COLLECTIVE INVESTMENT SCHEMES ADVICE AND PROMOTION

John Virgo, Guildhall Chambers

1. Basic Terminology

1.1 Collective Investment Schemes ('CIS') are of two kinds: (1) regulated schemes or (2) unregulated schemes.

1.2 A regulated CIS is defined as:

1.2.1 An investment company with variable capital ('ICVC')[1]

1.2.2 An authorised unit trust scheme ('AUT')[2]

1.2.3 A recognised scheme[3]

1.3 An unregulated scheme is any scheme that is not regulated.

1.4 UCISs generally entail a high degree of investment risk. As such the promotion of investment into such schemes is heavily restricted. The ingenuity of providers in creating investment structures which could be seen as falling outside a strict definition of a CIS but which exposed investors to like risks provoked regulatory concern in 2010 (see the FSA paper **Unregulated Collective Investment Schemes: Project Findings**, July 2010). This led in due course to a Consultation Paper CP12/19 in August 2012 (**Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes**) and the publication of the FCA's Policy Statement in June 2013 with new Rules governing the retail promotion of investments now '**Non-mainstream pooled investments**' or NMPIs. These are defined as 'any of the following investments: (a) a unit in an unregulated collective investment scheme; (b) a unit in a qualified investor scheme; (c) a security issued by a special purpose vehicle other than an excluded security; (d) a traded life policy investment; (e) rights to or interests in any of (a) to (d)'.

1.5 More loosely the glossary of terms provides the following definition for NMPIs: 'Pooled investments or 'funds' characterised by unusual, speculative or complex assets,

[1] i.e. an open ended investment company ('OEIC') incorporated under the OEIC Rules in relation to which the FCA has made an authorisation order

[2] i.e. a UCITS scheme, a qualified investor scheme or a non-UCITS retail scheme ('NURS')

[3] i.e. a scheme recognised under s264 FSMA 2000 (schemes constituted in other EEA States), s270 (schemes authorised in designated countries or territories) and s272 (individually recognised overseas schemes)

product structures, investment strategies and/or terms and features. They are units in unregulated collective investment schemes (UCIS); securities issued by certain special purpose vehicles (SPVs); units in qualified investor schemes (QIS); and traded life policy investments (TLPIs). Note that not all pooled investments meet the statutory criteria for a 'collective investment scheme'; pooled investment special purpose vehicles, notably, do not generally amount to a collective investment scheme'.

1.6 An idea of the scale of this type of investment activity can be gathered from the following data collated by the FSA in 2011 which reported that the total retail UCIS funds under management were in the low billions: £20m invested by sophisticated retail customers; £280m by high net worth individuals and £2bn by retail customers (i.e. neither sophisticated nor HNWIs). £10bn was invested in qualified investor schemes (of which £420m was estimated to be held by retail investors). Investments in SPV structures were put at £27bn (£1bn held by retail investors) and £25bn in TLPIs (£1bn with retail investors).

1.7 In 2011 there were 189 UCIS cases were reported to the FSA's Unauthorised Business Department, the largest number of which related to illegal land banking schemes (60), followed by overseas forestry and crop schemes (39). Investor losses averaged £30k per capita for the former and £15k per capital for the latter. Investor losses in relation to TLPIs arranged through Keydata Lifemark were put at £350m in 2009: hence the need for tighter controls to be introduced.

2. Regulated activities

2.1 Activities associated with the operation of a CIS may be regulated by the FCA. Units or shares in a CIS are specified investments under the RAO 2001[4] and are therefore regulated by the FCA. Establishing, operating or winding up a CIS is a specified activity[5] meaning that unless the operator is authorised under Part 4A of the 2000 Act it will breach the general prohibition. Section 19 of the 2000 Act states that no person may carry on a regulated activity in the UK, or purport to do so, unless they are authorised or exempt from the requirement to be authorised.

2.2 Determining who or what is an operator of a CIS is not always clear and there is no helpful guidance from the regulator on this specific point. Certainly those parties involved in the initial structuring and formation of arrangements constituting a CIS will need to consider whether their activities constitute 'establishing' a CIS. This will depend on the facts of the arrangement in each case. It is also possible for there to be more

[4] RAO 2001, art 81
[5] RAO 2001, art 51ZG (as amended by SI 2013/1773, Schedule 2, Part 1)

than one operator. Case law recognises that even where responsibilities are limited or shared, there can be multiple operators.[6] Courts have held that *'there is no logical reason why, if there are two operators, they should have to be responsible for the entire operation of the scheme. It is enough that they are responsible for separate parts of the entire scheme*.'[7]

2.3 Given the relevance of 'day-to-day control' in determining the question of whether a CIS exists or not, the common sense view must be that an "operator" is most likely to be the person to whom 'day-to-day control' has been conferred.

2.4 Other activities carried out in relation to the operation of certain types of CIS are also likely to be regulated activities such as investment management, dealing in investments and arranging deals in investments.

3. What constitutes a CIS?

3.1 Section 235(1) to the **Financial Services and Markets Act 2000** ('the **2000 Act**') defines a "collective investment scheme" as meaning "any arrangements with respect to property of any description … the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income".

3.2 The term 'arrangements' is very wide in scope. In particular, no formality is required[8]. Communications do not need to give rise to any legally enforceable agreement[9].

3.3 The focus is on the intended operation of the scheme[10]. In **The Russell-Cooke Trust Company v Elliott (No 2)**[11] Laddie J commented (on the identically worded predecessor s75 in the **Financial Services Act 1986**):

> 'It seems to me that the words 'purpose or effect' are broad enough to cover all stages from the preparatory step of gathering in funds up to and including the making of the communal investment. Therefore, the fact that an investor's funds may rest in client account pending putting in place a particular loan, does not stop it being in a CIS. If the money was placed there for the purpose of such an arrangement, it is from that time in a CIS. The 'arrangements' to which

[6] *Financial Services Authority v Fradley & Woodward* [2005] EWCA Civ 1183
[7] ibid
[8] FSA v Fradley [2005] EWCA Civ 1183 Arden LJ at [33]
[9] Re Duckwari plc (No 2) [1998] 2 BCLC 315 at 319
[10] In re Sky Land Consultants PLC [2010] 399 Richards J at [16]
[11] Ch D, 16 July 2001 (unreported)

s 75 (1) relate are those which enable, or are intended to enable, the communal funds to be invested. They include the preparatory steps which allow individual investors to park their money in the Elliott's' client account with a view to future investment in a communal property-based loan as well as the investment itself'[12].

3.4 There may be an 'arrangement' between parties even where they do not share precisely the same expectation or intention[13].

3.5 To constitute a CIS, however, two further conditions must be established.

3.6 First, under s235(2) of the **2000 Act**: 'the arrangements must be such that the persons who are to participate ('participants') do not have day to day control over the management of the property, whether or not they have the right to be consulted or to give directions'.

3.7 The day to day control test is satisfied if the participants in practice do not exercise actual day to day control and that was envisaged as the realistic pattern from scheme inception, whatever apparent rights the documentation creating the scheme may have otherwise provided[14].

3.8 Secondly, s235(3) requires that: 'the arrangements must also have either or both of the following characteristics (a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled; (b) the property is managed as a whole by or on behalf of the operator of the scheme'.

3.9 **The Financial Conduct Authority v Capital Alternatives Limited**[15] provides important elucidation as to (1) 'pooling' of income; (2) the meaning of what 'property' is relevant for the purposes of section 235 of FSMA and (3) what is entailed by the concept of 'property' being 'managed as a whole by or on behalf of the operator of the scheme'. **Capital Alternatives** concerned two types of scheme, viz the African land Scheme and Carbon Credit Schemes. The former related to some 3,000 acres of rice farming land in Sierra Leone (called 'Yoni Farm') which was sub-let to investors in plots allocated to each sub-tenant for a sub-lease premium of £1,250. The rice harvests from each plot were counted so as to ensure that each 'plot sub-tenant' received 40% of the

[12] Adopted, endorsed and applied in Brown v InnovatorOne PLC [2012] EWHC 1321 Hamblen J at [1170]
[13] Financial Services Authority v Asset Land Inc [2013] EWHC 178 Andrew Smith J at [160]; [2014] EWCA Civ 435
[14] Brown v InnovatorOne PLC [2012] EWHC 1321 Hamblen J at [1167-1168]
[15] [2014] EWHC 144; [2015] EWCA Civ 284

profit arising from their individual holding. This artificial accounting method was operated deliberately in an attempt to avoid the arrangement constituting a CIS. On the key issues as to:

3.9.1 Income derived from specific plots could be regarded as pooled because a unit rate deduction was made of the costs of rice collection applied to all plots, Christopher Clarke LJ said[16]:

'I do not regard the judge as having fallen into error. Investors were, as he found [111] and [160], paid a standard price for the rice actually grown on their individual plot[s]. The standardised deductions, as he held: "*… might conceivably mean that minor variations in the actual losses through drying and milling, or in the amount of fertiliser used, might not be reflected in the price paid to investors, but there is no evidence that any significant difference in these respects from one lot of rice to another was likely.*" Since such "*minor variations*" made no "*significant difference*" the judge was entitled to find that they did not mean that there was pooling of income/profit on account of cross subsidization. In any event the making of a standard charge per unit for some service (whether it be fertiliser for fields or heating for flats) does not necessarily mean that there is what should be regarded as a pooling of income'.

3.9.2 Whether the scheme 'property' meant the individual plot or Yoni Farm as a whole Christopher Clarke LJ said[17]:

'Section 235 is concerned with an arrangement with respect to property, the purpose or effect of which is to enable investors ("*whether by becoming owners of the property or <u>any part of it</u> or otherwise*") to participate in or receive profits or income arising from, *inter alia*, the management of the property. In that context "*the property*" (which the section does not require to be owned by any investor) is perfectly apt to cover a farm from the management of which, including the buildings, roads etc., the investor, who becomes the owner of part of the property, is to receive the share of profit attributable to the proceeds of his plot'.

3.9.3 Whether in considering if the 'property' was 'managed as a whole' one looked at the generation of profits specific to a plot or took a broad view as to physical acts of management Christopher Clarke LJ said[18]:

'The phrase "*the property is managed as a whole*" uses words of ordinary language. I do not regard it as appropriate to attach to the words some form of exclusionary test based on whether the elements of individual management were

[16] Ibid, [29]
[17] Ibid, [50]
[18] Ibid, [72]

"substantial" - an adjective of some elasticity. The critical question is whether a characteristic feature of the arrangements under the scheme is that the property to which those arrangements relate is managed as a whole. Whether that condition is satisfied requires an overall assessment and evaluation of the relevant facts. For that purpose it is necessary to identify (i) what is "the property", and (ii) what is the management thereof which is directed towards achieving the contemplated income or profit. It is not necessary that there should be no individual management activity - only that the nature of the scheme is that, in essence, the property is managed as a whole, to which question the amount of individual management of the property will plainly be relevant'.

3.10 The FCA Perimeter Guidance in PERG 11 indicates that 'if a scheme, in substance, is a collective investment scheme, it cannot escape the need for regulation by being dressed up as something else.' This view was endorsed in **Capital Alternatives**:

'd) that the reference to the "*purpose or effect*" of the arrangements reflected the fact that what mattered was the way in which the scheme was run in practice and not contractual terms which might not reflect reality;

e) that whether there was day-to-day control depended on whether such control was actually exercised not on whether investors had a contractual right to exercise it'.[19]

4. When 'arrangements' do not amount to a CIS

4.1 By Regulation 3 of the **Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001** (SI 2001 No. 1062) 'arrangements of the kind specified by the Schedule to this Order do not amount to a collective investment scheme'.

4.2 There are 21 arrangements[20] which are specified as not giving rise to a CIS, including:

4.2.1 **Individual investment management arrangements**

The CIS Order excludes individual investment management arrangements[21] provided the arrangements relate to one or more of the following types of investments: shares[22]; instruments creating or acknowledging indebtedness (such

[19] Ibid, [80]

[20] In addition to those mentioned above: Enterprise initiative schemes, Pure deposit based schemes, Schemes not operated by way of business, Common accounts, Certain funds relating to leasehold property, Certain employee share schemes, Schemes entered into for commercial purposes related to existing business, Group schemes, Franchise arrangements, Trading schemes, Time share schemes, Other schemes relating to the use or enjoyment of property, Schemes involving the issue of certificates representing investments, Clearing services, Contracts of insurance, Funeral plan contracts, Individual pension accounts, Occupational and personal pension schemes.

[21] CIS Order, Schedule, para 1

[22] Financial Services and Markets Act 2000 (Regulated Activities) Order 20001, SI 2001/544 (the 'RAO 2001'), art 76

as debentures, loan stock and bonds)[23]; government and public securities[24]; instruments giving entitlements to investments (being warrants and other instruments entitling the holder to subscribe for shares, bonds and government and public securities for example);[25] certificates representing certain securities; RAO 2001, art 80 units in authorised unit trusts, shares in OEICs and shares in recognised schemes[26] and long term insurance contracts.

4.2.2 Paragraph 1(b) specifies that each participant must be entitled to a part of the property and to be able to withdraw that part at any time. This provision means that participants need not 'own' part of the property but can be contractually entitled to the property. Paragraph 1(c) states that the participants' contributions and the profits or income must not be pooled. However, the underlying property of the scheme may be managed as a whole by the manager but only in the sense that part of the underlying property to which different participants are entitled are not bought and sold separately (except on a person becoming or ceasing to be a participant). This allows a discretionary manager of segregated accounts to aggregate transactions and buy and sell stock in bulk without such arrangements being classed as a form of CIS.

