Smith & Williamson

Regulatory Focus

Smith & Williamson Fund Administration Limited

September 2020

For professional advisers only

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Introduction

What is the SWFAL Regulatory Focus

Our Regulatory Focus provides you with a summary of current and forthcoming regulatory changes that we feel may have an impact on our business partners over the coming months.

It also confirms the action, if any, that SWFAL will be taking in order to ensure that we and our business partners remain fully compliant.

This is the fourth time that SWFAL has published this update. We hope that you will continue to find it useful however as always we would welcome your feedback. Please feel free to contact Brian McLean, John McWilliam or Graham Duns should you wish to discuss further any points that you may have.

Regulatory Change Timeline

Brexit
31 January 2020

2020

2021

Q2 2020

Feedback to DP18/04 and consultation CP19/32 (Building operational resilience).

Consultation ends 3rd April 2020

FCA to publish findings of the second assessing suitability review

(H1 2020)

Publication of the FCA review of FAMR and RDR findings

(Expected early 2020)

Consultation Paper on Financial Crime Reporting

(Expected Q2 2020)

Q3 2020

Feedback to CP19/12 and final rules PS19/29 (Making Transfers Simpler)

(31 July 2020)

Feedback to CP18/27 and final rules PS19/24 (Illiquid assets and open ended funds)

(30 September 2020)

5MLD

Identification measures for control payment accounts to be set up

(10 September 2020)

Q4 2020

Feedback to CP20/15 (Liquidity mismatch in authorised open-ended property funds)

3rd Nov 2020

EMT Template – Deadline for use of v2, thereafter v3 must be used. 10th December 2020

(10 December 2020)

End of the SMCR transitional period for solo regulated firms

(9th December 2020)

Q1 2021

SMCR - Certified persons to be identified, assessed fit and proper and given roles and responsibilities certificate

EU Directive 2019/1937 (Protection of whistle-blowers).

Laws, regulations and provisions to comply to be in force by 17 December 2021

2020/2021 LIBOR transition

CP on exit fees in investment platforms & comparable firms

(Expected 2021)

Q2 2021

Q3 2021

Q4 2021

FCA – Our framework: assessing adequate financial resources (FG20/1)

Published

June 2020

In June 2019 the FCA consulted (CP19/20) on the purpose of adequate financial resources, what they look for from firms and their expectations as to the practices firms should adopt within their assessments of adequate financial resources. Consultation ended in September 2019 and in FG20/1, the FCA set out their expectations of how firms determine they have adequate financial resources.

In the five years between 2013 and 2017, over 70% of a total of £846m paid out by the Financial Services Compensation Scheme (FSCS) in compensation were for claims made against FCA solo-regulated firms not subject to detailed prudential standards.

The inability to compensate consumers, and the transfer of these costs to other market participants via the FSCS levy places an unfair and unnecessary burden on other firms. The FCA are looking for firms where their resources adequately match their risk resulting in fewer disorderly failures with lower costs being passed onto the industry via the FSCS levy.

In the guidance the FCA sets out its expectations of how firms should determine if they have adequate financial resources. The framework document provides more clarity on:

- the role of adequate financial resources in minimising harm
- the practices firms can adopt when assessing adequate financial resources
- how the FCA assesses the adequacy of a firm's financial resources

The finalised guidance is relevant for Threshold Condition 2.4 and Principle 4.

All firms should assess the risks inherent in their business model, the potential harm that can be caused and explain how to close the business in an orderly way.

The assessment should:

- consider a forward-looking approach to risks and how these evolve throughout the economic cycle
- reflect the risks to which the firm is exposed and the amount of risk it poses
- be proportionate to the likelihood of the risks occurring
- ensure they are financially sound while avoiding excessive costs, which could hinder firms from carrying out their business in a viable way
- happen at least annually, reflecting the fact that the business environment is dynamic so the assessments of risk and harm should be dynamic too.
- It also emphasises the importance of scenario analysis and stress testing the firm's position against 'severe but plausible' adverse circumstances.

Next Steps

Delegate Fund Managers should consider the above points when reviewing their own financial adequacy.

Senior Management and Certification Regime (SM&CR) – An update

As noted on the FCA website on the 30th June 2020, the Treasury has agreed to delay, from 9 December 2020 until 31 March 2021, the deadline for solo-regulated firms to have undertaken the first assessment of the fitness and propriety of their Certified Persons. This is to allow firms significantly affected by the coronavirus pandemic time to make the changes they need.

