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Financial Services and Markets

OEICs: Introduction of the Protected Cell Regime

The legislation required to introduce a protected cell regime for UK Open-Ended Investment Companies ("OEICs") has recently been passed into law. The Open-Ended Investment Companies (Amendment) Regulations 2011 (the "Regulations") came into effect on 21 December 2011. On the same date the FSA made various changes to the Collective Investment Schemes Sourcebook ("COLL") of the FSA Handbook to reflect the requirements of the Regulations.

This enhancement to the OEIC regime will be welcomed by investors and should improve the attractiveness of the UK as a fund domicile. However, its introduction is not without transitional costs and potential operational issues for existing umbrella OEICs. The new regime also has implications for service providers, investment counterparties and others who have a contractual relationship with an umbrella OEIC.

Introduction

A UK OEIC can be established as an umbrella company with a number of sub-funds. The OEIC will issue different classes of share in relation to each of the sub-funds. Each sub-fund represents a discrete pool of assets which are managed in accordance with the investment objectives and policies for that sub-fund. Operationally each sub-fund is distinct so, for example, separate accounts are maintained and valuations and share prices are produced for each share class within a sub-fund.

However, the sub-funds do not have separate legal personality and until now there has been no legal segregation of liabilities between different sub-funds. This created a risk that if the liabilities of one sub-fund could not be met out of the assets of that sub-fund, the assets of the other sub-funds would be utilised to meet the claim.

The protected cell regime seeks to address this contagion risk by providing for a legally enforceable segregation of the assets and liabilities of each sub-fund.

The protected cell regime is compulsory for UK umbrella OEICs, although transitional provisions apply to OEICs in existence on 21 December 2011 (see below). The regime applies to all umbrella OEICs regardless of the type of the fund, i.e. UCITS, Non UCITS Retail Schemes and Qualified Investor Schemes are all covered.

The Protected Cell Regime

The key elements to the protected cell regime are:

1. The assets of a sub-fund belong exclusively to that sub-fund and cannot be used to discharge the liabilities of any other person, including the OEIC itself or another sub-fund.

2. A liability incurred on behalf of a sub-fund must be discharged solely out of the assets of that sub-fund.

3. Where assets or liabilities are not attributable to any particular sub-fund, the OEIC can allocate them in a manner which it considers is fair to shareholders.

4. Any provision in any agreement with the OEIC (or in the OEIC's Instrument of Incorporation) which is inconsistent with the principles in 1 and 2 above (the "segregated liability principles") is void, as is the application of a sub-fund's assets in contravention of those principles.

Generally, from 21 December 2011 an OEIC must not enter into any agreement or contract which is inconsistent with the segregated liability principles. There are two exceptions to this prohibition which are available during the transitional period (see further below):

(i) **master agreements**. During the transitional period an OEIC may enter into a new contract which is subject to a "master agreement" that had been entered into by the OEIC prior to the Regulations coming into force. A master agreement is defined as standard terms and conditions which form part, but not the whole, of the terms for one or more transactions or contracts between the parties.

(ii) **micro businesses**. In relation to "micro businesses" i.e. where the OEIC either has no authorised corporate director ("ACD") or the ACD has fewer than 10 staff, the segregated liability principles do not apply during the transitional period.

5. The OEIC's Instrument of Incorporation must be amended to include a specific statement on segregated liability. The usual procedure for amending the Instrument of Incorporation (involving the submission to FSA of Form 21 at least one month in advance) will apply save that a solicitor's certificate will not be required.

6. When making the formal notification to FSA to modify the OEIC's Instrument of Incorporation, the OEIC must also confirm to FSA that it does not have any agreement or contract with a third party which is inconsistent with the segregated liability principles.

The Regulations include various consequential provisions, for example, modifications to the winding-up regime to enable a sub-fund to be wound-up as if it were an unregistered company, a provision to enable the property of a sub-fund to be made subject to a court order and for the OEIC to be able to sue (and be sued) in respect of a particular sub-fund. However, the Regulations confirm that a sub-fund does not have separate legal personality.

