# Consultation on better regulation measures for the asset management sector

May 2007

HM TREASURY

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# 1 BETTER REGULATION AND ASSET MANAGEMENT

## THE BETTER REGULATION AGENDA IN FINANCIAL SERVICES

**1.1** HM Treasury is responsible for ensuring that the overall regulatory framework in the UK for financial services is optimal and flexible to market developments. HM Treasury radically overhauled the system between 1997 and 2001 to establish the FSA, a world-leading model which many other countries including Japan, Germany and Sweden have subsequently sought to emulate. HM Treasury merged nine regulators into one to exploit regulatory synergies and efficiencies and to provide industry and consumers with a one-stop shop - successfully pioneering an approach which laid the foundations for other regulatory mergers being undertaken following Philip Hampton's review.

**1.2** HM Treasury provided the new regulator, the FSA, with modern powers backed by an effective accountability framework. Outdated legislation and self-regulatory arrangements were replaced with a single statute, the Financial Services and Markets Act 2000 (FSMA). The FSA covers almost all regulated financial activity. The FSA has four statutory objectives:

- market confidence;
- public awareness;
- the protection of consumers; and
- the reduction of financial crime.

**1.3** The purpose of financial regulation is to make financial markets work better, more efficiently, more fairly, and to avoid financial instability. Financial markets can suffer from significant and pervasive market failures. Regulation aims to address these market inefficiencies and asymmetries of information, reduce uncertainties, keep markets free from fraud and abuse, improve market stability and raise confidence. Put simply, financial markets cannot operate without an underpinning regulatory framework and the vast majority of regulated firms believe regulation benefits their industry.

**1.4** Effective regulation is one of the most important competitive factors determining the attractiveness of international financial centres. One reason why London has moved further ahead of Paris and Frankfurt in the perception of market practitioners, and one of London's comparative advantages over New York, is the UK's regulatory regime. Firms derive a reputational advantage from well-regulated markets but that regulation needs to be proportionate and appropriate. The move towards a more risk-based approach with lower administrative burdens on business will benefit consumers and investors because it frees up regulators to target enforcement on the most risky businesses or on those with a poor track record of compliance. Ineffective regulation, by contrast, can either needlessly over burden businesses or permit market failures that damage confidence and market efficiency.

## THE ASSET MANAGEMENT SECTOR

**1.5** Asset management is a key strength of the UK financial services sector, with more than £3 trillion in assets managed from the UK.[1] As with all financial services, regulation of the asset management sector is primarily the responsibility of the Financial Services Authority (FSA). However, some of the rules governing the sector's activities are also contained in Treasury legislation. HM Treasury is committed to acting where appropriate to ensure these aspects of legislation provide an appropriate framework and do not impose unnecessary costs on the financial services sector. In line with the Treasury's better regulation agenda, this consultation seeks views on three proposals to reform aspects of the legislation with the aim of reducing regulatory costs for UK asset managers and promoting international competitiveness:

- **facilitating paperless settlements** – changing the law to facilitate the electronic redemption or transfer of an investor's fund shares or units.
- **introducing a protected cell regime for Open Ended Investment Companies (OEICs)** – reforming OEIC legislation to allow segregation of liability between sub-funds within umbrella companies.
- **reforming notification requirements for non-UK Undertakings for Collective Investment in Transferable Securities (UCITS)** – amending the Financial Services and Markets Act 2000 (FSMA) so that non-UK UCITS can begin marketing in the UK immediately the FSA is satisfied they meet the relevant requirements rather than making them wait the current minimum of two months.

**1.6** The Government believes these proposals have the potential to deliver substantial regulatory savings for the asset management sector. The attached partial regulatory impact assessment suggests that these could amount to between £70 million and £290 million per year with the vast majority coming from the proposal on paperless settlement.

**1.7** The Government would be interested in suggestions from stakeholders for any further improvements which could be made to those elements of the regulatory framework for asset management contained in Treasury legislation.

1. Do you have any further suggestions for improvements to those aspects of the regulatory framework for asset management contained in Treasury legislation?

[1] Source: Investment Management Association Press Release of 4 July 2006.

# 2 Facilitating paperless settlements

**2.1** OEICs and authorised unit trusts (AUTs) are open-ended collective investment funds authorised by the FSA. Because they are open ended, investors can and generally do redeem their investments by selling their shares (in the OEIC) or units (in the AUT) back to the fund's management company. The Law of Property Act 1925 (LPA) only provides for these redemptions or transfers to be made in writing. Although the initial instruction can be made electronically, it must be confirmed by a written instruction from the investor.

**2.2** The requirement for paper settlement and transfer of title costs fund managers, stockbrokers, financial advisers and other intermediaries money. With a view to reducing the burden of these legal requirements, the Investment Management Association produced in 2003 a model Coverall Renunciation. This is intended to function broadly as a one-off direction from the holder of fund shares or units to the fund manager, informing it that the shares or units may be redeemed on notice from their holder or a firm nominated by that holder. However, there is legal uncertainty as to their effectiveness as a transfer instrument and an express permission to settle by electronic means appears clearly preferable.

**2.3** Outside the funds arena purely electronic settlement is becoming the norm. Electronic communications are also increasingly relied upon in retail financial services markets, for example banking and insurance. This suggests that electronic systems are sufficiently advanced to provide a secure and effective mechanism for transfer of title.

**2.4** As the asset management industry develops, electronic systems are becoming increasingly central and increasingly efficient. Growing use of platforms and wraps, where a firm holds a large holding in a fund on behalf of many small investors, alongside increasing standardisation of back office functions are two of the factors which suggest that the asset management sector could derive significant benefit by being allowed to settle trades electronically. The partial regulatory impact assessment at Annex A estimates annual administrative savings from allowing paperless settlement at between £70 million and £290 million.

> 2. Do you agree that the law should be changed to allow paperless settlement of trades in OEIC shares and AUT units?

**2.5** The Electronic Communications Act 2000 gives the Government power to modify provisions in legislation to facilitate or authorise the use of electronic communications to do anything which such provisions require to be done in writing and authorised by a paper signature. We propose to use this power and a power in the Financial Services and Markets Act 2000 (FSMA) to modify the effect of the LPA to facilitate purely electronic transfers of units in AUTs and shares in OEICs. We propose that this electronic alternative be subject to the condition that the company has taken reasonable steps to satisfy itself that the communication has been made by the person who has the right to assign the legal title to such units or shares or by his duly authorised agent.

