

Title:

HM Treasury and FSA proposals for a Protected Cell Regime for Open-Ended Investment Companies

Lead department or agency:

HM Treasury

Other departments or agencies:

Financial Services Authority

Impact Assessment (IA)

IA No:

Date: 19/07/2011

Stage: Final

Source of intervention: Domestic

Type of measure: Secondary legislation

Contact for enquiries:

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Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

Open-Ended Investment Companies (OEICs) are investment funds structured as bodies corporate. 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 UK law, there is no segregation of liabilities between different sub-funds. Many investors may be unaware of this contagion risk. There is also evidence that the unsegregated nature of liabilities within OEIC umbrellas may reduce the attractiveness of investing in UK OEICs for overseas investors.

What are the policy objectives and the intended effects?

The policy objective is to protect investors from the risk of contagion within OEIC umbrellas and to promote UK business and growth by increasing the attractiveness of the OEIC as an investment vehicle to overseas investors.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

The Government could: (option 0) do nothing; or (option 1) introduce a compulsory protected cell regime for both new and existing OEICs.

The Government's preferred option is the introduction of the regime as this increases investor protection and UK competitiveness. The benefits of introducing the regime outweigh any costs. The Government prefers compulsion for all OEICs, as this avoids investor confusion and a requirement for firms to provide extra labelling on whether their OEICs are in or outside of the regime.

Will the policy be reviewed? It will be reviewed. If applicable, set review date: 1/2015

What is the basis for this review? PIR. If applicable, set sunset clause date: 0/Year

Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?

Not applicable

Ministerial Sign-off For final proposal stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:

Ma Ila

Date: 2 July 2011

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Summary: Analysis and Evidence

Policy Option 0

Description:

Do nothing (baseline)

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -3.28	High: -328	Best Estimate: -166

COSTS (£m)	Total Transition (Constant Price) Years		Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0	N/A	0.35	3.28
High	0		35	328
Best Estimate	0		17.7	166

Description and scale of key monetised costs by 'main affected groups'

Feedback from industry is that there is an expectation that a protected cell regime will be introduced and that if the regime does not proceed it would not take long for funds to move offshore. Non-implementation of the regime is estimated to cost UK firms between £0.35m and £35m annually.

Other key non-monetised costs by 'main affected groups'

A decision not to implement could damage the reputation of the UK as a centre for fund management, in favour of jurisdictions such as Ireland and Luxembourg.

BENEFITS (£m)	Total Transition (Constant Price) Years		Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	N/A	0	0
High	0		0	0
Best Estimate	0		0	0

Description and scale of key monetised benefits by 'main affected groups'

N/A

Other key non-monetised benefits by 'main affected groups'

N/A

Key assumptions/sensitivities/risks

Discount rate (%) 3.5

- Between 0.1% and 10% of funds under management will be withdrawn from UK OEICs in favour of offshore funds if a protected cell regime is not implemented
- 0.2% of funds under management represents the revenue linked to the domicile of funds in the UK (IMA/KPMG report)
- 33% profit margin for the asset management industry (IMA annual survey 2009-2010)

Direct impact on business (Equivalent Annual) (£m):			In scope of OIOO?	Measure qualifies as
Costs: 17.7	Benefits: 0	Net: -17.7	No	NA

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Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom		
From what date will the policy be implemented?			01/01/2012		
Which organisation(s) will enforce the policy?			N/A		
What is the annual change in enforcement cost (£m)?			N/A		
Does enforcement comply with Hampton principles?			N/A		
Does implementation go beyond minimum EU requirements?			N/A		
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)			Traded: N/A		Non-traded: N/A
Does the proposal have an impact on competition?			N/A		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			Costs: N/A		Benefits: N/A
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	Micro N/A	< 20 N/A	Small N/A	Medium N/A	Large N/A
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on...?	Impact	Page ref within IA
Statutory equality duties¹ Statutory Equality Duties Impact Test guidance	N/A	
Economic impacts		
Competition Competition Assessment Impact Test guidance	N/A	
Small firms Small Firms Impact Test guidance	N/A	
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	N/A	
Wider environmental issues Wider Environmental Issues Impact Test guidance	N/A	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	N/A	
Human rights Human Rights Impact Test guidance	N/A	
Justice system Justice Impact Test guidance	N/A	
Rural proofing Rural Proofing Impact Test guidance	N/A	
Sustainable development Sustainable Development Impact Test guidance	N/A	