FSA Rules

The FSA's rules in COLL have been modified to complement the Regulations. New provisions in COLL require:

- the OEIC's Instrument of Incorporation to include a prescribed statement on segregated liability;
- the Prospectus to include a specific disclosure relating to segregated liability and also to highlight that this concept is new and it is not yet known how foreign courts will react to it;
- the ACD, whenever there are reasonable grounds for the ACD to consider that a foreign law contract entered into by the OEIC may have become inconsistent with the segregated liability principles, promptly to investigate whether this is the case and if so to take appropriate steps to remedy that inconsistency. FSA's guidance indicates that appropriate steps may include the renegotiation or termination of the offending foreign law contract. A foreign law contract is very widely defined as any contract other than one which is governed by UK law and which gives the UK courts exclusive jurisdiction.

One additional benefit of the new regime is that it will now be possible for one sub-fund of an OEIC to invest in another sub-fund of the same OEIC provided that:

- the second sub-fund does not hold investments in any of the other sub-funds of the same OEIC;
- the investing fund is not a feeder fund to the second sub-fund;
- the Prospectus discloses that cross investing may occur; and
- the ACD must rebate any initial or redemption charge received in relation to the investment.

Transitional Arrangements

The protected cell regime is compulsory but there are certain transitional provisions which are intended to provide ACDs with sufficient time to be in a position fully to comply with all aspects of the new regime.

The transitional provisions apply differently to "micro businesses" which are very small fund management operations where the OEIC either does not have an ACD or the ACD has fewer than 10 employees.

Standard OEICs i.e. non micro businesses

The segregated liability principles set out at 1 and 2 above apply from 21 December 2011 regardless of whether the liability was incurred before, on or after that date.

The obligation to ensure that the OEIC does not enter into any agreement or contract which is inconsistent with the segregated liability principles (see 4 above) applies as from 21 December 2011. The only exception is that noted above in relation to contracts entered into under master agreements which were in place prior to 21 December 2011, which is available during the transitional period.

Existing umbrella OEICs will be required to transition to protected cell status by amending their Instrument of Incorporation and the Prospectus and providing FSA with the required notification in relation to compatibility of contracts (see 6 above) within 2 years of the new Regulations coming into force i.e. by 20 December 2013. FSA has the power to extend the transitional period on a case by case basis on application by the OEIC for a further period of up to one year.

During the transitional period the FSA Rules introduced as a consequence of the protected cell regime do not apply. This means, for example, that the ACD's obligations in relation to foreign law contracts do not apply but also that the OEIC sub-funds will not have the ability to cross invest.

An existing umbrella OEIC may choose to make the transition to protected cell status at any time during the 2 year transitional period. Once notification has been given to FSA of the intention to change the Instrument of Incorporation and Prospectus, the transitional period in relation to that OEIC will cease with effect one month after notification has been given. At that point the protected cell regime requirements including the FSA Rules in COLL will apply in full.

An umbrella OEIC authorised after 21 December 2011 will have to comply with the protected cell regime from the outset.

Micro businesses

OEICs which qualify for micro business status will have until 20 December 2014 (i.e. a 3 year transitional period) to comply with the new requirements.

During the transitional period for micro business OEICs, the protected cell regime is disapplied entirely: the segregated liability principles do not apply, nor do the obligations to ensure that the OEIC does not enter into any agreement or contract which is inconsistent with the segregated liability principles.

The transitional arrangements for micro businesses are available to both existing umbrella OEICs and umbrella OEICs which are authorised during the 3 year transitional period provided that they meet the micro business criteria.

Key Actions for ACDs

Achieving compliance with the new requirements, particularly in relation to embodying the segregated liability principles into contracts, is not without transitional costs for existing funds. The final Regulations contain a longer transitional period than originally proposed (2 years rather than 1 year for standard OEICs and 3 years for micro businesses) which will be welcomed by ACDs.

