THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

The Investment Association
65 Kingsway, London, WC2B 6TD

T +44 20 7831 0898
W theinvestmentassociation.org
Twitter @InvAssoc

Matteo Basso
Strategy & Competition Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

By email to: cp15-27@fca.org.uk

Date: 7 December 2015

Dear Matteo,

RE: CP 15/27 Part III: FCA Consultation Paper (CP 15/27) – Chapters 7 & 8

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association represents UK investment managers. We have over 200 members who manage more than £5 trillion for clients around the world. Our aim is to make investment better for clients so they achieve their financial goals, better for companies so they get the capital they need to grow, and better for the economy so that everyone prospers.

We cover every link in the investment chain:

- We work with investors, helping them to understand the industry and the options available to them. We know investing can seem daunting, so we work hard to make it clear and accessible.
- We work with investment managers, promoting high standards and the need to put clients first. Our work includes helping members to manage money efficiently and communicate effectively.
- We work with the companies we invest in, helping them to achieve better long-term results and, ultimately, greater returns for investors and the economy.
- We work with regulators and governments around the world. We've built close, trusting relationships with these bodies and play an active role in shaping the rules that govern the industry.

The Investment Association's purpose is to ensure that investment managers are in the best possible position to help people build resilience to financial adversity, achieve their financial objectives and maintain a decent standard of living as they get older. It is also to help investment managers maximise their contribution to economic growth through the efficient allocation of capital.

RESPONSE FROM THE INVESTMENT ASSOCIATION

The Investment Association welcomes the opportunity to respond to the proposed changes to the FCA's Handbook in relation to the transposition of the UCITS V Directive. Our responses to applicable questions are attached to this letter.

If you would like to discuss any of the points raised in our response further, please contact me on 020 7831 0898 or by email to karen.bowie@theinvestmentassociation.org.

Yours sincerely

Karen Bowie
Senior Adviser, Product Regulation

APPENDIX

CP 15/27 Part III: FCA Consultation Paper (CP 15/27) – Chapters 7 & 8

Q30: Do you agree with our proposal to introduce a standard DRMP reporting template?

We recognise the FCA's stated objective in introducing a standard DRMP reporting template is to ensure the details submitted by AFMs on their DRMPs is complete and comparable, and the proposed template should achieve this objective. The template will also provide AFMs with clarity on the information they are expected to provide the FCA, which heretofore has been lacking. We welcome the proposal to remove the requirement in SUP 16 to file the existing FSA 042 report to avoid unnecessary duplication.

We do, however, have concerns regarding the proposed requirement for the DRMP report to contain the information as of 15 October. A mid-month date will be particularly problematic as this will fall outside of AFMs usual month end reporting processes. Our preferred option would be to allow the AFM to provide the information required in the proposed DRMP reporting template as at the annual accounting date for each fund. This would allow firms to align the process for gathering and preparing the information in the DRMP with the annual accounting process. This would also allow AFMs, where their UCITS have different accounting dates, to spread their DRMP reporting for different UCITS throughout the year.

We note that regulators in other EU jurisdictions, such as the CBI in Ireland, have adopted a similar approach. This significantly reduces the additional data gathering and reporting burden on firms, ensuring the most efficient use of resources, while ensuring the regulator receives the information it requires.

However, we recognise the FCA may require all AFMs to report their DRMP information as at the same specified date in order to provide comparable data. If a specified date is required, we request that a month end date is chosen, eg. 31 October, rather than a mid-month date. This would at least allow AFMs to align their DRMP reporting with their month end reporting process and thereby limit the additional work required in using the template to report the required DRMP information. We do, however, welcome the fact the FCA appears to have considered that the reference date chosen for UCITS derivatives usage reporting should not be a reference date for AIFMD Annex IV reporting, and agree an AIFMD Annex IV reporting reference date should be avoided.

Some of our members have expressed concerns about whether 6 weeks allows sufficient time to collate and report the information required, particularly for managers with a large number of UK UCITS. We therefore request the FCA allows a longer period for reports to be submitted, eg. two to four months. One of our members notes the CBI in Ireland allows up to four months for its derivatives usage report to be submitted – if the approach of aligning the derivatives usage report with the annual accounting date were to be followed, along with a similar reporting timescale of four months, this would allow firms to most efficiently meet the requirement from the FCA.

We would also welcome further clarification from the FCA about the proposed requirement to submit additional reports at any time during the year where there have been material changes to a fund's risk profile. We do not believe this requirement should arise in the event of normal investment activity – derivative usage will invariably change throughout the year, responding to varying market conditions. In addition, closing and rolling contracts will result in temporary increases in the absolute notional exposure of the derivatives being used, although do not affect the net exposure. These changes should not, in our view, necessitate an ad-hoc submission of the derivatives usage report. We would envisage these only being required in the event of a material change to the fund resulting in a change to its risk profile, eg. a change to the investment objective and policy of the fund allowing derivatives to be used for investment purposes. We would welcome clarification from the FCA on this matter.

Our understanding is that this proposed reporting requirement will only apply to UCITS, and not to NURS or QIS. As the latter are AIFs, these are already subject to the AIFMD Annex IV reporting requirements, hence the FCA is already receiving reports on their derivatives usage and leverage. We would welcome clarification from the FCA that this proposed reporting requirement will only apply to UCITS.

Q31: Do you have any specific comments on the proposed template in COLL 6 Annex 2R?

The report requires "Gross" long derivative positions and "Gross" short derivative positions to be reported, however the term "Gross" is not defined within the UCITS Directive. Nor is this information required per the CESR 10-788 Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (the "CESR Guidelines").

Also, we note the proposed template will require AFMs to provide the "Leverage limit as defined in the prospectus". There is no current requirement to define a leverage limit in COLL 4.2.5R. While COLL 6.12.13G points AFMs to the CESR Guidelines, these guidelines have not been implemented as rules within the FCA Handbook. Also, the CESR Guidelines do not require a leverage limit to be defined in the prospectus (unlike AIFMD). Rather, Box 24 item 2 requires that a UCITS using VaR approaches disclose the expected level of leverage and the possibility of higher leverage levels in the prospectus. We therefore suggest that this field is either removed, or aligned with the CESR Guidelines.