¹ Public bodies including Whitehall departments are required to consider the impact of their policies and measures on race, disability and gender. It is intended to extend this consideration requirement under the Equality Act 2010 to cover age, sexual orientation, religion or belief and gender reassignment from April 2011 (to Great Britain only). The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Summary: Analysis and Evidence

Policy Option 1

Description:

Introduce a compulsory protected cell regime for new and existing OEICs

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -4.4	High: 32.74	Best Estimate: 14.16

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	2.57	3	0	2.41
High	6.42		0	6.02
Best Estimate	4.50		0	4.21

Description and scale of key monetised costs by 'main affected groups'

One-off legal fees for firms with existing OEICs (up to £1.98m); one-off renegotiation of agreements not currently subject to segregated liability (between £1.78m and £2.67m); and one-off FSA authorisation costs (between £35k and £60k)

Other key non-monetised costs by 'main affected groups'

N/A

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	N/A	0.17	1.58
High	0		3.75	35.15
Best Estimate	0		1.96	18.37

Description and scale of key monetised benefits by 'main affected groups'

Increased competitiveness of UK funds, due to increased attractiveness of UK OEIC investments, which would attract additional Funds under Management (FuM) to the UK. This would increase revenue, and subsequently profits for firms. A cautious estimated indicative range is that FuM would increase over a ten year time period by between £527m and £11.7b. This equates to an average annual profit increase of between £0.17m and £3.75m (in constant prices).

Other key non-monetised benefits by 'main affected groups'

Additional benefits from perceived increased competitiveness of the UK fund management industry, due to increased attractiveness of UK OEIC investments. Removal of contagion risk, protecting investors from the liabilities of other sub-funds.

Key assumptions/sensitivities/risks

Discount rate (%)

3.5

- 10% of new offshore fund sales driven by lack of protected cell regime for UK OEICs
- 0.2% of funds under management represents the revenue linked to the domicile of funds in the UK (IMA/KPMG report)
- 33% profit margin for the asset management industry (IMA annual survey 2009-2010)
- Between 5% and 25% of OEICs will need to let expire or renegotiate at least one agreement during the transitional period

Direct impact on business (Equivalent Annual) £m:				In scope of OIOO?	Measure qualifies as
Costs:	0.45	Benefits: 1.96	Net: 1.51	Yes	IN

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Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom		
From what date will the policy be implemented?			01/01/2012		
Which organisation(s) will enforce the policy?			FSA		
What is the annual change in enforcement cost (£m)?			0		
Does enforcement comply with Hampton principles?			Yes		
Does implementation go beyond minimum EU requirements?			N/A		
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)			Traded: 0	Non-traded: 0	
Does the proposal have an impact on competition?			No		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			Costs: 0	Benefits: 0	
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	Micro N/A	< 20 N/A	Small N/A	Medium N/A	Large N/A
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

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Competition Competition Assessment Impact Test guidance	No	
Small firms Small Firms Impact Test guidance	Yes	14
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	Yes	14
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	No	
Sustainable development Sustainable Development Impact Test guidance	No	

¹ Public bodies including Whitehall departments are required to consider the impact of their policies and measures on race, disability and gender. It is intended to extend this consideration requirement under the Equality Act 2010 to cover age, sexual orientation, religion or belief and gender reassignment from April 2011 (to Great Britain only). The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessments of earlier stages (e.g. Consultation, Final, Enactment) and those of the matching IN or OUTs measures.

No.	Legislation or publication
1	http://webarchive.nationalarchives.gov.uk/20100315150725/http://hm-treasury.gov.uk/consult_protected_cell_regime.htm
2	http://webarchive.nationalarchives.gov.uk/20100315150725/http://hm-treasury.gov.uk/consult_betterregulation_index.htm
3	
4	

+ Add another row

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices – option 1

	Y ₀	Y ₁	Y ₂	Y ₃	Y ₄	Y ₅	Y ₆	Y ₇	Y ₈	Y ₉
Transition costs	1.99	1.99	1.99	0	0	0	0	0	0	0
Annual recurring cost	0	0	0	0	0	0	0	0	0	0
Total annual costs	1.99	1.99	1.99	0	0	0	0	0	0	0
Transition benefits	0	0	0	0	0	0	0	0	0	0
Annual recurring benefits	0.08	0.32	0.72	1.20	1.68	2.16	2.64	3.12	3.60	4.08
Total annual benefits	0.08	0.32	0.72	1.20	1.68	2.16	2.64	3.12	3.60	4.08

