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Marketing

FCA Emphasizes Need for Fund Managers to Monitor and Clearly Communicate Financial Benchmarks and Investment Practices

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Investors base high-stakes decisions on hedge fund marketing materials, disclosure documents and investment mandates, so it is imperative for hedge fund managers to ensure that those documents accurately and clearly describe the funds' operations. In the results of its recent thematic Review, entitled "Meeting investors' expectations," the U.K. Financial Conduct Authority (FCA) assessed whether U.K.-authorized investment funds (AIFs) and segregated mandates are operating in line with investor expectations set by marketing and disclosure materials. While managers generally ensure that their behavior lines up with disclosure, the FCA found room for them to improve and exercise vigilance in managing investor expectations.

The FCA's goals for the Review were to ensure that hedge fund managers and others in the fund management industry ensure that product descriptions are clear and correct, given the reliance of investors and financial advisers on that information for investment decisions; provide effective governance and oversight throughout the entirety of a fund's life, even when the fund is no longer being actively marketed; and monitor distribution channels to identify trends that may indicate inappropriate sales. This article enumerates the practices that the FCA outlines in the Review with respect to these goals.

For additional insight from the FCA, see "FCA 2016-2017 Regulatory and Supervisory Priorities Include Focus on AML, Cybersecurity and Governance" (Apr. 14, 2016); "FCA Expects Hedge Fund Managers to Focus on Liquidity Risk" (Mar. 3, 2016); and "FCA Report Enjoins Hedge Fund Managers to Improve Due Diligence" (Feb. 25, 2016).

Overview and Key Findings

In its Business Plan 2015/16, the FCA said it would conduct a thematic review to assess whether U.K. authorized investment funds and segregated mandates were operating in accordance with investor expectations as set by marketing and disclosure material, along with investment mandates.

Consequently, the U.K. reviewed 19 U.K. fund management firms responsible for 23 U.K. authorized funds and 4 segregated mandates. The 23 funds were Undertakings for Collective Investment in Transferable Securities (UCITS) vehicles sold to retail investors, 20 of which were available on commonly used execution-only platforms (allowing investors to make their own decisions without external advice). The funds varied in size, with a total value of approximately

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£50 billion. All of the funds followed active investment strategies, ranging from simple to highly complex, investing in a variety of asset classes including equities, derivatives, corporate and government bonds.

Overall, the FCA found that fund management firms are taking the right steps to meet investor expectations and comply with responsibilities toward investors. However, the regulator found some examples of bad practice and areas in need of improvement. Accordingly, managers must ensure that their product descriptions are clear; that they have adequate oversight and governance in place; and that they appropriately supervise distribution.

Clarity of Product Descriptions

"Clear product descriptions are necessary for investors to understand which strategies funds follow, how fund managers will invest on their behalf, and what risks are involved when investing," the Review notes. "Firms need to provide customers with enough detail about a fund in a clear and concise manner that they can understand."

Conversely, if fund documents provide insufficient information or use jargon, the FCA stated, a customer's ability to make informed investment decisions may be limited.

In the sample reviewed by the FCA, firms generally provided adequate information about the funds' strategies, characteristics and risks. Funds with clear product descriptions gave a thorough explanation of the investment strategy, including specifics about how the fund's assets would be invested.

Seven funds had quantifiable performance targets, enabling investors to measure whether performance was met on an ongoing basis. Those funds either aimed to outperform a common index or had a defined growth target over a specified period. For more on benchmarks, see "Hedge Fund Managers Must Prepare for Benchmark Regulation" (Feb. 11, 2016); and our two-part series on "The Use of Benchmarks to Measure Hedge Fund Performance by Pension Funds and Institutional Investors": Part One (Jul. 30, 2015); and Part Two (Aug. 6, 2015).

Seven funds also had descriptions of how much of each fund's assets would be invested into various asset types (*e.g.*, a maximum of 80% of the fund would be invested in equities).

On the other side, seven funds' key investor information documents (KIIDs) failed to include clear descriptions of how the fund would be managed. Of those seven, five funds used a benchmark-related approach that should have been disclosed, and one used jargon that a retail investor might not have understood. Finally, one fund gave a potentially misleading impression of the level of currency risk in the fund; the fund's KIID said that currency risk would be hedged by the use of currency contracts, although the fund manager actively decided whether to hedge some currencies or not.

Product Description Practices

The Review includes the following examples of good practice with respect to product descriptions that the FCA noted when studying the underlying funds:

- *Detailed Explanation of Investment Strategy*: One fund included a thorough explanation of its investment strategy, drafted with the involvement of the fund manager so as to reduce the risk that the actual strategy would deviate from the disclosure. The description included

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an explanation of the specific investment steps the manager would go through to choose individual investments for the fund's portfolio.

- *"Signposting" Complexity*: One firm that managed a highly complex fund included a strong recommendation in the fund's marketing material that investors should seek advice. "This could help mitigate the risk of inappropriate distribution to investors who did not understand all the important aspects of the fund," the Review states.
- *Being Specific About Investments*: One firm in the FCA's sample specified only the instruments that would be used by the fund manager, unlike other prospectuses that included any instrument that might be used, even if that use was unlikely.
- *Accuracy and Consistency*: Three firms ensured descriptions were accurate and consistent by requiring all new literature related to the fund be reviewed by someone with in-depth knowledge of that fund.
- *Consumer Dialogue*: Five firms performed end-customer testing to assess investors' understanding of documents, including characteristics and risks of the funds, and incorporated feedback from that testing into the product description.

