Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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By email: dp23-2@fca.org.uk

Dear Sir / Madam,

Financial Services Consumer Panel response to FCA consultation on Updating and improving the UK regime for asset management – DP23/2

The Financial Services Consumer Panel (the Panel) is an independent statutory body. We represent the interests of individual and small business consumers in the development of financial services policy and regulation in the UK.

We welcome the opportunity to respond to this consultation on updating and improving the UK regime for asset management. We consider that the Discussion Paper contains a helpful overview of the range of issues that will need to be addressed. There are four key themes that underpin our response to the more detailed questions within this consultation, namely:

- the need to ensure that consumer protection (for example from conflicts of interest) and benefits to consumers are used to prioritise regulatory change
- the need for consumer testing to determine which approaches are most effective in supporting consumers in making decisions about their investment options
- the need to future proof regulations to ensure that they will continue to work as the regulatory framework and industry evolves, for example where the role of authorised fund managers may change or disappear and
- concern about the potential pitfalls associated with any move to tokenised funds and cryptoasset options.

In general, the Panel considers it important that the overarching regulatory regime governing retail investments provides a coherent approach to setting regulation that meets consumers' needs. Our response should be considered in the context of our vision for how the market should function, which is set out in our response to the FCA's call for input on consumer investments. The foundation of this vision is a correctly implemented and

supervised Consumer Duty[1]. This would make the firm responsible for consumers' overall suitability for and understanding of the products which they invest in. This would create a market where:

- more of the population with investible assets, and where the decision is right for them, make an active and informed decision to invest, so maximising their own returns and supporting the real economy
- the information disclosed to potential investors is designed in a way that will allow them to make effective decisions, and to compare the risks, rewards and sustainability not only of different options for a given product type, but also of different products
- it is not possible to use regulatory arbitrage to circumvent rules designed to protect consumers
- help, be it information, education, guidance or advice is readily available and tailored to the consumer to ensure they are supported in taking decisions both pre-investment and on an ongoing basis. This will require the re-engineering of current thinking to better integrate these aspects and blend them throughout the customer's investment life-cycle. Only in this way will trust be established
- guidance or advice could be the gateway to a range of simple, tax-efficient investments too
- the use of client self-certification is removed
- products must be better designed, labelled and described to enable consumers to better understand fully the opportunities, risks and costs involved and easily compare these across options; and
- when harm does occur, there must be easily accessible and efficient redress and compensation solutions.

Our responses to the questions posed in the consultation are included at Annex A below.

Yours sincerely,

Helen Charlton

Chair, Financial Services Consumer Panel

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[1] For our comments on the FCA's proposed new Consumer Duty, please see here: https://www.fs-cp.org.uk/sites/default/files/final_fscp_response_cp21-36_a_new_consumer_duty_20220214.pdf

Annex A – responses to questions

Q1: Do you think that we should aim to create a common framework of rules for asset managers? What benefits would you see from this? What costs might this create? If you do not think we should do this, are there any areas discussed above where we should consider taking action, even if we do not create a common framework of rules? What would we need to consider around the timing of implementing a change like this?

The Panel considers that creating a common framework of rules that applies to all asset managers (be they fund managers or portfolio managers) has the potential to benefit both consumers and firms, as well as the economy more broadly. The Panel considers that such a framework would help achieve the regulatory principle of "same risk, same regulatory outcome". If rules covering issues such as conflicts of interest and financial stability risks are managed in a consistent way, this would help reduce the likelihood of regulatory arbitrage. It also has the potential to simplify the regulatory environment, reducing costs and making innovation easier.

The Panel considers that the guiding principle of any change should be ensuring that consumer interests are protected and that the benefits to consumers are maximised. This will be particularly important in areas such as conflicts of interest, where consumer harm may emerge if such conflicts are not managed effectively. The Panel notes that when considering options for change the FCA's primary objectives (of consumer protection, market integrity and promoting competition) may not always align with the proposed secondary objective (on international competitiveness). The Panel considers that where there is a clash, the primary objectives, and particularly the consumer protection objective, should be used to determine any proposed regulatory framework.

