

Asset management: the UK as a global centre



a report by the Asset Management Working Group

November 2009



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ISBN 978-1-84532-650-0
PU867

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Foreword



The Treasury established the Asset Management Working Group alongside a number of other working groups designed to report on different aspects of financial services. The groups covering professional services, the insurance industry, and competitiveness have already published their findings. This report identifies the particular challenges and opportunities for the UK as a centre for asset management. Like the other reports, it looks to the future.

The UK is a global leader and centre for asset management and this report sets out recommendations to industry, regulator and the Government to ensure we maintain that position. This industry employs tens of thousands of people and serves millions of customers, but I wanted to know whether we could do yet more.

I asked the Group to look at what needs to be done to ensure that the UK remains an excellent location for asset managers; to identify development opportunities for the sector; to develop the UK's input to international discussions on asset management issues and to provide a forum for buy-side input. The Group has achieved on all fronts, and I am grateful to my co-chair Bob Jenkins for pursuing these issues with energy and enthusiasm.

The Group started its work at the end of a year which caused many in the industry to reflect on their past performance. In this report, the Group notes the importance of confidence and trust in the industry and points out the importance of alignment of interests and of transparency. The Group also sets out what the industry gold standard should be and why the industry is important to the UK.

The Government and industry have already worked closely together to make key changes to boost UK funds. Asset managers can undertake a wide range of transactions with certainty of tax treatment, invest efficiently in property, sell to sophisticated investors without being impeded by complex tax rules and buy and sell units using electronic communication.

These measures have levelled the playing field for fund providers and investors and put the UK on a competitive footing. However, there is always more that can be done and in this report the Group sets out further opportunities for the UK as a location for fund domicile.

I believe that we must work together to build on our advantages and make use of opportunities that present themselves, and look forward to working with the industry in the future.

A handwritten signature in black ink that reads "Alistair Darling". The signature is written in a cursive, slightly slanted style.

Alistair Darling
Chancellor of the Exchequer
Co-Chair of the Asset Management Working Group

Foreword



Financial Services are a critical component of the UK economy and asset management is a fundamental pillar of financial services. The nation is host to a globally competitive money management industry. It is unmatched within the EU and a worthy rival to that of the

United States. It serves domestic and international investors alike. Thus the question: what can and should industry and Government do to ensure a vibrant future for this country's asset management industry?

To help supply an answer, the Treasury convened this Asset Management Working Group. It is the first such Government sponsored task force to focus explicitly on this important and growing sector. It is also timely. Recent market turmoil has sent lawmakers and regulators back to the drawing board. The new rules which result will shape our financial landscape for years to come. It is vital that this policy debate take account of the role and potential of the money management industry. Too often in the past, the drafting of regulatory road maps gave disproportionate weight to the banking world. Investment Banking – often referred to as the “sell side” – tended to take centre stage relative to asset management (the “buy side”). However, as this report illustrates, there is no sell side without the buy side. Nor can the buy side be successful unless the sell side is a success. It thus behoves both industry and policy makers to ensure that investors and those who serve them, are at the centre of the regulatory debate. As we were recently reminded, when liquidity and capital shortages surface, the system depends as much on those who have the money as it does on those who need it.

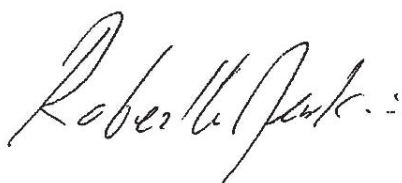
This report lists a wide range of key findings and recommendations. As the objective is to position the UK as a global asset management centre of choice, findings and recommendations should be read *in toto*. Nevertheless, I should like to highlight here three points in particular.

First: the industry must ensure that its clients have realistic expectations of what we can and cannot do. We serve the saver. We strive to help him achieve his investment goals. In doing so, we provide access to a range of markets and portfolio diversification to a degree and at a price that few individuals can achieve on their own. However, consciously or unconsciously we have allowed some clients to expect results which exceed what we can dependably deliver. Be it through our advertising or investor education, we must ensure realistic expectations of risk and return. If we fail to do this, we will not fail to disappoint. If we disappoint too often, we will fail. This is not the responsibility of Government. This is the industry's responsibility.

Second: our retail client proposition is muddled by confusion and conflict within the distribution system for financial products. Cost of advice must be distinguished and distinguishable from the cost of the product. Who is paid by whom must become even more transparent. The FSA's Retail Distribution Review shares this objective. Within the UK the “RDR” is potentially a crucial step forward. Similar principles must be adopted throughout the EU if the investor is to benefit fully and our industry to enjoy a level playing field.

Third: make the UK the “domicile of choice” for collective schemes. Recent Government proposals for tax reform will level the playing field for choice of retail fund domicile going forward. But Government and industry should openly debate the economic benefits of a tax advantaged (or at least tax neutral) asset management centre. Dublin and Luxembourg believe passionately that their fiscal policies toward fund activity accrue benefit to the nation as a whole. We should openly ask ourselves why the UK would not equally benefit. Meanwhile, an opportunity looms for the retention and attraction of the global alternatives industry by establishing a tax effective on-shore regime. To put it provocatively, bring Ireland and Luxembourg to the UK and do not allow the UK’s alternatives industry to move to an Ireland or Luxembourg. Surely this is consistent with ensuring the UK’s position as money management centre of choice.

I would like to express my appreciation to the many contributors to this study, not only the members listed, but the many other industry leaders and trade bodies without whose input and support this report would not have been possible. Last, but most certainly not least, I should like to thank the Chancellor and HM Treasury who have given our industry an unusual opportunity to raise our profile and express our views.

A handwritten signature in black ink, reading "Robert W. Jenkins". The signature is written in a cursive, flowing style with a long horizontal stroke at the end.

Robert W. Jenkins
Chairman of the Investment Management Association
Co-Chair of the Asset Management Working Group

Objectives and approach

Financial services are a key component of the UK economy and asset management is a major pillar of financial services. The Asset Management Working Group (AMWG), representing practitioners from the asset management industry, was convened to present what the industry sees as its challenges in the decades ahead, and to provide recommendations to industry, regulator and Government to consider in order to ensure a vibrant future for the nation's asset management industry.

Members of the Group who contributed to this report were:

- **Travis Barker** (Chairman, Institutional Money Market Funds Association)
- **Sarah Bates** (Deputy Chairman, Association of Investment Companies)
- **Dean Buckley** (Chief Executive, Scottish Widows Investment Partnership)
- **Elizabeth Corley** (CEO, Allianz Global Investors Europe)
- **Elroy Dimson** (Professor of Finance, London Business School)
- **Campbell Fleming** (Head of UK Business, JP Morgan Asset Management)
- **Martin Gilbert** (Chief Executive, Aberdeen Asset Management)
- **Robert Higginbotham** (President, Europe, Fidelity International)
- **Paul Marshall** (Chairman, Marshall Wace)
- **Colin McLean** (Managing Director, SVM)
- **Helena Morrissey** (Chief Executive, Newton Investment Management)
- **William Nott** (Chief Executive, M&G Securities)
- **Bob Yerbury** (Chief Investment Officer, Invesco Perpetual)

The Group was co-chaired by the Chancellor, Alistair Darling, and the Chairman of the Investment Management Association (IMA), Robert Jenkins. In addition to their own contributions, the Group sought and received input from across the asset management industry and from other sources, including the Financial Services Authority. The permanent secretariat of the IMA acted, together with HM Treasury, as secretariat to the Group.

The Group's deliberations took place in tandem with a number of other HM Treasury initiated financial service sector studies. The AMWG gratefully acknowledges and welcomes many of the findings and recommendations made to date. Thus, where the case has been made elsewhere, the AMWG has chosen to highlight the point and reference its source.

Key findings

Chapter One: The role of the asset management industry

- The UK is home to a leading global asset management industry. Its origins lie with the development of investment trusts in the nineteenth century and, since the Second World War particularly, the industry grew substantially as funded pension provision became more widespread. It has since become the world's largest outside the US, and is characterised by a wide range of firms, products, fund vehicles and clients.
- The factors contributing to its growth include those which have supported the UK as a world financial centre. These are well described in the recent Bischoff Report.¹ To these we would add the importance of a large domestic savings pool in combination with an open, highly competitive marketplace. The accumulated expertise, skill and talent are increasingly at the service of global investors.
- The industry's function is to invest the funds of its clients – ultimately for the most part ordinary savers and investors. It enables clients to achieve a level of portfolio diversification and gives them access to a range of instruments and markets in a way and at a price that they could not accomplish on their own.
- Its economic relationship with its client is one of agency. Investment management firms do not have or require large balance sheets because clients' money is held under separate custody. Reputation, not capitalisation, is the foundation of trust.
- The industry also fulfils wider economic roles. It is the principal source of investment capital for UK companies. And it provides the liquidity which underpins the global capital markets centre located in the UK.
- Just as asset management is a major pillar of financial services, alternative investment products such as hedge funds are a key component of asset management. They expand choice for clients seeking risk-adjusted returns. They also offer the wider industry an important source of R&D, talent and technique. They bring to the capital markets an important flow of business and liquidity.
- The last decade has seen two major bear markets in equities, and many of the industry's clients have seen their investments fail to grow as they would have hoped over that period. While asset management firms cannot control the direction of markets, they do need to ensure that they explain to clients and their advisers what can and cannot be expected.
- Asset management firms are an integral part of the checks and balances within a regulated free market. As agents for shareholders, they provide challenge and feedback to the corporate community. For governance to function effectively, Boards must be held to account. The financial crisis revealed that this did not always work as effectively as it should. The Walker Review contains a number of recommendations which, if implemented, will permit those who choose to engage to do so more effectively.
- A centre which aspires to be or remain a world leading asset management location needs an industry which meets, indeed defines, the highest standards. While professional bodies are well-established guardians of ethics, the industry should ask itself whether it should do more to define, monitor and raise standards.

¹ *UK international financial services – the future* (HM Treasury, May 2009).

Chapter Two: Location choice and competitiveness

- The UK has proven to be, and remains, a good place to locate an asset management business. Nevertheless, challenges and opportunities continually emerge. European legislation is a key factor in determining the competitive landscape, and Government and industry need to work to secure advantageous outcomes in Brussels, as they are currently doing with respect to the Alternative Investment Fund Managers Directive (AIFMD).
- The taxation of funds in the UK was at one time seen as a low priority for the tax authorities, and this left the door open for competing fund domicile centres to grow and prosper. The opportunity cost to the Exchequer in lost employment and other taxes when funds managed by a UK asset manager are domiciled outside the UK has been estimated at up to £1mn a year per £1bn of funds. With over £350bn of UK-managed funds already in Luxembourg and Ireland, this represents a significant loss of revenue and economic activity to the UK. A concerted effort by the Treasury and the industry over the last three years has resulted in changes which have largely levelled the playing field. This should serve as a model for future co-operation.
- It is likely that a number of developments, including prospective EU legislation on alternative investment funds, will lead to more hedge fund and other managers seeking onshore EU domiciles for their products. At present there is a range of hedge fund strategies and structures which it is not possible to offer through UK-domiciled vehicles in an economically efficient manner. Creating an attractive onshore fund regime for alternative vehicles such as hedge funds would be a substantial opportunity for the UK.

- Similarly, the UCITS IV Directive, which will be fully implemented in 2010, will make it possible for European asset managers to reorganise their fund ranges into one domicile. The UK needs to be in a position to benefit from this, or at the very least, to minimise any further movement of funds to other domiciles.

Chapter Three: Distribution and the consumer

- Many savers and investors are not familiar with the intricacies of the financial markets and therefore often look to advisers for help. Yet, there can be a real lack of simplicity of choice and transparency in the assistance that they will receive.
- The report suggests five principles for governing distribution. There should be:
 1. promotion of choice of distribution channels;
 2. transparency and clarity surrounding adviser status;
 3. transparency in remuneration, clarifying the cost of advice;
 4. enhancement of adviser professionalism and empowerment of consumers; and
 5. a level playing field for different products and different distribution channels.
- In the UK, there exists a wide choice of distribution channels, through banks, bancassurers, independent advisers and brokers. The FSA's Retail Distribution Review (RDR) will take forward many of the principles suggested above and is an important step in the right direction.
- There is also a substantial and growing opportunity for UK asset managers to distribute investment products within a single European market. The shape of the market in much of continental Europe is different from the UK,

with a preponderance of sales via commercial banks. For the European consumer to benefit fully from the enhanced competition of supply, it is important that there is depth and breadth of quality distribution and advice available to all segments. There are two forthcoming opportunities to ensure that this happens: the European Commission's work on Packaged Retail Investment Products (PRIIPs) and the review of the Markets in Financial Instruments Directive (MiFID). UK Government, regulators and industry will need to work together over the next few years to make progress in this area.

Chapter Four: The importance of pensions and savings

- The industry's strength today derives in significant measure from the legacy of a large and growing pool of domestic pensions and savings. This has driven scale, multi-asset class skill sets and cutting edge innovation. A thriving domestic market in the future can only help to sustain the industry's momentum and to capitalise on the expanding pool of global pensions and savings, which will be a major source of fresh opportunity.
- A major change in domestic pension provision planned for 2012 is likely to drive a significant expansion of pension saving, particularly through defined contribution (DC) schemes, in the UK. With the Individual Savings Account (ISA) already available as a more liquid and short-term savings vehicle, the asset management industry will play a role in the nation's savings provision that is far more visible.
- However, considerable challenges remain. The exposure of millions of people to investment products through their pension savings will require a new focus by the industry on product design, particularly default funds in DC schemes. At the same time, although substantial incentives are already available through the tax system to foster pension saving, these need to combine simplicity with a stable environment in which to encourage confidence going forward, while remaining fair and affordable.
- Simplicity is also a challenge at the level of available wrappers. Customers have two investment needs: discretionary savings and retirement savings. At present, there are multiple product structures with different tax incentives, charging structures and legal structures that have been built up over time to meet these two basic needs. This is a barrier to customer engagement with those needs.

Chapter Five: Capital market structures

- Financial markets are for investors and capital raisers, not for intermediaries; this should be a guiding principle for regulating markets. This means that the asset management industry has not only a legitimate interest in their structure but a duty to challenge and shape them where they do not work in the best interests of end investors. The importance of this was highlighted by the administrative problems revealed in the wake of the Lehman collapse. The Group therefore supports the work that HM Treasury and the European Commission have begun to bring better investor protection into UK market arrangements.
- The asset management industry has a vested interest in a soundly functioning banking system in which investors have confidence. There is no "sell side" (investment banks) without the "buy side" (asset management firms). Equally, the buy side will not be a success unless the sell side is successful.
- Maintaining liquid markets is crucial to the industry's ability to deliver the best outcomes for investors, and short selling is integral to maintaining two-way markets as well as to risk management.

- Financial reporting is primarily for capital providers; the asset management industry and its clients require transparency and accuracy of company accounts. Confidence in those accounts is a function of the integrity of the process by which they are constructed. The more that accounting rules are seen to be free of external pressures the greater will be that confidence.

Recommendations

Chapter 1	Recommendations	
Role of the industry	1.	The asset management industry should ensure that meeting client needs remains at the heart of its operating philosophy. This should include better shaping client expectations of what it can and cannot deliver – whether through its advertising or its contribution to investor and adviser education.
	2.	Engagement by shareholders is to be encouraged by both industry and regulator, recognising that it will always be ultimately for clients to determine their preferred investment style.
	3.	The industry must be pro-active in financial sector policy debates (domestic and EU). Policy makers should consult more with the industry on matters involving the financial sector at large, particularly on market issues.

Chapter 2	Recommendations	
Location choice and competitiveness	4.	The Group believes the industry and Government should work together to prevent further loss of UK fund business to other jurisdictions and make the UK a domicile of choice for collective schemes.
	5.	The UCITS IV Directive, combined with the welcome simplification of the UK tax regime for offshore funds, will bring greater scope for rationalising fund ranges. It needs to be ensured that the UK is not placed at an unnecessary disadvantage in this process.
	6.	The Group also believes the UK would benefit from a viable onshore hedge fund regime. The industry, regulator and Government should work together to develop such a regime.
	7.	Measures to consider include expanding the class of collective investments the FSA is empowered to authorise and changes to the FSA rules for Qualified Investor Schemes. The industry believes that further re-examination of the Schedule 19 SDRT regime is also necessary.

Chapter 3	Recommendations	
Distribution and the consumer	8.	<p>Five principles should be adopted as part of a pro-active agenda both at home and within the EU, particularly in the context of work on Packaged Retail Investment Products and the MiFID review. There should be:</p> <ol style="list-style-type: none"> 1. promotion of choice of distribution channels; 2. transparency and clarity surrounding adviser status; 3. transparency in remuneration, clarifying the cost of advice; 4. enhancement of adviser professionalism and empowerment of consumers; and 5. a level playing field for different products and different distribution channels.
	9.	<p>Policy should aim to create across Europe a level playing field for advice which does not unduly discriminate between different advice and distribution models that can all have positive outcomes for consumers.</p>
	10.	<p>There should be clarity for European consumers about the status of the adviser and the nature of the advice service they receive. Disclosure needs to have a strong and transparent role in the distribution process and must not be relegated to the status of “administration”.</p>
	11.	<p>The cost of the advice should be distinguished from the cost of the product at the point of sale. A move towards product pricing with cost of advice added on top will be much better for consumers.</p>
	12.	<p>There should be a tiered system of qualifications for advisers in a way that requires those advising on more complex products to have higher levels of qualifications coupled with continuing education requirements for advisers. The development and usage of web-based tools for consumers should be facilitated.</p>
	13.	<p>Standards of disclosure of product features and other aspects of the advice process should be raised to the level of best existing practice in an equivalent way for all investment products, including funds, unit-linked insurance products, certificates and structured banking products. Similar principles should apply to debt products.</p>

Chapter 4	Recommendations	
The importance of pensions and savings	14.	Industry and Government should work together to ensure open and fair access to overseas markets for the asset management industry.
	15.	The industry should work to ensure that retirement products, particularly the default funds within pension vehicles, are comprehensible and designed to address the needs of savers.
	16.	Savings incentives, for both pension contributions and for long-term saving more generally, should aim for simplicity for the consumer and for long-term stability, while recognising the need for fairness and affordability.
	17.	The number of different tax wrappers should be kept to the minimum in the interests of simplicity. It should not be necessary for fund management firms to wrap pension products in life insurance wrappers, and means should be explored of extending the same benefits to simple funds as are enjoyed by life products.
	18.	The Government should seek reform of current institutional and legislative structures in the EU which tend to exclude investment management from the pension environment.

Chapter 5	Recommendations	
Capital market structures	19.	Capital markets exist for the benefit of issuers and investors. This gives the investment management industry a legitimate interest in all aspects of the capital markets and banking system. The industry needs to articulate its positions better and more emphasis should be given to the interests of investors and capital raisers when regulating markets.
	20.	There is a need to ensure continuity in the operation of the capital markets and the banking system as a whole, irrespective of what happens to individual institutions. In particular, better infrastructure in the event of a default is needed. As part of this process, central counterparty coverage in OTC derivative markets should be expanded.
	21.	All avenues to maintaining market liquidity and efficiency should be promoted and protected. Unless evidence shows that such restrictions are necessary for market stability, then regulators should avoid imposing investment restrictions – e.g. short selling – which could have substantial adverse consequences for the effective operation of markets.
	22.	The main focus of financial accounts should be on investors. The interests of shareholders and regulators in this area are potentially different and this should be recognised.

