

FCA PUBLISHES DISCUSSION PAPER DP23/2: UPDATING AND IMPROVING THE UK REGIME FOR ASSET MANAGEMENT

FCA REQUESTS INDUSTRY INPUT AS IT SEEKS REFORM

With an estimated 2,600 firms with assets under management of approximately £11 trillion, the UK is by far the largest asset management centre in Europe and the second largest globally. More than that, the role that asset management plays in channelling new capital to public and private companies makes it systematically important to the financial system. In the UK, the sector continues to be largely governed by EU-derived requirements - namely the MiFID, AIFMD and UCITS regimes - following the on-shoring of the relevant legislation at the end of the Brexit transition period. The current legal and regulatory framework comprises a complex patchwork of separate regimes.

With the [Financial Services and Markets Bill](#) making steady progress through Parliament, discussion is turning to the detail of how the Government and regulators should shape the UK post-Brexit regulatory framework for asset management. Under the Future Regulatory Framework (FRF), the FCA will be responsible for those EU retained laws that set requirements for asset management firms. It will “*need to decide whether [UK] rules should in future copy those requirements*”. Against this background, the FCA has published a [discussion paper \(DP 23/2\)](#) covering a wide range of topics relating to the regulatory regime for asset management as it seeks industry input on how best to create a framework that continues to be “*coherent, agile and internationally respected*”. While no detailed recommendations are made at this stage, the paper serves to facilitate an open discussion with stakeholders as the FCA considers what changes to make and prioritise when reviewing the regime.

While the paper focuses most on the conduct and operations of firms, its scope is wide-ranging. The paper should also be seen in the wider context of various other reviews and initiatives in the sector, including the Treasury’s review of the UK funds regime ([response](#) published February 2022) and the previous recommendations of the UK Funds Regime Working Group.

Objectives and outcomes

There is no doubt that the FCA has a tall order when considering how best to approach reform in the sector. The FCA must meet its statutory objective of ensuring that markets function well, but (when the Financial Services and Markets Bill is passed) will also have a new secondary objective of facilitating the international competitiveness of the UK economy (including the financial services sector) and growth in the medium to long term. Further, the Government has set out certain priorities which are relevant to the outcomes that the FCA is seeking to achieve - among other things, better consumer outcomes and protection, delivery of “smart” reform, desire for “swift” implementation of the outcomes of the [Future Regulatory Framework Review](#), and active support for innovation and the use of technology in financial services.

Areas for reform

The paper considers four broad topics - with more detailed discussions of possible reforms to a number of areas within each topic:

- The structure of the asset management regulatory regime as a whole
- Improving the way the regime works (covering more granular conduct and product rules)
- Technology and innovation (covering the role of technology in various aspects of asset management and fund operations)

- Improving investor engagement through technology

A high level summary of some of the areas covered is set out in the Appendix.

Some themes

Tension between different objectives and outcomes

The scope of reform that the discussion paper addresses is ambitious. However, any attempt at a complete regime overhaul to simplify the framework may be tempered by other outcomes that the FCA is seeking. In recognition of the global nature of the asset management industry, the paper notes that the UK regime must work and interact effectively with the regulatory requirements to which firms are subject in other jurisdictions. The FCA must therefore have regard to relevant international standards in order to avoid creating unnecessary layers of complexity. Further, a cost-benefit analysis should be undertaken in relation to any change - as the FCA states in the discussion paper: *“where the rules currently work effectively, there may not be enough benefit to justify changing them, even if the resulting regulatory landscape is not as simple and coherent as one redesigned from first principles.”* In other words, the FCA acknowledges that perfection can be the enemy of the good. We may, at least initially, see incremental steps - for example more guidance on expectations - rather than major structural change.

Drawing the right lines between investor protection and investor flexibility

As seen in its discussion around the boundaries and thresholds for both retail and professional funds as well as the discussion on rules relating to eligible assets for retail funds, the FCA is constantly having to consider the right balance between investor protection and giving investors, including retail investors, more flexibility and investment choices. With respect to the requirements on prudent risk diversification, some, for example, have argued for the removal of quantitative limits and a move to a principles-based approach, but this may be seen as a bold step for retail funds. This will no doubt be an ongoing debate as the FCA develops its proposals for reform in future consultations.