3. If paperless settlement is to be allowed, what standards should be applied to ensure investor protection is maintained? Is the proposed requirement to "take reasonable steps" appropriate and sufficient?

**2.6** In the case of OEICs, achieving this would require a statutory instrument under the powers conferred in FSMA. At present, there is a discrepancy between the treatment of AUTs and OEICs. Whereas the transfer of AUT units may be made by the unitholder or his agent and our proposals would facilitate the electronic transfer of AUT units by the unitholder or his agent, there is no provision for transfer of OEIC shares by the shareholder's agent. In general, we aim to ensure equivalent treatment for OEICs and AUTs so we would like to take this opportunity to introduce a provision to allow electronic transfers of OEIC shares by the shareholder's agent. This would not entirely address the discrepancy between OEICs and AUTs as it would not provide for paper-based transfer and settlement of OEIC shares by an agent. However, we are not aware that this has proved a problem in practice with the present legislation. Amending it could also raise issues of consistency with the rules governing paper transfers of other types of shares. We therefore do not propose action in this area, but would welcome feedback on this point. The draft statutory instruments are at Annex B.

**2.7** We are confident that this would maintain an appropriate level of investor protection. The legislation would still allow for paper-based settlement. The FSA would make any amendments to its own rulebook which were required as a consequence of the proposed changes.

4. Would it be appropriate for provision to be made to allow electronic transfer of OEIC shares by a duly authorised agent but to make no provision for paper transfer of OEIC shares by an agent?

5. Do you think the draft statutory instruments provide adequately for the possibility in the context of an electronic communication of more than one person having the right to transfer the legal title to the AUT units or OEIC shares?

## The Stock Transfer Act 1963

**2.8** The Stock Transfer Act 1963 (STA) makes provision for the transfer of "registered securities" (as defined in 1(4)(e) and (f) to include AUT units and OEIC shares). It does not expressly foresee such transfer being made by electronic means. However, the provisions of the STA are not exhaustive. It makes provision for certain means of transfer but does not exclude others provided for elsewhere. In particular, section 1(3) of the STA begins:

> *"Nothing in this section shall be construed as affecting the validity of any instrument which would be effective to transfer securities apart from this section…"*

**2.9** The Government therefore believes that the provisions for paperless settlement described above can be made without prejudice to, and without the need for modification of, the provisions of the STA.

6. Do you agree that adequate provision for paperless transfer and settlement of OEIC shares and AUT units can be made without modification of the Stock Transfer Act 1963?

## The Uncertificated Securities Regulations 2001

**2.10** The Uncertificated Securities Regulations 2001 (the USRs) enable title to units of a security to be evidenced otherwise than by a certificate and transferred otherwise than by a written instrument. They also make provision for the authorisation of 'relevant systems' under which such transfers may be made. The above proposals to allow paperless settlement would be made without prejudice to the provision under the USRs for electronic transfer through a relevant system. The Government is aware that consideration is being given to facilitating transfer of OEIC shares and AUT units through CREST, a relevant system authorised under the USRs. The Government has an open mind as to the most appropriate route for electronic transfer under the various relevant circumstances and believes that a general provision for paperless settlement as proposed here could be an effective complement to the more specific provisions of the USRs. We are also aware of certain reservations about potential inconsistencies between the OEIC regulations and the USRs and would be interested to hear from stakeholders on any amendments to the OEIC regulations that might be required to address this situation.

7. Do you agree that a general provision for paperless settlement of transfers of OEIC shares and AUT units could be an effective complement to the more specific provisions for electronic transfer under the USRs?
8. Are there legislative barriers to electronic transfer of OEIC shares and AUT units under the terms of the USRs? What action would be needed to remove them?
9. Would the potential for differential treatment of electronic settlement and transfers of AUT units and OEIC shares under these proposals and electronic transfers of equities and bonds under the USRs raise any concerns?
10. Do you have any other comments on the draft Statutory Instruments?

# 3 Introducing a protected cell regime for OEICs

**3.1** OEICs are investment funds structured as bodies corporate. Large fund managers generally operate a small number of OEIC umbrella companies with a large number of sub-funds within each umbrella. This helps them to operate a large range of funds more efficiently. Under current law, there is no segregation of liabilities between different sub-funds. For example, if an umbrella fund contained one cautious UK bond fund and one high-risk Far-East equity fund and the Far-East equity fund collapsed with liabilities exceeding its assets, creditors would have a claim on the assets of the UK bond fund. Investors in the cautious fund therefore bear some of the risk of the riskier fund.

**3.2** In practice, the probability of an OEIC collapse is small. OEICs must comply with borrowing limits imposed by the FSA. OEICs authorised as UCITS may borrow up to 10 per cent of their assets, but this borrowing must be temporary. OEICs authorised as non-UCITS retail schemes (NURSs) may also borrow up to 10 per cent of assets but with no requirement for the borrowing to be temporary. In addition to this, NURSs may borrow up to 20 per cent of assets to invest in immoveable property, although total borrowing (including borrowing under the general borrowing power) may not exceed 20 per cent. OEICs structured as Qualified Investor Schemes (QISs) may borrow up to 100 per cent of net assets. However, we are not aware of any QISs structured as OEIC umbrellas with multiple sub-funds.

**3.3** In addition to these borrowing facilities, OEICs may also use derivatives to gain additional exposure. For a UCITS, NURS or QIS there are no maximum limits imposed for investment purposes, but the exposure generated must be fully covered by scheme property. Therefore, a scheme can achieve 100 per cent exposure to derivatives. This 100 per cent exposure can be extended by the use of the borrowing allowance, making the absolute total 110 per cent.

