

CISI 

CHARTERED INSTITUTE FOR
SECURITIES & INVESTMENT

Investment Operations
Certificate

Collective Investment Schemes Administration

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This learning manual relates to syllabus
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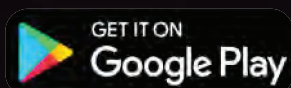


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Collective Investment Schemes (CISs)

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Syllabus Learning Map

It is estimated that this manual will require approximately 80 hours of study time.

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Chapter One

Collective Investment Schemes (CISs)

1. Overview
2. Structural Aspects

This syllabus area will provide approximately 2 of the 50 examination questions



1. Overview

1.1 Overview

1.1.1 Know why collective investment schemes are relevant to investors today: principal types of fund available by fund type, asset class and the Investment Association sectors; typical investment strategies; the role of multi manager funds, property funds and funds of funds

'Buying investments can involve risk. The value of your investments and the income from them can go down as well as up and is not guaranteed at any time. You may not get back the full amount you invested. Information on past performance is not a reliable indicator for future performance.'

These words – or ones very similar – are a common feature of advertisements issued by financial services firms. People generally invest because they want to benefit financially; they want the capital value of their investments to grow, and/or they want their investments to generate income.

But the reality is that investment carries risk. Some risks relate to the structures by which investment happens (eg, contractual risk to a given firm or counterparty), while others relate to the selection of particular assets and the potential that your assets fall in value relative to others. In theory, a skilled professional who has a deeper understanding of the financial markets and investment options should be able to generate growth and/or income at a lower overall risk than a retail investor trying to navigate their own path through the markets.

It can also be expensive for a small investor. To hold shares in a company generally needs the investor to have a custody account with a financial services firm, and buying and selling the shares incurs brokerage charges (and can give rise to tax impacts for the investor). If you happen to pick the next Microsoft or the next Alphabet Inc then the capital growth will cover the costs nicely – but would such an outcome be a matter of luck rather than judgement? How large is the risk that the shares you pick might reduce in value (aside from the costs and charges you pay to buy and hold them)?

A **collective investment scheme (CIS)** is a label used for various types of investment that are intended to help investors achieve the positive outcomes from investment (growth and income) while mitigating the risks (costs and portfolio risk). The benefits of a CIS stem from the 'collective' part; rather than each investor doing their own thing with their own money (being limited to the asset range they can afford, and each paying all the associated costs), a CIS enables many investors to effectively pool their own money so that a pre-agreed investment strategy can be effected over the aggregate amount of money. As 'the scheme' is far larger than any individual investor's money, it can buy a more diversified investment portfolio (reducing the risks of picking a poorly-performing asset which could result in a significant capital loss) and it can trade larger values than the individuals alone (which makes the transactions more efficient as a smaller proportion of the total value is lost on fees and charges).

There is still risk involved – such as:

- the value of the scheme's assets might fall (either in absolute terms, or relative to other investment methods)
- the companies operating the scheme might be more interested in their own profits than in working for the good of the investors, or
- one or more of those companies might make mistakes that harm the individual investors.

While the first risk is ever-present (you cannot have the benefit of market growth without the risk of market loss), the other risks can be mitigated through regulation. The focus of this workbook is, therefore, the authorised CISs that operate in the UK. These types of schemes all have a legal structure supporting them, with specific roles and responsibilities applicable to the different firms that operate them. For a UK-authorised CIS, the most important role is that of the **authorised fund manager (AFM)**, which is authorised by the **Financial Conduct Authority (FCA)** and is responsible for operating the CIS.

1.2 Asset Classes

The main asset classes used for investment are:

- **cash** – often in the form of bank or building society deposits, though it may include certain money-market instruments
- **interest-bearing securities** – debt instruments issued by governments (such as UK gilts) or companies – which pay interest at either a fixed or variable rate

- **property** – investment in commercial or residential property, whether made directly, or through shareholdings in related companies, or investment assets such as real estate investment trusts (REITs), and
- **equities** – shares.

