

22 September 2009

Matthew Cowie
Savings and Investments
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Matthew,

RE: Consultation on introducing a protected cell regime for OEICs

The IMA represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around £3 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies).

The IMA welcomes the proposal to introduce a protected cell regime for OEICs. As the consultation paper notes, a number of other jurisdictions already have a protected cell regime in place and we believe that the introduction of such a regime in the UK will assist in enhancing the UK's competitiveness. We therefore urge the government to introduce the regime as soon as possible.

Following consultation with our Members we believe that there are, in particular, two aspects of the proposals which require further consideration. One relates to the HMT part and one to the FSA part.

HMT proposal

Overall we have no adverse comments from Members on any aspect of the statutory instrument for new OEICs. **Responses from firms have shown there is a very substantial measure of concern over the proposal for compulsory conversion for existing OEICs within one year.** Unless it is possible to intervene statutorily in relation to all existing OEIC contracts and provide that they are deemed to be drafted on a protected cell basis, we believe that existing OEICs should only have to move to protected cell status once all non-compliant existing agreements have expired or are renegotiated. Given the responses, we cannot see how practically a time limit could be imposed and would urge you to delete the

phrase in Regulation 4(3) "before the end of the period of one year beginning with the date these Regulations come into force".

FSA proposal

The definition of "Foreign Law Contract" captures too many agreements that practically will not be at risk of a foreign court's action. This needs to be amended – for example the 2002 ISDA Master Agreement is defined as a foreign law contract by this approach.

These points are covered in more detail in the attached paper which sets out our responses to the questions in the consultation paper.

If you have any questions, or require any further assistance on this matter, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink that reads "Karen Bowie". The signature is written in a cursive style with a long horizontal stroke at the end.

Karen Bowie
Senior Adviser – Product Regulation

**Consultation on introducing a protected cell regime for OEICs
IMA responses to specific questions**

- 1. Do you have any comments on the impact of allowing paperless settlements, be it the legislation, its benefits, or unintended consequences?**

As the Consultation Paper notes, it is still too soon to evaluate the impact of the legislation. In the current economic environment, resources are scarce and, with competing demands upon firms' development budgets, it is unlikely that benefits will be felt for a while yet.

- 2. Do you agree that the provisions in Regulation 11A into the OEIC Regulations successfully create a protected cell regime for umbrella funds, with segregated liability for sub-funds?**

HM Treasury has sought to make the regime as robust as possible. It is important that the regulations prevent not only action by the courts and contractual claims but also prevent self-help remedies. The provisions appear to address this.

It is, of course, acknowledged that it is impossible to guarantee that all jurisdictions will share the UK interpretation of a protected cell regime. We note that this is addressed though the FSA disclosure proposals contained in Chapter 3 of the consultation paper.

- 3. Do you agree that the provisions in regulation 33A provide for a suitable wind up mechanism for OEIC sub-funds?**

We do. The regulation provides additional material as needed and then reads in the Insolvency Act which imports other provisions such as in relation to the liquidator's powers mutatis mutandis.

- 4. Do you agree with this disclosure requirement?**

We agree with the disclosure requirement. It is helpful to have a standard wording.

- 5. Do you agree that a compulsory regime for all OEICs, with a transitional period for existing OEICs, is the right approach?**
- 6. Is self-certification adequate to ensure that all OEIC umbrella agreements are compliant with the transitional provisions in the SI?**
- 7. Do you agree that one year is long enough for the transitional period? Are OEICs likely to have to renegotiate many agreements because they are not already on a segregated liability basis? If so, will an OEIC's agreements have expired or will it be able to renegotiate within the year?**

(Response to Qs 5-7)

For simplicity we have decided to answer these questions together.

Following consultation with our members, it is clear there are significant concerns regarding the practicability of the proposed transitional provisions for existing OEICs.

Before considering the practical issues, it is clear from feedback that firms may not understand how Regulation 4(1) will operate in practice for existing OEICs. If an OEIC agreed with its counterparty to amend an existing agreement in some way after the regulations commence would that trigger the Regulation 11A(3) protection or would it need to be referred to explicitly or by nature of the subject matter of the agreement? If for example there was an existing master agreement, would a fresh trade be protected by Regulation 11A(3) given that refers to an agreement and a contract?

Critical to the success of HM Treasury's proposal regarding existing OEICs will be the willingness of counterparties to address non-compliant existing agreements within a year.

