

Financial Services Consumer
Panel response to FSA's
Consultation Paper CP185:
The CIS sourcebook – a new
approach

September 2003

Summary

1. FSA proposes a more principles-based approach to regulating unit trusts and OEICs. This approach is welcome if it encourages a more competitive and efficient fund management industry. However, it also brings risks for retail consumers in two areas: that new products and practices may fail to meet consumer needs and expectations, and that greater freedom in fund administration and governance may permit abuse.
2. In the past, unit trusts have tended to be bought by better-off and more knowledgeable consumers. It is possible that the new, limited redemption products with capital protection or fixed returns, or investing in property, may be particularly attractive to less wealthy investors. Yet the introduction of (for example) limited redemption funds and performance fees mean that it will be even more important for consumers to be clear about what they are buying. It may also be difficult to compare the relative cost of such products. The Panel welcomes the opportunities new products bring, but is concerned that product complexity, leading to unsuitable or poor value purchases, could sour consumers' confidence in this market.
3. FSA's proposals also make changes to the detailed running of funds: for example, the proposal to allow 'fair value' pricing, which FSA recognises could give the opportunity for price manipulation; and the proposal to replace the two-hour window for box holdings with a requirement for fund managers to deal fairly. The Panel is not in a position to judge whether the benefits of these changes outweigh the risks – and the retail consumer is certainly not going to be able to spot price manipulation or conflicts of interest. The risk here is of an increasingly opaque industry, where a proliferation of different approaches allows poor practice to flourish.
4. To avoid these dangers, FSA's own role in regulating collective investments may have to change:

- *In supervision* As consumers are unlikely to spot abuses, the FSA will need to be more vigilant, prepared to act swiftly and decisively to deal with price manipulation and conflicts of interest.
- *In monitoring financial promotions and selling practices* to ensure effective disclosure of, for example, limited redemption and financial promotions. According to IMA research¹, one in three consumers buy direct from the fund management company, so we cannot rely entirely on advisers to guide investors.
- *In monitoring compliance with the Unfair Terms in Consumer Contracts legislation* If the FSA proposes to rely more heavily on scheme documentation, the Panel believes that the Unfair Terms legislation may be an important regulatory tool.

The Panel is concerned that the need for this extra activity must be recognised and planned for. For example, the cost benefit analysis states that ‘our proposals would not affect materially our systems and processes for either the authorisation of funds or the supervision of firms’. On the contrary, the Panel believes that the FSA should devote more resources to supervision while the market develops, and in particular to ensuring that funds are promoted appropriately.

5. There are also questions to be asked about fund governance. Trustees and depositaries may need to take on a rather wider role than in the past. For example, they may be required to exercise judgement in, for example, assessing whether fund managers have made appropriate use of proposed provisions for fair value pricing provisions. Where they are overseeing funds that make heavy use of derivatives, their own staff will also need a good understanding of the techniques involved. Below, the Panel suggests some strengthening of the rules affecting scheme governance, but it also believes that some cultural change may be necessary, so that trustees and depositaries are empowered to act as the

¹ Unit Trust Information Service Market Research Survey & Report, Investment Management Association, May 2003

unitholders' proxy in the broadest sense. Firms have the resources to track changes in the way principles are interpreted, while consumers do not.

Constitution

6. FSA proposes that more of a scheme's characteristics should be controlled by the scheme documentation, rather than through rules in the FSA rulebook. The Panel accepts that this gives greater flexibility, but is concerned that it is often difficult for retail investors to use scheme documentation. In encouraging flexibility, FSA runs the risk that less consumer-friendly aspects may also develop, which retail consumers will not be in a position to spot. In order to meet its statutory objective of consumer protection, FSA will need to be able to anticipate problems during the authorisation process. This places FSA under extra pressure. The Panel welcomes the idea of standard or model documentation, provided that the process of developing this is open and consultative.
7. The Panel notes the duties of the depositaries set out in rule 6.6.6 onwards, and welcomes in particular the duty (in 6.6.14) for depositaries to inform the FSA if they have cause to doubt whether the scheme is being managed properly in various respects. We also welcome the duty to inform the FSA if they have had cause to investigate a potential breach. However, these duties appear to relate to quite specific activities relating to valuation and pricing, and the handling of income. Given the shift in the role of trustees and depositaries referred to above, the Panel would like to see the duty to inform the FSA widened. For example, it might include cases where they suspect that the manager's discretion is not being exercised in the unitholders' interests.

