Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes: CP12/19

A submission by Amati Global Investors

1. Overview

1.1 The consultation paper CP12/19 embodies the point of departure from historic regulatory practice in the UK which was clearly signalled in January 2011 by DP11/1. Where DP 11/1 talked of a more interventionist approach, CP12/19 moves beyond defining the correct procedures and principles for the proper marketing of investments to retail clients, to the broader role of direct intervention in the investment decision making process through effectively banning the marketing of any funds (and a very wide range of "close substitutes") which do not fit the UCITS formula to ordinary retail investors. Amati Global Investors acts as designated manager of a UCITS fund, as well as two types of fund which would potentially be impacted by the proposals in CP 12/19, namely Venture Capital Trusts (Amati VCT and Amati VCT 2) and a non-UCITS open-ended managed futures fund domiciled in Malta, and regulated by the Malta FSA, called Amati Systematic Trend Fund. Our response to CP12/19 therefore, is written in the light of our experience with these funds.

1.2 We would agree that there are a variety of UCIS funds which should not be marketed to ordinary retail investors, in particular those which involve niche assets where price discovery is extremely difficult, and overly optimistic claims can easily be made. However, Lord Turner made clear in DP11/1 that an interventionist approach involves making judgements about trade-offs between consumer protection and consumer choice. CP12/19 seems less conscious of these trade-offs, and we believe the negative implications of the proposals for products caught in the scope of CP12/19 but not actually considered by it have not been adequately weighed, and that unnecessary damage will be wrought by the proposals on legitimate product providers who serve to increase consumer choice appropriately. As such, in their current form we suggest that the proposals are likely to cause significant harm.

1.3 However, we believe that all of the unnecessary damage can be avoided by the adoption of a more specifically targeted approach to the whole universe of funds which lie outside the scope of CIS. Specifically we recommend making a distinction amongst this range of products between those with no effective or credible regulation at all, and those which have an acceptable alternative regulatory regime in place. We also propose detailing specific product flaws which characterise funds that are likely to cause detriment to consumers, so that these can be avoided in whatever form they take.

1.4 It appears that in certain follow up discussions to CP 12/19 held in private it was indicated that a range of products not discussed in the paper were intended to be included in the intervention, including Venture Capital Trusts (VCTs) and ETFs listed on the London Stock Exchange (LSE).

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If this is correct, it is a highly confusing stance to take, as these products are themselves already regulated by the UKLA (a branch of the FSA), and subject to the Listing Rules. As such they cannot be accused of bearing any resemblance to the kinds of UCIS funds which have caused the problems which gave rise to CP12/19. As fully listed companies, VCTs are in certain respects more highly-regulated and transparent than UCITS funds, subject as they are to stringent reporting, governance and disclosure requirements. This supports the case for a more targeted approach. We include more detailed comments on what separates VCTs from the UCIS funds which are the focus of CP12/19 below.

1.5 We also look at another category of fund not considered by CP12/19, but which forms a significant segment of funds which fall outside of UCITS, namely managed futures funds. These funds typically fall foul of a quirk in the UCITS framework which discriminates against investment in commodity futures, as opposed to financial futures. These funds do not share any of the features outlined in CP12/19 as being typical of UCIS funds. They also benefit typically from being part of a credible, although lighter regulatory regime than UCITS. We recommend that these funds are not targeted in the same way as the funds discussed in the paper, and set out the rationale and potential workings of a more targeted approach.

1.6 The legislation surrounding the marketing of UCIS funds in the UK overly complex, being set out by three different sets of rules (the PCIS Order, COBS 4.12 and the FPO) , and it is easy to imagine that this tangle of over-lapping legislation leads to poor standards of implementation. We would suggest that rather than trying to curtail the exempt Categories in COBS 4.12, it would be much more constructive to combine all three sets of rules into one code of conduct in COBS, and for this set of rules to be discerning, readily grasped, well targeted and practical to implement.

2. A More Specifically Targeted Approach

2.1 CP12/19 (1.4) begins by noting that because mainstream equity and bond products have been highly volatile during the credit crunch there has been a marked increase in sales of alternative types of investment. This is undoubtedly true, and indicates that there are legitimate reasons why retail investors may wish to seek out a wider range of investment propositions. An additional factor here, which is not cited directly, is the ultra-low interest rate environment currently prevailing, which removes the attraction of deposit accounts and government securities for investors.