As both HMT and FSA will know, OEIC managers have had recent experience of seeking to agree with counterparties terms for OTC derivative transactions which comply with the provisions of COLL 5.2.23 when it was amended in July 2008. Obtaining counterparty agreement to COLL compliant terms has proved exceedingly difficult and, in many cases, impossible. We note that the FSA is now consulting upon changes to this section of the COLL rules. This experience highlights the fundamental inequality of bargaining power between the buy-side and the sell –side.

One possibility is just to drop the time-limit from Regulation 4(3), by deleting the phrase “before the end of the period of one year beginning with the date these Regulations come into force”.

If however some time limit is retained in Regulation 4(3), then in the light of responses from firms, we consider the following approach will be needed:-

- (i) Intervene statutorily in all existing OEIC contracts and provide that they are deemed to be drafted on a protected cell basis; and
- (ii) Allow existing creditors **who have not currently agreed to protected cell** treatment to intimate at the beginning of the one year transitional period that they wish to walk away from their OEIC contracts effective at the end of the transition period. This would be a one-off termination opportunity only for creditors. It is important to give creditors protection. No penalty would apply. Settlement payments would be simple for accrued fees. Calculations of the correct amount would be more complex for open swap positions but there may be scope for novation to OEIC friendly counterparties during the transition or an agreed close-out.

This approach would assist in levelling the playing field with new OEICs as agreements at the end of the transitional period would have protected cell status as a matter of law. It also addresses the problems arising from the inequality of bargaining power. It is also the case that some managers, perhaps owing to size of funds, may have less bargaining power than other managers in dealing with counterparties. In a matter as important as the

treatment of assets upon insolvency, all OEICs should be accorded the same protected cell status by a counterparty which wishes to deal with UK OEICs.

Placing the onus upon counterparties to renegotiate terms if they wish to continue doing business with a UK OEIC is the most effective way of ensuring the success of the regime. It is also fair in that the counterparty is free to choose whether or not it wishes to continue doing business with UK OEICs.

Unless it is possible to intervene statutorily in relation to all existing OEIC contracts and provide that they are deemed to be drafted on a protected cell basis, we believe that existing OEICs should only have to move to protected cell status once all non-compliant existing agreements have expired or are renegotiated. Given the responses, we cannot see how practically a time limit could be imposed and would urge you to delete the phrase in Regulation 4(3) "before the end of the period of one year beginning with the date these Regulations come into force".

One final observation on the "standard approach" theme is that one of the goals of this reform is to put UK OEICs on a level playing field with protected cell umbrella collective investment schemes in other jurisdictions:-

"2.4 Recent events highlight the importance of investors understanding the risks they are subject to. Investors in a very low-risk fund should not be subject to the risks in a separate sub-fund holding riskier assets. Furthermore, many investors have become risk-averse and see any possible risk of contagion as a reason not to invest, or at least to invest elsewhere. Feedback from stakeholders indicates this has become a contributing factor to investors' decisions not to invest in UK funds, instead favouring investment in funds in jurisdictions such as Jersey, Ireland or Luxembourg, which already operate protected cell regimes."

If there is any concern that the UK approach is sub-optimal by comparison to the approach in those competitor jurisdictions then this goal may not be realised. We do not know sufficiently how protected cell was achieved in those jurisdictions or whether it was the approach right from the beginning. It would, however, be useful to consider whether any of those jurisdictions also had to deal with the issue of "legacy OEICs" for whom the advent of protected cell occurred subsequent to their incorporation. If those jurisdictions took a wholly legislative approach, rather than a mix of legislation and bilateral contract amendment as is proposed in the UK, then it may be the case that they are in a better place from the investor perspective.

As mentioned above, we cannot see how practically a time limit could be imposed. As proposals are currently drafted- with the onus upon OEICs to renegotiate terms, there is a real concern that some counterparties will fail to engage.

A number of points have been put forward by members. These are as follows:-

a) Is a year long enough?

In reality, OEICs will not have a year as OEICs will have to discount the duration of any notice period for termination. Looking some of the contracts an OEIC has in place, they can be characterised into:-

(i) "friendly face" agreements with a related company or external service provider for whom OEIC business is a core business and whose role in the governance of an OEIC is fundamental.

Examples are: ACD/Registrar/Depositary/auditor

With a friendly face, an OEIC might expect an amicable discussion with a resolution within a year. So long as it is not too aggressive, the time frame is moot. But if renegotiation were not possible within a year, termination may not be practically possible, since some of these agreements would take a year or more to terminate. For example, an ACD agreement might be for an initial term of 4 years, with termination thereafter on 12 months notice.

As regards shorter periods a Registrar Agreement might be terminable on 6 months' notice so 6 months into any transitional period a judgement call would have to be made as to whether protected cell could be delivered before the end of the transitional period. If not then the sensible approach would be to terminate on notice.