4.2.3 **Debt issues**

Regulation 5 provides that '(1) arrangements do not amount to a collective investment scheme if they are arrangements under which the rights or interests of participants are… represented by investments of one, and only one, of the following descriptions: (a) investments of the kind specified by article 77 of the Regulated Activities Order (instruments creating or acknowledging indebtedness) which are — (i) issued by a single body corporate other than an open-ended investment company… and which are not convertible into or exchangeable for investments of any other description' (underlining added). Thus, a company may not rely on this exception when raising corporate finance if in addition to the debt instrument it provides additional security for the investment by another instrument e.g. a charge over the shares of the issuer.

4.2.4 **Bodies corporate**

[23] RAO 2001, art 77
[24] RAO 2001, art 78
[25] RAO 2001, art 79
[26] RAO 2001, art 77

Regulation 21 excludes building societies, friendly societies, industrial and provident societies and all bodies corporate other then open-ended investment companies.

4.2.5 It is important to note that limited liability partnerships (in the context of investment structures) are not exempted however and care must be taken when documenting the structure of such arrangements in order to prevent the LLP being treated as a CIS[27]. In that regard it may be advisable to ensure that all participants should have day-to-day control over the management of the LLP. It has recently been clarified in a case that concerned a number of LLPs, that it is not sufficient for participants merely to have a legal right to exercise control over the property, rather the important test is whether the participants actually exercise that right sufficiently to be regarded as being in effective control. Accordingly it is necessary to look beyond any documents which may provide for 'day-to-day control' and consider how the arrangements are designed to operate in practice.[28]

4.2.6 The Paragraph 21 exemption does not apply to any corporate body which is classed as an 'open-ended investment company'.

4.2.7 Schemes not operated by way of business

Arrangements are not regarded as a CIS where they are not operated by way of business.[29] This exemption is likely to benefit arrangements such as family trusts. Whether the arrangements in question are operated by way of business will depend on the facts in each case, the activity in question and the property or investment(s) concerned.[30] A syndicate of private individuals involved in an investment club is unlikely to be operating by way of business.

4.2.8 Certain employee share schemes

Paragraph 8 excludes arrangements which are designed to enable profits from a company to be used to purchase shares or debentures which are held on behalf of employees, former employees or another member of the same group or their dependants in accordance with paragraph 8(2). This covers most employee share option plans and other employee share incentivization schemes.

4.2.9 Schemes entered into for commercial purposes wholly or mainly related to existing business

[27] CIS Order, Schedule, para 21(2)
[28] Brown v InnovatorOne Plc [2012] EWHC 1321 (Comm)
[29] CIS Order, Schedule, para 4
[30] FSMA 2000, s 22

Paragraph 9 is intended to exclude business arrangements entered into by participants who do not carry out regulated activities in respect of the arrangements and who enter into the arrangements for commercial purposes.

4.2.10 The scope of this exemption was amended in July 2008 in order to exclude qualifying special purpose vehicles ('SPVs') used in property transactions and other co-investment arrangements from the definition of a CIS. The changes sought to provide greater certainty and flexibility for property and other joint ventures[31] by addressing concerns that where SPVs were established for property transactions arguably the SPV could fall outside the exemption because it did not have any existing business. Additionally, if a participant entered into a number of property transactions those arrangements could potentially be regarded as its existing business and therefore fall outside the exemption.

4.2.11 The key requirement is that participants in the arrangement must be 'permitted participants'.[32] Permitted participants are those carrying out an existing business which is not a specified regulated activity and SPVs established for the arrangement in question, being participants who: (a) at the time of entering into the arrangements carries on a business which is not a specified business (the "first business") but which may be in addition to any specified business carried on by that participant at that time and – (i) does not carry on that first business solely by virtue of being - (1) a participant in the arrangements; or (2) a member, partner or trust beneficiary of a body corporate, unincorporated association, partnership or trust which is itself a participant in the arrangements; and (3) enters into the arrangements for commercial purposes wholly or mainly related to the first business; or (a) is a body corporate, unincorporated association, partnership, or trustee of a trust (unless that trustee is an individual) which – (i) does not carry on a specified business; and (ii) only has as its members, partners or trust beneficiaries persons which themselves qualify, or would qualify if they participated in the arrangements, as participants of the kind mentioned in paragraph (a) of this paragraph.

4.2.12 As a practical point it may be worth ensuring that the arrangements in question contain conditions regarding the eligibility of the participants who may be involved, so as to maintain their exempt status.

[31] HM Treasury: 'Further Consultation on amendments to the CIS border for property transactions' August 2007
[32] CIS Order, Schedule, para (9)(5)

4.2.13 Arrangements entered into before 15 July 2008 which complied with paragraph 9 immediately before that date will not constitute a CIS if the participants were permitted participants.[33] Arrangements which constituted a CIS immediately before 15 July 2008, in which all participants are permitted participants and each participant agrees in writing that for the duration of the arrangements the arrangements do not amount to a CIS, will not be a CIS.[34]

4.2.14 Arrangements entered into on or after 15 July 2008 do not constitute a CIS if all participants are permitted participants, unless the participants agree in writing that the arrangements amount to a CIS.[35] Importantly, arrangements will cease to benefit from this exemption for as long as a participant enters into the arrangement who is not a permitted participant.[36]

4.2.15 The entry into and exit from such arrangements by any participant shall not constitute the creation of new arrangements, allowing participants to enter into multiple transactions without the arrangements amounting to a CIS.[37]

4.2.16 Other exclusions under the CIS Order

Paragraph 14 excludes arrangements relating to the use or enjoyment of property if the predominant purpose of the arrangements is to enable the participants to share in the use or enjoyment of property, or to make its use of enjoyment available gratuitously to others. The property in question must not consist of the currency of any country or territory or include any investment specified in the RAO 2001. Such arrangements are likely to include the co-ownership and co-habitation of domestic housing.

4.2.17 Other exclusions include enterprise initiative schemes, pure deposit based schemes, common accounts and certain funds relating to leasehold property.[38]

5. Open-ended investment companies ('OEIC')

5.1 By s236 of the Act an OEIC is a CIS so long as it satisfies (1) the property condition and (2) the investment condition.

[33] CIS Order, Schedule, para (9)(1)(a)
[34] CIS Order, Schedule, para (9)(1)(b)(i) and (ii)
[35] CIS Order, Schedule, para (9)(2) and (3)
[36] CIS Order, Schedule, para (9)(4)
[37] CIS Order, Schedule, para (9)(6)
[38] CIS Order, Schedule, paragraphs 2, 3, 6 and 7

5.2 The property condition is that the property belongs beneficially to, and is managed by or on behalf of, a body corporate ("BC") having as its purpose the investment of its funds with the aim of — (a) spreading investment risk; and (b) giving its members the benefit of the results of the management of those funds by or on behalf of that body.

5.3 The investment condition is that, in relation to the BC, a reasonable investor would, if he were to participate in the scheme — (a) expect that he would be able to realize, within a period appearing to him to be reasonable, his investment in the scheme (represented, at any given time, by the value of shares in, or securities of, BC held by him as a participant in the scheme); and (b) be satisfied that his investment would be realized on a basis calculated wholly or mainly by reference to the value of property in respect of which the scheme makes arrangements.

5.4 The key indicia are therefore: (1) pooled investments that spread risk; (2) a reasonable investor's expectation of receiving within a reasonable period of time the v value of the investment calculated by reference to the net asset value ('NAV') of the property held by the BC.

5.5 The above definitional conditions reflect the conventional understanding of an OEIC, shortly stated by HHJ Havelock-Allan QC in **Seymour v Ockwell**[39] as follows: 'An open-ended investment company is a company which runs an investment fund. It is "open-ended" in the sense that the fund grows and more shares in it are created as more investors invest. The fund shrinks and shares are cancelled as people withdraw their money. The price of each share reflects the value of the investments held in the fund. These investments may include the shares of other companies or other securities'.

5.6 The important point is to distinguish between (for example) a simple purchase of shares in a company that uses the capital to trade and pays dividends on the profits from a purchase of shares where the capital is applies to a single venture which on completion is expected to lead to a disposal of assets, the NAV of which will make up the investor's return[40]. If the expected returns are dividends and/or the value of any increase in share value where the shares may be separately traded, the arrangement will not qualify as an OEIC.

5.7 It is absolutely clear that a BC cannot be both a closed-ended company and an OEIC at the same time. **But** a BC may change its character from one type of company

[39] [2005] 1137 at [116]
[40] The investor's rights are generally contractual and the arrangement will not give rise to a *Quistclose* Trust: see Bieber v Teathers Ltd in Liquidation [2012] 1466

undertaking to another. The Economic Secretary to the Treasury when commenting on the definition of an OEIC in parliamentary debate said: 'It is a test that can be applied from time to time to allow for the possibility that a closed-ended company can become an open-ended company and vice versa on account of significant changes to the way on which the operation of the company and its constitution are structured and which push the company over the boundary between the two types'[41].

6. 'Wrappers and units in a CIS'

6.1 By s238 of the Act, an authorised person must not communicate an invitation or inducement to participate in a collective investment scheme. Sub-section (11) provides that "Participate", in relation to a collective investment scheme, means become a participant (within the meaning given by section 235(2)) in the scheme'.

6.2 Where the investment wrapper is issued by the CIS as a tax efficient means of the policyholder acquiring units in the fund it is clear that the investor is the participant in the CIS.

6.3 Where a wrapper bond is sold by a provider other than the operator of the CIS and the investment is made by the bond issuer – and not in the investor's name – it is difficult to see how the investor can be properly said to be a participant in the CIS. This is reinforced by s237(2) which defines "units" as meaning 'the rights or interests (however described) of the participants in a collective investment scheme'. Where the investment has been made by a third party wrapper provider, the investor's rights are against the bond issuer and not the CIS itself.

6.4 However, this is not the view of the Regulator who considers this would allow form to triumph over substance. In paragraph 1.28 of the **FSA Policy Statement on Non-Mainstream Pooled Investments** the FCA expressed the view that '*we do not regard investments that are merely wrapped by another product amount to indirect investment. Investment through products …are treated as direct investment for the purposes of [the consultation on non-mainstream pooled investments]…investment via wrappers will be subject to the same marketing restriction as any other direct investment in non-mainstream pooled investments*'.

7. Can 'introducing amount to making arrangements'?

7.1 Articles 25(1) and (2) of the **Regulated Activities Order** of course provide that 'making arrangements for another person (whether as principal or agent) to buy, sell, subscribe

[41] Hansard HC 5 June 2000, Col 123

for or underwrite a particular investment which is — (a) a security, (b) a relevant investment, or (2) making arrangements with a view to a person who participates in the arrangements buying, selling, subscribing for or underwriting investments falling within paragraph (1)(a), (b) or (c) (whether as principal or agent) is also a specified kind of activity'.

7.2 Some helpful guidance on what steps may constitute making 'arrangements' is to be found in **Re Inertia Partnership LLP**[42] which concerned services offered by the latter company in seeking to raise corporate finance for three different companies: Vivadi, Plasma and Police 5. Inertial Partnership LLP was introduced to Porterland Associates Ltd believed to have a body of HNWIs willing to invest.

7.3 In commenting on **Article 25** of the **Regulated Activities Order** the Judge stated: 'The critical words in art 25 are these: "making arrangements for" another person . . . to buy, sell [or] subscribe for shares. The exception under art 26 applies to "arrangements which do not or would not bring about the transaction to which the arrangements relate". In my judgment, the correct analysis of these provisions is as follows: 1. The word "arrangements" is, depending on the context, capable of having an extremely wide meaning, embracing matters which do not give rise to legally enforceable rights: 2. In arts 25 and 26, the word "arrangements" is used in contradistinction to the word "transaction"…3. In art 26, the word "transaction" is plainly a reference to the purchase, sale etc of shares contemplated by art 25. 4. As such, a person may make "arrangements" within art 25 even if his actions do not involve or facilitate the execution of each step necessary for entering into and completing the transaction (i.e. the purchase, sale etc of the shares). 5. The availability of the exception in art 26 is essentially a question of fact. As a matter of causation, did the arrangements bring about the transaction (ie the purchase, sale etc of the shares)?'[43].

7.4 In applying the above, the Judge considered the steps taken by Inertia Partnership LLP in relation to each corporate fund raising activity. In each case they were different, revealing different levels of engagement with the process involved in the fund-raising. In the case of Vivadi the services rendered did not go beyond simply putting the investors in touch with the company. This was held to be insufficient to constitute 'arranging'.

7.5 In particular he reasoned: 'Dealing first with Vivadi, as already noted, there is no evidence to suggest that TIP took any part in arranging the sale of its shares, beyond

[42] [2007] EWHC 539 Jonathan Crow QC
[43] Ibid, [39]

having introduced the company to Porterland… That introduction is in my judgment too nebulous and too remote an act to fall within the concept of "making arrangements" within RAO Art 25 Such an introduction in these circumstances is not an "arrangement" in any meaningful sense, for two reasons: first, because it does not necessarily result in anything further happening as between Vivadi and Porterland, let alone between any consumers and Vivadi or Porterland; and secondly, because any further steps that might be taken following the introduction were not within TIP's power to effect or to direct. As such, the introduction did not involve TIP in any violation of the general prohibition under FSMA s 19'[44].

7.6 In relation to Plasma Inertia LLP provided administrative services in respect of for the receipt of investor funds and payment to the company. This was sufficient to amount to 'arranging'.

7.7 In the case of Police 5, the position was said to be clearer still: 'The Application Forms are conclusive that the consumer was applying for shares, and that s/he might receive less than s/he applied for, or none at all. There was plainly no pre-existing contract concluded between the broker and the consumer over the phone. There is also some evidence to show that consumers who failed to send off cheques after they had spoken with brokers over the phone were not pursued: that is again inconsistent with any suggestion that the brokers were making binding contracts with consumers. As such, in sending out the Application Forms, collecting the cheques and paying the money to Police 5, TIP was not merely providing completion services, but was making arrangements for the company to enter into agreements with investors. For these reasons, there was in my judgment a breach of RAO art 25 in relation to Police 5'[45].

