Proskauer

The Future of Asset Management Regulation – The FCA's Post-Brexit Review

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Background

On 20 February 2023, the United Kingdom's Financial Conduct Authority ("**FCA**") published a discussion paper (DP23/2) on updating and improving the UK regime for asset management (the "**Discussion Paper**").

As part of the Edinburgh Reforms (which we wrote about here), the UK Government unveiled its Future Regulatory Framework, which set out how the UK financial services rulebook will change post-Brexit. The UK Government has proposed making the FCA responsible for the retained EU laws that set requirements for firms. In order to fulfil this responsibility, the FCA is seeking views on the future of asset management regulation via the Discussion Paper.

At this stage, it is important to note that the Discussion Paper only covers *possible* areas of change. The FCA has stated that any changes will need to have a "*clear benefit*" and ensure they:

- better meet the needs of investors, both domestic and international, and retail and professional;
- enable technological development, innovation and better use of data;
- are consistent with international standards and take account of rules in other jurisdictions, so that firms can continue to operate efficiently on a global basis; and
- are effective and proportionate, simplifying and standardising requirements where possible.

The key proposals are set out below.

The structure of the asset management regulatory regime

- **Creating a "common framework"**

The FCA has recognised that market participants may find themselves subject to differing rules depending on the role they are playing in a particular structure – e.g managers of authorised funds, managers of unauthorised funds, portfolio managers in relation to funds / other clients.

Given the rules come from varying EU legislation – namely the UCITS Directive, AIFMD and MiFID – there is significant duplication and navigating the different sources can be burdensome, particularly for new entrants.

To combat this, the FCA is considering the creation of a "*common framework*", that would set standards for all types of asset manager. While the FCA recognises the long-term efficiencies this may create, it remains mindful that a large-scale overhaul of its rules could cause a significant one-off burden for asset managers. It would therefore make this change with a lengthy implementation period.

- **Amending the "full-scope" AIFM Threshold**

Currently, the rules applicable to managers of funds with professional investors are largely derived from AIFMD. The rules are dependent on certain assets under management ("**AUM**") thresholds – managers of funds above particular thresholds are classified as "full scope UK AIFMs".

Although the FCA has stated that it does *"not plan to significantly change the rules derived from AIFMD"*, it is considering amending the current AUM thresholds or using alternative, non-AUM criteria to determine which exemptions can be relied upon (e.g. perhaps if a firm only has institutional clients).

Whether the thresholds are changed or not, the FCA is considering making its expectations of "small authorised AIFMs" (i.e. managers that do not meet the AUM thresholds) clearer by introducing a set of high-level rules setting minimum standards on core fund areas such as valuation, liquidity management and investor disclosure.

Improving the way the regime works

- **Responsibilities of host authorised fund managers ("AFMs")**

The FCA is concerned that portfolio managers do not have a clear understanding the role of host (i.e. third-party) AFMs. The FCA is proposing to create specific contractual requirements and/or new guidance to help combat this.

- **Liquidity management**

The current rules around liquidity management are designed to protect consumers, but the growth of the asset management industry has meant that liquidity management is also relevant to the good functioning of markets.

The FCA wants fund managers to carry out effective liquidity risk management and will convert the liquidity stress testing guidelines issued by the European Securities and Markets Authority ("**ESMA**") into FCA Handbook guidance. It is also considering clarifying / amending its existing rules to facilitate further stress testing.

For example, it may remove or significantly restrict the limitation around liquidity stress testing in COLL 6.12.11R(2) (which allows for discretion when carrying out stress tests of UCITS funds), so that the qualification "*where appropriate*" does not give fund managers a reason not to carry out such tests.

The FCA is also considering further liquidity reporting obligations for UCITS funds, as well as the possibility of public disclosures on liquidity for all types of funds.

- **Investment due diligence**

The FCA has identified that the practice around investment due diligence appears inconsistent. For example, investments are being made in illiquid or complex securities without significant due diligence.

The FCA is considering setting out regulatory expectations around investment due diligence for all types of asset management activity. The aim is not to create onerous restrictions, but instead a clear standard that is applicable to all asset managers.

- **Clarifying rules for depositaries**

The FCA is concerned that some depositaries are not providing effective oversight and challenge to their fund manager clients. This may partly be due to a difference in interpretation of the rules between the depositaries and the FCA.

The FCA believes there is benefit in updating and making its rules clearer for depositaries, fund managers and investors relying on these activities taking place. It is also considering the removal of certain rules where the oversight functions are of limited benefit.

- **Improving the fund rules**

Markets have changed significantly since the FCA wrote its fund rules, making them outdated and more complex than necessary. The FCA wants more effective and proportionate rules, with an appropriate level of detail.

For example, in line with stakeholder feedback, the FCA is considering amending the prescriptive, quantitative thresholds in the rules on risk management (e.g. how much a fund may hold of a particular asset), in favour of a more principles-based regime.

Technology and innovation

- **Technology for consumers / fund operations**

The FCA is concerned that its current rules may lack clarity about whether / how firms are able to respond to innovation and adopt changes in their processes. The Discussion Paper is seeking to identify areas where improvements could be made to fund regulation, so that firms can take advantage of technological developments in their customers' best interests

For example, the FCA is considering a consultation on the Investment Association's "Direct2Fund" proposition – an optional model which would make it possible for investors to transact directly with the fund when buying and selling units.

- **Tokenisation / Cryptoassets**

The FCA defines fund tokenisation as "*the ability to issue a fund's rights of participation (units or shares) to investors as digital tokens, usually by means of a distributed ledger*". In addition to the fund itself, the portfolio assets of the fund could also be traded in a secondary market in tokenised form, with fully digitised clearing and settlement.

The FCA is seeking to understand what investor interest there is to use this technology. It is also considering views on what regulatory changes will be needed, as well as how these changes should be prioritised.

As for cryptoassets more generally, unregulated tokens, such as stablecoins and other forms of cryptocurrency, are not currently permitted investments – authorised funds are not permitted to hold them.

Although some stakeholders want the FCA to consider reviewing its current position, it is the UK Government that is leading on this topic (most recently via its consultation paper on cryptoasset regulation). The FCA has stated that it will not do further work on this matter until the UK Government has advanced its thinking further.

Improving investor engagement through technology

- **Fund Prospectuses**

The FCA is concerned that prospectuses are not fulfilling their primary function of providing in-depth information to fund investors. It is considering modernising prospectus disclosures in several ways, for example: making prospectuses modular, making them machine-readable, renaming prospectuses with clearer names, and requiring the storage of prospectuses in a central depositary.

- **Managers' reports and accounts**

The FCA has found that such reports are often "*unengaging documents, given little prominence by fund managers*". Despite this, the FCA believes there is important information in a manager's report that any reasonable investor would wish to know.

The FCA is now seeking feedback on how the rules for managers' reports and accounts could enable firms to make better use of technology, to meet investors' information needs (for example, by using a common template that allow for machine-readability).

- **Investor engagement**

The FCA is seeking views on how to maximise fund investor participation in unitholder meetings and whether a better use of technology could help.

The FCA are also considering how the relationship between fund manager, intermediary and investor can be better reflected in the rules for authorised funds, as well as whether it should do more to enable investor / manager engagement.

Next steps

The Discussion Paper closes on 22 May 2023. The FCA will consider the input received and publish its feedback later in 2023, possibly as part of a consultation paper on some of the discussion topics.

Please contact the Proskauer team if you have any questions or would like to find out more.

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