**3.4** So although it is small, the risk of an OEIC insolvency is not zero. Although FSA rules require disclosure of the contagion risk in the fund prospectus and periodic reports there remains some risk that some OEIC investors may not fully understand it. This suggests that, provided adequate protection of existing creditors could also be achieved, segregating liabilities so that the liabilities of any one sub-fund could only be met out of the assets of that sub-fund (effectively giving each sub-fund limited liability status) could be desirable. Internationally, this type of segregated liability sub-fund is known as a 'protected cell'.[2]

**3.5** Another advantage of allowing protected cell OEIC sub funds in the UK would be improving international competitiveness. Protected cells have been introduced in several other jurisdictions and have become an expected feature of a corporate fund vehicle. The Government is aware that some UK fund managers have had difficulty marketing UK OEICs overseas because of confusion or mistrust stemming from the unsegregated nature of liabilities between sub-funds. The Government would therefore like to consider developing a protected cell regime for UK OEICs.

> 11. Do you support the proposal to develop a protected cell regime for UK OEICs?

[2] In this paper the terms 'protected cell' and 'segregated liability' are used interchangeably.

**3.6** The proposal to develop a protected cell regime raises a number of secondary questions. Most fundamental is deciding to which OEICs the reform should apply and whether it should be voluntary or compulsory.

**3.7** For new OEICs, the issue is relatively simple. Protected cell status could either be made voluntary or compulsory. A voluntary solution would allow greater flexibility but would also involve greater complexity. If investors did not fully understand the protected cell issue, there is a risk that managers might not take investors' interests fully into account when deciding what structure to adopt. A hybrid solution could be to make protected cell status compulsory for new OEICs to be offered to retail investors (UCITS and NURSs) but optional for new QISs. However, the additional flexibility this would offer in practice might be limited given that OEIC umbrella structures are not customarily used for QISs. On balance, the simplest and most effective solution would seem to be to require protected cell status for all new OEIC umbrellas.

12.Should protected cell status be compulsory or voluntary for new OEICs? Should there be any differentiation in the rules between schemes aimed at the retail and wholesale markets?

**3.8** For existing OEIC umbrellas, the question of conversion to protected cell status becomes much more complex. Many of these OEIC umbrellas already have liabilities agreed on the basis of non-segregated liability. A conversion to segregated liability would imply a worsening of credit terms for creditors since they would only have access to the assets of one sub-fund in the event of insolvency, reducing their expected recovery. In view of this, the Government does not believe that compulsory conversion of existing OEICs to protected cell status would be a sensible option. This leaves two main options – either make provision for existing OEIC umbrellas to convert to protected cell status on a voluntary basis or make no provision for conversion. Given the justification for introducing a protected cell regime discussed above, making provision for conversion appears the most desirable option.

13.Do you agree that provision should be made to allow existing OEIC umbrellas to convert to protected cell status?

**3.9** If provision is to be made for existing OEICs to convert to protected cell status, the key issue is the procedure by which conversion should be made and particularly how consent should be sought from affected stakeholders. The two key groups are creditors and shareholders. Creditors may have reason to oppose conversion to protected cell status since in the event of default, their expected recovery would be reduced. It therefore seems that unanimous consent from creditors should be required prior to conversion. If consent was not forthcoming, the OEIC manager could seek to renegotiate credit terms to facilitate an agreement.

**3.10** The second question is whether consent from shareholders should be required. FSA rules require prior shareholder consent for "fundamental" changes to the structure of the OEIC. "Significant" changes can be introduced with prior written notice to investors. If agreement can be reached with creditors, it appears unlikely that shareholders would ever oppose conversion to protected cell status since, other than the possibility of borrowing on slightly more favourable terms, they gain nothing from maintaining unsegregated liability. If there is no significant possibility of shareholders refusing conversion to protected cell status, the costs of requiring prior approval are unlikely to be justified. We would therefore be inclined not to require prior shareholder approval.

14. Do you agree that unanimous creditor approval should be required for conversion to segregated liability?

15. Do you agree that prior shareholder approval should not be required for conversion?

16. What impact would conversion to protected cell status have on creditors? Would creditors be likely to oppose conversion or demand compensation from OEIC borrowers in order to permit conversion to a protected cell?

**3.11** If and when protected cell status is achieved, there is a question over the extent to which protection should be applied. The central principle that the liabilities of one sub-fund should not be discharged with the assets of another sub-fund has been established. However, there are also questions relating to the assets and liabilities of the umbrella itself – whether the assets of the umbrella may be used to discharge the liabilities of the sub-fund(s) and whether the assets of the sub-fund(s) may be used to discharge the liabilities of the umbrella.

**3.12** Preventing access to the assets of the sub-fund(s) in the event of default by the umbrella does not appear a realistic option – if the umbrella were wound up, it is not clear how the sub-funds could continue to operate. However it does appear desirable to prevent access to the assets of the umbrella in the event of an individual sub-fund default. This seems to be a logical extension of the central aim of preventing the effects of one sub-fund default spilling over into other sub-funds. Using the assets of the umbrella to pay the liabilities of a sub-fund could impair the functioning of the whole OEIC, for example if the umbrella held real property which the OEIC used in carrying on its day-to-day business.

17. Do you agree that assets in individual sub-funds should not be protected in the event that the umbrella becomes insolvent?

18. Do you agree that the assets of the umbrella should be protected where one or more sub-funds becomes insolvent?

## Other issues

**3.13** There are a number of other subsidiary issues to be resolved. The first is whether protection from cross-liability should apply in the event of fraud. There is an argument that it should not, particularly if liabilities had been fraudulently transferred or misrepresented. In addition, retail investors should in general be compensated by the management company or the Financial Services Compensation Scheme in the event of losses due to fraud.

19. Do you agree that protection from cross-liability should not apply in cases of fraud?

**3.14** Protected cell status implies that a sub-fund must be able to be wound up separately from the rest of the umbrella. As there is currently no provision for winding up an individual sub-fund, the procedure by which it would be wound up would have to be defined. The Government believes that the winding up procedure already established in articles 31 to 33 of the OEIC Regulations 2000 could be applied to individual sub-funds, although some modifications may be required.

20. Do you agree that the existing procedure for winding up OEICs could be applied to winding up individual OEIC sub-funds? What modifications might be needed?

**3.15** Given that any of the three broad approaches to implementing segregated liability would be likely to involve a substantial transition period where some OEIC umbrellas would have protected cell status and others not, it would be important that OEIC umbrellas clearly disclosed their status to actual and potential investors and creditors.

21. Do you agree that if a protected cell regime is introduced, OEIC umbrellas should be required to disclose their status clearly to actual and potential investors and creditors? How should such a requirement be specified and enforced?

