the groups with protected characteristics under the Equality Act 2010, were they to be implemented.

## Legislative and Regulatory Reform Act 2006 (LRR)

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- 30.** We have had regard in this consultation to the principles in the LRR.

## Consistent

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- 31.** We will consider whether we should extend some of our proposals to adjacent markets, e.g. unit-linked or with-profit insurance products.

## Proportionate and targeted only at cases in which action is needed

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- 32.** 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.
- 33.** 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)

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- 34.** 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.

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

We have involved representatives from the industry, consumer groups, trade associations and others from the beginning of the AMMS. We have responded to stakeholder feedback and provided additional clarity where stakeholders have raised concerns.

- Regulators should base their regulatory activities on risk

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 AMMS and further work we have undertaken based on the feedback we have received.

### Treasury recommendations about economic policy

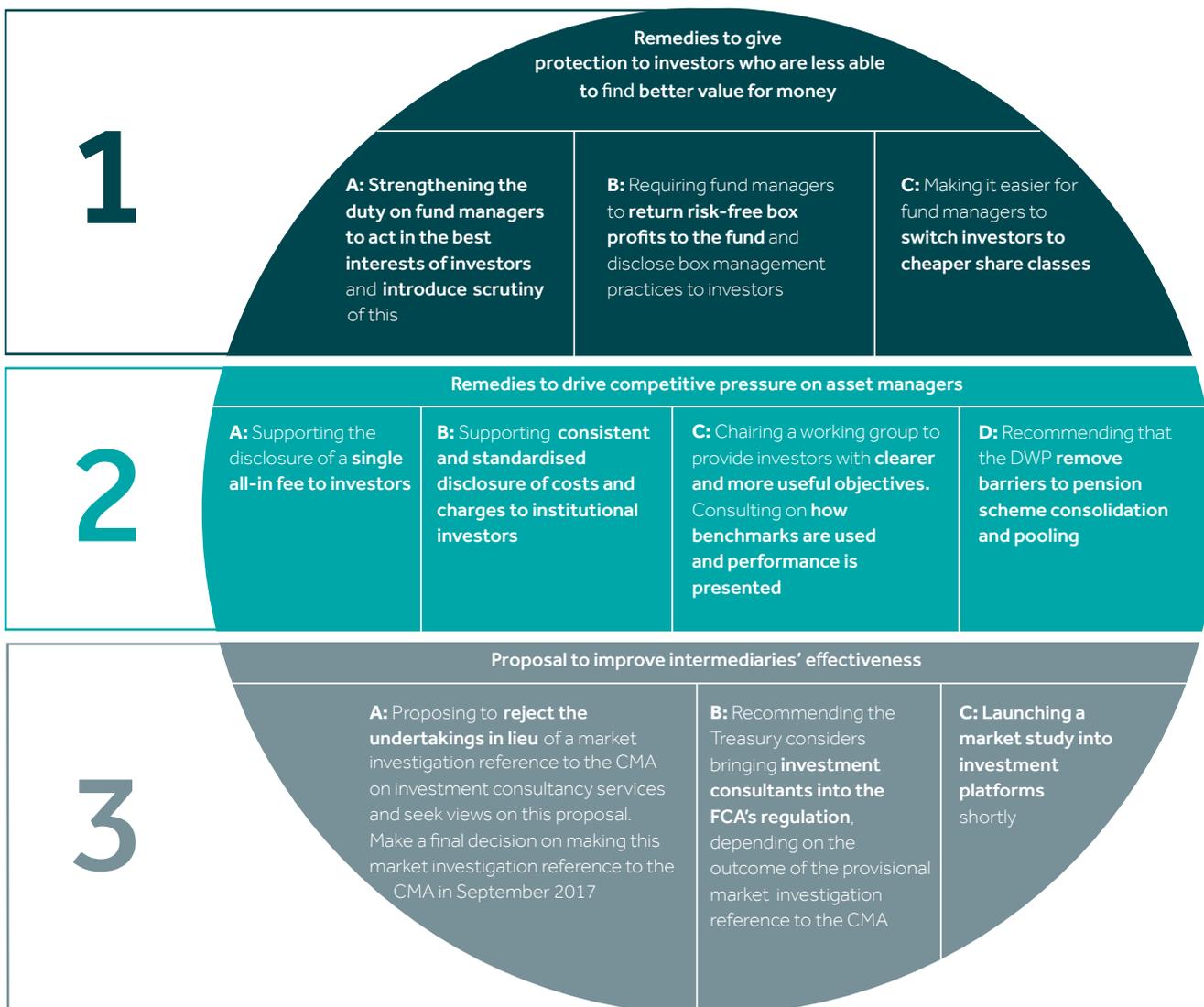
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- 35.** In the remit letter published by the Chancellor of the Exchequer on 8th March 2017 the Chancellor affirms the FCA's role in ensuring that effective competition in financial services can create the right conditions for access to finance, which 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.

