

An aerial photograph of London, England, showing a dense urban landscape. In the foreground on the right, the distinctive, curved, glass-clad facade of the Gherkin skyscraper is prominent. The city extends to the River Thames, where the Tower Bridge is visible in the distance. The sky is clear and bright, suggesting a sunny day.

IIMI

Independent
Investment Management
Initiative

Simplifying the UK fund regime for boutiques: A response to the FCA consultation

May 2023

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Executive Summary

Since the UK voted to leave the EU, the Independent Investment Management Initiative (IIMI) has been making the case for the UK to adopt its own globally competitive asset management regime. In February 2023, the UK Financial Conduct Authority (FCA) released its latest discussion paper (DP 23/2) – “Updating and Improving the UK Regime for Asset Management” – as part of the so-called Edinburgh Reforms, a Government initiative designed to stimulate growth and competitiveness in the UK’s financial services industry post-Brexit.

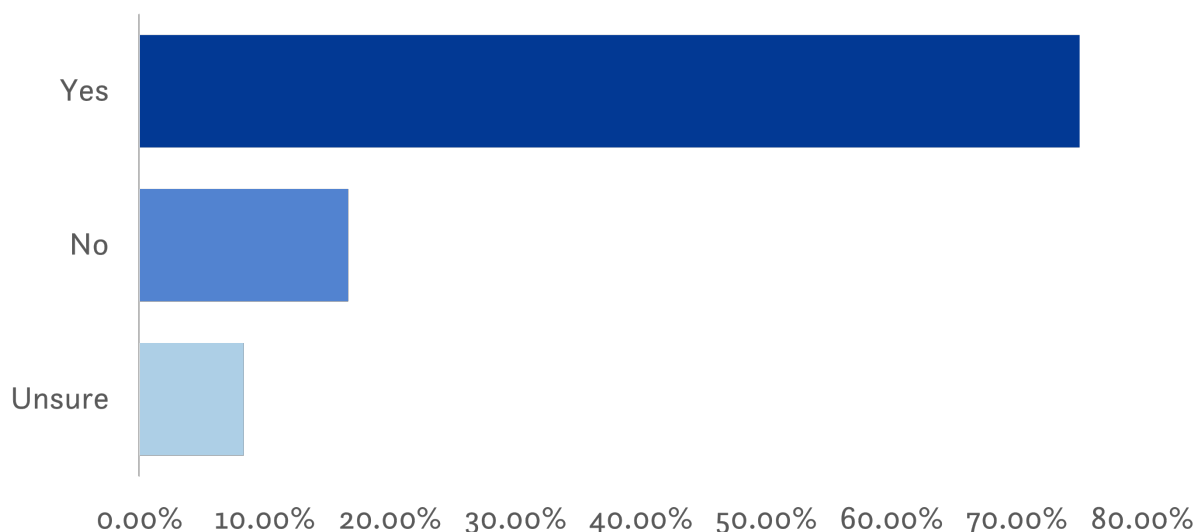
Under the UK’s Financial Services and Markets Bill (FSMB), the UK Government will be given extensive powers to overhaul, amend or retain EU regulations as it applies to financial services, including asset management. The IIMI looks at the latest FCA discussion paper, and shares its insights on some of the proposals. As part of this white paper, the IIMI spoke extensively with its diverse membership of boutique asset managers, along with a number of external law firms and consultants.

Simplification of existing rules should be actively encouraged, but caveats remain

Right now, asset managers in the UK are currently subject to a multitude of different rules, including UCITS, the Markets in Financial Instruments Directive (MiFID) and the Alternative Investment Fund Managers Directive (AIFMD), the contents of which are sometimes duplicative. This inconsistency and duplication often creates added costs for the industry, which are shouldered disproportionately by boutique investment firms.

Although the FCA is not proposing that AIFMD, MiFID and UCITS be merged into a single piece of regulation, it suggests a degree of consolidation could help streamline the rules for asset managers, and simplify their compliance obligations. A survey of COOs and CCOs from the IIMI's diverse membership found that 75% of respondents would be supportive of some sort of consolidation between MiFID, UCITS and AIFMD.

Would you support a degree of consolidation between MiFID, UCITS and AIFMD?



