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Client Alert

October 2023

United Kingdom: FCA sets out approach to asset management regime reform

In brief

On 11 October 2023, Ashley Alder, Chair of the FCA, delivered a speech on the FCA's priorities for updating and improving the UK regulatory regime for asset managers. Covering a number of interesting angles, the speech sets out a sketch of the FCA's vision for the UK asset management regime going forward, and includes some helpful clarity for the industry about the direction of regulatory reform. The speech highlights in particular the following priorities for reform:

- ensuring a more proportionate approach to the regulation of AIFMs;
- updating the retail funds regime; and
- supporting technological innovation in the sector.

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Background

The speech sets out the FCA's strategic approach and priorities after analysing industry feedback in response to its February 2023 discussion paper on updating and improving the UK regime for asset management. This discussion paper was drafted with reforms embedded by the Financial Services and Markets Act 2023 in mind, including the FCA's new competitiveness secondary objective and the Smarter Regulatory Framework approach to the repeal and replacement of retained EU law. For more thoughts on the Smarter Regulatory Framework, see our recent webinar on the Mansion House reforms.

Proportionality

Mr. Alder confirms that proportionality will be the FCA's guiding principle in constructing its reforms to the asset management regime. He describes in particular a "smarter approach" to proportionality, both in relation to firm size and customer profile (e.g. retail vs wholesale).

Mr. Alder goes on to note that, in his view, proportionality is aligned to the competitiveness objective. It is interesting, though perhaps not surprising, to hear that "[i]n discussions with a range of stakeholders it’s actually been hard to nail down the specifics of how conduct regulation can drive international competitiveness and growth".

Our thoughts

- A proportionate approach to regulation will be welcomed by many in the industry. Nonetheless, focusing solely on size of AUM and investor base (i.e. retail *vs.* wholesale) may not in practice provide a complete picture of how regulations should be tailored to individual firms. For example, the manager of a fund with a larger AUM that trades infrequently or invests in buy-to-hold assets may be particularly exposed to liquidity risk but is arguably less likely to create market volatility or disruption than a smaller manager that engages in, say, a higher frequency algorithmic trading strategy. It may, however, be the case that as the reforms evolve, the FCA aligns its concept of proportionality more closely with the AIFMD definition of proportionality, which encompasses a manager's "size, internal organisation and the nature, scope and complexity of their activities".[1]
- Given the explicit link between proportionality and competitiveness, we may see the FCA actively promote the entry of new asset managers to the market by reducing barriers to entry, or fostering the growth of smaller managers through reforms to the small AIFM regime (see below).

Regulatory consistency across UK AIFMs

Feedback from stakeholders on the preceding consultation indicated a desire to retain the existing AIFMD core framework and reform it with additional proportionality and tailoring, with many highlighting the practical issues caused by the full AIFMD regime applying only to firms above a certain AUM threshold. Following this feedback, the FCA intends to move to a consistent set of rules across all managers of alternative funds. In addition, the regulator intends to work with HM Treasury to make regulation "work far better" for small registered, small authorised and full scope managers.

Mr. Alder also refers to potential rule modifications in response to stakeholder concerns about AIFMD rules which prevent full-scope AIFMs from carrying out other activities within the same legal entity. Although there is as yet limited clarity around which restrictions may be removed or relaxed, the FCA is likely to be mindful of avoiding conflicts of interest from forming within the same legal entity or group.

Our thoughts

- It is not yet clear whether the proposal to use a set of consistent rules across all managers of alternative funds will be good news for UK small AIFMs, or whether it could in fact impose an additional regulatory burden. At present, the regime applying to small AIFMs is substantially less onerous than that which applies to full scope managers. On the other hand, allowing for AIFMs to grow AUM in an organic way without reaching a "cliff edge" that throws the manager into a significantly more regulated environment may be helpful (e.g. by comparison to a more gradual increase in regulatory obligations).

NURS reforms

On the retail funds regime, the FCA intends to simplify the retail rules for non-UCITS retail schemes (NURS). NURS are currently subject to AIFMD rules, but in principle only retail rules should apply. Thus, to help simplify retail funds regulation, the FCA is considering making NURS subject to a regime that is similar to the UCITS regime.

[1] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (AIFMD).

Innovation

On innovation, Mr. Alder notes that the FCA is exploring fund tokenisation and asset management use cases for distributed ledger technology (DLT). The FCA is also looking to develop proposals in the medium term around the Investment Association's "Direct2Fund" proposition.

Our thoughts

- The FCA's comments appear more focused on innovations in fund distribution than on novel fund vehicles, for example. However, there has been some UK activity in this regard. For instance, we have recently seen the introduction of a new category of UK fund, the "Long-Term Asset Fund" or LTAF, designed to be of particular interest to longer-term institutional investors. LTAFs have thus far met with some success, although have a relatively low launch rate to date.
- If successful, increased use of newer technologies such as DLT may help to foster a more active secondary market in trading of fund interests.

Product disclosure and consumer risk

As part of its review of the asset management regulatory environment, the FCA is looking to support consumers in managing their risk effectively. Mr. Alder mentions the FCA's joint review of the Advice Guidance Boundary with the Treasury, which is aimed at unlocking domestic consumer investment through better availability of support and guidance for decision-making – in other words, encouraging consumers to be supported as they explore their risk appetite and risk management on their financial journey.