# Annex 5

## An overview of all AMMS remedies

### 1. AMMS remedies in Final Report



## 2. Update to AMMS remedies

1: Remedies to give protection to investors who are less able to find better value for money	
A, B & C	Final rules and guidance for these remedies are set out in the April PS published alongside this CP.
2: Remedies to drive competitive pressure on asset managers	
A	<p>Single charge: PRIIPs and MiFID II now apply and firms subject to those requirements must produce information broadly equivalent to a single charge when communicating to investors about costs and charges.</p> <p>We have also conducted research on certain complementary areas which we are publishing alongside this CP, in OP32.</p>
B	The Institutional Disclosure Working Group of industry and investor representatives was launched in September with a view to agreeing a template for the disclosure of costs and charges. The Group is expected to make recommendations on this to the FCA by Summer 2018.
C	This CP covers these matters.
D	At the time of publication of the AMMS final report we recommended that the DWP continue to review and where possible remove barriers to pension scheme consolidation and pooling.
3: Proposal to improve intermediaries' effectiveness	
A	We reached a final decision to make an MIR on investment consultancy and fiduciary management services and to reject the UIL; the CMA launched a market investigation into investment consultants on the 14 September 2017 and will conclude the investigation by March 2019.
B	We have recommended that the Treasury consider an extension of our regulatory perimeter to include asset allocation advice, subject to the findings of the market investigation reference to the CMA.
C	The Investment Platforms Market Study terms of reference was published in July 2017 and we aim to publish an interim report by summer 2018.

## Annex 6

### Abbreviations used in this paper

<b>AFM</b>	authorised fund manager
<b>AMC</b>	annual management charge
<b>AMMS</b>	asset management market study
<b>AUT</b>	authorised unit trust
<b>BMR</b>	Benchmarks Regulation (EU2016/1011)
<b>CBA</b>	cost benefit analysis
<b>CIS</b>	collective investment scheme
<b>CP</b>	consultation paper
<b>FCA</b>	Financial Conduct Authority
<b>FSMA</b>	Financial Services and Markets Act 2000
<b>IA</b>	The Investment Association
<b>ICVC</b>	investment company with variable capital
<b>IDWG</b>	institutional disclosure working group
<b>IOSCO</b>	International Organization of Securities Commissions
<b>ISA</b>	individual savings account
<b>KID</b>	key information document
<b>KIID</b>	key investor information document
<b>LIBOR</b>	London inter-bank offered rate
<b>LRRA</b>	Legislative and Regulatory Reform Act 2006
<b>MiFID II</b>	the recast Markets in Financial Instruments Directive (2014/65/EU)
<b>PRIIPs</b>	Packaged Retail and Insurance-based Investment Products (Regulation EU1286/2014)

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<b>PS</b>	policy statement
<b>UCITS</b>	Undertakings for Collective Investment in Transferable Securities (Directive 2009/65/EC)

---

We have developed the policy in this Consultation Paper in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

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# Appendix 1

## Draft Handbook text

**COLLECTIVE INVESTMENT SCHEMES SOURCEBOOK (MISCELLANEOUS  
AMENDMENTS) (No 3) INSTRUMENT 2018**

**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 137R (Financial promotion rules);
  - (c) section 137T (General supplementary powers);
  - (d) section 139A (Power of the FCA to give guidance);
  - (e) section 247 (Trust scheme rules);
  - (f) section 248 (Scheme particulars rules);
  - (g) section 261I (Contractual scheme rules);
  - (h) 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. This instrument comes into force on *[date]* 2018.

