Consultation Paper

06/18*

Financial Services Authority

Quarterly consultation

(No. 10)

October 2006

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The Financial Services Authority invites comments on this Consultation Paper.

Comments on the proposed amendments should reach us by 6 December 2006.

You can submit your comments electronically using the form on our website (at www.fsa.gov.uk/pubs/cp/cp06_18_response.html).

Or you can respond by email: cp06_18@fsa.gov.uk

If you wish to respond by letter, please send your comments to the person named at the end of each chapter and set out below:

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It is our policy to make all responses to formal consultation available for public inspection, unless the respondent requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

1 Introduction

1.1 This Consultation Paper (CP) invites comments on miscellaneous amendments to the Handbook. It proposes amendments to:

- the *Glossary of definitions*;
- the *Insurance: Conduct of Business sourcebook*;
- the *Interim Prudential sourcebook for Insurers*;
- the *Conduct of Business sourcebook*; and
- the *New Collective Investment Schemes sourcebook*;

1.2 We describe each amendment in a separate chapter. Each chapter includes an explanation of the proposed amendment, a statement of purpose, a cost benefit analysis (if necessary) and a compatibility statement. The appendices to this CP contain the actual text of the proposed amendments.

1.3 The deadline for comments on these amendments is 6 December 2006.

Consumers

The proposed amendments in Chapters 2, 3 and 4 may be of particular interest to retail consumers and consumer groups.

The remaining amendments are largely technical amendments, clarifications and corrections and are, on the whole, unlikely to have a direct impact on consumers.

2 Proposed changes to the Glossary and the Insurance: Conduct of Business sourcebook to implement parts of the Fifth Motor Insurance Directive

Introduction

2.1 We are proposing changes to the *Handbook Glossary* and Chapter 7 of the *Insurance: Conduct of Business sourcebook* (ICOB) to implement two provisions of the Fifth Motor Insurance Directive. We propose to do this by:

- amending the definition of 'state of the risk' to allow a UK resident purchaser who imports a vehicle into the UK from another EEA (European Economic Area) state to take out insurance as if it were a UK risk, which is not possible at the moment; and
- extending the claims settlement procedure in the Fourth Motor Insurance Directive to cover all third party motor insurance claims.

2.2 These changes are described in more detail below. We intend to make the rules implementing these changes at the February 2007 Board, to come into force as from 11 June 2007, as required by the directive.

Consumers

2.3 **The proposed change to the definition of 'state of the risk' will benefit consumers, as it will be easier for a buyer to get insurance for an imported car before registering the vehicle in the UK.**

2.4 **The claims settlement procedure laid down in the Fourth Motor Insurance Directive applies where an injured person has a claim arising from an accident that occurs in an EEA state other than their country of residence and which is caused by a vehicle normally based and insured in an EEA state other than that of the injured party's residence. It has the benefit for injured parties of laying down time limits for dealing with third party motor insurance claims, and provides for payment of interest when these time limits are not met. The ICOB rules implementing this procedure currently benefit injured parties from other EEA states whose claim arises from an accident in the UK (UK residents who have an accident outside the UK benefit from the same procedure under the rules of other EEA states). The Fifth Motor Insurance Directive extends the procedure to all third party motor insurance claims. So the procedure will now also apply when a UK resident has a claim resulting from an accident in the UK.**

Background

2.5 The Fifth Motor Insurance Directive contains several provisions, in addition to those we are implementing, which will mainly be implemented by the Department for Transport (DfT). These include provisions relating to:

- cover for passengers, pedestrians and cyclists;
- the motor insurers' bureau responsible for vehicles imported from another EEA state during the 30 days during which the 'state of the risk' is the buyer's country, if the vehicle is uninsured (the bureau of the buyer's country);
- the right of policyholders to request a statement of third party claims relating to the insured vehicle during the previous five years;
- excesses under a motor policy, which the directive states cannot be applied to third party claims; and
- direct right of action by a third party against the insurer of the person responsible for an accident.

Temporary derogation from 'state of the risk'

2.6 At present, the 'state of the risk' for a vehicle is considered the state of its registration. This is reflected in the *Glossary* definition as currently worded. The change to the definition made by the Fifth Motor Insurance Directive means that an imported vehicle is deemed to be registered in the state of destination for 30 days from the day the buyer accepts the vehicle. This means that a purchased car imported into the UK will be treated as a UK risk for 30 days. And a UK-based insurer will be able to insure it without having to make a passporting notification to the EEA state from which the car is imported and without having to join that state's guarantee fund and motor insurers' bureau. This will give the buyer time to register the vehicle in the UK.

2.7 Before we can amend our *Glossary* definition, HM Treasury will need to gloss the definition of 'state of the risk' contained in Schedule 12 paragraph 6(3)(b) of the Financial Services and Markets Act 2000 (FSMA). On the Statutory Instrument (SI) to introduce this amendment, HM Treasury have said:

‘Article 4(4)4a(1) of the 5th Motor Insurance Directive provides a 30-day derogation from the general rule that cover can only be provided by an insurer authorised to write business in the member state in which the vehicle is registered. So in future, UK insurers will be able to provide cover for a non-UK registered vehicle that a customer wishes to bring back to the UK prior to it being re-registered here. HM Treasury propose to amend the Financial Services and Markets Act 2000 and related regulations in order to implement this Article and will consult on this in due course.’

2.8 The enclosed draft rules in Appendix 2 making this change will need to reflect the final wording of the SI, so may be subject to minor amendments.

Extending the claims settlement provisions of the Fourth Motor Directive to all third party motor insurance claims

2.9 The requirements of ICOB 7.6.8R to ICOB 7.6.10R, which implement Article 4(6) of the Fourth Motor Insurance Directive, require insurers to offer compensation to injured parties within certain time limits and to pay interest if those time limits are not met. The Fourth Motor Insurance Directive provisions apply only where:

a) the accident takes place outside the injured party’s country of residence; and

b) the vehicle causing the accident is normally based and insured outside the injured party’s country of residence.

2.10 The Fifth Motor Insurance Directive extends these provisions to all third party motor insurance claims.

2.11 When looking at implementation of the Fifth Motor Insurance Directive, we realised that we had not reflected the qualification in indent b) of paragraph 2.9 above in all the relevant parts of ICOB. We have corrected this in the enclosed draft rules relating to claims representatives (see ICOB 7.6.4R in the draft rules in Appendix 2), as the scope of these provisions has not been amended by the Fifth Motor Insurance Directive. We are not aware of any difficulties having arisen as a result of this qualification having been omitted. The qualification is no longer relevant to the claims settlement provisions in ICOB 7.6.8R to ICOB 7.6.10R, in view of these provisions being extended to all third party claims.

> Q1: Do you have any comments on the draft rules implementing the Fifth Motor Directive in Appendix 2?

Cost benefit analysis

Costs

2.12 We do not expect either of the changes to result in incremental costs to the FSA. There will also be no costs for consumers and we do not envisage any material adverse effect on the market. On costs for firms:

- We are not required to estimate costs for the change to the *Glossary* definition of 'state of the risk', as this results from the Treasury changing FSMA. The change will remove the ability for insurers to provide short term cover for vehicles being exported from the state in which they are established without making a passporting notification to the state into which the vehicle is being imported. However, we consider this disadvantage to be of minor significance compared to the benefits of the change.
- The extension of the Fourth Motor Insurance Directive's claims settlement procedure to all third party motor insurance claims resulting from accidents caused by EEA-based vehicles may result in costs for firms from systems changes and staff training. However, the three months deadline from receiving a claim to responding to third parties takes into account that liability may not have been admitted or the claim fully quantified by then. So this should not involve major changes for insurers' claims-handling procedures. And interest is only payable if the three months deadline has not been met. In addition, the civil procedure rules already contain similar requirements. In view of this, some major motor insurers have told us they expect the costs of extending the procedure to all third party claims (both one-off incremental costs and ongoing costs) to be insignificant, even though very few claims (less than 1% of all third party claims) currently fall under the procedure.

Benefits

2.13 We consider the benefits of the changes to be as follows:

- The change to the *Glossary* definition will benefit consumers by allowing them to obtain insurance more easily, and probably more cheaply, for vehicles they import from another EEA state into the UK. And it will benefit insurers by allowing them to insure an imported vehicle without needing to make a passporting notification to the EEA state from which the vehicle is imported and without joining that state's guarantee fund and motor insurers' bureau.
- The extension of the Fourth Motor Insurance Directive claims settlement procedure to all third party motor insurance claims will benefit injured parties in cases not covered by that directive, in particular where the claim arises out of an accident in the injured party's own country.

Compatibility statement

2.14 The proposed changes are in line with our consumer protection objective and we believe the costs they impose will be proportionate to the benefits resulting from the directive. The absence of any super-equivalence (rules going beyond the directive) means that the changes do not conflict with the principle set out in FSMA that we should have regard to the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom. The changes have no other effect on our objectives or on our meeting the principles of good regulation.

2.15 We consider that our proposals are the most appropriate way of meeting our objectives. This is because we think the directive's requirements provide a sufficient level of protection for consumers, so we have not gone beyond them in our proposed amendments.

Contact

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3 Linked long-term contracts – Proposed change to description of property by which the benefits under linked long-term contracts may be determined

Introduction

3.1 This section describes a change we propose to one aspect of the permitted links regime. This proposal comes ahead of our wider review of the permitted links regime overall, on which we plan to consult in Q1 2007 in our CP on eligible assets and unit-linked funds.

3.2 The current permitted links rules can be found at the *Interim Prudential sourcebook for Insurers* (IPRU(INS)) 3.7 and its associated Appendix 3.2. Appendix 3.2 describes the property (permitted links) in which unit-linked life and pension funds can invest. These rules date back to the early 1980s and have not been substantially reviewed since 1994. The regulations applying to unit-linked funds are significantly different to those for authorised collective investment schemes (authorised funds). This difference results from the separate historic development of unit-linked funds and authorised funds.