It is not clear whether the Commitment Approach and Absolute/Relative VAR calculations should be expressed as a percentage, a decimal figure or a ratio. We should therefore request the FCA clarify how these values should be expressed. We note that the majority of our members tend to disclose exposure as a percentage.

In respect of the second table, breaking down derivative usage by derivative type, we would welcome clarification if the indication that the derivative type is being used is as at the reporting date or whether a selection is expected if the instrument has been used at any point during the reporting period. If the latter is envisaged, some of our members have indicated that significant development and commitment of material resources will be required to develop the record keeping, analysis, approval, extraction and population of the appropriate information.

Q32: Do you agree with our proposed changes to the depositary reporting requirement in SUP 16?

We have no comments on the proposed changes.

Q33: Do you agree with proposed rules and guidance to encourage the use of PRNs in the fund's documentation?

We do not think there is any benefit to investors or potential investors of publishing funds' and sub-funds' PRNs in prospectuses and KIIDs. The CP says it will make it easier for stakeholders to find out the regulatory status of a fund, but we do not see why. The prospectus and the KIID will already state that the fund is authorised and by whom, and if investors want to check the Financial Services Register they can look the fund up by name.

Indeed if anything, given that KIIDs generally include ISINs, the inclusion of an additional identification number is likely to lead to investor confusion.

Q34: Do you agree with our proposed rules and guidance on CAIFs?

The Investment Association welcomes the initiative to provide for a regime for Authorised Funds set up specifically for charities and which are recognised as charities. Charity Authorised Investment Funds (CAIFs) will enable charity investors to benefit from the regulatory oversight and investor protections associated with Authorised Funds as well as the favourable tax treatment available to charity funds.

We note the proposed rules and guidance on CAIFs are intended to align these with some prominent features of Common Investment Funds, which until now have not been available for authorised funds. We welcome the additional flexibility offered by the FCA to CAIFs, particularly with regard to the allocation of income which is a key objective for the majority of charity investors.

We are comfortable with the proposed rules and guidance as they will apply to CAIFs. However, in respect of the rules proposed in COLL 14.4.2R, which allow an income reserve account to be established for the purposes of streaming income, we believe it may be desirable to allow other types of Authorised Funds to offer income streaming. This feature could be particularly useful for investment products seeking to provide a consistent stream of income, such as a retirement income. We note that comparable investment vehicles such as investment trust companies are able to retain some income. We would welcome the FCA opening a discussion on this proposal in the future.

Q35: Do you have any comments on our proposed treatment of the revised CESR guidelines on money market funds?

No – we note this change is required to reflect the ESMA Opinion issued in 2014, which modified the CESR Guidelines on Money Market Funds (MMFs) to remove references to reliance on credit rating agencies. The changes proposed by the FCA to COLL 5.9.6R reflect the modified MMF Guidelines.

Q36: Do you agree with our revised proposal for defining the Government and public securities available for investment by UCITS schemes and NURS?

While a change the Glossary definition of Government and Public Securities (GaPS), as was proposed in response to the previous consultation on this change by various organisations including ourselves, might provide a more straight forward means of achieving the change proposed, we note the FCA advise it would not be practical to do this.

We agree in principle that the requirements of COLL should be aligned with the UCITS Directive, and the changes proposed to COLL 3.2.6R(8), 4.2.5R(3)(i)(i) and 5.2.12R go some way to achieve this. However, Article 54(1) refers to "transferable securities and money market instruments issued <u>or guaranteed</u> by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong".

While the proposed amendments to COLL 3.2.6R(8) and 4.2.5R(3)(i)(i) both include the reference to "issued and guaranteed" from the UCITS Directive, the proposed amendment to COLL 5.2.12R(1) only refers to "a transferable security or approved money market instrument ("such securities") that <u>is issued by</u>…". COLL 5.2.12R(1) should be amended to refer to "a transferable security or approved money market instrument ("such securities") that is issued <u>or guaranteed</u> by…" to fully align this rule with Article 54(1) of the UCITS Directive.

Q37: Do you agree with our revised proposal for calculating the preliminary charge?

In our view the KII Regulation method of disclosing the entry charge is the clear. Investors should be able to relate to the amount they pay, so if they pay £1,000 and the entry charge is 5%, it is intuitive to expect the entry charge to be £50. We think the entry charge should always be disclosed in this way notwithstanding the complexities of price formation.

A problem arises in the choice of terminology – in the above example investors may regard their investment as being £1,000 but in reality only £950 gets invested. Indeed, annex II of the KII Regulation requires the entry charge to be described as the amount "taken out of your money before it is invested". Therefore, in the proposed amendment to COLL 6.7.7R, we think it would be clearer to replace the word "invested" with "subscribed", "contributed" or "committed".

We agree that it is not necessary to amend COLL 4.2.5R because it is helpful for investors to be told the basis of the calculation as well as the amount or rate.

Q38: Do you agree with our proposals for pension feeder funds?

Yes. The rules were written before the advent of feeder UCITS and feeder NURS and the change to the existing definition of 'feeder fund' brings clarity.

Q39: Do you agree with our proposal to allow all NURS some ability to invest in feeder funds?

Yes. We support this change. As the FCA notes, some of the aspects of existing rules prevents fund managers from making good use of the master-feeder structure and this should be addressed.

The FCA gives examples of situations where investment in a feeder may be useful. These include where it is tax-efficient for the NURS to invest via a feeder and where a master fund only accepts investment through feeder funds.

The FCA proposes a number of conditions that need to be met for investing in a feeder. We have a comments on one of the conditions and suggest an alternative wording to give effect to the FCA's expressed intention. We highlight in red the aspects on we have comments.

