15 October 2019 - SCM Direct Statement re Woodford and the FCA

Following today's announcement that the £3 Bn Woodford Equity Income fund will be wound up, SCM Direct calls on the Government to commission an independent root and branch review of the structure and functioning of the FCA, and for Mr Bailey, the current FCA CEO to step down with immediate effect.

The Woodford announcement today makes the FCA's recent rules on liquidity even more absurd than they were when the FCA published them. It is abundantly clear that retail investors should not be allowed to invest in funds with any unquoted holdings unless they have specifically signed a waiver that they have been made aware of the risks and are happy to proceed.

SCM Direct is aware that the FCA are saying that its hands were tied on UCITS funds because they are governed by an EU directive; and pointing out its upcoming work with the Bank of England on redemption terms on open-ended funds. But in a statement the EU Commission said '*We see no immediate reason for changing rules which are, in our view, clear but need to be applied properly by national authorities in order to ensure the intended protection of investors. The turmoil surrounding Mr. Woodford's decision to freeze withdrawals from his flagship fund "seems to be a supervisory issue concerning the application of the EU rules."*

It was shameful that the FCA chose to exclude UCITS funds e.g. Woodford from its recent liquidity rule changes even though the FCA had specifically delayed the publication by three months "to take account of the Woodford episode" and was reported to be merely "considering extending its reforms to the broader fund industry"[1].

In view of the enormity of the negative impact on investors of the Woodford scandal, SCM Direct reiterates the 5 Point Action Plan they recently published aimed at vastly improving UK investor protections to so that the public is shielded from the repeat of such scandals, many of which have taken place under the watch of Mr Bailey.

1. Government to launch an independent "root and branch review of the FCA".

2. Government should introduce Whistleblowing legislation along the lines of the US regulator's, the SEC, where whistle-blowers are encouraged, even financially rewarded.

3. FCA urgently bans all funds with daily or weekly dealing, from investing any further money into unquoted investments, directly held physical properties, or listed shares with nominal levels of trading activity.

4. FCA begins naming and fining organisations not complying with MiFID II Costs and Charges legislation that came into force in January 2018; as well as mandate a Common Cost Template for all retail funds.

5. UK should follow US mutual funds in having truly independent boards to foster a culture of honesty, treating customers fairly, passing back economies of scale and eradicating conflicts of interest.

[1] https://www.ft.com/content/9c0a8f79-dd6e-356b-8c81-d2c13e9b9c9d

Recent Scandals

As vocal consumer campaigners, SCM has produced extensive research, calling out failings by both conflicted industry trade bodies and the regulator, including anti-consumer behaviours in respect of research costs, closet index tracking, liquidity and mispricing, hidden fees, fund labelling, and lack of investment and holdings transparency, together with numerous regulatory failings.

However, SCM's Founders, Alan and Gina Miller believe the weight of regulatory failings is now so enormous that the Government must intervene to protect ordinary investors and pensioners.

Examples:

- The FCA whitewash report of the RBS/GRG scandal[2]
- The FCA climbdown from its initial hard hitting 2015 Asset Management Study[3] to its weak final report[4] leading to a package of token remedies[5] following extensive industry lobbying[6]
- The LCF scandal whereby a whistleblower was ignored by the FCA three years before its collapse[7]
- The Woodford scandal where the FCA ignored calls from the Guernsey Stock Exchange[8] and even claimed it was unaware of the decision to list assets there despite it being widely reported[9].

All of which amount to clear evidence of a systematic and widespread regulatory failure under the stewardship of the FCA's Chief Executive, Mr Andrew Bailey.

Trade lobbying and the 'cosy' relationship between the UK investment industry's trade body (The Investment Association) and the FCA has led to sensible proposals regarding regulatory issues being repeatedly watered-down following industry lobbying. The result has been countless consultations that have not led to firm action but worthless box ticking exercises that benefit no-one, least consumers.