**Amendments to the Handbook**

- D. The modules of the FCA Handbook listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Conduct of Business sourcebook (COBS)	Annex B
Collective Investment Schemes sourcebook (COLL)	Annex C

**Citation**

- E. This instrument may be cited as the Collective Investment Schemes Sourcebook (Miscellaneous Amendments) (No 3) Instrument 2018.

By order of the Board  
*[date]* 2018

**Annex A****Amendments to the Glossary of definitions**

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

*comparator benchmark* as defined in *COLL 4.2.5R(3)(c-b)(iii)*.

*constraining benchmark* as defined in *COLL 4.2.5R(3)(c-b)(ii)*.

*target benchmark* as defined in *COLL 4.2.5R(3)(c-b)(i)*.

## Annex B

## Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text.

**4 Communicating with clients, including financial promotions**

...

**4.5 Communicating with retail clients (non-MiFID provisions)**

...

Authorised fund managers' communications in relation to benchmarks

- 4.5.12 **R** Subject to COBS 4.5.13R, an authorised fund manager must include in any communication about an authorised fund to which this chapter applies:
- (1) a short explanation, in terms consistent with the relevant prospectus, of the choice and use of every target benchmark, constraining benchmark or comparator benchmark used in relation to the scheme; or
  - (2) where no target benchmark, constraining benchmark or comparator benchmark is referred to, a statement to that effect and a short explanation of how investors can assess the performance of the scheme.
- 4.5.13 **R** Where an authorised fund manager includes, in any communication about an authorised fund to which this chapter applies, an indication of past performance for any scheme it manages, it must (in addition to complying with COBS 4.6.2R where applicable):
- (1) include the corresponding past performance record of any target benchmark or constraining benchmark referred to in the prospectus of the scheme; and
  - (2) not include an indication of past performance for any index, indices or similar factor that is not referred to in the prospectus of the scheme.
- 4.5.14 **R** (1) Subject to (2), if a communication to which COBS 4.5.13R applies includes information comparing past performance of the scheme against any comparator benchmark, the authorised fund manager must include a comparison against the same benchmark and no other in every subsequent communication it makes that is also subject to COBS 4.5.13R, for the period specified in (3).

- (2) Paragraph (1) does not apply if such a comparison would not be compliant with COBS 4.5.13R as a result of a change to the prospectus of the scheme.
- (3) The period specified for the purposes of (1) is:
  - (a) twelve months after a one-off communication is made; or
  - (b) for as long as the communication remains available to the public in a durable medium and has not been superseded by a revised version.

4.5.15     R     COBS 4.5.12R to COBS 4.5.14R do not apply to any reference to a comparator benchmark that is not identified in the prospectus when that reference appears in communications:

- (1) used exclusively in the course of a personal visit, telephone conversation or other interactive dialogue; or
- (2) in response to a specific unsolicited request by a client for past performance to be compared with a particular comparator benchmark.

...

## Annex C

## Amendments to the Collective Investment Schemes sourcebook (COLL)

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

#### 4 Investor Relations

...

#### 4.2 Pre-sale notifications

...

#### 4.2.5 R Table: contents of the prospectus

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

...			
<b>Investment objectives and policy</b>			
3	The following particulars of the investment objectives and policy of the <i>authorised fund</i> :		
	...		
	<u>(c-b)</u>	<u>where:</u>	
		<u>(i)</u>	<u>a target for a <i>scheme's</i> performance has been set, or a payment out of <i>scheme property</i> is permitted, by reference to a comparison of one or more aspects of the <i>scheme property</i> or <i>price</i> with fluctuations in the value or <i>price</i> of an index or indices or any other similar factor (a "<i>target benchmark</i>"); or</u>
		<u>(ii)</u>	<u>without being a <i>target benchmark</i>, arrangements are in place in relation to the <i>scheme</i> according to which the composition of the portfolio of the <i>scheme</i> is, or is implied to be, constrained by reference to the value, the <i>price</i> or the components of an index or indices or any other similar factor (a "<i>constraining benchmark</i>"); or</u>
		<u>(iii)</u>	<u>without being a <i>target benchmark</i> or a <i>constraining benchmark</i>, the <i>scheme's</i> performance is compared against the value or <i>price</i> of an index or indices or any other similar</u>