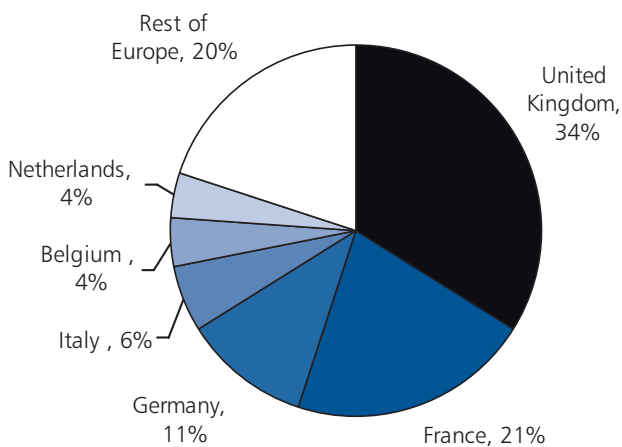
1 Role of the UK asset management industry

The UK is home to a global leading asset management industry, characterised by scale, breadth of expertise and breadth of client base, both domestic and international. Operating on an agency basis, its underlying goal is to help clients meet their savings and investment needs. However, it also has a wider role as a capital allocator in the economy and as a source of oversight in corporate governance. In the context of the current crisis, the industry needs to ensure that it is clear about its responsibilities, whether towards clients or in the broader corporate and policy environment.

1.1 Overview of the industry

The UK has long been a strong centre for asset management, with the first investment trusts established in this country just over 140 years ago. In the second half of the twentieth century, the development of extensive funded pension arrangements drove a considerable expansion in the industry, with pension fund assets increasing from under 15% of GDP in the early 1960s to over 70% by the late 1990s. The industry has now become the world's largest outside the United States and is highly diverse in terms of the range of firms, clients and products.

Chart 1.A: Country market shares - European assets under management (December 2007)



Source: EFAMA

The international dimension of the business has been facilitated historically by a number of features of the UK, which we explore further in Chapter Two, notably regulatory structure, strength of talent pool and time zone. It is also a key part of the City cluster, which defines the UK as one of the world's leading financial centres.

Asset management firms, including hedge fund and private equity, are responsible for the management of about £3.4trn of assets in the UK and generated in excess of £14 bn in net revenue in 2008.¹ The majority of the assets are managed in London, but there is a significant Scottish asset management industry (an estimated 12% of total assets under management) and a small number of firms based elsewhere in the UK.

In European comparative terms, this is the largest asset management industry, accounting for just over a third of total assets managed in Europe (see Chart 1.A). The closest rival to the UK in terms of total assets under management is Paris.

Purpose of industry

The industry's fundamental purpose is to help clients achieve investment goals that vary widely in terms of ultimate investment objective and time horizon. Some goals are short or medium term, others are longer term, for example individual retirement saving or liability management for institutions.

¹ Reliable data on overall industry revenue is difficult to obtain. This figure is an approximation based on IMA data and other estimates. See further discussion of economic contribution in Section 1.3.

The industry offers clients the ability to achieve a level of portfolio diversification and degree of access to a range of instruments and markets in a way and at a price that they could not achieve on their own. Money is managed for clients on both a pooled (i.e. co-mingled client assets in a collective vehicle) and segregated (managing client money in a distinct, separate account) basis.

In delivering its products and services, a distinguishing characteristic of the asset management industry is that it operates on an “arms length” agency rather than a principal basis. This sets it apart from financial services companies that are effectively balance sheet businesses and has important operational implications.

In practice, one of the most tangible facets of this agency relationship is the separation of assets from asset management or fund operating firms. In the fund management industry, assets are safeguarded by a depository or trustee working with a custodian. In the wider asset management industry, the assets of institutional clients such as pension funds will be held by custodians.²

Client base

The client base for UK managed assets falls into three broad categories: institutional (75%), retail (17%) and discretionary wealth management (8%).³ All categories have both UK and international components.

While close to a fifth of total assets managed in the UK are for retail clients (both UK and non-UK), the UK-domiciled investment fund industry is comparatively small as a proportion of total assets under management.⁴ Total authorised funds

accounted for £439bn in August 2009 of which 60% is estimated to be retail fund clients. As a proportion of total UK household financial assets, this equates to only around 7%. However, this low direct exposure is in contrast to a much larger indirect exposure to the asset management industry via occupational defined benefit pension schemes. There is also exposure via occupational and contract-based defined contribution plans and life products.

The term “retail” is problematic conceptually as retail investors increasingly access fund products through platforms or fund of fund and manager of manager approaches that asset managers see as wholesale or institutional business. This also raises issues for product development, distribution and regulation as asset management firms are further intermediated and their distance from the end client increases.

Institutional clients (see Chart 1.B) consist of private, public and non-profit institutions, primarily:

- funded UK and overseas occupational pension schemes, including UK local government pension schemes;
- insurance companies, primarily still based on parent relationships with asset management subsidiaries, but increasingly open to third party business;
- charities and endowments, which in many cases have very significant investible assets;
- Sovereign Wealth Funds (SWF), which often have in-house asset management capability and for now remain a relatively small component of UK-managed assets;
- corporations (as distinct from corporate pension funds), which have a variety of needs including cash management;
- local and central government and central banks; and
- other asset or fund management firms, for a variety of purposes including white label funds, fund of funds and manager of managers.

² The most obvious ramification of this for consumer protection is that the commercial failure of an asset management or fund management firm should avoid a situation in which consumers are directly exposed to that failure. Instead, separate custody arrangement should allow an orderly return of assets.

³ This is based on a calculation from IMA, IFSL and Compeer data.

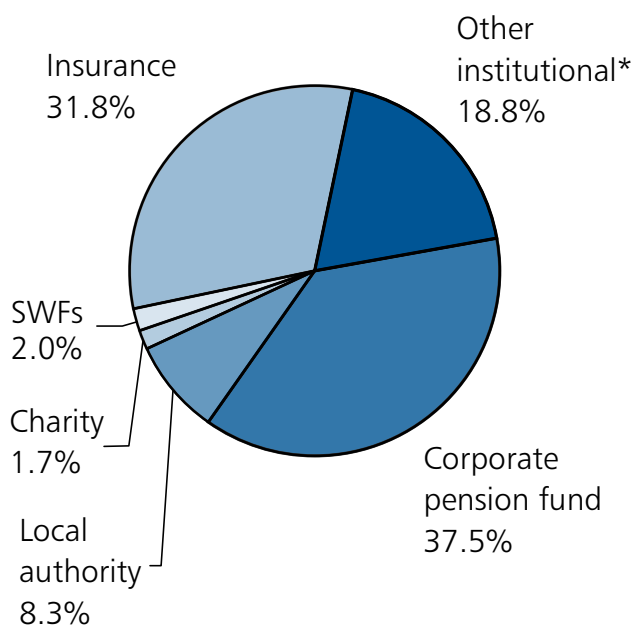
⁴ The report makes a distinction throughout between asset management (the broad set of activities including segregated mandates undertaken by firms) and fund management (referring more specifically to collective investment vehicles).

Institutional and retail investors tend to differ in one significant way. Retail investors looking to save in an investment fund or pension product are likely to be investing only a portion of their overall assets. They may often have other sources of financial (e.g. cash savings or direct holdings of stocks and securities) or non-financial (e.g. property) wealth. In contrast, an institutional investor such as a pension fund will be close to or fully invested with a number of specific goals.

The trend towards specialisation, together with greater diversification over the past decade, has also resulted in institutional investors, particularly pension funds, giving mandates to a larger number of firms than previously would have been the case. Niche capabilities as opposed to broad-spectrum services

have become increasingly the norm, although some firms operate on a multi-boutique basis looking to establish multiple centres of excellence. While there is some suggestion that the specialisation trend may be challenged, particularly with the emergence of solution-driven institutional products, available data points to specialist mandates accounting for a clear majority of institutional assets under management.⁵

Chart 1.B: Institutional assets under management in the UK (December 2008)



*Other institutional includes a range of clients, e.g. corporates, governments, central banks, international organisations and other asset management firms.

Source: IMA

⁵ See IMA, *Asset Management in the UK 2008*. Some 71% of total institutional assets are managed on a specialist basis.

Domestic savings base

It is useful to make a distinction between the domestic savings base and the international dimension (i.e. the industry as an exporter of investment management services). Chart 1.C shows the evolution of the UK asset management industry since 1960 based on two metrics of primarily domestic retail and third party institutional business: investment funds and UK occupational pension scheme (OPS) assets. By the mid to late 1990s, the combined total was approaching 100% of GDP, with pension funds over 80% of the total.

Within the pension saving environment and the third party institutional asset management base, occupational defined benefit schemes have historically been to the forefront, operating across both public and private sectors. While private sector pension schemes generally operate on a funded basis, much public sector provision tends to be unfunded, with the most notable exception in asset terms being the Local Government Pension Scheme (LGPS). This emphasis on private sector funded occupational provision has meant that, in an international context, the UK compares favourably in terms of funded pensions provision, with pension assets equivalent to just over 85% of GDP (see Chart 1.D).

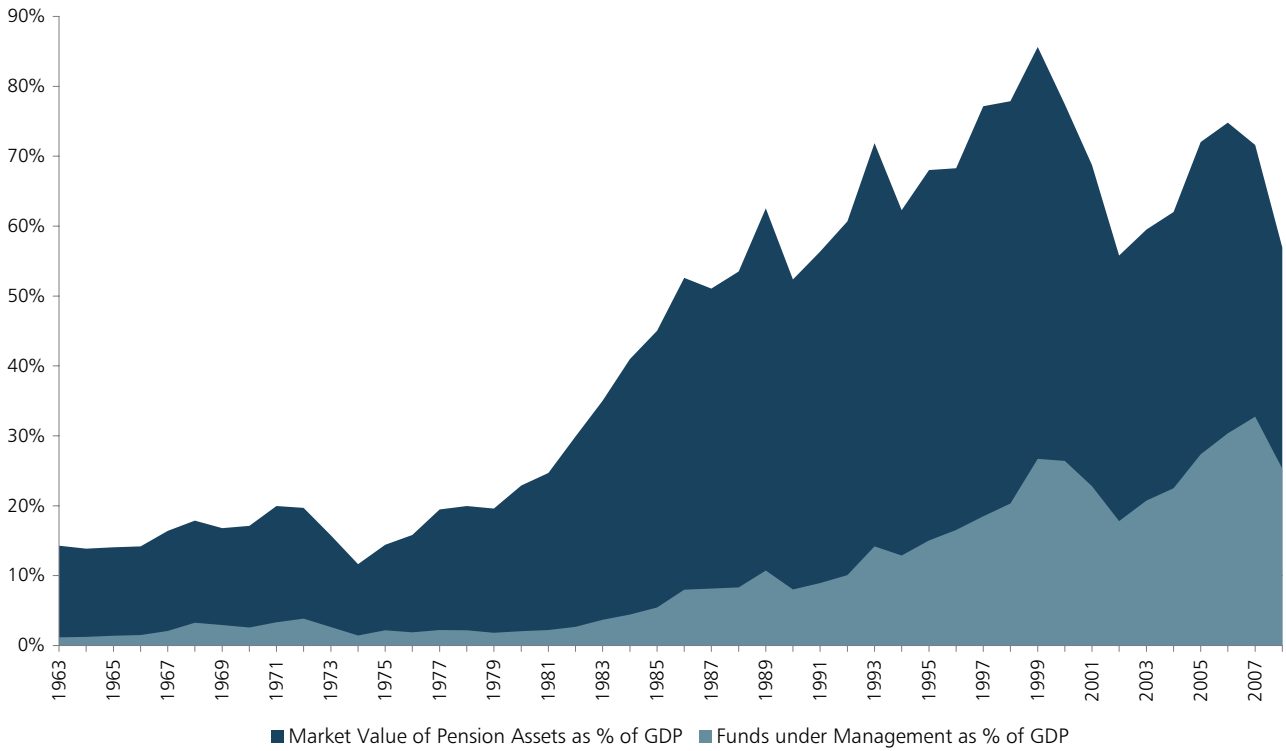
Together with the UK insurance company investment and savings business⁶, managed historically primarily by in-house management firms, the OPS and investment funds represent the “captive” dimension of the UK asset management industry: i.e. domestic business that would fall naturally to UK-based firms, although many international firms have a strong presence in the UK.

Another useful metric to measure the growth of the asset management industry is the number of UK investment funds and fund companies. Chart 1.E shows the progression since 1963, while Chart 1.F illustrates the growth in funds under management, together with account holders. The account holder information should be treated with caution due to considerable double counting. However, the magnitude of change over the last four decades is striking.

Overall, the IMA estimates that just over 70% of assets management in the UK are managed on behalf of UK clients.

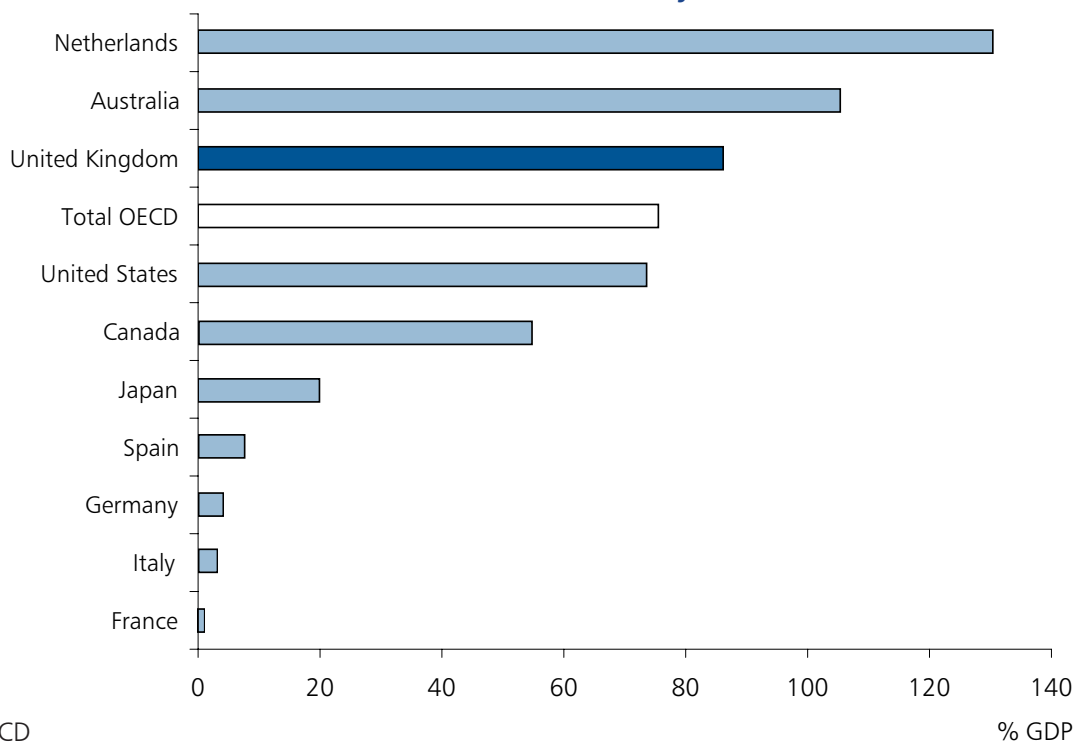
⁶ Comparative historical data is unavailable for the insurance part of the long-term savings industry. However, insurance-owned asset management firms currently account for around 30% (just under £1trn) of total assets under management in the UK.

Chart 1.C: UK occupational pension scheme and UK investment fund assets (% GDP, 1963-2008)



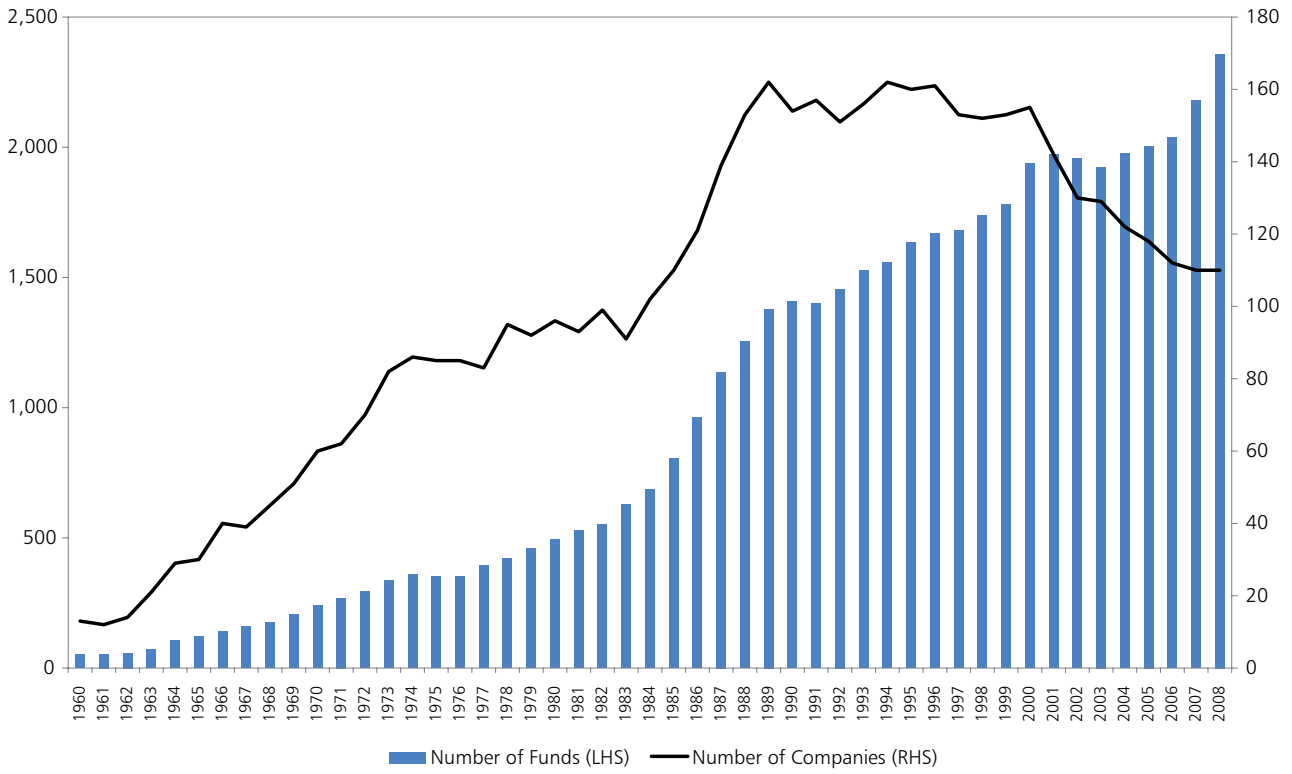
Source: ONS and AUTIF / IMA

Chart 1.D: Pension funds relative to the size of the economy in selected OECD countries (2007)



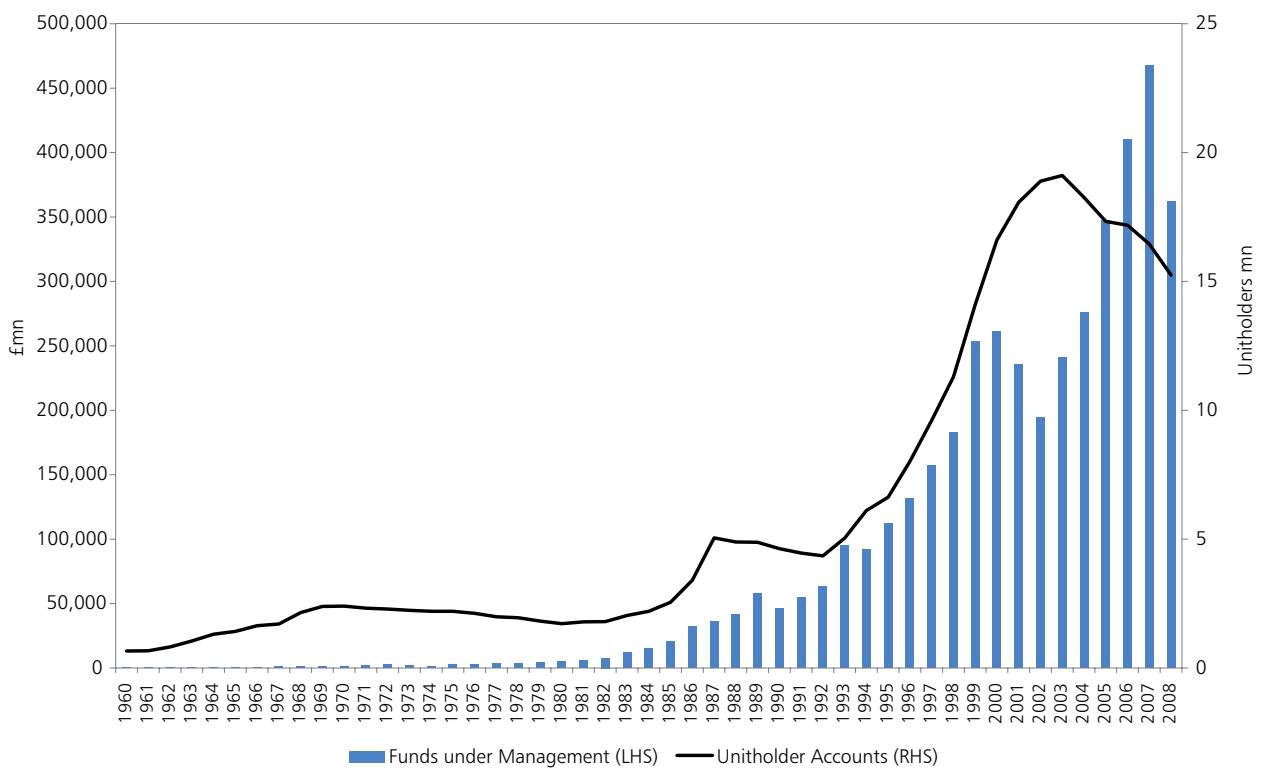
Source: OECD

Chart 1.E: Funds and companies (1960-2008)



Source: IMA

Chart 1.F: Funds under management and unitholder accounts (1960-2008)



Source: IMA

International dimension

There are five main international dimensions of the UK as an asset management centre:

- overseas firms operating in the UK;
- overseas clients for the UK asset management industry;
- overseas domicile of many vehicles whose assets are managed in the UK;
- investment in overseas stock and securities of client monies; and
- overseas management by firms of UK and other client assets.