Each regulated CIS will use a combination of these asset types in order to satisfy the fund's investment objective (which is a brief summary statement of what type of investment the fund will make in an attempt to generate growth or income for the unitholders). Some funds will be focused on certain asset types, while others will seek to provide a more balanced exposure across multiple asset types (and might be referred to as 'balanced' or 'multi-asset' funds). Some funds take the principle of asset diversification further by creating an investment portfolio that is made up of units/shares of other CISs (and known as a 'Fund of Funds'). Some AFMs construct a Fund of Funds to invest solely in other funds managed by that AFM, while some Fund of Funds buy units in funds operated by a range of different fund managers (and are sometimes known as 'multi-manager funds').

Each AFM will therefore need to establish the investment strategy that it believes will best deliver the intended type of investment outcome, deciding a balance across a number of variables – such as:

- whether to target assets that are considered likely to generate capital growth through an increased share price, or assets expected to generate income
- the balance between assets that generate income in the form of dividends or interest
- whether the fund will invest in a particular geographical area (eg, country or sub-continent) or take a global view, and
- how much exposure the fund will take to different sectors of the economy (eg, what portion to invest in mining, financial services, technology companies, or pharmaceuticals).

The Investment Association (IA), the industry's trade body, places CISs in more than 50 investment sectors which range from general to growth in overseas markets. The categories are intended to make performance comparisons easier and to aid investor choice. The IA categories can be found at: <https://www.theia.org/industry-data/fund-sectors/definitions>.

2. Structural Aspects

2.1 Legal Structures

1.2.1 Know the constitutional structures of authorised Collective Investment Schemes

As noted above, each authorised CIS will have a legal form. In the UK, there are three legal structures used for authorised CISs:

1. **Authorised unit trust (AUT).**
2. **Open-ended investment company (OEIC)**, sometimes referred to as an **investment company with variable capital (ICVC).**
3. **Authorised contractual scheme (ACS).**

While there are differences between these legal structures (eg, the terminology used, and the type of documentation that establishes the fund), most of the rules and operating principles apply similarly to all three legal structures. We will note in future chapters that the aims of a given scheme can determine the legal structure that is chosen when the AFM decides to launch a CIS.

2.2 Regulatory Categories

1.2.2 Know the four regulatory types of authorised CIS: UCITS; NURS; QIS; LTAF

Aside from the three separate legal structures that a regulated CIS might have, the UK rules differentiate funds into four regulatory categories. These four categories of funds are key to applying the FCA's **Collective Investment Scheme Sourcebook (COLL)** rules (the part of the FCA's Handbook that is dedicated to the operation of a UK-domiciled regulated CIS).

The first regulatory type is an **Undertakings for Collective Investment in Transferable Securities (UCITS)** fund. The name comes from the 'Undertakings for Collective Investment in Transferable Securities' Directive – a piece of EU regulation that established a base standard for retail collective funds within the EU and enabled such funds to be sold cross-border across the different Member States. While the UK has since left the EU, the UK's rules still reflect many of the EU rules that were in force. Indeed, the UCITS standard is recognised outside the EU – including by a number of Far Eastern countries. One of the key aspects of the UCITS standard is the set of requirements and limits on the scheme property that the UCITS fund can hold. We will discuss the specific limits when we look at investment and borrowing powers in chapter 4 in this workbook.

In some EU markets, a UCITS was the only type of CIS that could be authorised for sale to retail investors – but the UK rules already recognised a wide range of funds, some of which would not satisfy the UCITS standard for investment and borrowing powers. The UK regulator allowed these funds to remain active, and created the category of **Non-UCITS Retail Scheme (NURS)**. In many respects, a NURS behaves similarly to a UCITS, though has slightly more flexibility for investment and borrowing powers and the rules allow a NURS to adopt some mechanisms which are not allowed within a UCITS scheme. We will meet these mechanisms as the workbook progresses.

