

## FCA to limit promotion of unregulated collective investment schemes and close substitutes

### Introduction

As expected, the FCA is to prohibit promotion of unregulated collective investment schemes (“**UCIS**”) and securities issued by certain special purpose vehicles (“**SPVs**”) to “ordinary” retail investors, with effect from 1 January 2014. Under the current rules, firms may promote UCIS to retail customers if they are promoted in the context of an advisory relationship, and the investment adviser deems a product suitable in accordance with the rules on suitability in the FCA’s conduct of business rules (“**COBS**”). Securities issued by SPVs, on the other hand, are not currently subject to the marketing restrictions which apply to a UCIS.

This policy change is made to address FCA concerns that UCIS and similar investments are able to invest in an unlimited range of assets and projects where risks are often high and underlying assets frequently illiquid or highly speculative. There has been significant enforcement action in this area. While this policy change is as expected, some new issues are highlighted in [FCA Policy Statement 13/3](#), which announced the change:

- > The FCA is planning to undertake a consultation on proposals to confine the promotion of loss-absorbing capital instruments issued by banks and building societies to professional investors and only those retail investors who are sophisticated or high net worth. Such instruments can be expected to include contingent capital securities (“**cocos**”) but, as there is no definition of “loss-absorbing capital” in FCA PS13/3, the potential application of any proposals to other forms of bank and building society capital, as well as hybrid securities issued by other types of issuer (e.g. insurance companies), is unclear.
- > As the thresholds in the exemptions which permit promotion to “high net worth” investors were set in 2001 (at an annual income of more than £100,000 or investable net assets of more than £250,000), the FCA will consult on whether these remain appropriate or should be set at a higher level.
- > The FCA may use its new wide ranging power of product intervention, as a temporary measure, to stop promotion of other complex and higher-risk investment products to “ordinary” retail investors, until rule changes to effect such a ban can be made.

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## What changes are to be made to the marketing restriction?

Changes to the financial promotion rules in COBS are made to limit the types of customers to whom firms can promote UCIS and “close substitutes”.

- > The FCA is to prohibit promotion of unregulated collective investment schemes to “ordinary” retail investors (please see below for the specific investments covered), by deleting existing COBS 4.12.1R and COBS 4.12.2G and inserting a new COBS 4.12.3R setting out the restriction.
  - > In addition, the following exemptions set out currently in COBS 4.12.1R(4) are to be removed: existing investors (existing category 1)(except where the original product is being replaced or liquidated or the promotion is to a person who has an entitlement to a right arising as a result of a rights issue); advised investors (existing category 2); and investors who have the expertise, experience and knowledge to make their own investment decisions (existing category 8).
- > A new COBS 4.12.3 will also prevent firms from marketing “close substitutes” to UCIS to “ordinary” retail investors. Intermediaries may still, however, be able to continue to provide advice to existing retail investors on whether they should keep an investment or sell in favour of a more suitable investment.
- > A consolidated table of exemptions from the prohibition on the promotion of CIS under Section 238 FSMA will form a new COBS 4.12.5. Other exemptions from that prohibition, which are currently included in the FCA handbook, including the table set out in COBS 4.12.1R(4) and COLL 8 Annex 1 (Qualified Investor Schemes), will be deleted.

New exemptions will be introduced to allow firms to promote (i) a non-UK UCITS fund which has been approved by a home state regulator (but where the fund manager has not applied for the fund to be recognised in the UK), subject to a preliminary assessment of suitability; and (ii) regulated US mutual funds, registered under the US Investment Company Act 1940, to US persons temporarily resident in the UK, on an advised or non-advised basis.

The FCA refers in the policy statement to banning the general promotion of UCIS and close substitutes to the retail market in the UK. This, combined with its intention to apply the new restrictions to incoming communications from other EEA states, suggests that the territorial scope of the new rules is intended to cover all communications to retail investors in the UK, whether made by a firm within or outside the UK.

## What products does the prohibition cover?

The ban covers “non-mainstream pooled investments” including:

- > units in unregulated collective investment schemes.
- > units in Qualified Investor Schemes.
- > securities issued by SPVs pooling investment in assets other than listed or unlisted shares or bonds. This is to catch pooled investment SPVs that are functionally most similar to UCIS.
- > traded life policy investments.
- > rights to or interests in these types of investments.

Products which are excluded from the scope of the new regime include the following: SPVs that pool investment in listed or unlisted shares or bonds; exchange traded products; shares in investment trusts or in overseas investment companies that would meet the criteria for “investment trust” status, if based in the UK; REITS; venture capital trusts and covered bonds. Also excluded are securities whereby the issuer’s payment obligations to the investor are “wholly or predominantly linked to, contingent on, highly sensitive to or dependent on, the performance of, or changes in the value of shares, debentures or government and public securities, whether or not such performance or changes in value are measured directly or via a market index or indices and provided the relevant shares and debentures are not themselves issued by SPVs”.