5 Point Action Plan to Urgently Improve Investor Protection

1. **The Government should appoint an independent "root and branch review of the FCA" along the lines of the 2018 Kingman Review.[10]**

There are numerous similarities between the failings identified by the Kingman Review of the regulator of auditors, accountants and actuaries in the UK - the FRC, and the FCA. The Kingman review identified the FRC as being akin to a house that *"is – just – serviceable, up to a point, but it leaks and creaks, sometimes badly. The inhabitants of the house have sought to patch and mend. But in the end, the house is built on weak foundations. It is time to build a new house*" so it "*has a clear and precise sense of purpose and mission", "is firmly focused on the interests of consumers", "is respected by those who depend on its work, and where*

[2] https://www.bbc.co.uk/news/business-48621096
[3] https://www.fca.org.uk/publications/market-studies/asset-management-market-study
[4] https://www.fca.org.uk/news/press-releases/fca-publishes-final-report-asset-management-sector
[5] https://www.fca.org.uk/publication/policy/ps19-04.pdf
[6] https://www.ft.com/content/c7d2dac4-5802-11e7-80b6-9bfa4c1f83d2
[7] https://www.ft.com/content/f1efe506-4c7d-11e9-bbc9-6917dce3dc62
[8] https://international-adviser.com/guernsey-stock-exchange-claps-back-at-fca-over-woodford/
[9] https://www.ft.com/content/dc577b72-886a-11e9-97ea-05ac2431f453
[10] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

necessary feared by those whom it regulates", "has the right powers and resources it needs to do its job" and "is able to attract the highest-quality people."

All these statements apply equally to the FCA under Mr. Bailey's stewardship.

2. **Propose new Whistleblowing legislation along the lines of the US regulator's - the SEC, where whistle-blowers are encouraged, even financially rewarded**.

Since 2010, the US has had a proper, professional whistle-blower program[11] that correctly identified whistle-blowers as among the most powerful weapons in identifying "*possible fraud and other violations much earlier than might otherwise have been possible. That allows the Commission to minimize the harm to investors, better preserve the integrity of the United States' capital markets, and more swiftly hold accountable those responsible for unlawful conduct*."

Financial awards are between 10% and 30% of the money collected. This has led to the SEC awarding approximately $376 million to 61 individuals since 2012. All payments are made from an investor protection fund financed entirely through monetary sanctions paid to the SEC by securities law violators. No money is taken or withheld from harmed investors to pay whistleblower awards.

In sharp contrast, the FCA[12] was recently found to have spent less last year on its entire whistleblowing team than on its CEO's salary. The FCA's attitude to whistle-blowers was revealed when The Financial Regulators Complaints Commissioner[13] forced the FCA to apologise to a former Royal Bank of Scotland employee whose identity was wrongly revealed to its employer.

Similarly, when the Barclays CEO wrongly attempted to unmask a whistleblower, instead of banning the CEO, the FCA chose to fine him instead.[14]

3. **The FCA should <u>urgently</u> ban all funds with daily or weekly dealing, from investing any further money into unquoted investments; be it via private equity/unlisted shares, directly held physical properties, or listed shares which are rarely traded.**

The FCA should also bring in a requirement for 100% transparency of fund holdings by adopting the 2004 US rules which mandate funds to publish "*their full holdings within 60 days of each quarter end*." [15] SCM has been campaigning for this since 2012.

SCM Direct alerted the FCA[16] on the business day following the Brexit vote in June 2016 that major property funds investing via illiquid, directly held properties, needed to be re-priced and/or suspended.

The FCA chose to ignore SCM's warnings, leading to a stampede by investors to exit many of the property funds to take advantage of inflated valuations, until the funds belatedly re-priced and/or suspended dealings.

