Transposition of UCITS IV:

consultation document

December 2010

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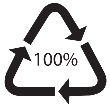

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Executive summary

On 13 July 2009, the European Parliament and the Council of the European Union (EU) approved a reform of the UCITS Directive. This recast Directive is commonly referred to as UCITS IV and repeals Directive 85/611/EEC on undertakings for collective investment in transferable securities (UCITS). On 1 July 2010 the European Commission completed a programme of improvements to the EU framework for UCITS funds by adopting four "level 2" implementing acts (two Directives and two Regulations), which provide more detailed rules.

UCITS IV introduces the following changes:

- **Removal of administrative barriers to the cross-border marketing of UCITS:** UCITS can access the market without delay once the regulator of the fund has notified the regulator in the EEA Member State where the management company wants to sell its product;
- **Introduction of a management company passport:** allows a management company to operate a fund in a different Member State[1] without the need to be established in the Member State of the fund; there are new harmonised requirements for the organisational, conduct of business and risk management processes of UCITS management companies;
- **Improved investor disclosure:** replaces the simplified prospectus with key investor information (KII). This will be a simple document giving key facts to investors in a clear and understandable manner. It will assist them in making an informed investment decision;
- **A framework for mergers between UCITS funds**: there will be a single regime across the EU on the requirements for authorisation of a cross-border fund merger and on the information that will have to be made available to investors;
- **Provision for 'master-feeder' structures:** where a UCITS fund (feeder) will be allowed to invest at least 85% of its assets into another UCITS fund (master);
- **Improved supervisory co-operation:** measures to improve and intensify co-operation between UCITS regulators, particularly in relation to supervising a UCITS management company and fund when they are established in different Member States.

This consultation paper outlines proposals for its implementation. This is a joint consultation paper with the Financial Services Authority (FSA) as transposition will require amendments to legislation and to the FSA Handbook.

The Government recognises the opportunities that UCITS IV presents for the UK funds industry and its investors. It believes that tax policy should be aligned with modern business practice and that commercial decisions should not result in adverse tax consequences. The Government is committed to taking all available measures, within the current fiscal constraints, to maintain and build on the UK's position as a major global centre for the asset management industry, and to ensure that UK businesses can take full advantages of opportunities created by EU legislation such as UCITS IV.

[1] Member States refers to EEA Member States

The Government will introduce the following:

- **Master-feeder** - As announced on 23 November, by the Financial Secretary, the Government will launch a tax transparent vehicle. One of the benefits this vehicle would provide is suitability for UCITS IV master funds. The Government will continue to develop the details of such a vehicle in consultation with industry, before introducing the new regime in 2012. It will also seek to give certainty to industry on technical concerns for Master Feeder structure, such as the Genuine Diversity of Ownership and Controlled Foreign Companies as part of this process.
- **Management Company Passport** - The Government will consult with industry to find an appropriate way of ensuring that there will be no adverse UK tax consequences for a foreign UCITS fund as a result of having a UK management company. This will be subject to ensuring appropriate parliamentary procedure and managing any risk to the Exchequer.

This consultation paper has 10 Chapters and various Annexes. Chapter 1 provides an introduction to the UCITS Directive and the changes being made by UCITS IV. Chapters 2 – 8 address each set of changes in turn, and Chapter 9 includes a statement outlining Government policy on the various tax issues arising from UCITS IV.

Responses to the consultation paper must be received by 21 March 2011.

The recast UCITS Directive must be transposed into UK law by 1 July 2011.

1 Introduction

Background

1.1 The Directive relating to undertakings for collective investment in transferable securities (UCITS) came into effect in 1988 and aimed to offer greater business and investment opportunities for both industry and investors by integrating the EU market for investment funds. The UCITS Directive sets out a harmonised regulatory framework for investment funds that invest in certain classes of assets, providing high levels of investor protection and a basis for the cross-border sale of these funds.

1.2 The UCITS Directive has been key to the development of the European investment fund industry. At the end of 2009 the assets under management of UCITS funds were slightly above €5 trillion, representing 75% of all investment fund assets in Europe. Total investment fund assets represented 55% of the European Union's GDP at the end of 2009 and about 10% of European households' financial assets. Funds marketed on a cross-border basis play an increasingly important role in the industry. The UCITS fund passport has paved the way for extensive cross-border marketing of funds.

1.3 The success of UCITS is not limited to the EU. UCITS are widely perceived as being regulated to a high standard and their status as a global "brand" has continued to boost net sales of cross-border funds outside Europe. In recent years, third-country sales have accounted for up to 40% of new sales of UCITS funds - primarily in Asia.

1.4 Despite the success of the UCITS vehicle, some inefficiencies have been noted which have reduced its competitiveness both at an EU and global level. In July 2005, a European Commission Green Paper[1] identified the following shortcomings within the existing regulatory framework:

- Bottlenecks and failures with the fund passport. Notification procedures for cross-border marketing (where the management company directly notifies each host Member State regulator) have often been cumbersome, time-consuming and expensive, at odds with the intention for a simple notification process and, crucially, raising costs. Significant differences across Member States in their requirements have hindered competition and the development of a single market in investment funds.
- Sub-standard investor disclosure: The simplified prospectus was intended to ensure retail investors could easily identify and understand key information about the fund before they invest. However, the document has in practice often been too long and complex and has failed to enable effective comparisons between UCITS funds, ultimately leading to an increased potential for mis-selling.
- Proliferation of small inefficient funds. The European fund market is characterised by a high number of funds of small size: 65% of all funds manage less than €50 million in assets, and the average size of a UCITS is a fifth of that of an American

[1] Green Paper on the enhancement of the EU framework for investment funds, European Commission, 12 July 2005.

counterpart. Economies of scale have thereby not been exploited, increasing costs for investors. The efficiency of (cross-border) business is further hampered by the difficulty of merging funds established in different Member States, or pooling the assets of funds.

- Obstacles to functional and geographical specialisation. The Directive requires concentration of all value chain activities in one Member State; only the fund can be passported. These legislative restrictions prevent the fund industry from taking full advantage of the single market.

1.5 Following detailed consultation, the Commission proposed, in a White Paper on enhancing the single market framework for investment funds published in November 2006, that a number of targeted amendments should be made to the UCITS Directive (rather than a complete overhaul), to address these inefficiencies. As the UCITS Directive has been substantially amended several times it was agreed that, in the interests of clarity, it should be recast into one consolidated document.

1.6 Changes to the Directive were undertaken using the Lamfalussy process. This involves reaching a political agreement in a "level 1" Directive, which focuses on core principles, and then agreeing the more technical details in subsequent "level 2" implementing acts. This provides greater flexibility by allowing tailored adaptation of the legislative framework in line with the evolution of financial markets and both investors' and the industry's needs.

1.7 On 13 July 2009, the EU legislative process approved Directive 2009/65/EC. This is a revised and recast version which consolidates and repeals Directive 1985/611/EC and its amending directives (known as UCITS III), so it is commonly referred to as "UCITS IV". On 1 July 2010 the Commission completed its legislative programme for UCITS funds by adopting the following "level 2" implementing acts:

- Commission Directive 2010/43/EU implementing Directive 2009/65/EC as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company;
- Commission Directive 2010/44/EU implementing Directive 2009/65/EC as regards certain provisions concerning fund mergers, master-feeder structures and notification procedure;
- Commission Regulation (EU) 583/2010 implementing Directive 2009/65/EC as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than by paper or by means of a website;
- Commission Regulation (EU) 584/2010 implementing Directive 2009/65/EC as regards the form and content of the standard notification letter and UCITS attestation, the use of electronic communication between competent authorities for the purpose of notification, and procedures for on-the-spot verifications and investigations between competent authorities.

Purpose of this paper

1.8 This is a joint consultation paper with the Financial Services Authority (FSA), setting out proposals for the implementation of UCITS IV. This exercise will require changes to both UK legislation and the FSA's Handbook of rules and guidance. The "level 1" and "level 2" Directives must be transposed into UK law by July 2011; the "level 2" Regulations apply directly in law, but any laws or regulations that would inhibit their effective application must be amended by the

same date. This consultation paper seeks stakeholders' views on the proposals by **21 March 2011**.

Who should read this paper?

1.9 The proposals in this paper apply particularly to fund managers who currently operate UCITS funds or may do so in future. This includes both UK-authorised firms and those authorised and regulated in another Member State, who may be considering the use of the management company passport to establish UCITS in the UK.

1.10 The proposals also apply to trustees and depositaries of UK-authorised UCITS schemes, to the auditors of such schemes, and to other persons that provide services to fund managers (such as third-party administrators). The proposals for key investor information (KII) and other UCITS marketing communications will be of particular interest to firms in the business of marketing and distributing UCITS, such as financial advisers and platform operators.

1.11 Although not all aspects of UCITS IV will affect consumers directly, the ability of non-UK management companies to operate a UK-authorised UCITS has implications for investors in terms of complaints-handling arrangements, and how compensation would work if the fund manager were unable to continue in business. Introducing KII will affect the way consumers receive pre-sale information about prospective investments.

Summary of UCITS IV

Remove administrative barriers to the cross-border marketing of UCITS

1.12 The UCITS Directive sets out common rules which allow a UCITS that is authorised in one Member State (the "home State") to market its units in any other Member State (the "host State"). Before a UCITS can start to access the market of the host State, it must complete a notification procedure. Some have claimed that the current procedure is burdensome, costly and time-consuming.

1.13 UCITS IV provides a new streamlined procedure based on regulator-to-regulator communication which will take a maximum of 10 working days. Under the new rules, the operator of a UCITS wishing to market its units in another Member State will file a notification letter with the UCITS home State regulator. An EU Regulation prescribes the contents of this letter, which will mainly describe the arrangements made for marketing the UCITS in the host State concerned. Several documents will be attached (e.g. the scheme instrument, prospectus and KII). After verifying that the documentation is complete, the regulator of the UCITS home State must transmit it to the host State regulator, together with an attestation confirming that the UCITS is authorised according to the conditions of the Directive. The UCITS can begin to access the market at once, without the prior approval of the host State regulator.

Introduce a management company passport

1.14 UCITS IV provides for a management company passport that will allow a management company authorised in one Member State to operate a fund authorised in a different Member State, without needing to be established in the Member State of the fund.

1.15 To provide a level playing field for management companies and greater certainty for investors, the Directive outlines harmonised rules for management companies regarding their organisational requirements, conflicts of interest procedures, conduct of business, and risk management. These rules apply to all management companies, whether or not they exercise passporting rights. Where a management company is to operate a UCITS established in another State, it must first have a written agreement with the fund's depositary on how the latter will be provided with the information it needs to fulfil its duties.

1.16 The Directive also outlines the division of responsibilities between regulators when the management company and the fund are established in different Member States.

Improve investor disclosure

1.17 The key investor information (KII) will replace the current simplified prospectus, which was designed to provide investors with relevant pre-sale information. The KII is intended to be a shorter, more concise investor document in straightforward language that gives potential investors the information they need to make an informed choice.

1.18 It must be provided to potential investors free of charge before they make an investment decision, and must include appropriate information about the essential characteristics of the UCITS, so that investors can reasonably understand the nature and risks of their investment decision. This information will identify the type of UCITS and include a short description of its investment objectives and policy, its risk/reward profile, charges and past performance information.

1.19 No civil liability will be attached to any person solely on the basis of key investor information, unless such information is misleading, inaccurate or inconsistent with the fund's prospectus.

Facilitate mergers between UCITS funds

1.20 UCITS IV provides an EU harmonised framework for UCITS funds to merge where there is a cross-border element. The rules would apply to all UCITS, irrespective of their legal form (unit trusts, investment companies or contractual funds).