To help firms assess what is a non-mainstream pooled investment, Annex 4 to FSA PS13/3 sets out a flowchart indicating the application of the new marketing restriction on the promotion of these investments to retail investors.

## To whom can firms still promote?

Firms may still, however, be able to market to retail clients in accordance with exemptions in the FSMA (Promotion of Collective Investment Schemes) Order 2000 (the “**CIS Order**”) and the FSMA (Financial Promotion) Order 2000 (the “**FPO Order**”). These include:

- > certified sophisticated investors (retail clients who meet the requirements set out in Article 23 of the CIS Order, Article 50 of the FPO or COBS 4.12.7R).
- > self-certified sophisticated investors (retail clients who meet the requirements set out in Article 23A of the CIS Order, Article 50A of the FPO or COBS 4.12.8R).
- > certified high net worth individuals (retail clients who meet the requirements set out in Article 21 of the CIS Order, Article 48 of the FPO or COBS 4.12.6R). However, guidance (in COBS 4.12.9G(2)) cautions that retail investors who can only satisfy the criteria for this exemption, and not also the certified sophisticated investor exemption

criteria, may be unable properly to evaluate the risks of the investment in question.

The FCA includes new guidance in COBS to help firms understand their obligations when relying on exemptions in the CIS Order and the FPO Order. Even if an exemption is technically available, a firm should not promote a product to a retail investor if it is not suitable for them or is not in their best interests. Changes to COBS clarify:

- > that where a firm wishes to rely on the “one-off communications” exemption in the CIS Order and the FPO Order, particularly where the firm is asked to advise on a specific non-mainstream pooled investment, upon a client’s request, the investment is unlikely to be appropriate for a retail client unless the client falls within the “high net worth” or “sophisticated investor” category (COBS 4.12.12(1) and (2)).
- > that promotion of a Qualified Investor Scheme to a retail client is unlikely to be appropriate unless the client falls within the “sophisticated investor” category or certified sophisticated category (COBS 4.12.13G).
- > the persons who can be certified as a “sophisticated investor” (e.g. certification as such is unlikely to be appropriate where a retail investor’s experience is limited to mainstream investments (COBS 4.12.10G(2))) and the process for certification.

The rules do not extend to execution-only sales, where there has been no financial promotion of a product (although the FCA reminds firms that its Principles for Business remain relevant).

Regulated investments that are permitted to hold non-mainstream pooled investments as part of their underlying assets (e.g. a regulated CIS may hold UCIS as a proportion of their underlying investments) are outside the scope of the restrictions. This is because they are currently subject to additional checks as regulated products. Investments that are merely wrapped by another product such as ISAs are caught by the restrictions.

## **Systems and controls requirements**

The FCA is introducing a new rule that requires the individual responsible for a firm’s compliance oversight function (the “CF 10”), or his or her delegate in the compliance department, to confirm that each promotion in respect of a non-mainstream pooled investment complies with the marketing restriction rules (COBS 4.11.1R(2A)(b)). Reliance on a delegate for this purpose is made subject to annual reviews and approval of the process for reviewing and confirming compliance, by the person holding the compliance oversight function. These changes are made to improve compliance with the financial promotion rules.

Firms will also be required to retain a record of the basis on which the promotion of a non-mainstream pooled investment has taken place for each

financial promotion. This should set out the COBS category, CIS or FPO Order exemption (COBS 4.11.1R(2A)(e)).

## Existing customers

Advice to customers that hold non-mainstream pooled investments as to the suitability of continuing to hold such investments is not prohibited by the new rules. Recommendations for future investment in such investments would, however, be caught.

## Action points

Firms that market and sell UCIS or similar products caught by the new restrictions will need to:

- > consider whether they are distributing non-mainstream pooled investments to retail, or whether they originate such instruments for distribution by intermediaries, and, if so, whether they will no longer be able to do so.
- > update financial promotion policy and procedures to reflect the FCA's guidance.
- > ensure that the CF 10 understands his or her new responsibilities and train compliance staff in (i) procedures for confirming the firm's financial promotions in respect of non-mainstream pooled investments satisfy the new criteria and (ii) resulting changes to the firm's procedures.

## Sources

The rule changes to the FCA Handbook discussed above will be made by the [Unregulated Collective Investment Schemes and Close Substitutes Instrument 2013](#) (2013/46). It will come into force on 1 December 2013 and will be implemented on 1 January 2014. The policy change is announced in [FCA Policy Statement 13/3](#), which follows [FSA Consultation Paper 12/19](#) and its [product intervention discussion paper published in January 2011](#) [FSA DP11/1](#).

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