Financial Conduct Authority

Discussion Paper DP23/2

Updating and improving the UK regime for asset management

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&

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Updating and improving the UK regime for asset management

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1. Introduction

1. We are pleased that the FCA is consulting on the UK regime for asset management with a view to updating and improving it. We are also pleased to be given the opportunity to make input to this.

2. We have identified three very basic requirements if the UK regime for asset managers is to be improved. These are:

    2.1. The need for clarity - rules must be understandable to the investing public not just to the industry. This reflects the greatly increased emphasis on the consumer since the current set originated.

    2.2. The need for consistency, proportionality, relevance and coherence when defining the information that should be given to consumers to help them make investment decisions. The shortcomings of the Key Information Document (Kid) are a reminder of just how easily objectivity and usefulness-to-the end-user can be lost in the output from the regulatory meat-grinder.

    2.3. Better recognition of the continuing impact of modern technology - both in the operation of the industry and on the regulatory and reporting regimes. This includes regulation of the technology itself as well the scope to make better use of it.

3. **Achieving clarity for consumers**.

    3.1. The 'consumer' or 'consumers' are mentioned over 70 times in the consultation. Despite this and the fact that the FCA says that this consultation will be of interest to consumers who invest in funds and that it particularly welcomes feedback from consumers and potential consumers, the consultation is structured in a way that makes it difficult for consumers to provide meaningful input.

    3.2. Many of the issues raised in Sections 3 and 4 of the discussion paper are presented in a way which only those who are very familiar with functioning of the industry are likely to be able to comment on. For example, paragraphs 3.29 to 3.34 talk in very broad terms about the UCITS and NURS regimes and imply that, for a variety of reasons, they are no longer fit for purpose. There are indications that this is partly because they have evolved over time and the market for the investments they were originally designed to cover has changed. However, there is little clear analysis of what the main shortcomings currently are or how this is compromising consumers - possibly adding

unnecessary cost to the investment process for consumers or generally failing to provide coherent regulation.

3.3. Paragraphs 3.35 to 3.40 put forward a number of options for change. The pros and cons of these from a consumer point of view are not explained in a way that consumers are likely to be able to interpret and comment on.

3.4. The fact that the DP regularly refers to 'consumers' as if they are a homogeneous group while at other times referring to 'professional' investors and 'sophisticated' investors without any serious attempt to define or differentiate these groups makes the task of responding meaningfully to the DP even harder.

3.5. As consumer oriented organisations, we have done our best to give meaningful feedback on the issues raised in the Discussion Paper. However, it has not proved easy. In many areas it has been impossible to decipher exactly what the main issues are, what might be done to address them and what the FCA is seeking to achieve apart from 'better outcomes' for all concerned.

4. **Technology issues**.

4.1. We agree that technology has become an essential part of financial markets and of the operating model of financial service firms. Technology cannot be siloed if 'straight through processing', i.e. digitisation, is the desired outcome. There must be a continuing drive to standardise technology and avoid a proliferation of bespoke systems. This is true for many other sectors of the economy. However, the comment in 5.2 that the commercial decisions that firms make about how they use new technology collectively shapes market standards and that 'regulation needs to reflect those standards' is very debatable. Surely, standards need to be set and regulation needs to ensure that those standards are maintained and are not undermined by technology.

4.2. From the consumer perspective, wider scope to make use of IT, although enticing, can present unexpected risks. The Financial Times published an article in its Money supplement on 8th April 2023 about how fintechs had been hit by a surge of customer complaints.[1] As the FT commented:

[1] Fintechs hit by a surge of customer complaints; Financial Times - 8.4.2023.

4.3. ‘The growth of online payment firms and digital-only banks has brought customers increased choice, speedy technology and lower costs. But their advance has been accompanied by growing complaints in the UK and the EU, as users are hit by everyday mishaps and by financial fraudsters’.

4.4. The key reasons are the ‘speed to market’ of IT solutions and the standard assumption that these solutions will work. The complexity of the IT inter-dependencies are huge. Consumers cannot be expected to understand these.

4.5. This discussion paper may be considering asset and portfolio managers rather than online banks and payment services; but many of the service standards that need to be maintained are very similar in each case. Investors must be able to invest and trade assets with confidence and must be certain that they can do so without unnecessary delays or interruptions to the service.

4.6. The FCA has warned e-money firms that they will need to show a significant change in culture and behaviour once new protections come into force in July (2023) under the consumer duty regime. If a new regime is to be introduced for the asset management industry it should attempt to foresee and head-off problems that could be caused by the introduction of new technology and resultant harm to consumers.