3.3 We are proposing a specific change now because, without it, we expect a significant increase in work both for firms and the FSA in February 2007. By consulting on a change now, we can pre-empt such problems, but if we left such consultation to the CP in Q1 2007, we could not change the relevant rules by February 2007.

3.4 The problem we anticipate is that firms would apply to the FSA for many waivers in or shortly before February 2007 to comply with the new *New Collective Investment Schemes sourcebook* (COLL) rules by that date. COLL is a specialist sourcebook that sits in Block 5 of the FSA Handbook. It provides the detailed framework within which authorised funds operate. Until 12 February 2007, compliance with the rules of COLL is optional for any person seeking authorisation of a fund, as the fund may be operated under the *Collective Investment Schemes sourcebook* (CIS). CIS will cease to apply after 12 February 2007, and firms already operating authorised funds under CIS will need to comply with COLL by that date.

3.5 In complying with the COLL rules, firms must decide if they want an authorised fund to be classified as a UCITS or a non-UCITS retail scheme ("NURS"). Under the present permitted links regime, a UCITS is treated as automatically acceptable, whereas a NURS is acceptable only if a waiver is granted by the FSA.

3.6 The waivers we expect would be requests to allow unit-linked life policies to link to NURS. Costs would be incurred by firms in submitting these waiver applications, and by the FSA in considering them. In some cases the existing CIS may already be a permitted link but would disqualify itself by converting to a NURS and consequently incur costs in obtaining a waiver to reinstate itself. In other cases, firms may wish to link life policies to NURS funds, but be deterred from doing so by the cost and inconvenience of making waiver applications. The fact that we are already receiving a number of such waiver requests leads us to expect many more by February 2007. Alternatively, authorised funds may elect to be classified as a UCITS instead of a NURS solely in order to avoid the need to seek a waiver. In that situation, the permitted links rules are creating a market distortion.

3.7 We believe the effect of the current rules in preventing NURS from being automatically acceptable as permitted links is difficult to justify. This is because a NURS has to comply with detailed FSA rules in order to gain authorisation. We believe that is acceptable to rely upon this for the equivalent purposes of the permitted links rules.

3.8 Previously the UCITS Directive allowed a UCITS scheme to hold only a limited range of assets. Now that changes through the UCITS III Directive permit a broader range of asset types, there is less reason to draw a distinction between UCITS and NURS funds.

3.9 There are two aspects of the current permitted links rules that create problems for a NURS. First, a NURS is allowed under the COLL rules to hold assets of a type that the permitted links rules do not allow (e.g. gold) and a proportion of unregulated collective investment schemes that exceed the levels allowed by the permitted links rules (20% as against 10%).

3.10 Secondly, the permitted links rules require a NURS to be "readily realisable" but our definition of readily realisable for such a scheme excludes the normal way in which these units are disposed of by sale back to the scheme operator. Instead it is based on a sale to a third party, and so assumes there is an active secondary market that may, in reality, not always exist. The current readily realisable rules do not always reflect how NURS are currently marketed. However as there are rules in COLL which deal with sale and redemption, valuation and pricing, we believe that it is acceptable to rely upon these for the equivalent purposes of the permitted links rules.

Proposed amendments

3.11 We propose that a NURS should automatically be eligible to be a permitted link without restrictions. Currently the existing waivers have been subject to the condition that the particular NURS restricts its property to the assets specified in Appendix 3.2. We propose that a NURS should be acceptable as a permitted link without having to restrict its assets in this way as is the case for a UCITS. We will also be making an amendment to rule IPRU (INS) 3.7.3 (d) to clarify the position.

> Q2: Do you agree that non-UCITS retail schemes (NURS) should be automatically eligible as a permitted link in the same way as a UCITS?

Cost benefit analysis

3.12 We believe the proposal would have no cost but significant benefits. We now discuss the costs and benefits of this proposal separately.

Costs

Costs to Firms

3.13 We do not believe the rule change would have any significant cost to firms. This is because it does not impose any additional obligations on firms. Firms will be free to choose whether to link life products to NURS, and will no longer have to apply for waivers in order to do so.

Consumers

3.14 **We do not believe the rule change would increase the risk of consumer detriment by allowing funds to be invested in a wider range of assets, including more risky assets, without consumers fully understanding these risks. This is for four reasons. First, NURS are regulated products of a similar nature to UCITS, have to comply with detailed FSA regulations to gain authorisation, and are already available to consumers through other retail wrappers such as PEPS and ISAs. Second, the governance requirements for NURS require firms to notify, or in more fundamental cases obtain prior approval of changes to the investment strategy of the funds the investors hold (the investor for the purposes of this change would include the unit-linked fund). Third, new linked funds will have to explain in their literature the nature of the fund, its investment strategy and risk profile. And fourth, were the investment strategy of an existing unit-linked fund to change significantly, the contractual obligations also oblige firms to notify policyholders about a significant change in the strategy of their fund.**

Costs to the FSA

3.15 We expect this rule change to have negligible cost to the FSA.

Benefits

Benefits to Firms

3.16 Firms that currently plan to submit waiver applications to the FSA so that they could link life products to NURS would no longer have to make these submissions. They would thus save on administrative costs.

3.17 Firms that wished to link life products to NURS but were discouraged from doing so by the cost and delay imposed by making a waiver application will now be able to offer their customers a wider range of asset choices and investment styles. This could lead to increased sales and thus profits for these firms.

Consumers

3.18 **Some consumers could benefit from gaining access to a wider range of assets and investment styles within their life products. This could enable consumers to move to a trade-off between return and risk that they preferred. It might also permit them to achieve diversification benefits. However, since consumers can already invest in NURS outside of life products, we would expect this type of benefit to consumers to be minor.**

Benefits to the FSA

3.19 The rule change would reduce costs within the FSA as it would reduce our administrative costs of processing waiver applications.

Compatibility statement

3.20 We do not believe this rule change would jeopardise the achievement of any of the FSA's statutory objectives. This is particularly because we do not believe the rule change would reduce the degree of consumer protection, due to the governance arrangements in place for NURS. The proposed rule change would have no effect on financial crime. We do not believe that there is any need to have a specific campaign on public awareness, because product providers will inform their own customers about the new possibilities for their funds.

3.21 We believe the proposed rule change is compatible with the FSA's principles of good regulation, and will in particular promote three of them. First, it will increase the efficiency with which the FSA uses its own resources. This is because the rule change will make it unnecessary for firms to make large numbers of waiver applications in February 2007, which would cause administrative cost both to firms and to the FSA. Second, the change would ensure that the restrictions we impose on the industry are proportionate to their expected benefits. We believe that from the perspective of risks the current limitation of not allowing a NURS to be a permitted link is not proportionate. Third, the change would help maintain the competitive position of the UK as a location for financial services. By changing this rule we will maintain the competitive position of the UK as a domicile for asset management.

3.22 This rule change is the most appropriate action because it will align the COLL rules for NURS with the Permitted Links rules to meet with the transitory timescales of the implementation of the COLL rules.

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4 Proposed amendment to rules relating to the application of shareholder/ policyholder distributions in with-profits funds

Introduction

4.1 Market Value Reductions (MVRs) are used by with-profits funds to reduce the amount payable to policyholders on early surrender if the face value of a policy is higher than the assets underlying it. In such circumstances MVRs can take back from policies bonuses that have been added in previous years.

4.2 However, when this happens in a proprietary with-profits fund – where typically 90% of annual distribution goes in the form of bonuses to policyholders and the remaining 10% goes shareholders usually in the form of dividends – there is often no parallel mechanism to ensure that the reduction in distributions (bonuses) already made to policyholders also applies to shareholder dividends.

Proposed amendments

4.3 This asymmetry was identified in one of the responses to our paper, CP04/14 Treating with-profits policyholders fairly, and the subsequent PS05/1 acknowledges this and contains a commitment, paragraph 2.9, to address it.

'We are still considering the implications of this new point and discussing it with interested parties. Any proposed changes to our requirements would be consulted on in a forthcoming quarterly CP.'

4.4 Subject to consultation we propose to amend the Handbook to eliminate this scope for unfair treatment of policyholders. Our rules (COB 6.12.48R and COB 6.12.51R to 6.12.53R) already address the issue of distribution ratios between policyholders and shareholders. However, we recognise it is not clear from the text that the requirement that the amounts distributed must not be less than the required percentage, for example 90%, should apply over time and not just to each individual distribution. We therefore intend to amend COB 6.12.48R to clarify that the requirement applies on an ongoing basis. We will apply this in conjunction with Principle 6, which requires firms to treat customers fairly. This will render COB 6.12.51R to 6.12.53R obsolete as we believe the amended COB 6.12.48R and Principle 6 together are sufficient to deal with the issue.

4.5 The new rule will require firms to take full account of the interests of both policyholders and shareholders in any distribution. We intend this to eliminate any behaviour that can allow shareholders to receive preferential treatment over policyholders in distributions when a proprietary with-profits fund applies an MVR.

Q3: Do you agree the proposed amendment will achieve its aims of protecting consumers and raising the standards adhered to by with-profits firms?

Cost benefit analysis

4.6 There are costs and benefit implications in two areas. The first is the reallocation from shareholders to policyholders which is a transfer within an affected firm rather than an additional cost to it. The second relates to any potential cost in establishing systems and procedures to comply with the new rule.

4.7 While the transfer from shareholders to policyholders is not a cost to affected firms, we are interested in its probable size. Our information on this point comes from a limited cross section of representative firms and so must be treated with caution. On the basis of information provided for previous years, it appears to us that the potential redistribution of shareholders' payouts would be in the region of 3%. We conclude that the scale of the transfer would be small but not negligible, although this figure is likely to vary considerably by market conditions and the size of the firm.