To ensure SM&CR deadlines remain consistent, and to provide extra time for firms that may require it, the FCA will consult on extending the deadline for the following requirements from 9 December 2020 to 31 March 2021:

- the date the Conduct Rules come into force
- the deadline for submission of information about Directory Persons to the Register
- references in the rules to the deadline for assessing Certified Persons as fit and proper (which has been agreed by the Treasury)

In order to give regulated firms certainty, and to allow the policy to be finalised as soon as possible, the FCA intend to consult alongside parliamentary process.

Senior Managers must ensure that Conduct Rules training is effective, so that staff are aware of the Conduct Rules and understand how they apply to them in their jobs. These programmes will require planning, time and effort to deliver effectively. The FCA will produce further communications about their expectations in due course.

Please note that the conduct rules became effective for all senior managers and certification staff on 9th December 2019 and this announcement does not alter the requirement for conduct rules to already have been implemented for these staff members.

Next steps

Firms should continue with their programmes of work in these areas and, if they are able to complete the relevant training, certification and completion of directory entries earlier than March 2021, they should do so. Firms should not wait to remove staff who are not fit and proper from certified roles.

The FCA will still publish details of certified employees of solo firms starting from 9 December 2020 on the Financial Services Register. Where firms are able to provide this information before March 2021, the FCA encourages them to do so.

UK Government – Consultation on expanding the dormant assets scheme

Published

21 February 2020, update 31 March 2020

Consultation ended

16 July 2020

Key consultation points

The government launched a consultation in order to gather views on its proposals to expand the dormant assets scheme (established by the Dormant Bank and Building Society Accounts Act 2008 (the Act)) to include new financial assets.

Since 2011, over £1.2bn from dormant bank and building society accounts has been transferred to Reclaim Fund Ltd (RFL), which has channelled more than £600m towards addressing some of the UK's most pressing social and environmental challenges.

Dormant assets remain the rightful property of their owners, and the scheme guarantees their right to reclaim the amount owed to them at any time. This underpins the entire scheme and is crucial to ensuring that everyone, from consumers to firms, trusts and supports it.

Four senior Industry Champions took on this challenge over 2018. Their report, published in April 2019, made recommendations to industry, the government and regulators on broadening the current scheme beyond bank and building society accounts to include assets from the insurance and pensions, investment and wealth management, and securities sectors. It concluded that primary legislation would be needed.

The Industry Champions' report identified FCA rules that may need to be amended to enable participation in an expanded scheme. In addition, the Champions indicated that best practice guidance on tracing, verification and reunification would be key to a successful scheme.

The government is working with the Prudential Regulation Authority and Financial Conduct Authority (FCA) to consider whether FSCS protection should apply if the scheme is expanded and, if so, how this would work.

Participation is voluntary and firms who want to participate must take into consideration the additional costs such as set up costs (e.g. setting up the right infrastructure, capabilities and processes to take part in the scheme, and dealing with dormant assets) and ongoing costs each year of administering and participating in the scheme: including transferring assets, dealing with them, and managing any reclaims.

Having considered industry's recommendations, the government is now inviting input on the detailed proposals to expand the scheme.

Next Steps

SWFAL awaiting feedback from consultation that ended in July 2020.

Orphaned Assets

A Morningstar study published 25 February 2019 found that there are far too many funds in the European fund universe relative to the pool of invested assets. As a result, many funds are too small to be cost-effective. With few assets, little investment and high fees, these funds deliver poor investor outcomes. Morningstar termed such funds as "orphaned funds," and the study shows the extent to which they are prevalent in Europe.

The Morningstar study was Europe wide and classed orphaned funds as funds with assets under EUR100m and net inflows/outflows of EUR10m or less in each of the five calendar years to the end of 2017.

In terms of the funds administered by SWFAL, and considered as part of the Assessment of Value process, a fund is deemed to be an orphaned fund if:

a) it has been running for 5 calendar years; and

b) it has shown a downward trend in AUM size over the 5 calendar years, or has shown limited or no investor inflows (less than 5% of the fund's starting NAV) per calendar year over 5 calendar years; and

c) it has high fees (e.g. high OCF, Investment Management or ACD fee) compared to their peers per calendar year over 5 calendar years.

In addition to the above, such funds may also be accompanied by the following characteristics:

a) Neutral or poor fund performance per year or over a 5-calendar year period; or

b) Have very few investors invested in the fund to spread the costs of running the fund.