4.7. The introduction of tokenised portfolio assets may well create new opportunities for the asset management industry. However, much of the thinking around this at present seems vague and ill-defined. Too often it is the provider who benefits most from the introduction of new technology rather than the user. In the case of investment platforms, for example, new technology seems to have been used to frustrate competition. Providers have used different pricing models to give the appearance of competing when, in fact, pricing has been used simply to confuse the market and make value-for-money comparisons very difficult. At the same time, functional differences between the services provided by platforms have been negligible with little or no attempt made to compete on this basis. Providers have tended to offer more or less the same package – although it looks now as though this may slowly be changing.

4.8. Another area in which sophisticated regulatory control is going to be required, and on a pre-emptive basis, is that of the application of artificial intelligence (AI). There are clear indications already that serious risk of harm to consumers could easily emerge in this area and

that financial services could be a near-perfect seeding ground. We discuss this further in our response to Questions 2 and 14 below.

4.9. There should also be relatively easy opportunities to use technology to enhance the service-offering to consumers. For example, introducing more flexible charging options that offer better value for money for consumers. We find it difficult se see how ad valorem charges can be justified in many cases. Similarly, if an annual performance fee is to be charged, it should be possible, using technology, to rebase the performance fee each year so that the performance fee is only levied on the incremental increase in the value of the portfolio at the end of each year.

5. **Consumer numeracy**.

Alongside all this, there remains the need for better financial education and awareness among consumers. The best approach to protecting consumers is to ensure that they are equipped as far as possible to protect themselves. It is within this context that better regulation should be set.

2. About UKSA and ShareSoc

6. UKSA and ShareSoc represent the views of individual investors. Between us we have over 23,000 members. In addition to our own members, 6 million people own shares or have investment accounts with platforms in the UK.

7. The Office for National Statistics estimates that at the end of 2018 UK-resident individuals held 13.5% of the UK stock market, up by 1.2% from 2016 and moving away from the historical lows of 10.2% in 2008. In 2020, the Financial Times estimated that 15% of the UK stock market is held by individual shareholders. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes. See https://www.sharesoc.org/investor-academy/advanced-topics/uk-stock-market-statistics/

UKSA (United Kingdom Shareholders' Association)

8. UKSA was originally formed to provide individual shareholders with a voice, influence and an opportunity to meet like-minded fellow investors. It is structured as a non-profit making company with annual subscriptions. An elected Chairman and Board of Directors (all volunteers and individuals with a wide range of backgrounds and experience) monitor a regional organisation. Each region benefits from oversight by an elected regional Chairman and Committee.

9. There are many agents and intermediaries in financial markets. Unlike them, UKSA represents solely those people who are investing their own money. UKSA and ShareSoc work together to build relations with regulators, politicians and the media to ensure that the voices of individual shareholders and their interests in the long term public good are reflected in the development of law, regulation, and other forms of public policy.

10. We also aim to build relations with regulators, politicians and the media to ensure that the voice of individual shareholders is reflected in the development of law, regulation, and other forms of public policy. See www.uksa.org.uk

ShareSoc (UK Individual Shareholders Society)

11. ShareSoc is a not for profit company. It is dedicated to the support of individual investors (private shareholders as opposed to institutional investors). It aims to make and keep investors better informed to improve their investment skills and protect the value of their investments. It engages with companies, the Government or other institutions if we think individual shareholders are not being treated fairly.

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12. ShareSoc actively campaigns to seek redress for private shareholders in cases where they have been the victims of unfair or unscrupulous treatment by companies and / or the financial services industry. See www.sharesoc.org

3. Answers to your numbered questions

Q1: Do you think that we should aim to create a common framework of rules for asset managers? What benefits would you see from this? What costs might this create? If you do not think we should do this, are there any areas discussed above where we should consider taking action, even if we do not create a common framework of rules? What would we need to consider around the timing of implementing a change like this?

13. In principle, we believe that a common framework of rules for asset managers has to be better than the current mishmash of separate rules for:

    13.1. authorised funds, fund managers and depositaries of authorised funds;

    13.2. fund managers and depositaries of funds *not* authorised by the FCA;

    13.3. portfolio managers making investment decisions on behalf of funds and other clients.

14. If a new regime is to be introduced it should apply to all asset managers. There should be no threshold below which full scope rules do not apply.

15. Based on the summary in paragraphs 3.7 – 3.22 of DP 23/2 many of the current differences between the various types of asset manager seem to be the result of piecemeal updating of the regime for different types of manager and the drafting / redrafting of individual frameworks which has left unintended gaps in the rules (or, worse still, contradictions or inconsistencies) and unnecessary duplication.

16. The benefits of change should include changes to the current systems which will:

    16.1. ensure greater clarity of oversight principles and rules for everyone (asset managers, their customers, regulators and other agencies such as the FSCS);

    16.2. avoid unnecessary duplication;

    16.3. eliminate current gaps in the rules;

    16.4. be fit-for-purpose in the light of the way in which the asset management industry needs to operate in today's competitive environment, access to technical support and to consumer wants, needs and expectations.

