

EXPLANATORY MEMORANDUM TO
THE OPEN-ENDED INVESTMENT COMPANIES (AMENDMENT)
REGULATIONS 2011

2011 No.

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. **Purpose of the instrument**

2.1 These Regulations amend the Open-Ended Investment Companies Regulations 2001 in order to introduce a protected cell regime for open-ended investment companies (OEICs). This regime will ensure the segregation of liabilities of different sub-funds held under the same OEIC umbrella company so that investors in one sub-fund will be not liable to creditors in the event of another sub-fund failing. The instrument provides a statutory basis for segregation and requires the introduction of contractual terms to this effect.

3. **Matters of special interest to the Joint Committee on Statutory Instruments**

3.1 None.

4. **Legislative Context**

4.1 OEICs are a form of collective investment scheme structured as bodies corporate but they are exempt from most of the provisions of company law. OEICs are regulated under Part XVII of the Financial Services and Markets Act 2000 (FSMA) and rules made under FSMA, the Open-Ended Investment Companies Regulations 2001 (the OEIC Regulations).

4.2 Large fund managers generally operate a small number of OEIC umbrella companies with a large number of sub-funds within each umbrella. This helps them to operate a large range of funds more efficiently. Under current law, there is no segregation of liabilities between different sub-funds. These Regulations amend the OEIC Regulations so as to provide that the assets and liabilities of each sub-fund belong exclusively to that sub-fund. Accordingly, any liability incurred by or attributable to a sub-fund shall be discharged solely out of the assets of that sub-fund. There is one exception to this provision: assets received or liabilities incurred by an umbrella company on behalf of its sub-funds or in order to enable the operation of those sub-funds and which are not attributable to any particular sub-fund may be allocated between the sub-funds in a manner which the umbrella company considers is fair to shareholders.

4.3 These amendments will mean that umbrella companies cannot enter into any agreement, transaction or contract which is inconsistent with the protected cell regime and require the umbrella companies to amend their Instruments of Incorporation to give effect to this prohibition. In order to give existing umbrella companies time to renegotiate their existing agreements, transactions or contracts or to let them expire, a compliance period of two years is introduced. The Financial Services Authority (FSA) can extend the compliance period by another year. During this time, existing umbrella companies can continue to enter into a transaction or contract which is subject to an existing master agreement. By the end of the compliance period, the umbrella companies must have altered their Instruments of Incorporation to contain the statement detailed in the paragraph above.

4.4 Special transitional provisions are made for umbrella companies that are micro-businesses. The general prohibition on entering into any agreement, transaction or contract which is inconsistent with the protected cell regime does not apply to micro-businesses during their compliance period of three years from the date that these Regulations come into force. After the expiry of the compliance period, the general prohibition will apply to micro-businesses and they will have had to alter their Instruments of Incorporation to effect compliance with paragraph 2(ba) of Schedule 2 to the Principal Regulations also.

4.5 Finally, these Regulations also amend the OEIC Regulations so that a sub-fund may be wound up as if it were an unregistered company and

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Financial Secretary to the Treasury, Mark Hoban, has made the following statement regarding Human Rights:

“In my view the provisions of The Open-Ended Investment Companies (Amendment) Regulations 2011 are compatible with the Convention rights”.

7. Policy background

- *What is being done and why*

7.1 OEICs are pooled investment funds of variable size structured as bodies corporate and their sole function is to own investments. Large fund managers generally operate a small number of OEIC umbrella companies with a large number of sub-funds within each umbrella, allowing them to operate a large range of funds more efficiently. The sub-funds (or cells) do not have a separate legal personality, but are separately managed, charged, accounted for and assessed for tax.

Under current UK law, there is no segregation of liabilities between sub-funds so creditors of one sub-fund could have claim on the assets of another sub-fund. While

using multiple separate OEICs instead of sub-funds within a single OEIC would provide protection from this risk, it would make operations less efficient and add significant cost.

In practice the probability of an OEIC collapse is small, as OEICs must comply with borrowing limits imposed by the FSA and because feedback from industry suggests that most credit agreements stipulate segregated liability. However, because this risk has never crystallised it is not certain how these stipulations would be treated by the courts.

