5 July 2018

Karen Northey
Financial Conduct Authority
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Canary Wharf
London
E14 5HS

CFA UK response to the FCA regarding CP18/9: Consultation on Further Remedies – Asset Management Market Study

Dear Ms. Northey,

The CFA Society of the UK (CFA UK) is delighted to have the opportunity to share its views on the FCA's Consultation on further remedies proposed following the Asset Management Market Study. CFA UK welcomes opportunities to scrutinise initiatives that aim to raise professional standards in the investment industry. Please see in Appendix 1 CFA UK's previous responses to the FCA's consultations.

We would draw attention to the work of CFA Institute on ensuring the highest standards in our profession. *The Code of Ethics and Standards of Professional Conduct ("Code and Standards"*[1]) are the ethical benchmark for investment professionals around the globe. If you are a CFA Institute member or CFA Program candidate, you are required to follow the Code and Standards. This requirement demonstrates the importance with which we regard ethical behaviour in the investment industry.

Your Consultation focuses on the specific area of investment reporting. We believe this is paramount for ensuring trust in our industry. Without the right information at our fingertips, we are all blind. To this end, CFA Institute created *GIPS* (Global Investment Performance Standards[2]) over three decades ago. We then added the *Principles For Investment Reporting*[3] four years ago. These standards were designed precisely to ensure clear and consistent communications between the preparers (e.g. AFMs) and users (e.g. investors) of investment reports.

We look forward to the results of your Consultation as we work with regulators such as yourselves across the world in order to rebuild and maintain the hard-earned but systemically-paramount trust in the investment profession.

About CFA UK & the CFA Institute

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[1] https://www.cfainstitute.org/en/ethics/codes/about-code-of-ethics-and-standards
[2] https://www.gipsstandards.org/Pages/index.aspx
[3] https://www.gipsstandards.org/utility/pages/search_results.aspx?k=principles%20of%20investor%20reporting&s=GIPS

CFA UK: serves nearly 12,000 leading members of the UK investment profession.

- Its mission is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute: is the global association for investment professionals.

- Its mission is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.
- It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.
- CFA Institute has more than 155,000 members in 159 countries, of which more than 148,000 hold the Chartered Financial Analyst (CFA) designation.

<u>EXECUTIVE SUMMARY</u>

There will always be a dialogue between the preparers of information and its users. Either party can have a quite different understanding of technical reporting concepts, particularly in a more complex world that incorporates derivatives and structured products. This creates opportunities for unethical behaviour to sneak into the process. Our profession must therefore endeavour to ensure its reporting is as clear as possible to all sides of the dialogue.

Our Principles are clear that firms '*include sufficient information (or indicate where the information can be readily obtained) so that the recipient understands the contents of the report and the reasons behind the selection presented'.*

To achieve this goal, we must also be prepared to be flexible. We do not want '*to restrict or define which elements should be in a report*'.

There is a natural tension between guiding principles and specific rules, but we must incorporate both. Too much leeway and the system becomes prey to pernicious forces. Too little and the profession becomes hamstrung and unable to deliver its ultimate objective of value for stakeholders.

In our responses we have therefore looked to strike what we feel is the correct balance. We refer to our Code and Standards, as well as our Principles of Investment Reporting, to provide our guiding light.

MAIN RESPONSE

Q1. Do you agree with our draft guidance on fund objectives?

We agree with the overall principles laid out in the draft non-handbook guidance on the description of fund objectives and investment policies. For the most part, we are satisfied that the guidance is consistent with the CFA Institute Code of Ethics and Standards of Professional Conduct, specifically section B:

B. Communication with Clients and Prospective Clients. Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
2. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
4. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

The categorisation between long-form, short-form and marketing communications is logical and represents the different levels and types of information available to an investor.

We agree that fair, clear and not misleading is a sound overarching principle for marketing communication which is consistent with the CFA Code and Standards.

We note that the expectation for the required language of the UCITS prescribed Key Investor Information Document is to be clear, succinct and comprehensible. We agree that these aims are appropriate for the intended retail audience, but would caution there are challenges in meeting them:

1. Being concise while also meeting the requirement to include the investment strategy, particularly when the strategy contains complex elements;
2. Translating the document into other languages while maintaining adherence to rules on font size and page length

In order to maintain the concise element, we suggest emphasising what the investment objective is and the outcome an investor can expect to receive if that objective is achieved. As a result, we think there should be relatively less focus on the detailed specifics of how this objective will be achieved. Rather this can be summarised with reference to terms a lay person may more easily understand, perhaps with reference to the investment style, e.g. active vs passive, small cap vs large cap, and investment grade versus non-investment grade. We suggest that a greater level of detail would instead be best suited to a factsheet where the fund manager has more flexibility to explain and illustrate any strategy, with reference to market commentary and any tools available which will vary significantly across the market place and will change from time to time.