This results in a considerable cross-border flow of client money in various forms. Indeed, the UK has established itself as a major centre for asset management on behalf of both overseas-domiciled clients and overseas-domiciled funds.

Table 1.A: European fund domicile locations (investment funds excluding offshore jurisdictions, December 2008)

Country	Market size
Luxembourg	25%
France	21%
Germany	15%
Ireland	11%
United Kingdom	8%
Italy	4%
Spain	3%
Switzerland	3%
Austria	2%
Belgium	2%
Other	7%

Source: EFAMA

Overseas firms

In keeping with the international nature of the wider UK financial services industry, asset management firms from around the world operate in this country. While 60% of total assets managed by the industry in the UK are managed by UK-headquartered firms, 40% are managed here by overseas-headquartered firms, with the largest component being US firms (just under 30% of the total).⁷

Overseas clients

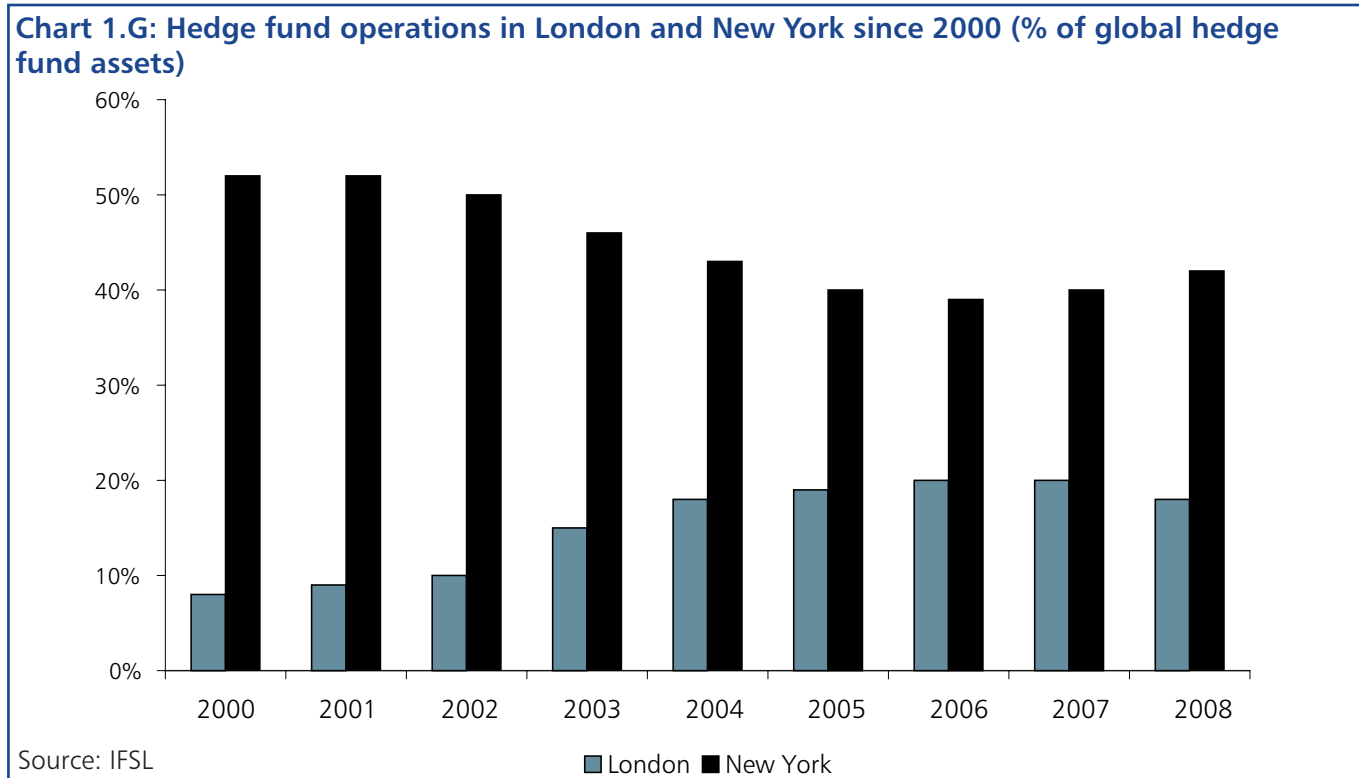
A variety of investors from institutional to retail, are both directly and indirectly clients of the UK asset management industry. Directly in the sense that some may contract directly with firms in the UK. Indirectly in two senses: first, overseas firms may delegate management of assets to their UK sister firms or to third party managers; second, assets may be managed in the UK for overseas fund vehicles. IMA data suggests that around 30% of assets managed in the UK are managed on behalf of overseas clients.

The opportunity set for asset management export activity is increasing as a result of shifts in savings needs internationally (particularly driven by the challenge of changing demography and ageing societies) and greater openness in terms of trade barriers. The growing international acceptance of UCITS is also a significant factor that could be further built upon.

Overseas funds

An important distinction that will run throughout this report is to be made between an asset management and a fund management centre. As a domicile for investment funds, the UK is in fifth place, and Luxembourg is the dominant player in Europe (see Table 1.A). However, in terms of where the assets are managed, the UK is easily the leading centre in Europe. The relatively low position of the UK as a fund domicile reflects the volume of assets managed in the UK but domiciled in funds located elsewhere. These are primarily located in Ireland and Luxembourg, although there are a number of other

⁷ Source: IMA, *Asset Management in the UK 2008*.



significant centres: e.g. Channel Islands and Cayman Islands.

Overseas-domiciled funds with UK managed assets fall into four principal categories:

- *mainstream investment funds* (primarily UCITS funds) marketed to a range of investors across the EU and, increasingly, in other regions of the world;
- *Institutional Money Market Funds* (IMMFs) based primarily in Ireland and consisting of triple-A rated money market vehicles used by a range of institutional investors (see also paragraph 2.30);
- *hedge funds*, which are usually overseas domiciled vehicles, but whose presence in London from an asset management perspective has grown considerably in recent years; and
- *non-UK authorised open and closed-ended collectives* marketed to the institutional or private client market (e.g. Jersey Property Unit Trusts).

This overseas element of UK business is potentially highly mobile geographically. Should the features determining the attractiveness of the UK as an asset management centre change significantly, firms may relocate aspects of their operations or not establish them in the first place. Equally though, and again as discussed later in the report, there are significant opportunities for the UK's tax and regulatory regime to evolve in such a way as to bring a greater number of offshore funds onshore (see Chapter Two).

Importance of alternatives industry

The alternatives industry, including both private equity and hedge funds, is a key component of the asset management industry. Internationally, hedge funds have grown strongly in the past decade, reflecting increasing client demand for absolute return management and the strong performance achieved by the industry. In the UK, the growth has been particularly striking, both in terms of assets under management and global market share. By 2007, International Financial Services London (IFSL) estimates suggest that hedge fund assets under management in the UK had reached \$425bn before

falling sharply to \$250bn in 2008. From under 10% of global hedge fund assets in 2000, the UK accounted for a fifth in 2007 (see Chart 1.G).

Although the numbers may be flattered by a greater degree of 'survivor bias', available data points to strong performance by hedge funds, especially in risk-adjusted terms. Even after the difficulties experienced by the hedge fund industry in 2008, the strong long-term record remains intact and is attracting institutional interest from around the world.

The availability of more flexible onshore structures, notably through UCITS III, is accelerating a process of convergence with traditional investment management. While many leading 'mainstream' investment managers are now offering hedged products within their overall offering, a number of leading hedge fund groups are now also offering 'long only' product. The process of convergence may be further accelerated by regulatory change, especially if this includes limits on use of leverage. However, as Chapter Two discusses further, there are also opportunities for a new onshore fund regime to attract hedge funds currently domiciled overseas.

The rapid growth of the hedge fund industry has been driven by a combination of factors:

- innovation, as investors develop new instruments for managing risk and portfolio structuring;
- flexible incentive structures, which have attracted high performing managers; and
- flexible fund structures, which have enabled managers to deliver more sophisticated product offerings.

The industry has played an important role in innovation, particularly in relation to methods of capital preservation and risk management. Hedge funds also play an important role in other areas, such as the provision of market liquidity and the evolution of trading execution strategies.

Understanding the importance of the hedge fund sector as a source of innovation within the fund management industry is critical to an appreciation

of its contribution to London as a financial centre. Hedge funds act as a major source of R&D to the financial services industry in general and to fund management in particular, with a number of techniques (e.g. absolute return strategies; long-short funds) being exported back into the wider industry.

This R&D role underlines the growing convergence between the so-called 'mainstream' and 'alternative' parts of the industry we identify above. The notion of a traditional asset management sector, defined by 'long only' investment in a range of standard asset classes (equities, fixed income, property, cash), is increasingly anachronistic. Considerable implications flow from this for product development as well as regulation. There are also competitive considerations arising from the risk to future innovation that might come about if the UK ceased to be an attractive location for hedge fund management.

1.2 Serving clients

The recent financial crisis has seen a profound dislocation characterised by a high degree of market turbulence and chronic instability in many institutions that lie at the heart of the financial system. Although asset management firms, including hedge funds, were not at the epicentre of the crisis, it has been a discomfiting experience for the industry and its clients, and raises a number of questions about industry products and client expectations.

While there will be lessons to learn in a number of areas, one positive outcome has been that the integrity of the fund structures has generally held up well during the credit crisis.⁸ In addition to the separation of assets from management companies, consumer protection is enhanced in the investment funds environment by a range of other governance rules and practices. Other collective vehicles, such as investment trusts, are also subject to rigorous if somewhat different governance requirements.

⁸ On the lessons for authorised funds specifically, see IMA, *The Credit Crunch: A Stress Test for Authorised Funds*, 2009.

At a general level, however, there is a need to ensure that the role of the industry is clear. Its role is to provide investors with a set of products and services to help them invest their assets over an appropriate time frame according to their risk tolerance and income aspirations.

For the industry to succeed and for clients to be satisfied, there needs to be active education of the consumer and more realistic goal setting between asset manager, adviser and client. While the highly intermediated nature of the industry (elaborated in more detail in the next section) imposes considerable challenges for asset managers, these must be overcome by manufacturers and distributors if the industry is to thrive in the longer term. The recent financial crisis has only served to underline the imperative for an examination of the relationship between communications, expectations and education.

The industry also needs to consider carefully the product set that is required to serve its client base. As we discuss in Chapter Four, a particular long-term challenge is the shift towards defined contribution pension arrangements. The transparent nature of these products – i.e. they are long-term unit-linked investment products within a tax wrapper – means that asset managers will achieve a greater prominence than previously has been the case. This is particularly so in the UK, given the traditional dominance of DB schemes where members had little cause to look beyond a promise made on behalf of their employer.

Finally, no centre can pretend to be a world leading asset management location unless it manages the higher interests of the industry. While professional bodies are well-established guardians of ethics, the industry may need to give consideration to the question as to whether it should do more to define, monitor and raise standards.

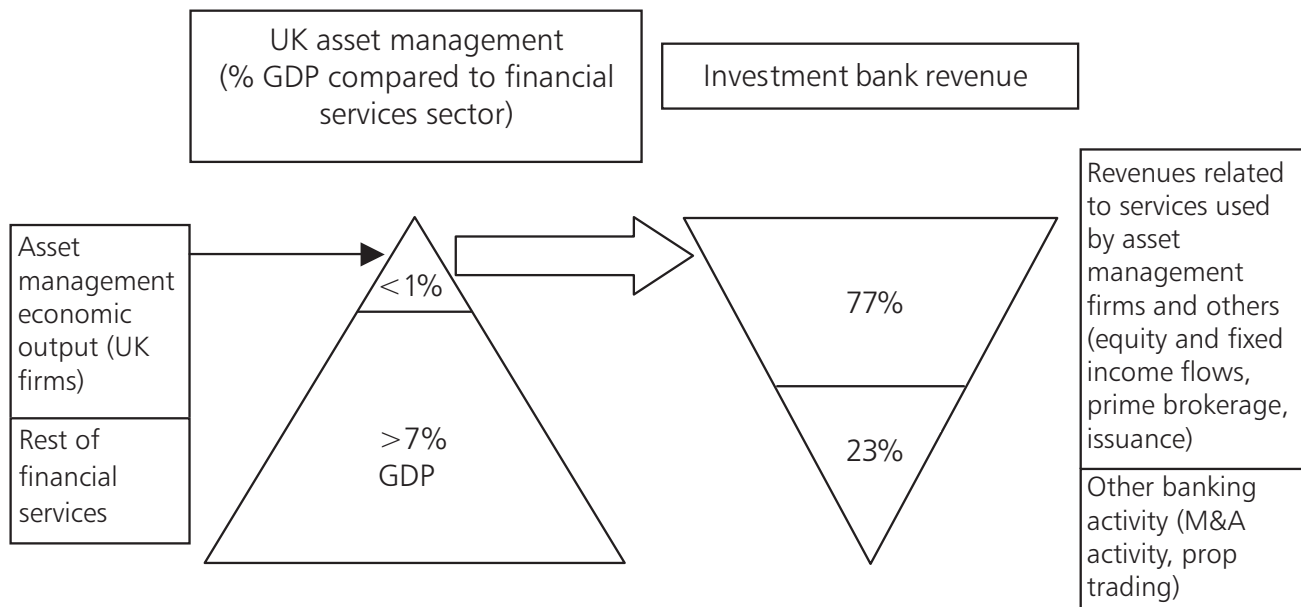
1.3 Wider economic role

Asset management firms fulfil a role as turntables of capital. At a broad economic level, the industry is a mechanism for ensuring an efficient route from those who have capital to invest to those who need capital. This year in particular, it has facilitated considerable issuance in the equity and fixed income markets. In fulfilling this function, asset management firm investment activity, the 'buy side', is a cornerstone of the City without which neither the 'sell side' nor the markets could function as effectively or efficiently.

In this respect, a distinction could be made between the value added generated by the asset management industry and its position within the financial services industry. Compared to other parts of the financial services industry, asset management value added for UK activities (outlined in more detail below) is far less significant. However, given its role as a conduit for capital, the industry contributes to a substantial proportion of other financial services revenues through the services consumed (e.g. stocks and securities broking services, prime broking, stocks and securities issuance). As Figure 1.A shows, these services (also consumed by other financial institutions and non-financial clients) account for the vast majority of investment banking revenue. In this respect, the industry's visible economic impact is dwarfed by a less visible but crucial contribution to the wider economics of the City.

The annual revenues and wider economic impact are also dwarfed by the scale of the asset base for which the industry is responsible: its revenues in 2008 were around 1% of GDP, but the £3.4trn it managed as at December 2008 equates to 235% of GDP.

A further point here is that while the presence of a significant onshore asset management industry is important in and of itself, the presence of that industry in combination with other parts of the financial services industry is crucial. This is fundamentally an argument about clusters and why geo-spatial features continue to matter so much in an age of rapid communication and global

Figure 1.A: Direct vs. indirect economic contribution of asset management industry

Source: IMA / JPMorgan Global Equity Research

competition, which is seeing increasingly widespread mobility of businesses as well as labour. This point is developed further in Chapter Two.

Direct economic contribution

Latest IMA statistics for the industry suggest that overall revenue (excluding commission expenses) among IMA member firms was around £9.4bn in 2008, down from £10.2bn a year earlier. However, this number only contains a small part of the hedge fund, private equity and discretionary wealth management sectors. It is therefore a significant under-statement of the earnings of the overall asset management industry. The most important single additional component is likely to come from hedge funds, where a different kind of fee base is in operation from that generally seen in the UK institutional asset management market. This part of the industry is likely to have generated at least £3.5bn in revenue during 2008 with some estimates suggesting that it could be over double this level.⁹

In GDP terms, the IMA has calculated that its members' activity contributed around 0.5% in 2008.¹⁰ Adding additional components, such as hedge funds, private client and private equity activity, is likely to take the figure closer to 1.0%.

If one applies the assumption that tax accounts for around 40% of GDP, asset management activity translated into a significant tax contribution, representing around £6bn in revenue in 2008. However, other methods of calculation would produce a higher number.

⁹ We have based this estimate on the higher charging structures associated with hedge fund products, assuming a 2% annual management charge on an asset base that was estimated by IFSL to be £170bn (\$250bn) at the end of 2008. Performance fees also need to be considered. A report by Open Europe estimates the tax revenue from hedge funds to be £3.2bn in 2008, which implies total revenues that are significantly higher. See <http://www.openeurope.org.uk/research/aifmd.pdf>.

¹⁰ In order to obtain a GDP contribution estimate, we have made an estimate of the specific value added of the asset management industry itself - this is the value that the industry adds over and above the services that it buys in from other industries - and taken at this as a proportion of GDP. It excludes services bought in and the "multiplier" effect as the income generated is spent by owners and employees elsewhere in the economy.

Translating into balance of payments terms, the most recent ONS estimates for the fund management industry suggest a net contribution of £4.0bn in 2008.¹¹ This contribution has been on a sharply rising trend over the past decade. The 2008 figure is six times higher than that of 1998.