		factor (a “ <i>comparator benchmark</i> ”),
		a statement providing sufficient information for investors to understand the choice and use of any <i>target benchmark, constraining benchmark or comparator benchmark</i> in relation to the <i>scheme</i> ;
	(c-a)	where no <i>target benchmark, constraining benchmark or comparator benchmark</i> is referred to, a statement to that effect and an explanation describing how investors can assess the performance of the <i>scheme</i> ;
	...	
	(o)	information concerning the historical performance of the <i>scheme</i> , showing in particular <u>historical performance compared against each <i>target benchmark</i> and each <i>constraining benchmark</i> used in relation to the <i>scheme</i></u> , presented in accordance with <i>COBS 4.6.2R</i> (the rules on past performance);
	...	

...

## Guidance on contents of the prospectus

4.2.6 G ...

(1A) In relation to *COLL 4.2.5R(3)(c-b)* the *prospectus* might explain, if it is the case, that one index or factor may be used for both a *target benchmark* and a *constraining benchmark* in relation to the same *scheme*.

...

**6 Operating duties and responsibilities**

...

**6.7 Payments**

...

## Performance fees

6.7.6 G ...

(2) Any performance fee should be specified in the appropriate manner in the *prospectus* and should be consistent with *COLL 6.7.4R*. In determining whether the performance fee is consistent the *authorised*

*fund manager* should have regard to factors such as:

- (a) ~~it should be calculated and paid after consideration of all other payments; [deleted]~~

...

...

6.7.6A    R    Any performance fee specified in the *prospectus* must be calculated on the basis of the *scheme's* performance after deduction of all other payments out of *scheme property*.

...



## Appendix 2

# Draft non-Handbook Guidance

# The description of fund objectives and investment policies

April 2018

## Introduction

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1. One of the areas of concern identified in the asset management market study was the usefulness of fund objectives for investors. The market study found that it is difficult for investors to know what to expect from their fund and to assess whether or not their fund is performing against relevant objectives, including those set by the fund manager.
2. We consider that investors could benefit from greater clarity as well as being better able to compare objectives between similar funds.
3. We therefore set out the relevant provisions and how we expect these requirements might be complied with in practice.
4. This guidance applies to UK *authorised funds*.<sup>1</sup>

## Background

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5. The objectives and investment policies of authorised funds must be provided in certain regulatory materials, and may also be provided in other documents that are subject to regulation. These may be categorised as long-form disclosures, short-form disclosures and marketing communications.

## Long-form disclosures

6. The prospectus of a UK authorised fund is required to state in detail what the investment objectives and policy of that fund are.<sup>2</sup>

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<sup>1</sup> Terms in italics in this document have the same meaning as in the FCA's Handbook Glossary.

## Short-form disclosures

7. UCITS schemes are required to have a Key Investor Information Document (KIID).<sup>3</sup> Providers of other investment products aimed at retail investors are likely to need to produce a Key Information Document (KID) under the PRIIPs Regulation for each product.<sup>4</sup> Non-UCITS retail schemes may provide a document equivalent to the UCITS KIID, as an alternative to the KID.<sup>5</sup>
8. The UCITS KIID must contain a section on the objectives and investment policy of the fund.<sup>6</sup> The PRIIPs KID must contain a section entitled 'what is this product?'<sup>7</sup> This must describe the product's objectives and the means for achieving them.

## Marketing communications

9. Other marketing communications, such as fund factsheets and other supporting literature, relating to a specific investment product are subject to the rules on communicating with clients in COBS 4. COBS 4 contains specific provisions in certain areas, for example on the disclosure of past performance, but does not contain any specific rules on objectives and investment policies. At a high level, marketing communications must be fair, clear and not misleading. They are also required not to contradict or diminish the significance of information contained in the prospectus, KIID or KID.<sup>8</sup>

## Existing obligations

---

### Prospectus

10. The prospectus requirements are set out in COLL 4.2.5R (3). The prospectus disclosure must include, among other things:

The following particulars of the investment objectives and policy of the authorised fund:

- (a) the investment objectives, including its financial objectives;
  - (b) the authorised fund's investment policy for achieving those investment objectives, including the general nature of the portfolio and, if appropriate, any intended specialisation;
  - (c) an indication of any limitations on that investment policy;
- [(c-b) where:
- (i) a target for a *scheme's* performance has been set, or a payment out of *scheme property* is permitted, by reference to a comparison of one or more aspects of the *scheme property* or *price* with