1.21 A merger must be authorised by the regulator of the merging UCITS (the UCITS that will cease to exist post-merger). The depositaries of both the merging and the receiving UCITS must verify certain elements of the merger proposal, and either the depositary or an independent auditor must validate the criteria used for valuing the assets and liabilities of the funds in the merger. UCITS IV also requires both the receiving and merging UCITS to provide their investors with pre-merger information, including details about the other UCITS, in a durable medium. Investors will have the right to redeem their units without cost before the merger, and the costs of a merger should not be borne by investors of either UCITS.

Provide for 'master-feeder' structures

1.22 The UCITS Directive places strict limits on the amount of a UCITS' assets that it can invest in another fund. However, UCITS IV will allow a UCITS fund (called a 'feeder' fund) to invest the majority of its assets into another single UCITS fund (called a 'master' fund), in what is referred to as a master-feeder structure. This new structure will allow funds to benefit from economies of scale, reducing costs and increasing returns for investors.

1.23 In order to operate within this structure, the master and the feeder UCITS must comply with several conditions. For example, the feeder UCITS must invest at least 85% of its assets in a single master UCITS; the regulator of the feeder UCITS' home Member State has to approve its investment in the master UCITS; and there must be a legal agreement between the master and feeder funds, governing the sharing of information and how the feeder will interact with the master. In addition, if the feeder and master UCITS have different depositaries or auditors, then there must be written agreements between those parties to ensure appropriate sharing of information.

1.24 The feeder's prospectus and KII must disclose how the master-feeder structure works and give investors extra information about it, e.g. the combined charges of the two funds. To protect unitholders, UCITS that wish to convert into feeder funds or to link up to a new master

fund have to inform all unitholders in advance of the change; the unitholders are then entitled to redeem their units free of charge within 30 days.

Improve co-operation mechanisms between national supervisors

1.25 The UCITS Directive has always imposed a general obligation on regulators to co-operate with each other, but UCITS IV establishes a more detailed framework for how this process should operate.

1.26 It sets out the situations when regulators must share information with each other. For example, when the supervision of the management company and the fund are split, the regulators must inform each other of problems they identify with the entities they are responsible for and concerns they have that an entity may be breaching the Directive, even if they are not responsible for its supervision.

1.27 It also provides for a minimum degree of harmonisation of regulators' powers to ensure that they all have the necessary tools to carry out their tasks. This includes requiring the management company's regulator to allow for the imposition of measures or penalties, particularly administrative measures and penalties, by the UCITS' regulator.

Format of this paper

1.28 Changes to UK legislation to implement UCITS IV will be effected by secondary legislation under the European Communities Act 1972. A draft statutory instrument, to be titled the UCITS Regulations 2011, is published in Annex B of this paper. Proposed changes to FSA rules and guidance are set out in a draft Handbook instrument published in Annex C of this paper. Chapters 2 to 8 address each set of UCITS IV measures in turn; the changes to be made by the UCITS Regulations to implement those measures are explained first, followed by a commentary on the related FSA rules and guidance. Chapter 9 includes a statement outlining Government policy on the various tax issues arising from UCITS IV.

Impact on consumers

These changes will benefit consumers by:

1. enabling firms to overcome inefficiencies in the market, so making it possible for them to achieve cost savings which can be passed on to the fund and its investors;
2. creating opportunities for funds and fund managers to access new markets more easily, resulting in wider choice and improved competitiveness; and
3. Increasing investor protection by providing improved pre-sale disclosure that enables investors to make better-informed investment decisions.

2 Simplified Notification Procedure

2.1 UCITS IV seeks to address the current inefficiencies in relation to the fund marketing passport. Under current rules, the operator of a UCITS notifies the regulator in the host State where it wishes to market its units. The host State regulator has two months in which to check the notification and, once it is satisfied with marketing arrangements made in the host State, it will inform the UCITS that it may commence marketing. The rules governing the required content of the notification and the procedure to be followed vary between Member States, despite efforts by the Committee of European Securities Regulators (CESR) to develop guidelines to streamline the process. This lack of harmonisation has made cross-border marketing a time-consuming and cumbersome process.

2.2 Articles 91 to 96 of the new Directive provide a new streamlined notification procedure, based on regulator to regulator communication, which will take a maximum of 10 working days. The operator of a UCITS wishing to market its units in another Member State will file a notification letter with its home State regulator. This letter will have a harmonised content and will mainly describe the arrangements made for marketing the UCITS in the host State concerned. Several documents will be attached (e.g. the scheme instrument, prospectus and KII).

2.3 After verifying that the documentation is complete, the regulator of the UCITS home State must transmit it to the host State regulator within 10 working days, together with an attestation confirming that the UCITS is authorised in accordance with the Directive. The home State regulator must inform the UCITS operator as soon as it has transmitted the file; the UCITS can begin to access the market at once, without the prior approval of the regulator of the host Member State.

2.4 The host State regulator may, once the UCITS has accessed the market, check the compliance of distribution arrangements and marketing communications with national law. Such compliance checks cannot, however, include the documentation required under the Directive, such as the KII, the prospectus and the annual and half-yearly reports. If the operator subsequently wishes to make changes to the marketing arrangements in the host State, it must first notify the host State regulator in writing.

2.5 Each Member State is required to publish, by electronic means, complete information about the laws and regulations directly applicable to the marketing of units of UCITS in its territory.

2.6 Commission Regulation 584/2010 sets out the procedure to be followed by national regulators when transmitting notifications to one another, and prescribes the format of the notification and attestation forms that are to be used. Since the Regulation applies automatically with the force of law from 1 July 2011, it does not form part of this consultation.

HM Treasury

2.7 Financial Services and Markets Act (FSMA) Section 264 (amended by regulation 2(24)) and Schedule 3 new paragraph 20B (inserted by regulation 2(32)() (k)) – implement Article 93 of the Directive, giving effect to the new procedure which must be followed before a UCITS may market its units in another Member State, and setting out the contents of the notice which must be given by the home State regulator.

Box 2.A: Question

2.8 Do you agree that the draft regulation implements the Directive requirements in relation to cross-border notification correctly? Are there any other matters that should be addressed in the regulation?

FSA rules

2.9 The FSA has transposed most of the Directive requirements, as they relate to a management company wishing to market a UK UCITS scheme in another Member State, into the Collective Investment Schemes sourcebook (COLL) in a new section (12.4). We have taken the opportunity to remove rule requirements currently appearing in other sections of COLL (specifically 3.2.8R (2) and (3) and 4.2.3R (2)) in order to put the notification requirements in one place.

2.10 COLL 12.4.4R and 12.4.8R cover the duties of the authorised fund manager (AFM) to ensure that regulators in the host States where the UCITS scheme is marketed are sent up-to-date versions of scheme documents and given notice of any changes to marketing arrangements. We will publish additional information for firms on our website, explaining the procedure for submitting a notification letter.

2.11 COLL 12.4.5R sets out the obligation to provide information and documents to investors in the host State. AFMs should note that the requirement to translate the instrument constituting the scheme and the prospectus into the language of the host State will no longer apply, and English language versions will be acceptable in all Member States. There is however a requirement to translate the KII, unless the use of English in that document is approved by the host State regulator.

2.12 For EEA UCITS passporting into the UK, the existing guidance in COLL 9.2 is no longer applicable and is deleted. We will be responsible for publishing the marketing information applicable to such UCITS in line with Article 91(3) and will do so on our website by 1 July 2011.

Box 2.B: Question

2.13 Do you agree with the proposed amendments to COLL? Are there any other matters related to cross-border notification on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

3 Management Company Passport

3.1 To address the lack of organisational flexibility in the UCITS industry, UCITS IV introduces a management company passport that allows a management company established in one Member State to operate a fund established in another Member State. This right, in common with the European single market rights conferred by other Directives, can be exercised by the management company either through the freedom to provide cross-border services or through the establishment of a branch in the UCITS' home Member State.

3.2 The new passport applies specifically to "collective portfolio management". It does not affect the existing right of UCITS management companies to offer individual portfolio management and other services permitted under Article 6 of the Directive, where authorised to do so by their home State regulator. Such services are subject to rules made under the Markets in Financial Instruments Directive (MiFID)[1].

3.3 To ensure the smooth functioning of the passport, including the mutual recognition of authorisation and supervision, and to provide investors with greater certainty about standards of protection, it was considered necessary to ensure that the rules governing management companies are sufficiently harmonised. The Directive therefore harmonises the rules pertaining to management companies' organisational requirements, conflicts of interest procedures, conduct of business, and risk management. These rules can be found in Chapter III of the Directive for management companies and Chapter V for investment companies. Further detailed rules are set out in the level 2 Directive (Commission Directive 2010/43/EU). These rules apply to all management companies, whether or not they exercise their passporting rights.

3.4 The management company passport relies on the principle of splitting supervisory responsibility between the home State of the management company and the home State of the UCITS (which is consequently the host State of the management company). The management company's home regulator is solely responsible for supervising the organisation of the management company. The UCITS' home regulator on the other hand will be responsible for supervising compliance with the rules regarding the constitution and functioning of the UCITS. To clarify what this entails in practice, the Directive specifically outlines the division of responsibilities between regulators when the management company and the fund are established in different Member States and provides rules on enhanced supervisory co-operation (see Chapter 7).

3.5 The Directive requires the depositary of a UCITS always to be established in the same Member State as the UCITS itself. So, where a management company intends to operate a UCITS established in another Member State, it must first enter into an agreement with the fund's depositary as to how the latter will be provided with the information it needs to fulfil its duties. Additionally, the management company must implement appropriate procedures and arrangements to deal with investor complaints and to make information available in the UCITS home State.

[1] Directive 2004/39/EC on markets in financial instruments, together with Commission Directive 2006/73/EC.

3.6 A management company that intends to manage a UCITS established in a different Member State must follow the procedure outlined in Article 20 of the new Directive, which involves the management company applying directly to the UCITS' home regulator. The UCITS' home regulator can refuse an application only if the management company does not comply with the rules relating to the functioning of the UCITS for which that regulator is responsible; if the management company is not authorised to manage that particular type of UCITS; or if the specified documentation has not been submitted. Article 21 sets out the powers given to the management company's host State to intervene in relation to a management company providing services to a UCITS within its jurisdiction.

HM Treasury

Procedural requirements for the use of intervention powers

3.7 **FSMA Section 199 and new 199A** (see regulation 2(9) and (10)) – implement Article 21 of the Directive. The amendments to Section 199 extend the additional procedural requirements which apply where the FSA wishes to use its intervention power against an EEA firm which is contravening requirements imposed under single market directives to cover management companies. New Section 199A imposes an obligation on the FSA to exercise its intervention powers to safeguard investors when it is informed that a management company's authorisation is being withdrawn by its home State regulator.

Requirements for application

3.8 **FSMA Sections 243 and 244** (see regulation 2(15) and (16)) – implement Articles 20 and 5.4 of the Directive. Section 243 is amended to make it clear that it is no longer necessary for the manager of an authorised unit trust to have a place of business in the UK, provided that they have a place of business in an EEA State; and to ensure that the FSA considers, in relation to an application for authorisation, whether the proposed manager is a fit and proper person to manage the unit trust scheme. Section 244 is amended to require the FSA to determine an application for authorisation of a unit trust which is a UCITS within two months. Equivalent provision is made for open-ended investment companies in regulation 3(2)(new paragraph 4A of regulation 14 of the OEIC Regulations)

Continuing requirements

3.9 **FSMA new Section 283B** (see regulation 2(26)) – implements Article 45 of Commission Directive 2010/43/EU in relation to reports on derivative instruments. It imposes a duty on management companies of UCITS to report to the FSA at intervals specified by the FSA (which must be no more than 12 months apart) on investments in derivative instruments in relation to the UCITS. The FSA is required to review the regularity and completeness of the information in the report.