Next steps

There may be a valid reason for assets remaining in these small funds, in that investors might be facing crystallising a capital gains tax position if they were to sell their holdings. In this situation, remaining invested in the fund might be the preferred option.

Conversely, Investment Managers can always merge smaller funds into another. It should be noted that the fund where the assets are moving to would require to have a similar objective. If that's not the case, the best course of action may be for the investor to redeem.

It is up to the individual Investment Manager to determine whether the fund falls into the criteria noted above and take the appropriate action.

SWFAL will consider the above points when conducting the Assessment of Value review.

FCA – Speech on open-ended funds investing in less liquid assets

Published

19 March 2020

On 19th March, Edwin Schooling Latter, Director of Markets and Wholesale Policy gave a speech to IA members on open-ended funds investing in less liquid assets.

The full text of the speech can be found on the **FCA's website here: www.fca.org.uk/news/speeches/open-ended-funds-investing-less-liquid-assets**

FCA and Bank of England work on fund liquidity

The FCA and Bank of England have been working together on the risks arising when there is a liquidity mismatch between the assets and liabilities of an open-ended fund. Where a large portion of the underlying assets in a fund cannot be liquidated within a day without significant loss of value, but the fund offers daily redemptions, there is an asset-liability mismatch.

This can be addressed in a way that better matches asset liquidity. The FCA already has rules and guidance that covers liquidity risks arising from mismatches, but recent experiences do raise the question of whether they need to be tighter.

Overall the FCA does not want to introduce new restrictions on these investors' access through authorised funds to investments that may offer a higher expected return.

Swing pricing and notice periods

Swing pricing and notice periods can help protect fund investors and reduce risks to the wider financial system, when there is pressure to sell fund assets to meet redemption requests.

Swing pricing is already allowed in the FCA rules. It is intended to help avoid remaining investors bearing an unfair proportion of costs, risks, or loss of value, as the fund's most liquid assets are sold to meet redemptions by exiting investors.

Swing pricing is a widely used tool that can help curb first mover advantage, protect investors ability to redeem and mitigate risk in the wider financial system, however it can be difficult to apply to less liquid assets.

Notice periods, between the investor requesting a redemption and the subsequent execution of that deal, are a relatively simple concept to explain to investors and may reduce liquidity issues caused by increased redemptions triggered by market stress. Managers need careful judgement in determining the length of a notice period.

The FCA feels that a fund could offer investors the choice between a fully swung price and a notice period.

Next Steps

The FCA invites industry and stakeholder comment on the best use of pricing mechanisms and liquidity tools to ensure open-ended funds appropriately manage liquidity risks while enabling investments that can benefit fund holders and the wider economy.

In the meantime, the FCA and Bank will continue with their work on fund liquidity and developing the right structures to allow funds to invest in less liquid assets.

FCA – Patient Capital and Authorised Funds Feedback on DP18/10 (FS20/2)

Published
February 2020

Firms in scope are; operators and investment managers of UK authorised funds and specialised funds (ELTIF, EuSEF and EuVECA), and their depositaries, intermediaries, such as platform service providers, discretionary wealth managers and financial advisers, pension plan operators (e.g. those offering self-invested personal pensions) life assurance companies with an interest in patient capital, either by direct investment or through holdings in investment funds, retail, professional and institutional investors.

In DP18/10, the FCA invited views as to whether there were any barriers which might impede investment in long-term assets through authorised fund vehicles. FS20/2 provides the FCA's feedback to responses received to its discussion paper DP18/10.

- The FCA found that there were no inappropriate barriers to investing in long-term assets within its authorised funds regime.
- They are fit for purpose for long-term investment by both professional and sophisticated retail investors.
- For retail investors, the barriers are deemed to be appropriate to reduce the risk.
- retail investors already have alternative ways of accessing long-term investments through other investment products, such as investment trusts.
- this will enhance financial stability and improve outcomes for investors.
- The work will, amongst other things, include the exploration of the use of a wider range of liquidity tools than currently permitted for UK authorised funds.

FCA will continue to work with the Bank of England's Financial Policy Committee (FPC) to assess how authorised funds' redemption terms can be better aligned to the liquidity of the underlying assets.

Next steps

The FCA will be considering any rule changes that may be recommended upon completion of the FPC work later on in 2020. SWFAL will continue to watch out for further regulatory publications and developments in this area.

The Investment Association – Disclosure of fund charges and costs

Published
July 2020

IA guidance was first issued in September 2012 setting out the new regulations with regard to MiFID II and the FCA's expectations as a result of various reviews carried out in respect of disclosure of charges and costs.

