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

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Dear Sir, Madam,

CP16/14: UCITS V Level 2 Regulation, SFTR and consequential changes to the Handbook

This is the submission of the Financial Services Consumer Panel to the FCA consultation paper on proposals to amend the FCA Handbook rules and guidance following the adoption of the Undertakings for Collective Investment in Transferable Securities V Level 2 Regulation (UCITS V Level 2 Regulation).

In its response to the Consultation Paper, the Panel focussed on question number two which relates to depositary independence requirements. The Panel agrees with the FCA that retaining the existing guidance in COLL 6.9, which implements structural requirements of independence, will provide for stronger investor protection than what is set out in the Level 2 Regulation.

The Panel has consistently argued for a full and effective separation of the UCITS management company and the depositary. This is an essential requirement to ensure conflicts of interest are not present in the first place, rather than managed which results in significant risks for the interests of consumers.

Without an appropriate regulatory framework that leads to good conduct by financial firms, consumers will remain hesitant to invest. Giving supervisory authorities the levers which they need to get the markets to behave would allow consumers to be confident that the financial services sector puts their interests first.

Yours sincerely,

Sue Lewis

Chair

Financial Services Consumer Panel

Response

The Panel has only answered Q2 which is where it has substantive comments.

Q2. Do you agree that retaining the existing guidance in COLL 6.9, when read together with the UCITS V Level 2 Regulation, will not result in a reduction in the current level of investor protection?

Yes. The Panel has consistently argued that restoring consumer trust requires better governance in asset management. Robust measures to ensure effective separation of the management company and depositary play a key role in preventing conflict of interest from arising in the first place.

The Panel is of the view that there should be a full and effective separation of the UCITS management company and the depositary. Current requirements in the UK go further than the UCITS Directive. While the Directive requires the management company and the depositary to act independently, the FSMA provisions for authorised funds require the management company to be independent of each other. As such, the UCITS L2 Regulation accepts that links could exist between the management company and the depositary and outlines a number of safeguards that need to be in place when this happen.

The FCA guidance under COLL 6.9 states at least three possible kinds of links the FCA would take into account in determining independence between the relevant parties: directors in common, cross-shareholdings, and contractual commitments. The Panel believes the FCA should retain this guidance as it provides for strengthened independence requirements and stronger investor protection when read together with the UCITS V Level 2 Regulation.

Research[1] has shown that governance of investment funds can often be weak and conflicted, especially in 'vertically integrated' financial services businesses, where affiliated companies control and manage multiple stages in the 'value chain', including investment management, brokerage and the administration at 'product' or wrapper level, e.g. in a DC pension scheme or ISA.

Weak governance also affects performance because it can be difficult to replace an under-performing investment manager. This can be due to the structure of commercial arrangements or through the operation of conflicts of interest because the manager effectively chooses those responsible for governance – a problem that can exist even when governors are supposed to be independent.

Governance is frequently contracted out to commercial organisations, which are unlikely to criticise the investment manager who appointed them. Governance can also be provided by an associated group company, which shares the same ultimate owner, creating similar conflicts of interest.

The sheer size of the UCITS fund sector means that the majority of governance problems in funds will be concentrated there. According to Eurostat, in 2010 more than 85% of EU mutual fund investments were directed towards UCITS vehicles (€5.9 out of €6.9 billion), with households accounting for 28% of EU investment in mutual funds (this figure comprises direct retail investments only and excludes intermediated investments such as pension funds and insurance)[2].

The Panel research concluded that well-governed funds are more likely to provide consumers with value for money by reviewing the quality of investment management and costs on a continuing basis. Poor governance can lead to investor detriment due to the use of inadequate or excessively risky investment strategies, or unnecessarily high costs.

As a result of the frequently ineffective governance of UCITS funds, consumer trust in the asset management industry has been eroded and has remained consistently low. All financial services markets are consistently towards the bottom of the table in the Commission's Consumer Markets Scoreboard, with asset management trailing by a long way.

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[1] In May 2014 the Panel commissioned JAITLY LLP to prepare a report on the state of play on charges, costs and expenses on retail collective investment schemes https://fs-cp.org.uk/sites/default/files/investment_report_executive_summary_for_the_fscp.pdf#page=6

[2] http://ec.europa.eu/internal_market/investment/docs/ucits-directive/20120703-impact-assessment_en.pdf