3.10 **FSMA Schedule 3, new paragraphs 26 and 28** (see regulation 2(32)() (l)) – implement Articles 13.1 (a) and 20.4 of the Directive. Paragraph 26 requires the FSA to relay information on the delegation of functions by a UK management company to the home State regulator of any EEA UCITS managed by that company. Paragraph 28 gives the home State regulator of an EEA UCITS a right to request information from the FSA in relation to an application by a UK management company to manage that UCITS, and requires the FSA to respond to such a request within 10 working days of receiving it.

Loss of authorisation

3.11 **FSMA Schedule 3, new paragraphs 15A and 15B** (see regulation 2(32)(d)) – implement Article 20.3 of the Directive. As substituted, these paragraphs set out the circumstances under

which the FSA may refuse an application by an EEA management company to manage a UK-authorised UCITS scheme, and the procedure which must be followed in that situation.

3.12 **FSMA Schedule 3, new paragraph 27** (see regulation 2(32)(l)) - implements Article 21.8 of the Directive, to require the FSA to consult with the home State regulator of any UCITS managed by a UK management company if it is considering withdrawing the authorisation of that management company.

Collective portfolio management

3.13 **FSMA Schedule 3 substitute paragraph 19 (4)** - implements the third sub-paragraph of Article 17.3 of the Directive which sets out the conditions which must be satisfied by the FSA before a UK management company may provide collective portfolio management services in another EEA State.

Box 3.A: Question

3.14 Do you agree that the draft regulation implements the Directive requirements in relation to the management company passport correctly? Are there any other matters that should be addressed in the regulation?

FSA Rules

3.15 The FSA needs to make two groups of amendments to its Handbook to implement the management company passport; those which establish harmonised operating standards for all such companies, and those which enable passporting rights to be exercised. Here, we deal with each in turn.

3.16 The requirements of the Directive that affect all UCITS management companies, irrespective of the management company passport, are wide-ranging. They fall broadly into three categories:

- prudential and organisational requirements;
- conduct of business requirements; and
- risk management requirements.

Paragraphs 3.17 to 3.51 explain in turn how each of these areas is to be implemented through our rules.

Prudential and organisational requirements

3.17 The existing prudential provisions of the UCITS Directive address such matters as the core requirements for authorisation, the level of capital necessary and the types of systems and controls that need to be in place. We implement them in the UK through rules in the prudential sourcebooks UPRU and BIPRU[2] and the Senior Management Arrangements, Systems and Controls sourcebook (SYSC).

3.18 Many of the current requirements of SYSC apply according to whether or not a firm falls within the definition of a common platform firm. A firm which undertakes only collective portfolio management (i.e. one which does not undertake individual portfolio management

[2] The Prudential sourcebook for UCITS firms and the Prudential sourcebook for banks, building societies and investment firms. The UCITS IV measures do not change the substance of the requirements for UCITS management companies set out in these sourcebooks.

under the powers of the UCITS Directive) will not be a common platform firm. As a result, many of the SYSC measures will apply to such a firm as guidance rather than rules.

3.19 The level 1 measures of UCITS IV have been expanded and supplemented by level 2 measures in relation to several matters. These include:

- control and oversight by senior management;
- the roles of the compliance, risk management and internal audit functions;
- accounting processes;
- management of conflicts of interest; and
- personal dealing rules.

These requirements are substantially based on equivalent provisions in MiFID in order to enable asset management firms carrying on business within the scope of both Directives to follow, as far as possible, a single set of rules in these regards.

3.20 The prudential rules will apply equally where the UK firm is exercising its right to establish and operate a UCITS authorised in another Member State, whether by setting up a branch in that State or by providing cross-border services.

3.21 We propose to amend SYSC by integrating these requirements wherever possible into the text that transposes the equivalent MiFID provisions. This means that for any UK firm undertaking the regulated activity of establishing and operating a collective investment scheme, where that scheme is a UCITS scheme, many of the current measures in SYSC will become rules requirements instead of guidance. It should be noted that the operator is not necessarily the firm which is undertaking or advising on the investment management activity of the fund. The investment manager may well be acting as the delegate of the operator, in which case the operator retains responsibility for ensuring compliance with UCITS Directive requirements.

3.22 The specific application of the SYSC rules to UCITS management companies is set out in a new column in the table of applications in Annex 1 of SYSC 1. This supplements the amendments to the text of individual rules and the addition of references to the relevant articles and paragraphs of the Directive. In places where inserting matters specific to UCITS management companies would have made the text too complex or cumbersome, we have added separate paragraphs or new rules. This involves a degree of duplication which we think is acceptable in order to make the sourcebook navigable for all its users, most of whom will not be UCITS management companies.

3.23 Consequently, the general requirements section of SYSC (4.1) contains new rules extending the scope of the rules to all collective portfolio management activities of the firm (4.1.2BR) and specifying that the firm must have the necessary resources and procedures for its business and employ them effectively (4.1.2CR). There is also a rule requiring internal reporting and communication obligations to be extended to any third party involved in the UCITS.

3.24 There is a new provision on delegation by management companies which is specific to the UCITS Directive and which supplements the existing rules contained in the Supervision manual (SUP) and COLL. Where a management company wishes to outsource any of its activities, it must retain enough resources and expertise to be able to oversee its delegate effectively (SYSC 8.1.13R). This rule aims to ensure that the management company is a functioning entity and not a mere "letter-box" presence in its home State. Please note that we have modified the requirement in SUP 15.8.6R, for a management company to notify us about delegation arrangements, so that the notification must be made before the arrangement is entered into.

3.25 SYSC 10 (Conflicts of interest) introduces a rule requirement (10.1.4R (4)) for a management company to take into account any conflict that arises where it undertakes the same activity for a UCITS scheme and any other client; this is not limited to collective portfolio management. SYSC 10.1.17R to 10.1.21R are specific to UCITS management companies, and represent an adaptation of MiFID requirements to the characteristics of collective portfolio management. Whereas MiFID refers to the firm's treatment of its clients, these rules treat the UCITS scheme as being in the place of the client and set out how the firm should reconcile its interests with those of other clients, including other collective investment schemes.

Box 3.B: Question

3.26 Do you agree with the proposed amendments to SYSC and SUP? Are there any other matters related to the prudential and organisational requirements for a UCITS management company on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

Conduct of business requirements

3.27 The current UCITS Directive contains relatively little material on what may be regarded as conduct of business requirements for a management company. UCITS IV substantially expands this material and supplements it with detailed provisions in the level 2 Directive. This new material will, like the prudential and organisational measures, apply to every UCITS management company irrespective of whether or not it uses the new passport. However, where a management company intends to use the passport, the exact manner of its application is somewhat complex, as explained below.

3.28 Some of these new requirements are derived, like the organisational requirements, from equivalent MiFID measures. They relate principally to inducements, best execution, aggregation and allocation of orders, personal account dealing and reporting of client orders. Our Conduct of Business sourcebook (COBS) has always applied the rules for these activities to UK fund managers, so the UCITS IV changes should have relatively little impact on them. To the extent that the Directive measures differ, or impose supplementary obligations, we propose to implement them by integrating them with the existing COBS rules.

3.29 COBS 2.3.1AR and 2.3.2AR clarify the application of the inducements rules. There is a duty to ensure that third-party payments are provided or accepted only if they are designed to enhance the quality of the service and do not impair compliance with the firm's duty to act in the best interests of its clients. This duty applies as if the UCITS scheme is the client. However, the duty to disclose the essential terms of the arrangements and to provide detailed information on request, applies at the level of individual unitholders of the scheme.

3.30 Similarly, the best execution rules apply at the level of the scheme, except for the rule on appropriate information on the execution policy, which must be made available to unitholders. This information may be included in the fund prospectus, or in a separate document that is identified in the prospectus. The requirement to obtain prior client consent applies to an investment company with variable capital (ICVC) as if the company itself were the client, so its directors must give the necessary consent. However, this rule is disapplied where (as is typically the case in the UK) the management company is the sole director of the ICVC.

3.31 COBS 16.2.1R, which contains the requirements for informing clients of the execution of their orders, includes new paragraphs ((6) and (7)) setting out the information that a management company must provide in the case of a subscription or redemption of units in a UCITS scheme.

3.32 Other elements of the conduct of business requirements do not derive directly from MiFID. These include provisions concerning fair treatment of unitholders, standards of due diligence, exercise of voting rights and recording of transactions. These requirements are implemented through a new part of COLL (section 6.6A).

3.33 COLL 6.6A.2R implements the requirement to act in the best interests of unitholders, including in relation to pricing, valuation and charging of costs. COLL 6.6A.4R sets requirements for the exercise of due skill, care and diligence in the management of scheme property, risk management and outsourcing arrangements. COLL 6.6A.6R requires the management company to have adequate documented procedures for exercising its rights as the owner of the assets held in the fund. This includes identifying and responding to corporate events (e.g. rights issues in shares), deciding how and when voting rights should be exercised, and acting in the exclusive interest of the fund and its investors.

3.34 Additional rules and guidance (COLL 6.3.3AR to 6.3.3DR) are proposed in the chapter on valuation and pricing of funds. These implement the level 2 Directive requirement concerning accounting policies and procedures to ensure accurate valuation and pricing of schemes. We do not consider that these rules impose any substantive new requirement on firms and the rules are made for the sake of completeness and transparency in implementation.

3.35 COLL 6.13 specifies requirements for the recording of transactions, both in relation to those undertaken for the scheme property of the fund, and the recording of orders for subscription and redemption of units. Such records must be retained for at least five years in a medium that allows ready retrieval.

Box 3.C: Question

3.36 Do you agree with the proposed amendments to COBS and COLL? Are there any other matters related to the conduct of business requirements for a UCITS management company on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

Risk management requirements

3.37 The UCITS IV measures for management companies do not simply reproduce existing MiFID measures. There are substantial new requirements concerning the risk management process, both in terms of the company's organisation and procedures, and the way in which it monitors specific schemes. The level 2 Directive introduces provisions which support Article 51(1) of the new Directive. These provisions replace the current Commission Recommendation on the use of financial derivative instruments by UCITS schemes (the Recommendation), which we previously implemented through rule requirements in COLL.

3.38 The requirements in the level 2 Directive relate to the risk management policy and risk measurement (Articles 38 and 39) and the risk management process, counterparty risk exposure and issuer concentration (Articles 40 to 43). We propose to implement this material through rules and guidance in COLL 6, except for the material on counterparty risk and issuer concentration, which will be covered in COLL 5.

3.39 As a result, the existing rules and guidance relating to risk management in COLL 5.2.24R and COLL 5.2.25G, which are based on Article 51 and the Recommendation, will be deleted. The Article 51 requirements will be covered in the new section COLL 6.12. Other parts of the Recommendation material deleted from COLL 5 are replaced by the level 3 guidelines developed by CESR, as explained in paragraph 3.51 below.

3.40 Article 43 of the level 2 Directive sets requirements for calculating the exposure to counterparties as a result of the UCITS scheme entering into OTC derivatives contracts. The Article also provides for the netting of exposure with the same counterparty and the reduction of exposure through the use of collateral. These measures replace broadly similar provisions in the Recommendation, which currently appear in COLL 5.2.11R.

3.41 We propose to transpose this article in COLL by deleting paragraphs 11 to 14 of COLL 5.2.11R, and setting out the replacement material in a new rule at COLL 5.2.11BR, which will make it easier to follow.

3.42 Article 44 of the level 2 Directive deals with the valuation of OTC derivatives. COLL 5.2.23R to COLL 5.2.23BR accurately reflect most of the requirements of Article 44, so we propose to leave these rules unchanged. The remaining matters covered in this Article are set out in a new rule at COLL 5.2.23CR, but we do not consider that the material will impose any substantive new requirement on AFMs.