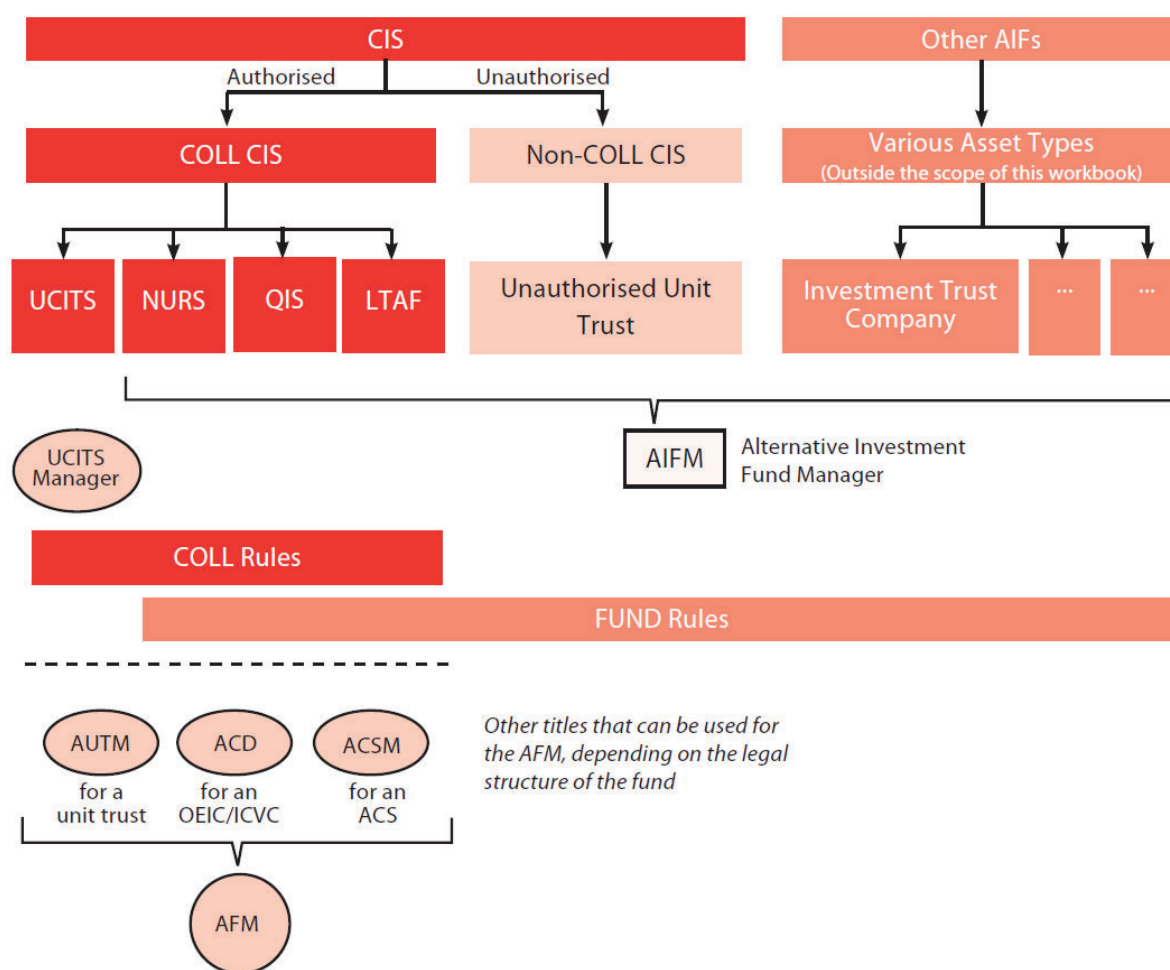
The third regulatory category recognised in the COLL Sourcebook is the **Qualified Investor Scheme (QIS)**. As the name suggests, this is an authorised fund, but is not to be sold to retail investors. The rules for QIS are far less detailed than for UCITS and NURS – which is understandable when many professional/qualified investors would have the option of using unregulated funds instead (such as the unauthorised unit trusts that have been a part of the UK market for many decades).

The fourth regulatory category is the **Long-Term Asset Fund (LTAF)**. The FCA created this category of CIS in the hope that such funds would be able to invest in different forms of asset, such as infrastructure projects that are by their definition less liquid than normal investment assets. As a result, any fund investing in such assets needs to have additional controls over the speed and rate with which investors might want to buy or sell units/shares in the CIS – and the LTAF rules make available to the AFM some mechanisms that are not available to the other retail fund types.

An AFM operating a UCITS, NURS, QIS, or LTAF must, therefore, ensure that they understand the COLL rules that apply for that type of fund.

Aside from the evolution of the UK regime, the EU became concerned that there was a regulatory gap which meant that some types of funds and ‘fund-like’ investment services were not being governed by EU rules, so they created the Alternative Investment Fund Manager’s Directive (AIFMD) to cover these **Alternative Investment Funds (AIFs)**. In the UK, the AIFMD scope therefore includes NURS, QIS and LTAF – even though these are subject to domestic regulation – and so the AFM of such funds may also be referred to as an **Alternative Investment Fund Manager (AIFM)** and must follow additional AIFMD-related rules set out in the FCA’s FUND Sourcebook.

