

The FCA's Timely Plan To Reform Asset Management Regime

By **Tim Dolan** (April 26, 2023)

Many jurisdictions have detailed regulatory regimes that have an impact on the establishment, management and marketing of funds, with differing requirements depending on the intended investor base, the extent to which marketing is occurring, the closed or open-ended structure of the proposed fund, the use of leverage by the fund and the fund's manager, adviser and subadviser structure.



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Those regulatory differences exist to take account of and balance the risks that potential investors may face, and the extent to which risky investment management activity requires greater regulatory requirements and prudential protections.

Since the early 1980s, the U.K.'s regulatory regime has developed over time with new layers being added to an existing regime each time to deal with different initiatives, without consideration being given to how the regime will work in totality from an investor, fund manager and fund distributor perspective.

The U.K. Financial Conduct Authority issued a discussion paper in February, on updating and improving the U.K.'s asset management regime, which finally addresses this.[1]

The discussion paper recognizes that as a consequence of Brexit, it is time to consider the shape the U.K.'s asset management regulatory regime will take in the future and the rationale for existing regulatory requirements and obligations.

By way of background, in the early 1980s, after substantial debate and consideration, the U.K. implemented a collective investment scheme regulatory regime that ultimately, alongside vital tax considerations, created the building blocks for the U.K.'s regulation of funds and fund managers. Over time, that regime was modified by both:

- European regulatory initiatives such as the Alternative Investment Fund Managers Directive affecting private funds, the Undertakings for Collective Investment in Transferable Securities Directive regime for retail funds, and the packaged retail and insurance-based investment products disclosure requirements for retail financial services products; and
- Substantial changes to the U.K.'s domestic requirements for marketing private funds under the FCA's rule book and different financial promotion exemption orders, which seek to achieve different objectives in an inconsistent manner.

After 40 years of gradual modifications the U.K.'s asset management regulatory regime is not always effective or proportionate. Consequently, the FCA has identified in its discussion paper several areas for potential reform, including:

- The obligations and rules of conduct in relation to portfolio managers and fund managers;
- The classification of different types of alternative investment fund manager and the rules specific to small- and full-scope alternative investment fund managers;
- The regime for retail funds; and
- Technology in fund operations and improving unit holder engagement.

Conduct Rules for Portfolio Managers and Fund Managers

A key subject area on which the discussion paper focuses is the current perceived uncertainty regarding which regulatory rules apply to fund managers, i.e., the actual operator of a fund, and which apply to portfolio managers, i.e., the entity given discretion to make decisions as to which investments a fund may actually buy and sell.

This distinction is important in cases where fund managers have delegated or contracted out portfolio management activity to third parties.

The FCA identifies the following issues in relation to portfolio management that it considers need reforming:

- There are no specific regulatory rules for portfolio managers in relation to investment due diligence and liquidity management, but there are specific rules for fund managers;
- There is no specific regulatory obligation on portfolio managers to consider the risks they pose to financial stability, but there are such obligations for fund managers; and
- There is a need to tighten up the existing regulatory framework to prevent the use of technology to manage multiple individual portfolios in order to evade the specific rules that apply to fund managers.

The FCA is considering different options for resolving these issues, one of which is standardizing the rules for portfolio managers and fund managers.

The discussion paper asserts that providers of host alternative investment fund manager services, i.e., professional firms that offer an FCA-authorized alternative investment fund

managers for hire model in the U.K. have on occasion fallen short of the relevant FCA standards in relation to portfolio management.

The FCA will endeavor to clarify the expectations of host alternative investment fund managers. Potential considerations for reform include imposing minimum contractual requirements on host alternative investment fund managers.

The FCA also states that there is a need to clarify the rules around dilution adjustments and liquidity risk management rules. In respect of the latter, the FCA is considering requiring fund managers to comply with liquidity stress testing guidelines issued by the European Securities and Markets Authority.

In particular, for retail funds subject to the FCA's collective investment schemes rules, the FCA is considering removing or amending Rule 6.12.11R(2) so that the qualification "where appropriate" does not provide a potential loophole for fund managers to avoid conducting stress tests.

Classification of Alternative Investment Fund Managers

At present, the rules that apply to fund managers marketing or carrying out regulated activities in the U.K. differ, depending on the size of the manager's total assets under management.

Firms that manage less than the minimum threshold, i.e., small alternative investment fund managers — currently €100 million (\$110 million) leveraged or €500 million (\$551 million) unleveraged — are subject to fewer reporting requirements.

The FCA is considering raising these minimum thresholds, which were imposed when the Alternative Investment Fund Managers Directive was introduced more than a decade ago, to reflect inflation and the growth in markets.

Additionally, the FCA is considering clarifying the existing rules and expectations of small alternative investment fund managers as well as the distinction between small registered alternative investment fund managers — the superset of small alternative investment fund managers who have registered with the FCA in relation to a fund — and small authorized alternative investment fund managers, who have been authorized by the FCA to conduct regulated activities.

The Regime for Retail Funds

In broad terms, the authorized retail fund regime consists of highly regulated funds structures that, in the main, are funds that are either Undertakings for Collective Investment in Transferable Securities Directive funds or Non-Undertakings for Collective Investment in Transferable Securities Directive Retail Schemes.

In connection with the FCA's new obligation on firms to demonstrate that they deliver good outcomes for retail customers — the consumer duty — the FCA has expressed a desire to reform the way the retail funds regime operates. The discussion paper considers potential approaches to reforming this area, including:

- Removing the distinction between Undertakings for Collective Investment in Transferable Securities funds and Non-Undertakings for Collective Investment in Transferable Securities Directive Retail Schemes funds, therefore reducing the

complexity of the regime by creating a single type of retail fund which draws on the benefits of both and removes unnecessary regulatory red tape;

- Rebranding Non-Undertakings for Collective Investment in Transferable Securities Directive Retail Schemes funds under a "undertakings for collective investment in transferable securities plus" to clarify the distinction between the Undertakings for Collective Investment in Transferable Securities funds regime and the more complex Non-Undertakings for Collective Investment in Transferable Securities Directive Retail Schemes regime; or
- Creating a new type of basic fund aimed at investors with less experience that would need to satisfy certain investment requirements to be considered a safe investment for consumers.

Technology in Fund Operations

In connection with the FCA's consumer duty principle, the discussion paper brings out several areas of the current asset management regulatory regime that could be modernized by the use of technology to be more consumer friendly.

The key considerations highlighted in the discussion paper are principally geared toward improving investor engagement, including:

- Making digital versions of prospectuses of funds more accessible to readers both in terms of content and format;
- Using technology to streamline ongoing reporting systems to make it easier for fund managers and distributors to comply with their reporting obligations and for investors to meet their information needs; and
- Reforming the rules and considering the use of technology with respect to unit holder meetings to enhance the participation of stakeholders in meetings with fund managers.

The discussion paper also briefly identifies other potential regulation updates relating to the use of blockchain and the tokenization of assets by asset managers to improve investor engagement and the transferability of investments whilst protecting the consumer.

Next Steps

This discussion paper is open for responses until May 22 and will eventually lead to a more

detailed consultation paper where actual changes are likely to be proposed.

It is not expected that this consultation process will lead to changes coming into force until late 2024 at the earliest, but, nonetheless, the opportunity to revisit and review the purpose and regulatory balance of U.K. asset management regulation is welcomed.

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[1] "DP23/2: Updating and improving the U.K. regime for asset management" <https://www.fca.org.uk/publications/discussion-papers/dp23-2-updating-and-improving-uk-regime-asset-management>.