17. As UKSA and ShareSoc are not asset managers we are unable to comment on the likely or potential costs of reform. However, it is difficult to escape the

conclusion that there must be significant costs associated with maintaining the current inadequate system. Some of these will be the direct costs of running systems that are not fit for purpose. Others will be the indirect costs of their failure to properly protect retail and other investors.

Q2: Do you think we should change the boundary of the UK UCITS regime? If so, do you think we should take any of the three approaches set out here? Should we consider any alternative approaches? What timeframe would be needed to allow firms to change their existing product offering or to develop new products?

18. In terms of tidying up the current regulations, it looks as though it would be helpful to change the boundary of the UCITs regime. This would probably be helpful to the financial services industry as the current rules and regulations appear to be dysfunctional in a number of areas.

19. We do not have any views on which of the three options proposed would, on balance, be the most appropriate. Nor are we able to comment on how long firms might need to adapt to changes of this sort.

20. It is not easy to see how simply changing the boundaries between the current UCITS and NURS regimes will necessarily achieve much in terms of protecting and benefiting consumers. As the DP notes:

    - *Both UCITS funds and NURS can be low or higher risk, simple or more complex.*
    - *The market for authorised funds can be hard to navigate for consumers, and it can be difficult to distinguish between different types of funds.*

21. One of the main problems from a consumer point of view is that the level of financial literacy among UK savers and investors is generally low. Comparisons with other countries shows that the UK also scores badly on basic standards of numeracy. Rejigging the boundaries between UCITS and NURS sounds rather like attempting to improve standards of road safety by making significant improvements to road signage when half the country's road users can't read and can't therefore familiarise themselves with the Highway Code.

22. It is also very unclear what proportion of retail savers and investors (e.g. those putting money into a pension, ISA, etc.) continue to make any investment decisions of their own. Most financial advisors and 'wealth managers' now operate on a discretionary basis whereby they make all the investment decisions on behalf of the client – and charge them accordingly. Under this sort of regime there is not much point in realigning the boundaries between UCITS

and NURS in the belief that this will benefit significant numbers of retail investors by making investment decision easier for them.

23. For retail investors who do not want a discretionary service the only other option is to take an 'execution-only' service. As the name implies, this comes without advice.

24. For most consumers who want to invest (be it in a pension, an ISA or some other portfolio service) making investment decisions does not need to be particularly complex or difficult. However, the one thing that is needed for many people to make sound investment decisions is good advice. Many consumers recognise this and recognise that good advice is always worth paying for. For many the availability of advice is an essential component of bolstering their own self confidence (or overcoming a lack of it). Ten or fifteen years ago advisory services were widely available, usually as an add-on to the execution service. Since then, it seems that bureaucracy (the need to keep detailed records of what was said to a client in case of any come-back) has resulted in most reputable financial advisors and portfolio managers refusing to give advice. Instead, the advisor carries out an assessment of the client's risk-appetite based on a structured profiling questionnaire and then proceeds to put the client's money into defined types of investment. In the light of this, the proposed options for change set out in the DP look unlikely to make much difference for many retail investors.

25. This issue needs also to be considered in the light of recent rapid advances in artificial intelligence (AI). Systems such as ChatGPT and Bard could potentially transform the provision of guidance – an issue which in itself raises the need for a clearer distinction between 'guidance' and 'advice'.

26. While on the topic of AI, the regulatory authorities and the FS industry need to start moving fast to get ahead of the game. There are plenty of examples of tangible harms caused by AI that are already here. It is already possible for AI to replicate someone's voice and even a face - known as 'deepfakes'. The potential for scams and misinformation is significant. As was noted in a recent FT article[2], AI systems that can generate, classify and understand text are dangerous partly because they can mislead the public into taking synthetic text as meaningful. The most powerful models are already beginning to demonstrate complex capabilities such as power-seeking or actively finding ways to deceive humans.

[2] 'The Dangerous race to God-like AI'; Ian Hogarth, FT Weekend Magazine. 15/16 April 2023

27. In the meantime, a perennial issue which remains unresolved for many retail investors is that of fees and charges where much greater clarity is still needed. These often remain very opaque. It is often difficult for retail investors to know whether they are getting value-for-money from the fees / charges they pay. Comparisons can also be difficult and time-consuming. Failure to manage and resolve this issue so far does not augur well for likely regulatory skill and competence in manging the use of AI by the FS industry and its would-be imitators.

Q3: Do you think we should work with the Treasury to amend the threshold at which AIFMs must apply the full-scope rules? If so, do you have any comments on the options described above? Are there any other areas we would need to consider if we were to do this?

28. We are not able to respond with any degree of authority on these questions. All we can say is that whatever regime is put in place it must be:

    28.1. effective; it is no good having a regime in which expectations are unclear (for example small AIFMs) or in which rules can be easily circumvented;

    28.2. clear and unambiguous; for example the terms ‘small authorised AIFM’ and ‘small registered AIFM’ could hardly be designed to be more confusing for many retail investors, no matter how experienced or sophisticated they are.

