ASSET MANAGEMENT - HOT TOPICS

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Welcome to the Winter 2022 edition of Asset Management - Hot Topics. The asset management industry has had to navigate a much changed investment landscape in a year dominated by an energy crisis, a rising inflationary environment and geopolitical upheaval following the Russian invasion of Ukraine. While consumer protection is already one of the FCA's priority objectives, market volatility, rapid increases in interest rates, the cost of living crisis, and increasing complexity of financial products available to retail investors all mean that the risk of harm to retail investors has become the subject of heightened regulatory scrutiny. It should therefore be no surprise that consumer protection is a common theme that cuts across various topics. This edition of our Asset Management Hot Topics series considers, among other things, the new Consumer Duty, the challenge of the Ukraine crisis for asset managers, ongoing regulatory developments relating to ESG investing, the rise of digital assets and retailisation of private capital.

1 A new consumer duty

With the publication of Policy Statement (PS22/9) in July 2022, the FCA has introduced a new consumer duty (the "Duty") that will apply to any firm which deals with retail customers in respect of its retail market business. As noted in its initial consultation paper (CP21/13) and re-iterated in the subsequent consultation (CP21/36), the FCA "*want[s] all firms to be putting consumers at the heart of their businesses, offering products and services that are fit for purpose and which they know represent fair value*".

For new and existing products or services that are open to sale or renewal, the rules come into force on 31 July 2023, but in-scope firms will also have to carry out a significant exercise in terms of testing all *closed* products and services by 31 July 2024. Further, firms ought to have agreed their implementation plans to implement the Duty into its products and services by now as the FCA required all firms to put in place such plans by 31 October 2022.

While it may be possible for some firms to conclude that, because they have no direct or indirect retail customers and/or because they do not ever engage in "retail market business", they are out of scope, the rules are complex and can potentially bring ostensibly wholesale market activities and asset management firms within scope (see our blog piece on implications for regulated firms more generally).

The Duty comprises an overarching principle (new Consumer Principle 12: requiring firms to act to deliver good outcomes for retail customers), three "*cross-cutting rules*" and four specified outcomes. Firms must ensure customers receive communications they can understand, customer support which meets their needs, and products and services which match their needs and are priced to offer fair value. Essentially, the Duty will require all firms involved in the design, manufacture and distribution of products to retail consumers to conduct more detailed and proactive monitoring of consumer outcomes throughout the product life-cycle.

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// the Duty will be a significant shift in what we expect of firms. It means making lasting changes to culture and behaviour to consistently deliver good outcomes. //

Sheldon Mills, FCA Executive Director, Consumers and Competition

Implications for asset managers

The Duty applies to asset management firms who deal with retail investors in funds (this would involve looking through to end investors and through distribution chains) in relation to "retail market business". Broadly, a "retail market business" is any regulated activity which involves a retail customer, although there are some exclusions, for example, for products with a minimum investment of £50,000. The Duty applies to firms where they can determine or have a "material influence" over the design or operation of retail products or services; the distribution of such products; the preparation and approval of communications that are to be issued to retail clients, and/or engaging in customer support for retail customers.

The concept of "material influence" is key, but the question of whether or not the firm does have "material influence" is not straightforward. The extent of a firm's responsibility will depend on its actual role and the extent of its influence over retail customer outcomes. A firm at the opposite end of the chain from the end retail customers may have more limited obligations than a firm with direct contact with such retail customers, subject to the extent to which it influences other material aspects such as the design of a product.

The Duty permeates across all other product level governance rules and the obligations overlap with many of the existing requirements under FCA's PROD/RPPD and COLL (regarding assessment of value) sourcebooks but firms conducting non-MiFID business may have to adhere to these obligations for the first time. The interaction between this Duty and the new FCA proposals on sustainability disclosure requirements and investment labels for "green" products (see "ESG and greenwashing risks" below for more detail on the proposals) was also explicitly considered in the FCA's consultation on those proposals - the FCA stating in that consultation that "*in complying with [the] consumer-facing disclosure rules set out in these proposals, firms must also comply with the consumer understanding outcome under the new Consumer Duty.*"

To illustrate how asset managers may need to consider the Duty at all stages, a firm that manufactures and sells a sophisticated product will need to ensure that it has the right target market (in this scenario, those who are able to take significant investment risk), scope out the "negative market", and develop a distribution strategy that ensures that the products are made available only to the relevant target market accordingly.

In the context of an increasingly complex investment landscape for consumers, the FCA is of the view the Duty is required to ensure that consumers are enabled to make investment decisions on an informed basis, and that products should be designed from the outset with a focus on consumer outcomes to ensure a high standard of consumer protection. The FCA is clear that the new Duty would require a significant shift for financial services firms, including asset managers, requiring that firms go beyond technical compliance and focus on the quality of consumer outcomes at all stages of the consumer journey.

2 Ukraine crisis and sanctions

The Russian invasion of Ukraine has dramatically altered the geopolitical and macroeconomic environment and exacerbated already rising inflationary pressures, with sharply rising energy and food prices a direct consequence of the crisis. While asset management firms have to consider how best to deal with the day-to-day task of managing their clients' assets and achieve returns against the backdrop of a global economic downturn, the crisis has also had some immediate ramifications for firms' operations and conduct, and implications in many other areas such as their ESG and stewardship considerations and strategies.

Of most immediate and direct impact are the imposition of sanctions on Russian assets and certain Russian political and business figures and their associates, and the call by the Chancellor to stop any investment in Russia in response to the invasion. The Russian government has, in turn, also applied restrictions on the trading of securities. While sanctions are not new, and asset managers and associated service providers have had to deal with the imposition of sanctions, for

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example, following the Crimean invasion in 2014, the much wider scope and extent of sanctions this time has required firms to deal with issues at all levels: at investor level (dealing with investors subject to sanctions), direct business exposures (for example, if a firm has a Russian office), and at portfolio or investment level (for example, due to restrictions on entering into new transactions in respect of assets subject to sanctions, or asset freezes affecting their portfolios or investments).