(ii) arm's length agreements typically with brokers/banks.

Examples are: exchange traded derivatives clearing agreement/ISDAs/broker terms of business

Again, if firms were to assume that they could not renegotiate within a year, would termination be possible within a year? That is to say, could the other party hold out for a ransom payment or special terms?

With ISDA Masters, there is no specified notice period to terminate and this is an example of a type of agreement where the thrust of the legislation does not really fit. Broker terms of business may be similar. What if there are no extant trades under the ISDA? In that case there is no obvious creditor yet would the new Regulations require that ISDA either to be renegotiated or terminated? Would the same apply to broker terms of business where there was no live trade? In those cases, would it be better to leave the agreement in place but require amendment at some point before it is next used for trading?

If there is to be a time limit, we would urge HMT and FSA to liaise with ISDA regarding this issue and how segregated liability may be addressed in ISDA agreements given that there is no specified notice period to terminate.

b) Ease of renegotiation

The problems will be encountered with the arm's length category of agreements discussed above. COLL 5.2.23 was not an easy renegotiation point and that was a much less controversial area than protected cell which has an impact on credit risk.

c) Are OEICs likely to have to renegotiate many agreements because they are not already on a segregated liability basis?

2.8 – “While most charges such as management fees are likely to be charged directly to the individual sub-funds, others may be charged to the umbrella.”

4.4 – “The previous consultation estimated that there could be additional costs in terms of higher borrowing costs, as creditors may demand higher risk premia given the lack of access to assets of other sub-funds. However, the industry indications that umbrellas already contract with creditors on a segregated liability basis would mean that these costs are not likely to crystallise.”

A number of our Members have advised that this is not their experience and have indicated that many agreements will be impacted. As an example, one Manager has advised that amendments would need to be made to almost 30 ISDAs across 17 counterparties and that this would be a major exercise, unlikely to be completed within a 12 month period. In addition to ISDA agreements, there is a variety of other agreements, some of which are mentioned in a) above, which will be similarly impacted.

One Member, having reviewed its legal documentation, has advised that it would not regard the wording of the following agreements as currently reflecting the requirements for protected cell status:-

ACD/Registrar/Depositary/exchange traded derivatives clearing agreement.

8. Do you agree with the proposed disclosure requirements?

Contracts which fall within the definition of ‘foreign law contract’ trigger disclosure requirements. We note the two leg test for what is carved-out of the scope of what counts as a foreign law contract. Both a governing law test **and** exclusive jurisdiction test must be satisfied. As mentioned in the covering letter, the definition of “Foreign Law Contract” captures too many agreements that practically will not be at risk of a foreign court’s action. This needs to be amended. We continue to be firmly of the view that it should solely be a governing law test.

At the very least, if the second leg is to be retained, the wording should be made more flexible and reflective of business realities.

Based on one Member’s review of its current OEIC agreements, it has advised that many of them would count as foreign law contracts, typically because there is no selection of an exclusive jurisdiction. Perhaps that was an omission at the time but more plausibly why would a Scottish OEIC and

Scottish Registrar with a Registrar Agreement governed by Scots law and performed in Scotland go other than to the Scottish courts? Would they really need to select the exclusive jurisdiction of the Scottish courts?

We believe the definition should cater for the above type of circumstance. This could be achieved by adding to the end of the second leg "or where the terms of the agreement and the identity of the parties are such that it can be reasonably expected that the parties would in practice expect the courts of the UK rather than any other courts to take jurisdiction."

Even with the above amendment, it would not resolve the potential problem relating to ISDAs. Notwithstanding the selection of English law as the governing law the further variable of jurisdiction and whether that is exclusive or not has the result that:-

- (i) A 1992 Master is not a foreign law contract, whereas
- (ii) A 2002 Master is a foreign law contract.

This seems an odd outcome and doubtless will necessitate the revisiting of 2002 Masters if the legislation is enacted as currently proposed.

In numbered paragraph 3.5, the FSA proposes to remove the required disclosure of potential cross-fund liability in the Authorised Fund Manager Reports as, under the new regime, the risk is greatly diminished and therefore the warning would be disproportionate. We agree with this view.

We are therefore puzzled that Annex B contains a provision requiring Managers Reports' to contain a warning (COLL 4.5.9R (11)). We recommend that this provision be deleted as it is not proportionate and we also query, in any event, the need to cover protected cell disclosure in Managers' Reports when it is already covered in both the Instrument and Prospectus.

Other proposals appear reasonable.

9. Is this sufficient notification for unitholders?

Yes.

10. Do you agree that the FSA transitionals as drafted help provide that updating documentation and FSA approval costs are kept to a minimum?