[11] https://www.sec.gov/whistleblower
[12] https://www.independent.co.uk/news/business/news/fca-executive-pay-whistleblower-team-andrew-bailey-a8852946.html
[13] https://www.cityam.com/city-watchdog-plans-overhaul-treatment-whistleblowers-2019/
[14] https://www.ft.com/content/f8a5160e-4482-11e8-803a-295c97e6fd0b
[15] https://www.thisismoney.co.uk/money/investing/article-6966853/What-hiding-Fund-firms-refuse-reveal-cash-is.html
[16] https://scmdirect.com/brexit-hits-property-fund-compensation-could-hit-140-million/

By failing to act quickly, the FCA comprehensively breached its statutory strategic objective to ensure that the relevant markets function well; together with its operational objective to protect the consumer.

SCM Direct published research in 2016 that found that "*73% of the UK Smaller Company funds had a liquidity mismatch between their underlying holdings and the daily liquidity offered to investors should 20% of their funds be redeemed*".

As evidenced by the Woodford saga, it is a disgrace that the FCA has not changed rules allowing companies "seeking" a listing within the next 12 months or companies listed on exchanges even if rarely traded, to be somehow treated as if they were listed, "eligible" assets i.e. liquid when they are patently illiquid.

The FCA should immediately ban any further investments by funds purporting to offer either daily or weekly liquidity, into unquoted investments, rarely traded listed securities or directly held physical properties e.g. commercial buildings.

The FCA recent liquidity review[17] shows the regulatory failure by the FCA to protect consumers, as even some months after the beginning of the Woodford crises, fuelled by liquidity related issues, the FCA chose to exclude UCITS funds e.g. Woodford from its recent suggested liquidity rule changes.

4. **The FCA must immediately begin naming and fining organisations not complying with MiFID II Costs and Charges legislation that came into force in January 2018; as well as mandate a Common Cost Template of all retail funds.**

Despite repeated and widespread evidence of non-compliance by firms, the FCA's CEO admitted to the Treasury committee earlier this year, that not a single company had faced enforcement action for failing to follow the new regulations on charges[18].

SCM Direct presented the FCA with two separate dossiers detailing widespread breaches across the entire industry during 2018. Since then the FCA has admitted investigating at least 48 firms for possible non-compliance and yet not a single firm is reported to have faced enforcement action. The FCA often spouts two equally morally and intellectually bankrupt excuses to explain its failure to enforce:

a) *"while the FCA had uncovered areas of non-compliance, claims that groups were **intentionally** circumventing the disclosures are "not supported by the evidence".*[19]
b) *"The FCA will act **proportionately** and not take a strict liability approach in relation to enforcement of Mifid II, given the size, complexity, and magnitude of the changes that are required to be in place in firms."*[20]

A Common Cost Template mandated across the retail industry should end this farce and improve consumers outcomes by enabling quick and easy product comparisons.

The FCA steadfastly refuses to implement this despite earlier this year admitting it had found[21] *"that firms in the sample interpreted the rules inconsistently, making like-for-like comparisons of costs and charges difficult"*

[17] https://www.fca.org.uk/publication/policy/ps19-24.pdf
[18] https://www.thetimes.co.uk/edition/money/revealed-fund-shops-that-hide-away-their-fees-ljt0v5dml
[19] https://www.ft.com/content/04345a14-3b47-11e9-b856-5404d3811663
[20] https://www.moneymarketing.co.uk/fca-rebukes-48-investment-firms-for-mifid-disclosure-failures/
[21] https://www.fca.org.uk/news/press-releases/fca-calls-firms-act-following-review-costs-and-charges-disclosure-investment-sector

and that *"asset managers generally do not disclose all associated costs and charges and these are therefore not sufficiently clear to the end investor. Where full cost disclosures are made, there are inconsistencies between different documents and websites, and customers can therefore find the information difficult to understand."*

There have been extensive media reports showing that retail investors find the cost disclosures they receive both "*baffling*" and "*almost impossible to understand."*[22]

Once again, it is incredulous that the FCA supports standardised Common Cost Templates for institutional investors[23] but fails to afford these same levels of understanding and protection to retail investors.