Paragraph 7.39 d gives the intention behind COLL 5.610AR (4) and related guidance COLL 5.610BG as follows (our highlighting):

"the authorised fund manager must be able to show on reasonable grounds that the use of a master-feeder structure would not disadvantage NURS investors, taking account of risks and costs (e.g., that it is tax-efficient or is the only way to gain exposure to certain investments)."

This makes clear that tax-efficiency or the fact that the master only accepts investment via feeders can be taken into account as reasons for investing via a feeder and that these can be taken into account in weighing up the costs and benefits to the NURS and its investors of investing via a feeder rather than directly in the master.

The proposed rule below does not appear to give this effect. Without the above commentary, one might read the rule and guidance as focusing solely on the risks and costs of investing in a feeder as compared to investing directly. Where there is a cost to investing in the feeder, it is not clear that investment is permitted even where, on a cost/benefit analysis, the AFM reasonably believes it is in the interests of the NURS and its unitholders to invest via a feeder.

There will be costs involved in the operation of a feeder fund (authorisation, accounting, auditing, administration, etc) and the manager of the master-feeder arrangements may not be prepared to meet the costs of operating a feeder itself). It would be detrimental to a NURS and its investors if the NURS were not able to take into account the benefits as well as the costs in deciding whether to invest via a feeder. Otherwise, the only circumstance in which a NURS could invest in a feeder is where there are no costs attached to investing in the feeder.

"(4) The *authorised fund manager* of the *non-UCITS retail scheme* must be able to show on reasonable grounds that an investment in one or more *schemes* permitted under (1)(a) to (d) is:

(a) in the interests of investors; and
(b) no less advantageous than if the *non-UCITS retail scheme* had held *units* directly in the relevant:
(i) *master UCITS*; or
(ii) *qualifying master scheme*; or
(iii) *property authorised investment fund*; or
(iv) *recognised scheme*.

5.6.10B G When determining whether an investment is no less advantageous for *COLL* 5.6.10AG(4)(b), an *authorised fund manager* should have regard in particular to:

(1) the risk profile of the *non-UCITS retail scheme*; and
(2) the total costs borne by the *non-UCITS retail scheme*."

We therefore suggest that that the above rule and guidance is amended as shown through 'track changes' below:-

"(4) The *authorised fund manager* of the *non-UCITS retail scheme* must be able to show on reasonable grounds that an investment in one or more *schemes* permitted under (1)(a) to (d) is~~:~~

~~(a)~~ in the interests of investors taking into account the risks, costs and benefits of via such *schemes* rather than holding units directly
~~; and~~
~~(b) no less advantageous than if the *non-UCITS retail scheme* had held *units* directly~~ in the relevant:
(i) *master UCITS*; or
(ii) *qualifying master scheme*; or
(iii) *property authorised investment fund*; or
(iv) *recognised scheme*.

~~5.6.10B G When determining whether an investment is no less advantageous for *COLL* 5.6.10AG(4)(b), an *authorised fund manager* should have regard in particular to:~~

~~(1) the risk profile of the *non-UCITS retail scheme*; and~~
~~(2) the total costs borne by the *non-UCITS retail scheme*.~~"

If we have misinterpreted the proposed rule/guidance and the FCA is of the view that it does not prevent investment in a feeder where there is some cost to investing in the feeder but the AFM believes that the benefits to investors out weight that cost, it would be helpful to draw that out in the feedback statement.

If, on the other hand, there is an intention to prohibit access such feeders, it will restrict the investment choices available to investing NURS as well as restrict the development of master-feeder arrangements in appropriate circumstances. That said, it would still be very useful to have the ability to make such investments. In this regard, we have had input from a member whose core fund is an offshore tax-transparent vehicle. Its target market is the UK wholesale market. The member's investors (including managers of NURS) have expressed a very keen interest in the strategy of the core fund but prefer the benefits of accessing the strategy via feeder for reasons of tax-efficiency. The firm has set up a feeder and the firm has chosen to bear the costs of running the feeder itself. Investors in NURS managers and investee feeders such as this would benefit from the FCA proposed change as currently worded.

We also recommend that the wording of COLL 5.6.10A(3) is amended. As it stands, it limits investment in <u>all</u> feeders to 35%. As investing via a feeder is simply a way of accessing the master, the rule should essentially replicate what would be the investment limit requirements should a NURS invest directly a number of masters (i.e COLL 5.6.7(6)). We can see no policy reason for preventing a NURS from holding more than 35% in a number of feeders where the AFM determines it is in the interests of the NURS so to do.

We have one technical comment on COLL 5.6.10A (2) – a master UCITS must comply with the tighter restriction of 10 % in COLL 5.2.13(3). It would therefore be worth referring to COLL 5.2.13(3).

Q40: Do you have any comments on the proposed antilayering rule?

We agree that there should be provisions preventing excessive layering. We are therefore supportive of an anti-layering provision.
Purely from a technical standpoint, we do not believe that COLL 5.6.26 R(3)(b) is strictly necessary to achieve this outcome for the following reason:

A qualifying master scheme has to fall within COLL 5.6.26 R(1) and cannot be a feeder UCITS, feeder NURS or scheme dedicated to a single CIS (COLL 5.6.26 (3)(a)). As the qualifying master scheme is therefore an ordinary UCITS or NURS, such schemes <u>cannot</u> hold units in a feeder UCITS or feeder NURS (owing to the circularity of investment rules (COLL 5.2.13(3) and COLL 5.6.10 (3)). These prohibit investment in second schemes which can invest more than 10%/15% in CIS units. Feeder UCITS/NURS will necessarily always hold more than 10%/15% in CIS units.

Recognised schemes which are UCITS and are not feeder UCITS are subject to the above mentioned 10% rule. We assume that individually recognised overseas schemes are subject to equivalent provisions.