Fund managers face twin challenges of ensuring their actions do not breach any relevant sanctions regimes, while fulfilling their duties to treat their investors (particularly, retail investors) fairly. Given the broad scope of restrictions on any "use of funds" (including securities) held by sanctioned persons under the sanctions regime, firms must be alert to the identity and profile of the investor base of investment funds managed by them in order to remain compliant with the various applicable sanctions regimes. Any payments to or through accounts held in Russian banks which are listed as designated persons (17 banks are currently listed) under the sanctions regime would also constitute a breach. The Government has also swiftly introduced the Economic Crime (Transparency and Enforcement) Act 2022 which includes important changes to the Office of Financial Sanctions Implementation's (OFSI) powers, enabling it to impose civil monetary penalties on a strict civil liability basis for breaches of financial sanctions that are committed after 15 June 2022. Many firms managing emerging market or Russia-focussed funds have had to write down the value of Russian, Belarussian or Ukrainian assets given the inability to deal with, or price, such assets. Where affected assets form a significant proportion of a fund, some funds have had to suspend dealing, restricting the ability of investors to deal with their investments or make redemptions.

In light of this situation, the FCA has implemented new rules (consulted on in CP22/8 and finalised in PS22/8) to allow UK authorised fund managers to establish a separate new class of units (side pockets) in their retail funds to hold the affected investments and separate them from the fund's other investments. An alternative proposal to pursue side pockets using a schemes of arrangement structure instead of establishing a separate class was also considered, and the FCA is willing to engage with parties considering their use in these circumstances. The FCA is also relaxing the requirement for investor approval, as well as requirements relating to notice periods, to facilitate the creation of side pockets in some circumstances.

Respondents to the consultation expressed broad support for the wider use of side pockets outside the Ukraine crisis. However, the FCA remains wary of the use of side-pockets more generally and expressed its concerns around any fundamental shift in policy to allow retail funds to implement side pockets as a liquidity management tool. Instead, it will consider side pockets more generally as part of its engagement with IOSCO on liquidity management tools for open-ended funds and bear in mind their effectiveness in this specific scenario before making any wider future policy decision.

ESMA has also issued a public statement with the aim of ensuring European authorities are aligned in their actions to manage the impact of the Russian invasion of Ukraine on investment fund portfolios exposed to Russian, Belarusian, and Ukrainian assets. The statement addresses issues relating to UCITS funds, as well as the obligations of EU AIFMs with respect to their funds – in particular, in relation to liquidity and valuation, and the use of side pockets. Similarly, while recognising that side pockets may be preferable from an investor protection perspective compared to temporary suspension, especially where assets are valued at significantly lower prices, ESMA is wary of the potential risks relating to the use of side pockets more generally.

The Ukraine crisis has had many other knock-on effects, complicating, for example, the already complex discussion surrounding integration of ESG matters in investment decisions and the role of asset managers in financing sustainable investments. In the area of climate change, many firms continue to espouse the importance of longer-term investments in "green" energy sources and renewables, and indeed see such investments as crucial towards long-term energy security. However, in the short term, with soaring energy prices amid supply shortfalls as a direct consequence of the Russian invasion, asset managers have to navigate the difficult pathway in balancing their net zero commitments with achieving financial returns, while catering for different (and in some cases, divergent) investor and stakeholder interests.

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3 ESG developments and greenwashing risks

The Ukraine crisis and resulting high energy and commodity prices and consequent impact of the cost of living for many has fed into the debate on the potential tensions between transition plans, net zero commitments and energy security – and asset managers have to consider how to address ESG issues in relation to their stewardship activities, investment decisions and capital allocation, and the design and marketing of new products against this backdrop. Already, some large asset managers have had to nuance their commitments to divest from fossil fuel investments in the midst of pressures from stakeholders on different sides of the debate, not least certain US states which have reportedly blacklisted a number of firms for their ESG investing policies.

Indeed, some have criticised the concept of ESG investing altogether, indicating that investors are simply paying higher fees for products which have no, or minimal, real-world societal or environmental impact or benefit. Some have argued that whatever (and however well-intentioned) actions asset managers may take in integrating climate issues in their investment decision process, there is a question as to whether these simply amount to the management of financial risks resulting from climate change and do not actually do anything "on the ground" to reduce greenhouse emissions, or mitigate other climate change impacts.

Addressing greenwashing risks

Nonetheless, amidst the wider debate, the number of firms eager to promote their ESG credentials and to market their funds and products as "sustainable" continue to grow and greenwashing risks remain of increasing concern to regulators. It is therefore unsurprising that regulatory developments, especially in climate-related reporting and disclosures, continue unabated. With the UK keen to be seen as a global leader in "greening" the financial system, the FCA has introduced a number of regulatory measures applying to asset managers in order to address greenwashing risks and improve transparency to investors.

Under the ESG Sourcebook (see our June 2021 client briefing), asset managers with assets under management of more than £50 billion and asset owners with assets under management or administration in relation to in-scope business of more than £25 billion are already required make mandatory climate-related disclosures consistent with the TCFD recommendations at both entity and product level from 1 January 2022.

Sustainability disclosures and product labels

Following publication of FCA's discussion paper DP21/4, seeking initial views on the development of Sustainability Disclosure Requirements (SDRs) for asset managers and a sustainable investment labelling system (as envisaged under the government's roadmap for green finance), the FCA has recently published its long-awaited consultation (CP22/20) on SDRs for asset managers and investment labels. The consultation sets out the FCA's proposals which comprise a consumer-focused labelling regime underpinned by a detailed criteria, disclosure requirements, naming and marketing rules, and rules for distributors (see our client briefing for more information).

The labelling regime allows firms offering in-scope investment products to use the FCA's "sustainable investment" labels for their products if they meet the proposed qualifying criteria. The labelling system is based on three categories ("**Sustainable focus**", "**Sustainable improvers**" and "**Sustainable impact**"), each underpinned by a stringent and objective qualifying criteria.

Firms will be required to prepare standalone consumer-facing disclosures for all in-scope products (not just those that apply a label) to help consumers understand the key sustainability-related features of a product, as well as more detailed entity and product-level disclosures which would build on the recently introduced TCFD aligned climate-related disclosure requirements. In addition, the FCA is proposing a general "anti-greenwashing" rule which applies to all FCA-regulated firms. This would require firms to ensure that any sustainability-related claims in relation to a product or service are: (i) consistent with the sustainability profile of that product or service and (ii) clear, fair and not misleading.