3.43 COLL 5.3 deals with the exposures created by, and the cover required for, derivatives and forward transactions held by a UCITS scheme. The current requirements in COLL 5.3 are derived from the Directive and the Recommendation. In order to transpose the new level 2 Directive and replace the Recommendation measures, we propose to delete COLL 5.3.3R and COLL 5.3.6R and replace them as follows:

- A new rule COLL 5.3.3AR replicates the first and third paragraphs of Article 51.3 of the UCITS Directive, restricting the UCITS scheme's ability to invest in derivatives and forward transactions to 100% of the net value of the scheme property. It also ensures that exposures created by the derivatives do not breach the investment restrictions in COLL 5.2.11R.
- COLL 5.3.3BR replicates Article 41.2 of the level 2 Directive, imposing the requirement for the AFM to calculate the global exposure on at least a daily basis.
- COLL 5.3.3CR replicates the second paragraph of Article 51.3 of the UCITS Directive, specifying the elements which must be taken into account when calculating exposure.

3.44 COLL 5.3.7R and 5.3.8R implement Article 41 of the level 2 Directive (with the exception of Article 41.2 as noted above). COLL 5.3.7R transposes paragraph 1, requiring an AFM to calculate the global exposure of a UCITS scheme as either the incremental exposure and leverage generated through the use of derivatives and forward transactions (including derivatives), or the market risk of the scheme property.

3.45 COLL 5.3.8R transposes paragraphs 3 and 4, requiring an AFM to calculate the exposure in COLL 5.3.7R using either the commitment approach or the value at risk approach. We do not propose to include "other advanced risk measurement methodologies" as described in paragraph 3, as any such methodologies will first need to be approved by CESR's successor body, the European Securities and Markets Authority (ESMA).

3.46 COLL 5.3.9R transposes paragraph 1 and the first part of paragraph 2 of Article 42 of the level 2 Directive, imposing requirements on the calculation of exposure using the commitment approach.

3.47 COLL 5.3.10R replicates the remainder of Article 42, permitting the use of calculation methods equivalent to the commitment approach, the use of netting and hedging in the exposure calculation, the exclusion from the calculation of derivatives which do not generate incremental exposure, and the exclusion of permitted temporary borrowing from the calculation.

3.48 A new section, COLL 6.10, implements the general requirement for a management company to ensure that its senior management carries out effective control and oversight of the business. This includes responsibility for the compliance and risk functions, the implementation of each fund's investment policy in line with its scheme documents, and approval and periodic review of the risk management policy. Reporting procedures must be in place to ensure that senior management receive the information necessary to carry out these functions.

3.49 COLL 6.11 is another new section which implements the requirements for the organisation of the risk management function. Each UCITS management company must have a permanent risk function, which should be independent (where this is proportionate in view of the size of the organisation) and adequately resourced. This function is responsible for implementing the risk policy, and advising and reporting as necessary on the risk profile of each UCITS scheme.

3.50 COLL 6.12 brings together existing and new material on the risk management process to be carried out for each UCITS scheme. This includes the UCITS III requirement (currently appearing in COLL 5) to use a risk management process and provide us with the parts of it relating to the use of derivatives. The section contains further detail (6.12.4R) on the necessary elements of the risk management policy, and on the way in which the management company should measure risk. This may include the use of stress-testing and back-testing where appropriate. The AFM should adopt a risk limit system deriving from the investment and borrowing powers applicable to the scheme and its stated investment strategy.

3.51 COLL 5.3.11G and 6.12.9G direct AFMs to the level 3 guidelines produced by CESR in relation to risk management and measurement. The guidelines on risk measurement published in July 2010[3] cover aspects of calculation of global exposure previously addressed by the Recommendation, as well as much new material clarifying appropriate practice in this area. The principles for risk management published in February 2009 have been substantially superseded by the Directive requirements, but remain valid and cover some points not dealt with in legislation.

Box 3.D: Question

3.52 Do you agree with the proposed amendments to COLL? Are there any other matters related to the risk management and measurement requirements for a UCITS management company on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

Exercise of passporting rights

3.53 Turning to the requirements which are specific to firms wishing to exercise rights under the management company passport, implementation requires two sets of distinctions to be made in FSA rules. The first is to reflect the split of responsibilities between the UCITS home State and the management company home State.

3.54 Article 19.1 of the Directive prescribes the measures in relation to which the management company is subject to the laws and regulations of its own home State. These measures relate to the organisation of the management company, including its delegation arrangements, risk management procedures, prudential rules and reporting requirements, and any other level 2 measures drawn up to implement Article 12 (prudential rules). Article 19.3 introduces the concept of "fund application rules". These are the rules which apply to the UCITS itself, rather

[3] CESR published a further consultation paper on "Risk measurement and the Calculation of Global Exposure for certain types of structured UCITS" in November 2010 (CESR/10-1253). It is expected that this will lead to the publication of further level 3 guidelines in early 2011, which will be incorporated in the final version of the COLL guidance.

than its management company, and which will always be the responsibility of the regulator in the UCITS home State.

3.55 This split of responsibilities introduces a new element of complexity which is not mirrored by other EU single market Directives. Since both the fund and its management company are authorised under FSMA, our rules have to accommodate the possibility of both UK-authorised firms and incoming EEA firms acting as managers of authorised unit trusts or authorised corporate directors (ACDs) of ICVCs. At the same time, those rules must address our responsibilities for UK-authorised UCITS management companies that operate EEA UCITS schemes subject to the fund application rules of other Member States.

3.56 For a UCITS scheme authorised in the UK, most of the fund application rules are contained within the COLL sourcebook; indeed, they encompass the greater part of the rules and guidance in COLL. Consequently, we propose to amend COLL to clarify the application of each section of its rules. Any rule which is a "fund application rule" will be expressed as applying to the authorised fund manager of a UCITS scheme. COLL 12.3.9R lists which sections and individual rules and guidance fall within this category. The term "authorised fund manager" is defined in such a way as to include an EEA UCITS management company exercising an inwardly passporting right into the UK. Conversely, such rules do not apply to a UK UCITS management company where it is exercising its outwardly passporting right to operate a UCITS authorised in another Member State.

3.57 Rules in COLL which implement measures falling under Article 19.1 will indicate that they apply to a UK UCITS management company operating a UCITS scheme or an EEA UCITS scheme. We have decided to retain the current Glossary definition of the term "UCITS scheme" so that it applies only to a fund authorised in the UK; the term "EEA UCITS scheme" will be defined as a fund subject to the Directive which is authorised in any other EEA State. We considered whether to redefine "UCITS scheme" to encompass both types of fund, but thought that it would be too confusing to stakeholders, now that its present meaning has been in use for a number of years.

3.58 The second set of distinctions to be made in our rules concerns the two methods by which passporting rights may be exercised – establishing a branch, or operating under the freedom to provide cross-border services. A management company which establishes a branch in another Member State and manages a UCITS authorised in that State, is (under Article 17.4) subject to rules drawn up in that host State to implement Article 14 (rules of conduct). By contrast, a firm which manages a UCITS authorised in another Member State under the freedom to provide services will (according to Article 18.3) be required to follow the laws and regulations of its own home State insofar as they implement Article 14.

3.59 For the UK, this results in a situation in which FSA rules implementing Article 14 apply to:

- a UK-authorised firm managing a UK UCITS scheme;
- an EEA UCITS management company operating a UK UCITS scheme from a branch it has established in the UK; and
- a UK-authorised firm operating an EEA UCITS scheme by means of the freedom to provide cross-border services.

However, those same FSA rules will not apply to:

- an EEA UCITS management company operating a UK UCITS scheme by means of the freedom to provide cross-border services; or
- a UK-authorised firm operating an EEA UCITS scheme from a branch it has established in the home State of that UCITS.

3.60 A particular difficulty here arises from the fact that two chapters of the level 2 Directive are stated to be made under both Articles 12 and 14 and there is no attempt to clarify which of these measures is made under which Article. This is particularly significant for branches, since Article 12 matters are for the home State and Article 14 matters are for the host State.

3.61 In these cases we do not believe it is realistically possible to categorise, with any degree of legal certainty, each level 2 provision as having been made under Article 12 or 14 alone. The most that can currently be said, in the case of a branch, is that to the extent that the subject matter relates to Article 12 it is a home State responsibility and, to the extent it relates to Article 14, it is a host State responsibility. We are seeking the Commission's clarification that the responsibilities of respective regulators might overlap in such cases and we acknowledge that we might have to modify the territorial scope of these rules in the light of its response. If our interpretation is right, it opens the possibility of regulators entering into bilateral or multilateral agreements as to how shared supervisory arrangements should be handled on a day-to-day basis.

3.62 COLL 12.2 sets out the material relevant to a UK management company wishing to operate an EEA UCITS scheme, while COLL 12.3 sets out the requirements in the opposite situation of an EEA UCITS management company wishing to operate a UCITS scheme in the UK. These requirements include the company's obligation under Article 20 to provide the FSA with information and evidence of its capacity to manage the particular type of UCITS in question.

3.63 The incoming management company must also (under 12.3.10R) ensure it has procedures to meet its obligations to provide information about the scheme to investors and to give us any information we ask for. These rules are supported by amendments to SUP 13 setting out the reporting requirements for UCITS operators, and a new form to be completed by an EEA UCITS management company to confirm it complies with Article 20.

3.64 If the AFM of an existing UCITS scheme is to be replaced by an AFM established in a different Member State, this change could potentially be of significance to unitholders. We set out below (paragraphs 3.69 onwards) our proposals for rights of redress for investors, which if adopted should ensure that investors in UK-authorised UCITS schemes should not suffer any adverse impact if a UK management company is replaced by an EEA management company. Nevertheless, we think the change is one that might cause investors to reconsider their participation in the scheme, and so should be treated as significant under the classification system set out in COLL 4.3. A new rule (4.3.10R) is proposed specifying this as a requirement. It would apply equally in the case of an inwardly passporting management company of a UK UCITS scheme being replaced by a UK AFM.

Box 3.E: Question

3.65 Do you consider that the proposed amendments to SYSC, COBS, SUP and COLL implement the split of responsibilities between the UCITS home State and the management company home State correctly? Are there any other matters related to the exercising of passport rights by a UCITS management company on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

3.66 The introduction of the management company passport has consequences for the role of the depositary. As noted above, a depositary must always be established in the same state as the UCITS it is appointed to, but may have to deal with a management company from another Member State. This potentially poses problems for the depositary in ensuring that instructions and information are sent and received so that it can carry out its functions effectively.

3.67 The Directive requires any management company that is exercising the passport to enter into an agreement with the depositary governing such matters, and it prescribes the essential

matters that must be covered by the agreement in some detail. A rule imposing the obligation on the depositary to enter into such an agreement appears in COLL 6.6.4R (6), and details of the essential elements are transposed in Annex 1 of COLL 6. It is open to the parties to the contract to include any additional matters that they think necessary.

Box 3.F: Question

3.68 Do you agree with the proposed amendments to COLL in relation to the duties of the depositary when dealing with an EEA UCITS management company? Are there any other matters related to the general responsibilities of the depositary on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

Rights of redress for investors

3.69 The introduction of the management company passport affects the scope of the UK's consumer redress mechanisms, the Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS). Our proposals for maintaining an appropriate degree of consumer redress are set out below.

Complaints

3.70 In the UK, we already have extensive complaints-handling rules that apply to UCITS management companies, set out in the Dispute Resolution: Complaints (DISP) module of the FSA Handbook. UCITS IV brings in requirements relating to complaints for all management companies, many of which are familiar in the UK context. These include the right for all investors to complain, and receive information about firms' complaints-handling processes, free of charge.

3.71 We include in this consultation the amendments to DISP where it does not already reflect the requirements of the Directive (respondents should also refer to Chapter 4 of CP10/21[4], which consulted on some of the relevant matters). We will also apply these complaints rules to UK branches of non-UK management companies (with the exception of rules requiring the firm to publish complaints data) to ensure that no potential gaps arise from how complaints rules are implemented by other Member States (see paragraphs 3.60 and 3.61 above). Management companies passporting into the UK on a cross-border services basis will have to comply with our complaints reporting requirements.