One expert said there is a lot of overlap between UCITS, AIFMD and MiFID in areas such as conflicts of interest, regulatory capital requirements and best execution. He continued that with the UK no longer a member of the EU, it would make sense to eventually harmonise the rules for asset managers into a single regulatory framework. “There is a lot of unnecessary duplication in these rules, which creates confusion,” said the expert.

Some IIMI members are less convinced by the merits of amending EU rules, warning it could lead to regulatory arbitrage between the UK and EU at a time when industry costs are rising exponentially. An IIMI member said excessive deviation from EU rules by the UK would also increase the costs for UK boutiques, who distribute products both domestically and into the EU.

“Most small and mid-sized asset management firms do not have separately staffed offices or separate suites of commingled funds that are intended to service the UK and EU markets. Instead, they combine both markets,” said the IIMI member.

There are also concerns that modifications to existing EU rules could undermine the UK’s efforts to obtain equivalence from the EU on financial services, including fund management. “The UK might be taking a view that it does not want to deviate too much from EU rules, as it could affect the country’s chances of obtaining equivalence in the future,” said Leonard Ng, a partner at Sidley Austin. Any substantive revisions by the FCA to existing EU rules ought to be carefully considered.

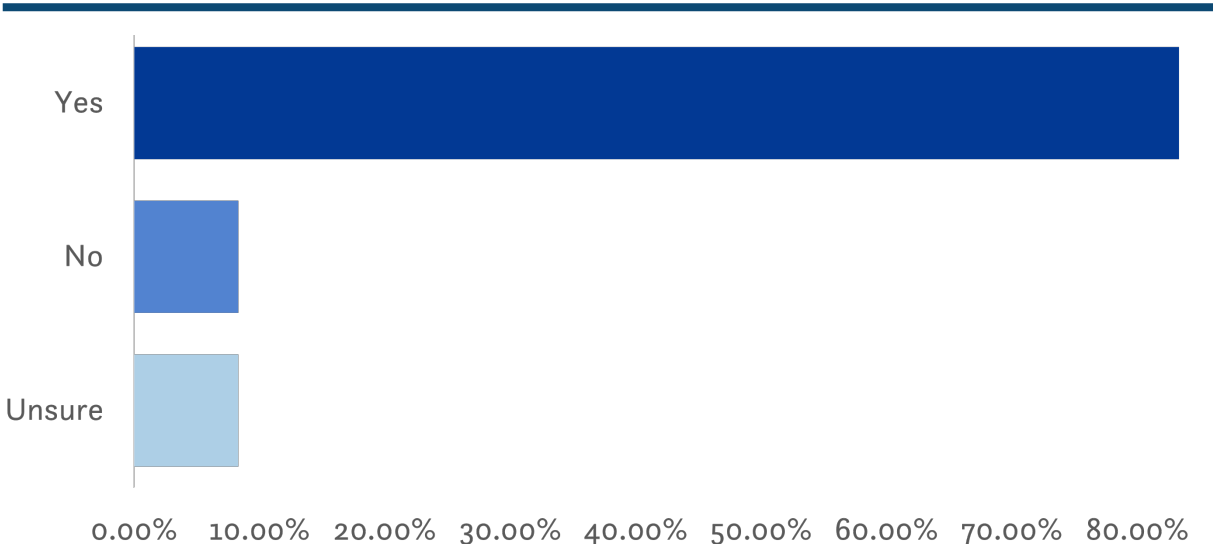
Easing the regulatory burden on boutiques

While the FCA has emphasised that it does not intend to dramatically alter the rules for AIFMD, it is open to the idea of amending some of the provisions, as it relates to managers investing on behalf of professional institutions. One approach, according to the FCA, would be to adjust the size threshold at which firms are subject to the full scope of AIFMD.

“Raising the AUM threshold for which fund managers are subject to full compliance with AIFMD could help stimulate growth and innovation among smaller managers. It may enable some start-ups to test the water for investor appetite without being subject to the full scope of AIFMD. Launch activity has been fairly limited because the barriers to entry are high. Tweaking the AUM thresholds for AIFMD could help remedy that.”
- Leonard Ng

However, the FCA also discussed an alternative option, where it would “allow firms that meet criteria other than their size to use the small authorised AIFM exemption. For example, this could relate to the types or strategies of AIF they manage, or the types of client they have.” In the case of the latter, firms looking after only institutional mandates could potentially be subject to fewer requirements versus those managing retail money. This suggestion appears to be more popular among the IIMI membership, with 83% of respondents supporting the idea.