A number of points to note on the proposals at this stage:

- Only products that have a sustainability objective and contribute to a *positive* sustainability outcome can qualify to use the proposed sustainable investment labels. It is

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not sufficient simply to consider the financial risks, opportunities and impact of ESG factors in investment decisions as that should be seen as merely part of an asset manager's existing fiduciary duty to clients and part of its usual risk management practice.

- Unsurprisingly, the proposals – including the labelling regime and consumer-facing disclosure requirements - are heavily consumer-focused. The FCA is concerned both with potential consumer harm and the risk that greenwashing may erode trust in the market for sustainable investment products especially in the retail market, affecting capital flows to genuinely sustainable investments.

- Diverging from the EU SFDR, the FCA has, for the moment, decided not to require firms to consider *principal adverse impacts* or "*do no significant harm*" concepts. The FCA, however, has made clear that the requirements will evolve over time and will, among other things, take into account the proposed ISSB standards and the UK Green Taxonomy when developed.

- It is likely that asset managers operating in multiple jurisdictions will be subject to overlapping but different disclosure regimes. Nonetheless, despite the FCA's stated desire to "remain as consistent as possible with [EU] SFDR", it is already evident that it is taking a very different approach when designing this regime. Mindful of the increasing burden on firms given the multiple regimes that may apply (including FCA's own existing requirements relating to TCFD disclosures), the FCA is allowing firms to incorporate cross-references to other documents to a large extent. Nonetheless, a major practical challenge remains in terms of resources available to firms to put in place systems and process that allow reporting against the myriad of requirements.

- the introduction of a general "anti-greenwashing" rule linking conduct rules with sustainability claims would enable the FCA to more easily challenge any greenwashing practices, and is potentially a significant enforcement tool within the FCA's arsenal to clamp down on greenwashing.

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Naming and marketing

The naming and marketing of funds have attracted particular scrutiny from regulators. The FCA's proposals in CP22/20 include a prohibition on the use of sustainability-related terms (such as "ESG", "environmental", "social", "climate", "impact", or "sustainable") in the naming and marketing of in-scope products made available to retail investors (products targeted at institutional investors are outside scope) if those products do not qualify for one of the proposed sustainable labels. This may well require firms to review their existing retail product range to consider whether they qualify for the relevant labels.

In line with the UK, ESMA has recently published for consultation some guidelines on using ESG or sustainability-related terms in funds' names. In short, ESMA is proposing that if a fund has an ESG-related term in its name, a minimum proportion of at least 80% of its investments should be used to meet the environmental or social characteristics or sustainable investment objectives as disclosed under SFDR obligations. Outside Europe, the US is proposing to expand the scope of the so-called "Names Rule" of the Investment Company Act 1940 to apply to any fund name with terms that suggest particular characteristics including, "ESG". Again, this would mean that such funds must meet certain thresholds in respect of its investment allocation. Notwithstanding objections by some firms to the SEC proposals arguing that these proposals place "undue weight" on a fund name, regulators clearly take the contrary view that a fund's name is, in ESMA's words, a "powerful marketing tool" and influential in the consumer decision making process.

Transition plans

The government's SDR framework as well as proposals under CP22/20 envisage that regulated

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firms making TCFD climate-related disclosures would be required to prepare transition plans. The UK Transition Plan Taskforce (TPT), established to develop a common "gold standard" transition plan for both financial and non-financial entities has, in early November 2022, published its proposed Disclosure Framework for private sector climate transition plans and accompanying Implementation Guidance for consultation. The Framework is designed to assist entities to disclose credible, useful and consistent transition plans as recommended under the TCFD Recommendations or transition plan disclosure recommendations in the ISSB's proposed standards. The FCA is clear that the Framework will be used to develop any further disclosure expectations on regulated firms relating to transition plans.

Enforcement risks

In tandem with the increase in the volume of regulation, regulators have increasingly shown their willingness to take enforcement action against greenwashing practices. German and US regulators have opened investigations into DWS Group arising from allegations that it has misled clients about its sustainable investing credentials. Most recently, Goldman Sachs agreed to pay a $4 million fine following an SEC investigation into certain ESG claims made by funds managed by its asset management division. Action has also come from more unexpected quarters –as widely reported, the UK Advertising Standards Agency has recently ruled that HSBC misled customers in two advertisements by selectively promoting its green initiatives, while omitting information about its continued financing of companies with substantial greenhouse gas emissions.

The various proposals, if adopted, will substantially add to the regulators' toolkit enabling them to challenge poor practices in this area. Asset managers would want to ensure a level of rigour in the design, marketing and distribution of any product promoted as sustainable to ensure that they are consistent with the sustainability profile of the product. At entity level, firms should ensure not just that policies are in place but that operationally, their practices and investment approach would need to be very demonstrably aligned.

ESG ratings and data providers

In the absence of direct data sources from investee companies, one major area of risk lies in the use of proxy data and the heavy reliance asset management firms place on third party private sector providers of ESG ratings and data. The IOSCO final report on ESG ratings and data providers (published November 2021) identified a number of issues relating to the use of such providers including the lack of clarity on what the ratings or data products are intended to measure; lack of transparency in methodologies underpinning the data; and concerns relating to conflicts where the ESG ratings and data provider (or an associated entity) performs consulting services for companies that are the subject of these ESG ratings or data products.

The current lack of regulatory oversight over ESG ratings providers is an issue that the FCA has also focused on, as seen in its discussion on third party ESG ratings and data in CP21/18 where the FCA noted the increasing reliance by asset management firms on ratings and data supplied by such providers to inform the design and delivery of their sustainable investment products. Similarly, in its recent letter to the European Commission following its call for evidence on ESG rating providers in the EU, ESMA noted a growing momentum amongst regulators to assess whether there is a need for specific regulatory intervention in this area.