4.8 We do not believe the proposed high-level rule will create significant costs for most proprietary firms operating with-profits funds. We base this view on the results of our survey of relevant proprietary firms. This survey revealed some with-profits funds already operate in a way that conforms to the proposed high-level rule. All firms contacted in our survey reported they maintained the relevant information necessary to comply with the proposed high-level rule. The need to update accounting systems to capture the required data does not therefore appear to be a widespread problem. Our consultations with firms therefore lead us to conclude that any cost will be minimal as most already have the relevant systems in place.

4.9 Those proprietary firms not carrying out this best practice regarding MVRs will already have the information required to do so as it is gathered as part of their normal accounting, systems and control procedures.

4.10 For a minority of firms operating with-profits funds, implementing the new high level rule could involve significant extra cost. This could be the case, for example, if firms need to set up new accounting systems to maintain accurate records of MVRs. To give a sense of the costs involved, in our paper CP207, Treating with-profits policyholders fairly (December 2003) we estimated the cost of a week's senior actuarial resource at £3,000. We have little information on how many firms would require significant expenditures to comply with the new rule, or what their expenditure might be, as our survey did not reveal any such firms. So if your firm is in this position, please describe your costs in your response to this CP.

4.11 It is also possible that some firms would stop marketing with-profits policies if this rule is accepted. This would create considerable cost for the exiting firms. However, on the basis of our survey, we think it is unlikely that any firms would find this rule onerous enough to stop marketing these products. Some operate this policy, while others collect the required information. So, we believe the costs that would arise through firms discontinuing with-profits policies would be minimal, because few or no firms would in practice stop marketing them.

4.12 We believe the proposed rule would have the benefit of increasing consumer confidence in the with-profits industry. It would do so by demonstrating to consumers that they are being treated fairly by all firms. We note that consumer confidence in with-profits policies has been severely dented in recent years, from which we infer that measures to help rebuild confidence would be valuable. We believe the proposed rule will also help create better quality with-profits products.

Compatibility statement

4.13 The proposed high-level rule will advance our statutory objective of maintaining confidence in the financial system. This is because it will increase consumers' confidence that with-profits firms make payouts to policyholders and shareholders in the ratios that consumers have been led to expect.

4.14 The proposed rule is also compatible with our principles of good regulation. The restriction imposed on the industry is proportionate to the benefits we expect from an improvement in consumer confidence. Further, we do not expect the proposed rule change to have a material impact on competition as it is unlikely that the rule will result in providers exiting the market. We also do not believe that the proposals will impose additional costs to the FSA, harm the UK's competitive position or materially affect innovation in with-profits products.

4.15 We believe the proposed high-level rule is the most appropriate way of achieving our objectives. While some firms are complying with this practice, not all with-profits firms are doing this in this particular circumstance. This issue needs to be addressed immediately as the asymmetry we have identified is still operating, as firms continue to apply MVRs.

4.16 Further, failure to tackle this issue would be a breach of Principles 6 and 8:

'A firm must pay due regard to the interests of its clients and treat them fairly.'

'A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.'

Consumers

4.17 **The planned addition to the Handbook has implications for customers in that it will reinforce their confidence that they are being treated fairly by firms and so have greater confidence in the market.**

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5 Proposed amendment to the Conduct of Business sourcebook (Use of Dealing Commission)

Introduction

5.1 Since the rules in COB 7.18 on the Use of Dealing Commission came into force at the beginning of 2006, we have received several queries about connectivity services and associated electronic systems and whether these services could be paid for out of client commission.

5.2 In particular, brokers have enquired whether client commissions could be used to pay for (either entirely or proportionally) direct fund manager/broker telephone lines, electronic communication and associated technical systems supplied to and used by fund managers. There was particular concern that inconsistencies in interpreting the COB requirements would lead to competitive distortions, with firms taking a strict approach at risk of losing business to those who took a more liberal interpretation.

Background

5.3 The rules and guidance under COB 7.18 form part of the package of measures introduced to address the market failure in relation to bundled brokerage and soft commission arrangements[1]. Together, these measures promote scrutiny and challenge of fund managers by clients and should help to improve decision-making by fund managers about the goods and services they acquire on behalf of clients. They limit potential sources of conflicts of interest and boost transparency and accountability of fund managers.

5.4 COB 7.18 limits to research or execution the goods and services that can be paid for out of commission. It also provides firms with criteria to assess whether services fall into these categories.

5.5 Our rules are drafted in this way rather than in a more a detailed and prescriptive manner because we believe it is appropriate for fund managers to take responsibility for making judgements about the goods and services they should purchase and charge directly to their clients via the commission charge (supported by accountability through enhanced transparency to clients).

1 See para 1.2 of PS05/9.

5.6 We have received feedback that additional guidance on connectivity and associated electronic systems would be helpful, given the difficulties in making judgements about these goods and services and the potential for competitive distortions. In this instance, the industry has satisfied us that the case for additional guidance is made out, even though that could weaken the dynamics inherent in the industry's solution. However, we reiterate our expectation that, in relation to the eligibility of goods or services more generally, firms should make reasonable judgements based on the high-level criteria we have set, looking carefully at their particular circumstances.

Guidance

5.7 In relation to connectivity services and associated software, our view is that they have characteristics which place them outside the range of goods and services which can be acquired with commission. This is because they:

- fail the temporal test and are not related to a specific transaction (COB 7.18.4E); and
- are inconsistent with duties owed to clients and raise potential for conflict of interest (COB 7.18.3(3)(b)).

5.8 This does not mean that firms cannot purchase the goods and services that they value. Rather, our position is that the commission charge is not the appropriate charging or payment mechanism for funding the purchase of these goods or services. Firms may, of course, recoup the costs of these services from clients under specific agreements or indirectly through their management charge.

5.9 We propose to amend the guidance at 7.18.8G which lists the non-permitted services as follows:

- COB 7.18.8G (c) – Connectivity services such as electronic networks and dedicated telephone lines;
- COB 7.18.8G (g) – Computer software including order and execution management systems and office administrative computer software, such as word processing or accounting programmes;

The underlining indicates proposed additional text.

Cost benefit analysis

5.10 Our requirements on firms have not changed. Investment managers are still required to judge whether goods or service can be paid for out of commission based on the criteria that we have set out at COB 7.18. However, we have clarified, by addition to the examples at COB 7.18.8G, that we do not believe connectivity services and associated systems (such as order and execution management systems) meet the criteria we have set. For this reason, we are satisfied that the costs resulting from this clarification are, if any, of minimal significance and that a full cost benefit analysis is not required.

Compatibility statement

5.11 Our dealing commission rules aim to meet our statutory objectives of market confidence and consumer protection. The compatibility of these provisions with the general duties was set out in detail in CP 05/5. The amendment to the guidance at COB 7.18.8G is designed to clarify our expectations in the treatment of connectivity services and associated systems. We consider that the proposed amendment represents the most effective use of our resources to achieve the desired result.

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6 Proposed amendments to the New Collective Investment Schemes sourcebook

Introduction

6.1 This chapter proposes amendments to the New Collective Investment Schemes sourcebook (COLL).

6.2 The proposed amendments will:

- permit the use of currency hedging techniques in relation to particular unit classes of an authorised fund;
- enable different unit classes of an authorised fund to be aggregated for the purpose of creating and cancelling units;
- modify rules relating to stock lending from the scheme property of authorised funds; and
- clarify the basis on which income arising from debt securities may be accounted for when they are held as scheme property.

6.3 We would make these amendments under sections 138, 140, 156, 157, 238(5), 242, 247 and 248 of the Financial Services and Markets Act 2000 (FSMA) and regulation 6 of the Open-Ended Investment Companies Regulations 2001. The text of the proposed amendments is set out in Appendix 6 to this CP. We propose that the new provisions should come into effect on 6 February 2007.

6.4 All of these proposals are relevant to Authorised Fund Managers (AFMs) and depositaries of authorised collective investment schemes. The proposal for currency hedging in unit classes is also relevant to investors in those schemes and prospective purchasers of units in the schemes. The proposals relating to stock lending are relevant to firms which arrange or participate in stock lending and repo transactions.

Currency hedging for unit classes

6.5 The rules of COLL permit the issue of 'currency class units', which are units denominated in a currency other than the base currency of the scheme. For example, a sterling-based fund can have a euro currency class, in which case the units are valued in sterling but the price is converted to euros at each valuation. Investors' subscriptions would be paid in euros, but converted to sterling by the AFM for investment in the fund.

6.6 The ability to issue currency class units is attractive to AFMs who market their funds in other countries. However, fluctuations in the exchange rate between the class currency and the base currency will affect the investment return. Investors in such units are exposed to the risk that the fund's investment gains could be rendered to them as a neutral – or even negative – return, because of an adverse rate of exchange.

Objective of unit class hedging

6.7 An AFM could use hedging techniques, such as undertaking forward or derivative transactions in the relevant currencies, to reduce or eliminate the currency risk in this situation. This type of hedging is a well-established technique and causes no particular difficulties from a regulatory perspective, provided the AFM has adequate systems and controls for managing risks relating to the techniques and instruments to be used. Several AFMs have proposed to us that it should be possible to use scheme property to carry out a class-specific hedging strategy. This is permitted within other European jurisdictions, notably Ireland and Luxembourg, for schemes both in and out of the scope of the UCITS Directive.[2]

6.8 At present, the rules of COLL restrict the extent to which unit classes of the same fund can confer differing rights to scheme property. They also require the gains and losses from investment of the scheme property to be attributed to all units in a fund, in proportion to the rights conferred by each unit class.