Increasing importance of technology-led solutions

It is clear that the FCA is keen to push the UK as being at the forefront of using technology-led solutions to *“support better outcomes”* for investors and modernise the operation of authorised funds. While any concrete proposals as to how the rules could be amended to facilitate this remain far off at this stage, the FCA is clearly of the view that technological changes can be harnessed to increase operational efficiency, resulting in better consumer outcomes such as reduced costs, better access to information and more scope for investor engagement.

Conclusion - feedback wanted

The FCA is clear that it wants feedback from a wide range of stakeholders in order to form a *“balanced viewpoint”* on areas of focus and intends to engage extensively with stakeholders through the use of roundtables and other forums. The FCA welcomes ideas that stakeholders may have. This is reflected in the open-ended nature of many of the questions that the FCA asks in the discussion paper. The paper presents an opportunity for asset managers and recipients of their services to participate and engage in the shaping of UK’s future regulatory framework for this critically important industry. The FCA is requesting responses by **22 May 2023**.

“We want feedback as we start to think about what the FRF means for the UK rules for asset management. This feedback will help us decide what we should prioritise.” FCA, DP 23/2

APPENDIX

Area	Issues	FCA proposals/possible approaches
Structure of the asset management regulatory regime		
Overall structure of regime	<ul style="list-style-type: none"> Different rules apply to different types of asset managers (whether they are a fund manager (governed by UCITS or AIFMD rules) or a portfolio manager (governed by MiFID rules) and other service providers (such as depositaries, custodians and fund administrators), resulting in a lot of duplication. This has resulted in identical or similar activities being regulated to different standards, some differences being simply technical and others more substantive. This organisation of the relevant rules is complex, with various rules set out in different parts of the FCA Handbook. The UK onshoring process for EU law has made the position still more complex. 	Possible creation of a common framework of conduct rules for asset managers, with the same rules applying to a firm's fund management and portfolio management activities, "except where differing treatment is appropriate".
Regime for retail funds (UCITS funds and NURS)	<ul style="list-style-type: none"> Differences between the UCITS and NURS regimes mean that the UK authorised funds regime is unnecessarily complex. The market for UK authorised funds can be difficult for consumers to navigate, and they can find it difficult to distinguish between different types of funds. There are certain restrictions on UCITS funds driven by what is permitted under the UCITS Directive, which make it an unattractive structure for certain products even where the product would be appropriate for retail investors. 	<p>Approach 1: Remove the boundary between UCITS and NURS regimes so that all authorised retail funds become subject to a single set of rules.</p> <p>Approach 2: Re-brand the NURS regime as "UCITS plus" (with mainstream products falling under the UCITS banner and more complex retail products under the UCITS plus banner), creating clearer differentiation between fund categories.</p> <p>Approach 3: Create a category of "basic" funds and establish a boundary to distinguish basic funds from other retail funds.</p>
Regime for managers of professional funds	<ul style="list-style-type: none"> Rules that apply to managers of funds for professional investors are derived mainly from the AIFMD regime. The rules that apply depend on size thresholds, with managers of non-UCITS funds with AUM above a prescribed threshold regulated as "full scope UK AIFMs". Rules relating to "full scope UK AIFMs" are detailed and prescriptive and, in some cases, go beyond what professional investors consider offers sufficient protection. There is investor confusion between the small <i>authorised</i> AIFM regime and the small <i>registered</i> AIFM regime. 	<p>Change the AUM threshold or use alternative criteria other than size to determine whether small authorised AIFM exemption is available.</p> <p>Address potential for misunderstanding of the small authorised AIFM regime and the small registered AIFM regime by requiring some registered AIFMs to be authorised and removing the registration requirement for others.</p>
Improving the way the regime works		
Rules for authorised fund managers	<ul style="list-style-type: none"> Host AFM responsibilities: Concerns have been raised that portfolio managers misunderstand the role of the authorised fund manager (AFM) and that host AFMs have, in the FCA's experience, not always met expectations of standards. Liquidity management: Rules relating to liquidity management are important to investor protection but also increasingly relevant to the good functioning of markets. The FCA is concerned to ensure that <u>all</u> firms carry out effective liquidity risk management and that firms provide necessary reporting on liquidity to allow appropriate regulatory oversight. Investment due diligence: Practice around investment due diligence is 	<p>Clarification of expectations and rules on portfolio managers using host AFM platforms.</p> <p>Introduction of additional requirements under conduct of business rules to require that more managers conduct liquidity stress tests and more detailed liquidity rules for portfolio managers.</p> <p>Introduction of requirements for enhanced reporting to align reporting between AIFs and UCITS funds.</p> <p>Introduction of additional regulatory expectations on investment</p>