The multi-dimensional nature of ESG performance (resulting in different providers using different methodologies and metrics to measure performance) as well as data gaps all contribute to the increased likelihood of the greater potential for harm through the provision of ESG ratings. The FCA has since published its response (FS22/4) to CP 21/18 (June 2022) in which various market participants raised issues ranging from qualifications of the analysts of these providers to costs of ESG data as a result of product bundling practices – providing a clear case for the regulation of ESG ratings and data providers. Pending HM Treasury consideration of any extension to the FCA's regulatory perimeter to include ESG data and ratings providers, the FCA has since announced the convening of an industry-led group (which includes Slaughter and May) to develop a voluntary Code of Conduct for such providers.

Wider developments

The EU continues its push to develop its more ambitious framework in terms of sustainability disclosures. It has been more than a year since the EU sustainable finance disclosure regime (SFDR)

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came into force in March 2021. Although not directly applicable, UK firms with cross-border EU businesses or marketing products in the EU are already having to make disclosures in line with the SFDR. Developments relating to the relevant regulatory technical standards under the SFDR and the EU Taxonomy Regulation continue apace, as the EU seeks to develop the more detailed regulatory technical standards under each of the regulations.

In this respect, a number of reporting obligations under SFDR and the Taxonomy Regulation will start applying to in-scope asset managers from 1 January 2023. With respect to reporting under the EU Green Taxonomy, firms must make detailed disclosures specified under the Delegated Act supplementing Article 8 of the Taxonomy Regulation concerning the proportion of environmentally sustainable economic activities in the relevant undertakings' business, investments or lending activities. For asset managers, this would mean reporting on its "Green Investment ratio" – the Taxonomy-related metric measuring the proportion of its investments which qualify as environmentally sustainable. In addition, when disclosing sustainability-related information under the SFDR, asset managers will have to comply with the Delegated Regulation on the technical standards relating to the principle of 'do no significant harm', sustainability indicators and principal adverse impacts.

ESG matters, of course, are not confined to climate change. Developments on the radar include the proposed EU Corporate Sustainability Due Diligence Directive which seeks to impose a duty on companies to perform human rights and environmental due diligence to avoid potential harms across a company's operations and value chain. For asset managers, the Directive serves to underpin and complement both the SFDR and the Taxonomy Regulation, as the requirements facilitate firms' reporting on adverse impacts and minimum safeguards under each of those regulations. Developments on the radar include the mooted EU social taxonomy, biodiversity matters and the nature-related disclosures (as the TNFD framework takes shape). As asset managers seek to integrate sustainability factors and risks into their investment decisions, it is becoming clear that they would have to grapple with far more than just climate change or environmental issues in isolation.

4 The Investment Firm Prudential Regime

The Investment Firm Prudential Regime (IFPR) that applies to FCA-regulated MiFID investment firms came into force in 1 January 2022, with the stated aim of streamlining the prudential requirements for those firms. Firms within scope include current BIPRU firms and Exempt CAD firms, as well as alternative investment fund managers that have MiFID top-up permissions (collective portfolio management investment (CPMI) firms).

While the aim is an overall streamlining of the regime by replacing the Capital Requirements Directive and Capital Requirements Regulation (which were designed for credit institutions) with a "fit for purpose" regime specifically tailored to the business models of investment firms, the new prudential rules do introduce more complex and, in many cases, more stringent capital, liquidity, reporting, governance and remuneration requirements for firms within scope.

The regulatory capital requirements are based on a quantitative assessment of the size the firm, and on the activities or services it undertakes or provides. Small and non-interconnected (SNI) firms must hold "own funds" that is the higher of a permanent minimum capital requirement (PMR) (which will usually be £75,000) and a fixed overheads requirement (FOR) (equal to one quarter of its relevant expenditure in the previous year) while Non-SNI firms will be required to hold an "own funds" amount that is the higher of its PMR, FOR and total "K-factor" requirement (specific to each firm). Furthermore, all investment firms must establish an internal capital adequacy and risk assessment (ICARA) process, which is designed to supplement a firm's own funds requirements and allow a firm to identify, monitor, and, if relevant, mitigate all material potential harms that could result from the ongoing operation or winding down of its business – this assessment may very well result in potentially higher capital requirements as firms will be required to satisfy an Overall Financial Adequacy Rule through this process.

Remuneration requirements

The new MIFIDPRU Remuneration Code (see our client briefing for more detail) applies to remuneration paid to "staff" (broadly defined) of all in-scope firms (including CPMI firms in respect of their MiFID business) although requirements will

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vary, depending on the type of firm. The requirements will apply to the remuneration earned after the start of the next performance year following implementation. All firms are required to establish and implement remuneration policies on a proportionate basis. In addition, further requirements apply to "material risk takers" within non-SNI firms, including the need to ensure that malus and/or clawback arrangements are in place for such persons. Non-SNIs (and SNIs on a more limited basis) are required to make remuneration disclosures, including a summary of their approach to remuneration, the objectives of their financial incentives and governance surrounding their remuneration policies and procedures. It should be noted that carried interest will be treated as variable remuneration.

Consolidation and re-categorisation of firms

Many of the queries arising from the new regime relate to consolidation requirements. The FCA may apply consolidated supervision if the firm belongs to an "investment firm group", (broadly where there is a UK parent entity of a group containing at least one FCA investment firm). This will mean imposing prudential consolidation requirements directly to (and at the level of) a UK parent entity unless the use of the group capital test (exempting the UK parent entity from applying the rules on a consolidated basis) is permitted for the group.

One issue that has emerged relates to the possible re-categorisation of certain asset managers which are currently "core firms" under the Senior Managers and Certification Regime (SMCR) as "enhanced firms". This arises from the inclusion of BIPRU firms in the IFPR and, therefore, potentially within one of the categories of "enhanced firm" under the SMCR, namely "significant SYSC firm". Prior to the commencement of the IFPR, BIPRU these firms were excluded from this category and, therefore categorised as "core firms" under the SMCR.

The definition of "significant SYSC firm" includes firms whose annual fees and commission received in relation to the regulated activities they carry on exceeds £160m over a 12-month period. It is this part of the definition which may catch certain alternative investment managers and mean they are categorised as enhanced firms under the SMCR. The impact of moving from a core to an enhanced firm is not insignificant – and will mean greater compliance costs for firms as additional governance and reporting processes are required to support such firms' new categorisation.