We agree that consistent language need not mean identical, but suggest that some flexibility is permitted as some promoters may use the same wording where appropriate to provide a simpler and more scalable disclosure process.

We agree with the guidance on Non-financial objectives. We would add that if any Non-financial objectives can't be easily assessed, firms should be prompted to provide an explanation of why this is the case.

Q2. <u>Do you agree that we should introduce a 'requirement to explain' with regard to AFMs' use of benchmarks?</u>

We agree that informing investors why specific benchmarks have been used could better inform their understanding and assist in an assessment of a fund's ability meet its objective. Disclosure on why a benchmark has been chosen and the type of benchmark it is should be made clearly and unambiguously.

While we agree that it's important to display performance data in relation to each target benchmark and constraining benchmark, we fear that this could prove confusing when it comes to the strict performance reporting requirements of prescribed documents. For example, requiring the graphical display of two benchmarks plus the fund's performance as calendar returns could end up obfuscating more for investors than it reveals. We would recommend that fund managers maintain an ability to elect which performance metrics are disclosed so long as the principles of a clear and fair comparison are adhered to.

Below a few observations of detail:

- Benchmark Differentiation: The proposed differentiation of different types of benchmarks for different purposes is useful. We applaud their categorisation into target benchmark, constraining benchmark or comparator benchmark. A constraining benchmark in particular, is in line with the CFA Standards of Professional Conduct, notably V.B.2.: to *'disclose to clients significant limitations and risks associated with the investment process'*.

- Multiple Benchmark Scenarios: It is welcome that the guidelines seek to recognise there are situations where more than one benchmark could be used for different investor groups. We would caution that in some instances displaying the performance of a large number of benchmarks could be confusing for investors as it could lead to decreased visibility of information.

- No Applicable Benchmark Scenarios: Where no benchmark is referred to, one potential explanation could be that there is no relevant benchmark index or comparator data set available. In this instance we would propose that absolute performance is referenced as an acceptable alternative as assessing performance on a relative basis could be misleading for investors. This could also apply where the objective of the fund is for performance to be achieved on an absolute basis.

- Best/Poor Practice examples: It would be useful for AFMs if the regulator could provide further examples of best practice and poor practice regarding explanations considered acceptable, thereby demonstrating what the 'requirement to explain' would look like.

- Intermediaries: We would like to draw attention to where benchmarks are displayed outside of the Prospectus and marketing documentation issued by the AFM, namely on platforms, data hosting websites, and other intermediated services. Often the AFM does not control which benchmark information reaches the end investor on these portals. Platforms may elect to use different performance benchmarks such as Sectors or Peer Groups compared to those published by the AFM. This inconsistency could bewilder investors when comparing against literature from the AFM, but could provide greater comparability when looking and products held on the same platform. These aspects should be considered as part of a Platform Market Study.

- Future proofing: Looking forward, we are conscious that the PRIIPS Key Information Document (KID) will supersede the existing UCITS KIID and so ask that any proposed changes to required KIID disclosures are taken in the context of this forthcoming change. In addition we would prompt regulators to review and consider whether the KIID is achieving its objective of clearly explaining the fund investment objective to the investor. We feel there is still room for improvement in how effectively the KIID does this, and in many respects the KIID sets the investor's' disclosure.

- Composite Benchmarks: We ask that the use of composite benchmarks is considered with regards to any handbook changes. Explaining each component of a composite benchmark could lead to additional unnecessary complexity. We suggest that the requirement to explain is specifically referenced to the overall benchmark, rather than any specific components.

- 'Soft-coded' Benchmarks: With regards to benchmark constraints, we suggest guidance is clarified to specify which types of constraints would apply. In order to manage risk, soft-coded constraints can be applied by fund managers[4] in order to flag when certain parameters or metrics are breached/ outside of tolerance. As these usually contain an ability to be overridden by the fund manager, these might not be applicable depending on certain marketing conditions. Our recommendation would be that only 'hard-coded' investment restriction constraints that can't be overruled by the fund manager would be relevant. These would be outside of the hard-coded limits imposed due to regulatory requirements such as UCITS.