Investor relations

Q1: Do you agree with our proposed approach for determining when an investor should vote for or receive notice of events? If so, is 60 days an appropriate minimum notice period?

8. The FSA proposes to move to a categorisation of changes to the scheme as being either 'fundamental' (requiring investor approval), 'significant' (requiring 60-days pre-notification) or 'notifiable' (requiring post-event notification).
9. The Panel supports the general principle of categorisation, but has the following comments:
 - The Panel would be concerned if it were possible to sidestep the investor approval process by writing a very broad prospectus allowing managers to take a very wide range of actions. For example, if the prospectus says that the manager can use derivatives, even if the fund is not originally advertised on this basis, would this make the decision to start using derivatives only 'pre-notifiable' rather than requiring investor approval? We appreciate that the existence of such powers will appear in the simplified prospectus. However, we believe that it is the decision to start using these powers that investors will need to have drawn to their attention, both at the time and in the short-form report
 - The 'notifiable' category includes some changes that the Panel believes that unitholders would want to know about immediately, for example a change of fund manager or introduction of limited issue arrangements. The Panel would like to see this category split, requiring immediate notification for such significant changes, even if they cannot be pre-notified for commercial reasons.
 - The draft guidance on notifiable changes seems to permit 'passive' notification such as publishing the information on a website. The Panel do not think that passive notification is likely to be effective, and believes that there should be positive written notification, though possibly (for some minor changes) within a time period which would allow managers to combine it with another mailing.
 - There is no guidance on non-notifiable changes, which the Panel believes might be helpful. The Panel would also like to see trustees, depositaries and the FSA acting together to ensure that there is a consistent approach

across the industry to classifying changes which are not listed in the guidance.

Q2. Do you agree with our suggested contents for short reports (at CIS 4.5.5 and CIS 4.5.6) and that we should not prescribe the contents in more detail?

10. The Panel welcomes the proposal for a stand-alone short-form report.

However, it believes that a greater measure of prescription may be needed than currently proposed. A reasonably consistent approach to reporting is important to ensure that consumers know what to look for and can compare their investments. For example, the guidance states that particulars of any significant change need be given only if it impacts on unitholders' ability to make an informed judgement. How will the industry ensure that this is interpreted consistently? It seems to us that all the significant changes listed, and some of the notifiable changes too, are ones that will affect the unitholders' decision on whether to stay in the fund.

11. A 'best practice' guide would be helpful, but this must be developed on the basis of full consultation and consumer testing. In addition, FSA should build into its regulatory plan a review of short-form reports to ensure that they reach minimum standards.

12. As well as reasonable consistency across different funds, the Panel also think that is important to ensure that post-sales information is consistent with pre-sales disclosure and marketing information – for example, if a product is marketed on the basis of a particular 'proposition', the reporting should enable consumers to judge whether that proposition has been fulfilled.

Q3 Should the AFM be required to explain how he has used the investment powers of the fund, and why he has chosen not to use certain powers? Should any such explanation be included in the short report or the long form report or both?

13. Yes. If managers are to have greater discretion and wider powers, they must be prepared to expose their use and non-use of such powers to public scrutiny. As to whether or not this information should be in the short or long form reports, the Panel believes that FSA and the IMA should develop some examples that can then be researched among investors.

Investment and borrowing powers

Q4: Are there other changes to the investment limits for real property that are desirable?

14. FSA proposes to relax the investment powers for property funds to make them more popular. The Panel is not in a position to judge whether these changes are desirable, but is concerned that there is no risk assessment to show whether there are any indirect costs to consumers arising from these changes, which appear to reduce the spread of risk.

Q5: Do you agree with our proposal for removal of the two-hour window rule?

15. The Panel are content with this change provided that the guidance at 6.2.12 covering the duty of depositaries to monitor box dealings and inform FSA of any breaches is strictly implemented. We also think that the fund's approach to box dealings should be open to public scrutiny through publication in the long-form report.

Q6: Do you agree with our proposal to allow a cut-off point for deals to be included at a valuation point?

16. No comment.

Limited redemption arrangements

Q7: Do you believe that all authorised CISs should normally provide redemption twice a month?

17. Yes.

Q8: Do you think there are other circumstances where limited redemption should be allowed?

Q9: Is six months an acceptable maximum period between redemptions?