Helpfully, following representations by industry bodies, the FCA has since published a statement highlighting the re-categorisation concerns. The FCA plans to consult shortly to clarify that only firms that would have been both significant IFPRU firms and IFPRU investment firms under the pre-IFPR arrangements fall within the new definition of significant SYSC firm for the purposes of the enhanced scope SMCR. In the meantime, the FCA notes that firms that have unintentionally come under the enhanced scope SMCR under the new definition of significant SYSC firm need take no action.

5 Effective Stewardship

Alongside the increased focus on ESG issues, expectations on asset managers' stewardship practices have also grown in tandem, as both asset owners and governments expect asset managers to exercise good stewardship in order to achieve positive outcomes among investee companies. The government's roadmap on Greening Finance is one example, in which asset managers' stewardship role is discussed in relation to facilitating companies' net zero commitments and transition strategies

The Financial Reporting Council's November 2022 Review of Stewardship Reporting re-iterated the need for firms to sufficiently demonstrate how their stewardship activities have led to tangible outcomes. While the latest signatories to the Stewardship Code 2020 have shown marked improvement in reporting in several areas, the FRC still wishes to see greater emphasis from signatories on reporting their activities and outcomes more effectively. The FRC's expectations for 2023 will continue to place more emphasis in the assessment process on reporting of activities and outcomes, with signatories expected to provide multiple case studies to evidence the activities undertaken in the reporting year and their outcomes, particularly for the Principles relating to their investment approach, engagement, and exercise of rights and responsibilities. Many firms tout their stewardship credentials by disclosing their policies, but the FRC has made it clear that simply having policies in place is insufficient. Firms must demonstrate how their engagement activities with investee

companies have resulted in good stewardship or have supported stated objectives.

Holding service providers accountable

An area of weakness that has previously been identified by the FRC is the monitoring of service providers. The influence of proxy advisors on voting decisions is widely recognised and firms rely heavily on technology and data supplied by third party service providers. Principle 8 of the Stewardship Code requires signatories to monitor and hold to account service providers. It should therefore come as no surprise that firms need to demonstrate that they have done proper due diligence when choosing their own service providers and ensure that there is proper monitoring of those providers to enable firms to address any shortcomings in service delivery. It should also be expected that good stewardship practices entails asset managers applying some critical judgement in deciding whether or not to follow a proxy adviser's recommendation rather than delegate voting decisions wholesale to proxy advisors.

Climate change – urgent engagement

Although many asset owners and asset managers do have engagement and voting policies in place, there is a sense that more robust stewardship actions are required to address the impact of climate change. To this end, the Institutional Investors Group on Climate Change (IIGCC) (the European membership body for collaboration on climate change whose membership currently comprises 375 asset managers and asset owners managing over €51 trillion in assets) has recently launched the Net Zero Stewardship toolkit which provides investors with a "foundational framework" to enhance their stewardship practices in order to facilitate the delivery of net zero by 2050. The emphasis is on bolder, more decisive engagement: "*To achieve [the rapid adoption of target emissions by companies], investor stewardship must be swift and bold…This unprecedented challenge will require an unprecedented shift in stewardship practices.*"

While recognising that it is not possible for asset management firms to actively engage with every single investee company in their capacity as investors and, therefore, emphasising the need for prioritisation), the toolkit does suggest that firms establish a baseline engagement and voting policy for *all* companies within scope (which may include voting triggers for "routine matters" that typically come up for voting during AGMs linked to whether or not certain net zero policy actions have been taken by the investee company). Asset managers are also encouraged to put in place a clear escalation plan - which includes both non-voting (increased senior or board-level engagement, public statements, collaborative action with other investors) and voting escalation actions – that can be executed where appropriate. The debate continues on the merits of engagement versus divestment, but the toolkit sees divestment very much as a tool of last resort – only to be used "*where escalation has been exhausted or change is otherwise seen as infeasible*".

It is also interesting that, in its consultation on sustainability disclosure requirements, the FCA notes that one of the main channels or mechanisms by which an investor may plausibly contribute to positive outcomes for the environment and/ or society is through active investor stewardship. This would require active engagement, the exercise of voting and other rights, shareholder activism, or participation in system-wide initiatives. For firms marketing products that purports to invest in assets in transition to becoming more sustainable, it would be expected that a key part of their investment strategy would involve an active stewardship approach directed towards encouraging and accelerating improvements in the environmental or social sustainability profile of its assets.

Passive investing and stewardship

For passive investors and index-trackers, however, it is more difficult to pursue a more "activist" strategy, given their more limited discretion over stock selection. It does raise the question of the extent to which passive funds – which have seen exponential growth in recent years – can be effective stewards.

One challenge, as already noted, stems from the inherent constraints of passive investment and index-tracking, making a divestment strategy in relation to specific companies difficult. This does mean that engagement becomes a more important tool. However, even with firms that are willing to take a more active stance in terms of engaging with investee companies, the limits of individual engagement can be seen: one example is LGIM, the UK's largest asset manager, which recently called time on providing feedback on remuneration policies, noting that this has not

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resulted in much tangible change among companies. The main challenge however stems from the practical difficulties for such funds to engage meaningfully with the large number of companies contained in the indices they track. With lower costs being one of the attractive features of passive or index investing, many have relatively fewer stewardship resources and rely extensively on proxy advisers. However, with investors and asset owners stating that they would like passive funds to take an active stewardship role, the onus is on these funds to show that they are not also passive owners.

6 Tightening the Appointed Representative regime

The use of Appointed Representative arrangements where persons (Appointed Representatives or ARs) carry out regulated activity under the responsibility of an authorised firm (principals - who are responsible for the AR's compliance with regulatory requirements), is not uncommon in the asset management sector. New investment advisers, and especially private fund sponsors or alternative investment managers, often make use of such arrangements in order to undertake regulated business without incurring the cost and complexity of obtaining direct FCA authorisation. Indeed, the FCA had previously identified that authorised firms have appointed and accepted responsibility for over 1000 ARs in the asset/investment management sector.