ACD's of umbrella OEICs will need to:

- amend internal controls, policies and procedures so as to ensure that all future contracts which the OEIC enters into are consistent with the segregated liability principles. Particular care will be needed in relation to foreign law contracts in this respect;
- review all existing contracts entered into by the OEIC to assess if the contract is compatible with the segregated liability principles. Again, particular care will be needed in relation to foreign law contracts;
- terminate or amend those contracts which are not compatible with the segregated liability principles in sufficient time to enable the required notification (confirming the compatibility of contracts with the segregated liability principles) to be given to the FSA with the Form 21 at least one month prior to the end of the transitional period;
- modify the Instrument of Incorporation for the OEIC to include the prescribed wording on segregated liability;
- amend the OEIC's Prospectus to reflect the FSA's new segregated liability disclosure requirements and, if required, the ability to cross invest;
- ensure all foreign law contracts entered into by the OEIC have been identified. ACDs should establish policies and procedures which will (i) enable the ACD to ascertain when there might be reasonable grounds to consider that a foreign law contract may have become inconsistent with the segregated liability principles and (ii) ensure that the ACD takes action to investigate and if necessary remedy the situation as required by COLL.

Issues

Depending on the number of sub-funds and the nature of the investment strategies employed, an existing umbrella OEIC may have a significant volume of contracts which will need to be reviewed and potentially renegotiated or terminated prior to the end of the transitional period. The transitional period (2 years for standard OEICs, 3 years for micro businesses) and the flexibility, if necessary, for standard OEICs to approach FSA for an extension to the transitional period is certainly helpful but ACDs may still face challenges in identifying, reviewing and then modifying or terminating all relevant contracts.

If a contractual counterparty refuses to accept the necessary modifications to a contract the OEIC may have to terminate the contract even if to do so would incur termination costs.

In view of the new requirements in relation to foreign law contracts and the breadth of the definition of a foreign law contract, ACDs may wish to consider amending the governing law and jurisdiction clauses in relevant contracts so that they fall outside the definition of a foreign law contract.

Where an OEIC has entered into foreign law contracts, ACDs will need to consider how they are going to determine if the contract and its interpretation in the relevant jurisdiction is consistent with the segregated liability principles. This may require, for example, legal advice to be taken in the relevant jurisdiction. If a foreign law contract is confirmed to be inconsistent with the segregated liability principles, it will not be possible for the ACD to provide the required notification to FSA on the compatibility of contracts whilst that contract is subsisting.

The ACD will also need to consider establishing ongoing monitoring procedures, again possibly involving local legal advice, so that it will be alerted if, in the future, circumstances arise which may constitute reasonable grounds to consider that a foreign law contract has become inconsistent with the segregated liability principles. Where a foreign law contract becomes inconsistent with the segregated liability principles, the ACD must take appropriate steps to remedy the situation and in doing so must have regard to the best interests of the shareholders. FSA's guidance states that appropriate steps may include renegotiation of the contract or causing the OEIC to exit from the contract.

It remains to be seen whether these foreign law contract provisions will create significant issues for ACDs in practice but there is at least a possibility that if the segregated liability principle is not upheld in a particular jurisdiction and it is necessary for an OEIC sub-fund which invests in that jurisdiction to do so under local law contracts, the ACD may have to consider amending the investment objective and policy of the sub-fund to remove that jurisdiction from its investment scope or potentially review the continued viability of that sub-fund.

Implications for Service Providers and Counterparties

Anyone acting as a service provider to an umbrella OEIC or who is a counterparty to a transaction with an OEIC should revisit the terms of the contractual arrangements and consider the extent to which these will need to be modified to reflect the segregated liability principles. For standard OEICS, prior to the contract being modified the Regulations provide that any contractual provisions which are inconsistent with the segregated liability principles are void as is the application of a sub-fund's assets in contravention of those principles. This has an immediate impact on the rights of recourse that a service provider or counterparty has to the assets of the umbrella OEIC.

Service providers and counterparties can expect ACDs to seek to amend contracts to incorporate segregated liability provisions and, as discussed above, ACDs may also wish to modify governing law and jurisdiction clauses in contracts.

For further information on these issues please contact one of the following professionals in our Financial Services and Markets department or your usual contact at Travers Smith.

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