Although it is not the focus of this consultation, the Panel considers that to maximise benefits to consumers, it will also be important to design an effective regulatory regime for consumer disclosures, both at point of sale and throughout the investment period. In particular, consumers need to be able to compare both the risks and the costs and charges associated with potential investment options. To do this effectively, consumers need to be able to compare not just different investment options within a single product class, but also to compare options across products. This will be particularly important for the regime governing the products provided by asset managers, where it can be hard to understand the differences between different products. The Panel considers that changes to the regulatory framework governing asset managers should be designed in a way that will help facilitate improving disclosure in future, and that having a common regulatory framework covering all asset managers could play a helpful role in achieving this.

Q2: Do you think we should change the boundary of the UK UCITS regime? If so, do you think we should take any of the three approaches set out here? Should we consider any alternative approaches? What timeframe would be needed to allow firms to change their existing product offering or to develop new products?

The FCA has identified three potential changes of the boundary to the UK UCITS regime, which would involve:

- removing the boundary between the UCITS and NURS regimes and bringing all authorised funds that can be widely distributed to retail investors under a single set of rules. This would simplify the funds regime, but mean that it covered more complex funds. NURS (Non-UCITS Retail Schemes) tend to be more complex funds that have a greater concentration of assets than would be acceptable within UCITS, or invest in illiquid or hard to value assets.
- rebranding NURS as "UCITS plus", with "UCITS plus" being a label applied to more complex retail products.
- Creating a category of basic funds, with requirements that would make them safer, or less complex than other funds – for example through requirements for a high level of diversification, only being allowed to invest in the largest and most liquid investments, or restrictions on the use of derivatives.

The Panel considers that the key decision-making criteria should be the extent to which consumers would benefit from any changes. This should include whether consumers will be able to differentiate the risks of different product offerings and make effective decisions that match their preferences and risk appetites.

The Panel considers that consumer testing should be used to inform potential changes to regulations, in order to ensure that the regime will work as expected. For example, the naming of different product types may have an impact on how they are perceived by consumers. If NURS funds were to be rebranded as "UCITS plus", this would mean that "UCITS plus" would be the label applied to more complex retail products with additional regulatory requirements. However, the Panel notes that "plus" has positive connotations that may lead to confusion amongst consumers, as they may think it denotes a superior product. Therefore, if a decision is made to move the NURS regime so that it becomes a subset of the UCITS regime, the Panel considers it will be important to undertake consumer testing of the proposed label to ensure that consumers understand what it means. Under the current proposed label of "UCITS plus" there is a risk that from a consumer perspective it will be interpreted as a better product, rather than simply a more complex one. This could distort decision making and lead to a situation where consumers take on more investment risk than they might have done, if a more neutral label was used. Similar considerations would apply to the use of a "basic" label, which might be seen as substandard and therefore undesirable.

Q3: Do you think we should work with the Treasury to amend the threshold at which AIFMs must apply the full-scope rules? If so, do you have any comments on the options described above? Are there any other areas we would need to consider if we were to do this?

While most Alternative Investment Funds (AIFs) are operated exclusively for professional investors, the Panel notes that this is not true for all AIFs. The Panel therefore considers that any changes made to the Alternative Investment Fund Manager (AIFM) regime should ensure that where AIFMs are offering products to retail consumers, consumers will benefit from the same level of protection that they would for similar products offered through different regimes. To achieve this would include the need for AIFMs with retail offerings to be subject to the Consumer Duty. This might therefore suggest that in developing the new regime, the FCA should consider an alternative approach to authorisation requirements that would be linked to whether AIFMs will offer products to retail investors, rather than the size of the AIFM.

The Panel shares the FCA's concern about the inappropriate marketing of high-risk alternative investments to retail or elective professional clients. It notes that previous FCA research undertaken to inform the FCA's proposed changes to the Financial Promotions regime identified that roughly twice as many consumers self-certified as sophisticated or high net worth investors than would objectively meet the criteria. The Panel considers that the use of client self-certification should be removed and urges the FCA to continue to make the case to HMT for this.

The Panel also considers that the FCA is right to be concerned that consumers will not understand the difference between a small authorised AIFM and a small registered AIFM. The Panel considers that this is another area where consumer testing would be important. It could be used both to highlight consumer understanding, as well as to test potential alternative labels, if a decision is made that both small authorised AIFMs and small registered AIFMs are needed.