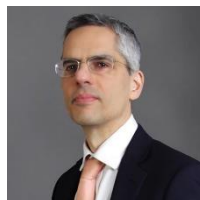
Area	Issues	FCA proposals/possible approaches
Rules for funds	<p>inconsistent. For example, in a range of scenarios, investments have been made in illiquid assets without significant due diligence.</p> <ul style="list-style-type: none"> • Eligible assets and eligible markets: The rules relating to eligible assets and eligible markets in which UCITS funds can invest are restrictive. There have been significant changes, for example, in what constitutes a ‘market’ since these rules were first made. The FCA sees some value in having more flexible rules (e.g. to ensure no forced sales in circumstances outside the manager’s control) but is also aware that these rules exist to ensure retail investors can have confidence in the types of assets that the fund holds. • Prudent risk spreading: Similarly, the rules on prudent risk spreading are detailed and seen by some as inflexible. 	<p>due diligence, including in relation to the provision of portfolio management services.</p> <p>More guidance on expectations around the use of relevant limits (e.g. the ability to invest up to 10% of the portfolio into markets that do not meet the eligible markets criteria). The FCA is also considering changes to loosening certain specific restrictions under the rules on spread of risk although it is not “currently minded to remove the quantitative restrictions”.</p>
Technology and innovation		
Use of technology in fund operations, and tokenisation of funds and portfolio assets	<ul style="list-style-type: none"> • While regulation may not expressly restrict the use of technology, the rules may be prescriptive about certain processes, and indirectly hamper the ability of firms to consider better solutions through technology. 	<p>Engagement with the Investment Association to consider the implementation of its proposed “Direct2Fund” dealing platform, which would facilitate investors transacting directly with relevant funds rather than requiring the authorised fund manager to buy and sell fund units on behalf of the fund and investors.</p> <p>Exploration of the benefits of “fund tokenisation” and wider forms of tokenisation, allowing for fully digitised clearing and settlement of fund units and underlying portfolio assets.</p>
Improving investor engagement through technology		
Information to investors	<ul style="list-style-type: none"> • Fund prospectuses are not fulfilling their primary function of providing more in-depth information to fund investors. • Managers’ reports are conceived as paper-based documents. 	<p>Consideration of a number of proposals to simplify fund prospectuses, including proposals to align content requirements with international best practice, to make the prospectus a more “modular” document for accessibility, and to require the use of electronic formats and machine-readable content.</p> <p>Similarly, the FCA is considering proposals to improve the presentation of managers’ reports and requiring managers to publish them in machine-readable format.</p>
Investor engagement	<ul style="list-style-type: none"> • Existing rules assume that investors have direct interaction with fund managers and do not take into account the increasing role of platform service providers and wealth managers as intermediaries. As a result, the rules may inadvertently disenfranchise investors while making it difficult for fund managers to deliver changes in a timely way. 	<p>Proposals include allowing virtual or hybrid meetings to improve investor attendance and participation.</p> <p>Better use of technology to improve interactions between the fund manager and fund investors in ways where an intermediary unitholder is involved - for example, solutions that will give fund investors more ability to voice their views over issues.</p>

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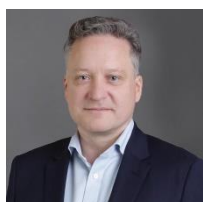
If you would like to discuss any of the issues highlighted in this publication or any other legal or regulatory matter, please do contact us or speak to your usual Slaughter and May contact.



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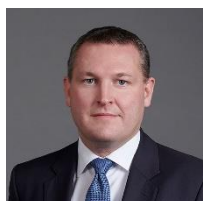
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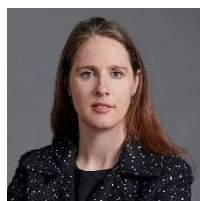
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