7.8 Oddly, no real consideration was given in that case to the second limb of **Article 25**. It cannot be regarded as providing definitive guidance therefore.

7.9 Despite the conclusion on the Vivadi transactions, where an introduction is made of an investor to any entity issuing or providing a regulated investment or of e.g. an entity seeking investment to a potential investor, as a matter of interpretation of the **Regulations** it seems to me clear that – depending on the facts – either of the above 'arranging activities' may well be taking place.

7.10 It is implicit in the above analysis that 'introducing' may form part of the regulated activity of 'arranging' which explains why two specific exemptions are provided:

[44] Ibid, [40]
[45] Ibid, [42]

7.10.1 **Article 29** i.e. introductions to authorised persons for or with a view to a transaction on which the authorised person will advise or which is execution only business[46].

7.10.2 **Article 33** i.e. introductions to authorised or exempt persons with a view to independent advice being offered on investments generally or a class of investments (other than insurance policies).

7.11 Doubt has been cast on the above however by **Watersheds Ltd v Dacosta**[47] which concerned a firm of accountants expressly engaged to introduce potential investors to the defendant company which was seeking to raise corporate finance. As to the first limb of **Article 25** the Judge concluded: 'Watersheds were required to use their experience and expertise to assist the company to ensure that all necessary material was provided to investors in the most attractive form so as to assist or promote a successful outcome to any meeting. Nevertheless, in my judgment, what was contemplated by the terms of engagement involved Watersheds at most trying to effect introductions and to assist the company in meeting potential investors in order that the company could try to reach agreement with those potential investors as to a transaction. I accept the submission that Watersheds were not able in any real sense to influence whether or not an investment was made in the company. I conclude that Watersheds were not undertaking activity which was of a kind specified by art 25(1)[48]'. Although the decision is fact specific, it is surprising.

7.12 Even more surprising is the Judge's conclusion on the second of **Article 25**. As to that Holroyde J stated: 'In relation to art 25(2), PERG 27.7.7B, which I have quoted in part above, continues in these terms: 'The activity of making arrangements with a view to transactions in investments is aimed at cases where it may be said that the transaction is 'brought about' directly by the parties. This is where this happens in a context set up by a third party specifically with a view to the conclusion by others of transactions through the use of that third party's facilities. This will catch the activities of persons such as exchanges, clearing houses and service companies (for example, persons who provide communication facilities for the routing of orders or the negotiation of transactions. A person may be carrying on this regulated activity even if he is only providing part of the facilities necessary before a transaction is brought about'…Had it not been for that guidance, with its emphasis on the provision of facilities for others as opposed to assisting one party, I would have been inclined to think that art 25(2) did

[46] The introducer must also receive no financial benefit from anyone other than his client which is not accounted for to the client
[47] [2009] EWHC 1299 Holroyde J
[48] Ibid at [64]

apply to Watersheds' activity in seeking to assist the company to raise equity finance. As it is, I am persuaded that it does not'.

7.13 The distinction (sic) between 'the provision of facilities for others' and 'assisting one party' is difficult to follow and it is obvious the FCA does not agree with the result. It would be unsafe to rely on it in dealing with the Regulator[49].

7.14 There are other specific exclusions from the activity of 'arranging', principally (1) arrangements which do not or would not bring about the transaction to which the arrangements relate[50]; (2) any arrangements for a transaction into which the person making them enters or is to enter as principal or as agent for some other person[51]; (3) arranging the acceptance of debentures in connection with loans[52] and (4) arrangements having as their sole purpose the provision of finance to enable a person to buy, sell, subscribe for or underwrite investments[53].

8. 'Advising' on or 'recommending' a CIS

8.1 **What constitutes 'advice'**

In terms of the common law approach to defining 'advice', it can be said that 'any element of comparison or evaluation or persuasion' is likely to indicate that advice is being given[54]. This was expanded and applied by Judge Havelock-Allan QC in **Rubenstein v HSBS Plc** where he commented: 'The key to the giving of advice is that the information is either accompanied by a comment or value judgment on the relevance of that information to the client's investment decision, or is itself the product of a process of selection involving a value judgment so that the information will tend to influence the decision of the recipient. In both these scenarios the information acquires the character of a recommendation'[55].

8.2 Whether statements made may constitute advice depends in part on the context in which they are uttered or provided. An important factual consideration is whether there

[49] See PERG 2.7.7 BD
[50] Article 26, RAO
[51] Article 28, RAO (unless the product is an insurance policy in which case the arranger must be the only policyholder
[52] 31, RAO 'Arranging the acceptance of debentures in connection with loans (1) There are excluded from article 25 (1) and (2) arrangements under which a person accepts or is to accept, whether as principal or agent, an instrument creating or acknowledging indebtedness in respect of any loan, credit, guarantee or other similar financial accommodation or assurance which is, or is to be, made, granted or provided by that person or his principal. (2) The reference in paragraph (1) to a person accepting an instrument includes a reference to a person becoming a party to an instrument otherwise than as a debtor or a surety'.
[53] Article 32, RAO
[54] Walker v Inter-Alliance Group [2007] EWHC 1858 Henderson J at [30]
[55] [2011] EWHC 2304 at [81]

is a written contract which stipulates whether an advisory or execution only service is being offered. Thus in **Wilson v M F Global**[56] Eady J emphasized that 'it is fundamentally important in relation to all of these accounts to have in mind those clauses which made clear, in each case, that the parties had entered into an "execution only" arrangement and that the Defendants were under no duty to give advice… Because, however, there would inevitably be communications between a client and one or more members of the Defendants' staff, it was important to make clear the basis upon which such communications would take place. As I have already recorded, there were hundreds of telephone conversations between [the parties] during the relevant period in which views were exchanged. The terms of business emphasized, therefore, that the Defendants were fully entitled to provide market information, advice and recommendations, but they were not deemed to give advice on the merits of particular transactions. Any such advice was to be regarded as "incidental" to the dealing relationship. No such communications would in any way undermine the basic nature of the relationship, which was "execution only" and non-advisory. These provisions are to be found in Clause 4 of the CFD terms of business, Clauses 11 and 13 of the Intermediate Customer Terms of Business and Clauses 9.2 and 9.3 of the Spread Betting Terms of Business'.

8.3 Significantly, Eady J stated[57]: 'Against this background, it is inappropriate to go through the hundreds of conversations that took place between [the Defendant] and [the Claimant], or even the relatively few that are available, with a view to classifying everything that fell from [the Defendant's] lips according to a rigorous analysis into separate categories of "information", "opinion", "advice" and "recommendations". That is simply not the way the conversations were conducted. Obligations of that sort could not be imported without express written amendment to the terms of business governing relations between the parties'.

8.4 The inability of the Claimant to prove a specific agreement to advise in **Bank Leumi Plc v Wachner**[58] proved fatal where the relevant terms of business provided: 'Unless BLUK enters into a specific agreement with you to do so, BLUK shall not owe you any duty to advise on the merits or suitability of any investment entered into or contemplated by you. You agree that you will rely on your own judgment for all trading decisions'.

8.5 Assuming the relationship is an advisory one then the next question is to characterise whether the relevant communication is 'advice'. For the purposes of deciding whether

[56] [2011] EWHC 138 at [79-80]
[57] Ibid, [94]
[58] [2011] EWHC 656 Flaux J

the **COBS Rules** are engaged, the inquiry is also quite specific. As Teare J pointed out in **Zaki v Credit Suisse**[59]: 'The first, and fundamental, question is whether CSUK, through Mr. Zaki, made a personal recommendation to buy the 10 notes. A recommendation is defined as advice on investments and advice is defined as "advice on the merits" of buying a particular investment. Thus the question is whether Mr. Zaki gave advice to Mr. Zeid on the merits of purchasing the notes… Advice on the merits of purchasing a structured product must, I think, refer to the advantages and disadvantages of purchasing the product. What may be regarded as an advantage for one client may not be regarded as an advantage for another client and so COB provides that the advice must be suitable for the client and COBS provides that the recommendation (that is, advice on the merits) must be suitable for the client. However, "advice on the merits" is to be distinguished from the mere giving of information. … Advice requires an element of opinion on the part of the adviser…'.

8.6 **FCA Guidance**

The above is mirrored in Guidance provided by the FCA in **PERG**. Thus, providing 'generic advice' (e.g. 'now is a good time to invest in Japan rather than Europe') or providing neutral information only (e.g. information as to a share price) does not constitute giving advice. **But** 'the context in which something is communicated may affect its character; for example, if a person gives information on share price against the background that, when he does so, that will be a good time to sell, then this will constitute advising on investments': **PERG 2.7.15G**.

8.7 In the FCA's view, advice requires an element of opinion on the part of the adviser which steers or is intended to steer a client towards a particular product[60]. Thus, even providing information may take on the nature of advice if the circumstances in which it is provided give it the force of a recommendation[61]. **PERG 4.6.10 G** gives examples of situations where information is likely to take the form of advice, in particular where the information is provided on a selected, rather than balanced and neutral, basis so that it would tend to influence the decision of the customer. In relation to mortgage products, this may arise where the person providing the information does so by pointing out mortgages that contain features specified by the borrower but then exercises discretion as to which mortgages to offer to the borrower.

[59] [2011] EWHC 2422 at [82 - 84]
[60] See PERG 4.6.13G in relation to mortgage recommendations
[61] See PERG 4.6.16G in relation to information about mortgage products

8.8 Alternatively, as a result of going through the sales process, the person providing information may discuss the merits of one regulated mortgage contract over another, resulting in advice to enter into or not enter into a particular one[62].

8.9 Information may take on the nature of advice if the circumstances in which it is provided give it the force of a recommendation. For example: (1) a person may offer to provide information on directors' dealings on the basis that, in his opinion, were directors to buy or sell investors would do well to follow suit; (2) a person may offer to tell a client when certain shares reach a certain value (which would be advice if the person providing the information has offered to do so on the basis that the price of the shares means that it is a good time to buy or sell them); and (3) a person may provide information on a selected, rather than balanced, basis which would tend to influence the decision of the recipient.

8.10 The circumstances, context and background of each transaction need therefore to be carefully considered to assess whether the 'information-advice' threshold has been crossed.

8.11 **Advice on and promotion of a CIS investment**

Recommending an investment in a CIS is self evidently a promotion and as such is caught by the general restriction against invitations and inducements to invest[63]. In the case of a CIS there is further restriction in s238 of the Act which prohibits even an authorised firm promoting such an investment unless the CIS is regulated or the promotion is exempted under the **FSMA (Promotion of Collective Investment Schemes (Exemption) Order 2001 (SI 2001 No, 1060)** ('the PICS Order') or otherwise permitted by **COBS 4.12**.

8.12 The PICS Order exemptions include:

8.12.1 **Introductions** to UCIS providers where no advice or recommendation has been given by the introducer

8.12.2 **Generic promotions** not relating to any particular UCIS

8.12.3 **Investment professionals** to whom a UCIS is promoted (subject to complying with particular prescribed caveat wording

8.12.4 **One off non-real time or solicited real time promotions** not part of a marketing campaign

[62] See PERG 5.8.11G for like guidance in relation to insurance products

[63] S21 (1)of FSMA, 'A person ("A") must not, in the course of business, communicate an invitation or inducement to engage in investment activity'

8.12.5 **Certified HNWIs** where the UCIS invests wholly or predominantly in the shares in or debentures of an unlisted company

8.12.6 **Certified HNW companies and unincorporated associations** (in which case the limitation to shares/ debentures of unlisted companies does not apply)

8.12.7 **Sophisticated investors** (in which case the limitation to shares/ debentures of unlisted companies does not apply).

8.13 **COBS 4.12** specifies 8 categories of persons to who an UCIS investment may be promoted, which include:

8.13.1 Category 1: existing UCIS investors or where they have been so within the last 30 months

8.13.2 Category 2: new or established clients where the firm has taken reasonable care to ensure the investment is suitable

8.13.3 Category 8: a person reasonably assessed as able to understand the risks and masking his own investment decision.

8.14 The FSA Consultation Paper CP 12/19 (August 2012) proposed to remove Categories 2 and 8 and remove reference in Category 1 to investors who have invested in a CIS within the last 30 months. In the result, these proposals went further so that in addition to removing Categories 2 and 8, Category 1 was restricted to any NMPI 'which is intended by the operator or manager to absorb or take over the assets of that non-mainstream pooled investment or which is being offered by the operator or manager of that non-mainstream pooled investment as an alternative to cash on its liquidation …or …securities offered by the non-mainstream pooled investment as part of a rights issue'.

9. Other species of CIS

9.1 The Alternative Investment Fund Managers Directive

9.1.1 On 22 July 2013, the Alternative Investment Fund Managers Directive[64] or, "AIFMD " was transposed into English law through a combination of the Alternative Investment Fund Managers Regulations 2013[65], the Investment Funds Sourcebook ("FUND") (which forms part of the FCA's Handbook of Rules and Guidance) and Regulation (EU) No. 231/2013[66] (which fleshes out some of the detail in the AIFMD and, as an EU regulation, has direct effect).

[64] Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers

[65] SI 2013/1773. These regulations have subsequently been amended by the Alternative Investment Fund Managers (Amendment) Regulations 2013 (SI 2013/1797)

[66] Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision

The Directive aims to establish an EU-wide framework for monitoring and supervising "Alternative Investment Funds" or "AIFs" and those who manage them. The Directive is therefore meant to capture all manner of commercial funds including hedge funds, private equity funds, retail investment funds (other than UCITS), investment companies and real estate funds. The way in which the UK legislation has been cast has resulted in a considerable overlap with the definition of collective investment scheme. Consequently, in the UK, it is necessary to consider not only whether an arrangement could be a collective investment scheme but also, whether it could be classed as an "Alternative Investment Fund ".

