Thoughts on the FCA's fund fee transparency proposals

9 January 2018

Any comments or queries?

James Kaufmann
Legal Director
+44 20 3060 6465
james.kaufmann@rpc.co.uk

Executive summary

The FCA's Final Report from its Asset Management Market Study sets out proposals regarding transparency of fees and charges. One such proposal is a standardised cost and fee disclosure, which is expected to be applied to alternative investment strategies (including hedge and private equity funds). Templates are expected by 31 July 2018 at the latest. In the meantime, there are some areas worth considering by asset managers to help frame thinking as and when the new regimen is unveiled by the FCA:

PERFORMANCE FEES

- How would these be accommodated in to any template?
- Is it even correct to do so?

OTHER VARIABLE COSTS

- How will these be calculated/estimated in any template?
- What will be the agreed/standard assumptions?
- And, conversely, how would any stock-lending profits be treated?

FUNDS WITH LESS THAN 12 MONTHS' TRACK RECORD

- Will there be no disclosure for such funds?
- Or estimated disclosure?

NON-UK FUNDS

- Will these enjoy a competitive (dis)advantage if disclosure rules differ across jurisdictions?

Background

One new measure being introduced following the Final Report is a standardised cost and fee disclosure template, which the FCA convened the Institutional Disclosure Working Group to produce. The Group first met on 18 September 2017 with the intention of setting out an agreed "mainstream" disclosure template by 24 December 2017, and an "alternative" disclosure template(s) by 31 July 2018.

The scope of the fund fee transparency proposals is unclear. Some commentators suggest that the provisions only relate to managers/ACDs of UK authorised funds. Others consider that the provisions apply (or can be expected to apply) to the broader investment and alternative investment management sector in the UK, including hedge and private equity funds.

What seems clear at this time is that the Group expect their output to apply to all alternative investment strategies, including hedge and private equity funds. This seems to be a departure from the remit of the Study (which gave rise to the Group), but the Group's membership includes representatives of both industries and minutes of their meetings from November and December 2017 indicate their thinking in this regard.

Whilst the Study's Terms of Reference indicate private equity funds are expressly out of scope (and by inference we consider private equity real estate funds to be out of scope as well), the Interim Report states that the Study's focus is funds and segregated mandates managed in the UK and/or provided and marketed to UK investors. However, whether directly applicable in the near term to all FCA authorised investment managers or not, we consider these proposals are a clear indicator to the industry as a whole of the "direction of travel". As such, the proposals certainly merit time and consideration to assess how to be well positioned on fund fee transparency.

The templates

According to their Terms of Reference, the Group considers that the calculation of a single overall total fund cost must include all costs that may impact the value of a fund's assets to the ultimate beneficial owner (i.e. investors, as opposed to the manager).

This view was underlined in the critical comments made by the Chairman of the Group, Dr Christopher Sier, toward the "Standardised Total Expenses Ratio" approach generated by the Standards Board for Alternative Investments (formerly, the Hedge Fund Standards Board). This view is also reinforced by looking at the existing Local Government Pension Scheme disclosure template, devised in collaboration with Dr Sier, which was positively cited by the FCA in its Final Report.

In light of the above, it seems logical to look at the LGPS template for clues of the Group's (and ultimately the FCA's) thinking on this topic.

Food for thought

The LGPS template includes performance fees (although as a percentage of total AUM, not allowing for any application only to performance beyond a high water mark and/or hurdle). The LGPS template also includes stock-lending fees and anti-dilution costs. Clearly, all such costs are conditional, and will fluctuate in line with the performance and activity of the fund in question.

In relation to performance fees, even if it may be possible to engineer a way to present a single performance fee methodology in a template, it remains the case that (whilst management fees are generally applied to a portfolio's assets as a whole) performance fees are only applied to the proportion of a portfolio's assets that have outperformed a specific threshold. Thus, any template that seeks to capture performance fees within a fund's total cost of ownership to the investor must assume that the fund is outperforming to a degree. But, how should such outperformance be measured and expressed? And, if the template seeks to draw on performance fees paid for the last, say, 12 months, it must be evident that such fees would likely not be payable again in the same amount over such period.

There is also the question of whether performance fees are "fees" in the same sense as, say, management fees. If a performance fee is only charged upon outperformance, is it actually a cost to the fund (or investor) at all? Or is it actually viewable as a success bonus for the benefit of the manager? If so, the question is not whether performance fees should be included in the fund's total cost of ownership to the investor (they would not), but rather how to generate a valuation of the fund's assets that allows for any potential performance fees at that point in time to be accrued outside of the portfolio's net asset value calculation.

Like performance fees, transaction, stock-lending and anti-dilution costs are conditional, so cannot be expressed with any certainty in a projected figure for expected total cost of ownership, and it would be misleading to assume that such costs incurred over a previous period would constitute an accurate guide for the next period. However, if the agreed methodology is to be retrospective, the approach (and its limitations) should at least be uniform.

A further question that emerges from using historic data for the total cost of ownership of a portfolio is how to address a portfolio that does not have such a track record? Will the FCA seek to apply its own rules on use of past performance data for new funds? Will the FCA expect newer funds to model expected past performance data based on internal modelling? Each approach has its drawbacks.

Focussing briefly on stock-lending, the question also arises how any profits from stock-lending would need to be treated (this is also a question under MiFID II). Would these necessarily be credited against any stock-lending costs? If so, what would treatment of stock-lending costs and profits in this way mean about the intent, performance and operation of stock-lending? Is stock-lending an aspect of discretionary investment management? Is it a matter for Trading or Operations desks to determine? Is stock-lending performed for efficient portfolio management purposes? It may be that different approaches to stock-lending would mean different approaches to treatment of stock-lending costs and profits should be appropriate.

Finally, the FCA's proposals would apply to all funds managed in the UK or marketed in to the UK. Thus, for all funds marketed in the UK (wherever they may be managed) there should be a level playing field. However, will adoption of such a standardised template in the UK be an advantage or disadvantage to portfolios managed from the UK when marketed outside of the UK? What if other international regimes do not require adoption of such a figure, or do not calculate it in the same way? (ie meaning the whole exercise actually inhibits the very competition the FCA is seeking to enhance.)

The situation here seems similar to the situation with MiFID II, where different national regulators are implementing different transparency requirements at a national level. In some instances, fund managers may feel the best option is to operate parallel structures across more than one jurisdiction to satisfy the competing requirements of regulators, investors and other market participants in different European countries.

There are no simple answers to many of the issues flagged here, and indeed it could be argued that these issues are theoretical at this stage as we wait for the final templates and next round of statements from the FCA. However, the direction of travel on these issues is clear. And if the recent past teaches us anything, it is that we need to be prepared for a range of eventualities.

17822

Tower Bridge House
St Katharine's Way
London E1W 1AA
T +44 20 3060 6000

Temple Circus
Temple Way
Bristol BS1 6LW
T +44 20 3060 6000

11/F Three Exchange Square
8 Connaught Place
Central Hong Kong
T +852 2216 7000

12 Marina Boulevard
#38-04 Marina Bay Financial Centre Tower 3
Singapore 018982
T +65 6422 3000

RPC