Direct employment by IMA member firms is estimated at just under 25,000 as at end 2008. Direct employment in other parts of the asset management industry is likely to add at least 10-15,000 further jobs, taking the total of direct employment to around 40,000.¹²

An outsourced and intermediated industry

However, the asset management industry has several features that mean its overall economic and employment contribution is much greater than will be simply expressed by headline revenue and employment numbers:

Outsourcing

Almost all functions – including the asset management and operation of fund vehicles – can be outsourced. 75% of respondents to a recent IMA survey outsourced some part of their activity.¹³ This means that there is a significant services industry, consisting primarily of:

- third party administration firms;
- fund accounting firms;
- depositaries or trustees for investment funds (which have to be external);
- custodians;
- professional services support (primarily legal and audit); and
- infrastructure services (notably IT systems).

¹¹ See ONS, *The Pink Book*, 2009, p. 51.

¹² Primarily in three segments: hedge funds, private equity and discretionary private client management.

¹³ See IMA, *Asset Management in the UK 2008*.

Third party distribution

In both the institutional and retail markets, asset managers significantly depend on third parties to facilitate the distribution of their products:

- In the institutional pension fund market, clients tend to engage consultants to organise the commercial process and provide advice to trustees.
- In the retail funds sector, re-intermediation has seen an increasing distance between retail end investor and product manufacturer with platform-based distribution starting to dominate. As Chart 1.H shows, direct sales have never been a defining feature of this market, with Independent Financial Adviser (IFA) intermediation very strong in the funds industry. However, direct sales have declined markedly in recent years as the growing role of platforms has led to a sharp increase in sales via the intermediary channel.
- It is not just the advent of the platform that characterises the re-intermediation process. The increasing popularity of fund of funds and manager of managers products inserts another layer between end investor and asset manager.

1.4 Corporate engagement

Asset management firms operating in the UK are estimated to hold UK equities equivalent to 43% of total UK domestic market capitalisation as at end-December 2008. As agents of the end-investor, asset managers monitor companies they invest in, enter into a dialogue with them, and usually decide how shares will be voted on their clients' behalf.¹⁴

In considering their general approach to engagement, asset managers have a choice:

- some believe that superior returns will accrue to those who actively challenge the management and boards of companies they invest in and who vote their shares in an informed way;

¹⁴ See IMA, *Survey of Fund Managers' Engagement with Companies*, 2009.

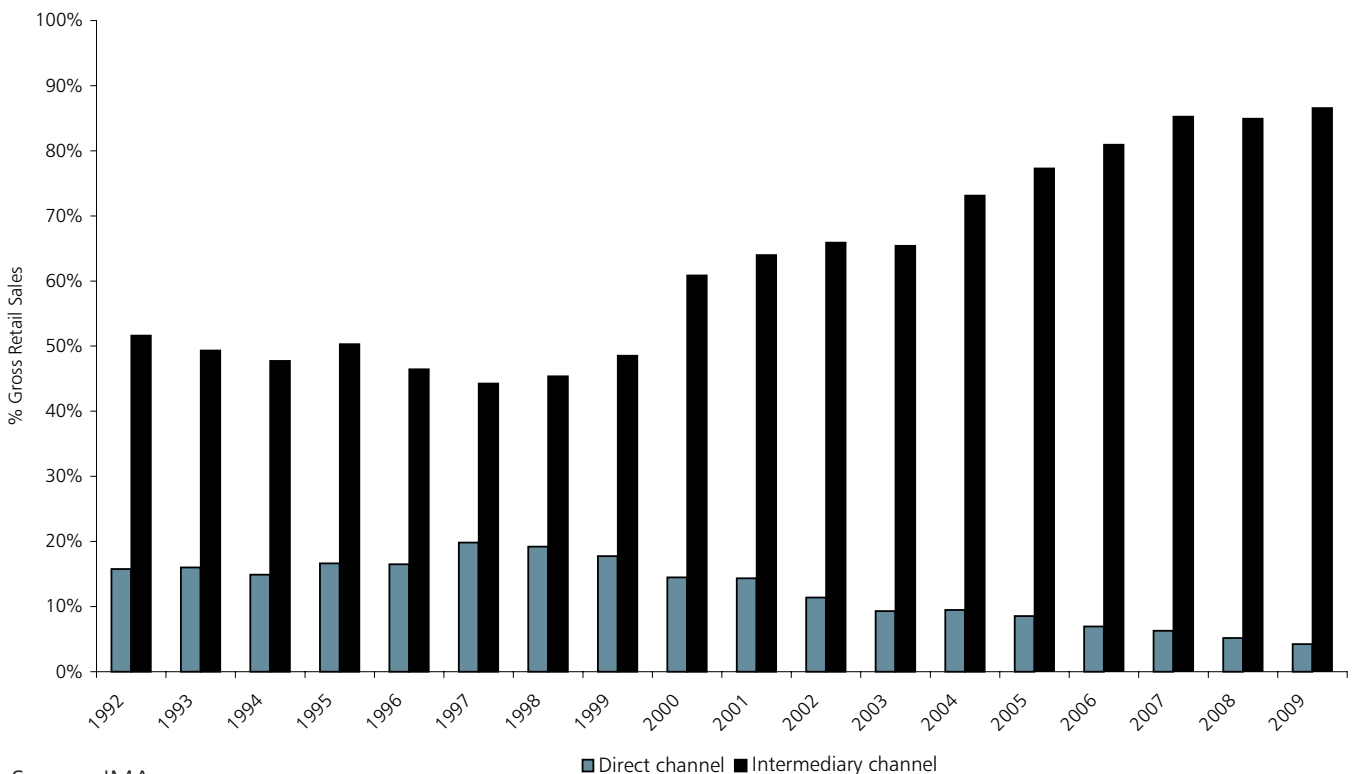
- others believe that the best way to send a signal to poorly managed companies while maximising investor returns in the process is to exit the shareholding altogether (although this option may not be available to all managers, most obviously those who are running indexing vehicles); and
- finally, there are those both inside and outside the industry who would rather mobilise investor engagement to strengthen governance in the corporate community and check management excesses.

In this context, it is evident that, as practised to date, engagement failed to check the governance failures within the banking sector. The asset management industry itself recognises that it needs to improve in this area. Hence the questions recently raised by both government and industry: could engagement be made more effective and would more effective governance have made a difference?

The debate becomes difficult because there is no factual basis on which to resolve it. There is little objective evidence that engagement produces portfolio returns which are superior to those who do not and yet it comes with a cost. However, few would want to invest in badly run companies and what is evident is that there is a growing trend towards engagement and that the UK industry is at the forefront of that trend. That momentum continues to build as shown by the IMA Engagement Survey. The latest survey shows that 32 fund managers representing 68% of UK equities under management actively engage, vote their UK shares, and increasingly publish their votes.

However, efforts to mobilise the asset management industry to engage more and more effectively have run up against a number of obstacles – some removable and some not. One that could be removed is the perception amongst fund managers that to team up with like-minded investors to bring pressure to bear on management might raise issues of insider

Chart 1.H Sales channel trends (1992-2009)



Source: IMA

trading, changes of control, and industry collusion and “the concert party” rules.

The authorities have issued guidance to help allay these concerns and pave the way for more aggressive shareholder action. Assuming investors’ concerns are addressed and there is a willingness to make use of the opportunity, industry engagement should become more effective. Nonetheless, obstacles will persist: less than 50% of UK shares are in the hands of UK based fund managers and rarely will all of those feel the same way about issues at the same time to the same degree. A question that immediately arises is whether the UK could persuade non-UK holders of UK shares to embrace engagement, and whether it should try.

It is also unlikely that more widespread engagement would have prevented recent bank related excesses. Investors, unlike regulators and Boards, are not insiders. The insiders failed to spot the problem. It is unreasonable to assume that outsiders would have done so to a greater extent.

Legislation which mandated engagement would most certainly add to industry costs without any certainty of adding to investor returns or systemic safeguards. Were Government to appear to favour one style of investment over another, that could create significant problems for both industry and Government.

The policy challenge is therefore to reconcile the much sought after but elusive benefits of engagement with the desire to retain the competitiveness of the fund management industry and the City of London more generally. Government and industry policy should encourage engagement because it is necessary to a well functioning capitalist system that the owners of capital are able to hold company managements to account. They should not mandate it, because company management can also be held to account by selling the shares of poorly performing companies. Those who choose to engage should endeavour to do so more effectively. With the right protections in place, they should not hesitate to make their views known and weight felt.

Ultimately the issue is accountability. It is in the interests of shareholders and of the system that

company management be held to account. The question is how best to do this. The fund manager acts as agent for its clients, the shareholders. Logically it should be for the client to decide how best his money should be managed.

1.5 Wider policy environment

As we discuss throughout this report, both the European and domestic policymaking and regulatory contexts are crucial to the long-term health of the asset management industry.

For the industry to prosper in the UK, there needs to be a clear willingness by the authorities (both at UK and EU level) to take the interests of the asset management industry seriously and to recognise the role it plays in the savings and pensions market. Although progress has been made domestically in this area in recent years, a sub-theme of other chapters of this report is that more could be achieved.

One prominent area, discussed in more detail in Chapter Five, is the question of market regulation and ensuring that the interests of the buy side are recognised and upheld. However, there are others, notably the tendency, particularly at European level, to see long-term savings and pension products as synonymous with insurance products. This is clearly not the case and needs to be rectified in both legislative and institutional terms (see Chapter Four).

Like any industry operating internationally, the ability of the asset management industry to access and operate effectively in overseas markets may be constrained by local barriers to entry. This is particularly evident in the cross-border funds market: for example, requiring local partners for fund distribution or having to base fund management operations in the local jurisdiction. It is important for the UK industry to work with the UK and European authorities to ensure the development of export markets, particularly in light of some of the opportunities arising in the long-term savings market as a result of demographic and welfare system change (see Chapter Four).

RECOMMENDATIONS

1. The industry should ensure that meeting client needs remains at the heart of its operating philosophy. This should include better shaping of client expectations of what it can and cannot deliver – whether through its advertising or its contribution to investor and adviser education.
2. Engagement by shareholders is to be encouraged by both industry and regulator, recognising that it will always be ultimately for clients to determine their preferred investment style.
3. The industry must be pro-active in financial sector policy debates (domestic and EU). Policy makers should consult more with the industry on matters involving the financial sector at large, particularly on market issues.

2 Location choice and competitiveness

The UK as an asset and fund management location has benefited historically from a number of significant advantages, many of which still hold true. However, other jurisdictions have been able to establish strong fund domicile centres, partly by moving more quickly and decisively on occasion to embrace new opportunities. With the wider tax and regulatory environment currently changing (both at EU and international level), there is now a substantial opportunity to establish the UK as a domicile of choice for both the mainstream and alternative parts of the industry.

2.1 UK attractiveness

As we illustrate in Chapter One, the UK asset management industry has developed substantially to respond to a domestic savings pool, channelled primarily through occupational pension schemes, insurance products and investment fund sales. The scale of the domestic savings pool has enabled the domestic asset management industry to reach critical mass across a broad range of asset classes and has served also to drive innovation.

The international dimension of the business has been facilitated historically by a number of features of the UK, which historically have made it attractive for global asset management firms:¹

- *Regulatory and legal structure.* The UK has had a reputation founded on a solid institutional and legal structure, complemented by a competent regulatory regime.
- *Strength of talent pool.* The UK has both a significant domestic skilled labour force and the ability to attract overseas workers. Although the UK has experienced successive waves of immigration historically, London has over the past decade solidified its reputation as one of the most international cities in the world, able to attract a substantial pool of highly skilled migrants.
- *Language and broader culture.* The talent pool has been facilitated by a natural language advantage, but also a business culture generally seen as accommodating and innovative.
- *Time zone.* For asset management specifically, but also for other financial activities, the geographic position of the UK allows it to bridge global time zone differences between North America and the Far East. For a firm investing in these regions, this country remains an ideal location from which to operate.
- *Proximity to markets and clients.* The presence in London of key markets in which asset managers operate in works to the advantage of the UK. The UK is also a favourable base for firms with business activities across Europe.
- *Operating infrastructure and quality.* The UK's operating infrastructure in its broader sense – i.e. support services such as administration, legal and IT as well as transport – is well developed.

¹ Clearly, these are not unique to the asset management sector. Several recent reports have examined the wider competitiveness issue see *UK international financial services the future* (HM Treasury, 2009) and *London: Winning in a Changing World* (Merrill Lynch, 2008).

Table 2.A: Global financial services index ranking²

Rank	Asset Management	Banking	Government and regulatory	Insurance	Professional Services
1	London	New York	London	London	London
2	New York	London	New York	New York	New York
3	Singapore	Singapore	Singapore	Zurich	Hong Kong
4	Hong Kong	Hong Kong	Hong Kong	Singapore	Singapore
5	Zurich	Chicago	Chicago	Hong Kong	Zurich
6	Jersey	Zurich	Tokyo	Dublin	Geneva
7	Geneva	Geneva	Frankfurt	Tokyo	Jersey
8	Guernsey	Frankfurt	Paris	Hamilton	Guernsey
9	Dublin	Boston	Zurich	Munich	Frankfurt
10	Luxembourg	Toronto	Toronto	Geneva	Chicago

Source: GFCI 5, City of London, March 2009

The UK financial services industry also benefits from some significant cluster effects, particularly in London. Broadly speaking, there are two core elements to the cluster argument, both with particular relevance to London given the exceptionally wide range of financial services activity in the City:

- *Critical mass and economies of scale.* Critical mass brings with it a number of advantages, notably the ability to develop with a *self-sustaining dynamic* through attracting new businesses. With a greater range of activities come economies of scale and scope.³ The self-sustaining dynamic is extremely important with respect to location competition. Not only does it serve to reinforce London's pre-eminence in certain areas, it also

makes it comparatively harder for rival centres to develop rapidly.

- *Increasing competition.* There are competition impacts from clusters, with a well-known analysis identifying three key features. The first is in driving the *productivity* of companies based in the areas; the second is in driving *innovation*; and third is in stimulating the *formation of new businesses*. While productivity in the asset management industry is difficult to measure, the innovation and business formation points both seem to hold true. There are also other factors driving the latter in the industry: comparatively low barriers to entry, the importance of intellectual capital and the impact of specialisation.

Such advantages have allowed London to become and remain the pre-eminent centre for the asset management industry and a number of other financial services activities globally (See Table 2.A).

However, while aspects such as time zone, language and proximity to clients and markets are relatively

2 The GFCI, undertaken by the City of London Corporation, ranks cities on the basis of their attractiveness to financial services professionals. It is based on what they describe as a "component factor model", a statistical model built up with different types of data components or inputs. The two main inputs are individual indices measuring competitiveness (e.g. index of office rental costs) and a rankings survey of locations completed by financial professionals.

3 Study by David Raikes and Andrew Newton cited in OXERA, *The Future of UK Asset Management: competitive Position and Location choice* (IMA/Corporation of London, 2005), p.19.

4 Michael Porter, *Clusters and the New Economics of Competition*, Harvard Business Review, 1998.

immutable, the competitive environment continues to evolve and it is important to protect London's longer-term trajectory as an asset and fund management centre.

Regulatory and legal structure

An increasing proportion of financial services regulation emanates from EU and not UK institutions. This shifts the focus of activity by the UK authorities substantially onto both shaping in a proactive way regulatory proposals and implementing them in a way that can help to foster and avoid any damage to UK and wider European industry. The draft Alternative Investment Fund Managers Directive (AIFMD) is the most pressing current example of legislation affecting (potentially very negatively) the asset management industry. There is also a wider international dimension, with a number of significant regulatory bodies operating at global level. Here again, the Government has an important role to play in ensuring that the AIFMD is pursued in a way that retains the attractiveness of UK and other major European centres as a global hub for asset management activity rather than drive future innovation in supply and products outside the EU.

Tax regime

Recent changes to the UK fund tax environment have been welcomed by the industry and have considerably improved the UK's competitive position. Also welcome is the ongoing regular and constructive dialogue between Government officials and the industry on fund taxation. However, it is important to ensure that opportunities to enhance the UK's position as a fund domicile location are not missed, particularly in the light of broader changes in both the European and international tax and regulatory environment. These are discussed in more detail below.

At a broader level, there is a perception in the UK asset management industry that a stronger sense of certainty regarding the tax environment needs to be created. This applies as much to personal as corporate tax treatment and also extends to areas such as savings incentives (see Chapter Four). While

Government will inevitably have cause to revisit fiscal arrangements, great benefit could be derived from minimising the development of any culture or perception of uncertainty.

Strength of talent pool

A good talent pool and skills base is an issue for all firms, but has particular resonance among international firms operating in the UK. The industry is keen to ensure that the culture of openness which they have come to expect here is not undermined by changing immigration policy. This could come about in both direct and indirect ways: directly through raising the bar on criteria to filter skilled migrants; indirectly, through general requirements for work or study in the UK that lead to a broader perception that the country is no longer as welcoming to overseas workers.

As the Bischoff report on the future of UK international financial services noted, accessing the right skills is not just about tapping an overseas reservoir, but ensuring that the UK develops its own capacity for sustaining and boosting a labour pool suitably qualified for employment in the sector. In Chapter Four of this report, the AMWG supports a greater emphasis on financial literacy and skills in the education system; this mirrors the recommendations of the Bischoff Report and the report from the Insurance Industry Working Group (IIWG). The Group also supports the calls for greater collaboration between industry and higher educational institutions to develop courses correctly calibrated for the needs of the industry.

2.2 Domicile and the UK funds industry

In contrast to the position of the UK as a European leader in asset management terms, its position as fund management domicile is less favourable (see Table 2.B which shows side by side the rankings of asset management and fund management centres presented earlier in the report).

Other countries, notably Ireland and Luxembourg, have established an apparently self-sustaining dynamic as fund domiciles. As Chart 2.A shows, the growth in Luxembourg over the last 15-20 years has been very striking, but Ireland has also expanded rapidly. Certain products have been especially prone to overseas domicile of the fund: notably, institutional money market funds, exchange-traded funds, hedge funds and property funds. As we discuss in the next section, a range of factors, few immutable, determines domicile choice.

In a European context, UK promoters are thought to account for 41% of total net asset value for Irish-registered investment funds and 8.7% of Luxembourg funds equating to €409bn as at end December 2008.⁶

Domicile of the fund has not had a direct bearing on location choice with respect to core value adding functions, notably asset management. The argument could also be made in favour of comparative advantage whereby centres such as Luxembourg or Ireland have established a momentum and cluster of expertise which the UK may not be best placed to rival. Nonetheless, the Group believes that domicile does matter, both economically and to the broader operating culture of the industry.

Economically, it is clear that domicile decision is likely to account for a significant range of activities in the value chain, notably investor servicing (e.g. processing applications, maintaining the share register), fund accounting and the trustee or depositary function. These may be complemented by professional services such as legal and audit. An IMA/KPMG report in 2007 concluded that the annual loss to the UK exchequer in consequence could be as high as £1mn per £1bn of funds domiciled overseas.⁷

Determinants of fund domicile decision

The determinations of a successful fund centre can be categorised in four broad categories:

- general approach of the authorities;
- tax and regulatory structure;
- legal structure; and
- quality of the workforce.