Q3. <u>Do you agree that we should introduce rules and guidance to require consistency in references to benchmarks across the same fund's documentation?</u>

We agree that consistency with reference to the same benchmark should certainly be aimed for as best practice. We agree that it should become impossible for a comparator benchmark to change between

[4] Fund Managers refers to those running portfolios within an AFM

different pieces of documentation, in order to prevent more favourable comparisons being drawn with hindsight.

As per our response to Q2, we would however caution that specific rules and guidance may not be possible to meet under all circumstances, such as:

1. no relevant benchmark is available or where a benchmark used in the past ceases to be available;
2. benchmarks appear in documentation that is not controlled by the AFM;
3. fund documentation is too concise to allow for further benchmark detail or for the inclusion of several benchmarks.

We believe the draft text in Annex B is sufficient with regard to communication by the AFM, but would highlight that it does not prevent inconsistency with regard to communications produced by other providers. Investors receive information from many platforms, not just the AFM and its authorised documentation.

Annex B makes an exception for AFMs whereby a benchmark is referenced in "interactive" communications. We understand the need for flexibility, but would refer to Principle 1 of CFA Institute's "Principles of Investment Reporting", which emphasises that "interactive" communications between the AFM and potential investors '*should make sure the user has adequate information to understand why the information is being presented and what it conveys*'. It must be '*presented in a full and fair manner so that the user can make an unbiased, informed choice*'. Applying this principle to "interactive" communications should ensure that they cannot be used as a loophole method through which misleading comparator benchmarks could be used inconsistently.

Q4: Do you agree that we should introduce rules and guidance on which benchmarks should be displayed against a fund's past performance, where past performance is shown?

We agree that some guidance should be in place to select which benchmarks should be displayed against a fund's past performance. This can include a requirement to explain why a particular benchmark is selected. As the CFA Code and Standards highlights as part of Standard 1C *'When a benchmark is used... make reasonable efforts to ensure that they disclose the reasons behind the use of this reference index to avoid misrepresentation of their performance'.*

We believe that the same benchmark should be used consistently across all disclosure documents for that particular fund. There should be no discrepancies between various kinds of disclosure documents e.g. KIID and Prospectus and marketing documentation issued by the AFM. This can be further enhanced by some form of standardisation in a reader-friendly format. It may be prudent for certain types of funds also to include absolute return benchmarks in addition to relative benchmarks for transparent disclosure purposes.

We aim to strike a balance between specific rules and guiding principles, and therefore we argue that there should be some flexibility to allow for a change in the benchmark, in appropriate circumstances.

However, we are not of the view that benchmarks should be able to be changed retrospectively, to be compared against historic performance data, only prospectively where appropriate. Some examples include cessation of comparable indices or extreme structural market stress like the Global Financial Crisis. This may even lead to the changing of investment objectives in some cases. Notwithstanding, there should be some control parameters around this requirement to ensure this is not used as a loophole to lower benchmarks for past performance. This could be an area for the FCA to consider for future detailed consultation.

In case a benchmark is changed, the AFM needs to explain the background and rational for this change. CFA GIPS standards 4.A.30 provides the following guidance: '*If the firm changes the benchmark, the firm must disclose the date of, description of, and reason for the change*'. Similarly, the first sub-bullet of the fourth Principle (Clear and transparent presentation of investment risks and results) in the *Principles for Investment Reporting* reiterates the notion that for effective investment reporting, historical information presented in the investment report should not change without disclosure to the user.

In some cases, a transition period may be necessary to cover a change in regime. A good example is the end of LIBOR as a reference rate. As global markets move away from LIBOR to SOFR and other funding rates, a reasonable period of transition is needed to manage this complex change.

Q5: Do you agree that we should remove the possibility that performance fees could be taken on gross performance?