However, it was already evident in the FCA's thematic review of the investment management sector conducted back in 2019 that there were various shortcomings in the use of the AR model. It was noted that activities carried out through ARs generate more complaints than those undertaken directly by authorised firms and ARs are thought to present a greater risk of consumer harm. In particular, recent years have seen the growth of 'Regulatory Host' models where the 'Regulatory Host' principal firm does not itself carry on any substantive regulated activity, but acts solely as a host for ARs to use its permissions. AR personnel may also be seconded to the principal firm, and become approved persons to undertake regulated activities (such as managing investments) for which the AR cannot be exempt. The FCA's findings found many principal firms with weak or under-developed governance arrangements, including deficient risk frameworks, internal controls and resources, resulting in an inability for such firms to provide effective oversight and direction over ARs as required.

> *// Most principal firms we reviewed had weak or under-developed governance arrangements in place, including a lack of effective risk frameworks, internal controls and resources. //*
>
> FCA Review of Investment Management Firms

Spurred in part by the Greensill scandal, the FCA has committed to improving oversight of the AR regime. To this end, alongside a UK Treasury Call for Evidence (proposing changes to the overall scope of activities that may be carried out by ARs), the FCA has, in December 2021, published a consultation (CP21/34) on proposals to clarify and strengthen principals' responsibilities and its expectations of them. The FCA is also proposing to increase the amount and timeliness of information the FCA receives on principals and their ARs. The final FCA rules were published in Policy Statement PS22/11 (August 2022) and will come into force on 8 December 2022.

The new regime will require, among other things:

- principals to put in place appropriate safeguards where principals delegate functions or tasks to an AR, assess senior management at an AR for competence and capability, and take reasonable steps to ensure an AR acts within the scope of its appointment.
- principals to assess whether they maintain, on an ongoing basis, adequate controls and resources for effective oversight of their ARs
- new annual assessments of each AR's suitability, fitness and propriety, financial position and the adequacy of the principal's controls and resources to effectively oversee the AR, although this requirement can be achieved by principals integrating the assessments into existing internal reporting processes.

As noted, a large part of the FCA's focus has been on consumer harm. However, the new rules are not restricted to ARs engaging with retail investors, and apply equally to those operating in the wholesale sector. Many, including managers of alternative investments and private funds, have

used the AR regime as a stepping stone towards full FCA authorisation.

Although obligations are imposed on the principal, it is likely that the principal will impose additional obligations on the ARs in order to obtain necessary information and comfort on their conduct. Going forward, asset managers using or considering AR arrangements (in particular those making use of regulatory hosting services) should be aware of the tighter regime and, in practice, the likelihood of intensified FCA supervision and scrutiny — and ensure that their arrangements are robust in this regard. Some may decide the practical benefit of the regime is now limited and opt for full authorisation instead.

7 The evolving world of digital assets

Digital assets, including a range of cryptoassets (tokens and stablecoins) and also increasingly financial products linked to crypto performance, has largely reached mainstream consciousness. Some regulated firms have been quick to provide cryptoassets services and products to both their professional and high-net worth retail customers, but others have been wary of the high volatility associated with, and regulatory risks of, offering cryptoassets investments products. The collapse in the price of TerraUSD, a stablecoin designed to hold a steady value by being pegged to another cryptocurrency (Luna), and most recently, the bankruptcy of the cryptocurrency exchange FTX underline the high-risk nature of the sector.

Notwithstanding this, investor demand means that the wealth management arms of bulge-bracket banks like Morgan Stanley and JPMorgan have started offering bitcoin or other crypto-related funds to certain clients. More worryingly for regulators, given the largely unregulated nature of the sector, the substantial retail interest in cryptoassets means that the potential for harm is ever-present, particularly given such investments' speculative and high risk nature.

The regulatory environment

While some cryptoassets are regulated (those characterised as "e-money" or "security" tokens), the FCA's current regulatory remit does not cover much of the cryptoassets sector. The regulatory landscape is evolving, but establishing an appropriate regime has proven challenging as the government seeks to promote innovation while wanting to ensure suitable consumer protection at the same time. Some regulators have heeded a cautious approach in giving approval to service providers operating in a sector that remains little understood – the criticism of the recent move by the French markets regulator to approve the registration of a subsidiary of Binance, the world's largest digital assets exchange platform, amid concerns that the platform remains in its infancy when it comes to its approach to consumer protection and money laundering risks is a case in point.

In a move that may be seen to encourage investment in cryptoassets, the government has announced a proposal on the possible expansion of the UK's investment manager exemption (IME) to include such assets. The IME enables UK-based fund managers to provide management services relating to qualifying "investment transactions "to non-UK located funds without subjecting such funds to UK taxation. In order to avoid risk of consumer confusion, the FCA has made public its expectation that fund managers ensure that consumers understand the extent of the manager's that is regulated and their unregulated business is clearly distinguished. The FCA is keen to emphasise that firms remain responsible at all times for identifying and managing potential risks related to cryptoassets. Further, in order to enhance consumer protection, the Treasury has proposed to bring some cryptoassets within the scope of the financial promotion regime and the FCA is currently consulting on proposed rules.

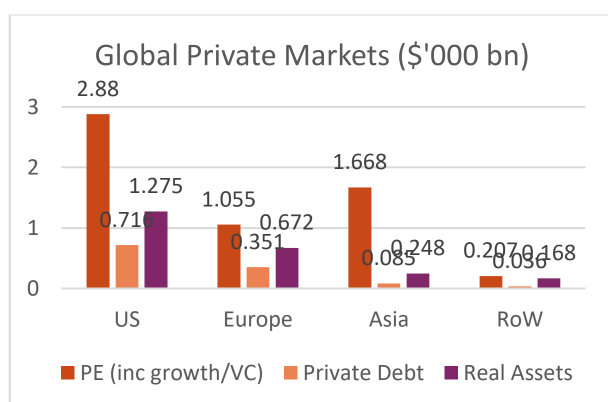
> *// Events…have further highlighted the need for appropriate regulation to help mitigate consumer, market integrity and financial stability risks. //*

Systemic risks to financial stability are also a concern. In January 2021, the Treasury consulted on proposals to establish a future regime on fiat-linked stablecoins used for payments, which includes a call for evidence on investment and wholesale uses of these technologies. Following that consultation, the Treasury also recently published a consultation on managing the failure of systemic digital settlement asset (DSA) firms, in which it proposes to extend the scope of existing legislation to "systemic DSA firms" (defined as "a payment system based on the use of stablecoin

and/or an operator of such a system or a DSA service provider of systemic importance") in order to address potential risks to financial stability that could result from the collapse of an issuer or service provider for a stablecoin that has reached "systemic scale". Events in cryptoassets markets "*[that] have further highlighted the need for appropriate regulation to help mitigate consumer, market integrity and financial stability risks*" were referenced - although specific examples such as the TerraUSD collapse were not named. The Treasury also proposes to extend the insolvency regime that applies to systemically important payment systems (the Financial Market Infrastructure Special Administration Regime) to systemic DSA firms.