The following diagram summarises the resulting position:



The above diagram shows that UCITS, NURS, QIS, and LTAF may adopt any of the three legal structures. It also notes an extra name that might be used to describe the AFM (according to the legal structure of the CIS):

- **Authorised Unit Trust Manager (AUTM)**, if the CIS is an AUT
- **Authorised Corporate Director (ACD)**, if the CIS is an OEIC
- **Authorised Contractual Scheme Manager (ACSM)**, if the CIS is an authorised contractual scheme.

This workbook focuses on COLL CIS funds: UCITS, NURS, QIS, and LTAF. While the workbook makes occasional reference to non-COLL CISs, and any AFM might also operate a range of AIFs, our focus will be on the operation of COLL funds.

2.3 Other Structural Decisions

1.2.3 Know: the differences between single funds, umbrella schemes and master feeder schemes; the permissible share and unit classes issued by schemes

Having set out the framework of CIS types, we can now look at some features of an individual COLL fund. An AFM can either create independent legal structures for each fund, or can use a legal structure that can contain multiple distinct investment options.

The first of these is known as a 'standalone' fund (or sometimes a 'single' fund); the legal documentation will create a single investment opportunity. As this was the usual approach for unit trust schemes it was common in the UK – though it did mean that creating any new fund meant starting from the beginning, which was not cost effective when an AFM might already have multiple funds in operation. When the OEIC rules were created, it was expected that a single OEIC might operate multiple sub-funds – meaning that the new investment fund could be created within the legal structure already in existence (reducing the costs for the AFM and making the launch of a new fund quicker). It had been possible for unit trusts to have a similar 'umbrella structure' (with sub-funds being added when required), but these were comparatively rare.

The master-feeder structure is different. It might be adopted for a number of reasons (usually relating to operational efficiency and/or as a consequence of tax law), and arises when one fund is dedicated to investing in a separate fund (ie, rather than itself having an independent investment portfolio, one fund will invest entirely in the units/shares of another fund). The former fund is said to 'feed' the latter (its 'master').

Master-feeder structures can be adopted for funds based in different jurisdictions and so present a way for a corporate group (with different fund management companies located in different jurisdictions) to effectively centralise its asset management function and so increase the total portfolio value being managed. Where multiple local funds each had a similar investment objective, one of those funds could be declared the 'master' so that other similar funds would simply invest in that master fund (each being a 'feeder' to that 'master') rather than constructing a separate (though similar) portfolio.

The other structural decision the AFM must make when choosing the structure of its funds is whether to offer multiple share classes. An authorised fund (or each sub-fund of an umbrella scheme) has an investment portfolio which determines the current value of the fund. Each unitholder/shareholder owns a proportionate amount of the fund – but that does not mean that all units/shares must be exactly the same.

Consider first the currency that the investor might pay to the AFM when buying units/shares in the scheme: in most cases, for a UK fund, the units/shares will be priced in sterling (GBP), but if the fund manager plans to sell the units/shares to investors resident in other countries, they might also want to accept payment in euros (EUR) or US dollars (USD). While the AFM could offer to accept a payment of EUR and convert it to an equivalent GBP figure (effectively performing a foreign currency exchange trade outside of the fund), AFMs prefer to create a separate class of fund units/shares which will be priced in the relevant currency. Therefore, a given fund might be available in a GBP class, a USD class, and an EUR class.

Another difference between share classes is how the income generated by the fund will be treated. We will discuss the treatment of income in more detail in chapter 9, but the core choice for the AFM is whether the fund will allocate the income to each unitholder/shareholder as a cash payment (known as **income units/shares**), or whether the fund will retain the income within the fund and use it to try and generate further investment growth (known as **accumulation units/shares**).

A third common difference between share classes is the level of charges that the investor might pay when buying or holding those units/shares. Each fund will apply an **annual management charge (AMC)** against the scheme property (generally accruing the relevant portion each day), and this AMC is intended to cover the costs of running the fund. Some funds also apply an **initial charge** when the investor buys units – though initial charges seem to have become less common since the Retail Distribution Review (RDR) prevented various types of commission payments.