* For non-monetised benefits please see summary pages and main evidence base section



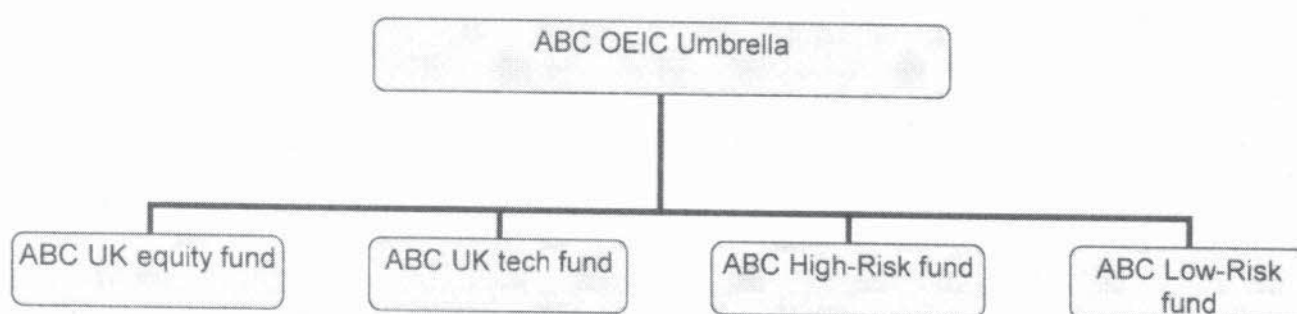
Microsoft Office
Excel Worksheet

Evidence Base (for summary sheets)

What is the problem under consideration?

Open-ended Investment Companies (OEICs) are pooled investment funds of variable size structured as bodies corporate and their sole function is to own investments. UK regulations for OEICs were approved by Parliament in 1996 in order to catch up with jurisdictions like Ireland and Luxembourg which already offered OEICs. However, Ireland and Luxembourg (and others) have since then introduced the concept of protected cell companies, making their OEICs more attractive to investors than UK OEICs and making UK firms offering UK OEICs less competitive.

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 law there is no segregation of liabilities between the various sub-funds. For example, if an umbrella fund contains a high-risk equity fund which collapsed with liabilities exceeding its assets, creditors could have a claim on the assets of the other sub-funds, which could include a Low-Risk fund. Investors in the low-risk fund therefore bear some of the risk of the riskier fund. While using multiple separate OEICs instead of sub-funds within a single OEIC would provide protection from this risk, it would make operation much 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 Financial Services Authority (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.

Current FSA rules require disclosure of the contagion risk in the fund prospectus and periodic reports, although there is a danger that some OEIC investors do not fully understand it. Recent events highlight the importance of investors understanding the risks they are subject to. Investors into a very low-risk fund should not be subject to the risks in a separate sub-fund holding riskier assets. Furthermore, many investors have become risk-averse and see any possible risk of contagion as a reason not to invest, or at least to invest elsewhere.

Feedback from stakeholders indicates this has become a contributing factor to investors' decisions not to invest in UK funds, instead favouring investment in funds in corporate form in jurisdictions such as Jersey, Ireland or Luxembourg, which operate protected cell regimes. As a result of this, UK fund managers have been calling for the introduction of a protected cell regime (PCR).

Policy option objective

The policy objective is to protect investors from the risk of contagion within OEIC umbrellas and to increase the attractiveness of the OEIC as an investment vehicle to overseas investors. A viable PCR would remove the contagion risk by providing an effective ring-fencing of a sub-fund's assets from the other sub-funds and the umbrella itself. This would ensure that each sub-fund has segregated liability and its assets cannot be used to satisfy the liabilities of another sub-fund or the umbrella, thus ensuring that the insolvency of one sub-fund does not lead to the insolvency of other sub-funds or the umbrella.

A PCR would improve the features and efficiency of UK OEICs allowing UK fund managers to provide their clients with a better product. Its introduction would bring the UK in line with other jurisdictions, improving the UK's ability to compete with those jurisdictions. This will help UK firms attract new business and promote UK growth.