Although not strictly necessary to achieve the purpose behind the rule for the technical reason outlined above, we have no objection to COLL 5.6.26 R(3)(b) remaining.

Q41: Do you agree with the proposed flexible dealing arrangements for a feeder fund investing in a PAIF?

We agree with the proposals. Master-feeders are administrative arrangements, typically created in order to achieve specific legal, regulatory or tax outcomes that could not be delivered by the master itself. Investors will invest in the arrangement in order to gain exposure to the underlying investment strategy of the master regardless of whether they use or bypass the feeder. Therefore, returns for investors in the feeder should not be diluted by carrying uninvested cash and the proposal facilitates a mechanism for ensuring inflows to the feeder are invested as timeously as inflows directly to the master.

We do not agree with restricting the proposals to PAIFs and these should be made available to all feeders because we do not agree with the assessment in paragraph 7.43 that feeders invest in the master alongside other direct investors. The reality of a master–feeder arrangement is that investors that subscribe at the same time should gain exposure to the underlying pool of investments at the same time regardless of whether they pass through the feeder. Therefore, it is the feeder's investors that should be regarded as investing alongside other direct investors.

In practice, masters are designed to deliver a tax neutral means of pooling investments that can be distributed through feeders. Government introduced the tax transparent ACS regime in order to facilitate master-feeder arrangements. The operations of ACS are complex and in practice it is necessary that they have very few investors – they are designed to channel investors through feeders.

In contrast a PAIF is a type of fund intended for the masses wishing to gain exposure to real estate in a tax efficient manner. A PAIF is recognised by HMRC in order that it can deliver gross rental income to investors. This provides a benefit for tax-exempt investors and investors accessing the PAIF through an ISA or pension scheme. In order to recognise PAIFs, HMRC require that a corporate holder's interest in the PAIF is limited to less than 10% and places obligations on the AFM to monitor and manage corporate holdings to ensure the limit is not breached. The feeder is a practical solution originally created to remove the risk of breaching this limit. Contrary to the statement in paragraph 7.43, retail investors will want to access the master directly if they are investing through a tax-exempt wrapper or, from April 2016, if they earn significant income from dividends.

Q42: Do you have any comments regarding the rules and guidance on the application of COLL to AIFMs? Are there any other matters of this kind we should address?

We have the following comments regarding the application of COLL to AIFMs:

COLL 3.2.2 R (1) and 4.2.2 (2) (c) – The deletion of 'in this sourcebook' substantially widens the requirement beyond what is necessary to ensure alignment with FUND (as it would capture the entire FCA Handbook). To meet the FCA's intention we suggest it be amended to read 'in this sourcebook and FUND'.

COLL 4.2.2R (2) (aa) and COLL 4.2.6R (7) (a) - AIFMD does not fetter AIFMs by requiring that investor prior and periodic disclosures are made in a particular way.

Whilst we appreciate that AFMs may choose to meet the AIFMD requirements via disclosures in the prospectus, the sourcebook should cater for those that choose to disclose in a different way. We therefore recommend that the content of (aa) be included in the guidance section (COLL

4.2.6) as matters which an AFM may include in the prospectus as a way of meeting the specified FUND disclosure requirements.

The guidance section could also clarify that if an AFM chooses to make the disclosures via its prospectus, the AFM does not need to make them available via another means as well. We agree with this clarification.

Q43: Do you agree with the proposed guidance on the calculation of the borrowing limits for the purposes of COLL 5.5.5R?

The proposed guidance provides a helpful indication of the FCA's interpretation of how currency positions should be reflected in the borrowing calculation. We understand the majority of our members already do not net long and short positions in different currencies when calculating their borrowing, and as such we do not anticipate any significant impact arising from the proposed guidance.

Q44: Do you have any comments on the proposed deletion of out-of-date provisions?

We have no objections to deletion of the rules permitting authorised unit trusts to issue bearer shares.

With regard to SDRT provisions, the FCA states its intention to remove reference to SDRT in the COLL, since SDRT was abolished in 2014. On looking at the accompanying draft Instrument (page 17), it seems that this is not a straight removal of the 'SDRT provision' - COLL 4.2.5 (19). Rather the FCA has amended this to require firms to include in the prospectus details of its large deals policy. The commentary does not provide the reason for this amendment. We do not believe the amendment is necessary and the SDRT provision and its content should be deleted in its entirety.

Our reason for reaching this conclusion is in the FCA Glossary definition of 'large deal' –

"(in *COLL*) a transaction (or *series of transactions* 19) in one *dealing period*) by any *person* to *buy*, *sell* or exchange *units* in an *authorised fund*, of any value as set out in the *prospectus*, for the purposes of:

i. (a) an *SDRT provision*;
ii. (b) a *dilution levy*;
iii. (c) a *dilution adjustment*; or
iv. (d) calculating the *prices*, for a *dual-priced authorised fund*, at which *units* may be *sold* or *redeemed*."

COLL 4.2.5 (19) caters with what a 'large deal' means in the context of SDRT. With SDRT falling away, so does 'large deal in that context. COLL 4.2.5 (18)(b)(i) already caters for 'large deal' in the context of Glossary (b) dilution levy and (c) dilution adjustment, and COLL 4.2.5 (16)(b)(v) caters for 'large deal' in the context of Glossary (d) (calculation of prices).

Q45: Do you have any comments on any of these changes? Are you aware of any other similar errors or out-of-date references we should correct?

We have no comments.

Q46: What would be the practical benefits and risks, for firms and investors, of changing the limited issue rule?

We very much welcome and comment the FCA's engagement on this important topic. As we outlined in our paper, 'Restricting the issue of shares – an investor protection measure' (copy attached for ease of reference), we consider the ability to simply and swiftly restrict the issue of shares an important protection measure for the reasons given therein. The paper sets out the issue, the current regulatory provisions, approaches taken in other fund domiciles, the problems to which the current regulatory approach gives rise, liquidity management and a proposed solution.