18. The Panel appreciates the justification for limited redemption for the two types of fund stated, for a maximum period of 6 months. However, we remain of the view that consumers' general expectation is that they should have immediate access to their money, albeit at a cost. For this reason, we believe that six months should be the absolute maximum period, and that FSA should monitor the marketing material of such funds particularly carefully.
19. We have previously expressed concern that when investors die, there may be an urgent need to liquidate funds. We appreciate that it may take longer to obtain probate than the 6 months maximum redemption period, but on reflection still believe that managers should be required to offer early redemption in these circumstances. It would offer considerable reassurance to investors at (presumably) relatively little cost to managers.

Deferred redemption arrangements

20. This is a fundamental change that is likely to be extremely difficult to disclose effectively. As we understand it, consumers in a falling market might have to wait for up to a month to get their money. Not only must consumers appreciate this, but managers will have the discretion to apply it at different trigger points – so consumers will need to look in the prospectus to see the figure and then compare it with that for other funds. Are there no alternative ways of dealing with the problem of having to sell the fund's assets at less than their value at the valuation point, such as requiring more frequent valuation points?
21. If deferred redemption is permitted, it is essential that a very clear 'Risk warning' is enclosed on all marketing material, not just the simplified prospectus, with prescribed wording along the lines of 'If a large number of investors ask for their money back when the value of this fund is falling, you may have to wait for up to X days to be paid'.

22. It appears from paragraph 6.2.19 (4) that it will not be possible to operate deferred redemption on a limited redemption fund. The Panel would be grateful for FSA's confirmation that this will be the case.

Pricing issues

Q10: Do you agree that we should explicitly permit fair value pricing (FVP)? This involves using a best estimate of a price which is not obtainable on a market in place of an historically provable but out-of-date market price.

23. The Panel is concerned about the possibility of price manipulation, and possible conflicts of interest if the manager is operating a box. The guidance at 6.3.6 covering the role of the depositary in monitoring pricing offers some comfort, but we also believe that FSA will need to improve pricing transparency, for example by requiring information about pricing practices and pricing breaches to be placed in the public domain.

24. The Panel is concerned by the proposal not to require price publication in a national newspaper. The cost benefit analysis states that an investor may need to go to several sources for information in future, but believes that it will in the interests of fund managers to provide information in an appropriate manner. We question this. For example, will there be an incentive for managers to make it less easy to find out the price of their poorly performing funds? The Internet is not yet sufficiently accessible to be an acceptable substitute – in recent IMA research², internet access was greater than the national average but (at 65%) was still far from universal.

Q11: Do you believe that there is demand from potential investors for a retail (money market) fund with such features?[i.e. with interest accrued on a straight line basis rather than using market values at each valuation point] If so, do you agree that we should introduce special provisions in the sourcebook for it, including rules to limit the scope for and/or to govern the management of any capital gains or losses?

25. The Panel is not in a position to judge demand. However, given the difficulties that FSA has already identified, we would not support the

² Unit Trust Information Service Market Research Survey & Report, Investment Management Association, May 2003

introduction of such funds without further consultation and the publication of a full risk assessment.

Charges and expenses

Q12: Do you agree that performance fees should be permitted on the lines proposed?

26. The Panel appreciate that funds with performance fees are already sold in the UK from other countries, and that performance fees may appeal to some consumers. But research among funds with performance fees overseas³ also suggests that they can be very complex, not easily comparable, and so constructed that they benefit the manager far more than the investor.

27. The Panel welcomes the steps FSA has taken to avoid some of the worst abuses, for example only permitting a performance fee where the price has actually increased. However, we would like to see the proposed rules strengthened by a specific rule stating that a performance fee will only be acceptable where the consumer receives a fair proportion of any performance that attracts a performance fee. Paragraph 5.42 of CP185 refers to COB section 5.6, which requires that charges should not be excessive, but presents no evidence of whether this has proved effective in the past.

28. In addition, while we welcome the requirement that the fees should be disclosed in plain language with examples, we are uneasy about the lack of any detailed guidance based on consumer testing. The discretion given to managers to develop their own approaches adds to the difficulties of comparing charges. This may be an area where a good practice guide, based on consumer testing, could help avoid problems.

Q13: Do you agree with our proposals to continue the prohibition on promotional payments by ICVCs and extend that prohibition to AUTs?
Yes.

³ Research by Fitzrovia, cited in Money Management, July 2003

Non-retail funds

29. The Panel has no comments to make regarding FSA's proposals for non-retail funds.

Cost benefit analysis

Q22: Do you agree with our estimates of the costs and benefits of these proposals? If not, what additional considerations should we take into account?

30. See our comments in paragraph 4 above.