29. Other observations are:

    29.1. it is not clear what is meant by a ‘professional’ investor and how they should be differentiated from a ‘sophisticated’ retail investor in terms of their investment understanding, knowledge and capabilities, or indeed their likely wants and needs as investors.

    29.2. No information is given on what the size threshold is for an organisation to be classed as a ‘full scope UK AIFM’, the basis for this, what the implications might be of changing the threshold (except that, for firms falling below the new threshold, the regime would be less prescriptive), what the new threshold itself might be or the reasoning for setting the threshold at the proposed new level.

    29.3. You say that you want ‘*The market for asset management for professional clients to be open to innovation, underpinned by high standards of market integrity and consumer protection’.* These look like excellent aspirations but without any further indication of what you are

aiming for here it is very difficult to comment or provide meaningful feedback.

Q4: Are there aspects of the current AIFM regime that professional investors do not value? Would there be benefit in us removing any of these?

30. We are not able to comment on this.

Q5: Do you think that we should amend our fund rules or add guidance either to make clearer the requirements on portfolio managers of funds, or to set minimum contractual requirements between host AFMs and portfolio managers? Do you think this would lead to any other consequences that we need to consider?

31. If there is clear evidence that the current rules and guidance surrounding the requirements on portfolio managers of funds are unclear or in any way deficient, then it seems logical that the rules and guidance should be amended and improved as soon as possible.

32. An interesting aspect of the commentary on ‘host AFMs’ is that many retail investors almost certainly have little or no knowledge or understanding of who the provider is of the various elements of service they receive from or via their portfolio manager. Similarly, they will have little idea of how the components of the service are being bundled up, what each provider of the different components of the services is really providing and on what basis they are charging for their services. More clarity in this area alone would help retail investors (the ultimate end-client) to assess the value-for-money they get from charges against their accounts.

33. Most AFMs, for example, do not appear to manage the assets of their funds. Instead, another firm acts as portfolio manager. However, most investors are unaware of this and the marketing materials avoid any mention of it. In practice, the power in the relationship is with the portfolio manager.

34. All this points to the current system being the wrong way round. We would prefer an approach in which:

    34.1. The fund should have directors who appoint the portfolio fund manager.

    34.2. The portfolio fund manager should have some of the responsibilities currently held by the AFM.

    34.3. The portfolio manager could outsource some tasks to what you currently call the AFM, but the responsibility would remain with the portfolio fund manager and the directors of the fund.

34.4. There should be adequate insurance and other assets so that in the case of a claim for redress for mismanagement, there are adequate amounts available for full redress to be paid.

35. The Woodford Link (LFSL) debacle highlighted flaws in the way the system operated in 2017 to 2019. The FCA has since written to fund managers and AFMs to outline their responsibilities but it has not published its report into its findings about Woodford or any recommendations for the future. Until the FCA publishes its detailed findings it is difficult to answer Q5 fully.

36. Woodford highlighted ways to arbitrage the existing rules. The rules either need better enforcement or new rules (or possibly both) to stop a re-occurrence.

37. The proposed FCA settlement with Link and the FCA has also highlighted the need for stronger capital adequacy requirements and insurance cover.

Q6: Do you have any comments on us potentially amending the rules and guidance around liquidity stress testing?

38. Woodford highlighted ways to arbitrage the existing rules. The rules either need better enforcement or new rules (or possibly both) to stop a re-occurrence.

39. The use of TISE (Guernsey Stock Exchange) and announcing a future IPO should not be permitted in the categorisation of liquid investments. The Woodford case has highlighted the problems that can arise from this.

Q7: Do you have any comments on whether we should make our rules on liquidity management and anti-dilution clearer?

40. See our answer to Q6 above. If there is any lack of clarity in the current rules around dilution adjustments and there is evidence that some consumers are being compromised (or harmed) as a result of this, then the rules need to be amended promptly so that this cannot happen.

41. One option that should be considered is banning illiquid investments (non-market securities or physical assets that are not easily realisable) from funds that allow investors instant access to their money. As we note in paragraph 46 below, Mark Carney, former Governor of the Bank of England has pointed out that these are "built on a lie".

Q8: Do you have any comments on the benefits or costs associated with public disclosure of fund liquidity?

42. In the light of the Woodford scandal we believe that there would be benefit in requiring greater disclosure of fund liquidity.

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Q9: Do you have any comments on us making our expectations on investment due diligence clearer for all asset managers?

43. If the FCA itself is concerned that the rules surrounding due diligence are inadequate, then it is essential that they are updated urgently. There then needs to be a period of close monitoring of the results to ensure that the updated rules have been understood by asset managers, that they are being fully implemented and that they are having the desired effect.

Q10: Do you agree that we should make our expectations of depositaries clearer? Do you have any comments on the areas where greater clarification would be desirable? Are there any areas where we should consider removing oversight functions from depositaries? Are there areas where the contribution of depositaries is particularly valuable for the interests of investors?