The PRIIPS regulations now requires the synthetic OCF to include investment trusts. Previously this was just collective investment schemes. As a result of the IA Guidance in July, SWFAL has implemented this for funds with year-ends of 31 July funds onwards.

You may see increases in some OCF figures, if the fund is invested in investment trusts. There is no increased cost to the fund, SWFAL are now disclosing the costs of holding those investment trusts.

Next steps

Should you have any queries or concerns please contact your usual Client Relationship Manager.

FCA – Consultation paper on ETF Listing: Premium to Standard Listing (CP20/5)

Published
9th March 2020

Consultation ends
1st October 2020

Key points:

- Current listing regime for OEICs was drawn up in 2007.
- Listing Rules at that time were tailored to account for the underlying funds regulation.
- Proportion of the listing requirements for OEICs impose a layer of regulation on top of the funds regulation that already applies to these issuers and their fund managers through other rules.
- These parts of the Listing Rules do not offer any appreciable value to investors, but they impose additional costs on issuers.
- FCA published a Discussion Paper in February 2017 on the Effectiveness of Primary Markets (DP).
- This covered exchange-traded funds (ETFs) and whether the premium-listing obligations which apply to open-ended investment companies (OEICs), the legal form that ETFs usually take, should be dis-applied and OEICs should be listed in the standard listing segment.
- Standard-listing regime is based on minimum EU directive standards and primarily focusses on transparency.
- Premium-listing regime sets requirements which exceed standard listing, including greater transparency and rights for shareholders.
- Feedback Statement published in October 2017 the FCA committed to prepare rules for consultation for the standard-listing of OEICs.
- This commitment was also included in the 2019/20 Business Plan.
- The proposed changes to the Listing Rules are intended to create a more proportionate listing regime for OEICs in standard listing, whilst ensuring existing investor protections are maintained.
- They are also intended to ensure their obligations in the Listing Rules are more proportionate and more tailored to OEICs' business models and structures.

Next Steps

Consultation ends on 1 October 2020. SWFAL will review the outcome of the consultation in due course.

Brexit

The UK has now left the EU and has entered an "implementation period" or "transition period" until 31 December 2020. During this time all existing EU legislation continues to apply whilst the UK negotiates the future relationship with the EU. The UK Government has indicated that it does not intend to extent the implementation period.

There has been a number industry led workshops and presentations. Some of the key points that SWFAL took away from a recent update from Macfarlanes:

- Any deal is likely to come very late if at all! There may be no deal but with equivalence drawn in some sectors.
- Outsourced third parties may not be covered by passporting. There is no guarantee this will be allowed post 31st December 2020. As a result, firms should have a clear understanding on their dependencies on EEA outsourcing or third-party service providers so they can assess if they will be able to continue providing their services after the implementation period, e.g. a firm using an EEA broker for best execution.
- There will not be "wilful" divergence of the FCA from EEA rules – FCA will still be covered by outcome-based approach.
- It is felt by the FCA that due to asset management industry having a "good COVID-19" with regard to dealing with the turbulence, any further turbulence expected by Brexit the industry is seen in good shape to cope.
- For UK based managers marketing in the UK not much is expected to change. There may be some prospectus updates and re-papering of contracts if required.
- Irish/Luxembourg funds will still be able to market in the UK under the long-term funds regime but full scope not outlined as yet.
- Irish/Luxembourg AIFs under the control of UK asset managers – memorandum of understanding allows for delegation of investment management to remain come 31st December 2020.
- Reasonable steps – firms are expected to document and review contingency plans / expected impact. If there were any issues the FCA would seek plans outlined by firms for any leeway provided.
- Follow the FCA website closely over what they expect to change.
- Equivalence assessments – FCA has carried out much work in this area but is still seen as reflecting the EU desire that this is part of the wider internal market considerations – not as the UK sees it as a way for financial services to get a discrete deal.
- UK asset managers with customers residing in the EU – if you have EU investors in your UK funds post Brexit – the rule of thumb is that is fine for those investors to stay in those funds; and at this stage acceptable for them to top-up; but if you are providing new investors or new services you will need to check with the local jurisdiction as you may be in breach of performing a regulated service.

Next steps

We are now coming up to the end of the transition period. SWFAL will continue to review any further guidance and information from the FCA and will be in touch as necessary.

Assessment of Value

The relevant regulations have now been in place for a year. Over the last 12 months SWFAL has performed the required Assessments of Value on over 160 funds.