9.1.2 The meaning of an "Alternative Investment Fund" is set out in the Alternative Investment Fund Managers Regulations 2013, Article 3: 3(1) "AIF" means a collective investment undertaking, including investment compartments of such an undertaking, which – (a) raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (b) does not require authorisation pursuant to Article 5 of the UCITS directive. (2) An AIF may be open-ended or closed-ended, and constituted in any legal form, including under a contract, by means of a trust or under statute. (3) None of the following entities is an AIF- (a) an institution for occupational retirement provision which falls within the scope of Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision; (b) a holding company; (c) an employee participation scheme or employee savings scheme; (d) a securitisation special purpose entity.

9.1.3 The meaning of "AIF" as set out in the Directive is simultaneously broader and narrower than the meaning of "collective investment scheme ". For example, the "AIF" classification includes bodies corporate such as investment trusts but excludes UCITS. There is thus a separation of the relevant regulated activities as set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("RAO"). So, for example, the RAO now includes the new activity of "managing an AIF"[67]. A person who has the regulatory permission to manage an AIF does not need permission to establish, operate or wind-up a collective investment scheme in respect of that AIF, even if that AIF is, simultaneously, a CIS. There is a separate regulated activity of "managing a UCITS". Again, a person who has the "managing a UCITS" permission does

[67] RAO 2001, art 51ZC (as amended by the Alternative Investment Fund Managers Regulations 2013, SI 2013/1773, Schedule 2, Part 1)

not need permission to establish, operate or wind-up a collective investment scheme in respect of that UCITS.

9.1.4 Since the implementation of the AIFMD it is now necessary to consider (a) whether the entity or arrangement in question is a CIS; (b) whether it is a UCITS; and (c) whether it is an AIF. In practice, there are likely to be very few commercial collective investment schemes that are neither an AIF nor a UCITS.

9.1.5 The activity of "managing an AIF" is now set out in the Regulated Activities Order, Article 51ZC: 51ZC – (1) Managing an AIF is a specified kind of activity. (2) A person manages an AIF when the person performs at least risk management or portfolio management for the AIF. (3) A person does not manage an AIF if the functions they perform for the AIF have been delegated to it by another person, provided that such other person is not an AIFM that has delegated such functions to the extent it is a letter-box entity. (4) Paragraph (5) applies if a person manages an AIF, and also carries on – (a) one or more of the additional activities listed in paragraph 2 of Annex 1 to the alternative investment fund managers directive (the text of which is set out in Schedule 7) for that AIF; or (b) one or more other activities in connection with or for the purposes of the management of that AIF. (5) The additional or other activities are included in the activity specified in paragraph (1). (6) Any expression used in this article which is not defined in this Order and is used in the alternative investment fund managers directive has the same meaning as in that directive.

9.1.6 An "Alternative Investment Fund Manager " or, "AIFM" is therefore any legal person whose regular business is to manage one or more AIF. The Regulations and the Directive itself specify that 'manage' includes both the provision of "portfolio management services" and the provision of "risk management services". Neither of these terms is defined within the Directive and firms will need to make an assessment based on the factual circumstances of each entity.

9.1.7 Whilst all persons carrying on the activity of "managing an AIF " will need to be authorised by the FCA and hold the relevant permissions, a lighter regulatory regime applies to certain managers of funds with a cumulative value of less than €500m in total where the fund portfolio consists of funds that are not leveraged and have a lock-in period for investors of at least five-years. Where an AIF is leveraged and/or investors have redemption rights within the first five years, the AIFM can benefit from the lighter touch regime where the AIFs' assets (including assets acquired by leverage) do not exceed €100m.

9.2 Marketing and promotion

9.2.1 In addition to the concept of "financial promotion ", the AIFMD and, consequently, the AIFMD Regulations have introduced the concept of "marketing ". Under the AIFMD Regulations, Article 47(1) states that a person "markets" an AIF when the person makes a direct or indirect offering or placement of units or shares of an AIF. Whilst there is clearly an overlap between the concepts of "promotion" and "marketing", the Treasury acknowledged[68] that there could well be circumstances where there is marketing but no promotion. The Treasury referred to the example of a financial adviser who passes on subscription material to an investor who asks that investor if he would like to subscribe. On the one hand such action would constitute the placement of shares in an AIF and, therefore, "marketing" under the Directive and the AIFMD Regulations. However, on the other hand, such conduct would not constitute financial promotion if there is no element of incitement or persuasion. The AIFMD Regulations prohibit the marketing of an AIF in the UK unless such marketing is permitted under the Regulations.

9.2.2 In very broad terms, an AIF which is managed by an AIFM subject to the full requirements of the Directive (so, an EU-based full scope AIFM) may be marketed to professional investors in the UK provided the relevant FCA notification requirements set out in the AIFMD Regulations are complied with. Simultaneously, the AIFM will be exempted from the financial promotion regime or the restriction on promotion of CIS (as applicable).[69]

9.2.3 The AIFMD Regulations permit the marketing of an AIF to retail investors if, in broad terms, the AIFMD can be complied with in terms of marketing to professional investors and, the person looking to market the fund is able to do so under the existing financial promotion regime. In practice, this means the current position for the marketing of funds to retail investors is maintained without any modification. So, in the UK, AIFs that are authorised by the FCA but are not qualifying investor schemes – i.e. Non-UCITS Retail Schemes may be marketed to retail investors in the UK.

9.2.4 As envisaged under the AIFMD Regulations[70], the FCA has developed the "AIFMD National Private Placement Regime" or the "NPPR" to allow the marketing by AIFMs of AIFs that are not permitted to be marketed under the domestic marketing or EU passporting regimes. The NPPR therefore relates to the marketing of non-EEA AIFs and AIFs managed by non-EEA AIFMs. In practice this regime is reserved for certain

[68] See HM Treasury Consultation, 'Transposition of the Alternative Investment Fund Managers Directive', 11 January 2013
[69] Financial Promotions Order, Article 29 and CIS Promotion Order, Article 16
[70] AIFMD Regulations, Chapter III

offshore funds and offshore managers looking to market to professional investors in the UK. It does not apply to the marketing of such funds to retail investors in the UK. The NPPR will be available for use until at least 2018 and, until 2015 the NPPR will be the sole regime available to those AIFMs looking to market in the UK. Following 2015, a non-EEA marketing passport may be introduced, but this depends on a number of conditions being satisfied (as set out in the AIFMD).

10.1 UCITS and other authorised CIS in the UK

10.1.1 Funds authorised by the FCA in the UK can take the following legal forms: (a) unit trust authorised for the purposes of the 2000 Act by an authorisation order under section 243 of that Act; (b) a co-ownership scheme or partnership scheme (together referred to as "contractual schemes") authorised for the purposes of the 2000 Act by an authorisation order under section 261D(1) of that Act; or (c) an open-ended investment company authorised for the purposes of the 2000Act by an authorisation order under the Open-Ended Investment Companies Regulations 2001, Regulation 14.

10.2 Authorised unit trusts

10.2.1 A unit trust is defined in the 2000 Act as a specific type of CIS under which the property is held on trust for the participants.[71] An authorised unit trust is a unit trust which is subject to an authorisation order issued by the FCA pursuant to section 243(1). For the purposes of this section we refer to an authorised unit trust as an 'AUT'.

10.2.2 An AUT must be constituted by a trust deed which is entered into between the authorised fund manager and the trustee.[72] The authorised fund manager is responsible for operating the AUT on a daily basis, and the trustee is responsible for holding the property of the AUT on trust for the participants.

10.2.3 The participants or 'unitholders' are said to have a beneficial interest in the trust's property by reference to the number of units held. It has been argued by some that unitholders are not beneficiaries with equitable proprietary interests as equitable co-owners of the property held by the trustee until the point at which the scheme is wound up, and therefore do not have the collective right to divide the property held by the trustee between themselves.[73] This, it has been argued, is because unitholders have contractual rights to a sum of money representing a proportion of the net value

[71] FSMA 2000, s 237(1)
[72] COLL 3.2.3R
[73] Underhill and Hayton, *Law of Trusts and Trustees* (18th edn, LexisNexis) 68, 1.125

calculated and realizable as provided in the trust deed. Therefore the rights of unitholders in an AUT are governed by the terms of their subscription being in practice the trust deed, prospectus and any application form.

10.2.4 An application for authorisation must be made by the authorised fund manager ('AFM') and the trustee under section 242 of the 2000 Act, and the FCA must be satisfied that the proposed AUT complies with the requirements in the 2000 Act and COLL,[74] in particular: (a) *the AFM and the trustee must be independent of each other, must be corporate bodies which are either incorporated in the UK or an EEA State and which have a place of business in the UK, and must be authorised to act as AFM and trustee respectively;[75] (b) the name of the AUT must not be undesirable or misleading,[76] and (c) the purposes of the AUT must be reasonably capable of being successfully carried into effect;[77] and (d) unitholders must be able to redeem their units either at a price related to the net value of the property to which the units relate, and determined in accordance with the scheme, or by selling their units on an investment exchange at a price which is not significantly different.[78]*

10.2.5 An application must contain the trust deed and a solicitor's certificate confirming that it complies with section 234 of the 2000 Act and the applicable rules.[79] In addition to the general requirements in COLL 3.2.6R, which also apply to OEICs, the trust deed must contain certain specific statements confirming: (a) *the trust deed is binding on each unitholder and authorising the trustee and AFM to act in accordance with its terms; (b) the governing law; (c) the scheme property is held on trust for the unitholders by the trustee in proportion to their interests; (d) sums for distribution or allocation are held by the trustee on trust; (e) authorisation of payments to the trustee in respect of its services; and (f) the identity of the registrar.[80]*

10.2.6 The unit trust is a creature of trust law and fundamentally the trustee and AFM owe fiduciary duties to unitholders which are, in the main, supported by specific rules in COLL. Section 253 of the 2000 Act renders void any provision in the trust deed constituting the scheme which seeks to limit liability of either the trustee or the AFM for failure to exercise due care and diligence in the discharge of their respective functions.

[74] FSMA 2000, s 243(1)(a) and (b)
[75] FSMA 2000, S 243(4), (5 and (7)
[76] FSMA 2000, s 243(8) and regulatory guidance on undesirable or misleading names in COLL 6.9.6G also applies
[77] FSMA 2000, s 243(9)
[78] FSMA 2000, s 243(10) and (11)
[79] FSMA 2000, s 243(1)(c)
[80] COLL 3.2.6R(23) to (27)

10.2.7 The FCA may revoke an authorisation order if it appears that the AUT no longer complies with the requirements mentioned in section 243(1) of the 2000 Act, the AFM or the trustee has contravened a requirement under the 2000 Act, or they have knowingly or recklessly given the FCA information which is false or misleading in a material particular, or where the FCA deems it is desirable in order to protect the interests of participants or potential participants in the AUT.[81]

10.2.8 In addition the FCA may require the AFM to cease issuing and redeeming units in the AUT or require the AUT to be wound up if, for example, the FCA deems it necessary to protect the interests of participants or potential participants in the AUT.[82] The FCA may apply to the courts to remove the manager and/or the trustee of an AUT and either replace them with suitable persons nominated by the FCA or wind up the AUT.[83]

10.2.9 Any proposed alterations to an AUT, or any proposal to replace the manager or the trustee, must be notified to the FCA in advance and the FCA has one month in which to object.[84] Any proposed change to the trust deed constituting the AUT requires a solicitor's certificate to the effect that notwithstanding the change, the trust deed still complies with the applicable regulations.[85]

10.3 Authorised contractual schemes

10.3.1 The Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013[86] (referred to as the "**ACS Regulations**") came into force on 6 June 2013 and introduced the "authorised contractual scheme " or "ACS " to UK law, as well as a new Chapter 3A to the 2000 Act. The ACS Regulations are part of HM Treasury's ambitious plan to attract a greater share of European pooled funds to the UK and also to build on the UK's reputation as the largest asset management centre in Europe.

10.3.2 An ACS may take one of two forms (a) a co-ownership scheme; or (b) a limited partnership scheme. Either structure may be established as a UCITS, a Non-UCITS Retail Scheme or a Qualified Investor Scheme. These new forms of authorised fund are intended to offer a tax transparent vehicle for investors.

10.3.3 A co-ownership scheme is established by way of deed entered into between the authorised fund manager (on behalf of investors) and a depositary. The deed must comply with the requirements set out in Chapter 3A of the 2000 Act and the FCA's

[81] FSMA 2000, s 254(1)(a), (b), (c) and (e)
[82] FSMA 2000, s 257(1) and (2)
[83] FSMA 2000, s 258(1) and (2)
[84] FSMA 2000, s 251(1) and (4)
[85] FSMA 2000, s 251(2)
[86] SI 2013/1388

rules. Investors automatically and by operation of law acquire rights and liabilities by subscribing for units in the scheme rather than entering into the deed. The scheme itself has no legal personality. The scheme's property is owned by its unitholders as tenants in common (common property in Scotland), while the depositary holds legal title. A unitholder's liability under a co-ownership scheme is limited to the price of his or her units. Co-ownership schemes (but not limited partnership schemes) may be in the form of an umbrella fund as well as a standalone vehicle. Property subject to a sub-fund of an umbrella fund may only be used to discharge the liabilities of the participants in that sub-fund.