It is generally accepted that servicing an institutional investor is proportionately less expensive than servicing a retail investor, as retail investors are more likely to require administration effort (eg, changes of name and/or address, change of bank account, death) and at the same time invest smaller sums than the institutional investors. As such, most AFMs will offer a share class that has a lower AMC, but set a higher minimum investment level before an investor is allowed to buy that share class. It might also be the case that the AFM will offer a range of share classes – perhaps retaining a share class with a higher AMC rate that can be used for any investors still paying commission to an IFA for financial advice given prior to the RDR. Some AFMs have created share classes with slightly lower AMC rates that can be used by particular investment platforms (which effectively aggregate the investments of many separate retail investors – thus reducing the administration burden on the AFM, who would not have a direct relationship with those investors).

There is no limit to the number of unit/share classes that might therefore be created, and each AFM will often use an alphabetic code to distinguish classes with certain AMC rates (though there is no industry-wide convention for what the letters represent so it is important to read the AFM's literature carefully to avoid misunderstanding).

The result is that a given fund/sub-fund might be available in a range of classes – each granting exposure to the same underlying asset portfolio, but different in terms of the level of charges incurred by the investor, the currency in which the investor can trade, and the way that income will be apportioned. The AFM must however ensure that it does not create unit/share classes that would result in unfair outcomes to certain investors – particularly in the light of the Consumer Duty that is enforceable under FCA rules. The AFM should have understood its target market for the fund/sub-fund and should ensure that the classes it creates are aligned with its view of that target market.

2.4 Guaranteed and Protected Funds

1.2.4 Know the following scheme characteristics: guaranteed; protected

The FCA's focus is to ensure that regulated firms conduct themselves in an appropriate way – which includes preventing an AFM from misleading investors about the financial risks associated with a given product/service. The FCA is therefore cautious about the ways in which words such as 'guaranteed' and 'protected' might be used – particularly within the name of a CIS.

The COLL rules note that the FCA is unlikely to approve a fund that has the word 'guaranteed' in its name – unless there is an enforceable guarantee offered by a party other than the AFM or the **depository**, which will be applicable to all investors and covers the full value they invested.

The term 'capital protected' (or other forms of word denoting a degree of capital security) is subject to similar restrictions, but the protection need not cover the full purchase cost of the units/shares. As a result, the degree of protection being offered must be apparent from the fund name and clearly stated in the fund **prospectus** (a document that sets out detailed information to investors about the operations of the fund). In such cases, the investment objective and investment policy of the fund should also demonstrate the intention to provide a material degree of capital security.

2.5 Physical and Synthetic Structures

1.2.5 Understand the differences between physical and synthetic investment structures

We have explored various structural decisions taken by an AFM when creating a regulated CIS. A further consideration for the AFM – particularly if the fund/sub-fund is intended to achieve a similar investment return to a benchmark index – is whether the fund will purchase a portfolio of underlying assets, chosen to try and replicate that index (and potentially outperform the index), or whether to use derivative contracts to gain a corresponding financial exposure without needing to trade in actual securities.

While in general an investor will expect the AFM to be selecting securities according to the investment objective of the fund, we have already noted that scale economies in the fund management work can be important to the way the AFM establishes a fund. In some cases, it might therefore be preferable to a target market of investors to simply track the performance of a stock market index – and to do so at the lowest possible cost.

In such a case, it may be that the AFM will adopt a 'synthetic structure' for investment behaviour (using financial derivatives such as futures and options contracts to gain a corresponding market exposure without actually buying the assets). While the costs of such an approach may be lower, the fund is exposed to additional risks, as rather than owning actual assets, the scheme property would substantially consist of promises made by other financial firms. These are fine provided the firms concerned remain healthy and solvent – but if these counterparties to derivative contracts were to fail, the fund may lose considerable value. Therefore, investors being offered a regulated CIS that uses a synthetic structure should be made aware of the counterparty risk that accompanies such a fund. The regulatory investment limits applicable to a UCITS scheme would however limit the proportion of the fund that can be invested in derivative instruments.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. In what way does investing via a CIS help the investor achieve diversification?