Stakeholder feedback and consultation

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 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 expert group with membership consisting of fund managers, fund lawyers, insolvency lawyers and a depositary, making it possible to utilise the expertise and experience of the industry and gain direct stakeholder input. Firms/organisations that provided assistance and expertise were the Investment Management Association, The Insolvency Service, M&G, Insight, Schroders, State Street Trustees, Norton Rose, Herbert Smith, Macfarlanes, Linklaters and KPMG. As Treasury legislation on this matter requires the FSA to amend its rules and to ensure smooth implementation, officials have worked closely with the FSA to develop the PCR.

In July 2009, HM Treasury and the FSA published a joint consultation on introducing a PCR for OEICs with a fully developed proposal, including a Statutory Instrument and Impact Assessment. The majority of the responses were in agreement with the proposals, with responses from 14 stakeholders (firms and trade bodies). Most comments were on the transitional provisions. The consultation proposed a 12-month compliance period, which many agreed would be sufficient. However, a number of issues were raised by those that thought companies would not be able to meet the requirements within the 12-month period, although it was also suggested that more time would help even those who did not strictly need it.

In response, two changes have been taken forward. First the compliance period was extended from one year to two years, providing the vast majority of existing OEICs with sufficient time to successfully complete conversion to segregated liability. Second, an OEIC would be allowed to apply within the compliance period to the FSA for an extension. The FSA may then extend the compliance period for a further period not exceeding a further one year. This effectively gives firms three years to complete the transition.

Estimated industry benefits

Policy option 0 (do nothing)

There are no benefits to industry from doing nothing.

Policy option 1 (implement a PCR)

The industry is strongly supportive of this regime, as it will improve the competitiveness of their UK funds, by increasing the attractiveness of UK OEIC investments. Feedback from stakeholders suggests that as investors have become more risk averse following the global downturn, the potential of this benefit has increased.

It is very hard to quantify benefits such as increased UK competitiveness, particularly for a specific and technical piece of legislation. However, anecdotal evidence from firms is that institutional investors are citing the lack of a PCR as a reason to withdraw their investment from UK OEICs, and that there are other concerned investors that are waiting to decide whether to stay or withdraw, due to an expectation that a PCR will be implemented. However, estimating this benefit is made difficult because on the one hand the lack of a PCR may not always be the main factor, and on the other hand this evidence only captures the existing business that firms risk losing and not new business that they are not able to win.

Because there is an expectation that a PCR will be implemented the cost of not doing this has been included in the costs of policy option 0 (do nothing), rather than a benefit of option 1 (implement the PCR). The benefits of option 1 will therefore be in attracting new business. Calculating the current lost

opportunity to firms is made difficult due to the lack of data, but the analysis below attempts to use the data that is available to make a reasonable estimate.

According to data from the Investment Management Association (IMA), UK domiciled funds under management (FuM) at the end of March 2011 stood at £583b, but there is a further £700b in FuM that is domiciled offshore, for example in Ireland and Luxembourg. The UK fund regime has been viewed as less favourable by managers and investors for a number of reasons, with the lack of a PCR being one of them. It is therefore reasonable to assume that a proportion of that £700b was placed offshore rather than in the UK due to the lack of a PCR. Additionally, a proportion of the growth of offshore funds will also be due to the lack of a PCR. The IMA suggests that it is reasonable to assume that this proportion is around 10%. Reliable data covering the whole amount of this growth is not available, but the IMA does have data on where these investments were sold to UK investors only (i.e. but not for sales to non-UK investors). Using the latest available data from the IMA's website (www.investmentuk.org) between 2006 and 2010 net sales to UK investors averaged £620.2m annually (although this includes the financial crisis which saw large-scale redemptions of investments and is unlikely to be repeated in the near future unless there is a crisis on a similar scale). Using the IMA's estimate of 10%, this would equate to £62m in annual missed sales due to the lack of a PCR. However, there are several factors which suggest this is a very cautious estimate, which can be used as a lower range.

First, the estimate of £62m per annum does not take into account the potential growth in the value of the underlying assets (which would increase revenue, see below on Total Expense Ratio).

Second, in calculating the annual missed sales figure, net sales data was used, which is gross sales data subtracted by outflows (where investors redeem their investments). As we are trying to capture new sales, in the first instance gross sales would be the obvious choice, however, this would then not take future redemptions into account. It is likely that redemptions of these new investments would be proportionately smaller than redemptions of existing investments, but it would be difficult to try to meaningfully untangle the two.

