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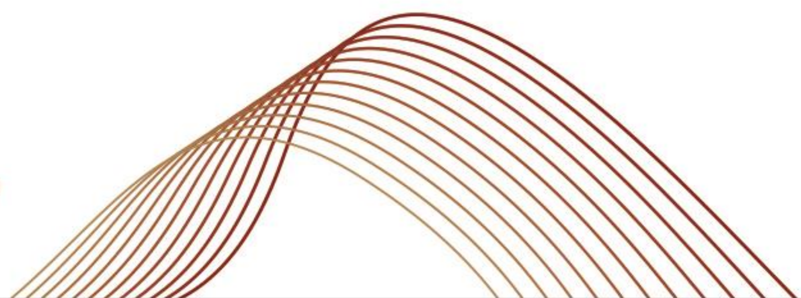

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Asset Management - The Rise of ESG and FCA Expectations for 2020

By Konstantin Burkov, Nina Moffatt & Arun Srivastava

The U.K. Financial Conduct Authority (the "FCA") has set out its expectations for the asset management industry early in the New Year.

The asset management sector has been the subject of a number of recent thematic reviews and market studies. These include the FCA's analysis of the asset management market, which resulted in the set of remedies published in Policy Statement PS 19/4 in February 2019, the findings of the multi-firm review of principals and their appointed representatives in the investment management sector (20 May 2019) and the FCA's report on risk modelling and other portfolio management tools used by managers (13 January 2020). In addition to this, recent "Dear CEO" letters evidence an intention to keep the pressure up on asset managers.

We highlight below some key current issues flagged in recent FCA communications, which include the following:

- Governance and SM&CR
- ESG
- Appropriateness and suitability
- Product governance
- Market abuse
- Anti-money laundering and anti-bribery and corruption
- Brexit implications
- Adequacy of financial resources and professional indemnity insurance
- Compliance with oversight and control of client money and client assets
- LIBOR transition
- Operational resilience
- Market integrity and disruption
- Liquidity management
- Asset management market study remedies

I. ESG (Environmental, Social and Governance)

A major emerging theme for the asset management industry is ESG. Environmental and social responsibility issues are prominent politically and across society. Regulators are encouraging transparency in relation to these issues and imposing ESG obligations. Many of the developments in this area are derived from the EU level, including ESMA. The EU Commission have introduced a package of reforms for sustainable finance, and of particular relevance to the asset management sector are: (i) Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (the "Disclosure Regulation"), which will apply with effect from 10 March 2021 and contains various transparency and disclosure requirements in relation to sustainability, and (ii) a proposed regulation on the establishment of an EU wide classification system for identifying the

extent that economic activities can be considered to be "environmentally sustainable" (the "Proposed Taxonomy Regulation"), which will apply in stages following the adoption of delegated acts between 2020 and 2022.

The aim of the Proposed Taxonomy Regulation is to give investors and the financial services industry a definition of what is "green" by setting out common criteria to be considered. The EU Commission hopes that this will reduce "greenwashing" (the practice of marketing financial products as "green" or "sustainable" when they do not meet basic environmental standards) given the increase of funds labelled as "ESG funds".

In addition to these matters, on 15 January 2020 AIMA published guidance on Responsible Investment Policies for Hedge Fund Firms and, separately, ESG Considerations for Alternative Investment Management Firms.

The implementation status of the Disclosure Regulation and the Proposed Taxonomy Regulation in the UK is still unclear. The Disclosure Regulation is in force, but will only apply from 10 March 2021, and if the dates on which the Taxonomy Regulation will apply are after the end of 2020, these regulations will not be in scope of the European Union (Withdrawal) Act 2018 ("EUWA"). The U.K. government has indicated that it may use its own legislation to clarify the status of such "in-flight" legislation, and the December 2019 Queen's Speech referred to a "Financial Services Bill" with the objective of building on the secondary legislation brought forward under the EUWA, but it is unclear whether the sustainable finance legislation will be included. In any event, the government has indicated it will take steps to ensure the financial services sector helps meet the government's commitments on climate change and to "match the ambition" of the EU's Sustainable Finance Action Plan, so this is still a relevant consideration for UK asset managers going forwards.

