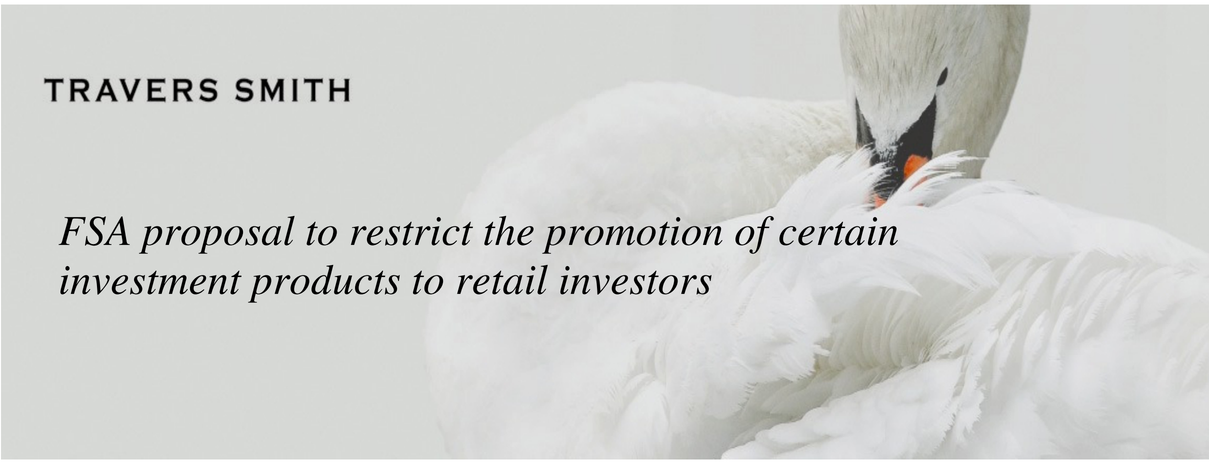

FSA proposal to restrict the promotion of certain investment products to retail investors

You may have seen an article in the Financial Times on 31 December that talked about FSA proposals to ban the marketing of REITs to retail investors. This story is derived from an FSA consultation paper published in August that has already been subject to an AIC commentary which focussed on the potential exclusion of retail marketing in respect of VCTs and certain offshore investment companies.

Given the shock value of the headlines that have been applied to the consultation paper and the importance of the retail investor base to certain listed closed-ended funds, we thought it would be useful to send you a note setting out what exactly the FSA have proposed and the potential implications arising from it. It is a fairly technical issue but the implications are potentially important, in particular in respect of marketing conducted through certain private wealth networks.

In the context of the plethora of fund regulation currently in the pipeline, this is an issue that is not attracting as many headlines as the AIFMD and FATCA but is certainly something of which those involved in the marketing of listed funds should be aware.

Overview and background

By way of background, the promotion of unregulated collective investment schemes (which are, at the most basic level, funds structured other than as companies) is governed by a similar, but different set of rules to investment companies. Currently, the key difference is that it is not possible for an authorised firm to make or approve a financial promotion in respect of an unregulated collective investment scheme unless an exemption applies; the exemptions have the effect of limiting distribution to institutional investors and only very limited classes of natural persons.

The FSA believes that this rule has not been complied with properly and that it also needs to be extended to other products providing access to the same investment strategies that are often pursued by unregulated collective investment schemes, products that they refer to as "non-mainstream pooled investments" (**"NMPI"**). As a result, in August last year, the FSA published a consultation paper (CP 12/19) which proposed a restriction on authorised firms communicating or approving an invitation or inducement to acquire, convert or underwrite a NMPI where that financial promotion is addressed to or disseminated in such a way that is likely to be received by a retail investor.

Application of the proposed restriction to the listed closed-ended fund sector

The definition of NMPI includes a security issued by a "special purpose vehicle". Special purpose vehicle is defined as a body corporate that is "established for the purpose of securitising assets" and whose sole purpose is one or more of, amongst other matters, issuing designated investments (for example, shares) and/or entering into or terminating transactions involving designated investments in connection with the issue, redemption, termination or re-purchase of designated investments. You might expect that definition to catch securitisation vehicles but, confusingly, UK investment trusts were specifically carved out from the proposed definition implying that prima facie they will be a NMPI under the proposed new rules.