Answer reference: Section 1.1

2. What main risk areas remain when an investor uses a CIS?

Answer reference: Section 1.1

3. What are the main asset classes used for investment?

Answer reference: Section 1.2

4. What are the three legal types of authorised CIS that exist in the UK?

Answer reference: Section 2.1

5. Explain the four categories of collective investment schemes (CISs) authorised under the COLL Sourcebook.

Answer reference: Section 2.2

6. In what ways is a QIS different from a UCITS or NURS?

Answer reference: Section 2.2

7. Which categories of COLL fund would be regarded as AIFs, and what additional rules would be applicable?

Answer reference: Section 2.2

8. What other title might be used for the AFM according to the legal structure of the CIS?

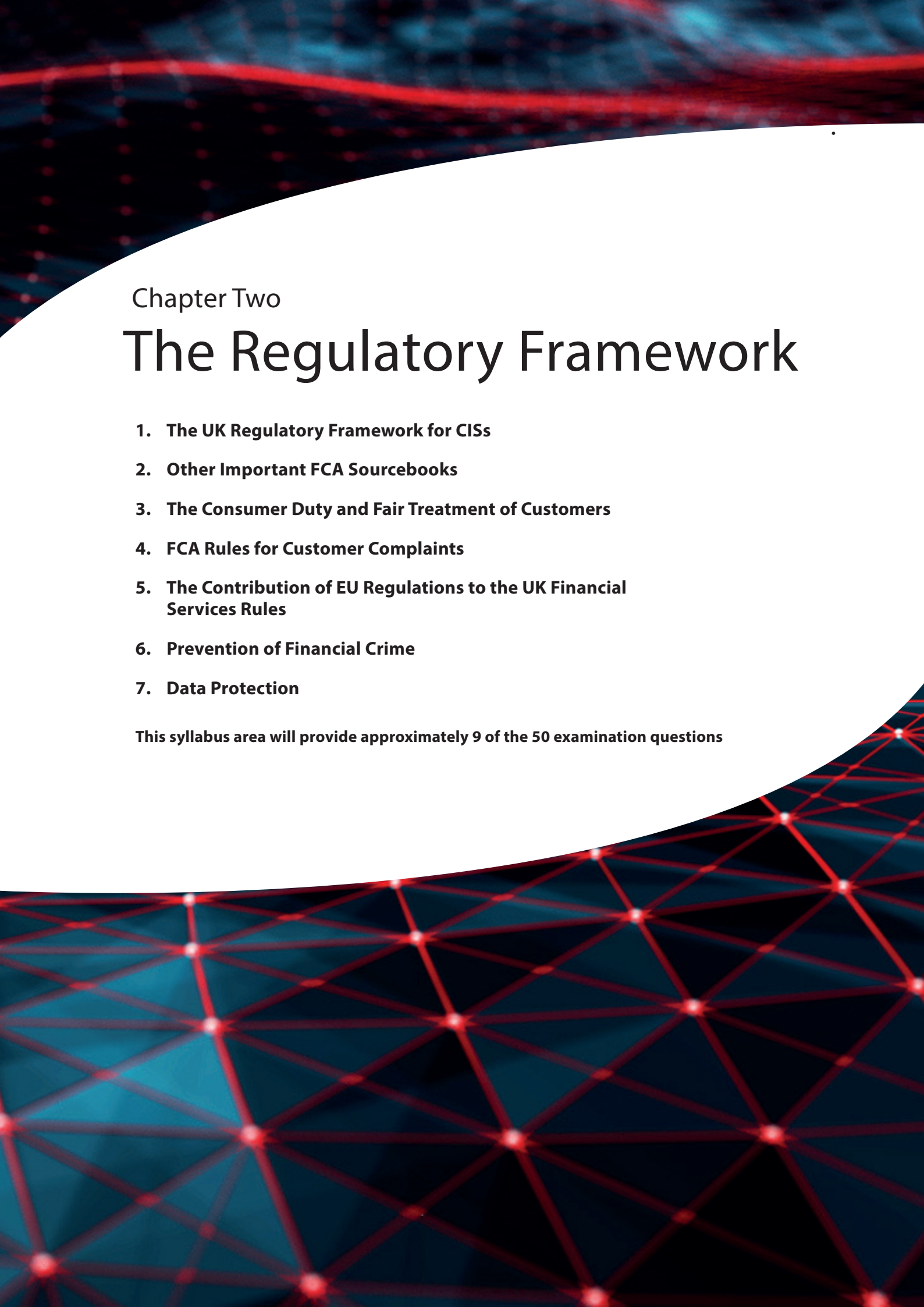
Answer reference: Section 2.2

9. How does a 'standalone' structure differ from an 'umbrella' structure?

Answer reference: Section 2.3

10. What is the difference between a guaranteed fund and a capital protected fund?

Answer reference: Section 2.4

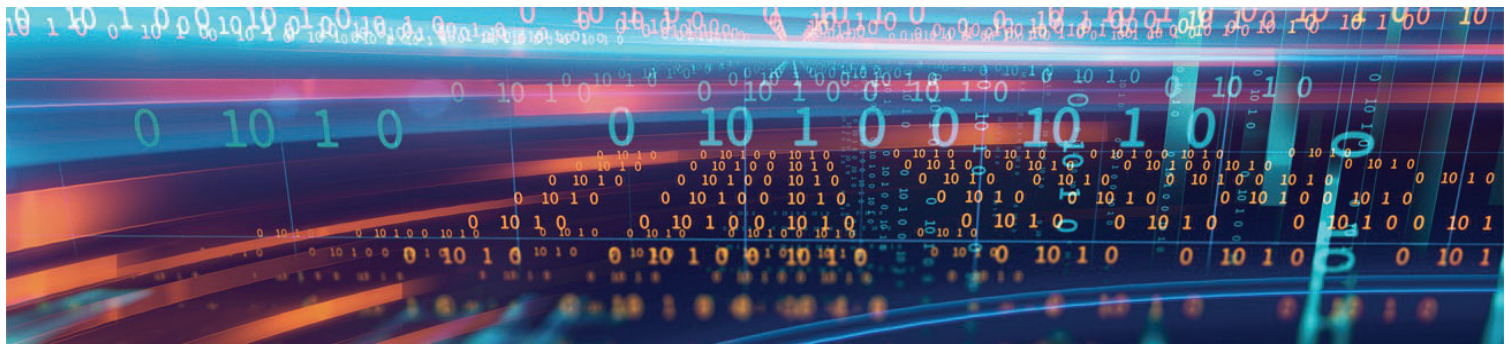


Chapter Two

The Regulatory Framework

1. **The UK Regulatory Framework for CISs**
2. **Other Important FCA Sourcebooks**
3. **The Consumer Duty and Fair Treatment of Customers**
4. **FCA Rules for Customer Complaints**
5. **The Contribution of EU Regulations to the UK Financial Services Rules**
6. **Prevention of Financial Crime**
7. **Data Protection**

This syllabus area will provide approximately 9 of the 50 examination questions



1. The UK Regulatory Framework for CISs

2.1.1 Know the framework of UK regulation and the purpose of the following: The Financial Services and Markets Act 2000; The Collective Investment Schemes Sourcebook (COLL); The Investment Funds Sourcebook (FUND); The OEIC Regulations 2001