22. Are there other measures that could be pursued to address issues around this transition period?

## Enforceability

**3.16** The Government is aware that in jurisdictions where protected cell regimes are already in place, there remains some uncertainty about the enforceability of segregated liability, particularly in respect of cross-border credit transactions. It is likely that in the event of a sub-fund insolvency where the umbrella continued to operate, creditors who had not been fully repaid because of segregated liability provisions would explore the possibility of challenging those provisions. We would be interested in views on the extent of the risk that protected cell provisions may not stand up to legal scrutiny and suggestions on how they might be made as robust as possible.

23. Is there a significant risk that segregated liability might not be enforceable in the event of a sub-fund insolvency where the umbrella continued to operate? How could that risk be minimised?

## Relevance to Authorised Unit Trusts

**3.17** The view has been expressed that existing trust law makes sufficient provision for segregation of liability in umbrella schemes structured as AUTs. The Government does not therefore intend to pursue further legislation to make explicit protected cell provisions for AUTs. We would be interested in stakeholders' views on whether existing law would in fact be effective in ensuring segregated liability between sub-funds in an AUT umbrella or whether legislative action in this area should be considered.

24. Do you believe that any further legislation would be needed to ensure effective segregation of liability between sub-funds in AUT umbrella arrangements?

## Developing the proposals

**3.18** There is no draft statutory instrument attached for the proposals on protected cells. The Government intends to review comments from stakeholders and, if there is widespread support for the principle of developing a protected cell regime, bring

forward concrete proposals taking into account suggestions received. We would also welcome any comments on any aspects of a possible protected cell regime which are not specifically covered in this consultation.

25. Do you have any further comments on the most desirable approach to developing a protected cell regime?

# 4 Reforming notification rules for non-UK UCITS

**4.1** Under the UCITS Directive, investment funds authorised in another EU Member State and subject to the UCITS rules may be marketed in the UK without requirement for further authorisation. The fund, or its distributors, are required only to comply with UK marketing rules which are not harmonised under the UCITS Directive. The UCITS Directive states that funds must notify the 'host' regulator of their intention to begin marketing units in the new jurisdiction. The host regulator then has two months in which to raise any concerns relating to the fund's marketing procedure before it can begin marketing. Under the FSMA rules which implement UCITS, the fund must currently wait the full two months before it can begin marketing, even if the FSA is satisfied that the relevant requirements are met before that. The FSA receives around 40 new notifications per year. For around 80 per cent of those, the FSA's consideration of the notification is completed within one month.

**4.2** The Government therefore proposes to amend the Financial Services and Markets Act 2000 (FSMA) so that a fund may begin marketing either where the two-month period has expired and the FSA has raised no objections or as soon as the FSA is satisfied that its requirements have been met, whichever is sooner. This would remove unnecessary delays in the large majority of new notifications which the FSA can approve quickly.

**4.3** The European Commission has proposed a more fundamental reform to the UCITS Directive rules on notification which would cut the two-month delay more substantially. The Government strongly supports these proposals and is pushing to ensure they are agreed and implemented as soon as possible. However, pending the adoption of any more fundamental reform, we believe it is still worthwhile to implement this more minor deregulatory measure. A draft statutory instrument is at Annex C.

26. Do you agree that FSMA should be amended to allow incoming UCITS to begin marketing as soon as they have received approval from the FSA?

27. Do you have any comments on the draft Statutory Instrument?

# 5 Responding to the consultation

**5.1** The Government would welcome responses on its proposals to deliver better regulation for the asset management sector, facilitating paperless settlement and transfer of OEIC shares and AUT units, developing a protected cell regime for OEICs and streamlining the notification procedure for non-UK UCITS.

## How to respond

**5.2** The Government would welcome the views of all stakeholders on the issues raised in the document. The consultation begins with the publication of this document and will last for a period of 12 weeks. Please respond by 1 August 2007. Responses to the consultation should be sent to:


Tom Springbett
Savings and Investment Team
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1 Horse Guards Road
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SW1A 2HQ

Tel: 020 7270 4356

Email: tom.springbett@hm-treasury.gov.uk


**5.3** This document can be found on the Treasury's website at www.hm-treasury.gov.uk. When responding, please state whether you are responding as an individual or as part of an organisation. If responding on behalf of a larger organisation, please make it clear whom the organisation represents and, where applicable, how the members' views were assembled.

## Confidentiality

**5.4** All written responses will be made public on HM Treasury's website unless the author specifically requests otherwise. In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded for the purpose of publishing responses unless an explicit request for confidentiality is made in the body of the response. If you wish, part, but not all, of your response to remain confidential, please supply two versions – one for publication on the website with the confidential information deleted, and other confidential version for the team managing the consultation.

**5.5** Even where confidentiality is requested, if a request for disclosure of the consultation response is made in accordance with the freedom of information legislation, and the response is not covered by one of the exemptions in the legislation, the Government may have to disclose the response in whole or in part.

**5.6** Further information on the consultation process can be found in Annex D that sets out the Cabinet Office's Code of Practice for Written Consultations.

## Partial regulatory impact assessment

**5.7** The partial regulatory impact assessment is included at Annex A.

**5.8** The Partial RIA lays out implementation options for the areas highlighted above and considers qualitative, and where possible, quantitative costs and benefits for the options.

**5.9** A copy of the Partial RIA can be found on HM Treasury's website - www.hm-treasury.gov.uk - or requested through HM Treasury's correspondence and enquiry unit. Contact details can be found at http://www.hm-treasury.gov.uk/contact/contact_index.cfm.

## CABINET OFFICE CODE OF PRACTICE ON WRITTEN CONSULTATIONS

**5.10** The Cabinet Office has published a Code of Practice for Written Consultations to guide Departments' activities in this area which sets down the following criteria:

- Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy;
- Be clear about what the proposals are, who may be affected, what questions are being asked, and the timescale for responses;
- Ensure the consultation is clear, concise and widely accessible;
- Give feedback regarding the responses received and how the consultation process influenced the policy;
- Monitor the department's effectiveness at consultation, including through the use of a designated consultation coordinator;
- Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

**5.11** If you feel that this consultation does not fulfil these criteria please contact:

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## CONFIDENTIALITY DISCLOSURES

**5.12** Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily) the Freedom of Information Act 2000 (FOIA), the Data Protection Act (DPA) and the Environmental Information Regulations 2004). If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities

must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality will be maintained in all circumstances.