The Assessment of Value focuses on overall value to investors, broken into seven key components:

- quality of service,
- performance,
- AFM costs,
- economies of scale,
- comparable market rates,
- comparable services and
- classes of units.

The aim is for AFMs to identify poor value or uneconomical funds, particularly smaller share classes where the costs will naturally be high by comparison.

In the reviews of the funds that have been completed so far, the following elements have seen the largest number of concerns:

- Quality of Service (27%), This includes concerns around Penetration Testing and Best Execution processes,
- AFM Costs (24%), this is concerns about some of the charges that are taken from the fund. SWFAL has a good understanding of what services cost and takes a view based on its experience in dealing with a number of delegate investment manager firms,
- Comparable Market Rates (23%), SWFAL uses data sourced from Morningstar to make a comparison of the overall cost of the fund in the market place. Funds that are above the average for their peer group are highlighted however to take into account the different nuances of some of those funds a tolerance is used,
- Comparable Services (16%), As above data is sourced from Morningstar however the comparison is made with other SWFAL administered funds. Again, a tolerance is used to smooth the effect of funds at either end of the peer group,
- Performance (7%), There has been a small number of funds where the performance of the fund against its stated objectives have been disappointing. Action taken includes closing the fund, merging the fund with a better performing fund that shares similar objectives or a change in investment manager.

Next Steps

SWFAL will continue to liaise with delegated Investment Managers in order to ensure that the best interests for the end investor are protected. This may include challenges around fees, fee structures and the performance of the fund against its stated objective.

Closed Markets - Suspension and restart of dealings

The COVID-19 pandemic continues to have an effect on world markets. In March we reminded you of the procedure for suspending a fund if, in the unlikely event, stock markets close for an extended period of time.

SWFAL continues to closely monitor the day to day effect of the funds. The following is a reminder of the processes and controls SWFAL employs to highlight potential issues and which may lead to discussions around the closure of a fund; where the fund has over 10% invested in a closed market, and if the dealing is over 1% of the NAV then the anticipated next relevant market opening will be reviewed to establish if we believe the market will move greater than 5% of the NAV. If this is the case then a geographic 'fair value price' (FVP) may be required to be adjusted within the fund.

The SWFAL Fair Value Pricing committee have been contacted on several occasions due to market volatility over recent months, for example to vote on pricing of suspended assets etc, but this is the normal course of action for SWFAL as ACD for the SWFAL Fund range.

SWFAL can confirm that to date they have not had any occasion where pricing/dealing had to be suspended due to inability to price the funds.

Where clients best interests will not be served and if pricing is not reliable then the fund would suspend accordingly until it could be resolved in accordance with COLL 7.2 SWFAL would seek the prior approval of the depositary before taking the necessary steps to formally notify the FCA in writing as well as the fund's investors.

COLL 7.2, the authorised fund manager may, with the prior agreement of the depositary, and must without delay, if the depositary so requires, temporarily suspend the issue, cancellation, sale and redemption of units in an authorised fund where due to exceptional circumstances it is in the interest of all the unitholders in the authorised fund.

Next steps

SWFAL will continue to closely monitor the situation and will contact you where required.

European MiFID Template *(EMT v3.0)* - Reminder

Background

On Tuesday 10 December 2019, FinDatEx (Financial Data Exchange Templates) validated the new EMT (European MiFID template) v3 template. A few important changes have been made to EMT v1, the version currently used by investment funds, which include updates from existing EMT v1 fields as well as additional new fields. A one-year transition period has been recommended from validation date, i.e. from 10 December 2019 until 10 December 2020.

Please note that the EMT Version 2 was adopted by some national associations in 2018 and is used only for structured products. The template has not been endorsed by FinDatEx or by members of the FinDatEx Steering Group and for this reason was never adopted by SWFAL.

Next steps

SWFAL is currently working on this project and will be in touch with you with regards to the updates where necessary.

Appendix 1 - References

- FG20/1 - Our framework: assessing adequate financial resources (FCA)
- Orphaned Funds - A Morningstar study on sub-scale funds lying dormant and their disservice to investors. (Morningstar)
- Consultation on expanding the dormant assets scheme (UK Government)
- Speech on open-ended funds investing in less liquid assets (FCA)
- Patient Capital and Authorised Funds Feedback on DP18/10 (FS20/2) (FCA)
- Macfarlane's webinar (20 July 2020)
- The Investment Association – Member Guidance, Disclosure of fund charges and costs. 2 July 2020

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