II. Appropriateness and Suitability

The FCA has highlighted risks in relation to appropriateness and suitability assessments both in its "Portfolio Strategy for Financial Advisers" letter and in its "Alternatives Supervision Strategy" letter. In relation to alternative investments the FCA raises concerns over risks of alternative investments being made available to less sophisticated investors.

As well as ensuring that suitability and appropriateness procedures are applied and are effective, the FCA has raised concerns over the practice of opting-up retail clients to elective professional client status. This, of course, results in the client receiving fewer protections. Ultimately, firms are subject to the client's best interest rule (COBS 2.1.1R). To the extent that firms are considering opting up retail clients, the FCA states that "robust" standards must be applied to this. Firms should pay particular regard to whether the client has knowledge and experience of the relevant market.

III. Product Governance

The FCA intends to review compliance with MiFID II product governance rules. Since asset managers are in many cases co-manufacturers and/or distributors of products, they are required to comply with MiFID Product Governance Rules and must identify the client type and investment need for the funds they manage, recognising that they may only be appropriate for a very specific market. This is a particular concern where a manager has retail clients. In situations where the manager only deals with professional clients, compliance with product governance rules will be more straightforward. However, even with a target market of professional clients, firms should ensure that product governance rules are appropriately applied. In particular, the requirements in the PROD 3 Sourcebook of the FCA Handbook apply irrespective of the category of the end client that the financial instrument is intended for. In addition, where the manager acts as a "co-

manufacturer" of a product, it must ensure that there is a written agreement in place between all parties cooperating in the manufacturing of a product outlining their mutual responsibilities.

IV. Market Abuse

The FCA identifies asset managers as key buy-side participants in financial markets. Firms must ensure that MAR policies and procedures are tailored to their particular business models. The FCA believes that firms have "significant" scope for improvement in this area.

Firms should review their policies and procedures to ensure that these are not off the shelf and that they are, in fact, appropriate and relevant to the firm's business.

The relevance of MAR rules will, of course, depend on the firm's strategy. Market abuse will be a more important issue for hedge funds dealing in securities, for example, when compared to real estate funds. MAR and conflict of interests issues will arise for CLO managers where managers might have access to private-side information about borrowers whose debt is purchased for a listed CLO portfolio. Additionally, MAR issues will also arise for firms who are private on loans, which make up CLO portfolios which they also trade in. With listed CLOs, firms should ensure that they have appropriate procedures in place to manage information flows.

V. Anti-Money Laundering ("AML") and Anti-Bribery and Corruption ("ABC")

The FCA states that it intends to review firms' AML and ABC controls, particularly in the alternatives sector. Wholesale markets are generally regarded as posing lower risks, but the FCA Thematic Review on AML risks in the capital markets, TR19/4, highlighted risks in this sector. Firms should also ensure they are compliant with the Fifth Money Laundering Directive which came into force in the U.K. earlier in January 2020. This does introduce practical changes to customer due diligence procedures, for example, in connection with the application of enhanced due diligence. Funds can often have HNWI, PEP and SWF investors where ABC risks can be higher. Firms should review the risk profile of their client and investor bases and apply enhanced procedures as appropriate.

VI. Brexit Implications

The U.K. is, of course, in a transitional period until the end of 2020. Given the U.K. Government's intention to be able to diverge from EU rules, firms should work on the assumption that Brexit will be at the harder end of the spectrum and that passporting rights will be lost.

The fact that the U.K. will likely not align itself to EU rules may mean that the U.K. will not be judged to be an equivalent third country. EU equivalence regimes are, in fact, a patchwork of different regimes that do not provide a composite basis for securing market access. The U.K. Government has indicated that it will seek permanent equivalence with the EU to secure market access but this remains uncertain. The Government intends to issue a Whitepaper on Brexit and financial services in the Spring.

Many firms will have reviewed the position in the run up to the original March 2019 Exit Day. Firms should consider whether changes have occurred in their circumstances in the period since then that might affect their analysis. In other cases, firms might need to implement plans to flip responsibility for management to an EU manager with delegation back to the U.K. ESMA, and the FCA has previously announced the existence of an MOU between them that would allow delegation back to the U.K. Firms should also consider the availability of reverse solicitation where they do not proactively target the EU market. In these circumstances, firms need to be cautious over any activities carried out in the EU. Accepting investment into a new fund on a reverse solicitation basis might not be possible where any marketing or profile raising activities have been engaged in.