**5.13** An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department. The Department will process your personal data in accordance with the DPA, and in the majority of circumstances, this will mean that your personal data will not be disclosed to third parties.

## FREEDOM OF INFORMATION CONTACT

Any Freedom of Information Act queries should be directed to:

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# A PARTIAL REGULATORY IMPACT ASSESSMENTS

**A.1** This annex contains partial regulatory impact assessments for each of the proposals put forward in this consultation document. The Government believes that they could each be implemented independently and as such the estimated costs and benefits of each proposal are not dependent on implementation of the others.

## FACILITATING PAPERLESS SETTLEMENTS

### Summary

| | |
|---|---|
| **Annual costs** | £0 |
| **One-off costs** | <£5m |
| **Total costs** | <£5m |
| **Key non-monetised costs** | None |
| **Annual benefits** | £70m - £290m |
| **One-off benefits** | £0 |
| **Key non-monetised benefits** | Faster and more accurate processing of investor instructions |
| **Net annual benefits** | £70m - £290m |
| **Net first year benefits** | £65m - £290m |

### Key Assumptions and Sensitivities

**A.2** These estimates rely on the assumptions that:

- the overall EU estimates for the additional costs of manual fund processing are accurate;
- the UK industry suffers these costs in proportion to its share of total funds under management; and
- between one quarter and one half of those costs would be avoided if paperless transfer and settlement were permitted.

### What is the problem under consideration? Why is Government intervention necessary?

**A.3** OEICs and authorised unit trusts (AUTs) are open-ended collective investment funds authorised by the FSA. Because they are open ended, investors can and generally do redeem their investments by selling their shares (in the OEIC) or units (in the AUT) back to the fund's management company. The Law of Property Act 1925 (LPA) only provides for these redemptions or transfers to be made in writing. Although the initial instruction can be made electronically, it must be confirmed by a written instruction from the investor.

**A.4** The requirement for paper settlement and transfer of title costs fund managers, stockbrokers, financial advisers and other intermediaries money. The Government believes that provision could be made to facilitate purely electronic settlement of trades in OEIC shares and AUT units without compromising investor protection.

## What are the policy objectives and the intended effects?

**A.5** The policy objective is to facilitate purely electronic settlement of trades in OEIC shares and AUT units in order to remove the need for a manual, paper-based, settlement process for authorised investment funds. This is intended to allow fund managers, stockbrokers, financial and other intermediaries to realise cost savings which can be passed on to investors.

## What policy options have been considered? Please justify any preferred option.

**A.6** The Government could:

- do nothing; or
- allow for electronic transfer and settlement of AUT units and OEIC shares by the assignor or his duly authorised agent.

**A.7** The Government's preferred option is the second one above due to the significant potential cost savings and reduced administrative burden.

## Estimated Costs

**A.8** This change would not directly bring any additional costs. While the option of paperless transfer and settlement would be introduced, there would be no requirement on firms to allow it. Although it seems unlikely in practice, if the costs of handling electronic instructions outweighed the benefits for a particular firm it would have the option of maintaining existing paper-based systems.

**A.9** However, it is necessary to subtract from the estimated savings any additional costs that would be involved in the set up of new electronic systems to benefit from the removal of the requirement for paper transfer and settlement. It is necessary to consider these costs across the range of potentially affected stakeholders. For custodians the systems implications should be minimal. Many are using a workaround for settlement known as a coverall to allow largely paperless processes already. These could be replaced with standard settlement instructions which under the proposals would have the advantage of giving greater legal certainty than coveralls currently do. Other than that, the systems used should be essentially the same. It would be possible to provide these standard settlement instructions in electronic form, but this is unlikely to have a significant impact on cost.

**A.10** Brokers who already deal on clients' behalf over CREST are likely already to have in place mechanisms to identify and authenticate their clients' instructions. There should therefore be no significant systems implications for them. Small financial advisers would be likely to rely on infrastructure provided by fund managers or fund supermarkets.

**A.11** Fund managers may not always have the same electronic mechanisms. However, it is unlikely that electronic settlement would be used in transactions where there was not already some method for secure electronic communication established

between the client and the fund manager. It therefore seems unlikely that entirely new electronic systems would be set up purely in order to allow electronic transfer and settlement.

**A.12** In all, the costs to the industry of allowing electronic settlement are not likely to be material and are estimated at less than £5 million one-off cost. The day-to-day running costs of electronic settlement systems are taken into account in the estimates of cost savings from electronic straight through processing.

## Estimated benefits

**A.13** The direct additional costs of manual fund processing compared to straight through electronic processing have been estimated at €1 billion per year across the EU.[3] However, the higher error rates generally associated with manual processing are thought to bring additional costs through loss and correction. Taking this into account, the total cost has been estimated at between €5 and €10 billion[4]. Assuming the UK share in these additional costs is equal to its share of the EU UCITS market of around 7 per cent, this puts the total costs of manual processing for UK UCITS funds between €350 million and €700 million. Around 20 per cent of UK retail funds are non-UCITS[5]. Assuming a constant ratio of additional costs from manual processing to assets under management this increases the total cost to between €420 million and €840 million. In Sterling, this range is approximately £290m to £580m.

**A.14** It is difficult to estimate what percentage of these costs are directly applicable to the requirement for paper transfer and settlement. There is still a significant amount of manual processing even in EU Member States where there is no requirement for paper transfer and settlement so it would not be reasonable to assume all of the cost would disappear as a result of the proposal. However, there is a general trend towards implementing electronic straight through processing. If allowing paperless transfer and settlement were helpful in encouraging this trend it could bring additional indirect savings. A reasonable range seems to be between one quarter and one half the total additional costs of manual processing related to the requirement for paper transfer and settlement. This yields a range of £70m to £290m for gross annual cost savings. This range is consistent with research carried out by the Investment Management Association with various individual stakeholders in the UK.

**A.15** In sum, this yields an annual cost saving of £70 million to £290 million with an initial one off cost of less than £5 million.