44. We are not able to comment on the detail of the current rules for depositaries or on those aspects of depositaries' duties that provide little benefit.

45. We agree that if there are clear deficiencies in the rules or the scope for misinterpretation or misunderstanding of the rules, then they should be amended urgently. The same is true in terms of clarifying the regulator's expectations of the depositaries.

Q11: Do you have comments on the analysis of the eligible assets rules for UCITS set out here? Do you think we should update or provide guidance on these rules? If we did so, what impact would this have for managers of UCITS funds?

46. We are mindful of the comment made by Mark Carney, then Governor of the Bank of England, in June 2019 in response to the emerging Woodford scandal that funds that invest in illiquid assets but allow investors instant access to their money are "built on a lie". He rightly called for regulatory change.

47. When the value of liquid, easily-tradeable assets within the Woodford Equity Income Fund fell, leaving the fund with a disproportionately high level of investments in illiquid assets, the response of Mr Woodford and his team was, amongst other things, to get some of these illiquid assets admitted to the Guernsey stock exchange so that they could be reclassified as 'liquid / tradeable' assets. The logic and rationale of some of Woodford's moves are understandable. However, the risks the fund was taking with this strategy and the ultimate outcome proved to be calamitous.

48. This fact notwithstanding, it would be appropriate for the FCA to give clear and unambiguous guidance on the use of the 10% rule and its expectations in ensuring that the best interests of retail investors are not compromised by the way in which the 10%rule is applied.

Q12: Do you have any comments on whether we should consider removing or modifying detailed or prescriptive requirements in the rules on prudent spread of risk?

49. We see 'prudent spread of risk' as a core principle of fund rules and one which should not be removed or diluted. It allows any investor, ACD and / or depository, trustee or regulator to go after a fund manager where a prudent spread of risk has not been implemented or followed.

50. We are also concerned that the Kid, which investment trusts have been required to produce since early 2018 and which UCITS were already producing (but for which they were required to bring their format into line with that of the investment trusts from 2019), are not fit for purpose. As John Kay writing in the Financial Times on 19th January 2018 commented:

    'The concept of the Kid is admirable; unfortunately its execution is a disaster'.[3]

51. Professor Kay goes on to say that:

    'Key information documents are misleading because when you wade through the complexity the prospective returns are little more than a projection of historic returns over the past five years. The calculations that are required involve fitting a probability distribution to the actual recent experience of returns. The various future scenarios that are presented are not projections of what investment yields might be under various economic conditions but drawings from that hypothetical distribution of past returns'.

52. Our understanding is that fund managers are required to produce the information in the Kid in accordance with detailed guidelines that leave them with virtually no discretion.

53. In his article John Kay gave examples for Scottish Mortgage Investment Trust and Bitcoin XBT Tracker Fund. In both cases he identifies how the information provided in the Kid is potentially seriously misleading to investors. We urge the FCA to carry out a thorough review and overhaul of Kids.

Q13: Are there any other areas where you think we should consider removing or modifying prescriptive requirements in the retail fund rules?

54. We believe that large redemptions on funds (for example, 20% or more of a fund being redeemed) should result in a pro-rata share of the fund assets being

[3] Risk, the retail investor and disastrous new rules; John Kay. Financial Times – 19.1.2018

moved into a separate redemption fund which can be sold down so as to meet redemptions in a way that is fair to both those redeeming their investment and those who decide to remain invested. This would have stopped Woodford selling liquid assets to meet redemptions, leaving a disproportionately high level of less liquid assets for the remaining investors. This should also help avoid a self-fuelling fund implosion as increasing numbers of investors start to question the underlying viability of the fund and make a stampede for the exit.

Q14: Do respondents agree that we should work towards consulting on rules to implement the 'Direct2Fund' model?

55. Yes. As set out in 5.10 of the consultation, we find the approach in Direct2Fund an exciting opportunity.

56. Firms may have some of this expertise but their customers are unlikely to have it to the relevant degree. The latter point is important for the new consumer entrants the finance sector wants to attract and is also important for levelling-up. We also cannot take it for granted that an otherwise 'sophisticated investor' will know what to expect when using new technology. All consumers are being implicitly asked to take on more IT risk.

57. To protect consumers from the outset (functionality with safety and security being part of the fundamental design), we are seeking minimum requirements covering the components necessary to take full advantage of the technology, such as:

    57.1. Distributed ledgers.

    57.2. Blockchain.

    57.3. Digital wallets.

    57.4. Smart contracts.

    57.5. Web3.

    57.6. The mechanisms for storage of and access to owners' tokens.

    57.7. The source and scope of information, and means used to communicate that information to consumers.

    57.8. Access to useful and swift support and redress, including the financial ombudsman.

    57.9. Insurance such as deposit protection, accident, theft, loss of service, business disruption, cyber risks, personal liability.