Following requests for clarification from industry bodies about what is a "special purpose vehicle", the FSA has said privately that it intends the new regime to apply to VCTs and to certain offshore investment companies and REITs (which we assume to be Chapter 15 fund REITs, not property company REITs). If you are confused by how certain offshore investment companies and REITs can be caught when investment trusts are carved out, it is down to the fact that the definition of investment trust specifically refers to funds that are approved, or (in respect of funds located in an EEA state) could qualify, for the UK tax treatment attributable to an investment trust.

Is such a restriction necessary?

Feedback from the asset management industry has generally not been supportive of the proposals nor the subsequent informal FSA feedback.

The consultation paper states that the proposed rules are a response to examples of investment products being mis-sold and the development of new products that are not suitable for retail investors. We do not believe that the proposed rule changes are a suitable response to this concern for a number of reasons:

- the existing rules already prohibit the promotion of unregulated collective investment schemes to the general public and guidance requires that promoters and distributors exercise the necessary care to ensure that products are only promoted and sold to the right customers. If, as stated in the consultation paper, these rules are not being complied with, it strikes us that rather than introducing product-based investment restrictions it would be simpler and more effective to impose tougher sanctions on those breaching the existing rules;

- the changes implemented through the retail distribution review have been adopted to address substantially similar issues and time should be given for such changes to work their way into market participant policies and procedures before adding a further layer of regulation;

- denying access for retail investors to offshore listed investment companies, VCTs and REITs with diversified portfolios potentially restricts the ability of such investors to invest in asset classes such as property, infrastructure and small companies; and

- it is especially confusing to carve investment trusts out of the new restriction without extending that carve out to offshore investment companies, REITs and VCTs. There is no reason for believing that an investment policy of an offshore investment company will, in all cases, attract significantly greater risk than an investment policy of a UK investment trust. Given the significant number of offshore investment companies as compared to investment trusts, the proposed restriction is an unwelcome development in the context of an industry trying to recover in a difficult economic climate.

It is to be hoped that the FSA, having considered this feedback, will produce revised proposals that are properly targeted at the practice of mis-selling investment products rather than just denying retail investors access to investment products that they may benefit from if properly advised.

Implications of the proposed restriction if adopted in its current form

Notwithstanding the views expressed above, if the FSA adopts the rule changes in the form proposed in the consultation paper, it is worth considering what the proposed impact would be and how managers, private client brokers and other authorised persons would need to alter their current procedures in order to comply with the restriction on promoting closed-ended funds to prospective investors.

The proposed restriction only applies to financial promotions of NMPIs that are made or approved by an authorised person. As a result, an issuer will be able to continue to promote its own shares freely to its existing shareholders. Further, a promotion to anyone exclusively by means of an approved prospectus (or an extremely anodyne covering letter to the prospectus) would also be permitted, but there could be no active informal promotion in support of the prospectus (for example through a website, marketing presentation or other roadshow materials).

There are steps that may be taken by managers and private client brokers who promote listed funds to ensure that marketing falls within these exemptions, but they are limited. For example: (i) financial promotions to existing shareholders and publication of prospectuses by way of a website should be made on a website maintained by the issuer (and not, for example, the manager's website) – this may in particular require a change in practice for VCT managers; and (ii) private client brokers that forward prospectuses to clients will need to stop producing summaries of the contents of the prospectus and simply send a simple covering letter referring to an enclosed prospectus.

Further, authorised firms may wish, where it is possible to do so, to reclassify certain of their clients as professional clients rather than retail so that the FSA authorised firm can make the promotion to them. If such an approach is taken, the firm will also need to take responsibility for the financial promotion being "clear, fair and not misleading". Opting-up can be done on a case-by-case basis but it is laborious and results in increased risk for that authorised firm. Realistically, it will not be possible to opt-up a significant number of potential investors for a targeted marketing campaign and, therefore, only provides a limited solution.

The consultation paper states that it will still be possible to promote NMPIs to certain classes of retail investors who fall within existing financial promotion rule exemptions (namely certified and self-certified sophisticated investors and high net worth individuals). These exceptions are unlikely to be of assistance in the promotion of closed-ended listed funds as two of the exceptions only apply to the promotion of unlisted shares or units in collective investment schemes and the third is not commonly used and is generally unattractive to an authorised firm.

Next steps

The final rules are due to be published by the FSA in March and it is to be hoped that the issues raised above are taken into account in the final text.

If you would like further information on the above, please contact either Aaron Stocks or Will Normand or your usual contact at the firm.

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