10.3.4 A limited partnership scheme is also established by way of deed, entered into by the general partner as authorised fund manager (although it may delegate management functions to another person) and a nominated partner. The nominated partner is the only limited partner of (but not a participant in) the scheme on its formation. The contents of the deed must comply with Chapter 3A of the 2000 Act and the FCA's rules. The investors in the scheme will become limited partners and legal title to the scheme's property will, as in a co-ownership scheme, be held by a depositary. The form of a limited liability ACS follows that of a limited partnership made under the Limited Partnership Act 1907, although the ACS Regulations amend the 1907 act specifically in its application to ACS to provide sufficient flexibility to enable such scheme to operate successfully.

10.3.5 In the case of a limited partnership ACS, limited partners will be able to withdraw their contributions without this requiring the dissolution of the partnership as a whole, provided that at least one limited partner remains. Also, the general partner of a limited partnership ACS will not be liable for the debts of the limited partnership in the absence of wrongdoing on its part. Liability of a limited partnership scheme is restricted to the amount of partnership property of the general partner to meet debts and obligations.

10.3.6 Application for authorisation of an ACS is made by the scheme's authorised manager and the depositary pursuant to section 261C, FSMA 2000 (as introduced by the ACS Regulations). There are specific provisions and requirements relating to the authorised fund manager and the depositary and the scheme's name must be neither undesirable nor misleading. The purposes of the scheme must be "reasonably capable of being successfully carried into effect ". The application must be determined by the FCA within six months of receipt (or two months where the ACS is a UCITS).

10.3.7 Given the reporting obligations to which an ACS is subject, units may only be issued to (a) a professional ACS investor[87]; (b) a large ACS investor[88]; or (c) an existing ACS investor. Also, where an ACS is a Qualified Investor Scheme, units may only be issued to a person who is a "Qualified Investor "[89]. While units in an ACS may be transferred (subject to any restrictions contained in the deed), they may not be transferred to a person who does not fall within one of the categories of eligible investor.

10.4 Authorised OEICs

10.4.1 Until the arrival of the authorised OEIC in 1997 it was not possible for any corporate body incorporated in the UK to issue and redeem shares on request at any time by a shareholder. Indeed, it has only been possible for a limited company incorporated under the Companies Acts to buy back its own shares since 1980. The open-ended retail market had been cornered by the authorised unit trust until the Open-Ended Investment Companies (Investment Companies with Variable Capital) Regulations 1996 and the Financial Services (Open-Ended Investment Companies) Regulations 1997 came into force. This legislation set out the corporate framework and the necessary mechanics to enable an open-ended corporate to be established under English law with a structure suitable for investment by all classes of potential investor – including the retail public. The 1996 and 1997 regulations have since been replaced by the Open-Ended Investment Companies Regulations 2001[90] (the "OEIC Regulations") and the rules and guidance in the FCA's Collective Investment Sourcebook ("COLL") and, where applicable, the FCA's "FUND " Sourcebook which, together, comprise part of the FCA's Handbook of Rules and Guidance.

10.4.2 As a corporate body, unlike its unit trust and contractual scheme equivalents, an OEIC has a separate legal identity and can enter into contracts, take legal proceedings and be sued. An OEIC owns its own portfolio of investments. Shareholders have no beneficial interest in the underlying assets[91] but own shares in the OEIC giving them legal rights as against the OEIC. Such rights include the right to participate in profits and/or income, the right to vote at any general meeting, as well as such other rights as are permitted in accordance with the OEIC's Instrument.[92]

[87] Defined as being a person who falls within categories (1) to (4) of Section 1 of Annex II (professional clients for the purpose of that directive) to MiFID
[88] An investor who makes a payment of, or contributes property with a value of not less than £1 million
[89] COLL 8, Annex 1R
[90] The Open-Ended Investment Companies Regulations, SI 2001/1228
[91] OEIC Regulations, regulation 45(2)
[92] OEIC Regulations, regulation 45(3)(a) to (c)

10.4.3 An OEIC is incorporated upon the issue of an authorisation order by the FCA pursuant to the OEIC Regulations.[93] An application for authorisation must be submitted to the FCA in accordance with regulation 12 of the OEIC Regulations. In order to approve an application the FCA must be satisfied that the OEIC complies with the various requirements of the OEIC Regulations including in particular: (a) *the head office must be situated in England, Wales, Scotland or Northern Ireland;[94] (b) the OEIC must have at least one director who is fit and proper,[95] (c) a depositary must be appointed to safeguard the scheme property who is independent of the OEIC and its directors, and is a body corporate incorporated in the UK or the EEA, has a place of business in the UK and is authorised to act as a depositary;[96] (d) the aims of the OEIC must be reasonably capable of being achieved;[97] and (e) shareholders must be entitled to either redeem the shares upon request at a price related to the net value of the OEIC property and determined in accordance with the Instrument and the FCA rules, or to sell their shares on an investment exchange at a similar price.[98]*

10.4.4 The name of the OEIC must not be undesirable or misleading and may not include the word 'limited' for example.[99] FCA guidance also prohibits names which are substantially similar to other authorised funds, or which may suggest that the OEIC has merits or qualities which are not justified, which is inconsistent with its objectives, or implies that the OEIC is not an authorised fund or which may mislead investors as to who is responsible for the OEIC.[100]

10.4.5 An application for authorisation must include a copy of the instrument of incorporation ('Instrument') constituting the OEIC and a solicitor's certificate confirming the Instrument complies with Schedule 2 of the OEIC Regulations.[101] The Instrument, which is binding on the directors, the depositary and shareholders,[102] must also contain the core information in COLL 3.2.6R. Schedule 2 of the OEIC Regulations requires the Instrument to contain statements confirming: (a) *the name and status of the OEIC as an investment company with variable capital; (b) in the case of an umbrella OEIC that the assets of a sub-fund belong exclusively to that sub-fund and shall not be used to discharge the liabilities or claims against the umbrella company or any other person or*

[93] OEIC Regulations, regulation 3
[94] OEIC Regulations, regulation 15(3)
[95] OEIC Regulations, regulations (4) and (5). Typically OEICS will have one director in the form of an authorized corporate director being a corporate body permitted to act as sole director of and OEIC
[96] OEIC Regulations, regulation 15(8). regulatory guidance on the requirement for depositaries to be independent is set out in COLL 6.9.2G
[97] OEIC Regulations, regulation 15(10)
[98] OEIC Regulations, regulation 15(11)(a) and (b)
[99] OEIC Regulations, regulations 15(9) and 19(1)
[100] COLL 6.9.6G(2)
[101] OEIC Regulations, regulations 14(1)(c)
[102] OEIC Regulations, Schedule 2, para 6(1)

body, or any other sub-fund;[103] *(c) that the shareholders are not liable for its debts; (d) a depositary is responsible for safekeeping the scheme property; (e) the object and category of the OEIC; (f) the share classes available and rights attaching to those shares; and (g) procedures for the appointment and removal of the director(s).*

10.4.6 The FCA may revoke an OEIC's authorisation order or issue a direction where it fails to satisfy any of the requirements for authorisation, or where it is in the interests of shareholders or potential shareholders.[104] For example, the FCA may require the OEIC to cease issuing and redeeming shares or to be wound up.[105] Following authorisation significant changes to an OEIC's prospectus or any change to the Instrument require prior FCA approval.[106]

10.4.7 Since their introduction to the UK in 1997, OEICs have grown enormously in popularity – overtaking the authorised unit trust as the preferred structure for new fund launches. This is probably the result of a fund management industry keen to market their funds to investors in continental Europe. It was argued prior to its arrival on UK shores that the OEIC structure was more familiar to overseas investors than its common law competitor, the unit trust.

10.4.8 In practice there is little difference between the core features of the three types of authorised fund structures. Either a unit trust, contractual scheme or an OEIC structure may be used to create any of the three categories of authorised fund available (UCITS, Non-UCITS Retail Scheme and Qualified Investor Scheme) and each of the structures may be single or dual priced.

10.4.9 Umbrella schemes: Section 235 of the 2000 Act contemplates the existence of a single collective investment scheme where the arrangements provide for the pooling of separate parts of the property. Such arrangements will be regarded as a single CIS provided the participants are entitled to exchange rights in one part for rights in another. This provides the basis for umbrella unit trusts and umbrella OEICs alike where, within a single structure, it is possible to distinguish between different parts of the scheme property and to manage the property attributable to those parts so as to achieve different aims. These separate parts are generally referred to as 'sub-funds'. The main advantage with the umbrella structure from the provider's perspective is that it is generally more cost effective to run an umbrella structure with a number of sub-funds than an equivalent number of separate schemes

[103] Open-Ended Investment Companies (Amendment) Regulations 2011 (SI 2011/3049)
[104] OEIC Regulations, regulations 23(1) and 25(1)
[105] OEIC Regulations, regulation 25(2)
[106] OEIC Regulations, regulation 21(1)

10.4.10 The umbrella open-ended investment company is contemplated by the OEIC Regulations. The main requirement is for the instrument of incorporation to provide for the pooling of separate parts of the OEIC's property and to provide for shareholders exchanging rights in one part for rights in another. Umbrella unit trusts are typically constructed using a sub-trust structure again, with provisions which enable unitholders to exchange rights in one sub-fund for rights in another.

10.4.11 Following a joint consultation launched by HM Treasury and the regulator, legislation came into force in December 2011 which introduced a 'protected cell' regime in the UK for umbrella OEICs.[107] Prior to the introduction of the regime it was not possible to ring-fence the liabilities of each sub-fund of an umbrella OEIC. Hence, where a particular sub-fund was unable to meet all of its liabilities, such liabilities could be met out of the assets of another sub-fund within that scheme. This is known as the risk of 'contagion' and had to be disclosed in the prospectus of an umbrella OEIC. Besides enhancing investor protection this move will undoubtedly help to make the UK authorised fund industry more competitive. It should also create more of a level playing field with jurisdictions such as Ireland, Jersey, and Guernsey which already operate a protected cell regime. By way of comparison the predominant view expressed in a consultation published by HM Treasury in May 2007 was that existing trust law made sufficient provision for segregation of liability in umbrella schemes structured as AUTs.[108] The regulator has now moved away from this position, taking the view that a court would focus on the provisions of the trust deed constituting the scheme in order to determine whether segregation between the sub-funds of an umbrella AUT was intended. The FCA now requires all managers to ensure that the trust deeds of the schemes they manage accurately reflect sub-fund segregation, as well as accompanying scheme documentation, particularly investment contracts.

10.5 Categories of Authorised CISs

10.5.1 There are three categories of scheme which can be authorised by the FCA in the UK: (a) UCITS schemes; (b) non-UCITS retail schemes ('NURS') (including a NURS operating as a Fund of Alternative Investment Funds ('FAIF') and an umbrella NURS with sub-funds operating as a mixture of standard NURS and FAIFs); and (c) qualified investor schemes ('QIS').

10.5.2 As both UCITS schemes and NURS are the only types of UK authorised CIS which are permitted to be marketed to retail investors in the UK the following sections will focus predominantly on the regulatory framework that applies to these types of regulated CIS.

[107] Open-Ended Investment Companies (Amendment) Regulation 2011 (SI 2011/3049)
[108] HM Treasury 'Consultation on better regulation for the asset management sector' May 2007

QIS are a form of CIS which may only be promoted to sophisticated investors in accordance with the rules governing the marketing of unregulated CIS[109].

10.5.3 UCITS has become a brand in itself representing 'safety' in the world of investment funds. Investors, regulators and product providers alike have become attracted by the investor protection the UCITS Directive[110] affords and consequently a high level of confidence has grown up around the UCITS product. The fund industry however maintains that we do not have an efficient regulatory framework to allow a free pan European market in collective investment schemes.

10.5.4 'UCITS' stands for 'Undertakings for Collective Investment in Transferable Securities' and are a specific class of collective investment portfolio. The original UCITS Directive was adopted by the European Council on 20 December 1985 with the ultimate aim of making it easier to market UCITS in Member States whilst ensuring a high level of protection for investors. There were clearly problems with the original UCITS Directive – it failed to address the main obstacles that were preventing a true free market to develop. For example, each Member State was still free to impose their own marketing rules, local taxation requirements were variable and the class of assets in which a UCITS could invest was relatively narrow hindering product development.

10.5.5 During the 1990s there was much debate about the steps that needed to be taken in order for UCITS to achieve its original objective. This culminated in proposals being put forward by the EU Commission in 1998 that were formally adopted by the EU in December 2001 and which are generally referred to as UCITS III.[111] The primary aim of the Product Directive[112] was to allow a wider range of financial instruments than the original rather narrow definition of 'transferable securities' permitted. As the current UK market demonstrates, it is now possible to establish a far more dynamic suite of regulated investment funds under the UCITS regime than was originally the case. However, the marketing of UCITS schemes throughout Member States remains a problem: (a) UCITS wishing to undertake marketing in another EEA state must comply with the applicable marketing and advertising rules in the host state; (b) UCITS must maintain certain facilities (including dealing facilities) in the Host State; and (c) the Host

[109] COLL 1.2.2G(3)
[110] Directive 2009/65/EC of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), which replaced the original UCITS Directive (8/611/EEC)
[111] There were actually two directives – the Management Company Directive (2001/107/EC) and the Product Directive (2001/108/EC) that were published on the same day but generally the two are collectively referred to as 'UCITS III'
[112] Council Directive 2001/108/EC amending Council Directive 85/611/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities

State regulator is required to be notified of the proposal for the fund to be marketed within that jurisdiction and has two months in which to object.