Do you think managers running only institutional money should be subject to lighter touch AIFMD compliance requirements?





Building a stronger regime

The role of service providers was also referenced in the FCA's consultation

Fund depositaries – namely entities entrusted with ensuring that client assets are protected and which are subject to strict liability provisions should those assets go missing or be misappropriated in the custody chain, were admonished by the FCA for not always intervening or challenging managers when they should be. Depositaries – when AIFMD was first introduced – were seen as a highly effective investor protection mechanism, especially following the financial crisis and Bernard Madoff fraud. That the FCA believes depositaries are not fulfilling these responsibilities is a cause for concern.

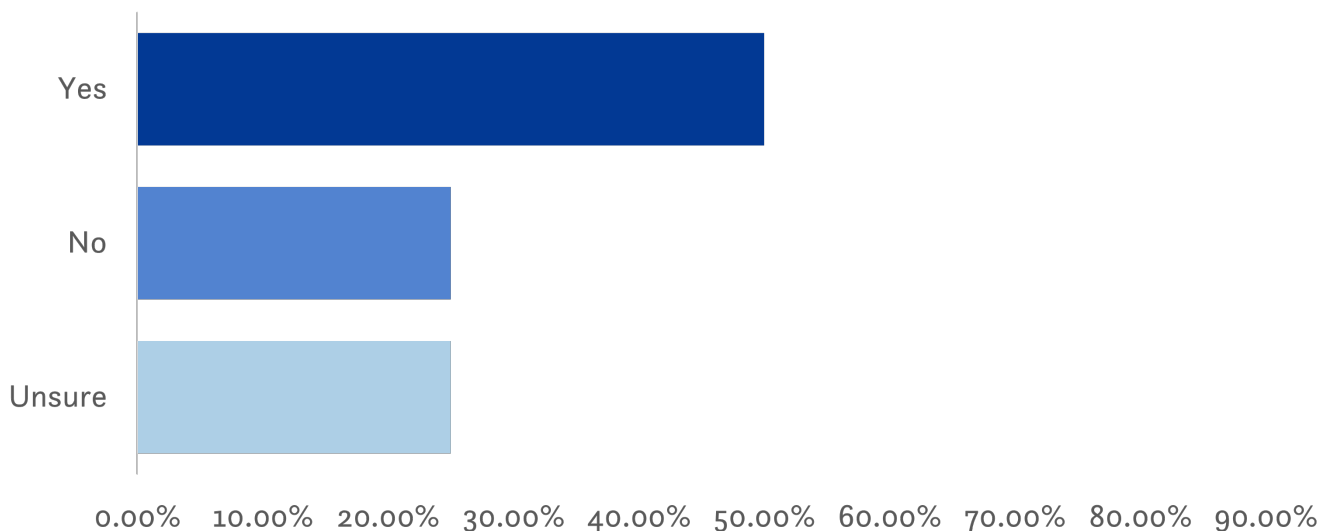
In response, the FCA intends to clarify in detail what it expects from depositaries when dealing with recalcitrant managers.

“One of the takeaways we can infer from the FCA's comments is that the regulator does not intend to relax depositary, but rather tighten up the rules around oversight. I believe depositaries have played a positive role in improving fund governance and safeguarding investors, so reinforcement of standards is something that should be welcomed,”

- Industry Expert

Despite this, IIMI members appear to broadly believe that depositaries are fulfilling their obligations, with 50% saying their depositary did an adequate job as it related to fund oversight, versus 25% who said the opposite.

Do you believe your depositary does an adequate job in terms of fund oversight?



Elsewhere, the UK has said that it wants firms to improve their liquidity risk management processes and investment due diligence as it relates to illiquid or complex securities. In the case of the former, the FCA said it intends to incorporate the European Securities and Market Authority’s (ESMA) stress testing guidelines into its handbook, before adding: “We are also considering removing or significantly restricting the limitation around liquidity stress testing in COLL 6.12.11R(2), so that the qualification ‘where appropriate’ does not give fund managers a reason not to carry out stress tests.”