8 'Retailisation'of private capital

Private capital (which encompasses a whole range of non-publicly traded assets including private debt, infrastructure, private equity and real estate) as an asset class has grown exponentially as investors seek higher returns away from public markets in what has been a prolonged period of low interest rates. Estimates put assets under management allocated to private capital as at 30 June 2021 at approximately US$9.8 trillion (McKinsey Global Private Markets Review, 2022).



Despite much more difficult market conditions in 2022, with rising inflation and interest rates and amid concerns relating to over-valuation of certain private asset classes, long term trends towards infrastructure, decarbonisation and digitisation means that many industry participants are still bullish about the case for increased investment in private and alternative markets. Indeed, growing demand for alternative investments continues to be a trend among individual investors - with retail investors certainly in the sights of many alternative asset managers and private fund sponsors.

New open-ended structures

One interesting feature of this "retailisation" trend is the growth of open-ended structures as a means to invest in these asset classes, especially in infrastructure. Notably, in the UK, the government has introduced a new open-ended vehicle for so-called "long term" or "patient" investments - the Long Term Asset Fund (LTAF) - in a bid to harness demand to encourage further investment in more illiquid assets, particularly infrastructure. The vehicle is based on the existing Non-UCITS Retail Schemes (NURS) structure but adapted to include certain characteristics. The view is that having an FCA authorised open-ended fund which invests in long-term assets should broaden choice to investors by widening the options available. This also feeds into initiatives to make the UK a more attractive and competitive regime for funds. However, the design of such structures is challenging - regulators have to grapple with a difficult balance between ensuring a suitable level of investor protection with affording sufficient flexibility in order for the structure to be a viable and credible vehicle for firms designing products for long term investments.

In this respect, the FCA have, when finalising its rules on LTAFs, worked with many stakeholders such as the Investment Association at consultation stage to address some of the criticisms levied against the initial LTAF proposals - including onerous obligations imposed on depositaries and external valuers with respect to the valuation of assets, and distribution rules (based on Qualifying Investment Scheme (QIS) rules) which were perceived as unduly restrictive. Depositaries are only required to determine that the manager has the resources and procedures for carrying out a valuation of the assets, and access was extended from just professional investors to sophisticated retail and high net worth individuals. Although an open-ended vehicle, redemptions will be no more often than monthly, with the rules also requiring the LTAF to have a minimum notice period for redemptions of at least 90 days. In practice it is expected that many LTAFs will have significantly longer notice periods.

The government's view is that the primary distribution market for the LTAF is defined contribution (DC) pension schemes. In tandem with this, the Productive Finance Working Group (comprising asset managers, insurers and trade

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associations) has made a series of recommendations to encourage a shift in mindset for DC scheme trustees and investment consultants from a sole focus on achieving the lowest costs of investment to generating better and more sustainable returns for investors in order to better facilitate investment in illiquid assets.

Suggestions considered in a November 2021 consultation paper include amendments to increase the DC charge cap (currently capped at 75 basis points) to accommodate asset classes such as private equity or private credit for which managers often charge higher fees and carried interest. The government published its response in 30 March 2022 in which it, recognising the mixed response among stakeholders on the proposals, notes that "any reforms should be careful but precise". The government is intending to consult further, including on principle-based draft guidance alongside any proposed consultation on draft regulations.

The FCA is also consulting on broadening retail access to LTAFs, which sets out a proposal to allow distribution to individuals who have undergone appropriateness assessments and who invest a maximum of 10% of their investable assets into LTAFs as part of a wider diversified investment portfolio. Despite high hopes, it remains to be seen whether the LTAF gains sufficient traction in the market. Commentators have noted that uptake (of its current iteration) has been muted – there being no LTAF products in the market at the moment. However, the broadening of access may encourage firms to launch products, although with the time lag relating to the introduction of any rule changes and the execution of any resulting fund launches, it will be a while before an assessment of the success or otherwise of these proposals, and more broadly, of LTAFs can be undertaken.

Europe is similarly keen to facilitate wider access to private markets and alternative investments. European Long-Term Investment Funds (ELTIFs) (a structure which was similarly meant to provide a collective investment framework allowing investors to invest into companies and projects that need long-term capital) have, to date, only met with very limited success. On recent estimates, there have only been 68 funds raising around €2.4 billion since 2015. However, reform is on the agenda to make it a much more usable vehicle in this respect. The European Council and Parliament finally reached political agreement on reforms to ELTIFs in October 2022, which have been warmly welcomed by industry associations.

The reform package will make it easier for retail investors to invest in ELTIFs, including no minimum subscription restrictions, permitting the establishment of ELTIF funds of funds and master-feeder structures, as well as broadening the scope of eligible assets to include, for example, fintech companies. A major appeal of ELTIFs is the availability of full passporting, so that the funds can be distributed on a cross-border basis across the EU to both professional and retail investors.

Making private capital investment more accessible carries its own risks: alternative asset managers used to offering products only to sophisticated institutional clients may need to be prepared for a major "cultural" shift if they do decide to target the retail market. Many would welcome the availability of such vehicles but broadening access would mean dealing with increased compliance burdens, and the challenge of managing higher enforcement and reputational risks.

9 Post-Brexit funds and broader regulatory regime

The UK government has not hidden its desire to position UK as a leading location for funds and the asset management industry post-Brexit as it seeks to ensure that UK retains its influence as a pre-eminent financial centre and to bolster its attractiveness now that it is outside of the EU regulatory ambit. Even as the government continues to consider its overall response to the wide-ranging UK funds regime review launched earlier in 2021, it has already taken a number of concrete steps towards the implementation of a more fund-friendly regime. The introduction of the LTAF structure (discussed above) is one; the proposals relating to asset holding companies (AHCs), which have been the subject of a number of earlier consultations, is another.