6.9 It is reasonable for an AFM to seek to reduce currency risks, and to protect or enhance returns to investors, through the use of efficient portfolio management techniques such as hedging. However, it would clearly be unfair if the costs of transactions, undertaken for the sole benefit of investors in one class, were to be borne by unitholders in other classes. For class-specific hedging to be permitted, firms would have to provide an appropriate level of protection for all unitholders, and address the risk that the rights conferred by the hedged class might cause prejudice to holders of other classes of units in the same fund.

6.10 We propose to modify our rules to allow the issue of a currency class unit in which transactions may or will be undertaken for the sole purpose of hedging movements between the class currency and the base currency. The costs of entering into the relevant transactions, and the profits and losses arising from them, must be attributed only to that unit class. Any transaction is, however, subject to the full requirements of COLL 5 in terms of such matters as the type of contract, the nature of the underlying, and cover for the exposure generated.

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2 Directive 85/611/EEC as amended.

Q4: Do you agree that we should permit the issue of hedged currency class units?

Managing the risks of hedged currency class units

6.11 At each valuation point, the AFM will need to review the overall hedged position and increase or reduce it in line with subscriptions or redemptions by unitholders in the hedged class. The transaction can be undertaken only for hedging purposes, so it should be no larger than is necessary to provide protection for the value of the hedged units. As a result, it should have no effect on the value of the other classes of unit. There is a risk the AFM might nevertheless enter into commitments which cannot be met out of the property attributable to the hedged unit class, with the result that all the other classes might suffer a loss in relation to the hedging. We consider there are two options for mitigating this risk.

6.12 The first option is to rely on the existing safeguards in our regulatory regime, in terms of the AFM's systems and controls, the independent oversight provided by the depositary, and adequate disclosure to all investors. Our rules on management of derivative risks set out the AFM's responsibility for applying due skill, care and diligence when undertaking these types of transaction. They include an obligation to use a risk-management process to monitor and measure the effect of all such transactions on the fund's overall risk position. The depositary will have day-to-day oversight of each individual transaction, and will monitor the AFM's systems and controls as they relate to the exercise of investment and borrowing powers.

6.13 In terms of disclosure, an AFM wishing to introduce a hedged currency class in an existing fund would need to decide whether the change was fundamental, significant or notifiable under our rules, and communicate with investors accordingly. It may be appropriate for the AFM to disclose in all scheme documents the risk to all investors of 'contagion' resulting from losses related to one class of units. Investors would then have the choice whether to purchase units in that fund, or to select another without such exposure. Investors in umbrella ICVCs are exposed to a comparable risk (that the liabilities of one sub-fund may have to be met from the assets of other sub-funds), for which adequate systems and controls and disclosure to investors are judged to offer an appropriate degree of risk mitigation.

6.14 A second option would be to introduce an additional safeguard for unitholders of the other classes. We could require the AFM to provide the fund with an indemnity or guarantee to make good, from its own resources, any losses suffered by the unitholders of unhedged unit classes as a result of liabilities incurred on behalf of the hedged class or classes. However, we think this is likely to prove impracticable for several reasons.

6.15 Such a measure would be likely to deter some managers from launching hedged currency classes in the UK, if other regulatory regimes are perceived to offer a more flexible operating environment. The costs to AFMs of providing this protection are difficult to estimate exactly, but are likely to be significant both in terms of one-off costs of setting up the necessary arrangements with commercial providers, and the ongoing costs of funding them. It is reasonable to suppose the AFM would pass those costs through to investors in its management charge, in which case funds offering hedged currency classes could become relatively expensive and uncompetitive.

6.16 Although the second option has some superficial appeal in terms of safeguarding the interests of investors in unhedged classes, we think the costs of it are likely to outweigh the benefits. We believe the first option represents a more proportionate approach by focusing on the responsibilities of authorised firms to operate effective systems and controls and to explain product risks clearly to investors. The fact that such arrangements are operated successfully in other jurisdictions, indicates the risks can be managed effectively in that way. We have drafted the rules on the basis of the first option, but welcome comments on the likely benefits and costs of both options.

Responsibilities of the authorised fund manager

6.17 We also propose new guidance setting out the key issues the AFM needs to address when planning to offer a hedged currency class. Firstly, the instrument constituting the scheme must make provision for the issue of the class and describe the rights attached to it. The prospectus must explain clearly and fully the operation of the class and the risks arising from it, and the simplified prospectus must give an adequate summary of these matters.

6.18 The AFM should consult the scheme's depositary and auditor to establish how the hedging transactions will be accounted for, and to consider their likely tax treatment and any implications this may have for the fund as a whole. The AFM should also describe in the prospectus how the assets attributable to a hedged currency class will be treated if the scheme is wound up, or its property is transferred to another fund under a scheme of arrangement.

6.19 As with any product innovation, it is the firm's responsibility to ensure that its systems and controls are adequate to deliver the proposed product features without undue risk to investors. This means that the AFM and its delegates must have administrative systems capable of supporting the valuation, pricing, dealing and registration processes needed for currency class units. As mentioned above, its derivative risk management processes must reflect any additional risk arising from the introduction of the hedging, and should be appropriately 'stress-tested'. For example, the AFM should consider what might happen if hedged classes grew to represent the majority of units in issue in the fund, and how it would ensure the interests of unitholders in unhedged classes were not prejudiced in such a situation.

> Q5: Do you think our proposals for hedging of currency class units appropriately protect the interests of all investors in a fund?
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> Q6: Should the proposed rules and guidance address any other issues?

Aggregation of unit classes

6.20 In CP06/7[3] we referred to concerns that an authorised fund may incur unnecessary costs when units are created and cancelled in the individual classes of the fund. COLL rules require the AFM to consider each class of a fund separately when determining how many units are to be created or cancelled by the trustee or the

3 CP06/7 Single and dual pricing for authorised collective investment schemes, April 2006.

ICVC, so units may be created in one class and cancelled in another at the same valuation point. Such transactions could be reduced or eliminated altogether, with a consequent saving of costs, if some or all of the amounts to be created and cancelled could be offset to arrive at a net figure. We asked respondents to the consultation paper for their initial views on this issue, so we could consult formally at a later date.

6.21 A number of respondents to CP06/7 provided comments. A few suggested the AFM should have complete flexibility in this regard, provided it complies with the obligation to create at least as many units as there are in issue to unitholders at each valuation point, for each fund or sub-fund taken as a whole. There was broader support for introducing partial flexibility in the rules. Some respondents pointed out that we had always previously allowed income and accumulation units to be aggregated for this purpose, where the difference between them is determined by reference to undivided shares in the scheme property (sometimes called 'standard units'), multiplied by a factor representing the amount of capitalised income brought forward for that accounting period.

6.22 However, many of those who commented on the issue expressed concerns about the risks of allowing unrestricted aggregation of classes. They said that administration systems might not be able to cope, and the desire to take full advantage of the flexibility offered might result in an increase in the number of errors, and consequent losses for unitholders. This was seen as particularly likely where prices of unit classes are calculated by a factor that is adjusted daily.

6.23 We consider there is sufficient support for us to consult now on allowing 'netting' of unit classes where there is no undue risk to unitholders. We propose to amend our rules to allow aggregation of unit classes, to determine the numbers of units to be created or cancelled, provided the classes comply with either or both of the following criteria:

- they are identical in terms of their rights of participation in scheme property, including all charges and payments that are permitted to be taken out of scheme property under COLL 6.7.4R; or
- they differ only in terms of whether income is distributed to the unitholder or accumulated as capital, where calculation of the difference between classes is carried out by reference to undivided shares in scheme property.

6.24 The first criterion should enable an AFM to aggregate classes of the same fund or sub-fund that differ only in terms of the:

- application of preliminary or redemption charges outside the fund;
- minimum amounts for investment and redemption by unitholders;
- channels through which units are distributed; or
- the characteristics of unitholders to whom the fund is promoted.

6.25 It should also be possible to aggregate currency class units (provided there is no hedging of the kind proposed above) with units giving equivalent rights but denominated in the base currency, provided the AFM's instructions to create and cancel units of all classes are given in the base currency.

6.26 The second criterion will cover ordinary (net) income and accumulation units, and may also be applied to gross income and gross accumulation units, where the difference relates purely to the unitholder's own liability to taxation.

6.27 The AFM should obtain the prior agreement of the depositary before issuing any instruction to aggregate two or more eligible classes. We suggest that the AFM and the depositary should agree in writing the circumstances in which aggregation may take place, and whether it will be a standing instruction or will be decided by the AFM on a case-by-case basis.

> Q7: Do you agree these proposals for allowing aggregation of unit classes provide a suitable balance between operational flexibility and investor protection?

Stock lending

6.28 Our rules permit stock lending to be undertaken to generate additional income for the benefit of an authorised fund and its investors. Stock lending is an agreement for the temporary transfer of securities, in which the borrower undertakes to return equivalent securities at a pre-determined time. The lender (in this case, the authorised fund) effectively retains ownership of the securities, and earns income from the borrower for agreeing to the loan, but the borrower is able to exercise the voting rights attached to the securities.

6.29 We have reviewed the current rules and identified several aspects where we think changes are desirable. Most of these changes would give greater flexibility to carry out stock lending, although we also propose to clarify the treatment of income earned from stock lending, and to introduce guidance on the reinvestment of cash collateral received for loaned securities.

Increased flexibility for stock lending arrangements

6.30 We propose to allow repurchase and reverse repurchase agreements (collectively known as 'repo agreements') within the scope of permitted stock lending. Repos involve the sale and repurchase of securities with an agreement that they are to be bought or sold back at a specified later date. They are economically very similar in effect to stock lending, but can be used in situations where traditional stock lending may not be appropriate or practical. We believe repo agreements could be undertaken for an authorised fund, subject to the same safeguards as stock lending, without additional risk for investors.