58. There are two technological elephants in the room that must not be forgotten as we innovate. The first, AI, we have already referred to as part of our response to Q2. The other is quantum computing.

59. AI/ML (machine learning) technology are fast and scalable, as demonstrated by Bard and ChatGPT. Technically, AI/ML have great potential but their value to legitimate business and investment decisions remains questionable as to the accuracy of the information and the legitimacy of the source.

60. The attraction in AL/ML, for example ChatGPT , is that they can create code for the seamless running of processes and computers. 'ChatGPT as a service' exists already, although not perfect, to gather and analyse data, create suitable marketing materials, seek potential customers, email them with relevant links to websites. Improved language capability alongside more people sharing more personal information across social media makes for more sophisticated targeting.

61. The downside falls more to consumers than businesses, as the information may be biased, out-of-date (note that ChatGPT's data sources are as Q4 2021), with no ability to differentiate the legitimate from the fake.

62. The ability to fake is the key attraction for criminals who also benefit from AI/ML/ChatGPT's attractions. Criminals' 'as a service' would include all the above plus seamless modifications to legitimate data, creating false information, and phishing emails that link to hoax websites.

63. Quantum computing is moving rapidly and businesses and regulators are behind the curve. In terms of security, accuracy and non-repudiation, Quantum's power means that the main safeguard, encryption, will be broken in a matter of minutes. When we combine quantum computing power with AI/ML, speed and scalability will reach to near-unimaginable heights without constraints.

Q15: What benefits would tokenised units in authorised funds provide for investors? What regulatory changes would be needed to enable tokenised units to be issued? How much of a priority should we put on enabling tokenisation of units?

Benefits:

64. Allowing the purchase and sale of fractions of funds, theoretically allowing a more affordable way to invest, especially for high cost assets. This currently happens in cryptocurrency, where customers can buy a fraction of a bitcoin (one bitcoin is made up of 100 million satoshis).

65. Allowing access to private sector firms outside the FTSE by removing the high minimum investment often needed in private markets – fractions of shares can be purchased for those who do not have large amounts to invest and/or are wanting to manage down risk.

66. Increases liquidity of traditionally illiquid, non-fractionable assets.

67. Cost reduction by needing fewer steps to complete a transaction, using smart contracts and removing intermediaries.

68. Streamlining the payment and settlement processes by removing the need for a back office to deal with company actions, such as dividend payments and sell and purchase transactions, with nearly instantaneous settlement into e-wallets.

69. Removes the small risk of losses because an AFM fails.

70. Increased efficiency and reduced errors in the creation, issuance, and management of securities, which ultimately reduces cost as well.

71. Increased transparency for all parties through the block chain's immutable capability.

Downside:

72. Vulnerabilities in the APIs (Application Programme Interfaces) often provided by 3rd parties and act as the link between the parties and the block chain.

73. How will owning a fraction of an asset impact voting rights, assuming the proposed changes in tokenisation (5.17 – 5.19) go ahead?

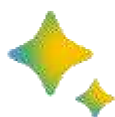
74. The relationship between authorised and unauthorised funds. It must be clear into which category a fund and its tokens fall and what the consumer regulatory consequences are for choosing either sort.

75. It is difficult for consumers to understand how tokens will work. An example of how a token will operate, as part of 5.12, would be useful, especially how they will be valued. For example, if tokens are being offered alongside the current, non-token approach, how will the valuation take place? Will it be NAV per token rather than per share? If so, surely there will be a difference between the number of shares and the number of tokens, as tokens could represent any number of shares or fraction of shares.

Regulation:

76. We cannot comment on the regulatory rules that need changing but we do have some views on crypto tokens. Research data shows that high proportions (14-

33% from some sources) of under 18's and 18-30's have "invested" (gambled might be a better word) in Crypto. We asked Google Bard for this data:

> *"What percentage of under 18's and 18-30's have "invested" (gambled might be a better word) in Crypto*
>
> 
>
> *According to a recent survey by Finder, 14% of under 18s and 33% of 18-30s have invested in cryptocurrency. This is up from 10% and 27% respectively in 2021. The survey also found that millennials are more likely to invest in cryptocurrency than older generations, with 43% of 31-40 year olds and 38% of 41-50 year olds saying they have invested in cryptocurrency.*
>
> *It is important to note that cryptocurrency is a volatile asset and its value can fluctuate wildly. As such, it is important to do your research and only invest what you can afford to lose.*
>
> *Here are some of the reasons why young people are investing in cryptocurrency:*
>
> - *They are more likely to be tech-savvy and understand the technology behind cryptocurrency.*
> - *They are more likely to be open to new and innovative investment opportunities.*
> - *They are more likely to be optimistic about the future of cryptocurrency.*
>
> *It is important to note that cryptocurrency is a risky investment and there is no guarantee that you will make money. As such, it is important to do your research and only invest what you can afford to lose."*

77. Given these statistics, we think Crypto must be within the FCA perimeter.

78. We agree on having an outcomes-based approach but we would want to see minimum mandatory standards to prevent a wild-west environment that makes it difficult for consumers to assess their own risks and rewards.