We agree that performance fees must be viewed as a level playing field. All must be regarded on the same basis. The eye can be drawn to the number of the fee, rather than how it is calculated. This is misleading and can only be corrected by removing the possibility of it being taken on gross performance. According to CFA UK research paper titled "Fees and Compensation", "*CFA UK believes that clients need to have a complete picture of the fees and charges apply to their portfolios or segregated accounts."*

We believe that performance fees should only be applied on the true performance received by the client net of all fees, including any performance related fee[5], given that the following criteria are satisfied:

1. Clarification over the time period for the calculation. The factsheet and prospectus of the fund must ensure the time period is specified, as the CFA UK society explained in our *"Response to consultation paper 17/18: Consultation of implementing the asset management market studies remedies and changes to Handbook*".
2. Clarification over what the performance fee is measuring. Fees can be broken down into two types: management fees (raised for the investment and the reporting of assets) and performance fees (based upon pre-agreed return targets. *"CFA UK believes that the fee and compensation structures should be transparent and aligned with clients' interests. Whereas transparency is relatively easy to achieve in relation to management fees and it is relatively simple to make a case that different management fees structures are aligned with clients' interests, both are harder to achieve in relation to performance fees."*

[5] See CFA UK Paper "Fees: The Cost of Investing" (December 2015) https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/3-research-and-position-papers/fees.pdf

3. Agreement between clients and investment firms on a simple structure for performance fees which use appropriate benchmarks, hurdle rates, and which can be assessed over appropriate periods. *"By taking into account performance, charges and risk, a client has transparency about the quality of the returns they receive, the fees they pay and the value provided by their investment professional. By taking this three-dimensional approach we can move on from the current focus on fees and charges alone (which ignores value entirely), can move beyond the comparison of fees and charges to headline performance (that misrepresent value) and can arrive at a position where value is correctly identified and appropriately compensated"*. The most common model for hedge funds is the straightforward "2% and 20%". Under that model, the fund manager is paid a base fee of 2% and a performance fee of 20% of the return. The performance fee should relate to the true net return (net of the 2% management fee and the 20% performance fee – and so requiring an iterative calculation) above a pre-determined hurdle rate.Our Principles of Investment Reporting recommends that "Comprehensive Fee Disclosure" includes: 'Fees that are being accrued, an indicator of fees that will be incurred upon researching targets, and the current position of the relevant assets relative to these targets'.

By way of additional context, we thought it helpful to highlight some industry data on the extent of the use of performance fees. According to an Investment Association study 'Investment costs and performance'[6], performance fees apply mostly to institutional clients and not retail funds and have generally become less prominent across the industry. Nevertheless, in their further study 'Asset Management in the UK 2016-2017: The Investment Association Annual Survey, September 2017'[7], 80% of respondents reported that they used performance fees, in line with the average of recent years. However, just under one fifth of respondents reported that performance fees were becoming less prevalent to their business as the assets managed according to this fee type fell to around 10% of the total.

Finally, risk tolerance should be a major consideration for the calculation of performance fees and clients should be given the information to understand and determine their own needs. We refer to CFA UK's paper on "Benchmarks and Indices"[8] which highlights that '*While benchmarks play an important role for asset owners and investors, it should be accepted that none is likely to be a perfect match for a client*'.

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6 https://www.theinvestmentassociation.org/assets/files/press/2016/IAInvestmentCostsPerformance.pdf
7 https://www.theinvestmentassociation.org/assets/files/research/2017/20170914-ams2017.pdf
8 https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/3-research-and-position-papers/benchmarks-and-indices.pdf

CONCLUSION

We believe that our Code and Standards, GIPS and Principles of Investment Reporting provide guidance for best practice. The desired outcome for using Benchmarks well is '*where the right indices (built, governed and operated correctly) are selected to form the most relevant benchmarks (through effective selection processes) and are used appropriately by investment managers and their clients'*.

We strive to achieve a balance between the imposition of specific rules which remove loopholes and guide practice and the maintenance of the flexibility necessary to enable our profession to meet its clients' needs. We are pleased to have been able to contribute to the work of the FCA in its Asset Management Market Study and we look forward to the implemented changes as a result of this Consultation Paper.

Yours sincerely,

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With thanks to contributions from:

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Appendix 1: Previous Related CFA UK Publications:

Previous CFA UK consultation responses to FCA on the Asset Management Market Study:

- Response to FCA Consultation Paper 17/18 (Oct 2017): Consultation on implementing the Asset Management Market Study remedies and changes to Handbook

https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-fca-consultation-paper-1718.pdf?la=en

- Response to FCA Market Study 15/2.2 Asset Management Market Study, Interim Report (Feb 2017)

https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-ms15-22.pdf?la=en

- Response to FCA Asset Management Market Study (Jan 2016):

https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/letters/2016/1-january/theassetmanagermarketstudy.pdf?la=en