3.72 Article 15 of the Directive refers to the languages in which management companies must allow investors to file complaints. We believe this Article is meant to oblige management companies to deal with complaints made in any official language of the UCITS home State or of those host States into which the fund is notified for sale, and we are consulting on this basis. We recognise that an alternative interpretation of this clause exists: that management companies have to be prepared to deal with complaints made in any official language of any Member State, on the basis that an investor may be a national of a Member State other than one into which the UCITS fund has been notified (e.g. if they have purchased units via the internet). This interpretation would apply equally to a UCITS fund that had not been notified for sale in any other Member State. We are seeking clarification of the meaning of Article 15 from the European Commission.

[4] Consumer complaints – the Ombudsman award limit and changes to complaints-handling rules, September 2010.

Box 3.G: Question

3.73 Do you agree with the proposed changes to DISP to implement the complaints-handling requirements of UCITS IV?

3.74 We have considered which "eligible complainants" should be able to refer their complaint to the Financial Ombudsman Service (FOS) once the management company passport comes into force. The current position (DISP 2.6.1R) is that the compulsory jurisdiction (CJ) of the FOS applies to services provided from an establishment in the UK, but does not apply to services provided cross-border from an establishment outside the UK. So, at present, a complaint against the manager of an FSA-authorised UCITS scheme would be covered by the FOS, because the operator would be an establishment in the UK. – and we see no reason to change DISP 2.6.1R where both the UCITS fund and its management company are authorised by us.

3.75 However, the management company passport will allow an FSA-authorised UCITS scheme to be operated cross-border from an establishment outside the UK, as well as allowing UCITS schemes authorised in other EEA states to be operated cross-border from an establishment in the UK. How far should the CJ apply in these circumstances? We consider below the various scenarios that could arise through use of the management company passport:

Scenario 1. UCITS scheme authorised by the FSA, operated by a UK branch of a non-UK management company.

- This is also already covered under DISP 2.6.1R, and we see no reason to change it.

Scenario 2. UCITS scheme authorised by the FSA, operated by a non-UK management company, using a cross-border services passport from outside the UK.

- This would not be covered under the current DISP 2.6.1R, because the service is provided from outside the UK. But we are considering extending the CJ to cover complaints against the operator of an FSA-authorised UCITS scheme, even if that firm is based outside the UK – especially as the rules applying to the operation of the scheme will be those in the FSA Handbook.

3.76 We are concerned that investors in an FSA-authorised UCITS will not understand if some operators (based in the UK) are covered by the FOS and others (based outside the UK) are not. And this might also appear to work against non-UK management companies seeking to use the passport, as eligible complainants for FSA-authorised UCITS operated by UK management companies will continue to have their current FOS referral rights.

3.77 On the other hand, there might be practical issues with the non-UK company co-operating with the FOS investigation, or for the investor to enforce any award the FOS makes against the non-UK company if it does not pay this voluntarily. However, under UCITS IV we have extensive supervisory co-operation duties and powers – including the ability to take action against an incoming management company – and we could look to use these powers in the event of such difficulties.

Box 3.H: Question

3.78 Do you agree that FOS referral rights should be available in respect of complaints by eligible complainants where the UCITS scheme is FSA-authorised, irrespective of the location of the management company or the type of passport it is using (that is, scenarios 1 and 2 above)?

3.79 *Scenario 3. A UCITS authorised in another Member State, operated by a UK management company using a cross-border services passport*.

- This scenario would be covered by FOS under the current DISP 2.6.1R, because the operation is carried out from the UK. Complaints that relate to the operation of the UCITS may require the FOS to make judgements based on the management company's compliance with the rules that apply to UCITS in the relevant Member State where the scheme is authorised.

Box 3.I: Question

3.80 Do you think FOS referral rights should continue to be available for complaints by eligible complainants against a UK management company operating an EEA UCITS authorised in another Member State via a cross-border services passport?

3.81 *Scenario 4. UCITS authorised in another Member State, managed by a UK management company through a branch established in that member State*.

- This scenario would not be covered by FOS under the current DISP 2.6.1R, because the service is provided outside the UK. So, for example, the CJ does not cover other services provided by UK firms from branches outside the UK (e.g. a current account in a French branch, or insurance underwritten by a German branch). The argument for providing cover is that the "motive force" behind the scheme is an FSA-authorised management company, and consumers may feel short-changed if they find they cannot access the same dispute resolution service that would apply to UK management companies operating FSA-authorised UCITS schemes.

Box 3.J: Question

3.82 Do you think FOS referral rights should be available for complaints by eligible complainants against a UK management company operating a UCITS authorised in another Member State via a branch passport?

3.83 In all these scenarios, FOS referral rights would remain available only to "eligible complainants", not all investors in the scheme. The FOS has a general right to dismiss a complaint without considering its merits if it is being dealt with by a comparable independent complaints scheme or dispute resolution service (DISP 3.3.4R (7)). Also, if the complainant consents, the FOS may refer the complaint to another complaints scheme if it considers the matter would be more suitably dealt with by that scheme (DISP 3.4.1R). These powers are clearly relevant in regard to cross-border financial services activity.

3.84 The relevant rules can be found in the DISP section of Annex C. The draft rules implement the broadest possible option (scenarios 1 to 4); the final rules we make will, if necessary, be "cut back" to cover the chosen scenarios.

Compensation

3.85 The Financial Services Compensation Scheme (FSCS) currently provides compensation cover (where all the various conditions for a claim are met) in certain cases if the management company of a UCITS scheme fails[5], i.e. a company providing collective portfolio management. At the moment, both the management company and the UCITS scheme will be authorised by the FSA, but in future this might not always be the case.

3.86 The rules relating to the FSCS are found in the Compensation module (COMP) of our Handbook. In respect of UCITS business, we previously amended COMP to reflect the attempts to bring in a management company passport under UCITS Directive 2001/107/EC. Valid claims could be made only in respect of UK-authorised UCITS schemes. However, this passport proved ineffective in practice.

3.87 We have now considered a number of options for the scope of the FSCS once the management company passport comes into effect. There are no EU requirements for Member States to provide compensation cover for UCITS management companies carrying out collective portfolio management and the UK is unusual in providing such cover. However, we have rejected the option of removing cover for UCITS collective portfolio management business altogether.

3.88 Instead, we propose that the FSCS will be able to provide compensation coverage for UCITS collective portfolio management business - subject to all the usual conditions for a claim to be met – in cases where the UCITS scheme concerned is authorised by the FSA. This will be irrespective of whether the home State of the management company is the UK or elsewhere in the EEA (and in the latter case, irrespective of whether it is passporting into the UK via a branch or on a cross-border services basis). This means that incoming EEA UCITS management companies will be subject to the relevant FSCS levies.

3.89 Conversely, where a UK-authorised management company operates an EEA UCITS scheme, neither the investors in that scheme nor the scheme itself would have any recourse to the FSCS if the management company were to fail. Compensation in such cases would depend on what arrangements, if any, had been made in the home State of the UCITS concerned.

3.90 This proposal has no effect upon the current FSCS coverage position for incoming EEA management companies regarding activities other than collective portfolio management (individual portfolio management, advising, and safeguarding and administration). Neither does it affect the position of EEA UCITS schemes being marketed in the UK under the fund passport, which remain outside the scope of the FSCS.

3.91 The draft rules to implement this proposal appear in the COMP module of Annex C. Please note that the Financial Services and Markets Act 2000 (Compensation Scheme: Electing Participants) Regulations 2001 will also need to be amended to implement that proposal, and the relevant amendment can be found at regulation 6 of the draft UCITS Regulations in Annex B.

Box 3.K: Question

3.92 Do you agree with the proposal that the FSCS should provide compensation coverage where valid claims arise from the default of a management company (irrespective of its home State), if the claims relate to an FSA-authorised UCITS scheme? If not, what do you think the scope of FSCS coverage should be?

[5] It should be remembered that a default by a UCITS management company should not affect the assets of the UCITS scheme, which are held by the depositary, although there is a risk to any monies held by the management company for settlement of outstanding transactions.

4 Investor Disclosure

4.1 Articles 68 to 82 of the new Directive outline the requirements for investor disclosure, including the new requirements for "key investor information" (Articles 78 to 82).

4.2 The key investor information (KII) document will replace the current simplified prospectus, which was designed to provide investors with relevant pre-sale information. KII is intended to be a shorter, more concise form of disclosure that contains only the essential information for investors to make their investment decisions, and sets this information out in a clear and accessible manner.

4.3 The KII must be a single document of limited length. It must identify the type of UCITS and include a short description of its investment objectives and policy, past performance information, charges, and its risk/reward profile. The KII should be produced for all UCITS – there is no category of UCITS that is subject to the Directive but exempt from the KII requirements. It should be provided to all investors as a separate document, free of charge, and in good time before the subscription of the UCITS, in order to allow investors to make an informed investment decision.

4.4 Any person who provides KII to an investor will not incur civil liability solely on the basis of information disclosed in the KII, unless such information is misleading, inaccurate or inconsistent with the fund's prospectus.

4.5 To achieve the objective of providing a highly harmonised document that will be essentially the same for all investors throughout the EEA, the detailed requirements for its contents and format are set out in Commission Regulation 583/2010. Under EU law this Regulation will apply automatically from 1 July 2011, so it does not form part of this consultation.

4.6 Article 118 of the Directive allows Member States to grant a transitional period of up to 12 months before replacement of the simplified prospectus becomes compulsory, and the Government intends to allow the full period. Consequently, from 1 July 2011 until 30 June 2012 a UCITS authorised prior to 1 July 2011 may be promoted in the UK with either a simplified prospectus or KII. Similarly, a UK-authorised UCITS scheme that has been notified for marketing in another Member State may continue to use the simplified prospectus in the host State for as long as it does so in the UK.

4.7 Those UCITS IV provisions relating to KII that are not contained in the Regulation require some minor amendments to FSMA, but will largely be implemented through FSA rules.

HM Treasury

Civil liability

4.8 FSMA new Section 90ZA (see regulation 2(3)) - implements Article 79.2 of the Directive. This ensures that a person is not subject to civil liability solely on the basis of the key investor information document unless the information was misleading, inaccurate or inconsistent with the relevant parts of the prospectus of the UCITS scheme.

Marketing communications

4.9 **FSMA Section 145** – implements Article 77 of the Directive. This sets out rules relating to UCITS marketing communications. These apply to all marketing communications to investors (including communications to sophisticated investors which are exempt under the FSMA (Promotion of Collective Investment Schemes) (Exemptions) Order 2001). The proposed amendments to section 145 extend the FSA's powers under this section to make rules applicable to any person in relation to marketing communications addressed to investors about UCITS.

Box 4.A: Question

4.10 Do you agree that the draft regulation implements the Directive requirements in relation to key investor information and marketing communications correctly? Are there any other matters that should be addressed in the regulation?

FSA rules

4.11 The parts of the Directive which deal with key investor information, and on which we are consulting, are relatively short. The article relating to its form and contents does no more than set out the high-level principles on which the Regulation is based. We propose that the term "key investor information" is defined in our Handbook Glossary as relating to any UK or EEA UCITS scheme, while "key investor information document" (KID) is used more specifically in relation to the document produced for a UK-authorised UCITS scheme under our rules.

4.12 We have transposed most of the Directive requirements into a new section 4.7 of COLL, with the text of the Regulation to be provided in an Annex (not included in the draft Handbook Instrument published in this paper).

4.13 CESR has produced several sets of level 3 guidelines relating to the KII. The first two of these are methodologies for calculating the synthetic risk-reward indicator and the figure for ongoing charges, which were published in July 2010. It is expected that ESMA, once it assumes its new powers in 2011, will adopt these methodologies as binding technical standards; this may happen by July 2011. We have incorporated the CESR methodologies in the Handbook by inserting cross-references at COLL 4.7.8G.