---

<sup>2</sup> COLL 4.2.5R (3)

<sup>3</sup> COLL 4.7.2R

<sup>4</sup> Article 5 of PRIIPs Regulation (EU 1286/2014)

<sup>5</sup> COLL 4.7.1R, COLL 4.7.1AG

<sup>6</sup> COLL 4.7.2R (4)(b) and Article 7 of UCITS KII Regulation (EU 583/2010)

<sup>7</sup> Article 8 of PRIIPs Regulation

<sup>8</sup> PRIIPs Regulation and COBS 4.13.2R

fluctuations in the value or *price* of an index or indices or any other similar factor (a "*target benchmark*"); or

- (ii) without being a *target benchmark*, arrangements are in place in relation to the *scheme* according to which the composition of the portfolio of the *scheme* is, or is implied to be, constrained by reference to the value, the *price* or the components of an index or indices or any other similar factor (a "*constraining benchmark*"); or
- (iii) without being a *target benchmark* or a *constraining benchmark*, the *scheme's* performance is compared against the value or *price* of an index or indices or any other similar factor (a "*comparator benchmark*"),

a statement providing sufficient information for investors to understand the choice and use of any *target benchmark*, *constraining benchmark* or *comparator benchmark* in relation to the *scheme*.

(c-a) where no *target benchmark*, *constraining benchmark* or *comparator benchmark* is referred to, a statement to that effect and an explanation describing how investors can assess the performance of the *scheme*.]<sup>9</sup>

(ca) for an authorised fund that has indicated in its name, investment objectives or fund literature (including in any financial promotions for the fund), through use of descriptions such as 'absolute return', 'total return' or similar, an intention to deliver positive returns in all market conditions (and where there is no actual guarantee of such returns), additional statements in the authorised fund's investment objectives specifying:

- (i) that capital is in fact at risk;
- (ii) the investment period over which the authorised fund aims to achieve a positive return; and
- (iii) there is no guarantee that this will be achieved over that specific, or any, time period;

(d) the description of assets which the capital property may consist of;

(e) the proportion of the capital property which may consist of an asset of any description;

(l) where a scheme invests principally in scheme units, deposits or derivatives, or replicates an index in accordance with COLL 5.2.31 R or COLL 5.6.23 R (Schemes replicating an index), a prominent statement regarding this investment policy;

## UCITS KIID

11. The UCITS KIID requirements are set out in Regulation EU583/2010:<sup>10</sup>

<sup>9</sup> COLL 4.2.5 R (3) (c-b) and (c-a) are subject to consultation in this CP

<sup>10</sup> Article 7 of UCITS KII Regulation

## Objectives and investment policy

### Article 7

#### Specific contents of the description

1. The description contained in the 'Objectives and investment policy' section of the key investor information document shall cover those essential features of the UCITS about which an investor should be informed, even if these features do not form part of the description of objectives and investment policy in the prospectus, including:

- (a) the main categories of eligible financial instruments that are the object of investment;
- (b) the possibility that the investor may redeem units of UCITS on demand, qualifying that statement with an indication as to the frequency of dealing in units;
- (c) whether the UCITS has a particular target in relation to any industrial, geographic or other market sectors or specific classes of assets;
- (d) whether the UCITS allows for discretionary choices in regards to the particular investments that are to be made, and whether this approach includes or implies a reference to a benchmark and if so, which one;
- (e) whether dividend income is distributed or reinvested.

For the purposes of point (d), where a reference to a benchmark is implied, the degree of freedom available in relation to this benchmark shall be indicated, and where the UCITS has an index-tracking objective, this shall be stated.