Q4: Are there aspects of the current AIFM regime that professional investors do not value? Would there be benefit in us removing any of these?

No comment.

Q5: Do you think that we should amend our fund rules or add guidance either to make clearer the requirements on portfolio managers of funds, or to set minimum contractual requirements between host AFMs and portfolio managers? Do you think this would lead to any other consequences that we need to consider?

The Panel considers that it is important that both fund management and portfolio management services operate in a way that protects consumers and delivers good outcomes. Therefore where an authorised fund manager (AFM) uses another firm as a portfolio manager, or hosts funds managed by small portfolio managers, it should be responsible for ensuring that the services provided by those portfolio managers serve this purpose. This should be the case regardless of whether the portfolio managers are part of the same group, or independent entities. As portfolio managers often use host AFMs to avoid the need to set up their own AFM, the onus will need to fall on AFMs to ensure that the services provided by the portfolio managers they are associated with meet the appropriate standards. Achieving good consumer outcomes in this area should be a key outcome of the Consumer Duty for AFMs.

The Panel therefore agrees that the FCA should look to change its approach to regulating this relationship, given the evidence of harm that the FCA has found in some cases where host AFMs fall below appropriate standards. The Panel would prefer to see FCA ownership of the approach taken to ensuring that the relationship between AFMs and portfolio managers is robust. It considers that industry designed guidance is less likely to be effective from the point of view of consumers.

Q6: Do you have any comments on us potentially amending the rules and guidance around liquidity stress testing?

No comment.

Q7: Do you have any comments on whether we should make our rules on liquidity management and anti-dilution clearer?

The Panel agrees that anti-dilution rules should be applied in a way that will benefit consumers and reduce any first mover advantage. The Panel would therefore support strengthening the rules in this area, where the FCA has evidence that existing practices within the industry may harm consumers. However, the Panel notes that anti-dilution rules can also be charged to consumers that leave a fund.

Q8: Do you have any comments on the benefits or costs associated with public disclosure of fund liquidity?

The Panel considers that any changes to the rules on the public disclosure of fund liquidity, for example extending the rules to cover UCITS, should be designed in a way that will help reduce potential harm to consumers. It notes that the disclosure of fund liquidity could potentially be helpful to the market. However, retail investors are typically much less engaged than market participants. This might put them at a disadvantage, particularly if the information is provided in a way that is hard for consumers to interpret,

or at a significant lag compared to any market announcement. A standard liquidity measure-such as percentage of fund that can be liquidated in 5 or 7 days *which is easy to understand* could be helpful.

Q9: Do you have any comments on us making our expectations on investment due diligence clearer for all asset managers?

The Panel agrees that it would be helpful for the FCA to introduce clearer standards around investment due diligence in order to prevent consumer harm. This should include strengthening the rules around the assessment of suitability requirements, in order to ensure that investment choices reflect the needs of retail investors.

Q10: Do you agree that we should make our expectations of depositaries clearer? Do you have any comments on the areas where greater clarification would be desirable? Are there any areas where we should consider removing oversight functions from depositaries? Are there areas where the contribution of depositaries is particularly valuable for the interests of investors?

Depositaries play an important role in the system, particularly in relation to their ability to challenge fund managers and, if necessary, intervene. The Panel therefore considers that it would be helpful to strengthen the regulation of depositaries, by making the FCA's expectations clearer, in order to protect consumers.

Q11: Do you have comments on the analysis of the eligible assets rules for UCITS set out here? Do you think we should update or provide guidance on these rules? If we did so, what impact would this have for managers of UCITS funds?

The Panel considers that it is important that fund rules are interpreted by the industry in a consistent fashion, in order to support consumer confidence. This is particularly true in relation to UCITS, which are widely available to consumers. The Panel would therefore support the FCA clarifying rules, where there is evidence that they have been applied inconsistently. In addition, the Panel recognises that it might be helpful to revise rules to reflect changes in markets since the rules were introduced. A key principle of any revision should be to ensure that it will benefit consumers.

The Panel considers that the Consumer Duty should be used to enforce good behaviour in this area. For example, to meet the Consumer Duty, UCITS managers should consider the implications for suitability and risk management when applying the 10% rule that allows UCITS funds to invest up to 10% of their portfolio in assets that do not meet the eligible asset criteria.