Our response here, therefore, focuses on the specific questions the FCA asks.

Firstly we consider the benefits and risks to investors as the interests of unitholders is the sole driver behind our request for a change to the regulatory approach in the UK.

What would be the practical benefits and risks to investors of changing the limited issue rule?

It is necessary to distinguish between investors who are existing unitholders and potential purchasers of new units.

<u>Benefits to investors who are existing unitholders</u>

The ability to swiftly restrict the issuing of units is in the interest of all existing unitholders in respect of units already purchased. An AFM would only seek to apply such restriction where it believes that it is in the interests of unitholders. This includes circumstances such as where a fund or share class has reached a size such that the capacity of the market has been reached or that it becomes difficult to manage in an optimal manner, and/or where to permit further inflows would be detrimental to the performance of the fund or the share class.

In short, the benefit to existing unitholders is that of taking of swift action to protect their interests.

Under the current UK regulatory regime, we understand that an AFM cannot implement this investor protection mechanism unless it has sought and gained FCA approval to amend the fund prospectus to include the wording *"the very specific soft closure wording at the point or shortly before it sees those specific circumstances that require soft closure arising".* Given the lead time to make changes to prospectuses, together with the one month approval timescale, the current UK approach represents a threat to the interests of investors in the fund. Moreover, it puts unitholders in UK funds at a disadvantage compared to UK and other unitholders in UCITS in other jurisdictions which do have the ability to immediately restrict the issue of units.

It is worth noting that such non-UK UCITS can be marketed into the UK so UK investors already have the ability to invest on non UK UCITS which can close immediately to new subscriptions.

The potential impact on existing investors in a UK Authorised Fund can also be exacerbated where a fund house has similar funds in other jurisdictions and considers it in the interests of the unitholders in all such funds to close immediately to new subscriptions. Given that the timescale for obtaining UK approval is one month, this gives rise to the real risk that where funds in other jurisdictions are closed immediately in the interests of investors, such monies will flow en masse into the UK Authorised Fund, which remains open pending receipt of regulatory approval for the prospectus change. Potentially, investors in the UK Authorised Fund suffer as a result.

Existing unitholders would also benefit from avoiding the sort of costs that the current UK approach gives rise to. Updating the prospectus to include very specific circumstances giving rise to soft closure (and also updating it when those circumstances have been resolved), as well as completing a form 21 or equivalent, is costly and time consuming. In addition, where a UK fund house uses its UK Authorised Fund for distribution into Continental Europe, changes to a prospectus has knock on impacts. For example, an AFM might have different versions of the prospectus for Dutch, German and French investors, which are also translated in some cases, and external legal counsel may also review the new draft prospectus resulting in further costs. Some paying agents might need to be notified depending on the country. Documents need to be uploaded onto the relevant websites or sent to the relevant investors. In short, the inability in the UK to have a general prospectus wording that applies at umbrella level can lead to significant additional costs, some of which will be met by the fund and therefore investors. It is therefore of benefit to investors that such costs are avoided.

The transparency that would come with a change to the rules would benefit existing and new investors. At the moment, AFMs have only a few soft levers which they can use to slow monies into a fund. AFMs have generally sought to address the situation through ceasing actively to market such a fund or though removing discounts on the initial charge. These approaches seem a rather artificial and roundabout way of seeking to achieve what the AFM believes is in the interests of investors in the fund. It is also counterintuitive and potentially puzzling for investors – an investor might think an AFM is removing a discount (where there is an initial charge) simply to make more money rather than simply to discourage flows in the interests of fund investors.

This confusion is not limited to investors. Anecdotal evidence suggests that overseas regulators (particularly those which also deal with European UCITS that can close immediately to new subscriptions) do not understand why a UK UCITS immediately close rather than employ other ways of deterring investment.

From an investor perspective (existing and new), we believe investors would much prefer to know that there may be circumstances in which a fund will cease taking subscriptions and that it will do so only where the manager believes it to be in the interests of the fund.

Other than in the case of regular savers (where there may be a contractual right to buy units in the future) there is, of course, no absolute legal right to buy units in a fund. The open-ended nature of an Authorised Fund is sometimes mentioned as possibly preventing a fund from ceasing to accept subscriptions. Apart from the fact that the FCA rules already recognise the validity of limiting issue, UK law defines open-endedness in terms of the ability to exit a fund rather than to enter it. Under FSMA, the essential characteristic of an open-ended fund is the ability to redeem units, not to subscribe to it. This is consistent with UCITS –Article 84, which concerns UCITS providing to investors the ability to redeem. The focus, therefore, for potential investors is that they should know when a fund is open to receive new subscriptions and when it is not. A change to the UK's approach would achieve that.

Even for regular savers, the ability to close immediately when it is in the interests of unitholders benefits those regular savers in respect of the existing units they hold.

It may however be the case, as the FCA recognises, that it is possible for regular savings to continue. This should be possible where the AFM believes that the amount concerned is not of a magnitude which threatens capacity, or that regular and predictable nature of the savings flows is such that the AFM believes that they can invest such monies effectively.

From the instances we have seen (of an AFM seeking approval to restrict the issue of units), it is very common for regular savings to continue.

In the event, however, that the AFM was of the view that it was necessary to apply the restriction to regular savers, it is important that such savers should be made aware that such action is a possibility and what it would mean for them if this were to occur. We discuss this in response to Q 47 below.

Risks to investors who are existing unitholders

We have identified no risks to existing investors.

Risks to investors who potential purchasers of new units

Clearly, there would be a risk of disappointment as they would not be able to invest in the fund.

As mentioned above, apart from regular savers (who may have a contractual right) there is, of course, no absolute legal right to buy units in a fund.

In any event, we believe that a clear understanding that a fund may close to new subscriptions and how to establish whether a fund is closed better meets such investors' information needs.

What would be the practical benefits and risks to firms of changing the limited issue rule?