Third, while the key assumption here is the 10% which could be too high, it is important to note that offshore funds sold to UK investors are only a small proportion of the total of offshore funds (£31.7b compared to £700b, or around 4.5%, as at March 2011). Assuming sales of the total grew at a similar rate this would equate to an annual missed sales opportunity of £1.4b. This can be used to represent the higher range.

In order to derive figures for the benefit to firms from these additional sales that increase UK FuM, we consider the increased revenue. The average Total Expense Ratio (TER) in the UK is 1.7% and this represents the total revenue ratio of FuM. IMA and KPMG analysis¹ identified that annual fee income of approximately 0.2% of FuM represents the revenue specifically linked to the funds being domiciled in the UK rather than offshore. In other words, for every £100 in FuM, firms receive on average £1.70 in revenue, of which 20p is linked to the funds being in the UK. According to the IMA's 2009-2010 Asset Management Survey, the industry's profit margin is approximately 33%.

Table 1 below shows the cumulative effect on revenue and profit of the increased sales. Note that if a PCR were to be implemented the full benefit could only be reached after the transitional period, when all existing OEICs would have been converted to protected cells. Although it is likely some firms will take the earliest opportunity to convert their OEICs, others may wait for the annual review of their documentation. The FuM increase for the first three years has therefore been adjusted to reflect a linear growth rate, flattening out at the above estimated range of between £62m and £1.4b. This means that the average benefit over the ten year period is reduced.

¹ <http://www.investmentfunds.org.uk/assets/files/research/20080124jointimakpmgreport.pdf>

Table 1: The benefit to industry of implementing a PCR (in constant prices)

	<i>FuM increase (cumulative) (£m)</i>	<i>Annual revenue increase (£m)</i>	<i>Annual profit increase (£m)</i>
Year 0	10 – 230	0.02 – 0.46	0.01 – 0.15
Year 1	41 – 919	0.08 – 1.84	0.03 – 0.61
Year 2	93 – 2,067	0.19 – 4.13	0.06 – 1.38
Year 3	155 – 3,444	0.31 – 6.89	0.1 – 2.3
Year 4	217 – 4,822	0.43 – 9.64	0.14 – 3.21
Year 5	279 – 6,200	0.56 – 12.4	0.19 – 4.13
Year 6	341 – 7,578	0.68 – 15.16	0.23 – 5.05
Year 7	403 – 8,956	0.81 – 17.91	0.27 – 5.97
Year 8	465 – 10,333	0.93 – 20.67	0.31 – 6.89
Year 9	527 – 11,711	1.05 – 23.42	0.35 – 7.81

Total benefit (in present value using a discount factor of 3.5%) of implementing a PCR is between £1.58m and £35.15m, using the average of £18.37m as a best estimate.

What has not been considered is the potential benefit from funds that have been previously lost due to the lack of PCR returning to UK OEICs, as there was no concrete evidence or data on which to base any analysis.

Estimated industry costs

Policy option 0 (do nothing)

As explained in the previous section, there is an expected cost of not implementing a PCR. Feedback from industry is that there is an expectation that a PCR will be introduced and that if the regime does not proceed it would not take long for FuM to move offshore.

Like the benefits described above, it is difficult to put a figure on this, but it is not likely to be zero. From the anecdotal evidence from industry about concerned institutional investors, a very cautious estimate would be around 0.1% of FuM, which we can use as the lower range. This would involve only a few large investors withdrawing their funds in favour of offshore funds. The IMA suggests it is reasonable to assume that 10% of UK FuM could leave the UK should a protected cell regime not be introduced. While this may seem high, we can consider this the upper range of potential costs. This would mean that the cost of doing nothing is the loss of profit from losing between 0.1% and 10% of UK FuM. This equates to a potential loss of between £0.583b and £58.3b in FuM, which, using the revenue assumption of 0.2% from above, equates to a loss of revenue of between £1.17m and £117m per annum, or £0.39m and £39m per annum profit. It is unlikely this loss would happen overnight, and therefore we could look at this loss of FuM building up over the next two years, which would reduce the average annual loss over a ten year period.