4.14 Subsequently, in December 2010, CESR published:

- guidelines on preparing performance scenarios for structured UCITS in place of past performance information;
- details of how regulators would apply the 12-month transitional period for implementing KII in various situations;
- guidance on the use of plain language in KII; and
- a suggested template for the two-page layout of KII.

4.15 These guidelines have also been incorporated by cross-reference under COLL 4.7.9G. CESR, in adopting the guidelines on performance scenarios and transitional provisions, intends them to be strictly followed by all funds and management companies, and they may be adopted by ESMA as binding technical standards. The plain language guide and template offer examples of good practice and are not intended to be prescriptive.

4.16 Some stakeholders have asked whether there is a requirement or expectation that once investors have made their investment, they should be sent any revised version of the KID for their fund to keep them informed of changes to key information. The KID is a pre-contractual

document, so if the investor is not contemplating making any further investment, there should be no need to send a revised version post-sale. Any changes to the information about the fund which existing investors ought to be made aware of should be disclosed to them under the rules of COLL 4.3. In the case of a notifiable change, this may be done in the annual and half-yearly reports.

4.17 To supplement this form of disclosure, we propose to add specific requirements (COLL 4.5.5R (1)() (a)() (iv) and 4.5.9R (9A)) that for both short and long reports, each annual and half-yearly report of a UCITS scheme should contain a statement of the latest published figure for the synthetic risk and reward indicator, with an indication of any changes to it that have occurred during the period under review.

4.18 Firms should be aware that the obligation to prepare a KID applies in principle to every class of every UCITS scheme; there is no concept in the Directive of an exemption for "institutional" funds, classes or unitholders. However, AFMs may where appropriate prepare a KID which combines details of two or more classes of the same fund (provided this does not make the document over-complicated) or select a representative class as permitted by the Regulation.

Box 4.B: Question

4.19 Do you agree with the proposed amendments to COLL? Are there any other matters related to producing the KID on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

Providing key investor information

4.20 The other aspects of the key investor information provisions in the Directive are addressed in the COBS sourcebook. It is important to note that the proposed changes in this CP relate only to UCITS schemes – we will bring forward separate proposals in the first half of 2011 for the treatment of non-UCITS retail schemes (NURS) under these rules. For this reason, the text of the draft Handbook instrument retains existing references to a "simplified prospectus scheme", but only in relation to a NURS.

4.21 We propose to implement in COBS 14 the requirements relating to provision of the KID by a management company, both when selling directly and when providing text or copies of the KID for distribution by other intermediaries. Because the Directive requires a KID to be provided to all prospective and existing investors before they make a subscription, most of the existing exemptions from the duty to provide the simplified prospectus, set out in COBS 14.2.9R and 14.2.11R, cannot be retained for the KID. We have also amended COBS 14.2.16R and 14.2.17R to clarify that the distance marketing exemptions do not apply where a firm has an obligation to provide pre-contractual key investor information to an investor.

4.22 We believe, however, that for a top-up investment or a switch between classes of the same fund or sub-fund, we can make exceptions to the requirement to provide a KID as long as the investor has already received the latest version of the KID for that fund (or sub-fund) and class. This is reflected in COBS 14.2.9AR.

4.23 COBS 14.2.1R contains a new requirement for firms selling UCITS schemes to provide investors with the relevant pieces of information set out in COBS 13.3.1R (2), at the same time as the KID. This will include information about complaints handling, compensation rights, and cancellation rights (if applicable). Under present rules, firms can satisfy this requirement by including the information in the simplified prospectus, but it will not be possible to do the same thing in the KID, so firms will need to produce a separate form of disclosure. This disclosure

should be sufficiently prominent to ensure that the communication as a whole is fair, clear and not misleading, although the rule does not define what form the disclosure should take.

4.24 The Directive also contains some new and amended material setting out certain factual and risk disclosures that must be stated in any "marketing communication" about a UK or EEA UCITS scheme. These provisions apply to any firm that sells units in the UCITS, not just its management company, so we propose to implement them through rules in COBS 4.2 and 4.3. The term "marketing communication" is not defined in the Directive. We considered whether to replace it with the term "financial promotion", but judged that this would potentially widen the scope of the rule beyond what was intended by the Directive. We have retained "marketing communication" in our draft rules as an undefined term, so it has its natural meaning.

4.25 In relation to any marketing communication about a UCITS scheme, the rule requires any specific information about the fund to be consistent with its prospectus and KID and to make clear that scheme documents are available on request. If the fund's investment objective and policy have certain specific characteristics (e.g. ability to hold significant exposure to Government and public securities, likelihood of high volatility through holding derivatives or warrants), then the communication must draw attention to them.

4.26 Finally, the Directive permits both the KID and the prospectus of a UCITS scheme to be published in a durable medium; we have added rules implementing this at COBS 14.2.1B R for the KID and at COLL 4.2.3R (1A) for the prospectus.

Box 4.C: Question

4.27 Do you agree with the proposed amendments to COBS and COLL? Are there any other matters related to providing the KID or marketing communications on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

5 Master-Feeder Structures

5.1 Chapter VIII of the new Directive (Articles 58 to 67) introduces the ability for UCITS funds to establish master-feeder arrangements.

5.2 The UCITS Directive places strict limits on the amount of a UCITS' assets that it can invest in another fund. However, UCITS IV will allow a fund (called a 'feeder' fund) to invest the majority of its assets into another single fund (called a 'master' fund), in what is referred to as a master-feeder structure.

5.3 UCITS operators wishing to establish a master-feeder arrangement can be established in the same Member State or different Member States, but both the master and feeder funds must be subject to the Directive. The master UCITS cannot itself be a feeder, nor can it hold units in any other feeder UCITS. A master UCITS may accept investment from the general public, or may be restricted to feeders — in which case it must have at least two feeder UCITS (there is no restriction on a master UCITS accepting investment from non-UCITS feeders).

5.4 The feeder fund must have its investment in the master UCITS approved by its home State regulator. The regulator must grant the feeder UCITS authorisation if all the conditions set out in the Directive are met, and must inform it as to whether or not the investment in the master UCITS has been approved within 15 working days of receiving a complete application.

5.5 The level 1 and 2 Directives contain a considerable amount of prescriptive material concerning master-feeder arrangements. The feeder UCITS must invest at least 85% of its assets in units of a single master UCITS. There must be a legal agreement between the master and feeder funds governing the sharing of information and how the feeder will interact with the master. In addition, if the feeder and master UCITS have different depositaries or auditors, then there must be agreements in place between those parties to ensure appropriate sharing of information.

5.6 The feeder's prospectus and key investor information must disclose how the master-feeder structure works and give investors information about it, e.g. the combined charges of the two funds. To protect unitholders, UCITS that wish to convert into feeder funds or to link up to a new master fund have to inform all unitholders in advance of the change; the unitholders are then entitled to redeem their units free of charge within 30 days.

5.7 The master-feeder provisions require amendments to FSMA and the Open-ended Investment Company Regulations 2001 (OEIC Regulations) to provide for master-feeder structures in relation to authorised unit trusts and open-ended investment companies. The amendments will set out the terms on which an investment by a feeder UCITS in a master UCITS will be approved by the regulator, the consequences for a feeder UCITS of the winding-up of its master fund, and make provision for certain information relating to the master fund to be given to the feeder UCITS.

HM Treasury

Master-feeder structures

5.8 **FSMA new Section 283A** (see regulation 2(26)) - implements Article 59 of the Directive which requires any investment by a UCITS in another UCITS which exceeds the limits set in Article 55 to be subject to prior approval by the regulator, and sets out the conditions which must be satisfied before approval will be given. Regulation 3(4) makes equivalent provision for open-ended investment companies (new regulation 22A of the OEIC Regulations).

Liquidation of a master UCITS

5.9 **FSMA new Sections 252A and 258A** (see regulation 2(19) and (21)) - implement Article 60.4 of the Directive in relation to authorised unit trusts. Section 252A sets out the procedure which will apply where the manager of an authorised unit trust which is a feeder fund proposes to convert it to a non-feeder fund. Section 258A sets out the consequences for a feeder UCITS where its master UCITS is liquidated, merged with another UCITS or sub-divided into two or more new UCITS. Equivalent provision is made in relation to open-ended investment companies in regulation 3(6) (new regulations 33A and 33B of the OEIC Regulations). Further consequential amendments have also been made to FSMA Section 251 and Section 259 in order to implement these requirements.

Information to the home State regulator and feeder UCITS

5.10 **FSMA new Sections 261A and 261B** (see regulation 2(23)) - implement Articles 66.7 and 67 of the Directive in relation to authorised unit trusts. Section 261A requires the FSA to inform the home State regulator of any EEA UCITS which is a feeder UCITS of an investment by that UCITS in a UK master UCITS. Section 261B imposes further obligations on the FSA, where it becomes aware of a significant issue in relation to a master UCITS (such as a breach of rules affecting investors or an enforcement action against a person connected with the UCITS), to notify that matter to the manager of an authorised unit trust which is a feeder of that master. Equivalent provision is made in relation to open-ended investment companies in regulation 3(5) (new regulations 29A and 29B of the OEIC Regulations).

Information-sharing agreements

5.11 **FSMA new Section 351A** (see regulation 2(28)) - implements requirements in Articles 61.1 and 62.3 of the Directive, for the depositaries (Article 61) and auditors (Article 62) of the master and feeder UCITS to enter into information-sharing agreements, and to be exempt from liability in relation to disclosures of information made under those agreements in relation to authorised unit trusts. The trustee of an authorised unit trust is its depositary for the purposes of the UCITS Directive. Equivalent provision is made in relation to open-ended investment companies in regulation 3(8) (new regulation 83A of the OEIC Regulations).

Box 5.A: Question

5.12 Do you agree that the draft regulation implements the Directive requirements in relation to master-feeder arrangements correctly? Are there any other matters that should be addressed in the regulation?

FSA rules

5.13 Those parts of Articles 58 to 67 being transposed through FSA rules are located in the Collective Investment Schemes sourcebook (COLL). We have decided to insert them in various parts of COLL, according to their precise subject matter, rather than placing all of them in a

separate section. As a result, any firm intending to operate either a feeder UCITS or a master UCITS will need to look carefully at both the UCITS Regulations and COLL as a whole.

General provisions concerning master-feeder arrangements

5.14 The largest part of the material is contained in a new Chapter 11. Following the introductory section, section 2 of the Chapter sets out the information that the AFM of a feeder UCITS must provide for us to approve its investment objective and policy. If the master UCITS is an EEA UCITS scheme, its home State regulator must provide an attestation that the scheme fulfils the Directive conditions for a master UCITS. By July 2011 we shall establish and publish a procedure for firms to request a corresponding attestation in respect of a UK UCITS scheme that is to be the master for a prospective EEA feeder UCITS.

5.15 Section 3 of Chapter 11 deals with the ongoing obligations of AFMs of feeder and master UCITS. The AFM of the feeder has the responsibility for ensuring that an agreement has been entered into with the master, unless both funds are managed by the same AFM, in which case internal conduct of business rules may be substituted. The Directive specifies the minimum requirements of the agreement and the internal rules (set out in Annexes 1 and 2 of the Chapter), which AFMs may supplement as they see fit in the light of their operational arrangements.

5.16 The other key obligation of the feeder AFM (set out in COLL 11.3.8R) is to monitor the activities of the master UCITS. This is necessary to demonstrate that the feeder is not merely a "slave" fund of the master, but that its senior management is treating the feeder as an independent entity and the master UCITS as an asset in which the feeder has chosen to invest.

5.17 The management companies of feeder and master must, of course, co-operate to a great extent to ensure the agreement between them works effectively. In particular they must ensure that the timings of calculations of the net asset value and publication of unit prices are co-ordinated in a way that does not create opportunities for market timing activities.