Benefits to firms

The ability restrict the issue of units immediately where an AFM considers it to be in the interest of unitholders to do so is of benefit to AFMs and intermediaries as it assists all parties in protecting the interests of their clients who hold units in the relevant fund.

For such of their clients who are potential purchasers of new units, it enables all parties to provide clear information about the fact that any UK authorised fund may restrict the issue of units as well as being able to provide information, when it happens, that a fund is closed and why.

Risks to firms

The FCA notes that the closure to new investment at short notice could create problems in an intermediated market.

The ability to restrict the issue of units in UCITS is already an investor protection measure utilised in other jurisdictions. We have seen examples of this in German, Irish and Luxembourg UCITS. There may be other jurisdictions that provide a similar investor protection mechanism. Given that such UCITS may be sold in the UK, this is already a potential issue that intermediaries face. Even in the UK, although approval is required in order to put such a restriction in place, once approval is received, it can be put in place immediately thereafter –so intermediaries may even face this issue with a UK fund under current rules.

We welcome the fact that the FCA is raising awareness about the potential need to cease issuing units where it is in unitholders interests to do so. Indeed, one could argue that dealing with such situations is a function of offering services in relation to UCITS (and other funds) for clients. It is also in keeping with both IOSCO and ESMA work in liquidity management tools and the need to have the tools necessary to manage liquidity throughout the lifecycle of a fund.

We are also pleased that the FCA is seeking responses from all parties in the distribution chain as this will serve to highlight any issues that need to be solved in order to deliver the primary goal of protecting existing unitholders.

It will be useful to know how parties in the distribution chain currently handle closure of non UK UCITS, and UK Authorised Funds which have received approval to limit issue.

It may be the case that a transitional period is needed (before a change in policy approach is implemented) to allow those in the distribution chain to review the processes and procedures they have in place to address actions that need to be taken upon receipt of notification that a fund is ceasing to issue units. This could include procedures for putting information on their websites, removing the ability to make investment via websites, ensuring that telephone dealers know that a fund is no longer available for purchase, providing information to relevant third parties, having arrangements in place to return monies received from investors.

For AFMs, this could include having in place procedures to swiftly communicate to distributors the decision restrict the issue of to cease issuing units, updating their websites, ensuring that telephone dealers know that a fund is no longer available for purchase, and having arrangements in place to return monies received from investors.

Q47: What specific changes, if any, do you think would strike the best balance between the interests of the manager, existing investors and prospective new investors?

The balance should be driven by the UCITS Directive and AIFMD – which places an obligation upon the AFM to act in the best interests of the UCITS/AIF and the investors in those funds. This means having the ability to cease issuing units swiftly. Directive requirements essentially mean that acting in the interests of existing investors takes precedence over the desire of new investors to invest in the fund.

As far as prospective new investors are concerned, the provision of clear information, that funds may cease to issue units and knowing how to find out whether a fund is open to not, would greatly assist such investors.

We believe that the wording of the rule to which the then FSA had regard (COLL 6.2.18R(1)) – Limited issue) has been interpreted very narrowly. It is also worth bearing in mind the genesis of this rule (e.g. SIB CP 110, FSA CP 11) – i.e. a desire to facilitate new product offerings that might need certainty as to size of fund at the outset and so have a limit set at launch. It was not specifically designed to cater for situations that arise post launch (e.g. sudden changes in the market/other external events) and are beyond the control of the AFM.

However, that said, we think that that COLL 6.2.18R (1) can and should be construed more flexibly so as to cater for such post launch situations. Specifically, an AFM should be understood to meet the requirement to set out the 'circumstances and conditions' when units will be issued by including a section in the prospectus:

- Stating that, should the AFM consider that it is in the interests of fund investors to cease taking subscriptions, lump sum and/or regular savings investments(the circumstance being that the AFM determines that such action is in the interests of investors), it will do so;
- giving examples of when such a determination might be made;
- stating that the AFM will begin taking subscriptions when the AFM determines that the issue has been resolved (the condition being the determination that the issue has been resolved); and
- giving information on where an investor can access the latest information.

FCA guidance to the effect that the rule can be interpreted in this way could be the simplest way introducing a change in regulatory approach.

This approach would enable AFMs to update their prospectuses at the next review and then be in a position to act immediately in the interests of investors should such circumstances arise.

An example from a UCITS prospectus in another jurisdictions is as below:-

"Closing of a Fund or a class of Shares to further inflows

A Fund or a class of Shares may be closed totally or partially to new subscriptions or switches in (but not to redemptions or switches out of it) if, in the opinion of the Directors, this is necessary to protect the interests of existing Shareholders. One such circumstance would be where the Fund has reached a size such that the capacity of the market and/or the capacity of the relevant Investment Adviser has been reached, and where to permit further inflows would be detrimental to the performance of the Fund. Where any Fund is materially capacity constrained in the opinion of the Directors, the Fund may be closed to new subscriptions or switches into without notice to Shareholders. Details of Funds which are closed to new subscriptions and switches will be provided in the Reports.
Where any type of closure to new subscriptions or switches in occurs, the Website of the Management Company will be amended to indicate the change in status of the applicable Fund or class of Shares. Shareholders and potential investors should confirm with the Global Distributor or the Registrar and Transfer Agent or check the website for the current status of the relevant Funds or class of Shares. Once closed, a Fund or a class of Shares will not be re-opened until, in the opinion of the Directors, the circumstances which required closure no longer prevail."

As an example of the way in which a European UCITS manager provides up-to date information as to the status of funds subject to capacity constraints, the manager has a specific webpage;-

"Capacity Constraints

In order to protect the interests of investors, [XYZ Asset Management] may find it necessary to limit the size to which a fund is allowed to grow. This might arise for example, when the investment manager is of the view that allowing further inflows into the fund might have a significant impact on fund performance.

Generally speaking, such a situation is more likely to arise with funds following a highly specialist investment objective and with a concentrated investment portfolio – however other reasons may also give rise to capacity limits in a fund.