2. The description referred to in paragraph 1 shall include the following information, so long as it is relevant:

- (a) where the UCITS invests in debt securities, an indication of whether they are issued by corporate bodies, governments or other entities, and, if applicable, any minimum rating requirements;
- (b) where the UCITS is a structured fund, an explanation in simple terms of all elements necessary for a correct understanding of the pay-off and the factors that are expected to determine performance, including references, if necessary, to the details on the algorithm and its workings which appear in the prospectus;
- (c) where the choice of assets is guided by specific criteria, an explanation of those criteria, such as 'growth', 'value' or 'high dividends';
- (d) where specific asset management techniques are used, which may include hedging, arbitrage or leverage, an explanation in simple terms of the factors that are expected to determine the performance of the UCITS;
- (e) where the impact of portfolio transaction costs on returns is likely to be material due to the strategy adopted by the UCITS, a statement that this is the case, making it also clear that portfolio transaction costs are paid from the assets of the fund in addition to the charges set out in Section 3 of this Chapter;

(f) where a minimum recommended term for holding units in the UCITS is stated either in the prospectus or in any marketing documents, or where it is stated that a minimum holding period is an essential element of the investment strategy, a statement with the following wording:

'Recommendation: this fund may not be appropriate for investors who plan to withdraw their money within [period of time]'.

3. Information included under paragraphs 1 and 2 shall distinguish between the broad categories of investments as specified under paragraphs 1(a), (c) and 2(a) and the approach to these investments to be adopted by a management company as specified under paragraphs 1(d) and 2 (b), (c) and (d).

4. The 'Objectives and investment policy' section of the key investor information document may contain elements other than those listed in paragraph 2, including the description of the UCITS' investment strategy, where these elements are necessary to adequately describe the objectives and investment policy of the UCITS.

### **PRIIPs KID**

12. The PRIIPs KID must contain the following information:<sup>11</sup>

(c) under a section titled 'What is this product?', the nature and main features of the PRIIP, including:

(i) the type of the PRIIP;

(ii) its objectives and the means for achieving them, in particular whether the objectives are achieved by means of direct or indirect exposure to the underlying investment assets, including a description of the underlying instruments or reference values, including a specification of the markets the PRIIP invests in, including, where applicable, specific environmental or social objectives targeted by the product, as well as how the return is determined;

(iii) a description of the type of retail investor to whom the PRIIP is intended to be marketed, in particular in terms of the ability to bear investment loss and the investment horizon;

13. This is further expanded in the Delegated Regulation as being:<sup>12</sup>

Information stating the objectives of the PRIIP and the means for achieving those objectives in the section entitled 'What is this product?' of the key information document shall be summarised in a brief, clear and easily understandable manner. That information shall identify the main factors upon which return depends, the underlying investment assets or reference values, and how the return is determined, as well as the relationship between the PRIIP's return and that of the underlying investment assets or reference values. That information shall reflect the relationship between the recommended holding period and the risk and reward profile of the PRIIP.

<sup>11</sup> Article 8(3) of PRIIPs Regulation

<sup>12</sup> Article 2(2) of PRIIPs Delegated Regulation (EU 2017/653)

## FCA expectations

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### Language requirements

14. Both the UCITS KIID and the PRIIPs KID are required to be written in language that communicates in a way that facilitates understanding of the information and that is clear, succinct and comprehensible.<sup>13</sup> The UCITS KIID must avoid the use of jargon and technical terms.<sup>14</sup> The same requirement is implied of the PRIIPs KID.<sup>15</sup>
15. There are no explicit requirements about the style of language of the prospectus. The UCITS KIID and the PRIIPs KID require the information provided in them to be consistent with the information in the prospectus.<sup>16</sup> This does not mean that the text must be identical to that in the prospectus.<sup>17</sup> The Committee of European Securities Regulators (CESR), which was the predecessor to the European Supervisory and Markets Authority (ESMA), published a guide to clear language in the KIID.<sup>18</sup>

### Description of factors that are not covered in the prospectus investment objectives and policy section

16. As noted above, there is no requirement for the text used in the prospectus to be identical to that used in the KIID or KID. Firms need to consider whether they should provide information in the KIID objectives and investment policy and the KID 'what is this product?' section which goes beyond what is set out in the prospectus.
17. Key information disclosure is intended to set out clearly and in terms understandable to retail investors what the overall aims of a fund are and how these objectives are to be achieved.<sup>19</sup> It should also aid comparisons.<sup>20</sup>
18. The KIID section on objectives and investment policy must contain information on the broad categories of investments used and the approach to these investments.<sup>21</sup> There is a requirement to cover those essential features about which an investor should be informed, even if these features do not form part of the description of objectives and investment policy in the prospectus.<sup>22</sup> It may contain other elements including the description of the investment strategy, where these elements are necessary to adequately describe the objectives and investment policy.<sup>23</sup>
19. In practice, taking into consideration that the KIID should indicate to the investor what the overall aims of the fund are and how they are to be achieved, the FCA considers that it would generally be necessary for an adequate description of the objectives and investment policy to include relevant elements of the investment strategy. This description should explain the current investment strategy. If it is not the manager's strategy to invest in a particular area where the investment policy permits investment, this should be made clear. If it is the manager's strategy to make specific use of one of the investment powers, for example around the use of derivatives, this should also be made clear.