6.31 For retail authorised funds, we propose to extend the list of permitted counterparties with whom stock lending transactions may be undertaken to include US broker dealers and certain US banks. This proposal will bring the COLL rules in line with changes made in 2005 to the list of permitted counterparties for stock lending by insurers.[4]

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4 PRU 4.3.36R (1)(b).

6.32 COLL 5.4.4R requires the delivery of collateral to the authorised fund, which must be 'adequate' and 'sufficiently immediate' as defined in 5.4.6R. These rules preclude stock lending through Euroclear Bank's Securities Lending and Borrowing Programme (SLBP), which does not involve a direct contractual relationship between lenders and borrowers or the delivery of collateral. Instead, Euroclear Bank guarantees the lender it will return the securities, or cash equal to their market value, at the option of the lender in specified circumstances.

6.33 A substantial volume of stock lending is conducted through the SLBP and we think retail authorised funds should be permitted to participate in it. We previously assessed the structure and operation of the SLBP in order to permit its use under the rules of the Integrated Prudential Sourcebook[5], and we consider such arrangements to be sufficiently secure for retail authorised funds as well. We propose to modify our rules so that, provided the use of the SLBP is acceptable to the depositary, the requirement for collateral will be disapplied.

6.34 We also propose to add two categories to the list of acceptable types of collateral for stock lending transactions in COLL 5.4.6R (1)(c). These are commercial paper, and liquidity (money market) funds which offer daily dealing and maintain a triple-A credit rating or equivalent. The addition of these types of collateral will provide greater flexibility to borrowers and counterparties, with only a minimal increase in risk. The existing types of permitted collateral include 'readily realisable securities'; since the definition of this term includes 'government and public securities', there is no need to refer to the latter separately in the rule and we will delete the reference at (1)(c)(ii).

> Q8: Do you agree that these proposals will facilitate stock lending by authorised funds without a significant increase in risk?

Treatment of income from stock lending

6.35 Currently, our rules do not specify or limit the payments that may be deducted from income generated through stock lending activities. This reflects the fact that various parties may have an interest in the arrangement. For a unit trust, the trustee will carry out the lending; for an ICVC, it may be the company itself or the depositary on its behalf. The activity may be delegated to a third-party custodian, and the AFM may also participate in the arrangements.

6.36 A review of past applications we have received for authorisation of funds has shown that the proposed deductions by way of expenses and remuneration range from 20% to 50% of the gross stock-lending income. These deductions do not in all cases appear to be related to clearly defined or specific activities or services. It also appears that in some cases, payments are deducted at source and a net amount is credited to the fund.

6.37 We propose a new rule, making it clear that all income generated from stock lending or the reinvestment of collateral must be treated as income property of a retail authorised fund. Any fees or expenses taken from the income will be subject to the rules on payment out of scheme property, and must be disclosed in the prospectus.

5 PRU 4.3.36R (2).

We also propose to specify the types of payment that may be taken. We consider the following payments to be acceptable:

- costs of the arrangement of loans by the counterparty;
- transaction charges; and
- charges made or incurred by the depositary for safekeeping of collateral.

6.38 The depositary or trustee, when agreeing the basis on which it is to be remunerated for undertaking stock lending for a fund, should consider carefully whether the proposed charging structure is consistent with its duty to act solely in the interests of unitholders.

> Q9: Do you agree with our proposed treatment of income from stock lending?

Reinvestment of stock lending collateral

6.39 Collateral received in the form of cash may be reinvested by the depositary or its agent to generate income for the fund. It is general market practice at the time of signing a stock lending agreement for a cash collateral investment profile to be established, detailing specific guidelines for investing the cash to earn a return on the transaction. However, our rules are silent on the reinvestment of cash collateral.

6.40 We propose new guidance on how cash collateral held by retail funds should be reinvested. We think it should be aligned with the types of collateral that can be received under COLL 5.4.6R, although we specify that deposits should be capable of being withdrawn within five business days (unless the agreement or contract specifies a shorter period). Also, in our view, investment should not be made contrary to the fund's investment objective and policy; so, for example, a fund dedicated to investment in European smaller companies should not hold collateral in securities of UK blue-chip companies.

6.41 If the guidance is introduced, it is probable some funds will be holding assets outside its scope at the point when it is implemented. We would not expect AFMs or depositaries to disinvest from such assets immediately, since guidance does not have the force of a rule and no breach would occur as a result. We consider it would be reasonable for funds to continue holding such assets as collateral until the stock lending agreement or repo is terminated, or until the assets can conveniently be reinvested. Alternatively, we could allow a formal transitional period following the introduction of the guidance.

> Q10: Do you agree the proposed guidance on the reinvestment of cash collateral is appropriate? Should there be a transitional period following its introduction?

Accounting for income from debt securities

6.42 The Statement of Recommended Practice (SORP) produced by the Investment Management Association (IMA) is the basis for preparing the accounts of authorised funds. It is periodically revised by the IMA, in consultation with interested parties, to keep it up to date with modifications to regulatory requirements, accounting standards and market practice.

6.43 The version of the IMA SORP published in December 2005 introduced a new basis for accounting for the income payable from bonds, gilts and other fixed-interest securities, known as the 'effective yield' basis. Its introduction will make fund accounting consistent with International Financial Reporting Standards (IFRS). The amortisation of income from debt securities on an effective yield basis is to be applied for fund accounting periods beginning on or after 1 January 2007.

6.44 For funds which have the generation of income as their investment objective, it may still be appropriate to distribute income to unitholders on the basis of the income actually received by the fund (the 'coupon' basis) to achieve the fund's stated distribution policy. We propose to modify the Glossary definition of 'income property' so that it includes income from debt securities that has been accounted for on either an effective yield basis or a coupon basis, as the AFM may determine after consulting the auditor.

6.45 It should be noted that when accounting for fixed-interest securities on an effective yield basis, particular care is needed when following the guidance on the AFM's pricing controls in COLL 6.3.6G 2(2). This is because this method of accounting for income could, if calculated incorrectly, result in a higher variance than an accrual calculated on a coupon basis.

Q11: Do you agree with the proposed amendment to the Glossary definition of 'income property'?

Cost benefit analysis

6.46 Most of the proposals in this chapter are permissive, and will be adopted by firms only if they consider the benefits will outweigh the costs of doing so. We comment below in more detail on the estimated costs and benefits of the proposals.

6.47 The proposal to permit currency class-specific hedging transactions is an extension to the powers of AFMs and imposes no obligation on any firm to adopt such measures. Its likely benefits include the launch of new funds and fund classes, investment by consumers who would not previously have used UK-based currency classes, and a boost to the competitive position of UK fund managers in other jurisdictions. The proposal is unlikely to generate direct costs to the FSA of more than minimal significance.

6.48 An AFM wishing to offer such classes will incur some one-off costs in setting it up and some ongoing costs in operating it. For example, the firm will need to put the administrative arrangements for valuation, pricing and dealing in place, and issue new scheme documentation or amend existing documentation and promotional material. These types of costs are incurred whenever a new fund, umbrella sub-fund or unit class is set up.

6.49 The use of hedging techniques would create a risk for investors in unhedged classes that the hedging might result in losses that have to be met from the fund as a whole. Since hedging is a long-established and relatively straightforward procedure which most AFMs and all depositaries are familiar with, we believe this risk is a small one. It would be mitigated by the AFM's adherence to its systems and controls, and the depositary's oversight and monitoring of the hedging operations, in addition to the disclosures referred to above.

6.50 This may involve some additional one-off and ongoing costs to both to the AFM (which may, for example, need to review and enhance its systems and controls for managing risks related to use of derivatives), and to the depositary, which may need to carry out some additional monitoring. However, we think such costs should be of no more than minimal significance as most AFMs already undertake efficient portfolio management techniques, including currency hedging, and should have the necessary arrangements in place. Similarly, depositaries will already be exercising the necessary oversight of how those AFMs carry out hedging operations.

6.51 We have considered whether the AFM should provide a guarantee or indemnity to the fund to protect the interests of investors in the unhedged classes. This could benefit investors in unhedged classes by reassuring them that they will not suffer any loss through contagion from their fund's hedged classes. In the absence of such arrangements, investors might fail to appreciate the additional risk represented by a fund offering hedged classes, compared with one that did not, and as a result might make unsuitable investment decisions.

6.52 The potential cost of an indemnity or guarantee is difficult to estimate because there are no comparable arrangements in place for other UK or overseas funds, so there are no commercial providers able to quote a market rate. It is likely that any AFM wishing to set up such arrangements would face significant one-off costs in identifying a suitable provider and negotiating commercially acceptable terms.

6.53 A requirement to put in place a guarantee or indemnity might deter some AFMs from launching hedged currency classes, resulting in fewer choices for investors, less competition in the UK market, and less opportunity for UK managers to compete effectively in non-UK markets. Even if funds were offered with such protection, the costs – if passed through to investors – might make them uncompetitive compared to funds without hedged classes. There is also a risk that the presence of an external safeguard might weaken the incentive for the AFM to adhere rigorously to its internal systems and controls, which in turn could increase the probability of an error occurring. We conclude that imposing a requirement of this kind would not be likely to deliver benefits to investors greater than the related costs.

6.54 The proposals for stock lending are mostly permissive in nature. They seek to increase the quantity and variety of stock lending transactions that may be undertaken by authorised funds, and to improve the efficiency of competition by enabling funds to transact with a wider range of counterparties. The ability to accept additional categories of collateral may also improve the quality of transactions.

The guidance on reinvesting cash collateral should improve the quality of transactions, by limiting collateral to assets that are liquid, relatively low-risk, and in keeping with the fund's stated investment aims and policy. Any additional direct costs of regulation are of no more than minimal significance.