Another example is the FCA's indication that it is considering how to move from a prescriptive product disclosure regime to one where firms are focused more on designing good customer journeys.

Our thoughts

- These reforms to the UK product disclosure regime will sit alongside HM Treasury's decision to disapply the current requirement to publish Key Information Documents (KIDs) under the PRIIPs Regulation.[2] The PRIIPs regime has been notoriously unpopular with asset managers and others caught by the requirement to publish a KID, given the challenges involved in balancing a highly prescriptive and formulaic set of disclosures with the need to ensure that information being disclosed is fair, clear and not misleading. Mandatory performance scenarios and summary risk indicators built into KIDs have, in particular, been singled out as leading to "overly optimistic or otherwise biased" outcomes, leading to a risk of harm to investors.[3]
- Unfortunately for those hoping to avoid a substantially reduced disclosure burden, the FCA is intending to replace PRIIPs with replacement disclosure rules aimed at retail products. While the shape of these replacement rules has yet to emerge, some ideas that have been floated by the FCA in its December 2022 discussion paper on retail disclosure include: (i) "layering" disclosures, whereby firms would include certain "succinct and useful" information upfront, with more granular information provided later on in the process; and (ii) the introduction of less prescriptive requirements on length and specific content, and greater flexibility to tailor disclosures to the relevant target audience.

[2] Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).

[3] See the FCA's Consultation Paper (CP21/23) - Proposed scope rules and amendments to Regulatory Technical Standards.

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Cross-border considerations

On the issue of navigating competing regulatory requirements that apply on a cross-border basis, Mr. Alder notes as follows:

> *By way of some assurance, we are aware of the potential for firms (and the FCA) to suffer policy overload given the sheer volume of reform proposals. We are also aware of the challenges facing many globally active firms who need to comply with requirements in multiple jurisdictions. I've made very clear on other occasions that our evolving rulebook is bound to differ from EU regulations, but that we won't be pursing change just for the sake of it.*

Our thoughts

- It is helpful that the speech demonstrates an awareness of the issues faced by firms navigating regulation in more than one jurisdiction. However, there is an acknowledgement that the UK's regulatory framework will differ from EU rulemaking over time, and we have already seen a fair amount of this in action with respect to the AIFMD Review, EMIR 3.0 etc. This divergence is particularly challenging for firms trading or marketing on a cross-border basis, and makes it difficult for managers to stay on top of frequently required amendments to internal policies and procedures.
- Convergence around product labelling standards may, however, be an area where both regulators and the market could helpfully focus their efforts going forward. It is possible, for example, that we could see greater EU/UK convergence in terms of ESG fund labelling as a result of the European Commission's broad-ranging consultation on revisions to the Sustainable Finance Disclosure Regulation (SFDR).

Productive investment

Finally, Mr. Alder sets the FCA's reforms to the UK asset management regime within the context of the UK's wider policy agenda to mobilise domestic consumer capital in order to fund productive investment in the UK. For example, Mr. Alder notes:

> *You will be aware that there is a great deal going on in this area, with multiple initiatives and reports making recommendations to reverse what many see as stagnation in the UK's capital markets. The Chancellor's Mansion House reforms are a part of this, aiming to funnel more money from UK pension funds into promising UK growth companies.*

This statement reflects a number of recent initiatives that have focused on increasing consumer investment in a greater range of vehicles through reforms to funds, pensions and capital markets, including, for example:

- the Mansion House Compact, which commits many large UK DC pension providers to allocate at least 5% of their default funds to unlisted equities by 2030;
- broadening collective defined contribution (CDC) arrangements in the UK to non-connected, multi-employer arrangements, which will contribute to risk mitigation in order to invest in more productive assets;
- forthcoming new guidance from The Pensions Regulator (TPR) on investing in productive finance, and a new defined benefit (DB) funding code that will also clarify where DB schemes are able to accommodate investment in growth assets, particularly for open and immature schemes; and
- proposed reforms to streamline and simplify the UK listing regime.[4]

[4] For more detail on the pensions-related proposals in the Mansion House reforms, see this recent client alert.

Our thoughts

- It is important to understand the FCA's evolving approach to regulation in the context of the policy agenda set by the Mansion House reforms.
- A key priority of the Mansion House reforms is to unlock investment by pension schemes in unlisted and smaller corporates. In summary, UK legislators (and specifically the Chancellor) are aiming to channel pensions savings into higher growth, illiquid assets (particularly unlisted equities) and simultaneously encourage smaller pension funds to consolidate with a view to creating economies of scale. The Chancellor is targeting up to GBP 50 billion of investment in high growth companies by 2030. These proposals are accompanied by reforms to the way in which companies list and access capital in the UK, including with respect to the UK prospectus regime and the introduction of a new "Intermittent Trading Venue".

Next steps

The FCA intends to consult on amending the AIFMD regime and re-evaluating the AIFMD rules for non-UCITS retail funds in 2024, and will review the regulatory reporting regime in 2025. We can expect to see more clarity on the points raised in the speech as these consultations are released.

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