Set out below is a summary of the current position of all [XYZ Asset Management] funds, which are closed or have recently been reopened.

If you are a private investor and you require investment advice, please contact your professional financial advisor.

Fund name	*Status*	*Date*
Fund A	*Reopened*	*11.10.15*
Fund B	*Soft closed*	*11.05.14*

"

The above solution around the interpretation of COLL 6.2.18R (1) would reduce the potential need for changes to the rules in COLL. Guidance could also be included on the FCA's expectations (for example, that it would expect the AFM to keep the situation under review, role of the depositary and whether the FCA would wish to be notified of the closure to subscriptions and subsequent re-opening).

Such guidance could also make clear that, where circumstances permit, an AFM can notify third parties in advance of the proposed closure where the AFM has no reason to believe that the third party would use that information to the detriment of existing investors. This flexibility could be useful, for example, where the AFM is nearing capacity but is of the view that there is sufficient capacity to enable a small amount of notice to be provided to third parties so that they in turn can make arrangements to cease taking deals. Such flexibility would be helpful given the intermediated marketplace.

Finally, guidance could be given to the effect that, where advance notice is not practicable, orders in transit to the AFM at the time closure is announced may be processed. This would reduce the impact upon intermediaries with deals in transit. As above, such flexibility would be helpful given the intermediated marketplace.

With regard to regular savers, as mentioned above, in examples we have seen, it is usual for such savings to continue. If it were necessary to cease taking such contributions, time would be needed to allow relevant parties to stop the receipt of BACS payments.

The addition of guidance to the FCA COLL sourcebook would, of course, still be subject to the FCA's normal consultation process.

It is important that this liquidity management tool is as flexible as possible, in the interests of unitholders. To this end, it should be possible to recycle units following closure. Recycling of units means that the AFM has the ability to offer redeemed units for sale while the fund remains closed to subscriptions. This mechanism allows for a fund to remain at the capacity level AUM. It avoids the necessity of having to consider reopening the fund as AUM falls, only to close it again as AUM rises. This offers a more consistent investor experience and avoids a Yo Yo effect, with the fund being opened and closed over time.

Flexibility is important in the context of capacity management. It should be recognised that market-related capacity constraints may take time to resolve themselves. We have seen examples of where, in the interests of its investors, funds have restricted the issue of shares for a number of years.

We are aware that COLL 6.2.16(2)(a) has been mentioned as potentially allowing an AFM to cease taking subscriptions. This allows an AFM to refuse sale where it has reasonable grounds to do so. This could equally be used to deliver the investor protection outcome sought, with 'reasonable grounds' being understood to cover situations where it is in the interest of unitholders to cease taking subscriptions. The guidance covering the matters outlined above could be included in the Sourcebook with a link to this rule rather than the limited issue one.

As regards categorisation of the event for the purposes of COLL 4.3, in our view, the introduction of such a provision can be categorised as a notifiable event. The introduction of limited issue arrangements is given as an example of a notifiable event (COLL 4.3.9(2)(d)). The manner and timescale for notification will depend upon the particular circumstances of the situation. For example, if it does not affect regular savers and reinvestment of dividends, we believe that a combination of notifying prospective investors when they contact an AFM to place a deal, together with a post change notification to existing investors at the next available opportunity would be sufficient. There is no automatic right to be able to make ad hoc purchases so the notification of the prospectus update - which includes details of where investors may find out whether or not a restrictions is in place- may be sufficient for other existing investors/prospective investors. Existing investors who wish to make additional ad hoc investments are able to check in advance of placing a deal or at the point of placing a deal. It would result in higher costs if there were a regulatory requirement to individually notify such investors. If the change will affect regular savers and reinvestment of dividends, we believe that notification prior to the next regular savings purchase/reinvestment of dividends takes place. The inclusion of guidance in COLL 4.3 would be helpful.

Finally, the then FSA advised that it considered the addition of limited issue as one requiring FSA approval. We ask that this stance be reviewed. The addition of a general standard paragraph in prospectuses to cater for the possibility of the need to close to subscriptions where it in the interests of fund investors is an investor protection measure and it should be possible to update the prospectus with such disclosure immediately and without the need for specific FCA approval. Similarly, we understand that in at least one case, an AFM was asked to amend its Instrument of Incorporation to make it a 'limited issue' fund. We do not believe that this should be a requirement in the case where a restriction on issue is put in place as an investor protection measure.

One additional tool could assist to a degree, and that is permitting only existing unitholders the ability to invest. This would have only a limited effect on fund flows given that most trades are through nominee vehicles such as fund platforms. Furthermore there are operational difficulties with transfer agencies ensuring that only existing investors to that fund have subscriptions processed. Nevertheless, this tool would allow some degree of flow control and so may avoid the need to completely cease taking subscriptions.

Q48: What are the challenges fund managers face in applying our rules defining eligible counterparties for OTC derivative contracts?

COLL 5.2.23R permits only the following to be an eligible counterparty to an OTC derivative contract: an eligible institution (ie. a CRD credit institution or a MiFID investment firm authorised by its Home State regulator), an approved bank or a person whose permission (including any requirements or limitations), as published in the Financial Services Register, or whose Home State authorisation, permits it to enter into the transaction as principal off-exchange. This rule therefore prevents an investment firm from outside the EEA being an eligible counterparty, in particular US broker-dealers who are not approved banks. This therefore excludes managers of UK Authorised Funds from being able to enter into OTC derivative contracts with a significant section of the OTC counterparty community.

Following regulatory developments in recent years, in particular EMIR in Europe and Dodd-Frank in the USA, an increasing number of OTC derivative transactions are being centrally cleared.