2.2 The paper then moves on to say there are good reasons to consider the vast majority of such "non-mainstream" investment products as likely to be unsuitable for ordinary retail investors, and that it is effectively worth sacrificing the small number which are, along with the additional choice that may bring, for the greater good of preventing sales of unsuitable funds. This strikes us as too indiscriminate, and that the full range of fund types being sacrificed in order to capture a relatively small group of completely unregulated funds has not been properly weighed. Retail investors have good reason to want access to a broader range of investment types. The extraordinary growth of global macro strategy UCITS funds over recent years, which take long and short positions in currencies, commodities, bonds and equities makes their appetite clear. The regulator should be more concerned not to remove potentially important investment choices for retail investors, and this does not seem to us to be irreconcilable with the goal of preventing the sale of the kind of funds which the paper cites as causing detriment.

2.3 The mere fact of being a fund being structured as a UCIS does not mean that there is anything wrong with it. It is the content of the fund which determines that. Likewise the mere fact of a fund being structured as a UCITS does not mean that it is necessarily suitable for distribution to retail investors. It is worth recalling that two of the highest profile fund disasters in the UK over the last few years have been UCITS funds (Key Data and Arch Cru). The blackening of all products which cannot be structured as UCITS produces some undesirable consequences, which themselves will bring detriment to ordinary retail investors.

2.4 The UCITS legislation has some strange twists, and we would suggest that these need to be properly ironed out before imposing a sweeping ban on everything which doesn't fit the current rules. For example, UCITS funds are allowed to invest in financial market derivatives but not commodity-based derivatives. We have not been able to find an adequate reason being given for adopting this position. From a risk management perspective the two types of derivative positions are identical. If the fact that commodity-price derivatives often settle in the underlying commodity is taken to be the reason, then this doesn't explain the fact that the UCITS rules also specifically rule out commodity derivatives which are swapped into financially settled contracts. This quirk may sound small, but it has a host of unintended consequences for providers of managed futures funds (of which Amati Global Investors is one). Managed futures funds, which can offer the lowest cost means of providing exposure to macro-strategies across the whole range of global and liquid asset classes, have grown hugely over the past decade. However, due to the quirk of the UCITS legislation they either have to take the form of UCIS funds, in which case their reputation is immediately blackened, or they must take a compromised and inferior form, of which the most popular is achieved through exchanging a portfolio of futures positions including commodities, for a total return swap with a single counterparty on the profits from that portfolio. This compromise is both costly and more risky for the investor in that it introduces counterparty risk un-necessarily. In these cases the retail investor would often be better served through a UCIS from the same provider as the UCITS version, but under the existing legislative regime (even before the proposed changes to it), they are unlikely to be told about it. If the proposed changes come into force there would be no viable routes for marketing the superior UCIS version of these funds. This represents the kind of unintended consequence which we believe a more specifically targeted regulatory approach could avoid. In these cases the exact opposite of the situation described in CP12/19 (2.6) occurs, where a UCIS version of a product offers lower risks and lower charges than its direct CIS counterpart.

2.5 Unlike the kinds of UCIS funds described in CP12/19, managed futures funds (the majority of which take UCIS form) do not deal in opaque or obscure instruments where price discovery may be impossible, but rather deal with some of the world's most liquid and transparent regulated markets. These funds can be much larger in size than would be typical of those discussed in CP12/19. Most providers would prefer to offer these products as UCITS, but do not wish to run counter to the current restrictions imposed by the UCITS framework with a workaround that introduces higher costs and risks for investors for no benefit. Instead, providers will typically adopt a form of fund administered in a European territory with the relevant expertise, and regulated in that territory. Amati Global Investors' managed futures fund is regulated by the Malta FSA for example. So in this sense classifying it as an Unregulated Collective Investment Scheme (USIS) is something of a misnoma which promotes an undiscriminating attitude to funds which operate outside of the UCITS regime. We understand that discussion is also underway suggesting that UCITS 6 will remove the restriction on commodity derivatives, and think that this would be a very positive step towards ironing out a significant anomaly which removes some important investment choices from retail investors.