The FCA continued that it had seen shortcomings in due diligences by fund managers on some of their investments into complex or illiquid securities, which have occasionally resulted in clients incurring losses. Law firm Linklaters noted: “Whilst the FCA does not intend to create complicated or onerous restrictions in this area, it thinks there could be benefits from having clearer standards that apply to all asset managers.” Efforts to strengthen liquidity risk management and due diligence practices – especially following recent liquidity crises – should be fully supported.

Fund modernisation - What needs to happen

Innovation is an area which the FCA discussion paper focused on too. For instance, the FCA asked for feedback on both fund tokenisation and tokenising the underlying portfolio assets, and the type of regulation needed for the market to grow. Interest in tokenisation among the IIMI's membership is mixed, but this is mainly because our members sell only to institutions, where tokenisation is not relevant.

However, the IIMI fully recognises the funds industry is struggling to attract a newer generation of retail investors. It is also aware that young people are enthusiastic about investing, as evidenced by the surge in day trading and pivot into crypto-assets. Adoption of tokenisation by the industry could help fund managers target younger investors more effectively.

Nonetheless, appetite for tokenisation among the IIMI members is limited. A recent IIMI survey found 33% of members thought tokenisation would become more popular, while over 50% expressed uncertainty about its prospects. Furthermore, 63% of respondents said they had no interest in tokenising their funds even if it does make them more attractive to retail, whereas only 4% said they would tokenise their funds. Although tokenisation may not be particularly relevant for the IIMI members, the technology could be useful for more retail-focused managers, who are looking to win inflows from younger investors.

Next Steps

The FCA's consultation contains a number of interesting initiatives. The IIMI is broadly supportive of these, and will engage closely with the regulators during the consultation stages. However, several IIMI members said that more work needs to be done to develop a UK funds regime. "I would like the UK to come out and establish its own UK UCITS brand," said one member.

If the UK is to become a truly competitive funds centre, then it will need to make some substantive changes to its taxation regime.

One asset manager urged the UK to replicate what Ireland and Luxembourg have done by establishing a tax transparent fund structure. "Where UK funds have fallen short is around tax transparency. While it is straightforward for a UK investor to invest in a domestic fund, it is more complicated for international investors. This is something which needs to change if the UK is to compete with Ireland and Luxembourg, although I am conscious such a move would be a political hot potato," commented the asset manager.

Were the UK to create a successful tax transparent fund product, it could lead to the development of a robust, domestic asset servicing industry - an outcome which would have a very positive impact on job creation.

Key Recommendations

While consolidation of fund regulations such as UCITS, AIFMD and MiFID could simplify compliance processes for investment firms in the UK, the IIMI believes it is critical that the rules do not diverge too much from the EU, as it will add to managers' compliance burden.

The IIMI supports the idea of easing some of the AUM/investor thresholds for full scope compliance with AIFMD as this will help facilitate cost benefits for boutique managers at a time when their overheads are rising.

Improving practices around liquidity risk management and encouraging modernisation of fund operations should be actively encouraged.

While all of the FCA's proposals in its discussion paper are very interesting, the best way for the country to compete with leading EU fund jurisdictions – such as Ireland and Luxembourg - would be to establish a tax transparent fund structure.

About IIMI

The Independent Investment Management Initiative (IIMI) is a member-led industry think tank representing specialist, entrepreneurial investment boutiques that are entirely focused on and aligned with the interests of their investors.

Founded in 2010¹, the IIMI counts amongst its 40 members some of the world's leading specialist asset management firms, overseeing c. \$500bn in client assets and representing c. 2,000 members of staff. Over the past two decades, as the financial services industry has been dominated by global giants, an increasing appreciation of a traditional 'client-centric' approach has enabled entrepreneurial firms in the UK and beyond to emerge as a growing competitive force. The IIMI offers these firms an expert voice in the debate over best practice and the future of financial regulation, with the aim of building a better future for smaller and independent asset managers that prioritise specialism over scale in delivering the best results to clients.

About the Author

Charles Gubert is a consultant to IIMI and Head of Regulation. He is founder of GTL Associates, a research, copy-writing and marketing consultancy to financial services institutions, and a contributing editor at Global Custodian Magazine. Prior to this, he was a research manager at Thomas Murray IDS, a consultancy and editor at COOConnect, an online title aimed at chief operating officers at alternative and long-only fund managers. He started his career as a reporter at Risk Magazine and Hedge Funds Review.

¹ Originally incorporated as the New City Initiative, the IIMI rebranded in 2021.

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