The Panel notes that the FCA is considering changes to the boundary of the UCITS regime and considers that it will be important to consider revisions to eligible asset rules in that context, in order to ensure the regime as a whole functions as expected.

Q12: Do you have any comments on whether we should consider removing or modifying detailed or prescriptive requirements in the rules on prudent spread of risk?

The Panel notes that rules on risk management, including the spread of risk and the limits on investments in any individual issuer, are designed to protect consumers. It would therefore not want to see any changes to these rules, unless it can be shown that doing so would benefit consumers.

Q13: Are there any other areas where you think we should consider removing or modifying prescriptive requirements in the retail fund rules?

No comment.

Q14: Do respondents agree that we should work towards consulting on rules to implement the 'Direct2Fund' model?

The Panel recognises that the adoption of new technology can deliver advantages, such as reducing costs. However, it notes that many aspects of regulation were put in place to protect consumers, often in response to industry scandals. It therefore considers that it will be important to ensure that, where the risks remain the same, equivalent protections are in place before new models such as the Direct2Fund model are adopted.

The Panel considers that part of this risk assessment should include the implications for consumers using existing models, as well as consumers who adopt new technology. For example, what happens if a given fund is offered both through the traditional and new Direct2Fund models? To what extent will older and potentially more vulnerable consumers be disadvantaged?

The Panel also notes that the FCA is considering strengthening regulation governing the relationship between AFMs and portfolio managers in order to address potential harm, particularly as portfolio managers are often not directly regulated. To the extent that the proposed Direct2Fund model eliminates the need for AFMs, the Panel considers that the FCA should assess whether this would require direct supervision and regulation of portfolio managers offering Direct2Fund options, in order to deliver equivalent consumer protection.

Q15: What benefits would tokenised units in authorised funds provide for investors? What regulatory changes would be needed to enable tokenised units to be issued? How much of a priority should we put on enabling tokenisation of units?

The Panel considers that the introduction of tokenised units in authorised funds would create several risks that will need to be managed before tokenised funds could be considered beneficial for consumers, including:

- ***The legal treatment of NFTs***. In its recent consultation on cryptoassets, HMT characterised non-fungible tokens (NFTs) as not being an investment and therefore proposed omitting NTFs from the scope of the cryptoassets financial promotions regime.[2] However, while an NFT linked to a digital artwork would not be classified as an investment, an NFT structure used to create a tokenised fund or to facilitate infrastructure investment (both of which have been discussed by the Investment Association) would. To ensure that the same risk will result in the same regulatory outcome and to avoid regulatory arbitrage, the Panel considers that tokenised units in authorised funds should only be introduced, if the legal framework set up by HMT to govern the regulation of cryptoassets recognises these as investments and allows appropriate regulatory safeguards to be put in place.[3]
- ***Reclaiming lost assets, including in relation to inheritance***. How will digital registers be managed to ensure that consumers are protected from issues such as fraud or hacking? How will the issuers of tokenised funds ensure that consumers can access their money, if they have lost their passwords and access details, etc? Where the tokenholder dies, what procedures will be in place to allow their heirs to claim any funds once probate has been granted?
- ***Potential to create an unlevel playing field***. When an investment fund is issued in both traditional and tokenised form, if something goes wrong, will token holders have the same rights as the traditional asset holders? Alternatively, if tokenised funds are initially used within the wholesale market by large intermediate unitholders, will retail investors holding traditional units be at a significant disadvantage?
- ***Potential for principal-agent problems to arise***. How will the rights of token holders be protected, if they clash with the interests

[2] See Box 2A of HMT consultation on "Future financial services regulatory regime for cryptoassets", as well as the Panel's response.

[3] For example, in its response to HMT, the Panel suggested it might be helpful to classify different types of NFTs (for example split into investment NFTs and lifestyle NFTs) and to bring investment NFTs within the financial promotions regime.

of holders of non tokenised units, or with the shareholders or managers of the underlying assets?