10.5.6 The European Commission considered potential amendments to the UCITS Directive and published a white paper in November 2006 which recommended a package of measures. This culminated in the further revised UCITS Directive ('UCITS IV') which was passed by the European Parliament on 13 January 2009. At the heart of the revised Directive is the creation of a genuine European passport for UCITS management companies and the facilitation of cross border marketing. Member States were required to implement the revised Directive by 1 July 2011. HM Treasury and the FSA published a joint consultation on the implementation of UCITS IV in December 2010. The UCITS Regulations 2011 came into force on 1 July 2011 and relevant amendments were made to the FSA Handbook (now the FCA Handbook).

10.5.7 On 3 July 2012 the European Commission published a legislative proposal to amend UCITS IV (UCITS V).[113] UCITS V will, when it comes into force, change the rules governing the role of depositaries, introduce rules on remuneration policies for senior management, risk takers and control functions; and apply a common sanctions regime for UCITS. On 4 December 2013 the Council of the European Union published a press release which stated that a position on UCITS V had been agreed. Negotiations with the European Parliament will commence during Q1 2014, although it is anticipated that UCITS V will not apply until the end of 2015. The UCITS regime continues to evolve with the EU consultation on UCITS VI well underway[114]. UCITS VI is likely to cover areas such as efficient portfolio management techniques the use of over-the-counter derivatives; and money market funds. It is not yet clear when a UCITS VI legislative proposal will be published.

10.5.8 *Operation of UCITS in the UK* - One of the key aims of the UCITS legislation is to protect investors by laying down minimum standards for investments which may be held by UCITS schemes and investment techniques which may be employed. There are specific restrictions governing the spread of investments a UCITS scheme may invest in and the extent to which such schemes may be invested in a particular type of asset, which are designed to ensure that all UCITS schemes operate within a defined investment parameter as laid out in the UCITS Directive. These minimum standards

[113] Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration provisions and sanctions

[114] European Commission Consultation Document, 'Undertakings for Collective Investment in Transferable Securities (UCITS) Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments', 26 July 2012

and restrictions have been implemented in the UK through the FCA's rules and guidance.

10.5.9 Since the implementation of the AIFMD, the FCA's rules relevant to the regulation of AIFs and UCITS are contained in two sourcebooks – the "COLL" Sourcebook and the new, "FUND" Sourcebook. At present FUND is only relevant to the managers of AIFs (including NURS) and not UCITS, however, the intention is that the "FUND" Sourcebook will, eventually, contain the rules relevant to both AIFs and UCITS funds. In the short term COLL and FUND will sit alongside one another. However, it is worth noting that where an AIFM is subject to the requirements of FUND and COLL (e.g. in respect of a non-UCITS Retail Scheme) the effect of FUND 1.1.2R is that if a rule in COLL conflicts with a rule in FUND transposing the AIFMD or the AIFMD level 2 regulation, the COLL rule will be deemed to be modified accordingly.[115] I will focus on the rules in COLL which, as at the date of writing, continues to contain most of the rules applicable to retail funds (so, UCITS and Non-UCITS Retail Schemes) in the UK.

10.5.10 The UCITS Directive defines UCITS schemes as undertakings which: (a) are solely invested in transferable securities and/or other liquid financial assets; (b) operate on the principle of risk-spreading; and (c) whose units may be redeemed directly or indirectly out of its assets at the request of investors.[116]

10.5.11 The types of assets which UCITS schemes are permitted to invest in are: (a) transferable securities; (b) money market instruments; (c) derivatives and forward transactions; (d) deposits; and (e) units/shares in collective investment schemes.[117]

10.5.12 UCITS schemes may also hold cash and near cash in certain circumstances,[118] and may employ investment techniques such as borrowing and stock lending.[119] The scheme property of an OEIC may consist of movable and immovable property necessary for the direct pursuit of the UCITS scheme's business, meaning that it may enter into leases as required in order to carry out its business activities.[120]

10.5.13 UCITS schemes have clearly developed beyond simply investing in transferable securities, a process assisted by the implementation of the Product Directive and the UCITS Eligible Assets Directive[121] (the 'EAD'). The EAD clarified certain terminology

[115] FUND 1.1.3G
[116] UCITS Directive Article 1(2)
[117] COLLG 2A.1.4G(1)(a) to (e)
[118] COLL 5.5.3R
[119] COLL 5.4R, 5.5.4R and 5.5.5R
[120] COLL 5.2.6AR(6)
[121] Commission Directive 2007/16/EC implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions

used in the UCITS Directive and was implemented in its entirety in the UK through changes to the rules and guidance in COLL on 23 July 2008 (although authorised fund managers could elect to implement the changes with effect from 6 March 2008). I next detail the main asset classes and investment techniques that may be employed by UCITS schemes established in the UK.

10.5.14 **Transferable securities** UCITS schemes may invest in 'transferable securities' which include a wide range of instruments such as shares, debentures, bonds, warrants and certificates representing certain securities, where title to the instrument may be transferred.[122] In addition, the liability of the holder to contribute to the debts of the issuer must be limited to any amount which is unpaid by the holder,[123] and the potential loss which the UCITS scheme may incur with respect to the transferable security must be limited to the amount paid for it.[124] The EAD as implemented in COLL provided further clarification as to which types of transferable securities are eligible for investment by UCITS schemes, in particular requiring eligible transferable securities: (a) to be sufficiently liquid; (b) to have available reliable valuation and appropriate information; (c) to be negotiable; and (d) to have adequate risk management processes.[125]

10.5.15 A core requirement of a UCITS scheme is that the AFM must be able to redeem its shares at the request of an investor, except in certain exceptional circumstances (such as suspension of dealings in accordance with COLL 7.2),[126] and the AFM is required to consider the liquidity risk posed by any investment undertaken by the UCITS scheme. A transferable security must not therefore compromise the ability of the AFM to comply with its redemption obligations.[127] Transferable securities which are listed on eligible markets[128] are deemed not to compromise the UCITS scheme's ability to comply with its redemption obligations (unless there is information which would lead the AFM to believe otherwise).[129]

10.5.16 In order to maintain sufficient liquidity, the European Securities and Markets Authority (then known as the Committee of European Securities Regulators ('CESR')) has issued the following guidelines which AFM's should take into account when considering whether to invest in a transferable security: (a) *the volume and turnover in the transferable security; (b) where the price of the transferable security is determined by*

[122] COLL 5.2.7R(1) and (2)
[123] COLL 5.2.7R(4)
[124] COLL 5.2.7AR(1)(a)
[125] COLL 5.2.7AR(1)
[126] Art 84 of the UCITS Directive
[127] COLL 5.2.7AR(1)(b)
[128] As defined in COLL 5.2.10R
[129] COLL 5.2.7AR(2)(a)

supply and demand in the market, the issue size, and the portion of the issue that the AFM intends to buy; (c) evaluation of the opportunity to buy and sell that transferable security; (d) where necessary, an independent analysis of bid and offer prices over a period of time in order to establish the relative liquidity and marketability of the transferable security; and (e) analysis of the quality and number of intermediaries and market makers dealing in the secondary market of the transferable security.[130]

10.5.17 Whilst UCITS schemes may invest all of their scheme property in transferable securities which are listed (i.e. are traded on an eligible market), UCITS schemes may only invest in recently issued transferable securities provided the terms of issue of such instruments include an undertaking that application will be made for those securities to be admitted to an eligible market within one year of issue.[131] It is possible for up to 10% of the scheme property to be invested in transferable securities which are unlisted and which do not comply with the requirements attaching to recently issued transferable securities.[132]

10.5.18 CESR's guidelines state that where instruments are not traded on a regulated market the AFM cannot automatically assume the instruments are liquid and due diligence will therefore need to be undertaken to assess the level of liquidity in order to ensure that the UCITS scheme would meet its redemption requirements.[133] Where the transferable security in question is deemed to be insufficiently liquid to meet foreseeable redemption requests, it should only be purchased if the assets comprising the rest of the portfolio were sufficiently liquid to enable the UCITS scheme to meet its redemption requirements.

10.5.19 UCITS schemes must ensure that reliable valuations are available in respect of the transferable securities it invests in. For transferable securities listed on eligible markets this means accurate, reliable and regular prices which are either market prices or prices made available by valuation systems independent from the issuers.[134] For transferable securities not admitted to or dealt in on an eligible market, valuations must be carried out on a periodic basis derived from information from either the issuer or competent investment research.[135]

10.5.20 UCITS schemes may only invest in transferable securities about which appropriate information is available. Appropriate information concerning transferable securities

[130] CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007
[131] COLL 5.2.8R(3)(e)
[132] COLL 5.2.8R(4)
[133] CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007
[134] COLL 5.2.7AR(1)(c)(i)
[135] COLL 5.2.7AR(1)(c)(ii)

listed on an eligible market means regular, accurate and comprehensive information available to the market, or where relevant, on the portfolio of the transferable security.[136] Information concerning transferable securities which are not traded on an eligible market must be regular and accurate.[137]

10.5.21 UCITS scheme may only invest in transferable securities which are negotiable. Transferable securities which are traded on an eligible market are presumed to be negotiable unless there is information which would lead an AFM to believe otherwise.[138] However negotiability of transferable securities which are not listed cannot be automatically assumed and the liquidity risk must be assessed to ensure compliance with the UCITS scheme's redemption requirements.[139]

10.5.22 The onus is therefore clearly on the AFM and the underlying investment manager of a UCITS scheme to undertake appropriate levels of due diligence in respect of the transferable securities a UCITS scheme will be investing in, and monitor this on an ongoing basis to ensure that the UCITS scheme will be complying with its redemption obligations. In carrying out its responsibilities the AFM is required to maintain adequate records evidencing compliance with the eligibility requirements of the instruments a UCITS scheme will invest in, and to be able to provide this evidence to the trustee as required.[140] In addition the risk of the transferable security must be monitored on an ongoing basis, as well as the contribution to the overall risk profile of the portfolio.[141]

10.5.23 **Transferable securities linked to other assets** Investments which fulfil the above criteria for transferable securities, and which are backed by or linked to the performance of other assets, are regarded as transferable securities for the purposes of COLL.[142] The underlying asset to which the investment is linked is not required to be 'eligible' in accordance with the UCITS Directive.[143] However, if such an investment contains an embedded derivative component it will be regarded as a derivative and the rules in COLL relating to derivatives will apply. AFMs will therefore need to ensure that where such instruments are considered for investment appropriate due diligence is carried out so as to ascertain whether a UCITS scheme is investing in a transferable security or a derivative, and whether these investments will fall within the scope of investment powers applicable to that scheme.

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[136] COLL 5.2.7AR(1)(d)(i)
[137] COLL5.2.7AR (1)(d)(ii)
[138] COLL 5.2.7AR(2)(b)
[139] CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007
[140] COLL 6.6.6R.(1)(a) and (b), and (4)
[141] CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007
[142] COLL 5.2.7ER(1)
[143] COLL 5.2.7ER(1)(b)

10.5.24 **Closed end funds** Units in closed end funds ('CEF') are treated as transferable securities provided that the instruments in question comply with the eligibility criteria set out above in relation to transferable securities.[144] In addition, if a CEF is constituted as an investment trust or a unit trust it must be subject to corporate governance mechanisms applied to companies and where another person carries out asset management activity on its behalf, that person must be subject to national regulation for the purposes of investor protection.[145]

10.5.25 If a CEF is constituted under contract law it must also be subject to corporate governance mechanisms equivalent to those applied to companies, and it is managed by a person who is subject to national regulation for the purposes of investor regulation.[146] Evidence that voting rights of investors in a contractually-based CEF permit investors to vote on the essential decisions of the CEF[147] and control the investment policy of the CEF will, CESR guidance suggests, assist the AFM in deciding whether the corporate governance mechanisms are equivalent to those applied to companies.[148]

10.5.26 Whilst AFMs should not permit UCITS schemes to invest in CEFs in order to circumvent the investment restrictions applicable to UCITS schemes in COLL, the regulator confirmed AFMs are not required to 'look through' to the underlying investments held by the CEF in question.[149] However, AFMs should exercise care when selecting such investments, for example, if a UCITS scheme holds close to the maximum amount permitted in respect of a particular share, the AFM should not acquire a significant shareholding in a CEF which has a major exposure to that same share.