6.55 There are two aspects of the stock lending proposals which require further commentary in terms of the potential compliance costs for firms. First, the proposed rule on treatment of income from stock lending may require some AFMs to make additional disclosures in scheme documentation, and may restrict the ability of AFMs or connected persons to receive a share of the income generated. If the fund prospectus has to be amended, any costs in doing so should be of no more than minimal significance as there is no obligation to reissue it to investors, except on request. Even if the effect of the rule is to reduce the overall amount of payments out of stock lending income there will be no net costs, because any revenue foregone by the AFM or another party will be transferred to the fund and will benefit its unitholders.

6.56 Second, the proposed guidance on reinvestment of cash collateral will affect any AFM currently placing such collateral in assets outside the scope of the guidance. AFMs who comply with the guidance will face a restriction in the choice of assets available for reinvestment of collateral. However, the proposed range of suitable assets is, we believe, in line with current standards of market practice and should not negatively impact the quantity, quality or variety of transactions that may be undertaken with cash collateral. Where assets outside the scope of the guidance are being held at the time it is implemented, the AFM will have flexibility in deciding whether or not to continue holding them for the duration of the stock lending agreement or repo that they relate to. So there should be no additional costs to the fund or the AFM from restructuring the collateral earlier than intended.

6.57 Our proposals to permit aggregation of unit classes, and to modify the Glossary definition of 'income property', are intended to improve the operational flexibility available to firms without imposing any obligation on them. The aggregation of classes when creating and cancelling units should enable AFMs to reduce the number of transactions undertaken, with a resulting saving in costs. We consider that both proposals will not generate additional risk for consumers, and will generate net costs of no more than minimal significance for the FSA and for authorised firms. For these reasons, we are satisfied that a full cost benefit analysis of the proposals is not necessary.

> Q12: Do you agree with our assessment of the costs and benefits of our proposals?

Compatibility statement

6.58 This section explains why we consider our proposals to be compatible with our statutory objectives and the principles of good regulation. These proposals, though differing in substance from one another, each relate particularly to the objectives of protecting consumers and maintaining market confidence.

6.59 The proposal for hedged currency classes addresses the currency risk faced by consumers who invest in currency class units. It is intended to enable the AFM to reduce that particular risk without weakening the overall level of protection enjoyed by all investors in the fund. It also supports the market confidence objective by enabling AFMs to introduce innovative products and to compete with fund managers in other jurisdictions where similar products are already available.

6.60 The proposal to permit netting of certain unit classes when creating and cancelling units, contributes to our market confidence objective by seeking to improve AFMs' ability to operate efficiently and control costs to investors. It also supports the consumer protection objective by limiting the types of unit class that can be treated in this way, so the AFM does not undertake over-complex transactions that run a high risk of causing valuation and pricing errors in the fund.

6.61 The stock lending proposals support the market confidence objective by recognising that certain types of transaction not presently permitted could be undertaken for the benefit of investors without any material increase in risk. They extend the ability to lend assets of authorised funds, while protecting investors by maintaining the key controls over the types of transaction that may be undertaken, the acceptability of counterparties and the provision of collateral or equivalent guarantees of repayment. The proposals address investors' information needs by requiring disclosure in the fund prospectus of the policy on stock lending and the charges that may be made, and disclosure in the accounts of all income arising from it.

6.62 The proposal to amend the definition of income property is intended to protect consumers by clarifying the AFM's responsibility (in consultation with the auditor) to determine how income should be accounted for in an authorised fund.

6.63 The following principles of good regulation are particularly relevant to the various proposals:

Burdens or restrictions to be proportionate to benefits

6.64 Most of these proposals are permissive and impose no requirements on regulated firms. The proposal for aggregating share classes is specifically intended to remove a burden, by simplifying the process of creating and cancelling units and eliminating costs arising from unnecessary transactions.

6.65 The proposed clarification of what constitutes income from stock lending activity, and what payments may be taken from it, may restrict the ability of firms to receive such payments, or else may require them to improve disclosure to investors of the payment arrangements. We consider this is proportionate since it treats income from stock lending in the same way as other forms of income received by the fund. The proposed guidance on the reinvestment of cash collateral sets standards which, if followed by firms, should reassure investors all the scheme property is being invested in accordance with the fund's investment objectives.

Desirability of facilitating innovation

6.66 The proposals for hedged currency classes will allow AFMs to offer new classes of unit and should enhance the attractiveness of UK funds to certain categories of investor who may not have considered them before. The stock lending proposals also enable depositaries and their agents to undertake innovative arrangements designed to generate extra income for investors at an acceptable degree of risk.

Desirability of maintaining the competitive position of the United Kingdom

6.67 Hedged currency classes are already available to retail investors in other European jurisdictions, so allowing UK AFMs to offer them would help the UK funds industry to attract and retain overseas investors.

Desirability of facilitating competition

6.68 The stock lending proposals will give fund depositaries and their agents access to a wider range of transactions and counterparties, and the ability to receive additional types of collateral which are already available to insurers. These proposals should increase awareness among AFMs, depositaries and potential counterparties of the opportunities that exist to lend the assets of authorised funds, which should in turn stimulate market activity.

Acting appropriately to meet our statutory objectives

6.69 Our proposals are intended to give authorised firms new opportunities to operate funds more efficiently, to enhance returns for investors by reducing costs and generating extra income, and to offer a broader range of products capable of meeting currently unfulfilled investor needs. We consider these proposals to be the most appropriate way of meeting our statutory objectives.

Contact

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Appendix 1

List of specific consultation questions

Chapter 2

Q1 Do you have any comments on the draft rules implementing the Fifth Motor Directive in Appendix 2?

Chapter 3

Q2 Do you agree that non-UCITS retail schemes (NURS) should be automatically eligible as a permitted link in the same way as a UCITS?

Chapter 4

Q3 Do you agree the proposed amendment will achieve its aims of protecting consumers and raising the standards adhered to by with-profits firms?

Chapter 6

Q4 Do you agree that we should permit the issue of hedged currency class units?

Q5 Do you think our proposals for hedging of currency class units appropriately protect the interests of all investors in a fund?

Q6 Should the proposed rules and guidance address any other issues?

Q7 Do you agree these proposals for allowing aggregation of unit classes provide a suitable balance between operational flexibility and investor protection?

Q8 Do you agree that these proposals will facilitate stock lending by authorised funds without a significant increase in risk?

Q9 Do you agree with our proposed treatment of income from stock lending?

Q10 Do you agree the proposed guidance on the reinvestment of cash collateral is appropriate? Should there be a transitional period following its introduction?

Q11 Do you agree with the proposed amendment to the Glossary definition of 'income property'?

Q12 Do you agree with our assessment of the costs and benefits of our proposals?

Appendix 2

THE FIFTH MOTOR INSURANCE DIRECTIVE INSTRUMENT 2007

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making powers);
(2) section 156 (General supplementary powers); and
(3) section 157 (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [11 June 2007].

Amendments to the Handbook

D. The Glossary of Definitions is amended in accordance with Annex A to this instrument.

E. The Insurance: Conduct of Business sourcebook (ICOB) is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Fifth Motor Insurance Directive Instrument 2007.

By order of the Board
[22 February 2007]

Annex A

Amendments to the Glossary of Definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

…

claims representative	a *person* appointed by a *motor vehicle liability insurer* to satisfy the requirements of *threshold condition* 2A or ~~*COB* 6.8.20R~~ <u>*ICOB* 7.6.2R</u>.

…

<u>*Fifth Motor Insurance Directive*</u>	<u>the European Parliament and Council Directive of 11 May 2005 amending Council Directives 72/166/EEC, 84/5/EEC, 88/357/ EEC and 90/232/EEC and European Parliament and Council Directive 2006/26/EC relating to insurance against civil liability in respect of the use of *vehicles* (No 2005/14/EC).</u>

…

injured party	(in *ICOB* 7.6) ~~a *person* who claims damages as a result of any loss or injury suffered in, or as a result of, an accident which occurs in an *EEA State* other than his usual *EEA State* of residence which is caused by the use of a motor vehicle insured and normally based in an *EEA State*.~~ <u>a resident of the *EEA* entitled to compensation in respect of any loss or injury caused by *vehicles*.</u> <u>[**Note**: Article 1(2) of Directive 72/166/EC (First Motor Insurance Directive)]</u>

…

<u>*motor vehicle liability claims handling rules*</u>	<u>*ICOB* 7.6.8R to *ICOB* 7.6.11G.</u>

…

<u>*normally based*</u>	<u>(in *ICOB*) (in relation to a *vehicle*):</u> <u>(a) the territory of the *EEA State* of which the *vehicle* bears a registration plate; or</u> <u>(b) in cases where no registration is required for the type of *vehicle*,</u>

but the *vehicle* bears an insurance plate or a distinguishing sign analogous to a registration plate, the territory of the *EEA State* in which the insurance plate or the sign is issued; or

(c) in cases where neither registration plate nor insurance plate nor distinguishing sign is required for the type of *vehicle*, the territory of the *EEA State* in which the keeper of the *vehicle* is permanently resident.

[**Note**: Article 1(4) of Directive 72/166/EC (First Motor Insurance Directive)]

…

state of the risk (in accordance with paragraph 6(3) of Schedule 12 to the *Act* (Transfer schemes: certificates)) (in relation to the *EEA State* in which a risk is situated):

(a) if the insurance relates to a building or to a building and its contents (so far as the contents are covered by the same policy), the *EEA State* in which the building is situated;

(b) if the insurance relates to a vehicle of any type, the *EEA State* of registration;

(ba) if the insurance relates to a *vehicle* dispatched from one *EEA State* to another, in respect of the period of 30 days beginning with the day on which the purchaser accepts delivery, the *EEA State* of destination (and not, as provided by sub-paragraph (b), the *EEA State* of registration);[6]

(c) …

[**Note**: Article 4(4)(4a) of the *Fifth Motor Insurance Directive*]

…

vehicle any motor vehicle intended for travel on land and propelled by mechanical power, but not running on rails, and any trailer whether or not coupled.