5.18 The Directive obliges the AFM of a master UCITS to:

- inform the FSA of the identity of each of its feeder UCITS;
- ensure that no fee is charged to the feeder when it buys and sells units in the master; and
- ensure that all the information to which the feeder, its depositary and auditor are entitled, is made available to them in a timely manner.

5.19 In addition, we propose to introduce a rule (COLL 11.3.14R) applicable to any UK master UCITS which has unitholders other than feeder UCITS. The rule is intended to protect the interests of non-feeder UCITS unitholders and ensure they are fairly treated. It will require the AFM of the master to satisfy itself that the terms of its relationship with its feeder(s) do not unfairly prejudice the interests of other investors. The AFM must also consider whether it should inform other investors in the master of any matters reported by the master's depositary to the feeder (as explained in the next paragraph). It may legitimately decide not to inform them, provided it keeps a record of each such decision and the reasons for it. The record should contain enough detail to show why withholding the information from other investors was not likely to result in them suffering a material disadvantage compared to the feeder UCITS.

5.20 Sections 4 and 5 of Chapter 11 transpose the obligations of the feeder's and master's depositaries and auditors to enter into agreements and share information. Depositaries of master UCITS should note that although COLL 11.4.3R (2) lists specific potential "irregularities" which should be reported to the feeder UCITS and to us, the list is not exhaustive and the

depositary must exercise its judgement to determine whether any matter it becomes aware of might have a negative impact on a feeder UCITS.

5.21 Section 6 deals with the options available to a feeder UCITS when its master goes into liquidation or is to be wound up, merged with another scheme or sub-divided. Under the Directive, the default position is that the feeder must be wound up unless it applies to us for approval to do one of the following:

- invest in a master resulting from the merger or division;
- invest in an entirely different master; or
- adopt a new objective and policy and cease to be a feeder UCITS.

5.22 The Directive measures impose tight timescales on the process, which should not be problematic in straightforward situations (e.g. where the master is the receiving UCITS in a merger) but which might cause the feeder difficulties if the master were to give only the minimum period of notice required by the legislation and the feeder had no prior warning of the impending change. The AFM of the feeder will need to be aware that certain types of change (e.g. any decision to cease operating as a feeder and adopt an entirely new investment objective) must be approved by resolution of a meeting of unitholders, in addition to the specific requirements of the Directive.

Box 5.B: Question

5.23 Do you agree with the proposed amendments to COLL? Are there any other matters related to the general provisions for master-feeder arrangements on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

Investment powers of a feeder UCITS

5.24 COLL Chapter 5 section 8 sets out the investment and borrowing powers of a feeder UCITS scheme. Much of the rest of COLL 5 is disapplied for such schemes; sections 1 and 8 set out which parts are still relevant.

5.25 COLL 5.8.2R transposes the requirement for a feeder UCITS to invest at least 85% of its scheme property in units of the master. We propose to include a rule requiring the rest of the feeder's scheme property to have a prudent spread of risk. Although such a rule might appear unnecessary where the proportion of the scheme property affected by it is very small (and it must always be less than 15%), we think it is desirable to cover situations such as the placing of monies on deposit, or the selection of counterparties for OTC derivatives entered into for hedging purposes.

5.26 The AFM of a feeder may, as for any other authorised fund, add limitations to the scheme instrument and prospectus as to how the scheme property may be invested. We also propose a rule (COLL 5.8.7R) clarifying that the ban in Article 66.2 on charging fees on a feeder's subscriptions to and redemptions from the master UCITS, does not apply to the deduction of a dilution levy and an SDRT provision from transactions made by a feeder. The rule does not refer to a dilution adjustment in respect of a fund with a swinging single price, since we consider that such an adjustment is not a fee or charge within the meaning of Article 66.

Disclosure to investors

5.27 Other measures which are relevant to feeder and master UCITS are contained in Chapters 3 and 4 of COLL. A feeder must contain a statement in its trust deed or instrument of incorporation that it is a feeder UCITS (COLL 3.2.6R 7D), although it is not obliged to identify the

specific master UCITS. This will avoid the need to amend the instrument if, for example, the master UCITS changes its name. The feeder must however identify the specific master in its prospectus (COLL 4.2.5R 25A), along with various other pieces of information concerning the master UCITS and the agreement between the two fund operators.

5.28 The prospectus of a master UCITS must contain an explicit statement that it is not a feeder UCITS and will not invest in units of a feeder UCITS (COLL 4.2.5R 3(t))., It is recommended that the prospectus states that the UCITS scheme operates (or intends to operate) as a master UCITS, although the prospectus need not identify the specific feeder UCITS that are linked to it.

5.29 A feeder UCITS must, on an ongoing basis, give us copies of the master UCITS' prospectus and its annual and half-yearly reports, and make these documents available to its own unitholders free of charge on request (COLL 4.2.3AR and 4.5.15R).

5.30 COLL Chapter 4 section 8 is closely related to the process for a change of master, as it sets out the information to be provided to unitholders when an existing UCITS applies to become a feeder, or when an existing feeder is to invest in another master. The Directive grants investors a 30-day period during which they have the right to sell their units without charge, before the fund can begin to follow its new investment aim.

Changes affecting a feeder UCITS

5.31 The AFM of a UK-authorised feeder UCITS is subject to the rules in COLL 4.3 concerning changes to the scheme. A new rule (4.3.11R) proposes that the AFM should treat any change to the master as a change to the feeder and classify it accordingly. This means that the AFM should assess the impact of the change to the master in terms of how it affects the unitholders in the feeder.

5.32 For example, if the master were to change its investment objective and policy in a way that alters its risk profile, this would have the effect of a fundamental change for investors in the feeder. The AFM of the feeder would need to consider whether it was still appropriate to invest in that master. It would have the options of deciding to switch to a different master that offers an unchanged risk profile (which would require it to follow the proposed procedure set out in Section 252A of FSMA) or holding a meeting of unitholders to vote in favour of continuing to invest in the master according to its new objective and policy.

5.33 However, the feeder AFM's assessment might result in a different classification than if the change to the master were itself being assessed under the rules of COLL 4.3. A change which would generally be regarded as significant for unitholders of the master (e.g. a change in how the master publishes unit prices) would not necessarily be significant for investors in the feeder, so could be treated as a notifiable change. The feeder's AFM could in some cases choose to take action to mitigate the effect of the change on the feeder. For instance, the feeder's AFM could react to an increase in the charges borne by the master UCITS by absorbing it or by reducing the feeder's own charges, so that the effect on the feeder's unitholders is neutral.

5.34 We recognise that in some cases the AFM of the feeder may receive short notice of a change and so may be unable to follow the COLL process within the timescales set down in our rules. While we are sympathetic to the need to avoid undue burden on the AFM in such cases, and not to penalise firms for a breach of rules that is beyond their control, it would be difficult to write rules or guidance providing a general relief from such duties, given the potentially wide range of problematic situations that might arise in practice.

5.35 We think that the most practical approach in the early stages of implementation would be to encourage firms to apply for a rule waiver or modification where necessary, and to consider in the light of experience whether to make general rule changes. We particularly welcome the views of stakeholders on this last point.

Suspension of dealing in units

5.36 COLL 7.2.1AR provides that where dealings in the units of a master UCITS are suspended, the AFM of a feeder UCITS scheme may suspend dealings in its own units until such time as dealing in the master UCITS is resumed. As with any other situation in which suspension of dealing is contemplated, it is for the AFM of the feeder to determine what is in the best interests of its unitholders on a case by case basis. The normal rules of COLL apply in terms of notification to the FSA and keeping unitholders appropriately informed.

Box 5.C: Question

5.37 Do you agree with the proposed amendments to COLL? Are there any other matters related to disclosure of master-feeder arrangements, the investment powers of feeder UCITS, changes to the master affecting feeder UCITS, and suspension of dealing, on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

6 Mergers

6.1 To remove barriers to the consolidation of UCITS, Articles 37 to 48 of the new Directive introduces a harmonised EU framework for mergers of UCITS funds where there is a cross-border element. This includes mergers where:

- at least two of the UCITS involved in the merger are established in different Member States;
- UCITS established in the same Member State are to merge into a newly constituted fund in another Member State; or
- the UCITS are based in the same Member State and at least one of the UCITS involved uses the fund passport to market in other Member States.

6.2 The last scenario is, somewhat confusingly, referred to as a "domestic merger". However, the merger of two or more UCITS established in the same Member State, where none of the UCITS has been notified for cross-border marketing, is not covered by the Directive.

6.3 The rules apply to all UCITS, irrespective of their legal form (unit trusts, investment companies or contractual funds). Each Member State should recognise cross-border mergers between all types of UCITS but they do not need to provide for new legal forms of UCITS in national law. Neither do Member States need to introduce new types of merger techniques in their domestic legislation, but they will need to recognise a transfer of assets resulting from any of the three techniques identified in the Directive.

6.4 All mergers covered by the Directive must be subject to prior authorisation by the regulator of the merging UCITS (the UCITS that will cease to exist post-merger) The Directive sets out the procedure for seeking such authorisation, including the content of the information which must be provided by the merging UCITS to its regulator. The merging UCITS regulator will transfer a copy of the authorisation file to the regulator of the receiving UCITS (the UCITS that will continue to operate after the merger).

6.5 Each regulator will then assess, and may demand amendments to, the information to be provided prior to the merger to the investors of the UCITS which it regulates. This information includes details about the other UCITS, and must be supplied in a durable medium. Detailed rules about the content and method of delivery for this information are set out in Articles 1 - 7 of the level 2 Directive 2010/44/EU.

6.6 UCITS IV also introduces a number of other measures to ensure that the interests of unitholders are suitably protected. Depositaries of both the merging and the receiving UCITS must verify certain elements of the merger proposal, and either the depositary or an independent auditor must validate the criteria used for valuing the assets and liabilities of the funds in the merger. Unitholders in both the merging and receiving UCITS must have the right to repurchase or redeem their units or, where possible, to convert them into units in a similar fund, without charge (other than costs retained in the fund), prior to the merger. Also, the costs of a merger should not be borne by investors of either UCITS.

6.7 The merger requirements will be implemented through regulations 7-14 of the proposed UCITS Regulations and changes to the FSA Handbook.

HM Treasury

Definitions

6.8 Regulations 7 and 8 – set out the definitions relevant to mergers contained in Article 2 of the Directive.

Application for authorisation

6.9 Regulation 9 – implements Article 39 of the Directive, which requires all mergers to be subject to prior authorisation by the home State regulator of the merging UCITS and sets out the process for seeking such authorisation.

Modification of information

6.10 Regulation 10 – implements Article 39.3 of the Directive, which sets out the process through which the regulator of the receiving UCITS can request a modification of the information from the regulator of the merging UCITS.

Report by depositary or auditor

6.11 Regulation 11 – implements Article 42 of the Directive, which requires that before a merger is undertaken, a report is drawn up by the depositary or an independent auditor, validating the method of valuation of the assets and liabilities, the calculation method of the exchange ratio, the actual exchange ratio and, where applicable, the cash payment per unit.

Right of redemption

6.12 Regulation 12 – implements Article 45 of the Directive. This establishes the right of the unitholders in both the merging and receiving UCITS to require the AFM to either repurchase or redeem their units or convert them into units in a similar fund, in each case free of charge (except for costs retained in the fund), prior to the merger.

Consequences of a merger

6.13 Regulation 13 – implements Article 48 of the Directive which sets out the consequences that result from each type of merger (i.e. merger by absorption, by formation of a new UCITS, or by scheme of arrangement).

Publication of a merger

6.14 Regulation 14 – implements the requirement in Article 47.2 of the Directive for the entry into effect of the merger to be made public, which will be done in the FSA Register.

Box 6.A: Question

6.15 Do you agree that the draft regulation implements the Directive requirements in relation to UCITS mergers correctly? Are there any other matters that should be addressed in the regulation?