2.6 We therefore propose that, instead of setting out to treat all non-UCITS investment vehicles in the same way, the Regulator should draw a more specifically targeted quality map of this universe of funds. There should be a fundamental distinction drawn between funds which operate entirely without regulation, and those which operate under a regulatory regime other than UCITS. For example, some UCIS funds are within the scope of regulators in other European jurisdiction such as Ireland, Luxembourg or Malta. As already mentioned a good number of investment vehicles which may fall within the scope of "close substitutes" in CP12/19 are in fact subject to the stringent regulatory regime of the Listing Rules as enforced by the UKLA. Funds which are not CIS, but which are subject to credible alternative forms of regulation, should not be impacted by further marketing restrictions.

2.7 It seems to us that the real target of CP12/19 are funds which operate entirely without regulation, or with regulation from a jurisdiction that lacks credibility (such as the Channel Islands Stock Exchange which gave the Arch Cru funds a veneer of credibility, for example), or where the main investments held by a regulated fund are in investment vehicles which themselves are completely without regulation, or with regulation lacking in credibility. These are the funds which are likely to cause detriment to retail investors, and which in the past have found ways of providing large incentives to advisors to make sales, and it is this more narrowly defined group of funds that should face the kind of curtailed marketing envisaged by CP12/19.

2.8 It would be helpful to characterise the kind of funds which cause detriment in more detail, so that avenues for regulatory arbitrage are difficult to pursue, as advisors will be unable to market funds with certain flawed characteristics. These would include funds that invest in single niche asset classes with limited liquidity, and lack of independent price discovery mechanisms. They would include funds with an open-ended structure investing in highly illiquid assets. They would include funds with charging structures which lie significantly outside the industry norms.

3. Detailed comments on Venture Capital Trusts

3.1 Amati Global Investors acts as manager for two VCTs which invest predominantly in AIM quoted companies, and hence has an in depth knowledge of the existing regulatory framework and governance structure already in place for these types of funds. In this section we draw distinctions between the kinds of UCIS funds cited by CP12/19 (1.5-1.7) and VCTs.

3.2 VCTs cannot be said in any sense to adopt the form they take in order to facilitate the kind of regulatory arbitrage discussed by CP12/19 in relation to "close substitutes" of UCIS funds. Their structure is defined by the relevant UK legislation on VCTs, and is not a matter of choice. Moreover, as fully listed companies they are subject to stringent rules covering investment and borrowing powers, disclosure of fees and charges, management of conflicts of interest, and a prudent spread of risk and other investor safeguards; all the things in fact cited by CP12/19 (1.5) as being absent from "close substitutes".

3.3 VCTs are set up in order to provide additional availability of financing to small businesses. As such it is inevitable that they will make investments which are illiquid. An open-ended CIS structure would be wholly inappropriate for them. Being fully-listed closed-ended investment vehicles is the most appropriate and most tightly regulated form they can take.

3.4 Within the VCT universe, AIM VCTs in particular predominantly invest in companies quoted on the London Stock Exchange's Alternative Investment Market, which has proven itself to be one of the most effective small company stock exchanges in the world. The underlying investments, therefore, are valued at transparent closing bid prices. Unquoted investments across all VCTs are valued following the valuation guidelines of the International Private Equity and Venture Capital Association and are reviewed frequently by each VCT's independent board of directors.

3.5 The investment activities of VCTs are not generally difficult to understand, and these have to be clearly disclosed in a legally verified Prospectus. Their application is then supervised by an independent Board of directors. Manager charges and performance are likewise evaluated by the independent Board of directors.

3.6 Most VCTs will publish Net Asset Values (NAVs) regularly, and in the case of AIM VCTs this is normally once weekly. They publish detailed and rigorous Annual and Interim reports, as well as Interim Management Statements. Amati Global Investors also makes a monthly fact sheet available to investors in the VCTs it manages. Hence, investors are able to track the progress of their investment easily. Where components of these NAVs are unquoted investments, the values are signed off by an independent Board of directors.

4. Responses to the specific Questions set out in CP12/19.

1) Do you agree that we should look to impose restrictions on the promotion of non-mainstream pooled investments to ordinary retail investors?

We believe agree that there is a category of non-mainstream pooled investment vehicles which should not be marketed to ordinary retail investors, but would argue that this category is narrower than that proposed by CP12/19, and that it should be more tightly defined around funds which have no regulation at all, or regulation which lacks credibility, and funds which have certain specified flawed characteristics. We strongly believe that it is wholly inappropriate for VCTs to be included within this category.