[**Note**: Article 1(1) of Council Directive 72/166/EEC (First Motor Insurance Directive)]

…

[6] The amendment to this definition reflects the amendment to paragraph 6(3) of Schedule 12 to the Financial Services and Markets Act 2000 proposed by HM Treasury. HM Treasury will consult on this amendment.

Annex B

Amendments to the Insurance: Conduct of Business sourcebook (ICOB)

In this Annex underlining indicates new text and striking through indicates deleted text.

…

1.1.2 G (1) …

(2) *ICOB* implements, in part, provisions contained in a number of EC directives:

(a) …

…

(d) the *Third Non-Life Directive*, in respect of information requirements relating to *general insurance* contracts; ~~and~~

(e) the *Fourth* and the *Fifth* *Motor Insurance Directives*, in respect of *claims* made by ~~an~~ *injured parties* ~~*EEA* resident~~ arising from ~~a~~ motor accidents in the *EEA*. ~~but outside his country of residence~~

…

Motor vehicles normally based in the UK

1.3.13 R Notwithstanding anything in this section, the *motor vehicle liability claims handling rules* apply to a *motor vehicle liability insurer* in respect of a *vehicle normally based* in the *United Kingdom*.

…

7.1.5 G All of this chapter, except *ICOB* 7.6, applies to *claims* made by *retail customers*. Part of *ICOB* 7.3, all of *ICOB* 7.4 and all of *ICOB* 7.7 apply to *claims* made by *commercial customers*. *ICOB* 7.6 applies to certain *claims* by *injured parties* arising from ~~an~~ accidents occurring in ~~an~~ the *EEA* ~~*State* other than the *EEA State* of residence of the *injured party*,~~ involving the use of ~~a vehicle~~ *vehicles*. ~~insured and normally based in an *EEA State*.~~

Purpose

7.1.6 G (1) …

…

(3) The purpose of *ICOB* 7.6 is to transpose certain requirements of the *Fourth Motor Insurance Directive* and the *Fifth Motor Insurance Directive*.

…

7.6 Motor vehicle liability insurers: claims representatives and claims handling rules

Motor vehicle liability insurers: claims representatives

7.6.1 G …

…

7.6.3 R (1) When a *motor vehicle liability insurer* for which the *United Kingdom* is the *Home State* appoints a *claims representative*, it must give the *MIIC*, and each other *information centre*, the *claims representative's* name, business address, telephone number and effective date of appointment within ten *business days* of that appointment being made.

(2) …

[**Note:** Article 5(2) of the *Fourth Motor Insurance Directive*]

7.6.4 R A *motor vehicle liability insurer* for which the *United Kingdom* is the *Home State* must ensure that each *claims representative* is:

(1) resident or established in the *EEA State* for which it is appointed;

(2) capable of examining cases in the official language or languages of the *EEA State* of residence of the *injured party*;

(3) responsible for, and has sufficient delegated authority from the *motor vehicle liability insurer* for which it is appointed, to be able to:

(a) handle and settle;

(b) collect all information, and take all measures, reasonably necessary to negotiate a settlement of; and

(c) represent, or arrange appropriate representation for, the *motor vehicle liability insurer* (whether in negotiations, in court or otherwise) in relation to; :

claims, by an *injured party* arising from an accident occurring in a *EEA State* other than the *EEA State* of residence of the *injured party*, and caused by the use of a *vehicle* insured through an

establishment, and *normally based*, in an *EEA State* other than the *EEA State* of residence of the *injured party*. ~~occurring in an *EEA State* other than the *EEA State* of residence of the *injured party*, involving the use of a vehicle insured and normally based in an *EEA State*.~~

[**Note:** Article 1(1) and (2) and Article 4(1), (4) and (5) of the *Fourth Motor Insurance Directive*]

…

Motor vehicle liability ~~insurers:~~ claims handling rules

7.6.8 R (1) Within three *months* of a receipt of a *claim* for *damages* caused by a *vehicle normally based* in the *United Kingdom* from an *injured party*, or his representative, the *motor vehicle liability insurer* must (directly, or through a *claims representative*):

(a) …

…

(4) …

[**Note:** Article 4(6) of the *Fourth Motor Insurance Directive* and Article 4(4)(4e, first paragraph) of the *Fifth Motor Insurance Directive*]

…

7.6.11 G ~~(1)~~ ~~*ICOB* 7.6.8R to *ICOB* 7.6.10R apply only to *claims* for damages for loss or injury suffered in, or as a result of, an accident which occurs in an *EEA State* other than an *injured party's* usual state of residence, which is caused by the use of a motor vehicle insured and normally based in an *EEA State*.~~

~~(2)~~ The *rules* and *guidance* at *ICOB* 7.6.1G to *ICOB* 7.6.10R are not intended to, and do not, restrict any rights which the *injured party*, or its *motor vehicle liability insurer*, or any other *insurer* acting on its behalf, may have and which would enable any of them to begin legal proceedings against the *person* causing the accident or that *person's*, or the ~~motor vehicle's~~ *vehicle's*, *insurers*.

…

ICOB TP 1 Transitional Provisions

(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**

	Material to which the transitional provision applies		Transitional provision	Transitional provision: dates in force	Handbook provision: coming into force
…					
11	*ICOB* 7.6.8R to *ICOB* 7.6.11G	R	The amendments to these provisions made by the Fifth Motor Insurance Directive Instrument 2007 do not apply in relation to *claims* received by a *motor vehicle liability insurer* or a *claims representative* on or before 11 June 2007.	From 11 June 2007	11 June 2007

Appendix 3

INTERIM PRUDENTIAL SOURCEBOOK FOR INSURERS (AMENDMENT NO 10) INSTRUMENT 2006

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 141 (Insurance business rules);
(3) section 150(2) (Actions for damages); and
(4) section 156 (General supplementary powers).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [date].

Amendments to the Handbook

D. The Interim Prudential Sourcebook for Insurers (IPRU(INS)) is amended in accordance with Annexes A and B.

Citation

E. This instrument may be cited as the Reinsurance Directive (Consequential Amendments) Instrument 2006.

By order of the Board
[insert date] 2006

Annex A

Amendments to the Interim Prudential Sourcebook for Insurers

In this Annex underlining indicates new text and striking through indicates deleted text.

Rule 3.7

…

3.7	(3)			Benefits payable under any *linked long term contract* must not be determined by reference to -
		(d)		property of any of the descriptions specified in Part I of **Appendix 3.2** other than the property specified in paragraph 5(a), which has the effect of a *derivative contract* other than a *permitted derivative contract*.

Annex B

Amendments to the Interim Prudential Sourcebook for Insurers

In this Annex underlining indicates new text and striking through indicates deleted text.

APPENDIX 3.2 (rule 3.7)

PERMITTED LINKS

PART I

DESCRIPTIONS OF PROPERTY BY WHICH BENEFITS MAY BE DETERMINED

…

5.		Units or other beneficial interests in -		
		(a)	a scheme falling within the *UCITS Directive* or an *authorised fund* which is a *non-UCITS retail scheme*; and	
		(b)	a *collective investment fund* which satisfies the following conditions-	
			(i)	the property of the fund comprises property of any of the descriptions in 1 to 10,
			(ii)	the units are *readily realisable* at a price which represents the net value per unit of the assets and liabilities of the fund, and
			(iii)	the price at which the units may be bought and sold is published regularly.

Appendix 4

CONDUCT OF BUSINESS SOURCEBOOK (AMENDMENT NO X) INSTRUMENT 2007

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 141 (Insurance business rules);
(3) section 156 (General supplementary powers); and
(4) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [date].

Amendments to the Conduct of Business sourcebook

D. The Conduct of Business sourcebook is amended in accordance with the Annex to this instrument.

Citation

E. This instrument may be cited as the Conduct of Business Sourcebook (Amendment No X) Instrument 2007.

By order of the Board
[February] 2007

Annex

Amendments to the Conduct of Business sourcebook

In this Annex, underlining indicates new text and striking through indicates deleted text.

…

Conditions relevant to distributions

6.12.48 R A *firm* must:

(1) not make a distribution from a *with-profits fund*, unless the whole of the cost of that distribution can be met without eliminating the *regulatory surplus* in that *with-profits fund*;~~ and~~

(2) ensure that the amount distributed to *policyholders* from a *with-profits fund* is not less than the required percentage of the total amount distributed (see *COB* 6.12.56R)~~.~~; and

(3) if it adjusts the amounts distributed to *policyholders*, apply a proportionate adjustment to amounts distributed to shareholders so that the distribution to *policyholders* will not be less than the required percentage.