This has given rise to new challenges and considerations when applying the UCITS counterparty rules, as was outlined in our response to ESMA's Discussion Paper on the calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations. One of the key issues highlighted was the difference between the European "principal model" and the US "agency model". In the case of a cleared OTC derivative transaction in Europe, the counterparty exposure of the fund will be with the clearing member, who in turn will usually be an eligible institution or an approved bank. However, in the case of a cleared OTC derivative transaction in the USA, the counterparty relationship will be directly with the central counterparty ("CCP"), through the agency of the clearing member. A CCP itself is unlikely to meet the current eligibility criteria for an OTC counterparty. As such, UK funds are not currently able to enter into cleared OTC derivative transactions in the US, and where such transactions are not available through a European CCP, or where the terms of the transaction are not favourable through a European CCP, UK funds have no other option other to engage in the OTC derivative transaction though an uncleared bilateral trade.

While many of the wider issues relating to the move to clearing of more OTC derivative transactions, such as the UCITS counterparty limits, are outside the scope of the FCA, it is important that the eligible counterparty criteria in COLL are revised to ensure that UK funds can participate fully in both bilateral and cleared OTC derivative transactions with US broker dealers and US CCPs (in the case of cleared transactions). The inability for UK funds to enter into such transactions will put these at an increasing competitive disadvantage as mandatory clearing requirements are extended to more OTC derivative transaction types.

Q49: Which of these options, if any, do you prefer and why? Are there others we should consider?

Of the three options suggested by the FCA, we believe the first of these, to extend the list of eligible counterparties to include all entities defined in COLL 5.4.4R as acceptable counterparties for the purposes of the stocklending rules, will be the quickest and most straight forward to implement. However, if this approach is adopted, this should not be regarded as providing an exhaustive list of eligible counterparties. In particular, further provision should be made to include US CCPs and other Non-EU CCPs recognised as equivalent by ESMA as eligible counterparties in order for UK funds to be able to enter into cleared OTC derivative transactions in the US and other key jurisdictions.

Q50: Do you think you can use UCITS, NURS, and QIS to invest in ELTIFs under existing rules? If not, what would you suggest changing?

We agree with the analysis presented by the FCA on the potential for ELTIFs to be eligible in each of the three listed regimes. In the case of UCITS, it should be possible for ELTIFs to be structured so as to be capable of fulfilling the criteria in COLL 5.2.7AR and COLL 5.2.7CR to be treated as eligible transferable securities, in particular those listed for trading on secondary markets. Without fulfilling this criteria, ELTIFs are unlikely to be suitable as eligible investment for UCITS due to liquidity considerations.

We do not suggest the existing investment and borrowing power rules should be changed for UCITS and NURS to accommodate ELTIFs other than those which already satisfy the criteria in COLL 5.2.7AR and COLL 5.2.7CR. Such a change would risk damaging the UCITS brand, which has gained wide recognition and is trusted by investors in many countries both inside and outside of the EU.

Q51: Do you think investment in ELTIF is likely to be more attractive to certain types of funds and, if so, which?

So far, we are not aware of any significant interest by fund managers in investing in ELTIFs. It is difficult to assess the likely level of interest in ELTIFs, since these are not yet available. Fund managers are unlikely to be interested in investing in ELTIFs until these have been established for long enough for investors to review their performance record and become familiar with and understand their characteristics. Those ELTIFs listed on secondary markets are more likely to appeal to fund managers, although this will depend on how liquid secondary trading in these vehicles proves to be.

The long-term commitment which will be required to invest in ELTIFs (in particular those not listed on secondary markets) will inevitably reduce the appeal for funds with daily liquidity requirements. We therefore believe ELTIFs are more likely to appeal to funds with a long-term investment horizon, such as life and pension funds rather than authorised funds, whose investors have the right to redeem their investments regularly and hence are required to retain sufficient liquidity to meet such demands.

Q52: Do you think it will be possible to invest in ELTIFs through permitted links? If not, what amendments to the rules could facilitate investment in ELTIFs?

We believe it may be possible to invest in ELTIFs through permitted links as unauthorised funds, although this is far from clear and would depend on whether the underlying investments in the ELTIF satisfied the permitted links rules. In addition, from 1 January 2016, COBS 21.3.1AR will require insurers to consider the economic behaviour of an asset over its legal. These "look-through" requirements create uncertainty and are likely to prove an impediment to long-term insurance businesses investing in ELTIFs, which should, at least in theory, be a reasonable fit for long-term insurance investments.

To make ELTIFs more attractive to insurance investors, the permitted links rules should be amended to clearly allow investment in ELTIFs without imposing limits (which the insurer would have to monitor) and without any further look through. We would suggest that ELTIFs should be a distinctive permissible investment category within the permitted links rules, eg. by amending the definition of "permitted scheme interests" in COBS 21.3.1R(g) to include ELTIFs as a separate category, and also to discharge the insurer from any additional look through requirement to the underlying investments in the case of ELTIFs, eg. through amending the forthcoming rule COBS 21.3.1AR. The ELTIF Regulation already applies investment restrictions and diversification requirements to ELTIFs, therefore further look through requirements for insurance investors will not add any further value and are likely to be a deterrent to insurers investing in ELTIFs.

Q56: Do you agree with our cost benefit analysis for the other miscellaneous changes to the Handbook affecting authorised funds?

We have no comments on this section other than in relation to the item below.

- **the introduction of a mandatory template for managers of UCITS to use to notify the FCA of details of their derivatives risk management process (DRMP);**

As mentioned in our responses to question 30, a mid-month reference date will result in significantly higher implementation costs than an end of month date. Aligning the reporting date with the annual reporting date of each fund will reduce the cost of implementation as this will allow firms to fully utilise operational efficiencies.

We do not agree with the assessment in paragraph 53 that minimal resources and no system development will be required by firms to implement reporting through the standardised template. While the FCA refers to the existing obligations in COLL 6.12.3R, the details on what firms have been expected to report under this rule have not been clear and have been interpreted by different firms in a number of ways. It is therefore likely that many firms will need to make changes to their systems to accommodate the standardised reporting. The extent of the system changes required will vary per firm, but for some firms these are likely to be material.