2) Are there any other investments that should be treated in the same way?

Yes, there is a case for asking distributors of funds to check all funds they market for certain flaws which characterise funds likely to be of detriment to retail investors. The aim would be to prevent acceptable regulated structures being used to house unacceptable kinds of funds (such as those of the Arch Cru range). Characteristics could include, for example, funds that invest in single niche asset classes with limited liquidity, and lack of independent price discovery mechanisms; funds with an open-ended structure investing in highly illiquid assets; and funds with charging structures which lie significantly outside the industry norms.

3) Are there any investments caught by the non-mainstream pooled investment definition in the draft rules that you believe should not be?

Yes, there are many. Broadly these would be products which are regulated adequately under a regime other than UCITS. In particular we highlight above investment vehicles (such as VCTs) which are subject to the UK Listing Rules, and those which are subject to regulatory regimes in countries such as Ireland, Luxembourg and Malta, but which fall outside of UCITS. Exempting these from the scope of CP12/19 will involve making judgements about the adequacy of such regimes. We would recommend that the Regulator should engage in making such judgments, rather than assuming that everything outside of UCITS is equally likely to be detrimental to retail investors. The price for not doing so will be a poor trade off between consumer protection and the restriction of choice.

4) Do you agree that we should remove the general ability of firms to promote UCIS under COBS 4.12.1R(4) category 1?

We only agree in relation to the narrower and more specifically targeted definition of target funds proposed above at question 1.

5) Do you agree that firms should still be able to promote replacement UCIS to retail customers where the original product is being replaced or liquidated?

Yes.

6) Do you agree that we should remove the ability of firms to promote UCIS under COBS 4.12.1R(4) category 2?

We only agree in relation to the narrower and more specifically targeted definition of target funds proposed above at question 1.

7) Do you agree that we should remove the exemption in COBS 4.12.1R(4) category 8?

We only agree in relation to the narrower and more specifically targeted definition of target funds proposed above at question 1.

8) Do you agree that we should limit the ability of firms to promote QIS, securities issued by SPVs and TLPIs in the retail market?

This is not within our area of expertise, so we make no comment.

9) Do you have any comments or suggested improvements for our approach to SPV-issued securities, including structured products?

This is not within our area of expertise, so we make no comment.

10) **Do you have any comments on the Handbook guidance we propose to add regarding the use of exemptions in the FPO and PCIS Order?**

COBS 4.12 1(R) is currently a clearer and more user-friendly regime for deciding which clients can be approved for marketing non-mainstream investments to. Having three overlapping pieces of legislation is unhelpful. We would prefer to see COBS 4.12 1(R) made more extensive, and discerning between different types of non-mainstream funds, and for this to replace the exemptions in the FPO and PCIS Order.

11) **Do you agree that we should require firms to retain a record of the basis on which the promotion of a non-mainstream pooled investment has taken place for each financial promotion?**

Yes, but only in relation to funds which are not adequately regulated by a regime other than UCITS.

12) **Should we require confirmation of compliance with the marketing restriction for each promotion?**

Yes, but only in relation to funds which are not adequately regulated by a regime other than UCITS.

13) **Do you agree that the CF10 individual is the correct person to confirm compliance?**

Yes.

14) **Do you have any comments on the Handbook guidance we propose to add regarding the link between promotion and advice?**

Yes.

15) **Do you agree with our proposed update to the retail investment product definition?**

Yes.

16) **Do you have any comments on the impact of our proposals on existing customers and the distributor firms serving them?**

Only to re-iterate the need for more discernment between different types of funds which fall outside of the UCITS regime.

17) Do you have any comments on our analysis of non-mainstream pooled investments?

Only to re-iterate once again the need for more discernment between different types of non-mainstream funds. There are no examples examined in the paper of funds which have sound regulation outside of UCITS, such as investment vehicles fully listed on major exchanges, and those regulated to a reasonable degree in countries such as Ireland, Luxembourg and Malta. It is notable that the Channel Islands Stock Exchange appears to lie behind many problem funds, such as the recent case of Cape Verde No. 4 Fund for example. This exchange does not, in our view, hold any regulatory credibility.

18) Do you have any further data on the size of the market?

This is not our area of expertise.

19) Do you have any comments on our overall strategy to deal with the risks to retail customers of investing in UCIS?

See the comments made in sections 1-3 above.