…

6.12.51 R ~~Subject to COB 6.12.53 R, and for the purposes of COB 6.12.48R (2), a *firm* must determine the amount to be distributed:~~

~~(1)~~ ~~in the case of a distribution, all or part of which is in the form of a transfer of assets out of the *with-profits fund*, by determining the fair *market value* of the assets that will be transferred; and~~

~~(2)~~ ~~in the case of a distribution, all or part of which is in the form of an increase in the *regulatory value of liabilities* of the *with-profits fund*, by determining the amount by which the *regulatory value of liabilities* of the *long-term insurance fund* would increase as a result of the distribution, if (for these purposes only) the *mathematical reserves* were calculated using the long-term gilt yield, net of tax (if that is appropriate), instead of the rate of interest prescribed by PRU 7.3.33 R.~~ [Deleted]

6.12.52 G ~~COB 6.12.51R (2) applies, in particular, to distributions that take the form of a reversionary bonus addition to conventional *with-profits policies*.~~ [Deleted]

6.12.53 R ~~Notwithstanding COB 6.12.51 R, a *firm* may determine the amount to be distributed in a different way, if:~~

(1) ~~it can show that that is consistent with its established practice; and~~

(2) ~~that established practice is explained in its *PPFM*.~~ [Deleted]

…

6.12.56 R The required percentage referred to in *COB* 6.12.48R ~~(2)~~ is, for each *with-profits fund*:

(1) …

…

Appendix 5

PROPOSED AMENDMENT TO THE CONDUCT OF BUSINESS SOURCEBOOK (USE OF DEALING COMMISSION) INSTRUMENT 2006

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (the "Act"):

(1) section 157 (Guidance);

Commencement

B. This instrument comes into force on [Month] 2007.

Amendments to the Handbook

C. The Conduct of Business sourcebook is amended in accordance with the Annex to this instrument.

Citation

D. This instrument may be cited as the Conduct of Business (Use of Dealing Commission) Instrument 2006.

By order of the Board

[Month] 2007

Annex

Amendments to the Conduct of Business sourcebook (COB)

In this Annex, underlining indicates new text and striking through indicates deleted text.

7.18.8 G Examples of goods or services that relate to the *execution* of trades or the provision of research that the *FSA* does not regard as meeting the requirements of either *COB* 7.18.4E(1) or *COB* 7.18.5E(1) include:

….

(c) connectivity services such as electronic networks and dedicated telephone lines;

…

(g) computer software including order and *execution* management systems and office administrative computer software, such as word processing or accounting programmes;

…

…

Appendix 6

NEW COLLECTIVE INVESTMENT SCHEMES SOURCEBOOK (MISCELLANEOUS AMENDMENTS No. X) INSTRUMENT 2006

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions:

(1) the following sections of the Financial Services and Markets Act 2000 ("the Act"):

(a) section 138 (General rule-making power);
(b) section 140 (Restriction on managers of authorised unit trust schemes);
(c) section 156 (General supplementary powers);
(d) section 157(1) (Guidance);
(e) section 238(5) (Restrictions on promotion);
(f) section 242 (Applications for authorisation of unit trust schemes);
(g) section 247 (Trust scheme rules); and
(h) section 248 (Scheme particulars rules); and

(2) regulation 6 (FSA rules) of the Open-Ended Investment Companies Regulations 2001 (SI 2001/1228).

B. The rule-making powers and related provisions listed above are specified for the purpose of section 153(2) of the Act (Rule-making instruments).

Commencement

C. This instrument comes into force on [date].

Amendments to the Handbook

D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

E. The New Collective Investment Schemes sourcebook (COLL) is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the New Collective Investment Schemes sourcebook (Miscellaneous Amendments No. X) Instrument 2006.

By order of the Board

[insert date]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

Amend the following definition as shown:

…

income property	all sums considered by an *ICVC* or by a *manager*, in each case after consultation with the auditor, to be in the nature of income received or receivable for the account of and in respect of the property of an *authorised fund*, including income in respect of *debt securities* whether calculated on a coupon basis or an effective yield basis but excluding any amount for the time being standing to the credit of the *distribution account*.

…

share	(1) (except in *CIS*, *COLL*, *LR* and *DR*) the *investment* …
	(2) (in *CIS* and *COLL*) …

…

Annex B

Amendments to the New Collective Investment Schemes sourcebook

In this Annex, underlining indicates new text and striking through indicates deleted text.

...

Rights of unit classes

3.3.5 R **…**

(4) **…**

(c) … or payments made. ; or

(d) the use of *derivatives* and forward transactions entered into for the purpose of reducing the effect of fluctuations in the rate of exchange between the currency of a *currency class unit* and the *base currency* of the *scheme* (in this section referred to as a "currency class hedging transaction").

Hedging of currency class units

3.3.5A R (1) A currency class hedging transaction must be:

(a) undertaken in accordance with the requirements of *COLL* 5 (Investment and borrowing powers); and

(b) attributed, for the purposes of valuing *scheme property* and calculating the *prices* of *units* in accordance with *COLL* 6.3 (Valuation and pricing), only to the *currency class units* for which it is undertaken.

Guidance on hedging of currency classes

3.3.5B G (1) The *authorised fund manager* before undertaking any currency class hedging transaction for a new or existing *class* of *units*, should:

(a) ensure that each of the constituent documents of the *scheme* explaining the nature, operation and effect of *currency class units* in the *scheme*, state clearly whether or not hedging may be undertaken for each *class*; and

(b) consult the *depositary* and auditor of the *scheme* to determine how:

(i) such transactions will be treated in the *scheme's* accounts; and

(ii) any tax liability resulting from the transactions will be met;

without prejudice to *unitholders* of *classes* other than the relevant currency *class*.

(2) Currency class hedging transactions should be entered into for the sole purpose of reducing the effect of movements in exchange rates on the value of a *currency class unit*, and not for investment or speculative purposes.

…

Application

5.4.1 R (1) This section applies to an *authorised fund manager* and a *depositary* of an *authorised fund*, and to an *ICVC*, in each case which is a *UCITS scheme* or a *non-UCITS retail scheme*.

(2) *COLL* 5.4.3R (Stock lending: general) also applies to:

(a) an *ICVC* which is a *UCITS scheme* or a *non-UCITS retail scheme*; and

(b) a *manager* of an *AUT* which is a *UCITS scheme* or a *non-UCITS retail scheme*.

(3) *COLL* 5.4.4R (Stock lending: requirements) also applies to an *ICVC* which is a *UCITS scheme* or a *non-UCITS retail scheme*.

Permitted stock lending

5.4.2 G …

(3) For the purposes of this section references to *stock lending* transactions include *repo* contracts.

Stock lending: general

5.4.3 R (1) The *stock lending* permitted by this section …

(2) Income generated from any form of *stock lending*, including income from the reinvestment of collateral, prior to the deduction of any payment, constitutes *scheme property* for the purposes of this sourcebook.

(3) A payment may be made out of the income generated from *stock lending* and collateral reinvestment, or otherwise out of *scheme property* in respect of such *stock lending activity*, only if it is

attributable to one of the following:

(a) the arrangement of loans by the counterparty;

(b) transaction charges; and

(c) safekeeping of collateral by the *depositary*.

(4) Any payment which may be made in accordance with (3) must be disclosed in the *prospectus* of the *authorised fund*.

Stock lending requirements

5.4.4 R (1) ... the Taxation of Chargeable Gains Act 1992 (without extension by section 263C) or a *repo* contract, but only if:

…

(b) the counterparty is :

(i) an *authorised person* ; or

(ii) a *person* authorised by a *Home State regulator*; ~~and~~ or

(iii) a *person* registered as a broker-dealer with the Securities and Exchange Commission of the United States of America; or

(iv) a bank, or a branch of a bank, supervised and authorised to deal in investments as principal, with respect to *OTC derivatives* by at least one of the following federal banking supervisory authorities of the United States of America:

(A) the Office of the Comptroller of the Currency;

(B) the Federal Deposit Insurance Corporation;

(C) the Board of Governors of the Federal Reserve System; and

(D) the Office of Thrift Supervision; and

…

(3) (1)(c) does not apply to a stock lending transaction that is made through Euroclear Bank SA/NV's Securities Lending and Borrowing Programme.

…

Treatment of collateral

5.4.6 R (1) …

(c) …

(ii) ~~*government and public securities*; or~~ [deleted]

…

(v) a *readily realisable security*~~.~~ ; or

(vi) commercial paper; or

(vii) daily dealing liquidity funds which have and maintain a triple-A credit rating or equivalent.

(1A) Where the collateral is invested in *units* in a daily dealing liquidity fund that is managed or operated by (or, for an *ICVC*, whose *ACD* is) the *authorised fund manager* of the investing *scheme* or an *associate* of that *authorised fund manager*, the conditions in *COLL* 5.2.16R (Investment in other group schemes) must be complied with, irrespective of whether the investing *scheme* is a *UCITS scheme* or a *non-UCITS retail scheme*.

…

Guidance relating to the use of cash collateral

5.4.8 G (1) The reinvestment of cash collateral should be consistent with the investment objectives and policy of the *authorised fund*.

(2) Collateral taking the form of cash may only be invested in:

(a) one of the *investments* coming within *COLL* 5.4.6R (1)(c)(iii) to (vii) (Treatment of collateral); or

(b) *deposits*, provided they:

(i) are capable of being withdrawn within five *business days*, or such shorter time as may be dictated by the *stock lending* agreement; and

(ii) satisfy the requirements of *COLL* 5.2.26R (1) (Investment in deposits).

…

Issue and cancellation of units in multiple classes

6.2.6A R (1) Where there are two or more *classes* of *unit* in *issue* in an *authorised fund* that fall within (2), the *authorised fund manager* with the agreement of the *depositary* may, for the purpose of determining the numbers of *units* to be *issued* or *cancelled* by reference to a particular *valuation point*, treat any or all of those *classes* as if they were a single *class*.

(2) To be eligible to be treated as a single *class* under (1), *units* in each *class* must:

(a) be identical in terms of their entitlement to participate in the *scheme property*, including their liability in respect of all *charges*, expenses and other payments that may be recovered from the *scheme property* in accordance with *COLL* 6.7.4R (Payments out of scheme property) ; or

(b) differ only as to whether income is accumulated by way of periodic credit to capital or distributed, provided the *price* of *units* in each *class* is calculated by reference to undivided shares in the *scheme property*.

…

Permitted stock lending

8.4.9 R (1) … within section 263B of the Taxation of Chargeable Gains Act 1992 (without extension by section 263C) or a *repo* contract …

…

Issues and cancellations of units

8.5.10 R …

(7) *COLL* 6.2.6A R (Issue and cancellation of units in multiple classes) applies to a *qualified investor scheme*.

PUB REF: 2374

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