Table 2.B: Ranking of top six European asset management centres and fund management domiciles⁵

Rank	Asset management centres	% Share (Europe)	Fund management domiciles	% Share (Europe)
1	United Kingdom	34%	Luxembourg	25%
2	France	21%	France	21%
3	Germany	11%	Germany	15%
4	Italy	6%	Ireland	11%
5	Belgium	4%	United Kingdom	8%
6	Netherlands	4%	Italy	4%

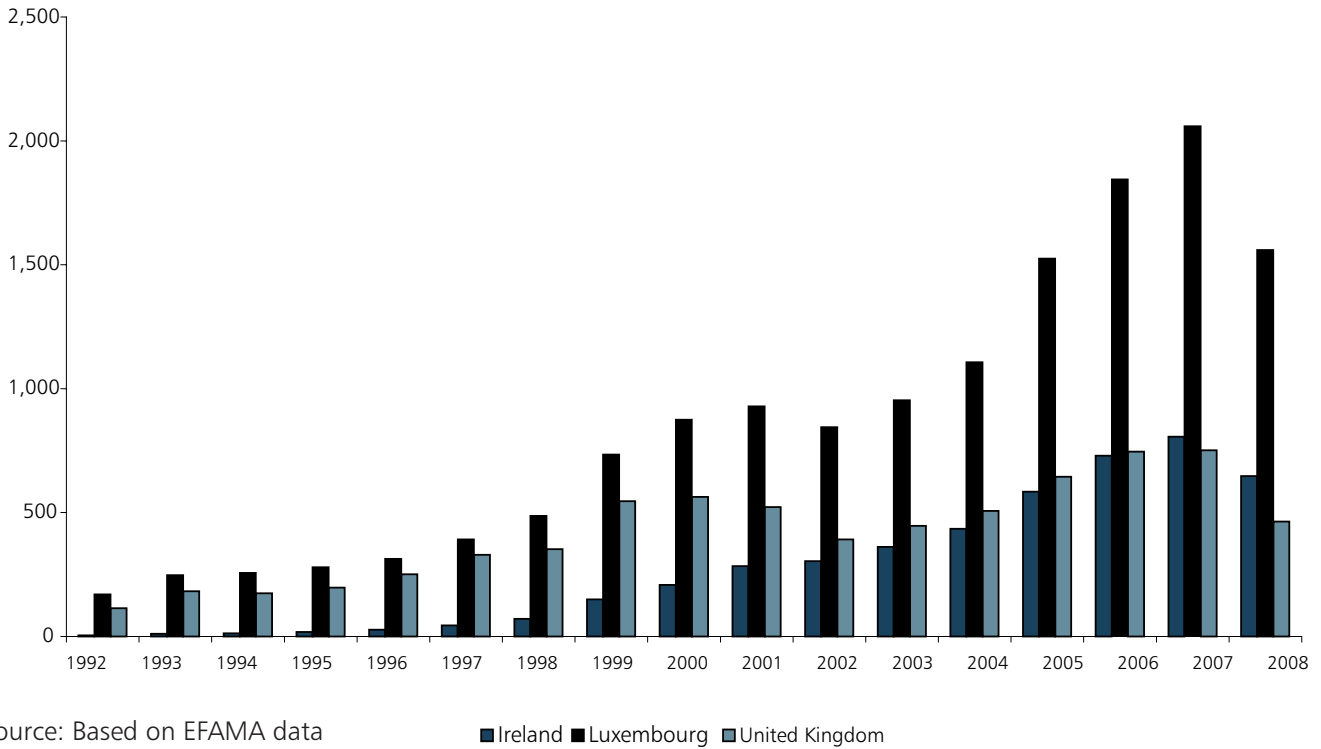
Source: Based on EFAMA data

⁵ This is based on a ranking of UCITS and non-UCITS vehicles (e.g. institutional special funds, regulated hedge funds and property funds).

⁶ Source: Irish Funds Industry Association and the Commission de Surveillance du Secteur Financier, Luxembourg.

⁷ For more detail, see *The value to the UK Economy of UK-Domiciled Authorised Investment Funds* (KPMG, 2007).

Chart 2.A: Relative growth of funds domiciled in Ireland, Luxembourg and the United Kingdom (1992-2008, EUR bn)



Box 2.A: Key components of successful European fund centres

Authorities

- Anticipation of industry needs and external developments
- Good coordination between entities
- Proactive support of industry

Tax and regulatory structure

- Tax efficient fund regime
- Flexible regulatory structure, accommodating of innovation

Legal structure

- Strong legal framework

Workforce

- Expertise based in relevant areas of fund administration
- Skilled and flexible labour force

General approach of the authorities⁸

The general approach of authorities can have a significant bearing on the funds industry. Three specific factors are worth noting here:

- *Anticipation of needs and rapid response.* It is helpful to the industry to have regulatory authorities who work very closely with the industry, understand its needs, anticipate external developments and construct rules accordingly.
- *Good coordination.* Good interaction and co-ordination between regulatory, revenue and fiscal authorities can help to improve the efficiency of developing product offerings in the UK market. All relevant authorities need to be involved from the start of any consultations to ensure that any new regimes are workable from both a regulatory and tax perspective.
- *Proactive support.* Firms with Luxembourg and Ireland fund ranges have expressed the view that regulators in those jurisdictions appear proactively to support and develop their fund industries by creating new fund regimes that cater for all areas and markets. They also work jointly with the industry in promotion of their industry in other jurisdictions.

Tax issues

Tax is clearly a key driver of competitiveness. In 2006, a KPMG report, commissioned by the IMA, concluded that more could be done in the UK both in terms of specific fund taxation measures and of relations between the tax authorities and the industry.⁹ Significant progress has since been made and this is summarised in Annex A. The landscape has substantially changed and the industry has welcomed the improvements, most notably:

- a regular and constructive dialogue between the Government and the industry, and open consultation;
- the launch of a Tax Elected Funds regime;

- a tax-efficient property funds regime;
- legislative change to clarify that transactions by UK authorised investment funds and equivalent offshore funds will be taxed as investing not trading;
- a workable regime for institutional funds (QIS); and
- a reformed Offshore Funds Regime.

The reforms mean that the tax regime has largely caught up with the UCITS III regulatory regime. But the industry believes other jurisdictions moved more quickly with the result that even hitherto UK-only players decided to domicile funds elsewhere.

As we discuss further in Section 2.3 below, it is important going forward that the UK tax regime anticipates rather than reacts to wider developments. Of particular note in this context are future opportunities afforded by the UCITS IV reform and a potential move onshore of parts of the hedge fund industry.

One tax issue that both the mainstream and alternative fund management industries continue to view as problematic is stamp duty. Stamp duty affects the assets managed by the industry in two ways: first, through the direct levy of 0.5% on all transactions in UK shares; second, through Schedule 19 of the Finance Act 1999 (Schedule 19 SDRT) which applies specifically to the transfer of units in authorised funds. However, the industry recognises that there would be revenue implications of abolition and that these would need to be addressed in order to justify changes.

That notwithstanding, the industry considers that Schedule 19 SDRT raises specific issues. It is felt by firms that it reduces returns to investors in UK funds and is a barrier to domiciling funds onshore. In 2008-09, Schedule 19 SDRT paid was £115mn, but the industry believes the losses to the Exchequer as a result of UK-managed funds being offshore could be significantly greater. On the basis of the calculations from KPMG cited above, the industry believes the UK would only need to attract £115bn of funds to

⁸ The observations below are based on a survey of collective investment schemes undertaken by the IMA in the spring of 2009.

⁹ See *Taxation and the Competitiveness of UK Funds* (KPMG, 2006).

generate the £115bn raised in 2008-09 (£115bn represents about 5% of total assets domiciled in Luxembourg and Ireland).¹⁰

It may be the case that the difficulties caused by Schedule 19 SDRT are as much about perception as the underlying fiscal reality. There is a substantial difference between the headline rate of 0.5% and the effective rate, which has been estimated by the Treasury to be equivalent to a level of only about 0.05% of relevant assets under management.¹¹ However, industry believes that for some investors, whatever the actual tax burden, the fact that Schedule 19 exists at all and that other jurisdictions (e.g. Ireland) have no equivalent, will have discouraged investment in UK funds.

Furthermore, given the computational complexity of Schedule 19, firms find it hard to explain to those not closely involved in Schedule 19 compliance the difference between the “headline” and the effective rate, a difficulty which the UK’s competitors are able to exploit.

In terms of the two major areas of future opportunity outlined in Section 2.3 (UCITS IV and hedge fund domicile), Schedule 19 SDRT is perceived as an obstacle by the industry. With respect to master feeder structures under UCITS IV, as the tax regime in the UK currently stands, non-UK investors are unlikely to invest into a master fund subject to Schedule 19 when they could invest in a fund domiciled in a jurisdiction without Schedule 19. UK domiciled feeder funds would also have difficulties with Schedule 19 as they could still be subject to SDRT even if the underlying assets in the master fund are not themselves subject to the principal charge (i.e. they are not UK equities).

Regulatory factors

There are also a number of specific measures which overseas regulatory jurisdictions have adopted to their advantage, for example:

- *Rapid launch.* Irish Qualified Investor Funds (QIFs) and Luxembourg Specialised Investment Funds (SIFs) have a much faster time to market (immediate for SIFs, 24 hours for QIFs). In the UK, Qualified Investor Schemes (QIS) can take up to six months to launch. This is particularly important when institutions want to take advantage of a particular opportunity.
- *Wider range of recognised fund structures.* Under the Financial Services and Markets Act 2000 (FSMA), while contractual vehicles and Limited Liability Partnerships (LLPs) are collective investment schemes, only OEICs and unit trusts can be authorised funds. Within Europe, contractual vehicles are more acceptable to investors than trusts. In the hedge fund arena, a common investment structure is or involves LLPs. FSMA therefore limits hedge fund managers setting up authorised vehicles in the UK.
- *Allowing for prime broker arrangement.* UK onshore hedge funds, operated as authorised vehicles, would have to have a depositary. If the hedge funds wished to continue to use a prime broker (where assets are re-hypothecated), the depositary would have to accept full liability for that activity, which it would not wish to do.
- *Few, if any, investment and borrowing restrictions.* Overseas jurisdictions have allowed great flexibility in the area of investment and borrowing. Although QIS are currently able to invest in a wide range of assets as per the COLL sourcebook (Chapter 8), there are assets that are not permitted by COLL: e.g. fine art and wine. Furthermore, the rules state that borrowing money is permissible, but it is not clear whether the QIS regime allows a fund physically to borrow stock to sell short or to employ certain liquidity tools such as notice periods and side pockets. Finally, physical leverage is limited to 100% of the fund. No such limit exists in jurisdictions such as Luxembourg or the Cayman Islands.

¹⁰ The hedge fund calculation is based on IFSL data, which estimated global hedge fund assets at \$1,500bn as at end December 2008. The Luxembourg and Ireland calculation is based on EFAMA data for Q2 2009.

¹¹ See HM Treasury, *Stamp duty reserve tax - Schedule 19: a discussion paper* (2007), p.6.

A summary of the main differences between the QIS, SIF and QIF can be found in Annex B.

These points are in contrast to the UK regulatory approach in retail funds, which is generally reactive to the industry's needs, while upholding a robust governance structure, which has stood up well even through extreme market conditions.¹²

Workforce

In a financial cluster, part of the ability to reach critical mass is based on skills and the UK has a significant talent pool. However, in terms of the domicile debate, there needs to be a strong match between specific requirements of the funds industry and the skills available in different jurisdictions. Here, there are certain issues for the UK:

- Luxembourg especially has the capacity for multi-lingual personnel which facilitates the cross-border distribution of funds;
- greater expertise in the administration of multi-currency share classes exists in Luxembourg and Ireland; and
- there is also more expertise in the administration of performance fees (a major factor for hedge funds) in traditional hedge fund domiciles.

2.3 New opportunities to establish the UK as a domicile of choice

The fund management industry is in a state of continuous evolution and bringing business to a centre can depend on how effectively regulation responds to innovation opportunities:

- One example is the experience of the institutional money market funds (IMMFs) industry. The European triple-A rated money market funds industry initially developed in Ireland and Luxembourg as these were the only two jurisdictions which interpreted UCITS in such a way that would allow amortised accounting.¹³ Sizeable industries established in these two jurisdictions from the mid 1990s onwards. These two localities now have recognised centres of excellence for the money market fund industry.
- A second example is the development of Common Contractual Funds (CCFs) in Ireland. The CCF is a fully tax transparent vehicle designed to allow pensions funds and other exempt investors who enjoy specific tax advantages, in particular double tax treaty benefits, to maintain these advantages: i.e. taxes apply to the underlying investor and not the investment vehicle.

As we note above, once financial centres reach critical mass or specific areas of excellence develop, it may be very difficult through regulatory or fiscal changes to reverse previous domiciliation decisions. However, there are now a number of opportunities for the UK authorities to boost the fund management industry, arising both out of UCITS IV, but also out of changes to the environment in which the hedge fund industry operates.

¹² For more detail on this see IMA, *The Credit Crunch: A stress test for authorised funds* (June 2009).

¹³ The UCITS directive requires that money market instruments must have a value which can be accurately determined at any time. It was only in Ireland and Luxembourg that the regulators would permit the use of amortised accounting and be deemed to be compliant with the requirements of the directive by virtue of the need for comparison with the market value.

UCITS IV

In terms of future advances in European fund market integration, the next substantial movement forwards will be offered by UCITS IV. Master feeder arrangements (see Annex C) are expected to offer considerable opportunities for asset pooling, which will go some way towards the creation of a more genuinely pan-European funds market.

Also, pension funds and other institutional investors will want the master fund to be tax transparent, so will favour contractual vehicles of the kind outlined on the previous page. In other words, it is not going to be attractive to domicile master funds in the UK.

Hedge fund domicile

Both the AIFMD and potential tax changes internationally affecting offshore centres may result in hedge funds looking to relocate from current domiciles into the EU. Given that so much hedge fund management takes place in the UK, this represents a chance for the UK potentially to secure domicile as well. A number of regulatory and tax issues have already been outlined above. There are also several further tax issues industry would ask the Government to consider:

- Hedge fund managers may be concerned about how they would be treated on non-domicile tax issues, primarily in relation to their own investment in a fund. There may be some areas of clarification as to how the regime for non-domiciled investors would operate in relation to particular structures.
- Where hedge funds invest in other offshore funds (through fund of funds structures), they will wish to have certainty that these offshore funds will be taxed as investing and not as trading. Industry therefore believes that the definition of “offshore equivalent funds” should accommodate as many investment vehicles as possible.

RECOMMENDATIONS

4. The Group believes the industry and Government should work together to prevent further loss of UK fund business to other jurisdictions and make the UK a domicile of choice for collective schemes.
5. The UCITS IV directive, combined with the welcome simplification of the UK tax regime for offshore funds, will bring greater scope for rationalising fund ranges. It needs to be ensured that the UK is not placed at an unnecessary disadvantage in this process.
6. The Group also believes the UK would benefit from a viable onshore hedge fund regime. The industry, regulator and Government should work together to develop such a regime.
7. Measures to consider include expanding the class of collective investments the FSA is empowered to authorise and changes to the FSA rules for Qualified Investor Schemes. The industry believes that further re-examination of the Schedule 19 SDRT regime is also necessary.

3 Distribution and consumers

Consumers need simplicity, transparency and choice when they seek to access investment products. That should include choice of distribution channel and transparency of adviser status and remuneration. The FSA's proposals in the Retail Distribution Review will move the UK in the right direction. There is also an opportunity for the MiFID review and the work on Packaged Retail Investment Products to achieve similar outcomes across the EU.

3.1 Principles for better serving consumers

Given the complexity of financial markets and their lack of familiarity in approaching medium to long term savings, retail consumers often look to advisers to help them find the right financial market solutions. The accelerating shift of responsibility for retirement provision from the state and corporations to the individual is driving the need for such advice. Yet, when investors turn to advisers and other intermediaries to assist them, there can be a real lack of clarity about the nature of the assistance that they will receive.

This section outlines five principles that the Group believes should be at the heart of the process of serving consumers well in the fund distribution environment. There should be:

1. promotion of choice of distribution channels;
2. transparency and clarity surrounding adviser status;
3. transparency in remuneration, clarifying the cost of advice;
4. enhancement of adviser professionalism and empowerment of consumers; and
5. a level playing field for different products and distribution channels.

Promotion of choice of distribution channels

Traditionally, in continental Europe, mutual fund distribution takes place through bancassurance channels complemented to a lesser extent by private banking, financial agents (tied agents) and independent financial advisers who can review the whole of the market. Quite often therefore, advisers are part of banking or insurance groups with whom the customer already has a connection e.g. through provision of retail banking services or provision of general insurance services. On the other hand, the UK market is relatively distinct in that independent advisers are dominant in fund distribution.

Whether in the UK or in Europe, it is important for consumers to have clear choices in terms of where to go to purchase investment services. A recent report by the European Commission, under its "Consumer Markets Scoreboard" initiative, raises concerns about the distribution of financial products by banks, highlighting a lack of information and impartial advice, and opaque charging structures.¹ Governments and regulators could help to enhance consumer choice through facilitating a wide range of distribution channels. Policy should not unduly discriminate between different models that can have positive outcomes for consumers (see also principle 5). This could progressively facilitate a greater focus on the quality of advice, putting the consumer first and provide downward pressure on costs.

¹ See *Commission Staff Working Document On The Follow Up In Retail Financial Services To The Consumer Markets Scoreboard* (European Commission, September, 2009).

Transparency and clarity surrounding adviser status

With a diverse distribution landscape, the consumer needs to be clear about the status of an adviser, and the nature of the service they are being offered. These questions are important because they set the agenda for the basis of the relationship between the intermediary and the consumer. An intermediary offering advice on a family of in-house products is offering a very different service from one providing advice on products from the whole of the market.

This is not just a question of semantics. It is vital for the consumer to understand on what basis the intermediary is acting and it is important that they have the full range of sales and advice options explained to them even if some or all of these options are not available from the intermediary that the customer has initially chosen.

Linking to the third principle below, it is also important that there is transparency, expressed in simple but explicit terms, around the remuneration that the adviser and his firm will receive, to provide the consumer with comfort that no conflicts of interest exist.

Transparency in remuneration, clarifying the cost of advice

Consumers would be helped if they were in a position where they could distinguish between the cost of the product and the cost of the investment advice. This would empower them to assess separately the value for money of the advice and the value for money of the product and to make meaningful comparisons. Too often the consumer is left as a weak economic force, unable to exercise real choice or compare the overall cost of investing in different products due to opaque or bundled pricing.

Enhancement of adviser professionalism and empowerment of consumers

The purchase of financial services products, including investment services, is not straightforward and, for that reason, consumers often seek advice. In so doing, it is reasonable for consumers to expect that their financial adviser should have a practising certificate in the same way as a lawyer or accountant. We also think it is sensible for the qualification structure to be organised in a way that requires those advising on more complex products to have a higher level of qualification.

However, improving consumer outcomes is not just about the abilities of intermediaries; it is also important to ensure that consumers are better able to interact with the financial services industry. While many consumers look to financial advisers for help, there is a significant body of consumers who are willing to take their own investment choices but nevertheless are looking to investment firms to provide them with better information about their products and practical tools to improve their financial capability and access to financial products.

Technology can be harnessed to provide consumers with decision trees and web-based tools which can assist with asset allocation as well as trimming the market offering down to those products which fit their purposes.

The RDR has sought to develop 'simplified advice processes' in conjunction with the industry. These are streamlined advice processes, normally involving a decision tree and a more simple set of lower risk products that provide the customer with a suitable personal recommendation based on an assessment of their needs. Industry generally agrees that such advice processes can be provided within the current regulatory framework, but is concerned about how the FSA and the Financial Ombudsman Service (FOS) would judge the process and associated risk of liability.

This concern can be alleviated if the definitions and limitations of guidance are properly communicated and understood: self-diagnosis using web-based tools cannot be considered equivalent to a meeting with a financial adviser and clear signposts would need to be put in place so that consumers are in no doubt about the potential restrictions of such an approach. The FSA is continuing to explore with the industry how these concerns might be overcome. In addition, the FSA is working with the Committee of European Securities Regulators (CESR) to help develop a clearer boundary between advice and non-advised services.