Investors are increasingly requiring segregated liability. The Government is introducing the regime to ensure the UK can continue to compete with other European jurisdictions which already operate protected cell regimes. Introduction of the regime will therefore increase consumer protection for investors in UK-domiciled funds, and the competitiveness of the UK as a domicile.

Consolidation

7.2 This Order only amends the OEIC Regulations. Since the amendments are so limited in scope, consolidation of the acts or orders is not merited.

8. Consultation outcome

8.1 In May 2007, the previous Government published a Consultation on Better Regulation Measures for the Asset Management Sector. The consultation sought views on three proposals to reform aspects of the legislation with the aim of reducing regulatory costs for UK asset managers and promoting international competitiveness. One of those proposals was the introduction of a protected cell regime (PCR) for OEICs. The overall response to the proposals was good, with responses from 22 stakeholders (firms, government and trade bodies).

The responses to the consultation were unanimously in favour of developing a PCR. On some of the details, however, the opinions of stakeholders differed. The previous Government set up an industry expert group and worked closely with the FSA to develop the PCR.

In July 2009, HM Treasury and the FSA published a joint consultation on the introduction of a PCR for OEICs with a fully developed proposal, including a draft Statutory Instrument and Impact Assessment. The majority of the responses were in agreement with the proposals and, in response to feedback, the general compliance period for existing umbrella companies was increased from one year to two years with the possibility of an extension at the discretion of the FSA of a further year.

9. Guidance

9.1 Rules and guidance in the FSA Handbook will provide further detail on the practical application of the statutory regime to OEICs.

9.2 Commercial pressures are likely to encourage fund managers to comply with the regime, and the transitional period for existing OEICs and new microbusinesses assists with this. In the event of a breach of the FSA's rules, the FSA has a full range

of powers to address the lack of compliance, which it will apply proportionately on a case-by-case basis.

10. Impact

10.1 The costs of implementing a Protected Cells Regime to the fund management industry comprise one-off legal fees for firms with existing OEICs (up to £1.98m) and one-off renegotiation of agreements not currently subject to segregated liability (between £1.78m and £2.67m). Total benefits from increased attractiveness of UK OEIC funds, are estimated at average annual profit increase of between £0.17m and £3.75m (in constant prices). See impact assessment for detail. We expect the legislation to have very little effect on any business other than the fund management industry. The impact on charities or voluntary bodies is minimal.

10.2 The impact on FSA has been estimated at £35-60k over the transitional period. See impact assessment for detail.

10.3 An Impact Assessment is attached to this memorandum and will be published alongside the Explanatory Memorandum on the OPSI website.

11. Regulating small business

11.1 The legislation applies to small business.

The costs in complying with the regulation when establishing a new OEIC are negligible but there are some costs in changing the terms of existing arrangements. To reduce costs for small businesses, a two-year transition period has been introduced, which may be extended at the FSA's discretion for a further year.

Consistent with the Government's moratorium on new legislation for micro-businesses, Authorised Corporate Directors (the firms that are operationally responsible for OEICs) employing fewer than 10 people will be exempt from the legislation's requirements for three years from the date of introduction. In practice, there are very few micro-businesses acting as Authorised Corporate Directors, with research for the Impact Assessment identifying only four micro-businesses. Given the competitiveness benefits of introducing Protected Cells protection, these firms were content with the legislation's introduction.

The method in this instrument of calculating the number of employees by dividing the contracted number of hours per week that all employees work by 37.5, is solely intended for the purpose of determining whether the moratorium on new legislation for microbusinesses applies. The phrase "contracted to work" means that if an employment contract is silent about breaks, then all the hours contracted count, so the figure is gross of breaks: if the employment contract sets out working hours and separately covers breaks, then the hours count net of breaks. This method has no application in employment law. In addition it does not reflect the Government's position on the status of employment by reference to number of hours worked, nor on what an ordinary or average working week consists of.

12. Monitoring & review

12.1 The Treasury will monitor compliance with the regulations after two and three years, and will also monitor its effectiveness in protecting investors in OEIC sub-funds in the event of a failure in a sister sub-fund. The Treasury will continue to monitor the volume of investment in UK-domiciled funds on an ongoing basis and will consider appropriate policy responses.

13. Contact

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