**A.16** An additional non-monetary benefit would be the potential for faster settlement and lower error rates with electronic (rather than manual) systems. This would benefit investors who would see their instructions executed more quickly and accurately.

**A.17** The Government would welcome comments on these estimates and any additional data that might help refine them.

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[3] Source: SWIFT. Available at http://www.swift.com/index.cfm?item_id=42770

[4] Source: Siebel, Rudolph (2006), *How to eat an elephant: exploring the future of investment fund processing in Europe*, available at http://ec.europa.eu/internal_market/financial-markets/docs/cesame/users/20060612-efama-background_en.pdf

[5] Source: EFAMA

## INTRODUCING A PROTECTED CELL REGIME FOR UK OEICs

### Summary

| | |
|---|---|
| **Annual costs** | Around £7m |
| **One-off costs** | £0 - £40m |
| **Total costs** | £0 - £40m one-off and £7m annual |
| **Key non-monetised costs** | None |
| **Annual benefits** | More than £7m |
| **One-off benefits** | £0 |
| **Key non-monetised benefits** | Increased attractiveness to foreign investors of investment in UK OEICs. |
| **Net annual benefits** | Likely to be positive. Definitive calculation difficult |
| **Net first year benefits** | May be net costs during conversion period. |

### Key Assumptions and Sensitivities

**A.18** These estimates rely on the assumptions that:

- OEICs would have average debt of 5 per cent of net assets at the time the measures were brought in;
- that OEICs' borrowing costs would increase by 10 basis points on average on conversion to protected cell status; and
- that creditors are better able to bear the risk of reduced recovery in the event of a sub-fund insolvency than investors are to bear the risk of contagion.

### What is the problem under consideration? Why is government intervention necessary?

**A.19** OEICs are investment funds structured as bodies corporate. Large fund managers generally operate a small number of OEIC umbrella companies with a large number of sub-funds within each umbrella. This helps them to operate a large range of funds more efficiently. Under current law, there is no segregation of liabilities between different sub-funds. For example, if an umbrella fund contained one cautious UK bond fund and one high-risk Far-East equity fund and the Far-East equity fund collapsed with liabilities exceeding its assets, creditors would have a claim on the assets of the UK bond fund. Investors in the cautious fund therefore bear some of the risk of the riskier fund.

**A.20** Many investors may be unaware of this contagion risk. There is also some evidence that the unsegregated nature of liabilities within OEIC umbrellas may reduce the attractiveness of investing in UK OEICs for overseas investors.

**A.21** The Government is proposing to introduce a protected cell regime for OEIC sub-funds whereby liabilities of a sub-fund could only be discharged from the assets of that sub-fund, even if the sub-fund defaulted.

## What are the policy objectives and the intended effects?

**A.22** The policy objective is to protect investors from the risk of contagion within OEIC umbrellas and to increase the attractiveness of the OEIC as an investment vehicle to overseas investors.

## What policy options have been considered? Please justify any preferred option.

**A.23** The Government could:

- do nothing; or
- introduce a protected cell regime for OEICs. This protected cell regime could be voluntary or compulsory for new OEICs. Provision could be made for converting existing OEICs, subject to consent from creditors and possibly shareholders.

**A.24** The Government has not yet arrived at a preferred solution and will take a decision on how and whether to advance the policy based on responses.

## Estimated Costs

**A.25** It is unlikely that there would be any significant ongoing administrative costs from the proposal. It would require or allow credit agreements to be adopted on a different basis than that currently used, but after one-off costs it is not likely that this new basis would be any more costly than the current one. There could be some additional cost in terms of higher borrowing costs since creditors may demand higher risk premia given the lack of access to assets of other sub-funds. OEICs hold around £270 billion in assets under management.[6] Assuming they have average borrowing of 5 per cent of assets and that a switch to protected cell status would increase borrowing costs by 10 basis points, this would imply additional annual borrowing costs of around £14 million. However, this assumes that all OEICs convert to protected cell status. The actual proportion would depend on the approach followed and is likely to be well below 100 per cent. 50 per cent could be a reasonable estimate, leaving a £7 million additional annual cost.

**A.26** If provision were made for existing OEICs to convert to protected cell status, there would be some conversion cost. The actual costs would depend on the procedure required for conversion. However they would be likely to include the costs of seeking agreement with creditors and shareholders, possibly renegotiating some credit agreements and amending the OEIC's legal documents. Since the Government is not currently considering making conversion mandatory, these costs would not be compulsory on existing OEICs. However, the cost to each OEIC umbrella that did choose to convert could be in the region of £100,000, although this would probably depend on the number of sub-funds. There are currently 396 authorised OEICs with 1,705 sub-funds. Total conversion costs would depend on how many chose to convert,

[6] Source; Investment Management Association monthly statistics, February 2006

but assuming a cost of £100,000 per OEIC, would be in the range £0 to £40m in one-off costs.

## Estimated benefits

**A.27** The two key benefits would be protecting OEIC investors from having to meet the liabilities of another sub-fund in the event of insolvency and improving the international attractiveness of the UK OEIC vehicle. In effect, moving to segregated liability would mean shifting the contagion risk which is currently borne by OEIC investors onto OEIC creditors. The creditors would lose the security provided by access to the assets of other sub-funds in the event of insolvency and the investors would gain additional security by not bearing the insolvency risk of other sub-funds.

**A.28** If we assume OEIC investors have the same risk preferences as creditors, the benefit to investors must be equal to the additional amount creditors charge for bearing the extra risk. The costs and benefits would therefore cancel each other out. However, there is reason to believe that in aggregate the risks could be borne more cheaply under a protected cell regime than with unsegregated liability. Under the current rules, assessing the creditworthiness of an OEIC sub-fund requires an assessment of the solvency of the umbrella as a whole. Potential investors would also have to assess the creditworthiness of other sub-funds in an umbrella to gain a complete picture of the risks of a possible investment. With segregated liability, both parties would only require information on the sub-fund and the umbrella (not including other sub-funds) in order to make a complete assessment of risk. Thus it is likely that the net benefit in terms of distribution of risk and payment of risk premia would be positive.