A level playing field for different products and distribution channels

Consumers need to have the same protections regardless of the financial services product they are purchasing or the distribution channel by which it is sold to them. Under existing regulation, there is considerable asymmetry regarding the way in which different financial services products can be sold both in the UK and more widely in Europe.

There is also an issue surrounding the focus of advice. Governments and regulators have focussed on assessing the suitability of a prescribed financial product when regulating retail distribution. This focus has led to a disproportionate level of attention centred on product choice, which in many cases, is the final and relatively small step in an advice process. Financial planning and advice is as much about the decisions made not to invest in a product or the order of investments or the necessity of reducing personal debt levels as it is about the products which are purchased. Regulation should take a holistic view of the advice process with appropriate focus on the product selection along the accompanying advice-giving process.

Regulators should also consider examining the behaviour of firms whose product offerings are skewed to a few high profile product lines to ensure that those products do indeed deliver value for consumers and that their success is not the result

of misaligned incentives. Such an obligation to demonstrate transparency to the satisfaction of the regulator would be activated where the product accounts for a disproportionate amount of total sales in a particular client or product category over a certain timeframe.

3.2 Regulatory responses

The comments and recommendations below are intended to support much of what is proposed in the RDR and also look beyond the RDR to Europe. The UK should always bear in mind the wider EU implications of UK initiatives (e.g. to those looking to operate a single business model on a pan-EU basis). A strong, competitive, well-regulated UK asset management sector will be well placed to take advantage of opportunities in the wider European market.

UK and the RDR

The asset management industry has broadly welcomed the RDR consultation paper *Distribution of Retail Investments: Delivering the RDR*, June 2009, as a substantial step forward. It sets out a blueprint for retail distribution in the UK, which includes a number of measures to improve the provision of financial advice including the professional standards of financial advisers. In general terms, it is our view that the measures set out in the RDR paper will help promote further improvement in the distribution of medium to long term savings in the UK. With respect to the principles set out above, the AMWG welcomes the proposals that:

- There will be a clear distinction between different types of advice – independent advice and restricted advice - with clear up-front disclosure of the type of services an adviser is able to provide. The RDR consultation paper has proposed that all investment firms clearly describe their services as either “independent advice” or “restricted advice”.

- Providers will be banned from offering advisers amounts of commission to secure distribution of their products.
- Adviser firms will be required to set out and agree “adviser charges” with customers, making clear the cost of the advice and the cost of the product.
- Advice (both independent and restricted) will be further professionalised.

European level

As previously noted, the EU funds market is becoming increasingly integrated, and so the policy issues around distribution at the European level become increasingly significant. There are two prospective initiatives which will provide an opportunity to move European regulation forward in the way that the RDR promises to in the UK.

Packaged Retail Investment Products (PRIIPs)

The European Commission has announced plans to consult before the end of the year on measures to harmonise requirements for disclosure and sales practices across retail investment products generally. The Group welcomes this development, which promises to be of unequivocal benefit for consumers. There are at present widely differing rules for different types of product, leading to confusion for investors and distortions in the market. There is now an opportunity to put this right.

In many ways, the standard in the UCITS directives provide a model of what should be aimed for. A case in point is the disclosure of information about products, where a new simplified “key investor (KII) information” document for investors is being developed. The Group welcomes the statement in the Commission’s communication on PRIIPs that “the recent work on developing KII for UCITS provides a clear benchmark of the standard for mandatory disclosures that is being sought across other packaged retail investment products.”

Market in Financial Instruments Directive (MiFID)

MiFID came into effect on 1 November 2007 and a review of its effect is due to begin in 2010. It contained provisions about the disclosure of the nature of investment services which apply to intermediaries in the retail market. Article 19 covers conduct of business obligations when providing investment services to clients:

1. *Member States shall require that, when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in paragraphs 2 to 8;*
2. *all information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading. Marketing communications shall be clearly identifiable as such; and*
3. *appropriate information shall be provided in a comprehensible form to clients or potential clients about:*
 - *the investment firm and its services;*
 - *financial instruments and proposed investment strategies; this should include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies;*
 - *execution venues; and*
 - *costs and associated charges,*

so that they are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis. This information may be provided in a standardised format.

The experience of members of the Group is that the application of these provisions in different markets has been patchy. We think it would now be right to seek to embed the principles of transparency, unbundling, choice, and consumer empowerment more explicitly in the EU level rules. The MiFID review will provide the opportunity to put these on the table, in particular to identify whether EU investors have benefited from the opening up of distribution channels throughout the EU, so that they can benefit from a diverse choice and a level playing field.

RECOMMENDATIONS

8. The UK Government and regulators should adopt five principles as part of a proactive agenda both at home and with the EU. There should be:
 1. promotion of choice of distribution channels;
 2. transparency and clarity surrounding adviser status;
 3. transparency in remuneration, clarifying the cost of advice;
 4. enhancement of adviser professionalism and empowerment of consumers; and
 5. a level playing field for different products and different distribution channels.
9. Policy should aim to create a level playing field for advice which does not unduly discriminate between different advice and distribution models that can all have positive outcomes for consumers.
10. There should be clarity for consumers about the status of the adviser and the nature of the advice service they are receiving. Disclosure needs to have a strong and transparent role in the distribution process and must not be relegated to the status of “administration”.
11. The cost of the advice should be distinguished from the cost of the product at the point of sale. A move towards product pricing with cost of advice added on top will be much better for consumers.
12. There should be a tiered system of qualifications for advisers in a way that requires those advising on more complex products to have higher levels of qualifications coupled with continuing education requirements for advisers. The development and usage of web-based tools for consumers should be facilitated.
13. Standards of disclosure of product features and other aspects of the advice process should be raised to the level of best existing practice in an equivalent way for all investment products, including funds, unit-linked insurance products, certificates and structured banking products. Similar principles should apply to debt products.

4 The importance of pensions and savings

A flourishing domestic pensions and long-term savings market continues to be the essential foundation for the future development of the industry. However, the importance of the domestic market goes beyond the imperative of meeting the needs of its UK customers. With growing international opportunities, particularly in the context of different forms of retirement-related investments, expertise and innovation nurtured in a strong domestic market is a major source of potential strength overseas.

4.1 Changes in the domestic pensions market

Private sector pension provision in the UK is undergoing a substantial evolution. Over the last decade, there has been a much-publicised decline in private sector defined benefit (DB) provision, which has seen a sharp fall in active membership. Table 4.A illustrates the scale of this change, while also showing that the experience of the private sector has been in contrast to sustained growth in public sector (primarily DB) scheme membership.

At the same time, defined contribution (DC) schemes – both occupational and contract-based – are now far more prevalent. DC provision falls broadly into three categories (see Figure 4.A): occupational, employer contract based and personal pensions. ONS estimates suggest that DC scheme membership (including personal pensions) has reached around 7.8mn.¹ However, in asset terms, DC is still in its infancy, compared to DB.

This is unsurprising given the traditional predominance of DB in the UK and a tendency towards much higher contribution rates.

As the Pensions Commission noted, many millions of those in work are thought to be making little explicit retirement provision through work-based or individual pension schemes. Although the precise numbers are difficult to gauge, the first report from the Pensions Commission estimated that this figure was 11.3mn in 2002-03 (including the self-employed).

The auto-enrolment reforms planned for 2012, based on the Pensions Commission's recommendations, are expected to significantly increase DC provision in the UK and to reach parts of the working population previously outside the private pensions market. With millions of estimated potential new account holders, this will mark one of the most radical changes in pensions provision in recent times. It will also be the first or only exposure for many individuals to investment products, which raises substantial communication

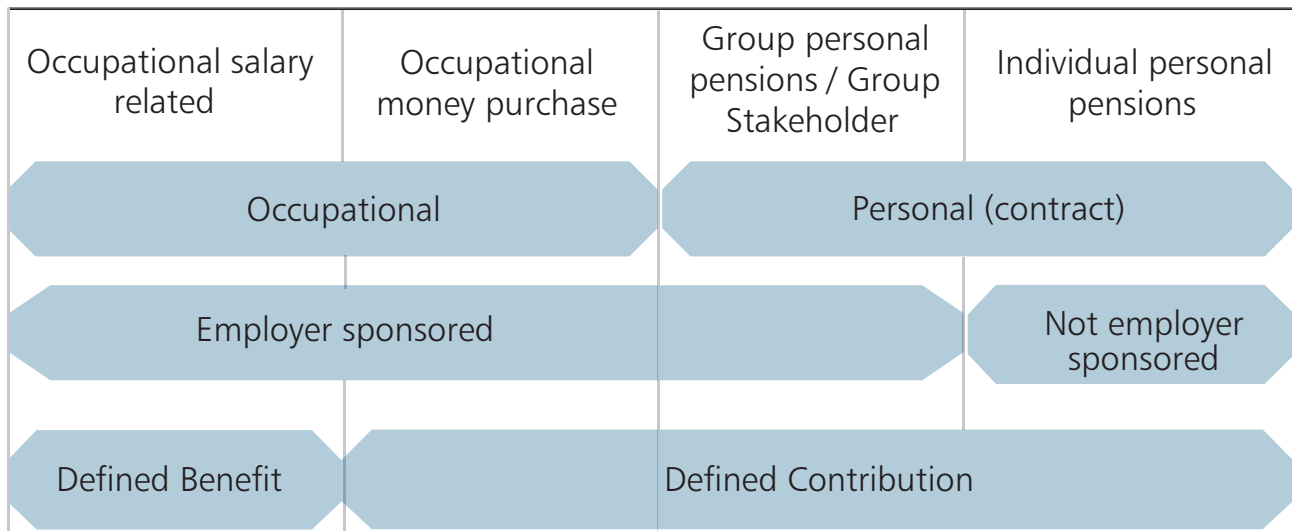
Table 4.A: Occupational pension scheme membership (millions, DB and DC)

	1991	1995	2000	2004	2006	2007
Active members	10.7	10.3	10.1	9.8	9.5	8.8
Private sector	6.5	6.2	5.7	4.8	4.4	3.6
Public sector	4.2	4.1	4.4	5.0	5.1	5.2

Source: Adapted from UBS Pension Fund Indicators 2009

¹ See ONS, Pension Trends, Chapter 6, June 2009.

Figure 4.A: Types of private pension provision



Source: Adapted from *Pensions: Challenges and Choices, the First Report of the Pensions Commission, 2004, p.80*

and design issues, not just for the Personal Accounts scheme, but also for schemes and products more widely.

Since the publication of the second Pensions Commission report, the asset management industry has supported the recommendation that auto-enrolment should lie at the heart of the reform to private sector provision. Although a national rollout is far from straightforward, existing evidence suggests that auto-enrolment will facilitate a move away from a voluntary approach that has not worked, while avoiding full compulsion. However, it needs to be made very clear to individuals that the 8% contribution, based on gross qualifying earnings, should be regarded as a minimum level.

The asset management industry has also agreed with the suggestion that a National Pensions Savings Scheme (now Personal Accounts) would be a viable entity. While there are major challenges inherent in the development of such a large scheme, particularly in the collection and enforcement mechanism for reaching hundreds of thousands of employers, the underlying account administration and investment

mechanics are not new in and of themselves. The trust-based Personal Accounts scheme will also offer visible and accountable governance, particularly on the investment side, which is likely to be a very sensitive and highly scrutinised issue.

The industry believes, however, that Personal Accounts should exist alongside and not cannibalise existing private pensions provision, particularly given the risk of a levelling down of employer contributions. It will be an unsatisfactory outcome for Government, pension savers and the industry if a quasi-government occupational pension scheme ever came to dominate the pensions market.

4.2 Long-term savings environment and the role of asset managers

The asset management industry's most visible contribution to the pensions industry historically has been through its management of the large funded base of DB occupational schemes. In this respect, it has a wide range of mandates – operated on both a segregated and pooled basis – from clients both in the UK and overseas e.g. Netherlands. In providing investment services to UK (and overseas) DB pension funds, the UK industry has both expanded in size and expertise over the last half century. With schemes focused on increasingly challenging liability profiles, the industry is again undergoing an evolution in the range of products and services it offers.

Within the wider long-term savings market, the asset management industry has had a more tangible connection with consumers via investment fund products. Since 1999, the Individual Savings Account (ISA) has provided a tax-incentivised savings vehicle that can be used to access such products, although there remains considerable potential for further growth in this area.

The growth of the DC market, which is based on individual investment accounts, is gradually seeing a changed role for the asset management industry. Personal pensions were traditionally bundled products where the accumulation and decumulation phases were intrinsically linked. Since the products ended up as pooled risk vehicles (annuities) for the payout phase, they were generally offered in an insurance wrapper. Pension regulation tended to institutionalise the role of insurance companies in this area.

With the introduction of the open market option (OMO) in 1978, the justification for this bundling weakened. But it was the A Day reforms in 2006 that recognised pensions accumulation products for what they are: a tax wrapper around an investment with a distinct set of rules for the drawdown

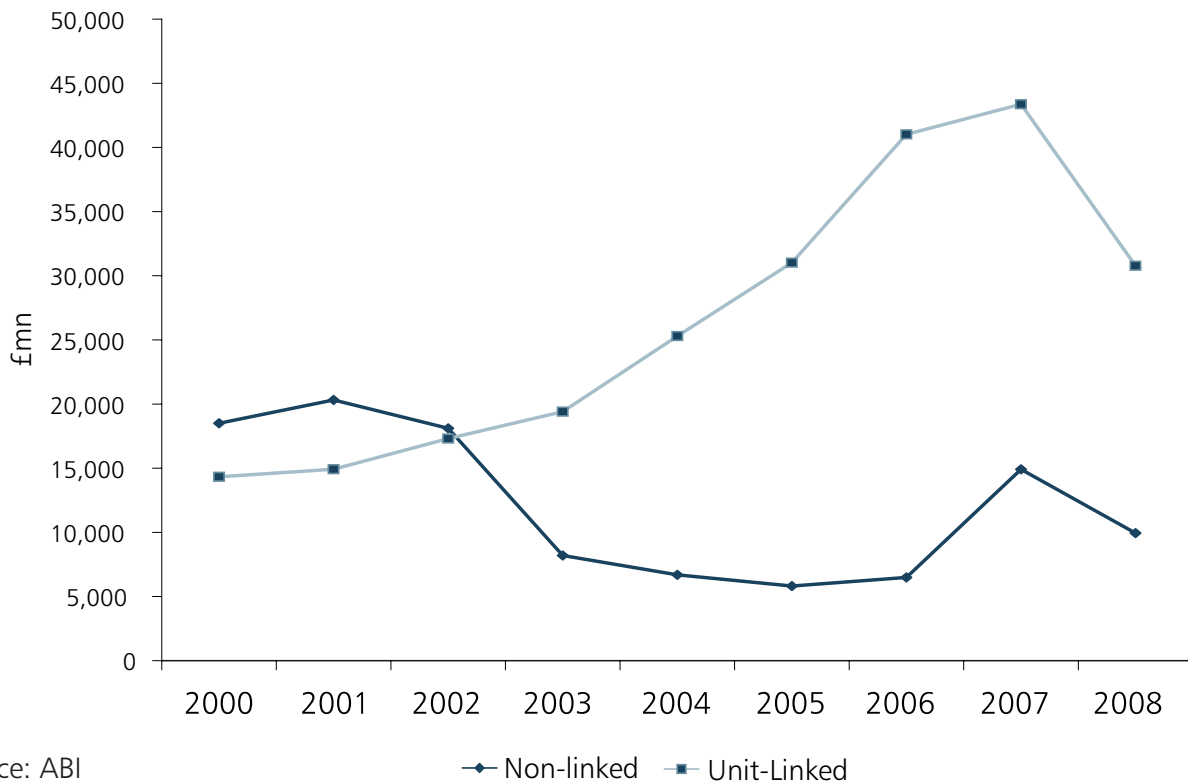
of the accumulated assets during retirement (primarily via an annuity). The possibility for income drawdown (until age 75) and the introduction of the Alternatively Secured Pension (ASP) have also helped to underline the point that pension saving is about more than simply pooling longevity risk in a fixed-income investment vehicle.

Over the past decade, two key trends within the insurance industry – the move away from with profits towards unit-linked policies (see Chart 4.A) and the emergence of open architecture – have significantly widened the investment options available to consumers and increased the visibility of asset management products.

In contrast, however, only a minority of independent asset management firms run bundled DC pension products in the UK, leaving the distribution to life and other forms of platform. This is partly a reflection of a historical legacy whereby the scale to operate such bundled products has tended to lie within the insurance industry. It also reflects the more general trend whereby the UK asset management industry as a whole does not control the distribution chain, being increasingly defined by its manufacturing skills. Many firms are only providing components (e.g. a specialist equity product) for strategies or default options determined elsewhere by consultants, other intermediaries or end investors themselves.

Significantly, those asset management firms that do operate in the pensions market, either on a bundled basis, or as providers of pooled institutional fund services, tend to do so via life company vehicles that they have seen the need to establish. These vehicles are not traditional insurance businesses and are used because it has not been operationally optimal for firms to operate via an investment funds route.

The perceived advantages have been identified as being primarily related to taxation, although there are some other considerations, such as ease

Figure 4.A: Non-linked vs. unit-linked life and pensions premiums (2000-2008)

Source: ABI

of creation of funds and share classes.² The asset management industry does not believe that such complexities are helpful and serve to reinforce an artificial division in the pensions environment, which does not reflect the contemporary realities of the long-term savings market, or ultimately serve to foster simplicity in the commercial environment that consumers encounter.

The structures in the DC market described above have meant that it has also historically been difficult for the asset management industry to be a key stakeholder in the pensions reform debate. This has now changed in the United Kingdom and the industry is pleased to work closely with the Department of Work and Pensions, the Personal Accounts Delivery Authority and the regulatory

² The tax issues encompass primarily two issues:

- Gross roll up of income. Authorised funds have to pay distributions even if the income is re-invested, creating administrative complexity. However, life funds can roll up gross.
- SDRT on *in specie* contributions and *in specie* exits. While authorised funds are subject to stamp duty on underlying investments in UK equities and tax through SDRT Schedule 19, life funds and offshore vehicles are not subject to Schedule 19.

authorities, alongside other stakeholders. However, there remains more to be done at the European level to persuade both national and EU officials of the need to recognise the role of the asset management industry in pension product provision (see section 4.4 below on IORP).

4.3 The importance of a stable, accessible and consumer-oriented pensions and long-term savings environment

For the private savings and pensions market to be a success, the broader policy framework needs to be characterised by simple and effective incentives, operating in a stable and reasonably predictable fiscal environment. This is a point also made by the IIWG.

Recent reforms have been positive. The 'A Day' legislation marked a considerable step forward in terms of simplicity. Auto-enrolment should prove an effective mechanism to encourage greater long-term saving for retirement. Together, they mark a significantly improved pension system.

However, the Group believes it would be helpful for the industry and government to reflect further about the operation of current savings incentives. Like the IIWG, it believes that exploring new options could be beneficial, while recognising affordability constraints for the Government. For example, there have been calls from a number of quarters for higher rate income tax relief for pension contributions to be abolished. The Group does not support this. If, however, it were to be perceived as a serious policy option at some time in the future, then the Group observes that simple abolition of higher rate relief would result in a significant reduction in the resources devoted to incentives for pension saving. In that event, other options might be explored, such as the 'matching' which has proved successful in the context of the Savings Gateway.

The Group also perceives a need to minimise the number of long-term savings wrappers (e.g. pensions products, ISAs, insurance bonds) which can act as a barrier to simplicity and ultimately to consumer engagement with savings needs.