VII. Adequacy of Financial Resources and Professional Indemnity Insurance

The FCA has raised concerns that some businesses are not being fully compliant with applicable capital requirements and do not hold adequate capital and/or professional indemnity insurance appropriate to their business model. The FCA reminds firms that valid professional indemnity insurance must be maintained for past and current business so there is no break-in cover. Firms should note that part of the FCA's focus on whether firms have adequate financial resources will include the steps that the senior management of firms has taken to maintain valid professional indemnity insurance.

VIII. Compliance with Oversight and Control of Client Money and Client Assets

The FCA intends to investigate whether firms that have permission to hold client money and/or safeguard client assets have robust systems and controls in place to minimise the risk of loss of money or assets. Firms should review their CASS policies and procedures.

IX. LIBOR Transition

LIBOR transition has been highlighted as a key topic for both the Bank of England and the FCA for 2020. The FCA has made clear that firms are expected to prepare for cessation of use of LIBOR at the end of 2021 and have a responsibility to facilitate and contribute to the transition to new rates such as SONIA. The FCA and the Bank of England are encouraging early take up of SONIA and have identified 2 March 2020 as the appropriate date for certain market participants to make the switch. The FCA is gathering information from various asset managers to further their understanding of firms' exposure to LIBOR risk and will provide further communications on their expectations for LIBOR transition.

X. Operational Resilience

The FCA will continue to focus on the operational resilience of firms and expect firms to ensure their technology and cyber risk is appropriately managed, including the oversight of any third-party or intra-group service providers. Asset managers deemed to have a greater risk of causing harm will be selected for a technology review, and firms may also be selected for ad-hoc reviews of their operational resilience arrangements more generally. The FCA are undertaking further work in the coming months and expect to publish their approach to strengthening the operational resilience of financial-services firms in due course.

XI. Market Integrity and Disruption

The FCA has warned alternative firms that, where very high-risk investment strategies are employed, in particular the use of significant leverage, correspondingly high quality risk management controls are also expected to be put in place. Firms should be aware that the FCA has indicated it may undertake in-depth assessments of firms' controls.

XII. Liquidity Management

Liquidity management continues to be a key focus of the FCA, in light of recent liquidity issues experienced by certain funds. The FCA has reiterated the responsibility of authorised fund managers to ensure effective liquidity management in funds, even where investment management is delegated. In particular, the FCA has warned of the liquidity mismatch in open-ended funds between the terms at which investors can redeem and the timescales needed to liquidate assets. The FCA expects authorised fund managers to take appropriate action following recent communications from the FCA and the Financial Policy Committee on liquidity and will ensure that authorised fund managers take prompt action to resolve any potential liquidity issues the FCA identifies in funds.

XIII. Asset Management Market Study ("AMMS") remedies

The FCA introduced a series of requirements following the publishing of the AMMS Final Report in June 2017. Those requirements are now in effect, and of particular note is the requirement for authorised fund managers to conduct value assessments of the authorised funds they manage. The FCA will spend the first half of 2020 looking into how effectively firms have undertaken value assessments and have made clear they will take "robust" action where funds delivering poor value are identified, including 'closet-tracker' funds. The FCA also intends to carry out more work in the future to evaluate the effectiveness of the AMMS reforms.

In summary, the FCA intends to carry out further reviews in the asset management industry with a focus on the above topics. Some firms will receive specific written requests for information from the regulator or may be subject to review. Therefore, U.K.-based asset managers should take proactive steps to review their current policies and procedures to ensure that they are fully compliant with the relevant legislation and the FCA Rules. With respect to Brexit contingency plans, they should ensure that they have a clearly defined and up-to-date action plan on how they intend to service their EU-based clients following the U.K. leaving the EU.

Looking ahead, firms should also be aware that the FCA is expected to start carrying out further work to assess the ongoing compliance of firms with rules on MiFID II inducements and research rules between late 2020 and 2021.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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