Table 2: The cost to industry of doing nothing (in constant prices)

	<i>FuM lost (£m)</i>	<i>Annual revenue lost (£m)</i>	<i>Annual profit lost (£m)</i>
Year 0	146 – 14,575	0.29 – 29.15	0.1 – 9.72
Year 1	437 – 43,725	0.87 – 87.45	0.29 – 29.15
Year 2	583 – 58,300	1.17 – 116.6	0.39 – 38.87
Year 3	583 – 58,300	1.17 – 116.6	0.39 – 38.87
Year 4	583 – 58,300	1.17 – 116.6	0.39 – 38.87
Year 5	583 – 58,300	1.17 – 116.6	0.39 – 38.87
Year 6	583 – 58,300	1.17 – 116.6	0.39 – 38.87
Year 7	583 – 58,300	1.17 – 116.6	0.39 – 38.87
Year 8	583 – 58,300	1.17 – 116.6	0.39 – 38.87
Year 9	583 – 58,300	1.17 – 116.6	0.39 – 38.87

The total cost (in present value using a discount factor of 3.5%) of doing nothing is between £3.28m and £328m, using the average of £166m as a best estimate.

Policy option 1 (introduce a PCR)

There are no ongoing requirements on firms from the introduction of a PCR and it is therefore unlikely that there would be any ongoing administrative costs from the proposal. The main costs of the proposal are conversion costs for existing OEICs. New OEICs would obviously not incur these. There are two broad scenarios:

1. OEICs can have no agreements or only agreements that are on a segregated liability basis; or
2. OEICs can have at least one agreement that specifies cross-liability or at least one agreement that does not specify either way.

There are also two types of one-off costs per OEIC:

- A) legal advice and cost of notifying the FSA of conversion and amending the instrument of incorporation and prospectus; and
- B) ongoing legal counsel and internal costs depending on negotiation and complexity of agreements.

Although feedback suggests that most OEIC umbrellas meet Scenario 1, there may be some that fall under Scenario 2, and will need to let expire or renegotiate at least one agreement during the transitional period. This is very difficult to estimate, as it will depend on specific circumstances within firms. The latest consultation suggested 25% as an estimate for scenario 2, which the majority of respondents agreed was reasonable (the others provided no comment). However, the original consultation was on the basis of a transitional period of one year. The transitional period is now three years, which will make it much more likely that agreements will have naturally expired or will have been renegotiated as part of normal business. Therefore it seems sensible to reduce our best estimate, but leaving 25% as the higher range. As it is likely that most agreements will have expired or been renegotiated (but perhaps not all) we can set the lower range at 5%, with the average of 15% as the best estimate.

Cost A

Previous industry feedback suggested that up to £5,000 is a reasonable assumption of Cost A per OEIC (this can be broken down into an initial half-day (4 hours) of legal advice and then another half-day spent making the necessary changes and getting sign-off from the legal department (all at up to £500 per hour), then rounded up to £5,000).

Cost B

Cost B is more difficult to estimate because it depends on details of specific credit agreement. It is also further complicated due to the fact that firms will likely have changed their behaviour when entering into new agreements since the intention to implement a PCR for UK OEICs became clear.

In estimating cost B, the lower end is taken from a rough estimate by industry participants, and the higher end is reached by looking at the potential costs of one of the more complicated and lengthy credit agreement (ISDA Master Agreement) negotiations. Responses to the latest consultation agreed with these estimates, as outlined below.

According to the latest ISDA survey (2006), negotiations of ISDA Master Agreements are likely to take 30-90 days. Feedback from stakeholders indicates that the global downturn has made negotiation of terms more involved, and will therefore take longer. This is difficult to quantify, but a reasonable estimate is 50 per cent more time or 45-135 days. If we then assume that on average it will take 90 days at an estimated cost of £500 per day (with negotiations taking up an average of one hour per day at an average rate of £500), negotiations will, on average, cost £45,000. Compare this with an industry-estimated cost of £10,000 per agreement, and that to satisfy regulations on risk diversifications it is likely firms will operate with a minimum of three agreements per OEIC. These estimates can be used as a range for Cost B of between £30,000 and £45,000.