These questions of incentives and retirement income behaviour are clearly difficult and raise significant questions. In addition to potential affordability, it is not clear whether those who are concerned about locking up savings in a pensions vehicle are choosing to use other more liquid savings or investment accounts (e.g. ISAs) or not saving at all. More research in this area could help the Government to focus fiscal incentives more precisely onto the goal of raising long-term savings levels.

Credible, understandable retirement products

At both domestic and international levels, clearer fiscal incentives and a more level tax and regulatory

playing field can be of benefit to both consumers and the asset management industry. However, it is also essential for the consumer to have confidence in the products and to understand them.

Policymakers increasingly believe that the transfer of risk to individuals for parts of their retirement income provision will form part of 21st century welfare state settlements. Decisions which affect significant parts of the lifecycle will often have to be made by many who feel neither well qualified to do so nor necessarily confident in the products themselves. The current financial crisis may exacerbate these problems.

If confidence and understanding are lacking and consumers eschew pension products, then retirement incomes may ultimately be sub-optimal. In consequence, there is an inevitable and desirable long-term alignment of industry and consumer interest. The asset management industry has a responsibility to help to ensure that DC investors are offered investment products that are suitable to their needs, that communications are effective and that expectations are aligned with potential outcomes.

However, there is a significant expectations challenge. The behaviour of many investors suggests that they are seeking consistently good returns with low volatility (or possibly some form of capital guarantee), something that is intrinsically difficult to deliver. In the long-term savings environment, it had been possible until comparatively recently to argue that 10 years was a satisfactory period of time to define as long term, with a view to expecting equity markets to deliver a reasonable return. Given the experience of the last 10 years, it is not going to be an easy task to persuade investors that the longer savings periods in pension products are likely to deliver strong, positive returns in a risk-seeking portfolio.

The asset management industry in the UK and Europe has publicly voiced concerns about structured products which will often offer

consumers a capital guarantee in exchange for upside potential linked to market movements. Such products still carry considerable risks and are frequently highly opaque about the costs associated with the guarantees.

This expectations challenge may be of considerable significance for the direction of the asset management and pensions industry in the coming years, but there is no consensus view among asset management firms about how best to meet it. Some firms believe that an absolute or target return style approach may in future better be suited to balancing consumer concerns about volatility with an investment approach that is nonetheless going to offer significantly better outcomes than a more cautious gilt-based investment portfolio. Others firmly believe that the challenge is about education and the need for consumers to have a better understanding of the risks-return trade-off inherent in investment and the importance of pro-active asset allocation.

Whatever the investment approach, the common denominator in building confidence will need to be better communication by the industry, ensuring clarity, simplicity and consistency in the way that products are presented.

Consumer education and empowerment

The common denominator in helping both Government and industry communicate with consumers regarding the savings and pensions market is consumer financial education. While a policy such as auto-enrolment is intended to harness inertia, this cannot be a substitute for education. In an environment where ever greater responsibility is placed upon individuals whose own levels of knowledge and engagement are limited, it is incumbent upon industry, government and regulators to work together to ensure improved levels of financial understanding with respect to investment issues.

As we discussed in Chapter Three, consumers will also be helped by regulatory regimes governing product packaging and distribution that ensure high standards in the sale of financial products, where asset managers may often be solution or component rather than bundled product providers.

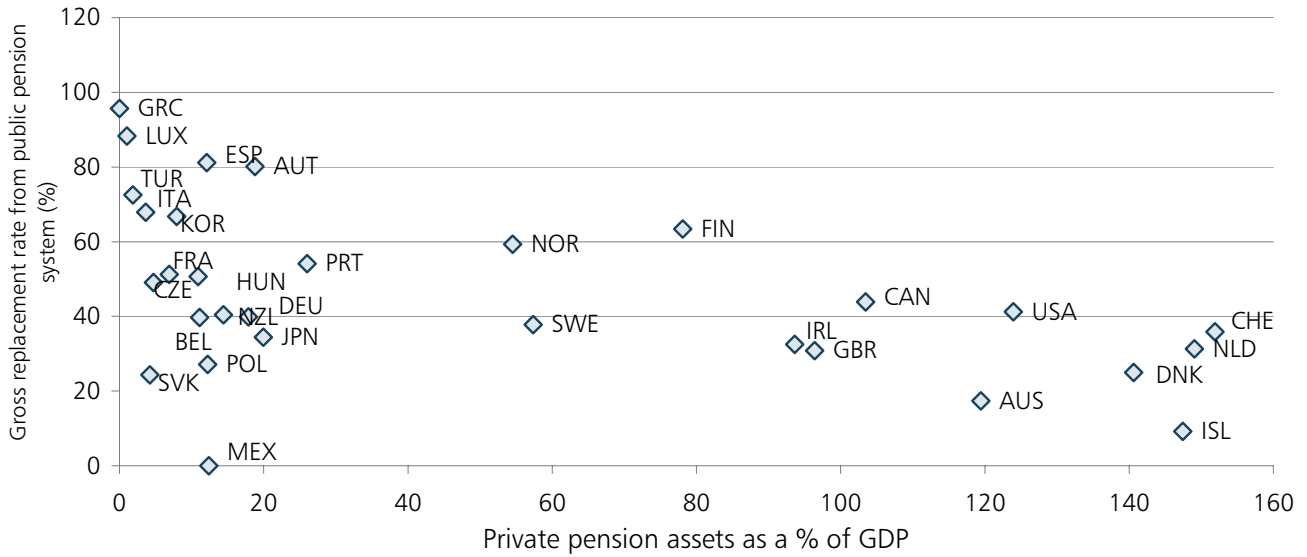
4.4 International developments, innovation and the UK industry

The current emphasis on improved pension saving in the UK is being driven fundamentally by demographic change as the ratio between working and retired population changes. Clearly, as we already note above, this is an issue that is felt far more widely, both in Europe and beyond. While demographic projections are notoriously unreliable, it seems reasonably certain that actual and anticipated fiscal pressures are likely to incline many governments internationally to consider carefully the balance in retirement income between state and private, funded and non-funded and compulsory versus voluntary provision.

As Chart 4.B shows, in a number of OECD countries, the United Kingdom is one of a number of countries whose high private pension provision complements a comparatively low gross replacement rate (just over 30%) from public pension provision. With demographic challenges (discussed further below) likely to exert significant strains on public finances in many countries both in Europe and globally, there may be a greater number of countries in the bottom right hand quadrant of the chart in future decades.

The general international potential for the UK asset management industry can be seen through the current international asset management market, where the UK accounts for a significant but nonetheless comparatively small share of overall professionally managed assets, particularly given the size of the US market. Clearly, this data captures far more than pension and other long-term savings vehicles, but it does illustrate well the scale of the global asset management market (see Chart 4.C).

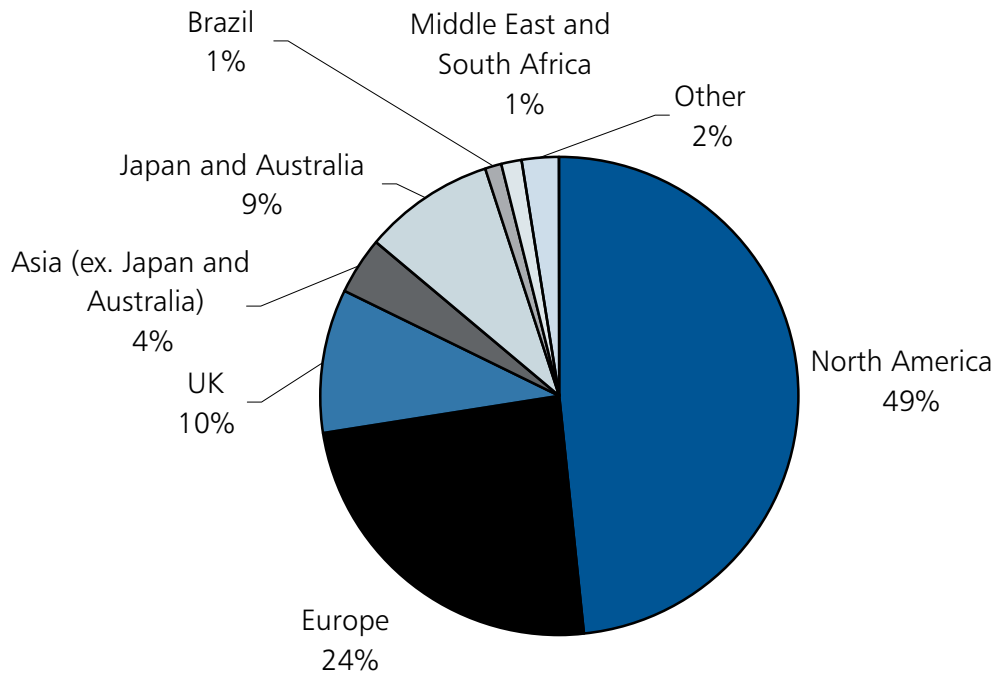
Chart 4.B: Private pension assets compared with the public pension system's gross replacement rate (2007)



AUS - Australia, AUT - Austria, BEL - Belgium, CAN - Canada, CHE - Switzerland, CZE - Czech Republic, DEU - Germany, DNK - Denmark, ESP - Spain, FIN - Finland, FRA - France, GBR - United Kingdom, GRC - Greece, HUN - Hungary, IRL - Ireland, ISL - Iceland, ITA - Italy, JPN - Japan, KOR - Korea, LUX - Luxembourg, MEX - Mexico, NLD - Netherlands, NOR - Norway, NZL - New Zealand, POL - Poland, PRT - Portugal, SVK - Slovak Republic, SWE - Sweden, TUR - Turkey, USA - United States.

Source: OECD

Chart 4.C: Global asset management market (% share by source of assets)



Source: Adapted from Boston Consulting Group, *Conquering the Crisis: Global Asset Management 2009*.

Individual DC schemes are likely to be a central plank of pension reform programmes, but approaches vary considerably in scope and ambition. Beyond the experience of Western Europe, which illustrates well the heterogeneity of policy response, Latin America, Central and Eastern Europe and parts of Asia have all seen considerable movement towards individual DC provision. Asset growth in funded pension schemes is expected to be considerable. One study projects a compound annual growth rate of 17.2% in Asia between 2008 and 2016 and 19.1% in Central and Eastern Europe, with pension scheme assets reaching €1,049bn and €245bn respectively.³

Individual DC is, however, not the only response to looming demographic challenges to pension provision. A number of countries have developed funds that are part of the wider social security system or are specific pension reserve funds (see Table 4.C for selected examples). These funds are often operated in quite distinct ways with a variety of goals:

- Some – for example, the French FRR – have a sophisticated and highly diversified investment portfolio operated by a range of external managers. However, not all are externally invested – for example, the Belgian ‘Silver Fund’, established in 2001 can only invest in government bonds (the same is true of the US Social Security Trust Fund which holds non-tradable Treasury bonds).
- Some have a remit that goes beyond pensions specifically: the US Social Security Trust Fund has a remit for disability payments.
- The reserve funds in a number of countries are frequently considered to be sovereign wealth funds: e.g. Norway Government Pension Fund. A clear distinction between pension reserve funds and SWFs is not straightforward to make, but the former will tend to have a more defined liability structure.⁴

³ Allianz Global Investors, *Pension Trends in Emerging Markets – The Rise of DC Plans and Its Consequences*, International Pensions Papers 2 (2008).

⁴ For more on this, see Roland Beck and Michael Fidora, *The Impact of Sovereign Wealth Funds on Global Financial Markets*, ECB Occasional Paper Series 91 (ECB, 2008).

There may also be greater future innovation in the area of hybrid or collective DC schemes. For now, this area is still one of considerable uncertainty of how a middle ground between DB and DC may be found. With individuals still often ill equipped for the transfer of risk associated with DC investment, it may be that there will be greater demand for DC solutions which do maintain both greater employer operational involvement and some form of risk-sharing between scheme members.

Whatever the mechanism, it does seem that funded approaches to retirement income are likely to receive ever greater focus internationally and that the asset management industry will find itself responsible for managing assets from a variety of sources, whether reserve funds, funded employer DB or hybrid schemes or individual pensions and savings accounts.

International role of the UK industry

As we have noted, the expertise of the UK asset management industry has been built in part on the back of a strong domestic pension saving base. It is open to question whether, for example, the innovative products and solutions that have emerged in recent years in the area of liability driven investment would have developed in the same way in a centre without proximity both to significant pension fund clients and to the expertise of a financial services cluster also involved in delivering these solutions (notably, investment banks). The role of a readily accessible large domestic savings pool in building industry economies of scale and breadth of asset class expertise is more obvious. In short, the UK industry has attained global competitive stature in strong measure due to the size and sophistication of the domestic savings base.

Looking forward ten years, a key issue is whether innovation in a changing pensions market globally can develop without a strong domestic savings culture in the UK. The group believes that in addition to the asset management industry serving its UK client base better as requirements evolve,

Table 4.C: Social Security Reserve Funds (SSRF) and Sovereign Pension Reserve Funds (SPRF) in Selected OECD and Non-OECD Countries (2008 or most recent)

	Country	Name of the fund/institution	US\$bn
OECD: SSRF	Canada	Canada Pension Plan	114.5
	Denmark	Social Security Fund	0.7
	Japan	National Reserve Funds	1,217.6
	Korea	National Pension Fund	228.7
	Mexico	IMSS Reserve	7.4
	Spain	Fondo de reserva de la seguridad social	44.9
	USA	Social Security Trust Fund	2,238.5
OECD: SPRF	Australia	Future Fund	49.1
	France	Fond de reserve des retraites (FRR)	42.3
	Ireland	National Pensions Reserve Fund	26.5
	New Zealand	New Zealand Superannuation Fund	10.6
	Norway	Government Pension Fund – Norway	20.4
	Poland	Demographic Reserve fund (DRF)	1.2
	Portugal	Social Security Financial Stabilisation Fund	8.3
	Sweden	National Pension Funds (AP1-AP4 and AP6)	137.0
OECD	Total		4,147.7
Non-OECD: SSRF	China	National reserve funds	94.6
	Jordan	Social Security Corporation	5.3
	Pakistan	Employees' Old-Age Benefits	2.4
	Saudi Arabia	General Organisation for Social Insurance	8.6
	Thailand	Social Security Office	11.6
Non-OECD: SPRF	China	National Social Security Fund	57.8
	Russia	National Wealth Fund	32.4
Non-OECD	Total		212.7

the existence of a flourishing private saving market in the UK will help to develop internationally competitive products that can generate overseas earnings for the UK economy.

However, the scale of the asset management industry's potential success in Europe and internationally will also be determined by a range of other factors.

At European level, the general question of obstacles to distribution is highlighted in Chapter Three. Looking specifically at pensions and savings, cross-border product development is hampered by a number of factors:

- Differential tax regimes make it difficult to develop true cross-border DC products based on a fund vehicle such as UCITS, which otherwise should provide precisely the mix of strong governance and transparency that would be expected of a long-term savings product.
- There remain cultural differences with respect to the role of insurance in pension provision that also make cross-border product harmonisation more difficult (for example, the requirement for guarantees in Belgian employer DC schemes).

- In EU regulatory terms, it is also harder for asset management firms. The Institutions for Occupational Retirement Provision (IORP) directive requires investment management companies to establish separate entities in order to qualify for the IORP passport, whereas in many EU member states, insurance companies are simply required to ring fence the assets and liabilities of IORPS. It would be desirable in the longer term for the industry to be able to operate on a more level playing field.

These issues are not helped by the European institutional structure, which sees the Committee of European Securities Regulators (CESR), dealing with the asset management industry, and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) bundling together insurance and pension issues. As the EU reshapes its financial services supervisory architecture, it would be helpful if the proposed European Securities and Markets Authority (ESMA, successor to CESR) were to have input into the pensions policy process. If this area were left solely to the European Insurance and Occupational Pensions Authority (EIOPA, successor

to CEIOPS), this would be a missed opportunity. Both ESMA and EIOPA will have industry advisory groups and the asset management industry believes it would be beneficial to be represented on the EIOPA group.

At a broader international level, the maintenance and further development of liberalised markets in financial services are prerequisites for further development of cross-regional business opportunities. In this respect, the UK government could play a supportive general role with respect to positions on international trade negotiations. Certainly, the success of UCITS as a global as opposed to simply a pan-European brand creates considerable potential at the individual savings level. As we discussed in Chapter Two, the location point here is whether this is a future opportunity for overseas-domiciled funds whose management takes place in the UK, or an opportunity to secure further advances for the UK as a global fund as well as asset management hub.

RECOMMENDATIONS

14. Industry and Government should work together to ensure open and fair access to overseas markets for the asset management industry.
15. The industry should work to ensure that retirement products, particularly the default funds within pension vehicles, are comprehensible and designed to address the needs of savers.
16. Savings incentives, for both pension contributions and for long-term saving more generally, should aim for simplicity for the consumer and for long-term stability, while recognising the need for fairness and affordability.
17. The number of different tax wrappers should be kept to the minimum in the interests of simplicity. It should not be necessary for fund management firms to wrap pension products in life insurance wrappers and means should be explored of extending the same benefits to simple funds as are enjoyed by life products.
18. The Government should seek reform of current institutional and legislative structures in the EU which tend to exclude investment management from the pension environment.

5 Capital market structures

Capital markets exist to serve investors and issuers. This needs to be recognised and those interests protected by regulators. In this respect, the credit crisis has highlighted a number of challenges. The Lehman failure demonstrated the need for better infrastructure in the event of default and for improved default protection for investors. In other areas, while there may be justification for regulatory intervention on occasion in the interests of maintaining orderly markets, activities such as short selling are both legitimate and contribute to market efficiency.

5.1 Investor needs in markets

Traditionally investors have always put “liquidity” at the top of their wish list for markets. Good liquidity brings the ability to trade when investors want to, access to an efficient pricing pool, the ability to hedge, switch assets around – in summary, being able to shape a portfolio as one chooses through use of the markets.

Recent market events have not in any way toppled the position liquidity holds at the top of the wish list, but they raise sharply the context within which liquidity is obtained. Liquidity has been defined colloquially as “something that is not there when you need it”. This is where market stability comes in. Investors as a group have no difficulty in agreeing what is meant by market stability – clean, fair, accessible markets which are open for business in all conditions. This does not mean that, in bad times, liquidity will be plentiful, pricing fine and spreads narrow. However, it does mean that business can still be done when needed and that pricing continues to reflect the fundamentals, taking account of increased uncertainty affecting the fundamentals.

Much has been written on short selling in the market and views on this are quite polarised. Investors as a group support short selling as a legitimate investment activity that can bring much needed liquidity to the market and help provide a better reflection of market interest. It is also a legitimate risk management tool for many funds, including hedge funds. Equally, short selling can

be used abusively, can give rise to orderly market concerns and sometimes also provides one-way opportunities for those operating from their own balance sheet (not something that discretionary managers will be doing).

As the ban on short selling took hold last year, it had a number of undesirable and unintended consequences for those with legitimate intention. It is welcome that internationally regulators appear to have recognised that outright bans, save for naked shorting, do more harm than good. Disclosure to regulators at an appropriate level is understandable, and should allow regulators to focus more on tracking the fundamentals in the market to try and spot mismatches against individual strategies. Public disclosure, except on an aggregated and delayed basis, does give rise to real risks that legitimate strategies taken in the interests of funds and savers will be disadvantaged or that commentators will misread the signals. More work could be done on considering how abusive – and frequently non-risk bearing – behaviour may be spotted.

From a policy perspective, it would work better for investors if the regulation of markets explicitly put their interests first. Current market arrangements often appear to work more for the benefit of intermediaries than for investors (or issuers). In an unregulated industry, markets would operate at the mercy of market forces. But in a highly regulated industry such as financial services, investors should be able to expect positive intervention by regulators to correct and improve the balance of interests

between intermediaries and users. What investors want is a “bottom up” approach from regulators, focusing on their responsibility for protecting investors and assessing market arrangements from this perspective. The recent focus for market regulators appears to have addressed more effort to the position of intermediaries offering markets and the impact of regulation on their businesses.