10.5.27 **Derivatives** Changes in COLL resulting from UCITS III and the EAD have meant that product providers have been able to develop innovative investment strategies involving the use of derivatives including structured products which provide exposure to underlying assets using financial indices. Whereas initially UCITS schemes were restricted to investing in derivatives for efficient portfolio management purposes in order to hedge risk within the scheme property, UCITS may now invest in both exchange-traded derivatives and, subject to certain conditions explained below, over-the-counter derivatives ('OTC Derivative') in order to achieve its investment objectives. In line with this expansion to the potential use of derivatives, fund managers must also

[144] COLL 5.2.7CR
[145] COLL 5.2.7CR(1)
[146] COLL 5.2.7CR(2)
[147] Such as the right to vote on the appointment and removal of the asset manager and the merger and liquidation of the CEF
[148] CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007 and COLL 5.2.7DG
[149] FSA Handbook Notice published 29 February 2008, paragraph 4.17

demonstrate that the use of derivatives is adequately managed in accordance with a risk management policy which has been designed to monitor the risk profile of the CIS in question, and which must reflect the particular investment strategy employed. Where a CIS uses a more sophisticated derivative strategy the risk management policy will need to reflect this.[150]

10.5.28 UCITS schemes may only invest in a derivative or forward transaction which is either an approved derivative (which is traded or dealt in on an eligible derivatives market and is effected under the rules of an eligible derivatives market)[151] or an OTC Derivative.[152] In either case the derivative transaction must be fully covered from within the scheme property.[153]

10.5.29 Investment in derivatives must not cause the UCITS scheme to diverge from its stated investment objective, and its exposure to the underlying assets of the derivative transaction must not exceed the spread requirements (except in limited cases in respect of index based derivatives).[154]

10.5.30 *Derivative transactions may consist of the following investments:[155] (a) transferable securities and approved money market instruments; (b) deposits; (c) derivatives; (e) other CIS; (f) financial indices satisfying the conditions in COLL 5.2.20AR; (g) interest rates; (h) foreign exchange rates; and (i) currencies.*

10.5.31 Eligible financial indices potentially provide UCITS schemes with exposure to classes of assets which are not permitted to be held directly within the scheme for example, hedge funds. Financial indices underlying derivatives must be sufficiently diversified, represent an adequate benchmark for the market to which it refers and be published in an appropriate manner.[156] Both the UK regulator and CESR have issued further rules and guidance concerning the eligibility criteria of financial indices.[157] UCITS schemes may not however enter into transactions in derivatives on commodities.[158]

10.5.32 **OTC Derivatives** UCITS schemes may enter into transactions in an OTC Derivative, provided they comply with specific conditions. The OTC Derivative must be with an

[150] The Investment Management Association's 'Derivative Risk Management Process: Guidelines for Managers of UK Authorised Collective Investment Schemes', April 2008
[151] COLL 5.2.20R(1)(a) and (3)
[152] COLL 5.2.20R(1)(b)
[153] COLL 5.2.19R(1)(b)
[154] COLL 5.2.20R(4) and 5.2.19R(2)
[155] COLL 5.2.20R(2)(a) to (i)
[156] COLL 5.2.20AR(1)
[157] COLL 5.2.20AR(2) to (5), COLL 5.2.20BG and CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007
[158] COLL 5.2.20R(8)

approved counterparty being an eligible institution or an approved bank, or a person whose permission (either as published on the FCA register or whose home state authorisation) permits it to enter into the transaction as principal off-exchange.[159] OTC Derivative transactions must also be on approved terms, capable of reliable valuation, and subject to verifiable valuation.[160]

10.5.33 In order to be a permitted derivative transaction the depositary must be satisfied that the counterparty to the OTC Derivative has agreed to provide a reliable and verifiable valuation corresponding to its fair value, which does not rely on market quotations, at least daily and at any other time at the request of the AFM.[161] In addition the depositary must be satisfied that the counterparty (or an alternative counterparty) will at the request of the AFM enter into a further transaction to sell, liquidate or close out that transaction at any time, at a fair value arrived at under the reliable market value basis or pricing model agreed as set out below.[162]

10.5.34 To be a permitted OTC Derivative transaction the AFM, having taken reasonable care, must have determined that it will be able to value the derivative transaction with reasonable accuracy throughout the life of the derivative on the basis of an up-to-date market value which the AFM and the depositary have agreed is reliable, or (if this is not available) on the basis of a pricing model which the AFM and the depositary have agreed uses an adequate recognized methodology.[163]

10.5.35 A permitted OTC Derivative transaction must also be subject to verifiable valuation, meaning that verification of the valuation is carried out either by an appropriate third party which is independent from the counterparty of the derivative, at an adequate frequency and in such a way that the AFM is able to check it, or verification is carried out by a department within the AFM which is independent from the department responsible for managing the scheme property and which is adequately equipped for such a purpose.[164]

10.5.36 The exposure of a UCITS scheme to one counterparty in an OTC Derivative transaction must not exceed 5% in value of the scheme property.[165] Exposure may be reduced using collateral which is: (a) *marked-to-market daily and exceeds the value of the amount at risk; (b) is exposed only to negligible risks and is liquid; (c) is held by a third party custodian not related to the provider or is legally secured from the consequences*

[159] COLL 5.2.23R(1)
[160] COLL 5.2.23R(2), (3) and (4)
[161] COLL 5.2.23R(2)(a)
[162] COLL 5.2.23R(2)(b)
[163] COLL 5.2.23R(3)(a) and (b)
[164] COLL 5.2.23R(4)(a) and (b)
[165] This may be raised to 10% for approved banks - COLL 5.2.11R(7)

of a failure of a related party; and (d) can be fully enforced by the UCITS scheme at any time.[166]

10.5.37 Derivatives transactions are deemed to be free of counterparty risk where they are performed on an exchange where the clearing house is backed by an appropriate performance guarantee and there is daily marked-to-market valuation of the derivative positions and at least daily margining.[167] OTC Derivative transactions with the same counterparty may be netted in accordance with COLL.[168]

10.5.38 **Embedded derivatives** Where a UCITS scheme invests in a transferable security or an approved money market instrument ('MMI') which embeds a derivative the COLL rules relating to derivatives will apply.[169] The characteristics of an embedded derivative are that the transferable security or approved MMI contains a component in respect of which: (a) *some or all cash flows that otherwise would be required by the transferable security or approved MMI which functions as a host contract can be modified according to a specified interest rate, financial instrument price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, and therefore vary in a way similar to a stand-alone derivative; (b) its economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract; and (c) it has a significant impact on the risk profile and pricing of the transferable security or approved MMI.*[170]

10.5.39 A component of a transferable security or an approved MMI which may be contractually transferred independently will not constitute an embedded derivative, instead that component will be deemed to be a separate instrument.[171] FCA guidance gives examples of transferable securities and approved MMI which could be assumed to embed a derivative including: (a) *convertible and exchangeable bonds; (b) credit linked notes; (c) transferable securities or approved MMIs with a fully guaranteed nominal value whose performance is linked to the performance of a basket of shares, with or without active management; and (d) transferable securities or approved MMIs whose performance is linked to the performance of a bond or a basket of shares.*[172]

10.5.40 Collateralized debt obligations ('CDOs') or asset-backed securities using derivatives, with or without active management, will generally not be considered to embed a derivative unless they are leveraged (they are not limited recourse vehicles and the

[166] COLL 5.7.5R(9)
[167] COLL 5.7.5R(11)
[168] COLL 5.7.5R(10)
[169] COLL 5.2.19R(3)
[170] COLL 5.2.19R(3A)(a)
[171] COLL 5.2.19R(3A)(b)
[172] COLL 5.2.19AG(3)

investors' loss can be higher than their initial investment), or they are not sufficiently diversified.[173]

10.5.41 It is the AFM's responsibility to monitor investments embedding a derivative to ensure they comply with COLL in light of the investment objective and policy of the UCITS scheme in question, and the nature and scope of the checks will depend on the type of embedded derivative in question. Use of embedded derivatives is not permitted to enable a UCITS scheme to circumvent the investment rules in COLL.[174]

10.5.42 The global exposure of a UCITS scheme created by derivatives and forwards transactions which it enters into must be covered by the scheme property, taking into account any reasonably foreseeable market movement.[175] The intention is to ensure that a UCITS scheme is not exposed to the loss of scheme property greater than the net asset value of the scheme. AFMs must calculate the cover required on a continuing basis, as frequently as is required, and if a transaction cannot be covered globally the UCITS scheme must withdraw from the transaction.[176]

10.5.43 **Money market instruments** UCITS schemes are permitted to invest in MMIs which are normally dealt in on the money market, are liquid and have a value which can be accurately determined at any time ('approved MMI').[177] MMIs normally dealt on the money market typically include treasury and local authority bills, certificates of deposit, commercial paper, and banker's acceptances.

10.5.44 A money market instrument that is normally dealt in on the money market and is traded on an eligible market will be presumed to be liquid and be capable of accurate valuation at any time unless there is information that would lead the AFM to a different conclusion.[178] Where this cannot be presumed the AFM is required to undertake appropriate assessment of the MMI in question.[179] COLL expands further on the eligibility criteria for maturity, liquidity and accurate valuation of approved MMI.[180]

10.5.45 A MMI is sufficiently liquid if it can be sold at a limited cost in an adequately short time frame, taking into account the UCITS scheme's redemption obligations.[181] AFMs will need to take into account cumulative factors when assessing liquidity of a MMI including the frequency of trades and quotes, the size of the issuance/program and the ability to

[173] COLL 5.2.19AG(1)
[174] CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007
[175] COLL 5.3.3AR and COLL 5.3.3CR
[176] COLL 5.3.3BR
[177] COLL 5.2.7FR
[178] COLL 5.2.7HR(3)
[179] CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007
[180] COLL 5.2.7GR and COLL 5.2.7HR
[181] COLL 5.2.7HR(1)

repurchase, redeem or sell in a short period at a limited cost and with a very short settlement delay. To ensure that investment in any individual MMI will not affect the liquidity of the UCITS scheme AFMs should also consider the structure and concentration of investors in the UCITS scheme and guidelines in the prospectus on limiting withdrawals.[182]

10.5.46 Whilst non-compliance with some of the above factors does not automatically mean that a money market instrument is illiquid, the emphasis again is clearly on an AFM to plan the structure of the portfolio and to ensure that there are sufficiently liquid investments which will permit it to predict and deal with the UCITS scheme's redemption obligations.

10.5.47 A MMI will be regarded as having a value which can be accurately determined if systems are available which enable the AFM to calculate the net asset value in accordance with the value at which the MMI could be exchanged between knowledgeable willing parties in an arms' length transaction, and which is based either on market data or on valuation models including systems based on amortised costs.[183] CESR provides further guidance on the methods which are appropriate.[184]

10.5.48 **Investment in other CIS** UCITS schemes may invest up to 100% of the scheme property in other UCITS schemes, and up to 30% of the scheme property in: (a) *schemes recognized under section 270 of the 2000 Act; and (b) NURS and CIS authorised in another EEA state provided they comply with section 50(1)(e) of the UCITS Directive (i.e. they have equivalent investment and borrowing powers as a UCITS scheme)*[185]

10.5.49 The FCA has been consulting on changes to COLL which will permit UCITS schemes to invest in other CIS which are not authorised in an EEA State, potentially allowing investment in US-based Exchange Traded Funds ('ETFs').[186] However AFMs will need to ensure that the target fund is authorised by the competent authority of an OECD country (other than an EEA state) which has: (a) *signed the IOSCO multilateral memorandum of understanding; and (b) approved the CIS's management company, rules and choice of depositary.*

10.5.50 In addition the target fund will need to comply with article 50(1)(e) of the UCITS Directive. AFMs will therefore need to consider the factors mentioned in CESR's

[182] CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007
[183] COLL 5.2.7HR(2)
[184] CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007
[185] COLL 5.2.13R(1)
[186] Quarterly Consultation Paper 08/16 October 2008

guidance including (but not limited to): (a) *the existence of an independent depositary or custodian; (b) the availability of pricing information and reporting requirements; (c) redemption facilities and frequency; and (d) the extent of asset segregation.*[187]

10.5.51 AFMs will need to decide on a case by case basis whether a CIS (such as a US based ETF) will comply with the specific requirements.

10.5.52 **Covered bonds** Covered bonds have been widely used in Europe but not, until recently, in the UK. Article 52(4) of the UCITS Directive however permits UCITS schemes to invest up to 25% of their scheme property in covered bonds issued by one issuer, and up to 80% in covered bonds as an asset class. This has now been implemented in COLL as part of the EAD changes in parallel with the introduction of legislation which now enables the issue of covered bonds in the UK.[188] A covered bond is a class of bond which is normally issued by banks which is backed by assets such as mortgages or public sector loans. Interest on the bond and the repayment of the principal is secured by ring fencing the assets backing the bond to ensure the priority claim of the bondholders to the assets.

10.5.53 **Government and public securities** UCITS schemes may invest in assets such as government and public securities ('GAPS'), and deposits in accordance with COLL. UCITS schemes may invest more than 35% in GAPS issued by one issuer provided that disclosure of the permitted issuers is made in the constitutional documents, and provided that no more than 30% consists of securities of any one issue and the scheme property includes such securities issued by that or another issuer of at least six different issues.[189]

10.5.54 **Cash and near cash** Cash and near cash may be held in certain cases in order to meet or to enable the efficient management of the scheme's objectives, to enable redemption of units or for other purposes reasonably regarded as ancillary to the scheme's objectives. During an initial offer period however the scheme property may consists of cash and near cash without limitation.[190]

10.5.55 **Borrowing** Borrowing is permitted on a temporary basis, provided that no period of borrowing may exceed three months without the depositary's permission.[191] Borrowing

[187] CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044) March 2007
[188] COLL 5.2.11R(5A)
[189] COLL 5.2.12R
[190] COLL 5.5.3R(1) and (2)
[191] COLL 5.5.4R(5)

is only permitted from an eligible institution or an approved bank, and may not exceed 10% of the scheme property.[192]

10.5.56 Subject to certain exceptions (such as stock lending transactions and acquiring debentures) scheme property may not be lent,[193] nor may it be mortgaged.[194] In tandem with the EAD changes the regulator originally proposed to amend the rules in COLL in order to give AFMs and depositaries more flexibility to grant indemnities, liens and charges over the scheme property however these proposals have not yet been implemented. Currently the ability to give guarantees and indemnities is restricted.[195]

10.5.57 **Efficient portfolio management** As part of the process of implementing the EAD the regulator re-introduced a definition of efficient portfolio management ('EPM') in relation to techniques and instruments which relate to transferable securities and approved MMI. EPM transactions must be (a) *economically appropriate in that they are realized in a cost effective way; (b) they are entered into for one or more of the following specific aims: (i) reduction of risk; (ii) reduction of cost; (iii) generation of additional capital or income for the scheme with a risk level which is consistent with the risk profile of the scheme and the risk diversification rules in COLL.*[196]

10.5.58 **Risk management policy** AFMs of UCITS schemes are required to use a risk management process which enables it to monitor and measure as frequently as appropriate the risk of a scheme's positions and their contribution to the risk profile of the scheme.[197] Previously the risk management process was only required to cover a scheme's derivatives and forwards transactions however following implementation of the EAD in COLL the regulator has clarified the scope of the requirement to reflect the UCITS Directive more accurately.