**A.29** The second benefit would be an increase in the attractiveness of UK OEIC investments to overseas investors. It is hard to quantify this benefit. However, it could materialise through increased sales of existing funds and cost savings if UK fund managers chose to maintain a consolidated UK fund range rather than adding a Luxembourg or Dublin range to sell to non-UK investors. However, on the second point, it may be relatively unlikely that a protected cell regime could be sufficient to sway a decision on fund domicile on its own.

**A.30** The Government would welcome comments on these estimates and any additional data that might help refine them. A more developed impact assessment will be produced if more specific proposals are developed.

# REFORMING NOTIFICATION RULES FOR NON-UK UCITS

## Summary

| | |
|---|---|
| **Annual costs** | £0 |
| **One-off costs** | £0 |
| **Total costs** | £0 |
| **Key non-monetised costs** | None |
| **Annual benefits** | £80,000 - £400,000 |
| **One-off benefits** | £0 |
| **Key non-monetised benefits** | Demonstrates UK commitment to strengthening the single market in investment funds. |
| **Net annual benefits** | £80,000 - £400,000 |

## Key Assumptions and Sensitivities

**A.31** These estimates rely on the assumptions that:

- new notifications for sale in the UK will continue at around 40 per year;
- total notification costs for UCITS funds are equal to 0.25 basis points of funds under management and that the proposal would reduce these costs by between 1 and 5 per cent in the year a fund notified for sale in the UK.

## What is the problem under consideration? Why is government intervention necessary?

**A.32** Under the UCITS Directive, investment funds authorised in another EU Member State and subject to the UCITS rules may be marketed in the UK without requirement for further authorisation. The fund, or its distributors, are required only to comply with UK marketing rules. The UCITS Directive states that funds must notify the 'host' regulator of their intention to begin marketing units in the new jurisdiction. The host regulator then has two months in which to raise any concerns relating to the fund's marketing procedure before it can begin marketing. Under the FSMA rules which implement UCITS, the fund must currently wait the full two months before it can begin marketing, even if the FSA is satisfied before that. The FSA receives around 40 new applications per year. For around 80 per cent of those, the FSA's consideration of the notification is completed within one month.

**A.33** The Government therefore proposes to amend the Financial Services and Markets Act 2000 (FSMA) so that a fund may begin marketing either where the two-month period has expired and the FSA has raised no objections or as soon as the FSA is satisfied that its requirements have been met, whichever is sooner. This would remove unnecessary delays in the large majority of new notifications which the FSA can approve quickly.

## What are the policy objectives and the intended effects?

**A.34** The objective is to speed up the process for notifying new non-UK UCITS for sale in the UK, increasing choice in the UK market and reducing cost for UK managers of non-UK UCITS ranges.

## What policy options have been considered? Please justify any preferred option.

**A.35** The Government could:

- do nothing; or
- amend the rules to allow a UCITS to begin marketing as soon as the FSA is satisfied it meets the relevant marketing and distribution requirements.

**A.36** The Government's preferred option is the second.

## Estimated Costs

**A.37** There should be no additional costs from the proposal. It would require only a minor amendment to the FSA process. There would be no additional costs to firms.

## Estimated benefits

**A.38** The FSA receives around 40 new notifications from non-UK UCITS funds per year. In around 80 per cent of cases, its consideration of the notification is completed within one month. Under the proposals, around 32 of those notifying funds would have been able to begin marketing at least one month earlier than under the current rules.

**A.39** Assessing the direct monetary benefit of this is difficult. However, looking indirectly, the overall costs of notifying UCITS funds for sale are estimated at around 0.25 basis points of funds under management.[7] The average UCITS fund manages around €150 million[8] or £100 million. Assuming this is also the average size of funds notifying for sale in the UK (although in practice funds marketed cross-border may tend to be larger than average), total annual notification costs for the 32 funds that would enjoy faster notification are £8 million. These notification costs relate to notification in all relevant Member States and not just the UK. Furthermore, there would still be some cost of notifying the fund for sale in the UK. It is therefore likely that the proposal would only reduce these costs by a small proportion.

**A.40** If the proposal reduced those total notification costs in the year of notification for sale in the UK by between 1 and 5 per cent, assuming consistent flows of new notifications, this would yield cost savings of between £80,000 and £400,000.

**A.41** The Government would welcome comments on these estimates and any additional data that might help refine them.

[7] Source: European Commission White Paper on Investment Funds. Available at http://ec.europa.eu/internal_market/securities/docs/ucits/whitepaper/impact_assessment_en.pdf

[8] Source: Deutsche Bank. Available at http://www.dbresearch.com/servlet/reweb2.ReWEB?rwkey=u21666224

# Draft Statutory Instruments on Paperless Settlements

*CONSULTATION DRAFT*

STATUTORY INSTRUMENTS

## 2007 No.

## FINANCIAL SERVICES AND MARKETS

### The Unit Trusts (Electronic Communications) Order 2007

| | |
|---|---|
| *Made - - - -* | *2007* |
| *Laid before Parliament* | *2007* |
| *Coming into force - -* | *2007* |

The Treasury, considering that the authorisation of the use of electronic communications by this Order for any purpose is such that the extent (if any) to which records of things done for that purpose will be available will be no less satisfactory in cases where use is made of electronic communications than in other cases, make the following Order in exercise of the powers conferred on them by sections 8 and 9 of the Electronic Communications Act 2000([9]):

**Citation, commencement and interpretation**

**1.**—(1) This Order may be cited as the Unit Trusts (Electronic Communications) Order 2007 and comes into force on [ ] 2007.

**2.**In this Order—

"the Act" means the Financial Services and Markets Act 2000([10]);

"the 2001 instrument" means the General Provisions and Glossary Instrument (2001/7) made by the Authority under the Act on 21st June 2001;

"the 2004 instrument" means the Collective Investment Schemes Sourcebook (Consequential Amendments) Instrument (2004/34) made by the Authority under the Act on 18th March 2004;

"authorised unit trust scheme" has the meaning given in section 237(3) of the Act;

"the Authority" means the Financial Services Authority;

"electronic communication" has the meaning given in section 15(1) of the Electronic Communications Act 2000([11]);

"manager" has the meaning given in that part of its definition in the 2001 instrument which relates to an authorised unit trust;

"register" has the meaning given in that part of its definition in the 2004 instrument which relates to unitholders of authorised unit trusts;

([9]) 2000 c. 7.