- ***Access to regulated advice***. In its recent consultation, HMT also proposed that advice on cryptoasset investment should not be regulated. If this were to include advice on investment in NFTs, for example tokenised funds, this would disadvantage consumers investing in these instruments, who may not have access to the same redress options such as the FOS in the event of poor advice.

Q16: Are there specific rules that could impact firms' ability to invest in tokenised assets, where the underlying instrument is itself an eligible asset? How much of a priority should we put on enabling investment in tokenised assets?

The Panel considers that the use of tokens to represent fractional interests in real estate or infrastructure has the potential to create significant principal-agent issues that will need to be addressed. For example, supposing an organisation specialises in a particular type of infrastructure, such as shopping centres, and decides to issue an investment NFT linked to shares in one particular shopping centre. Not only would the typical principal-agent problems exist between the shareholders of the company as a whole and managers of the company, there would now be additional risks where conflicts of interest arise between holders of the NFTs and shareholders, or holders of NFTs and managers. For example, if the organisation needs to restructure and close some shopping centres, how will the interests of NFT holders be represented? In those circumstances, shareholders might find it advantageous for the shopping centre associated with NFTs to be closed in preference to other shopping centres within the company's portfolio. If shareholders have a say in the remuneration of the executives, they may also have set remuneration policy in a way that helps to align their interests with managers' interests to the potential detriment of NFT holders.

Therefore, while it might be technically possible to create and trade tokens that represent fractional ownership of assets such as real estate, the Panel considers that such conflicts of interest call into question the real value of such assets. These questions will need to be addressed before such tokenised structures are likely to benefit consumers.

Q17: How important do you think the different kinds of 'fund tokenisation' discussed above are for the future of the industry? Are there examples from other jurisdictions that could be models for UK fund regulation?

The Panel notes that, in its recent consultation, HMT raised concerns about the possibility and effectiveness of providing regulated financial advice on

cryptoassets, and particularly cryptocurrencies and unregulated tokens, because:

- the price and value of unbacked cryptoassets is driven by speculation, and therefore is not amenable to an assessment of market fundamentals; and
- the difficulties associated with conducting due diligence on issuers.

The Panel considers that, while these concerns remain valid, it is undesirable to include such cryptoassets amongst the assets that widely used retail investment products such as UCITS can invest in.

Q18: What other regulatory changes, if any, would you like to see to enable fund managers to make wider use of advances in technology without weakening investor protection?

No comment.

Q19: Do you agree that improving the content and readability of the prospectus will improve investor engagement? What specific changes would you like to see?

The Panel supports the FCA's proposed review of the regulation of fund prospectuses to improve their accessibility and usefulness. Enabling consumers to access information easily, and to understand it once they have done so, will benefit consumers. The Panel considers that a key mechanism for ensuring that this review will be effective will be to make use of consumer testing to assess how proposed changes will impact consumer decision-making.

The Panel considers that it would be useful to include information within prospectuses on how UCITS managers will vote on proposals that relate to underlying holdings. It notes that voting behaviour and active engagement and stewardship on sustainability issues will form a key component of the proposed "Sustainable Improvers" label, proposed in the FCA's recent consultation on sustainability.[4] Therefore it will be important to align information provided through fund prospectuses with any new requirements proposed by the emerging sustainability regime.

The Panel considers that making fund prospectuses easier to find and access, including through the FCA's National Storage Mechanism, would be helpful. It notes that even if consumers do not directly access fund prospectuses themselves, having them readily available could help support the development of tools that will help support their investment decisions.

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[4] Sustainability Disclosure Requirements (SDR) and investment labels – CP22/20.

Q20: What changes to the rules for managers' reports and accounts could enable firms to make best use of technology to meet investors' information needs? How else could disclosure of ongoing information to fund investors be improved? For example would there be benefit in us consolidating ongoing annual disclosure reports for funds?

The Panel agrees that the provision of periodic reports containing key information is an important element of consumer protection. The Panel also agrees that it would be useful to review the need for additional reporting, for example where there has been a significant portfolio change or adjustments to investment strategies. When setting rules on additional reporting, it will be important to consider the speed of such disclosure, in order to ensure that there is no information imbalance between market participants and retail investors.