SCM Direct has been calling for a mandated Common Cost Template for retail funds since 2012.[24]

5. **UK should follow US mutual funds in having truly independent boards to foster a culture of honesty, treating customers fairly, passing back economies of scale and eradicating conflicts of interest.**

Independent Board Directors

In the US, since the 1940 Investment Company Act, at least 40 percent of a fund's board have had to be Directors who are not affiliated with the fund, its investment adviser or its principal underwriter.

It is estimated that about 75% of directors on US mutual fund boards are independent[25].

In contrast, the FCA has only recently changed the rules so that from 30 September 2019, the UK equivalent just needs "*at least two of its members (and 25% of its total) to be independent directors*".[26] This simply does not go far enough.

Economies of Scale

In the US[27], the SEC requires mutual funds to provide discussions of ''*the extent to which economies of scale would be realized as the fund grows*'' and ''*whether fee levels reflect these economies of scale for the benefit of fund investors''*. This has led to US mutual funds commonly having "fee breakpoints" whereby fees fall materially as the fund grows.

The FCA in its original Asset Management study[28] found that UK fund boards "*do not robustly consider value for money for fund investors" … "They do not typically question whether the economies of scale achieved when funds grow to reach certain levels of assets are shared with the fund investors in the way that break points are routinely used in institutional and segregated mandates."*

[22] https://www.telegraph.co.uk/investing/news/thousands-investors-sent-baffling-letters-due-eu-fee-disclosure/
[23] https://www.fca.org.uk/news/statements/fca-statement-launch-cost-transparency-initiative-cti
[24] http://www.trueandfaircampaign.com/true-and-fair-code/introduction-to-the-code/
[25] https://www.ft.com/content/21133602-266b-11e7-8691-d5f7e0cd0a16
[26] https://www.grantthornton.co.uk/insights/fca-issues-final-rules-on-fund-manager-governance/
[27] https://www.nera.com/content/dam/nera/publications/archive1/Journal%20of%20Investment%20Compliance%20article_0708.pdf
[28] https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

Given that the FCA was aware of this issue, it is even more shocking that its final remedies[29] were so inferior to the US standards. The new rules allow funds to justify not passing back economies of scale to unitholders, if it is for "*reinvesting savings achieved through economies of scale into the business, subsidising other parts of the business or covering development costs*" i.e. almost anything.

Conclusion

A French philosopher once said "every nation gets the government we deserve"[30].

What have hard working UK investors done to deserve the present FCA, and be treated as second class consumers compared to their US peers?

This latest Woodford Scandal emphasises the need for an urgent review of the FCA, and for Mr Bailey, the current FCA CEO to step down with immediate effect.

Anything else would be a dereliction of the political duty of care to UK investors.

Contact:

Gina Miller – gina@scmdirect.com
Tel: +44 (0) 20 7838 8650

Alan Miller – alan@scmdirect.com
Tel: +44 (0) 20 7838 8650
www.scmdirect.com

SCM Direct

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Established in 2009 by Alan and Gina Miller, the company aims to provide 100% transparent investing that respects investors by putting their best interests at the heart of all we do, stripping away layers of costs and inefficiencies; and concentrating on providing consistent performance.

The hybrid investment approach of actively managing pure ETF portfolios has seen Alan Miller continue his outperformance track record, whilst also offering clients extremely high levels of liquidity and diversification.

Through their True and Fair Campaign launched in February 2012, Alan and Gina have raised awareness of anti-consumer practices including lack of fee transparency, conflicts of interest, closet indexation and research costs. They have also either contributed or influenced text in 3 EU Directives – MiFID II, PRIPs and the Share Holder Directive.

The value of investments can go down in value as well as up, so you could get back less than you invest. It is therefore important that you understand the past performance is not a guide to future returns. SCM Direct is a trading name of SCM Private which is authorised and regulated by the Financial Conduct Authority, Registration Number 497525.

[29] https://www.fca.org.uk/publication/policy/ps18-08.pdf
[30] https://en.wikiquote.org/wiki/Joseph_de_Maistre