FSA rules

6.16 The FSA's rules relating to UCITS mergers are all set out in COLL 7.7. They cover:

- the requirement to draw up a terms of merger document and the matters this must cover (7.7.6R);

- the role of the depositary in verifying certain matters in the terms of merger (7.7.8R);
- the categories of information that must be provided to unitholders of the merging and receiving UCITS respectively (7.7.9R to 7.7.14G);
- the requirement to provide a copy of the KII of the receiving UCITS to unitholders of the merging UCITS (7.7.15R and 7.7.16R);
- the duty to provide merger information in a durable medium (7.7.18R);
- requirements for approval of the mergers by unitholders (7.7.19R); and
- the restriction on the AFM of either UCITS from charging any merger costs to the scheme itself or its unitholders (7.7.22R).

6.17 We propose to retain the Directive terminology of "cross-border mergers" and "domestic mergers" in our rules, and we have also copied the terms "merging UCITS" and "receiving UCITS" to represent the funds involved.

6.18 The COLL measures closely follow the Directive text, so we do not comment on all of them in detail here. However, please note that COLL 7.7.19R makes it clear that - in addition to the requirements of the Directive – a unitholder meeting must be held to approve the merger proposals where our rules require it. This will affect all mergers in which a UK UCITS scheme is the (or one of the) merging UCITS, and in addition any merger where a UK UCITS scheme is the receiving UCITS and the exemption provided in COLL 7.6.2R (5) and (6) does not apply.

6.19 The unitholder information requirements are the most detailed element of this section. The Directive text emphasises the importance of providing a document that is comprehensible to investors, using similar disciplines of clarity and plain language to those applicable to the KID (although there is no restriction on the length of the merger information document). The versions intended for unitholders of the merging and receiving UCITS have some matters in common, but generally speaking it should be possible to produce a shorter document for investors in the receiving UCITS, who do not need very much information about the operation of the merging UCITS.

6.20 We are not proposing at this time to apply this regime to mergers that are outside the scope of the Directive (i.e. non-UCITS schemes and mergers of UCITS that are not notified for marketing in other Member States). We expect any AFM proposing a merger to provide a fair, clear and not misleading explanation of the proposal to unitholders who are being invited to vote on it. The Directive material may be helpful to AFMs in indicating areas that a unitholder would reasonably expect to be addressed, but we do not have reason to think the current rules need to be more prescriptive.

6.21 Similarly, we are not persuaded that extending the ban on the charging of merger costs to the fund, so as to apply to mergers of UCITS schemes that are outside the scope of the Directive, is likely to produce better consumer outcomes. The need to obtain investor approval for a proposed merger acts in many cases as an incentive for the AFM to absorb some or all of the merger costs, but this may not always be the case.

6.22 Although on the face of it there will be an obvious disparity in the treatment of investors in funds within the scope of the Directive and those outside its scope, other factors may counter-balance this. For example, there is a risk that an inability to charge such costs to the fund might deter an AFM from proposing a merger as a means of addressing the problem of an unviable or under-performing fund. That would not necessarily be in the longer-term interests of its investors. Our preferred course of action is to see what effect the Directive provision (COLL

7.7.22R) has in practice, so that we can judge whether there is a sound cost-benefit case for extending the charging ban more widely.

Box 6.B: Question

6.23 Do you agree with the proposed amendments to COLL? In particular, do you agree that the Directive regime should not be applied to mergers of UCITS schemes that are outside the scope of the Directive? Are there any other matters related to UCITS mergers on which the FSA should publish rules or guidance to ensure the Directive is transposed effectively?

7 Improved Supervisory Co-operation

7.1 Many of the new measures in UCITS IV, especially the management company passport, are likely to give rise to increased cross-border activities, which will place high demands on regulators. It is important to have a clear definition of the roles and responsibilities for regulators, to avoid potential supervisory gaps or overlaps which may otherwise result from increased cross-border activity.

7.2 UCITS IV provides for a minimum degree of harmonisation of regulators' powers, to ensure that they all have the necessary tools to carry out their tasks, and minimises the risk for regulatory arbitrage. These powers are consistent with those conferred upon regulators in other EU financial services legislation.

7.3 The UCITS Directive already imposes a general obligation on regulators to co-operate with one another, but UCITS IV establishes a more detailed framework for effective information exchanges and other co-operation mechanisms to allow regulators to carry out their tasks properly. This will include supervisors requesting other regulators to co-operate in supervisory activities or on-the-spot verifications. It sets out the situations when regulators are required to share information. For example, when the supervision of the management company and the fund are split, then the regulators must inform each other of problems they identify with the entities they are responsible for. Each regulator must pass on any concerns they have that an entity may be breaching the Directive, even if they are not responsible for its supervision.

7.4 The Directive also gives host State regulators power to take measures against management companies or UCITS that operate in a Member State through the passport, even though the supervision of the rules which has been breached is the responsibility of the home State regulator. Such powers, however, are only triggered if the breach remains uncorrected, despite the measures taken by the home State regulator or because such measures prove inadequate or are not taken in good time.

HM Treasury

Host State disciplinary powers

7.5 FSMA Section 195 A (regulation 2(8)) – implements Article 108 of the Directive by ensuring that where the FSA is the host State regulator for a UCITS established in another Member State, and the UCITS contravenes provisions of the UCITS Directive which its home State regulator is primarily responsible for enforcing, the FSA can take the action permitted by Article 108. The FSA must, in the first instance, inform the UCITS home State regulator which should take the appropriate measures. If, despite measures taken by the home State regulator or because such measures prove inadequate or are not taken in good time, the UCITS continues to acts in a way that is contrary to the Directive, the FSA may itself take measures against the UCITS.

Box 7.A: Question

7.6 Do you agree that the draft regulation implements the Directive requirements in relation to supervisory co-operation correctly? Are there any other matters that should be addressed in the regulation?

FSA rules

7.7 The existing provisions of FSMA, together with the proposed amendment described above, give the FSA extensive powers to require the co-operation of authorised persons in relation to any requests for information or any investigation. We do not propose any rules or guidance in this regard in addition to those described in the preceding chapters of this paper (see Chapter 3 concerning amendments to the Supervision manual).

7.8 Where we consider it appropriate, we will publish in due course information for firms and other stakeholders, explaining how we intend to fulfil our duties of co-operation under the Directive. We may do this in a revision to the Collective Investment Scheme Information Guide (COLLG) or in a newly published document, or by providing information on our website.

Box 7.B: Question

7.9 Do you agree with our proposed approach? Are there any other matters related to supervisory co-operation on which the FSA should publish rules or guidance to ensure effective transposition of the Directive?

8 Other

HM Treasury

8.1 The various changes in UCITS IV require a number of consequential amendments to provisions in FSMA and an extension of the FSA's disciplinary powers.

Disciplinary powers

8.2 FSMA Section 66(2) (see regulation 2(2)) will be amended to ensure that the FSA's disciplinary powers may be used in relation to contraventions of directly applicable Community regulations or decisions which are made under the UCITS Directive. The Directive gives various powers to the Commission to adopt implementing measures, and is being further amended by the recently-negotiated Omnibus Directive (which makes amendments in relation to most of the EU sectoral directives on financial services in relation to the new European Supervisory Authorities). These further amendments to the UCITS Directive will give the European Securities and Markets Authority (ESMA) the power to develop draft technical standards. The standards may be adopted by either a Commission regulation or a decision, and both therefore need to be covered in Section 66(2). Similar amendments are proposed in relation to Sections 205, 206, 206A, 380, 382, 384 and Schedule 1, paragraph 6.

Consequential amendments

8.3 FSMA Section 140(3)(b) (see regulation 2(4)). This is a consequential amendment reflecting the fact that the definition of "management company" is now in a different article of the Directive. Similar consequential amendments are made to Section 301E(7), Section 422A(7), and paragraph 5(f) of Schedule 3 (see regulations 2(22), (24) and (26)(b)).

Box 8.A: Question

8.4 Do you agree that the draft regulation correctly implements all the Directive requirements not described in other parts of this paper? Are there any other matters that should be addressed in the regulation?

FSA Rules

8.5 The FSA proposes to make consequential changes to the Decision Procedure and Penalties manual (DEPP) which are set out in the DEPP section of the draft Instrument in Annex C. These reflect changes in the circumstances in which we can issue warning and decision notices in relation to a UCITS scheme.

8.6 Other consequential changes to the FSA Handbook will be necessary – for example, to update existing references to the Directive or specific articles in it. These changes will, if material, be consulted on in the first half of 2011 (changes that are not material will be made automatically).

8.7 As mentioned earlier in the paper, we are not making any proposals at this stage to modify the regime for other categories of UK-authorised funds. We are currently considering what

changes might be appropriate to make to the regime for non-UCITS retail schemes (NURS); these might include the application of the risk management and measurement procedures, allowing the use of the KID as an alternative to the Key Features Document, or creating a form of master-feeder structure. We aim to consult on any changes arising from this review in the first half of 2011, although we would not expect rules to be in place before 1 July 2011.

Box 8.B: Question

8.8 Do you agree with the FSA's proposed approach to the transposition of requirements affecting UCITS schemes? Are there any other matters related to the transposition of the Directive, not addressed in other parts of this paper, on which the FSA should publish rules or guidance?

8.9 What are the key issues the FSA should consider in deciding whether to apply requirements of the UCITS Directive to other types of UK-authorised funds?

8.10 Do you have any comments on the FSA's compatibility statement or cost-benefit analysis set out in Annexes D and E of this paper?

9 Tax Statement

9.1 The Government recognises the opportunities that UCITS IV presents for the UK funds industry and its investors. It believes that tax policy should be aligned with modern business practice and that commercial decisions should not result in adverse tax consequences. The Government is committed to taking all available measures, within the current fiscal constraints, to maintain and build on the UK's position as a major global centre for the asset management industry, and to ensure that UK businesses can take full advantages of opportunities created by EU legislation such as UCITS IV.

Master-feeder

9.2 As announced on 23 November, by the Financial Secretary, the Government will launch a tax transparent vehicle. One of the benefits this vehicle would provide is suitability for UCITS IV master funds. The Government will continue to develop the details of such a vehicle in consultation with industry, before introducing the new regime in 2012

9.3 . It will also seek to give certainty to industry on technical concerns for Master Feeder structure, such as the Genuine Diversity of Ownership and Controlled Foreign Companies as part of this process.

The management company passport

9.4 The Government will consult with industry to find an appropriate way of ensuring that there will be no adverse UK tax consequences for a foreign UCITS fund as a result of having a UK management company. This will be subject to ensuring appropriate parliamentary procedure and managing any risk to the Exchequer.

10 Responding to the Consultation

10.1 The Government would welcome responses on its proposals for the implementation of UCITS IV into UK law and the FSA would welcome responses on its accompanying proposed rule changes.

How to respond

10.2 The Government and FSA 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 three months. Please respond by Monday 21 March 2011. Responses to the consultation should be sent to:

James Steer
Savings and Investments
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5044

Email: james.steer@hmtreasury.gsi.gov.uk

10.3 This document can be found on HM 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

10.4 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 another confidential version for the team managing the consultation, which includes FSA staff.

10.5 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.

Cabinet Office Code of Practice for Written Consultations

10.6 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.

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

Angela Carden
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Email: angela.carden@hmtreasury.gsi.gov.uk

Confidentiality disclosures

10.8 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, among 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.

10.9 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.

10.10 Freedom of Information contact

10.11 Any Freedom of Information Act queries should be directed to:

Correspondence and Enquiry Unit
Freedom of Information Section
HM Treasury
1 Horse Guards Road
London
SW1A 1HQ

Tel: 020 7270 4558

Fax: 020 7270 4681

Email: public.enquiries@hmtreasury.gsi.gov.uk

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

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