In contrast to the good practice, above, the Review notes that one fund had a broadly drafted investment policy "to invest in companies." The policy mentioned that the fund may also hold government debt securities and cash, with no indication about what would cause the manager to invest in assets other than companies. However, the fund actually had a flexible investment approach, and the fund manager was able to shift the allocation between different assets depending on market conditions. A significant portion of the fund was invested in government bonds and cash for more than a year.

Benchmark-Related Funds

Part of the FCA's study focused on how funds' strategies were constrained by the investment approach and how that was disclosed to investors. The Review notes that an extreme example of this is a fund that is a so-called "closet tracker" – a fund designed to passively track an index that does not disclose that fact to investors.

The FCA found three actively managed equity funds in its sample that were following enhanced index strategies (following an index within certain predefined limits without adequately disclosing it to investors). The strategy, indices and degree of freedom the fund manager had in relation to each index were not adequately disclosed to investors, nor were any indices included as benchmarks in the past performance presented in each fund's KIID.

Two other funds studied by the FCA had material passive holdings that were not adequately disclosed, clouding investors' view of the fund's investment approach.

Consequently, the FCA recommended funds with benchmark-related strategies disclose the benchmark and, for active funds, the degree of freedom the fund manager has relative to the benchmark. This information should be disclosed regardless of whether the benchmark is public or private. If a fund passively invests a material portion of its portfolio, this should also be disclosed to investors in pre-investment documents.

Clear Communication of Risks

The FCA also found that two funds failed to adequately disclose material risks to investors in the KIID, as well as areas firms could improve to provide clearer risk descriptions. Furthermore,

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seven KIIDs did not clearly explain the consequences of risks (with one KIID rife with jargon), so an investor might not understand how the risks could affect the value of his or her investment.

Accordingly, the FCA recommends that fund prospectuses help investors compare risks and consistently communicate those risks.

Adequate Oversight and Governance

Portfolio Monitoring

The FCA found that firms generally had appropriate controls and monitoring to check asset types and the amount invested in a particular asset or group of assets. Firms also monitored investment returns, although the FCA did find one example where the amount of income provided by an income fund was not monitored.

"Firms should ensure that they monitor all relevant aspects that an investor would expect to be delivered by a fund from their marketing and pre-investment documents," the Review states.

Funds Not Actively Marketed

The monitoring of funds and fair treatment of customers must be consistent throughout the life of the fund, regardless of whether the fund is being actively marketed.

Although most of the funds reviewed by the FCA were actively marketed, four funds were only open to ongoing investment from existing investors and were not otherwise being actively marketed to investors. "In these funds there appeared to be a concentration of issues suggesting that the firms had not overseen them as carefully as the funds that were still being actively marketed," the FCA explained.

Appropriate Distribution

Because investors often invest through financial advisers or platforms, it is up to fund managers to control those distribution channels. The FCA found two funds that were available on execution-only platforms, even though the funds' respective fund managers intended for the funds to be available only with advice and were unaware of this method of access.

Regardless of how investors arrive at a fund, the manager is responsible for checking sales patterns against the fund's target market in an effort to identify unusual patterns that may indicate a problem with distribution or inappropriate sales. By identifying issues early, a fund manager may be able to resolve them quickly.

Monitoring Sales Patterns

Out of ten firms whose distribution oversight was reviewed by the FCA, two failed to identify unexpected patterns among distributors. Conversely, five firms were developing smarter methods to analyze data from distributors in order to better understand the types of customers investing in their funds and monitor whether funds were reaching their target markets.

"Firms should consider how to get enough data from distributors to allow them to ensure appropriate distribution of their products," the FCA advised. Two good practices the Review

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highlights in this respect are:

1. Using indicators (such as high levels of cancelled sales and customers redeeming shortly after investing) to monitor distribution and identify any unusual patterns; and
2. Interacting with, conducting considerable due diligence on and extensively training new financial advisers to ensure they have a good understanding of the investment characteristics and philosophy of the fund.

Providing Appropriate Information

"Regardless of the route investors take to buy a fund," the FCA said, "they need to be provided with the right information. This should be clear, fair and not misleading, and take account of the target audience."

Thus, if a fund manager produces documents that are designed to only be used by financial advisers and other investment professionals, it should be made clear that those documents are not for investor use. The FCA found three factsheets that failed to make it clear that they were designed for professional use only. In one case, there was only a small disclaimer in a large paragraph of small print at the end of the document.

Practical Implications of the Review

Although the funds examined in the Review were UCITS vehicles, the recommendations and practices highlighted by the FCA are important for hedge fund managers to be aware of. The FCA noted that its findings should be reviewed by "all fund management firms." Additionally, the FCA will follow up on the Review through its routine supervision of fund managers.

Accordingly, hedge fund managers and others in the asset management industry should review their arrangements and practices to determine whether they need improvement or enhancement as outlined in the Review.

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