We agree.

11. Do you agree all the proposed rule changes to COLL 7.3 are merely consequential or clarification and therefore do not represent and increased burden to firms? If not, please detail?

We agree.

- 12. Do you agree that our proposed changes to 7.3 award the same options for solvent wind-up to a sub-fund as for an ICVC? If not why?**

We agree.

- 13. Do you have any comments on the draft rules regarding cross sub-fund investment, specifically are there any unintended consequences or problems that should be addressed?**

We welcome the FSA's willingness to review this area of the rules in the light of the protected cell regime.

We have two comments on the draft rules.

a) Instead of replacing the current wording of COLL 5.2.30 (2) with a new wording, we suggest simply removing sub-paragraph (2). We believe that sub-paragraph (1) would adequately address the issue as this paragraph applies COLL 5.2 to 5.5 to each sub-fund as they would for an authorised fund. This, in turn, means that a sub-fund has to comply with COLL 5.2.15 and 16. In proposed rule COLL 5.2.30 (2), there is a replication of all provisions in COLL 5.2.15 and 16. By addressing the change in this way, it would avoid the need to repeat the same provisions in COLL 5.2.30.

b) In addition to the replication mentioned in a), we note that there are two additional requirements set out in COLL 5.2.30 (2). These are COLL 5.2.30 (2)(a) and (b). We question the need for these additional requirements. There are no equivalent requirements for situations which are similar to the situation where one sub-fund invests in another sub-fund within the same umbrella, such as where:

- A sub-fund in one umbrella invests in a sub-fund of another umbrella operated by the same manager.
- One unit trust invests in another unit trust/OEIC or sub-fund operated by the same manager.

As such requirements are not applicable in the above scenarios, we do not believe they should be applied simply because the sub-funds are within the same umbrella. All permutations involving investment in associated schemes should be treated in the same way.

The UCITS Directive addresses the potential for conflict that investments in associated schemes can give rise to and this has been implemented through 5.2.15 and 16. There are also provisions regarding investment in collective investment schemes generally. These contain provisions regarding the investee scheme but do not prohibit an investee scheme investing in another scheme within the same umbrella as the investor scheme and investee scheme.

For the above reasons, we believe 5.2.30 (2)(a) and (b) should be deleted. Current COLL provisions are sufficient.

There is, of course, the general overarching principle as set out in the UCITS Directive, that a Manager should act “with due skill, care and diligence, in the best interests of the UCITS it manages”.

14. Do you agree with the proposed approach modifying the obligation of ACDs in the case of negotiation of foreign law contracts? If not please explain.

In principle we do not object to a policy that ensures that ACDs are incentivised to do as much as possible to protect the fund when it enters into foreign law contracts. As a matter of practice therefore an ACD entering into a foreign law contract may be expected to require that the contract on its face provides for segregation consistently with the scheme behind regulation 11 A. We are unconvinced that the proposed rule change makes the extent of the duty sufficiently clear. COLL 6.6.14 A (which is repeated at COLL 8.5.3 A for QIS) draws a distinction between the terms “rectify” and “remedy” and we are unsure what that distinction may mean in practice.

For example, assume an ACD instructs its foreign law lawyers to ensure that the contract is to the extent possible under foreign law consistent with the principle of limited recourse. If it turns out later that a court rules that contracts of that type or identical clauses do not in fact have the effect that they were thought to have and that segregation is not secured by the inclusion of such clauses, do you consider that the ACD would not be liable for any consequential loss to a fund? We would expect the ACD then to take steps to have the contract amended if possible. In other words do you agree that the word “remedy” does not in fact require the payment of money from the ACD out of its own pocket? Clearly in other places within FSA's jurisdiction the word “remedy” has much wider meanings.

Subclause (b) causes the main problem. We are unsure why the trigger is said to be on an ACD becoming aware of a breach of COLL 6.6.14 A (1)? Is it not better to ensure that subclause (a) always applies and that the term “except where the inconsistency arises from a breach of (one) above” is deleted? Whatever the cause of the inconsistency, reasonable steps to remedy that inconsistency should be taken. After that the question is whether those steps should be at the expense of the ACD.

We propose for (2), the following:-

“The *ACD* of an *ICVC* which is an *umbrella* must:

(a) promptly upon becoming aware that a *foreign law contract* falling within (1) above is or has become inconsistent with the principle of limited recourse in the *ICVC's instrument of incorporation*, take reasonable steps to remedy that inconsistency;

(b) where the ACD did not take the reasonable care required by (1), then action required by (a) above shall be taken at its own expense.”