([10]) 2000 c. 8.

([11]) This definition in section 15(1) was amended by the Communications Act 2003 (c. 21), section 406(1) and Schedule 17, paragraph 158.

"trust deed" has the meaning given in that part of its definition in the 2001 instrument (as amended by the 2004 instrument) which relates to an authorised unit trust;

"trustee" and "unit" have the meanings given in the 2001 instrument; and

"unitholder" has the meaning given in the 2004 instrument.

**Electronic dispositions or assignments of units in authorised unit trust schemes**

**3.** Section 53(1)(c) of the Law of Property Act 1925([12]) (which imposes requirements for certain dispositions to be in writing) shall not apply (if it would otherwise do so) to any disposition of units in an authorised unit trust scheme where—

(a) it is made by means of an electronic communication; and

(b) the trustee or manager, being the person responsible for the register of unitholders in accordance with the trust deed, has taken reasonable steps to satisfy himself that the electronic communication has been made by the person who has the right to transfer the legal title to such units or by his agent authorised in writing.

*Name*

*Name*

Two of the Lords Commissioners of Her Majesty's Treasury

Date

**EXPLANATORY NOTE**

*(This note is not part of the Order)*

([12]) 1925 c. 20.

*CONSULTATION DRAFT*

S T A T U T O R Y   I N S T R U M E N T S

## 2007 No.

## FINANCIAL SERVICES AND MARKETS

# The Open-Ended Investment Companies (Amendment) Regulations 2007

| | |
|---|---|
| *Made - - - -* | *2007* |
| *Laid before Parliament* | *2007* |
| *Coming into force - -* | *2007* |

A draft of these Regulations has been approved by a resolution of each House of Parliament pursuant to section 429(2) of the Financial Services and Markets Act 2000([13]);

The Treasury make the following Regulations in exercise of the powers conferred on them by sections 262 and 428(3) of that Act:

**Citation and commencement**

**1.** These Regulations may be cited as the Open-Ended Investment Companies (Amendment) Regulations 2007 and come into force on [ ] 2007.

**Amendment of the Open-Ended Investment Companies Regulations 2001**

**2.**—(1) The Open-Ended Investment Companies Regulations 2001([14]) are amended as follows.

(2) In paragraph (1) of regulation 2 (interpretation), after the definition of "the designated person", insert—

""electronic communication" has the meaning given in section 15(1) of the Electronic Communications Act 2000([15]);".

(3) In Schedule 4 (share transfers)—

(a) after paragraph 4 insert—

"**4A.**—(1) Insofar as section 136(1) of the Law of Property Act 1925 (which provides for certain assignments in writing to be effectual in law) applies to an absolute assignment (not purporting to be by way of charge only) of any shares in an authorised open-ended investment company, it applies with the modifications mentioned in sub-paragraph (2).

([13]) 2000 c. 8.

([14]) S.I. 2001/1228, to which there are amendments not relevant to these Regulations.

([15]) 2000 c. 7. This definition in section 15(1) was amended by the Communications Act 2003 (c. 21), section 406(1) and Schedule 17, paragraph 158.

(2) Subject to sub-paragraph (3), an absolute assignment (not purporting to be by way of charge only) of such shares made by electronic communication of which express notice by electronic communication has been given to the company is also effectual in law to transfer from the date of such notice the same rights, remedies and powers, subject to the same conditions, as an assignment in writing signed by the assignor.

(3) Sub-paragraph (2) applies provided that the company has taken reasonable steps to satisfy itself that the assignment made by electronic communication has been made by the person who has the right to transfer the legal title to such shares or by his agent authorised in writing.

**4B**.The company may register a transfer of shares effected by means of an electronic communication as defined in section 15(1) of the Electronic Communications Act 2000 where—

(a) it has taken reasonable steps to satisfy itself that the electronic communication has been made by the person who has the right to transfer the legal title to such shares or by his agent authorised in writing; and

(b) such other evidence (if any) as it may require to prove the right of the transferor to transfer the shares in question has been provided to it.”; and

(b) in paragraph 5(1), after “paragraph 4”, insert “or 4B”.

*Name*

*Name*

Two of the Lords Commissioners of Her Majesty’s Treasury

Date

**EXPLANATORY NOTE**

*(This note is not part of the Regulations)*

# Draft Statutory Instrument on UCITS notification

STATUTORY INSTRUMENTS

## 2007 No.

## FINANCIAL SERVICES AND MARKETS

## Collective Investment Schemes (Recognised Overseas Investment Schemes) Regulations 2007

| | |
|---|---|
| *Made* - - - - | *** |
| *Laid before Parliament* | *** |
| *Coming into force* - - | *** |

The Treasury are designated([16]) for the purposes of section 2(2) of the European Communities Act 1972([17]) in relation to collective investment in transferable securities and other liquid assets.

The Treasury, in exercise of the powers conferred upon them by that section make the following Regulations:

**Citation and commencement**

**1.**These Regulations may be cited as the Collective Investment Schemes (Recognised Overseas Investment Schemes) Regulations 2007 and shall come into force on [ ].

**Amendment to the Financial Services and Markets Act 2000**

**2.**—(1) Section 264 of the Financial Services and Markets Act 2000([18]) (schemes constituted in other EEA states) is amended as follows.

(2) For subsection (1) substitute—

"(1) A collective investment scheme constituted in another EEA State is a recognised scheme if—

(a) it satisfies such requirements as are prescribed for the purposes of this section; and

(b) the operator of the scheme has given notice to the Authority of his intention to invite persons in the United Kingdom to become participants in the scheme, specifying the way in which the invitation is to be made, and either

(i) the Authority, by written notice, has given its approval to the scheme; or

(ii) two months, beginning with the date on which notice was given, have expired".

([16]) S.I.1994/757

([17]) S.I.2002/2840

([18]) 2000 c.8

Two of the Lords Commissioners of Her Majesty's Treasury

[ ] 2007

**EXPLANATORY NOTE**

*(This note is not part of the Regulations)*

These Regulations amend section 264 of the Financial Services and Markets Act 2000, which sets out the criteria for recognising collective investment schemes constituted in other EEA States, to include the situation where the Authority gives written notice of its approval of the scheme. This implements article 46 of EC Directive 85/611 EEC.

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