79. Because technology advances rapidly, we agree that future proofing regulation as per 5.2 is important. But what does that mean in relation to firms' governance over the technology? We suggest it includes considering the minimum standards necessary for asset managers to manage all 3rd parties

and the embedded hierarchy of 3rd parties in any given set of 3rd party services to a common high level that ensures:

79.1. Service resilience.

79.2. Customer focus covering clarity, usability, safety, security, privacy, redress, and disclosure over responsibilities and accountabilities across the business and technical supply chains.

79.3. Everything is demonstrably carried out fairly and timely.

Level of Priority for tokenising units:

80. This is unclear and depends on the outcomes wanted. High if we want a fully affordable way to invest and be an innovative leader in the fund markets. Low if we first want to sort out more fundamental issues such as investors, fund managers and regulators' capability in this area, and address the results of the many consultations and projects that this consultation is dependent on.

Q16: Are there specific rules that could impact firms' ability to invest in tokenised assets, where the underlying instrument is itself an eligible asset? How much of a priority should we put on enabling investment in tokenised assets?

Specific rules:

81. We are unable to comment but we agree that the rules, as mentioned in 5:14, around units must be reviewed to ensure firms can manage traditional and digital units and tokens.

Priority:

82. As for Q15 above.

Q17: How important do you think the different kinds of 'fund tokenisation' discussed above are for the future of the industry? Are there examples from other jurisdictions that could be models for UK fund regulation?

Importance:

83. All are important. The ability to engage potential and actual investors will require this. If the FCA does not allow this, people (particularly younger people) will move to new and unregulated services.

Other jurisdictions:

84. We are unable to provide evidence or feedback from other jurisdictions. However, we are aware that many countries have embraced decentralised

finance (DeFi) driven by block chain. The purpose of DeFi is to free people from restrictions imposed by traditional practice, including related laws and regulation. This is, therefore, an interesting dilemma for regulators: how to regulate something built to defy regulation? The FT makes a similar point "Using crypto for crime is not a bug — it's an industry feature"[4]. This also links to our points under 'Regulation' in Q15.

Q18: What other regulatory changes, if any, would you like to see to enable fund managers to make wider use of advances in technology without weakening investor protection?

85. We are unable to comment on the regulatory changes needed except to make them future-proof, they must take into account AI/ML, as demonstrated by Bard and ChatGPT, and quantum computing. Given that the drive is for outcomes-based regulation, we recommend (based on 5.8, 5.9 and 5.14) neither the consumer focus and nor the technology risks are forgotten. Our suggestions are that the FCA demand that asset managers and related key players concentrate on:

    85.1. The product: for whom it is intended and clearly articulating the consumer benefits.

    85.2. Ability to create valid tokens: they must be identifiable and recognisable, and state the token's divisibility (the fractions allowed).

    85.3. Service resilience: functionality, usability, capacity, safety, security, privacy, bias-prevention, confidentiality, availability, integrity, continuity.

    85.4. IT risks: ensuring that these are managed by design.

    85.5. Requirements for identification, authentication and access rights: how consumers can prove they are who they are, which assets they own, and their entitlement to the related benefits.

    85.6. Ability to switch from the virtual to the physical world and vice versa: ensure consumers can remove their money from the virtual/tech world into real world and fiat money.

    85.7. Real time statements and audit trails: accessible to each customer, showing what was done, when and by whom.

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[4] Using crypto for crime is not a bug — it's an industry feature | Financial Times (ft.com) 27th April 2023

85.8. Dealing with unintended and unexpected outcomes: risk management relevant to the asset manager and consumer.

85.9. Needing to have clear rules about AI: where it is used and for what purposes, such as advice, profiling, and risk monitoring, and avoiding 'the Computer says no' problem.

85.10. Redress: consumers have access to help, support, a complaints procedure that is straightforward and easy to use and resolves issues without procrastination.

Q19: Do you agree that improving the content and readability of the prospectus will improve investor engagement? What specific changes would you like to see?

86. Yes, we agree this will improve investor engagement.

87. We would also recommend that all investors have to include an email address in their application, that this is the default means of communication and that the investor's email address be added to the shareholder register and passed to the company registrar.

88. UKSA and ShareSoc are currently part of the Share Your Voice Campaign which is led by M&S and its Chair Archie Norman. This would require email addresses to be a requirement for owning shares (and so would apply to Investment Companies). Further information is at https://corporate.marksandspencer.com/give-all-shareholders-voice-bringing-company-law-21st-century-share-your-voice-campaign . We think the requirement should also apply to UCITS and the OEICS 2001 Regulations should be changed as well as the Companies Act.