In summary, investors seek:

- markets that will stay open through good and bad times;
- confidence that they get a fair deal when they use the market;
- transactional certainty; and
- regulatory intervention in markets guided by protecting the interests of those for whom trading is a cost of doing business, not those for whom it is a profit source.

5.2 Infrastructure and insolvency

One of the most problematic aspects of the Lehman insolvency was the discovery by many investors that the UK offered poor default protection for investors trading in UK markets. Much was left to unclear and incomplete bilateral contractual arrangements arising from trades treated by Lehman as OTC. There was real difficulty in establishing where trades had been executed, and there remains the major challenge of sorting through the client asset accounts and establishing what is owed to whom, and how much. The difficulty of seeking to obtain contractual certainty in the market where firms trade as agents is a longstanding problem that needs to be resolved.

Much clearer and better regulation and generally better infrastructure in the event of default is therefore a definite investor need. Clearing and settlement are the “back end” of the market, but they matter when a market default occurs. Another way of describing this is that investors want transactional certainty, i.e. that the investor can rely on the market to complete his transaction once commenced, or at least give him certainty about what has happened to disrupted transactions so that he can take further action. Without transactional certainty, the investor has an incomplete portfolio and carries excess market risk. The Group therefore supports the work that HM Treasury has begun to bring better investor protection into UK market arrangements. We single out the pressing need to bring about a proper segregation of client assets all the way through the execution chain; and we urge regulators to revisit the client protections offered in the market, whether in respect of asset holding or trade execution, to make sure they are fit for purpose.

With respect to OTC derivatives markets, and probably also cash markets, an obvious improvement could be obtained for investors if much of the market could become centrally cleared. Of course, this is dependent upon careful handling at the clearing house and much increased scrutiny over governance. It prospectively also raises significant issues about capital resources (bearing in mind that clearing

houses currently have no call on central banks). It would be very problematic if banks that are “too big to fail” are replaced by central clearers that could pull down the whole infrastructure of a market if they failed.

We therefore believe the time frame for bringing about this infrastructure change is years not months. Regulators should take the long-term view and develop a fully considered and if possible tested programme of work to improve all aspects of markets, cash and OTC.

This notwithstanding, the clear benefits to investors of introducing central clearing to OTC derivatives markets – as has now begun in the EU for CDS – include:

- properly handled, a reduction in counterparty risk;
- better collateral management;
- putting the terms of trade settlement on a fairer footing than the existing bi-lateral contractual negotiations permit;
- allowing much better information to be made available to the market;
- improving the ease and certainty by which portfolios may be valued, daily;
- promoting best execution, in its widest sense;
- if properly managed, it should bring about substantial cost reductions for investors;
- greater certainty and speed of action in the event of a counterparty default; and
- subject to proper governance in the clearing house, central clearing should also contribute significantly to better management of systemic risk.

As almost every investor (and certainly “long only” discretionary managers) will access clearing through a clearing member – bank or broker – of a clearing house, this distances the clearing house from the ultimate client to a trade. If regulators do not focus on investor benefits in the arrangements, it could fail to achieve the investor protection aspect of the initiative, which in effect means that it will not bring market stability.

There will always be a need for customised OTC contracts. It is also important that this genuine need is not stifled in the rush to improve handling of the mass OTC market.

5.3 Clarifying regulators’ objectives

The credit crisis has suggested that regulators could usefully clarify their objectives and obligations. This would help to ensure a smoother (not to say pre-emptive) response to market problems. They could, for example, introduce:

- An objective to ensure financial stability written into legislation such that it overrides all other objectives applied to financial services regulation. This will ensure a clear hierarchy of regulatory activity.
- Oversight of financial stability that explicitly encompasses market stability as well as systemic risk, whether presented by any regulated entity or group of entities. This should be dealt with by a regulator who is entirely focused on this aspect of financial regulation.
- Improved market regulation that deals explicitly with both stability and investor protection issues. In this context, market regulation includes oversight of OTC markets and (as now) statutory oversight of the recognised investment exchanges and the recognised clearing houses and some aspects of the investigations into market abuse.
- A radical re-think of the market abuse regime, to ensure cleaner markets. Whilst the identified offences have stood the test of time, the enforcement activity has had a slight success rate – and this despite an ever-increasing set of powers to deal with abuse.
- Lastly, governance: the importance of the market regulation function is such that its oversight should not be secondary to other forms of regulation, such as balance sheet regulation. As mentioned above, its place is probably with the regulator charged with ensuring financial stability.

5.4 Integrity of company accounts

The main focus of financial accounts should be on the holders of ordinary shares - they are the providers of the risk capital and bear the residual risk. They want accounts that are transparent and comparable, and prepared under high quality accounting standards which are applied consistently internationally.

Investors and regulators have different requirements – accounting requirements operate to present a company’s financial position to the market. It is the role of regulators to determine capital adequacy requirements from the reported numbers. The ‘procyclicality’ that many claim fair value accounting is responsible for is addressed if the financial reporting requirements of listed companies and the prudential requirements of financial services firms are decoupled.

RECOMMENDATIONS

19. Capital markets exist for the benefit of issuers and investors. This gives the investment management industry a legitimate interest in all aspects of the capital markets and banking system. The industry needs to articulate its positions better and more emphasis should be given to the interests of investors and capital raisers when regulating markets.
20. There is a need to ensure continuity in the operation of the capital markets and the banking system as a whole, irrespective of what happens to individual institutions. In particular, better infrastructure in the event of a default is needed. As part of this process, central counterparty coverage in OTC derivative markets should be expanded.
21. All avenues to maintaining market liquidity and efficiency should be promoted and protected. Unless evidence shows that such restrictions are necessary for market stability, then regulators should avoid imposing investment restrictions – e.g. short selling – which could have substantial adverse consequences for the effective operation of markets.
22. The main focus of financial accounts should be on investors. The interests of shareholders and regulators in this area are potentially different and this should be recognised.

A Fund taxation changes 2006-2009

This table shows the significant progress made since 2006, when the IMA and KPMG published a report looking at taxation and the competitiveness of UK funds. However, not all the points listed below were in the report itself.

Industry's perspective of the position, pre-2006 IMA/KPMG Report	Position post Budget 2009
UK Equity Funds – Direct Tax	
<p>UK authorised funds access treaty benefits from a large network of Double Tax Agreements, but a UK fund being “subject to tax” in the UK was a marketing disadvantage especially when marketing UK funds cross-border.</p>	<p>UK funds generally exempt from tax on all dividends. The elective ‘Tax Elected Fund’ regime was introduced from 1 September 2009 which will ensure that no corporation tax will stick in the fund.</p>
Offshore Funds Regime	
<p>The UK offshore funds regime was introduced in 1984 and became out-of-date with the development of the investment management industry. For example the restrictive rules included:</p> <ul style="list-style-type: none"> • physical distribution of cash must be made to UK investors to qualify for ‘distributor status’; • whole umbrella must distribute; • no funds of funds of funds; • retrospective effect – application for distributor status is made at the end of the accounting period; and • UK equivalent profits calculation – requiring conversion of local accounts into UK equivalents. 	<p>A reformed offshore funds regime will commence from 1 December 2009. The main changes are as follows:</p> <ul style="list-style-type: none"> • funds report income annually and there is no requirement to distribute income to investors; • each separate sub-fund in an umbrella structure is considered a separate offshore fund; • the fund layers restriction has been removed for investment in reporting offshore funds (although no more than 5% of NAV of a UK fund can be invested in a non-reporting offshore fund); • applications to HMRC for reporting fund status is made at the start of the accounting period – providing investor certainty; and • no requirement for ‘UK equivalent profits’ calculation, provided the offshore fund is domiciled in a jurisdiction where accountancy rules are deemed acceptable by Government.

Industry’s perspective of the position, pre-2006 IMA/KPMG Report	Position post Budget 2009
UK Investor Tax	
<p>Tax treatment put UK taxpayers at a disadvantage to receive income from UK bond funds, but at an advantage to receive income from UK equity funds.</p>	<p>The dividend tax credit is extended to individuals receiving distributions from offshore equity funds. An offshore bond fund regime was introduced which taxes distributions from these funds at the rate that interest is taxable on individuals.</p> <p>Overall there is parity of treatment for both equity funds and bond funds, UK or offshore.</p>
SDRT Schedule 19	
<p>The industry argued that this fund-specific regime added complexity to the overall UK tax regime and represented an additional compliance burden for managers. This could be seen as a marketing disadvantage to UK funds despite the fact that the headline figure of 50 basis points is reduced by (1) investment in assets other than UK equities and (2) the relationship between issues and redemptions, and that therefore the actual annual average equated to 5 basis points, not the 50 basis points headline rate.</p> <p>There were increasing concerns by UK fund managers that they would be liable for data supplied from intermediaries.</p>	<p>HM Treasury consulted on reforming the SDRT Schedule 19 regime in November 2007, and proposed a move to an asset-based charge (similar to a Luxembourg-style <i>taxe d’abonnement</i>). The industry however believed that this would not improve the UK’s perceived anti-competitive position, so the Government decided to retain the current regime.</p> <p>HMRC have clarified that managers are responsible only for deals on their books and are not responsible for data supplied by intermediaries.</p> <p>Discussions between HMRC and the industry are ongoing about the treatment of investments in other funds, which may have no UK equity investment, and/or certain derivative instruments.</p>
Trading v investing	
<p>The UK tax regime distinguishes between trading and investment activities, subjecting the former to corporation tax at fund level. Although the risk of the fund’s activities being classed as trading rather than investing were small, the consequences were of such magnitude that the issue gave rise to major concern to fund managers and investors. Furthermore, the risk is perceived to have increased in recent years because of the increased use of derivatives and more complex strategies.</p>	<p>Legislative certainty that transactions will be treated as investing rather than trading was given for authorised funds and offshore equivalents.</p> <p>The “white list” defines a list of transactions that will always be classified as investment transactions when carried out by a fund which meets certain conditions. The “white list” is comprehensive, and covers the vast majority of (and, in most cases, all) the transactions in financial instruments that a UK fund will carry out.</p>

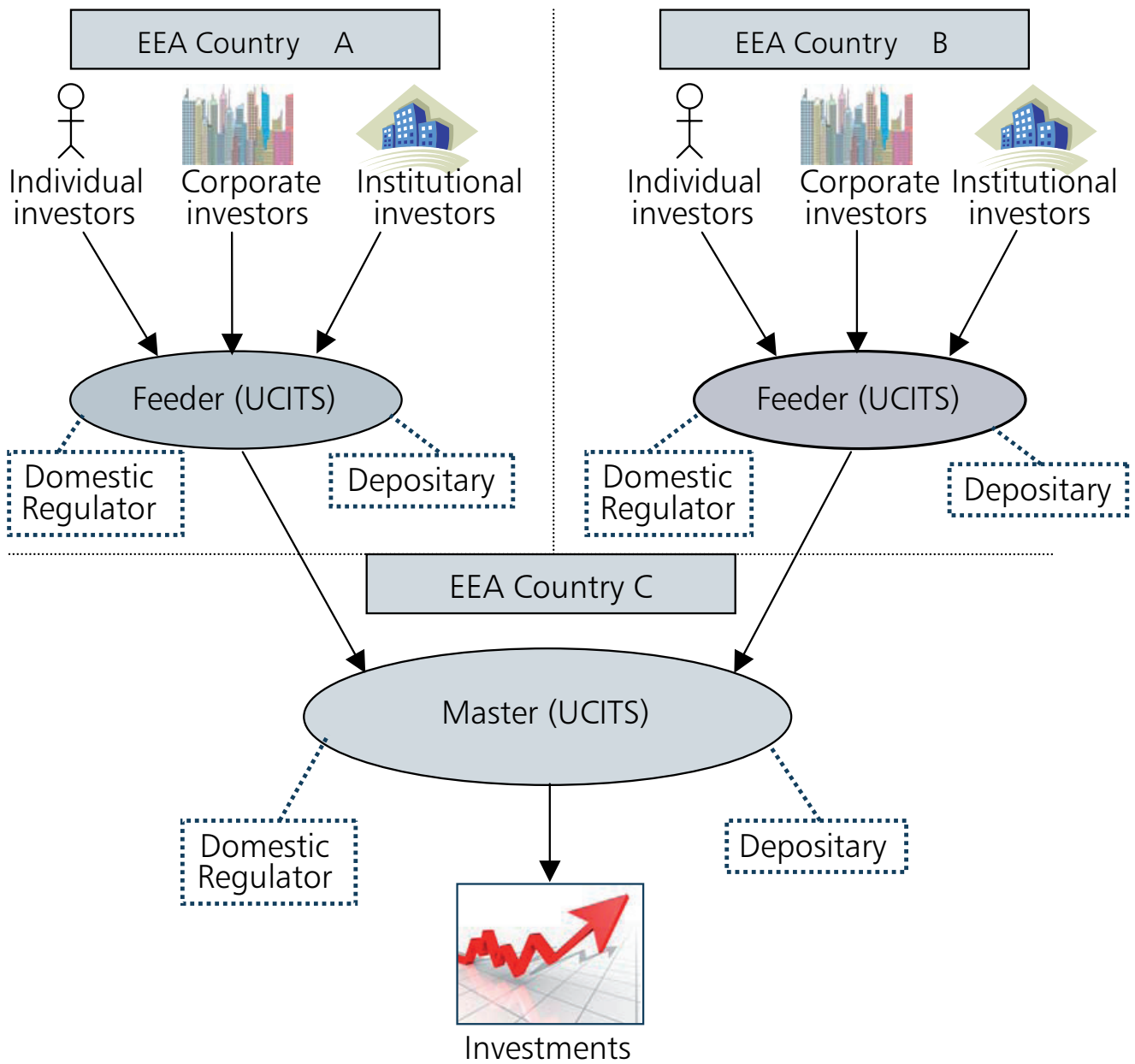
Industry’s perspective of the position, pre-2006 IMA/KPMG Report	Position post Budget 2009
	Discussions are ongoing about what funds will fall into the definition of “offshore equivalents”
UK Property Funds	
Corporation tax paid in a UK property fund is not recoverable by exempt investors (i.e. pension funds, ISA/SIPPs/CTFs and non-residents). UK property funds are therefore not attractive to these categories of investors.	The Property Authorised Investment Funds (PAIFs) regime was introduced from April 2008. This provides for a tax efficient open-ended vehicle suitable for both taxable and non-taxable investors. PAIFs are permitted electronically to report distribution information to investors.
Qualified Investment Schemes (other than pension funds, charities and UK life companies)	
No investor could hold more than 10% of units in a QIS.	The 10% holding requirement was abolished in favour of a workable “not intentionally closely held” rule – the “Genuine Diversity of Ownership Condition”.
Investment Management Exemption	
There was a risk that offshore funds managed by UK investment managers could be brought ‘onshore’ and taxed accordingly. The regime was out of date and had not kept pace with new investment strategies or instruments.	Legislative certainty that the offshore fund is investing rather than trading is provided in a “white list” (almost identical to the trading v investment white list – see above). This is available to UK managers of offshore funds.

B Difference between QIS, SIF and QIF

	Qualified Investor Schemes (QIS)	Specialised Investor Fund (SIF)	Qualified Investor Fund (QIF)
Country	UK	Luxembourg	Ireland
Applicable law	COLL Regulations	SIF Law	NU Notice 24.6
Eligible Investors	Qualified investor only (not mass retail)	Well-informed investors (minimum €125,000 is considered well-informed)	High degree of knowledge and relevant experience in markets and detailed understanding of risks involved - minimum investment is €250,000 per investor (who must have minimum net worth of €1.25mn or €25mn if institution). Investors must certify in writing that they meet these criteria.
Ease of set-up	Approval within 6 months	Launch possible prior to CSSF approval. Approval must be made within 1 month from creation of SIF	One day on a filing basis only
Eligible Assets	Only restricted to the Regulated Activities Order	No restrictions	No restrictions
Investment restrictions	Prudent spread of risk	Flexible principles based risk diversification required. Max 30% of assets in securities of same type with same issuer	Spread of investment risk for investment companies (Companies Act 1990)
Restrictions on borrowing	100% of NAV	None	None
Derivative exposure	100% of the scheme property (inconsistent with UCITS)	No limit	No limit

	Qualified Investor Schemes (QIS)	Specialised Investor Fund (SIF)	Qualified Investor Fund (QIF)
Country	UK	Luxembourg	Ireland
Possible listing	Yes	Yes	Yes
Minimum content of prospectus	COLL 8.3.2 provides detailed requirements	Must contain essential info for investor to make an informed judgement	Prominent risk warning on suitability and above average risk. Disclosure of investment objectives
Legal forms	AUT & OEIC	SICAV: public limited, private limited, cooperative, partnership. SICAF, FCP, LLP	Unit trusts, investment companies, LLPs, common contractual funds
Exposure to primebroker	Only if Depositary has strict liability	Depositary must approve primebroker (also circular 08/372 - appropriate organisation of the depositary-primebroker relationship)	Yes
Reporting requirements	Yes (semi-annually)	Yes (annually)	Yes (annually)
Shorting of physical stock	No	Yes	Yes

C Master feeder structure



D Abbreviations

AIFMD	Alternative Investment Fund Managers Directive
AMWG	Asset Management Working Group
ASP	Alternatively Secured Pension
AUT	Authorised Unit Trust
AUTIF	Association of Unit Trusts and Investment Funds
CCF	Common Contractual Fund
CDS	Credit Default Swap
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	The Committee of European Securities Regulators
CSSF	Commission de Surveillance du Secteur Financier
CTF	Child Trust Fund
DB	Defined Benefit
DC	Defined Contribution
EFAMA	European Fund and Asset Management Association
EIOPA	European Insurance and Occupational Pensions Authority
ESMA	European Securities and Markets Authority
FCP	Fonds Commun de Placement
FOS	Financial Ombudsman Service
FRR	Fond de Reserve des Retraites
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
GDP	Gross Domestic Product
IFA	Independent Financial Adviser
IFSL	International Financial Services, London
IIWG	Insurance Industry Working Group
IMA	Investment Management Association
IMMF	Institutional Money Market Fund
IORP	Institutions for Occupational Retirement Provision
ISA	Individual Savings Account

KII	Key Investor Information
LGPS	Local Government Pension Scheme
LLP	Limited Liability Partnership
M&A	Mergers and Acquisitions
MiFID	Markets in Financial Instruments Directive
NAV	Net Asset Value
OECD	Organisation for Economic Co-operation and Development
OEIC	Open-Ended Investment Company
OMO	Open Market Option
ONS	Office for National Statistics
OPS	Occupational Pension Scheme
OTC	Over The Counter
PAIF	Property Authorised Investment Fund
PRIPs	Packaged Retail Investment Products
QIF	Qualified Investor Fund
QIS	Qualified Investor Scheme
R&D	Research and Development
RDR	Retail Distribution Review
SDRT	Stamp Duty Reserve Tax
SICAF	Société d'Investissement À Capital Fixe
SICAV	Société d'Investissement À Capital Variable
SIF	Specialised Investment Fund
SIPP	Self-Invested Personal Pension
SPRF	Sovereign Pension Reserve Fund
SSRF	Social Security Reserve Fund
SWF	Sovereign Wealth Fund
UCITS	Undertakings for Collective Investments in Transferable Securities

E Acknowledgements

The Chairmen and Group members would like to express their thanks to the team which contributed to the report.

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ISBN 978-1-84532-650-0



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