Total costs

There are 395 authorised umbrella OEICs (as of 6 June 2011) and their minimum conversion costs are Cost A, and therefore, assuming a cost of £5,000 per OEIC, would be up to £1.98m. Assuming 15 per cent, or 59 OEICs, will need to negotiate an agreement at Cost B of £30,000-£45,000 per OEIC; this adds costs of between £1.78m and £2.67m. This amounts to between £3.76m and £4.65m in one-off costs over the transitional period. Using the range of between 5% and 25% for scenario 2, this provides a low estimate of £2.57m and a high estimate of £6.42m. Table 3 shows these costs over the ten year period, with the costs spread over the three year transition period.

Table 3: The cost to industry of implementing a PCR (in constant prices)

	<i>Cost A (£m)</i>	<i>Cost B (£m)</i>	<i>Total cost (£m)</i>
Year 0	0.66	0.2 – 1.48	0.86 – 2.14
Year 1	0.66	0.2 – 1.48	0.86 – 2.14
Year 2	0.66	0.2 – 1.48	0.86 – 2.14
Year 3	0	0	0
Year 4	0	0	0
Year 5	0	0	0
Year 6	0	0	0
Year 7	0	0	0
Year 8	0	0	0
Year 9	0	0	0

The total cost (in present value using a discount factor of 3.5%) of implementing a PCR is between £2.41m and £6.02m, using the average of £4.21m as a best estimate.

Further one-off costs arise for FSA approval of conversion. At 3.5-6 hours per approval of revised documentation per umbrella at a cost of £25 per hour and with 395 OEIC umbrellas, this is between £35k and £60k over the transitional period.

Estimated consumer benefits

Policy option 0 (do nothing)

There are no benefits to consumers of doing nothing.

Policy option 1 (implement a PCR)

The other key benefit would be protecting OEIC investors from having to meet the liabilities of another sub-fund in the event of insolvency. As proposed through changes in FSA rules, new consumers will be made aware of the status of their investments by the prospectus disclosure and existing customers will be notified in accordance with the requirements in COLL 4.3 in the FSA's handbook.

There is reason to believe that in aggregate risks could be borne more cheaply under a protected cell regime than with unsegregated liability. Under the current rules, assessing the creditworthiness of an OEIC sub-fund requires an assessment of the solvency of the umbrella as a whole. Potential investors would also have to assess the creditworthiness of other sub-funds in an umbrella to gain a complete picture of the risks of a possible investment. With segregated liability, both parties would only require information on the sub-fund (not including other sub-funds) in order to make a complete assessment of risk. Thus it is possible that the net benefit in terms of distribution of risk and payment of risk premia would be positive.

Estimated consumer costs

There is no material detriment to consumers of this new regime as it improves consumer protection by removing a potential risk to investors in sub-funds of UK OEICs. However, there is the possibility of creditors charging more under the new regime, although assuming OEIC investors have the same risk preferences as creditors, the benefit to investors would be equal to the additional amount creditors charge for bearing the extra risk and those costs and benefits would cancel each other out.

Finally, although a two-tier system will exist over the transitional period whereby there will be both protected cells companies and non-protected cell companies, investor confusion is mitigated by proposed disclosure requirements and by the intention that all OEIC umbrellas will convert by the end of the transitional period.

Summary

The aim of the policy option of introducing a PCR for UK OEICs is to remove investor confusion and contagion risk, and to provide UK OEICs with a competitive legislative landscape. The two key benefits are removing the contagion risk to OEIC investors and improving the international attractiveness of the UK OEIC vehicle. Total benefit (in present value using a discount factor of 3.5%) of implementing a PCR is between £1.58m and £35.15m, with a best estimate of £18.37m.

It is unlikely there are any ongoing net costs, although the cost impact of not implementing the regime is estimated at between £0.35m and £35m annually, due to FuM moving offshore if their expectations of implementation of a PCR are not met soon. The total cost (in present value using a discount factor of 3.5%) of doing nothing is between £3.28m and £328m, with a best estimate of £166m.

The estimated one-off costs of implementing a PCR to industry are between £2.57m and £6.42m with a best estimate of £4.50m. One-off costs to the FSA are estimated at between £35k and £60k. These costs can be put into context with estimated revenue for the sector of £1.13b (using figures from the Investment Management Association's Annual Survey 2008 and assuming a similar ratio of revenue to assets under management.)

In conclusion, the best estimate for net benefit (in present value) for not implementing a PCR is -£166m, while the best estimate for net benefit (in present value) for implementing a PCR is £14.16m, not counting the non-monetised benefits of a perceived increased competitiveness of the UK fund management industry.