The Panel would support the development of standards for machine readable reporting, which would help support both the development of tools to inform investors and transparency in the market. It also considers the use of techniques such as layering could be helpful as a way of making key information more accessible to consumers. When setting regulations, consideration should also be given to:

- the needs of those who prefer paper-based reporting, for example because they struggle with digital access;
- the needs of those with specific vulnerabilities, such as being partially sighted; and
- the need for there to be a permanent record of managers' reports and accounts, both so that consumers can assess changes over time and to ensure that there is a record if things go wrong.

The Panel also considers that consumer testing should be used as a key input when setting regulation in this area. Understanding how consumers either do, or might, use information, and how information can be enhanced to inform their decision making will be important for understanding the relative benefits of different approaches. For example, how important is it for information to be presented in a standardised way, in order to make it easy for consumers to compare options?

Q21: Do you agree we should review the rules for unitholder meetings? What changes should we make so that these meetings maximise the participation of fund investors?

The Panel would support a review of the rules for unitholder meetings, in order to make it easier for unitholders to participate (including virtually). It considers that this review should include an assessment of the role of intermediary unitholders, such as platform providers, and how to reduce the potential for intermediary unitholders to disenfranchise investors. The Panel notes that anecdotal evidence suggests that younger generations are

more likely to be motivated by the ability to influence decision making on issues such as sustainability. Therefore improving their ability to participate in unitholder meetings and vote on fund strategy may improve their engagement.

The Panel considers that any review of the rules should also consider how to enfranchise consumers in the event of the adoption of a tokenised model of fund management.

Q22: How could the relationships between fund manager, intermediary and investor be better reflected in rules for authorised funds? Should the FCA do more to enable investors to engage with the manager of their fund?

The Panel notes that the FCA's Consumer Duty makes it important for fund managers to ensure good outcomes for its customers, and that in this case the customer should be viewed as the ultimate investor, rather than any intermediary. To achieve this, fund managers will need to understand the likely profile, needs and risk appetite of investors. The Panel considers that it would be helpful to review whether the fund management industry feels that it has sufficient information in order to make this assessment. Where this is not the case, there may be advantages to the FCA requiring intermediaries such as platform providers to provide the information fund managers need.

Where fund managers only receive information about the preferences of a few actively engaged unitholders, they should be required to demonstrate how they have balanced these views with the potential needs of less active investors, in order to reach a fair decision. This will be particularly important where active investors are voting against proposals, as fund managers will have incentives to ignore such views, meaning they may need to reassess their assumptions on preferences before reaching a final decision.

Q23: Do you have any comments on the relative benefits of the topics raised in this paper which you think we should consider as part of prioritising our work? How would you rank the areas covered in this paper in terms of priority? (The response form for this question provides a tool for ranking the 10 major topics set out in Table 1 on p.14)

The Panel considers that the priorities for the FCA's work on asset management should be decided based on the potential to benefit consumers. These benefits could be in terms of:

- reduced costs;
- an easier to navigate system;
- ensuring that the system will better protect their interests, for example in relation to conflicts of interests; or

- improvements to the information they receive that will help support their decision-making.

The Panel considers that consumer testing should be used to inform the development of regulation, particularly in relation to consumer disclosures, as well as the regulatory labels that are used (such as the "UCITS plus" option).

The Panel considers that the tokenisation of fund units should be a lower priority than other issues considered within this Discussion Paper. This is because it considers that there are some important ground rules that will need to be established before the adoption of tokenisation and cryptoassets within the sector can be deemed to be of benefit to consumers. This includes how to ensure that the rights, needs and preferences of token holders will be accounted for in decision making. The Panel considers that the adoption of tokenisation and cryptoassets within the retail asset management sector should only be allowed, if it is deemed possible for regulated financial advice to be provided. If advisers are unable to value and price tokens or conduct due diligence on issuers, then this suggests tokens and cryptoassets are not suitable for retail investors.

Q24: Do you have any comments on potential reform of the UK regulatory regime for asset managers and funds in areas that are in scope of this paper but have not been discussed in detail?

The Panel considers that improvements to the UK regime for asset management should consider how the system as a whole will work together, not simply the functioning of the asset management section itself. This should include how the regulations governing the asset management industry might help or impede improvements to other parts of the value chain, such as the regulation of guidance and advice, suitability assessments, sustainability regulations and consumer disclosure.