89. To complement these, we would like to see the main mechanism of online access, websites, to be consumer friendly. We should be able to easily:

89.1. Accessible by all people, taking into account disabilities and age.

89.2. Understand the logic of the website containing the prospectus – is it obvious where it is and easy to get back to?

89.3. Navigate across the different sections with the use of appropriate hyper-links, bookmarking and access to examples and definitions.

89.4. Adjust fonts, sizes and colours for individual comfort.

89.5. Choose to see it in 'flat file' format.

89.6. Access ‘bite’ size’ chunks tailored by individuals to suit their needs.

89.7. Download of some or all it.

89.8. The information is written in plain English.

89.9. Have easy access to real people within the issuer to help individual investors understand the technical elements contained within the prospectus.

Q20: What changes to the rules for managers’ reports and accounts could enable firms to make best use of technology to meet investors’ information needs? How else could disclosure of ongoing information to fund investors be improved? For example would there be benefit in us consolidating ongoing annual disclosure reports for funds?

Rule changes:

90. We are not able to say what rules need changing. We support the aims of paragraphs 3.5 – 3.7 in DP22/6, relating to future-proofing that allows for technical innovation whilst retaining physical communications, so long as it takes all of our response to Q18 into account. We believe that any rule changes must complement the outcome of DP22/6.

Improvements:

91. Technical innovation will increase through the use of smart apps with embedded AI and Machine Learning (ML). This will lead to tailor-made products and services for each client based on a range of criteria (e.g. historic behaviour, client wish lists, risk-profiles). Adding company performance and company communications to that mix is within range now.

92. As retail investors, we want easier and more flexible access to company communications and information. We want to ensure that:

92.1. All information is made available in such a way that each investor can choose what they want / need to access. Regulation may mean that there is a minimum level of information that retail investors must have but, from then on, it is up to the investor to determine the breadth and depth of information they want to access and be able to do so.

92.2. Digital formats are easily accessible by all.

92.3. Digital communications and reporting are as valid virtually as in physical format whilst retaining the option to have physical formats available.

92.4. There is a means by which a digital piece of communication can be easily transformed by the end user into a printed format for easier reading.

Q21: Do you agree we should review the rules for unitholder meetings? What changes should we make so that these meetings maximise the participation of fund investors?

93. Yes. In the interests of investor engagement General Meetings, and especially AGMs, should be mandatory. The regulations should not allow fund managers the option of getting shareholders / unit holders to waive this requirement.

94. Make all unitholder meetings hybrid to reach the widest possible audience, enabling face-to-face interaction for those that prefer physical meetings. Hybrid options must be well managed to ensure those with a virtual presence have a chance to contribute, for example, questions and comments in real-time.

Q22: How could the relationships between fund manager, intermediary and investor be better reflected in rules for authorised funds? Should the FCA do more to enable investors to engage with the manager of their fund?

95. Better reflection of relationships:

96. We are unable to comment on rule changes. We recommend that you ask retail investors directly.

97. If using electronic means of communication, please ensure it is a two-way conversation including customers' ability for redress. The contact details and phone numbers provided by firms should ensure that the consumer is put in touch with a real person.

Q23: Do you have any comments on the relative benefits of the topics raised in this paper which you think we should consider as part of prioritising our work? How would you rank the areas covered in this paper in terms of priority? (The response form for this question provides a tool for ranking the 10 major topics set out in Table 1 on p.14)

98. We cannot offer a precise opinion on priorities. At a general level, we would always prioritise areas that are of interest to retail investors.

99. In terms of IT innovation, we would want improvements referred to in our responses in Sections 5 and 6, Q14 – 22, regardless of what other changes are made to the regime.

Updating and improving the UK regime for asset management

Q24: Do you have any comments on potential reform of the UK regulatory regime for asset managers and funds in areas that are in scope of this paper but have not been discussed in detail?

100. We support future-proofing regulation and that the regulation is outcomes focused.

101. To address the former, we must include crypto within the regulatory perimeter, take into account AI/ML and quantum computing, and the innovations that will follow (Chat GPT and Bard are just the start).

102. To achieve the latter, we must be clear about what is expected of, and demanded from, both providers of financial services and the consumers who use them.

103. Only then do we feel that regulation can be designed to safeguard consumers' best interests without stifling business opportunities.

104. But there remains a lot of outstanding work in this area, with many consultations and discussion papers on overlapping issues, making it difficult for us to make sense of what the desired and intended outcomes are. Equally important is how well all of us (firms, regulators, consumers) can cope with the risk of managing too many changes (just look at all the links and references mentioned). For example:

    104.1. There are some good ideas and aspirations but the co-dependencies are complex and priorities difficult to determine.

    104.2. There is no in-depth discussion on security, safety, redress and resilience.

    104.3. Clarifying who is liable, who is protected, should decentralised finance systems (DeFi) collapse.