**15. Do you agree with the estimated costs and benefits for the industry?
What is the breakdown of your estimated cost of conversion?**

These appear reasonable. We received input from only one member which confirmed that it agreed with the estimates.

16. Are there any unintended consequences for industry not covered here or in chapters 2 and 3?

None that we are aware of. However, there is a potential positive consequence of the introduction of the regime. Whether action is required to enjoy the benefits of the potential consequence depends upon how section 3(2) of Schedule 2 of the OEIC Regulations should be interpreted.

Section 3(2) requires that the Instrument must clearly state the kind of property in which the company is to invest. The FSA rules (COLL 3.2.6R(7)) indicate that, to meet this requirement, one must include in the Instrument a statement "as to the object of the scheme, in particular the types of investment and assets in which it and each sub-fund may invest." This FSA rule is taken to mean that all types of investment and asset must be listed. The implication of this interpretation is that, if a new type of asset becomes permissible, and the OEIC wishes to utilise it, the objects clause must be updated. To do this, it must be approved by the shareholders of the company in general meeting (Section 5(3) of Schedule 2).

It may be that this narrow interpretation of 'kind of property' has been taken because of the absence of a protected cell regime and the consequent existence of the risk of contagion. To the extent that such a possibility exists then, arguably, all shareholders have an interest in a change to the objects clause even if the sub-fund in which they are invested does not intend to make use of the wider powers.

We are in discussions with the FSA regarding the interpretation of section 3(2) and, in particular, how one might meet the requirement to state the 'kind of property' in the Instrument. We believe that it should be possible to define 'kind of property' by reference to COLL; namely, the kind of investments and assets permitted under COLL. This would enable an OEIC to future proof its objects clause as, if any new type of investment became permissible, it would automatically be covered in the objects clause and there would therefore be no need to seek shareholder approval. Shareholders are still safeguarded as, if a new type of asset became permitted under COLL and a Manager intended to use it in the management of a particular fund (or sub-fund if umbrella), he would need to consider its potential impact upon shareholders in accordance with COLL rules regarding approvals and notifications. If the use of the new asset constituted a fundamental change, the Manager would be required to seek approval from the relevant sub-fund(s) shareholders.

The problem with interpreting the provision as requiring the listing of types of investment can be seen in what occurred when UCITS III came into force. By way of example, one of our Members operates an umbrella which includes an equity range and a fixed income range of funds. The Manager wished to

make use of the new investment powers only for the fixed income range of funds. Because the Instrument listed each type of investment, it had to add the new types of investment permitted by UCITS and had to obtain the consent of all shareholders in the umbrella. This included equity unitholders even although the equity funds were not going to make use of the new powers. The cost of writing to shareholders not impacted by the change was significant. In addition, leaving aside the protected cell aspect mentioned above, it was also perhaps confusing to the equity shareholders as they were being asked to vote on something that would not affect the management of their funds.

The above interpretation could also lead to bizarre results. If the shareholders in sub-funds that will not be making use of the wider objects vote are larger in number than the shareholders in the sub-funds that will be making use of the wider powers and the former all vote against the change, then even if the shareholders in the latter voted for the wider powers, the sub-funds concerned will not be able to use them. In this worse case scenario, the OEIC manager would have to set up a new OEIC and new sub-fund and merge the affected sub-fund which significantly increases cost.

If the provision can be interpreted as allowing reference to the kind of property permitted under COLL, this would effectively allow future proofing to cater for changes to permissible assets under COLL. As mentioned above, shareholder interests are still safeguarded by the requirements of COLL. If this approach had been taken in the above example, the practical result would have been that shareholder approval would have been sought only from shareholders impacted by the change.

We would welcome HMT's view on whether Section 3(2) may be interpreted so as to allow future proofing as outlined above.

Whether or not the above interpretation is accepted we believe that, with the introduction of a protected cell regime, a change should be made to the OEIC regulations. Our proposal is to allow amendments to the objects clause of an umbrella, which are simply to reflect new types of asset permitted by regulation, to be permitted without shareholder approval. Any sub-fund intending to make use of new assets would, as now, be subject to the requirements of COLL regarding changes to sub-funds.

- 17. Do you agree with our assumption that this regime is good for all consumers invested in sub-funds of OEIC umbrellas? Are there any detrimental effects for consumers not identified?**

We agree.

- 18. Do you agree that the SI and proposed FSA Rule changes achieve what is set out in this consultation document? If not, what improvements would you suggest?**

Please answers to 8, 13, 14 and 16.

19. We would be grateful for any further comments.

Please see answer to 16 for further comments which, depending upon interpretation, may require a change to the OEIC Regulations to allow for a further benefit of the protected cell regime to be realised.