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<sup>13</sup> Article 5(1)(b) of UCITS KII Regulation and 6(4)(c) of PRIIPs Regulation

<sup>14</sup> Article 5(1)(b) of UCITS KII Regulation

<sup>15</sup> Recital 14 of PRIIPs Regulation

<sup>16</sup> COLL 4.7.5R (3), Article 6(1) of PRIIPs Regulation

<sup>17</sup> Recital 14 of PRIIPs Regulation, Article 2 of PRIIPs Delegated Regulation

<sup>18</sup> CESR/10-1320, available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/10\\_1320.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/10_1320.pdf)

<sup>19</sup> Recital 5 of UCITS KII Regulation

<sup>20</sup> Recital 4 of UCITS KII Regulation

<sup>21</sup> Article 7(3) of UCITS KII Regulation

<sup>22</sup> Article 7(1) of UCITS KII Regulation

<sup>23</sup> Article 7(4) of UCITS KII Regulation

20. There are similar, though less detailed, provisions in the PRIIPs Regulation. The KID is intended to enable retail investors to understand and compare the key features and risks of a PRIIP.<sup>24</sup> The KID must include information about the PRIIP's objectives and its means for achieving them.<sup>25</sup>
21. In practice, firms should consider how to describe the objectives, investment policy and investment strategy in a concise way and without using jargon to enable a retail investor to understand the product.

### Reference to a benchmark

22. In the UCITS KIID, firms must disclose whether the UCITS uses an approach that includes or implies a reference to a benchmark. The KII Regulation further requires that, where a reference to a benchmark is implied, the degree of freedom available in relation to the benchmark shall be indicated.<sup>26</sup>
23. In practice, firms should consider whether their investment approach implies a reference to a benchmark. The FCA considers that where the fund is, in practice, constrained in how far its holdings can deviate from the weightings of a benchmark, this implies reference to a benchmark for the purposes of the UCITS KIID Regulation. This includes situations where a fund is constrained in its portfolio construction relative to a benchmark.
24. The FCA also considers that, even where there is no explicit requirement for the portfolio manager to manage a fund in line with a benchmark, there may be practical, internal restrictions within the firm which limit how far a fund can differ from the composition of a benchmark. Examples of such restrictions include, but are not limited to:
- the risk management process for the fund causing it to be monitored and controlled relative to a benchmark
  - the individuals managing the fund being remunerated based on its performance relative to a benchmark
  - the portfolio management system restricting transactions using hard or soft limits relative to a benchmark
25. Firms should assess whether such restrictions mean that the fund is in practice managed with reference to a benchmark. If so they should disclose this, along with the degree of freedom in relation to the benchmark, in their KIID.
26. Where a fund has a *target benchmark* or a *constraining benchmark* we expect that this should be disclosed in the KIID.
27. The UCITS KIID Regulation requires performance to be displayed against such benchmarks where used. Following on from the above, this is likely to mean that firms will need to provide performance data in relation to each *target benchmark* and *constraining benchmark* they use.
28. When disclosing the degree of freedom, firms should use language that is clear, succinct and comprehensible and that avoids the use of jargon. They should also consider quantifying the degree of freedom.

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<sup>24</sup> Article 1 of PRIIPs Regulation

<sup>25</sup> Article 8 of PRIIPs Regulation

<sup>26</sup> Article 7(3) of UCITS KII Regulation

### Non-financial objectives

29. Sometimes funds set out non-financial objectives, for example environmental or social objectives, or state that they are aiming to achieve a non-financial return. We expect, if a fund has such objectives, that it will set them out in its prospectus.
30. Where a fund sets out objectives such as these, it must do so in a way that is fair, clear and not misleading. Firms that set out non-financial objectives should be clear about how they will measure whether those objectives are being met, and should provide ongoing information to investors.