Statutory Equality Duties Impact Test

The Government has considered the proposed policy in relation to its public sector equality duties under the Sex Discrimination Act 1975, the Race Relations Act 1976, the Disability Discrimination Act 1995, section 75 of the Northern Ireland Act 1998 and the Equality Act 2010. It has concluded that no relevant issues arise.

Small firms Impact Test

The benefits from introduction of the protected cell regime flow from certainty over its application to OEICs. This simplest and most effective way of achieving this is to introduce a compulsory scheme covering all OEICs. However, an alternative would be to exempt smaller fund managers from the regime – and instead require these firms to either opt in or to label their funds as non-protected (which would in itself have costs attached to it). A variant on this approach would be to make the regime voluntary for smaller fund managers.

The original consultation over the protected cells regime was open to all fund managers and the responses to the consultation were unanimously in favour of mandating a protected cell regime. However, further efforts have been made to determine the preference of micro-businesses in particular. In practice, these represent only a very small proportion of asset managers:

- 1) The Investment Management Association (IMA), the main trade body for the industry, has 100 relevant asset managers on its list. The IMA contacted by phone the smallest 20% of these by fund size to identify potential micro-businesses. After discounting firms that were part of larger businesses, two firms met the definition of microbusiness. Both of these firms were contacted directly and asked for the scheme to be mandatory; they considered the benefits of mandatory introduction of the regime to outweigh the transition costs.
- 2) The Financial Services Authority emailed the 13 firms which, based on fee data, were most likely to be microbusinesses. Of the 13, six responded and of these, two were eligible microbusinesses. None of the respondents raised objections to the planned introduction of a PCR.

While larger firms operate more funds and small firms fewer funds, the benefits of a PCR would apply equally across all OEIC umbrella funds, and the costs of introducing the regime are linked only to the number of funds. Smaller fund operators might have less negotiating power, but small firms will also have fewer complicated agreements that might need renegotiating.

Based on the efforts above to identify micro-businesses, a conservative approach would be to assume that 5% of micro-businesses and 5% of funds would be affected directly by the protected cell regime. In practice the proportions are likely to be lower. Adopting the assumptions elsewhere in this Impact Assessment, this would translate to a best estimate for total one-off costs in constant prices to micro-businesses of £225k. Again adopting the approach above, the best estimate for net benefit (in present value) to microbusinesses for implementing a PCR is £708k.

Given the benefits of a scheme covering all OEICs and the widespread support for this, there is a strong case for applying a waiver to the moratorium for microbusinesses. However, to reduce the impact further, Ministers have decided to grant the FSA extension of one year automatically for micro-businesses, which will be additional to the two year transition period for existing OEICs. As the only expense is incurred in covering existing OEICs, this means provisions incurring costs fall outside the micro-business exemption period. However, the scheme should be compulsory for all new OEICs, as there are no ongoing costs to businesses, while having to convert these later on would incur costs. As such, a waiver is requested to the microbusiness exemption for application of the regime to micro-businesses establishing new OEICs.

Human Rights Impact Test

Many creditors of sub-funds already operate under contracts that limit their claims upon other sub-funds of the same umbrella. However, this policy option would enshrine this in legislation. To mitigate the possibility of interfering with previous contractual rights the policy option does not take away those rights, but includes a transition period of 2 years (with a potential additional 1 year), during which agreements

not made on a segregated liability basis should be renegotiated. Accordingly, the legislation is compliant with the European Convention on Human Rights

Annexes

Annex 1 should be used to set out the Post Implementation Review Plan as detailed below. Further annexes may be added where the Specific Impact Tests yield information relevant to an overall understanding of policy options.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. If the policy is subject to a sunset clause, the review should be carried out sufficiently early that any renewal or amendment to legislation can be enacted before the expiry date. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

Basis of the review: [The basis of the review could be statutory (forming part of the legislation), i.e. a sunset clause or a duty to review, or there could be a political commitment to review (PIR)];

Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?, or as a wider exploration of the policy approach taken?, or as a link from policy objective to outcome?]

Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach]

Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured]

Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives]

Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection of monitoring information for future policy review]

Reasons for not planning a review: [If there is no plan to do a PIR please provide reasons here]

Add annexes here.