10.5.59 The AFM is required to notify the FCA of the details regarding the methods for estimating risks in derivatives and forward transactions, the types of derivatives and forwards that will be used in the scheme, the underlying risks and any relevant quantitative limits.[198] In addition AFMs must provide investors with supplementary information regarding the quantitative limits and methods used in the risk management

[192] COLL 5.5.5R(1)
[193] COLL 5.5.6R(1), (2), (3) and COLL 5.5.7R(2)
[194] COLL 5.5.7R(3)
[195] COLL 5.5.9R
[196] Glossary of the FCA's Handbook
[197] COLL 6.12.3R(1)
[198] COLL 6.12.3R(2)

process, and any recent developments in the risk and yield of the main investments held.[199]

10.5.60 The scope of the risk management process will need to reflect the investment objectives and policy of the UCITS scheme and should reflect whether the scheme is 'sophisticated' or 'non-sophisticated',[200] although there is no formal definition of what these terms constitute. This will typically depend on the type of derivatives used, their complexity and their relative importance to the scheme's objectives, for example. AFMs should document how a UCITS scheme is categorized for these purposes.[201]

10.6 Non-UCITS retail schemes

10.6.1 Non-UCITS retail schemes or 'NURS' are CIS which may be marketed to retail investors but because their investment powers are more flexible than UCITS schemes, NURS may not be passported throughout the EEA and therefore cannot be marketed to retail investors outside the UK. Unlike UCITS schemes NURS may invest up to 10% of the scheme property in gold, up to 100% in immovable property and they may invest in a wide range of CIS including unregulated CIS.

10.6.2 **Immovable property** Although NURS may invest entirely in immovable property, the immovable property must comply with specific requirements concerning the nature of the interest the NURS will be acquiring and appropriate valuation.[202] For example, a NURS acquiring immovable property in England, Wales or Northern Ireland must acquire a freehold or a leasehold interest. Broadly, immovable property in other jurisdictions must be an equivalent interest, or an interest which grants beneficial ownership and provides title as good as these interests.[203] Title to any immovable property must be good marketable title.[204]

10.6.3 Prior to acquiring immovable property the AFM must have received a valuation of the immovable confirming that either the immovable would be capable of being disposed of reasonably quickly at that valuation, or if adjacent to another immovable acquired by the NURS, the value of both immovables is equivalent to the price of the immovable and the value of the existing immovable.[205]

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[199] COLL 4.2.3(3)(a)–(b)
[200] Commission Recommendation of 27 April 2004, on the use of financial derivative instruments for undertakings for collective investment in transferable securities (paragraph 3.1)
[201] Derivatives Risk Management Process: Guidelines for Managers of UK Authorised Collective Investment Schemes April 2008
[202] COLL 5.6.18R(2) to (5)
[203] COLL 5.6.18R(2)
[204] COLL 5.6.18R(3)
[205] COLL 5.6.18R(4)

10.6.4 An immovable must be bought or be agreed by enforceable contract to be bought within six months following receipt of the valuation unless the report can no longer be relied upon.[206] Immovable property may not be purchased at more than 105% of the valuation.[207]

10.6.5 Investment restrictions also apply, for example a NURS may not invest more than 20% in mortgaged immovables, and any mortgage must not secure more than 100% of the valuation obtained by the AFM.[208] Also, up to 50% of the NURS may be invested in immovables which are vacant, in the course of substantial redevelopment or refurbishment or are not producing income.[209]

10.6.6 NURS may invest in overseas immovables through an intermediate holding company (or a series of such vehicles) in the form of a company, trust or partnership. Investment via an intermediate holding vehicle is usually more tax efficient and may be required in some jurisdictions. Investment in overseas immovables via an intermediate holding vehicle is treated as direct investment in the immovable therefore the NURS is not subject to the applicable rules governing investment in unapproved securities for example.[210] The AFM must ensure that unitholders are adequately protected.

10.6.7 Immovables held within the scheme property must be valued annually by a standing independent valuer, including a physical inspection, such valuation to be reviewed monthly.[211] Valuations must be undertaken in accordance with the specific industry methods set out in COLL.[212]

10.6.8 **Property authorised investment funds or 'PAIFs'** The PAIF regime was introduced in 2008 to allow investors to invest in an open ended fund whilst being treated for tax purposes as though they had directly invested in the property (the open-ended equivalent to a real estate investment trust). The fact that the first PAIF was authorised in 2010 is in no small part due to the sophisticated administration systems required to operate the income streaming for these funds as well as the economic circumstances of the last couple of years. The requirements of the relevant tax legislation combined with the FCA"s authorisations regime means that PAIFs require HMRC as well as FCA approval.

[206] COLL 5.6.18R(5)
[207] COLL 5.6.18R(5)(c)
[208] COLL 5.6.19R(5)
[209] COLL 5.6.19R(7)
[210] COLL 5.6.18AR
[211] COLL 5.6.20R(3)(a) and (c)
[212] COLL 5.6.20R(3)(f)

10.6.9 **Other permitted investments** Transferable securities and MMIs held by NURS may be admitted to or dealt in on an eligible market, be recently issued transferable securities in accordance with COLL, or approved MMI not admitted to or dealt in on an eligible market provided they comply with the requirements applicable to investment by UCITS schemes.[213]

10.6.10 However NURS may also invest up to 20% in transferable securities which fall outside these requirements and MMI which are liquid, and have a value which may be determined accurately at any time.[214] NURS may invest up to 10% in transferable securities or MMI issued by the same body, which is raised to 25% in respect of covered bonds.[215]

10.6.11 There is no limit to the extent to which NURS may invest in covered bonds as an asset class. NURS may also invest more than 35% in GAPS provided they comply with the requirements applicable to UCITS schemes with the exception that disclosure is required only in the prospectus.[216]

10.6.12 NURS may invest in a wider range of other CIS, including recognised schemes, schemes constituted outside the UK which have similar investment and borrowing powers as NURS. NURS have additional flexibility in that the second scheme must itself be prohibited from investing more than 15% in other CIS.[217]

10.6.13 **Funds of alternative investment funds** Product innovation and increasing popularity of alternative products such as hedge funds led the FSA in 2010 to introduce the Fund of Alternative Investment Fund ('FAIF') regime into the UK regulated market in order to achieve a better balance between consumer protection and access to investment products. However, to date, few FAIFs have actually been launched.

10.6.14 FAIFs are a type of NURS which may invest up to 100% of scheme assets in unregulated collective investment schemes, subject to a number of restrictions. The investment powers for FAIFs are contained in COLL 5.7.7R, which sets out that a FAIF must not invest in units in a collective investment scheme (the 'second scheme') unless the second scheme is a scheme which satisfies the criteria for investment by a standard NURS (a UCITS, a NURS, a recognized scheme or a scheme which is constituted outside the UK in respect of which the investment and borrowing powers are the same or more restrictive than those of a NURS), or alternatively the second scheme: (a)

[213] COLL 5.6.5R(1)(a) to (c)
[214] COLL 5.6.5R(2)(a) and (b)
[215] COLL 5.6.7R(3) and (3A)
[216] COLL 5.6.8R(2)
[217] COLL 5.6.10R(3)

operates on the principle of a prudent spread of risk; (b) is prohibited from investing more than 15% of its value in other collective investment schemes or, if there is no such prohibition, the NURS's authorised fund manager is satisfied, on reasonable grounds and after making all reasonable enquiries that no such investment will be made; (c) the participants in the second scheme must be entitled to have their units redeemed in accordance with the scheme at a price (i) related to the net value of the property to which the units relate; and (ii) determined in accordance with the scheme; and (d) where the scheme is an umbrella, provisions (a)–(c) above, apply to each sub-fund as if it were a separate scheme.

10.6.15 However, in order to balance the added investment flexibility of a FAIF, certain due diligence requirements apply to the authorised fund manager to ensure that the second scheme is suitable for investment by the fund.[218]

10.7 Qualified investor schemes

10.7.1 A QIS is an authorised CIS which is only open to investment by institutional or sophisticated investors who have sufficient expertise to understand the risks associated with investment in such CIS. AFMs are responsible for ensuring that only eligible investors may purchase units in QIS.[219] Promotion is restricted because QIS have wider investment and borrowing powers and therefore greater operational flexibility. For example QIS may invest directly in precious metal, commodity contracts, may borrow up to 100% of their net value and may invest up to 100% in unregulated CIS (subject to certain conditions).[220] Due to the less restrictive investment powers greater emphasis is placed on the information contained in the prospectus of a QIS.

10.7.2 Despite this flexibility QIS have not been attractive commercially largely because investors holding 10% or more of the NAV of a QIS were subject to a tax charge (the 'substantial holding rule'). HM Revenue & Customs ('HMRC') have replaced this restriction with the 'genuine diversity of ownership rule', removing the additional tax charge - provided participation is not limited to specific individuals or participants.[221]

10.8 Powers and duties of the authorised fund manager and trustee

10.8.1 AFM - The AFM (which in this section refers to both the authorised fund manager of a unit trust and the ACD of an OEIC) is responsible for the day to day management and operations of the CIS in accordance with the applicable rules in the Instrument or trust

[218] COLL 5.7.9R
[219] COLL 8.1.3R(1)
[220] COLL 8.4.4R and 8.4.5R
[221] HMRC 2008 Pre-Budget Report, 'Qualified Investor Schemes' PBRN07, 24/11/08

deed, COLL, the prospectus and, in respect of an OEIC, the OEIC Regulations.[222] The AFM is therefore responsible for certain specific functions including arranging for the issue and cancellation of shares, valuing the scheme property, calculating the price of shares in a CIS and maintaining the register of shareholders. In addition the AFM is also responsible for ensuring that the investment decisions are made in line with the investment objectives and policy of the CIS.[223] Whilst the AFM is responsible for these functions it may delegate the performance of these functions to third parties.

10.8.2 Except in certain limited circumstances a breach of the investment and borrowing restrictions of a CIS must be rectified at the cost of the AFM as soon as reasonably practicable having regard for the interests of the investors in the CIS.[224] Exceptions to this rule might include where due to market movements in prices the holding of an investment increases and exceed the levels set out in COLL. Timescales for correction of an investment made in error range from five days in relation to a derivative transaction, six months for other assets except for immovable property in respect of which the AFM has up to two years to restore compliance.[225]

10.8.3 In the event of an error in the pricing of units or the valuation of scheme property the AFM may be required to reimburse those parties affected including current and former investors and the CIS itself, depending on the error and whether the trustee considers the breach to be material.[226]

10.8.4 Trustee - The trustee (which in this section refers to both the depositary of an OEIC and authorised contractual scheme and the trustee of a unit trust) acts in an oversight capacity, being responsible for ensuring that the CIS is managed by the AFM in accordance with the relevant rules in COLL, the Instrument or trust deed and prospectus relating to the permitted investment and borrowing powers, dealing in the CIS, valuation of the scheme property, pricing of units and allocation of income.[227] In so doing, the depositary is required to act solely in the interests of investors in the CIS.[228] For example, where a CIS invests in other schemes operated by the AFM or an associate of the AFM the trustee is required to exercise voting rights in accordance with what it believes is the best interests of investors in the CIS.[229] Additionally the AFM is

[222] COLL 6.6.3R(1)
[223] COLL 6.6.3R(3)(a)
[224] COLL 6.6.14R(2)
[225] COLL 6.6.14R(5)
[226] COLL 6.6.3R(3)(c)
[227] COLL 6.6.4R(1)(a) to (e)
[228] COLL 6.6.4R(3)
[229] COLL 6.6.13R(2)

required to provide the trustee with information concerning the management and operation of the CIS which the depositary may require.[230]

10.8.5 As part of the trustee's responsibility for safekeeping the scheme property of the CIS, the trustee is also required to ensure that all transactions are completed properly, such that it has custody of title documents which are registered to the depositary for example.[231] The trustee must carry out any instructions received from the AFM requiring it to exercise any rights in respect of an investment.[232] However, the trustee may require the AFM to cancel a transaction (or secure restoration of the previous situation) where an investment falls outside the scope of the CIS's permitted investment and borrowing powers.[233] In addition the trustee's prior consent must be obtained before a NURS invests in or disposes of immovable property.[234] If an acquisition of property means that the documents evidencing title to that property must be kept by a third party and the depositary cannot reasonably be expected to accept the responsibility for custody it may request that the transaction be cancelled.[235]

10.8.6 Delegation - Both the trustee and the AFM may delegate the performance of their duties to a third party, subject to certain conditions. For example, the AFM may not delegate investment management to the depositary or to persons whose interests may conflict with the AFM or investors, or any person without the appropriate authorisation.[236] The AFM must also ensure that any such delegation will allow it to effectively monitor and instruct the delegate, and to withdraw the delegation immediately where it is in the interests of investors.[237]

10.8.7 The depositary is also restricted as to the persons to whom it may delegate its oversight and custody function, for example the AFM is not permitted to carry out these functions on behalf of the trustee.[238] If a trustee appoints an associate to carry out certain delegated functions under COLL the trustee will remain liable for the actions of that associate, however the liability of the trustee is restricted under regulation for other delegates, provided it was reasonable for the delegate to be appointed, the delegate was a competent person and carried out the functions in a competent manner.[239]

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[230] COLL 6.6.6R(4)
[231] COLL 6.6.12R(1)
[232] COLL 6.6.3R(3)(b) and COLL 6.6.13R(1)
[233] COLL 6.6.10R(3)
[234] COLL 6.6.10R(2)
[235] COLL 6.6.10R(4)
[236] COLL 6.6.15AR(2)(a)
[237] COLL 6.6.15AR(2)(b) to (d)
[238] COLL 6.6.15R(4)
[239] COLL 6.6.15R(5)