Asset holding companies

Numerous countries have committed to implementing the 15 Actions relating to base erosion and profit shifting (BEPS) practices, one effect of which is to make it more attractive to locate fund management activity and AHCs in the same place. In this context, given the scale of asset management activity currently in the UK, the proposals may help realise UK's potential as the location of choice for new AHCs. Currently, certain European jurisdictions – chiefly Luxembourg – have more favourable AHC regimes

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which better facilitate fund structures' objective of tax neutrality. The introduction of a new regime for qualifying asset holding companies (QAHC) in April 2022 is part of the government's efforts to redress this. The regime includes exemptions on gains from disposals of certain shares and overseas property by QAHCs; treatment of premiums paid on share repurchases from individuals as capital rather than income distributions; and certain entry and exit provisions, including the rebasing of certain assets when a company enters and exits the regime.

There has been anecdotal evidence that interest in the regime has been high although whether this does result in a substantial move of funds from their traditional Luxembourg, Irish or Channel Islands bases remains to be seen. Nonetheless, while the costs of moving existing fund structures may mean that few existing funds do in fact (at least initially) move, the hope is that going forward, the announced measures in the UK would increase UK's attraction as base both for funds and the industry servicing those funds.

There have also been calls to simplify the UK's archaic limited partnership legislative framework in order to facilitate the establishment of private funds in the UK, particularly given the growth in private equity and other private capital asset classes. Interestingly though, although modernisation of the limited partnership framework to make it more attractive is welcome, there are also competing pressures to make such partnership structures more transparent (note the recent introduction of the Economic Crime and Corporate Transparency Bill) given evidence that they are being (mis-)used to facilitate criminal activity, given that one attraction of such structures, particularly to private fund investors, is the relatively limited disclosures required.

The future regulatory framework

On a macro-level, the government published a further consultation in November 2021 (which closed in February this year) on the future UK regulatory framework for financial services, which also sets out its response to the previous October 2020 consultation. The proposals involve a wholesale reform of the framework, envisaging much greater responsibility on the FCA and PRA for setting detailed rules across the UK's financial services landscape, and the introduction of a new secondary growth and international competitiveness objective for both the PRA and the FCA. The direction is for UK regulators to be responsible for setting many of the regulatory requirements which were previously set by the EU, and much of retained EU financial services legislation to be repealed.

The proposals are now being implemented through the Financial Services and Markets Bill, which was introduced to Parliament in July 2022 and is currently going through the legislative process.

The FSMA regulation model will be largely retained - with the government retaining responsibility for overall policy approach while the PRA and FCA have responsibility for designing and implementing direct requirements that apply to regulated firms. As noted, EU retained law which are within scope of the regulators' rule-making powers under FSMA will be repealed and replaced with regulatory rules, although this is likely to be a process that will take several years. A new Designated Activities Regime will be established under which the regulators will be given additional powers to regulate certain activities – in the immediate term, these relate to those currently regulated under EU retained law, but this may change over time to cover new activities that emerge.

Overseas funds regime

In the meantime, the UK continues to show some pragmatism in permitting EU firms to market EU domiciled funds to UK investors - and ensuring UK investors have continued access to a full range of products - initially by putting in place the Temporary Marketing Permission Regime (TMPR). This regime allows such funds to be marketed in the UK on the same basis as they were prior to UK's exit from the EU.

Given the sheer number of funds (estimated at more than 8000) under the TMPR regime, it would always be difficult for the FCA to deal with individual applications for recognition under the current section 272 FSMA process once the TMPR expires. Although the TMPR was extended to the end of December 2025, the government has since legislated for the introduction of the Overseas Funds Regime (OFR), which will allow certain categories of approved non-UK CIS to be marketed in the UK, including to retail investors. Certain steps still need to be taken before the OFR regime is functional:

- HM Treasury must grant an equivalence determination in respect of the fund's home jurisdiction. This will be done on a jurisdiction-by-jurisdiction basis - although

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there is some indication that they may grant equivalence to UCITS on an EU-wide basis. The decision will based on "outcomes-based equivalence" in rules and supervision, rather than necessarily identical rules.

- the operator of the overseas retail fund will need to register with the FCA to become "recognised" under the OFR once equivalence is granted. This is meant to be a fairly straightforward process, as the FCA will be able to rely upon "self-certification" by the funds that they are eligible for recognition. The FCA will be entitled to ask for evidence of funds' authorisation in their home jurisdiction.

However, the timeframe for implementation remains uncertain as no equivalence decision has been made to date. The FCA has not given any timeline for implementation apart from stating that it is still "working on operationalising the OFR". It also intends to consult on various amendments to the FCA Handbook to ensure OFR funds are appropriately captured.

EU developments

On the EU side, after a long review period, the European Commission has finally published its proposed amendments (AIFMD II) to the Alternative Investment Fund Managers Directive. The overall changes are relatively limited, but some proposals may have significant impact on firms' business models – in particular, and as expected, in relation to delegation. The EU's concern surrounding the ("over")use of delegation is well known and is seeking to require EU regulators to scrutinise delegation arrangements and to report to ESMA on an annual basis. ESMA will then be required to report to EU institutions every two years on developing market practice and to conduct peer reviews of measures taken by national regulators to prevent firms becoming "letter-box" entities. Delegation arrangements, which the UK asset management industry relies heavily upon, would undoubtedly be subject to intense scrutiny. The European Council has since agreed its position on these proposals, which includes the introduction of new reporting requirements on delegation arrangements.

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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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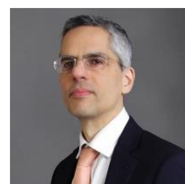

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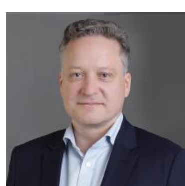

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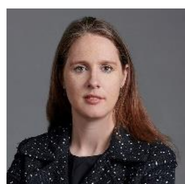

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