1.1 Financial Services and Markets Act (FSMA) and the Financial Conduct Authority (FCA)

The Financial Services and Markets Act 2000 – known as ‘FSMA’ – is the legal foundation for financial services regulation in the UK. It is primary legislation that defines a list of activities/services that a firm might undertake as part of servicing a client and requires that any firm offering those services must first be corporately authorised to perform that activity. Performing a regulated activity without being authorised is a breach of this FSMA ‘general prohibition’ and a criminal offence.

Two regulatory bodies exist to make financial regulations under FSMA and to ensure compliance with the rules: the **Prudential Regulation Authority (PRA)** is primarily concerned with financial stability, ensuring that large institutions (mainly banks and insurers) have sufficient capital resources, while the Financial Conduct Authority (FCA) sets the rules that govern how firms operate – particularly in their interactions with each other and their customers. While some large institutions are therefore subject to regulation by both bodies, most of the UK’s regulated firms are FCA authorised and not authorised by the PRA – and so this workbook will focus on the FCA rules rather than the PRA rules.

The FCA’s objectives are:

- securing an appropriate degree of protection for customers
- promoting efficiency and choice in the financial services markets, and
- protecting and enhancing the integrity of UK financial services.

The FCA is responsible for:

- regulating conduct in retail and wholesale markets
- supervising trading infrastructure that supports markets, and
- prudential regulation of firms not prudentially regulated by the PRA.

The set of regulated activities is laid out in the FSMA ‘Regulated Activities Order’ and includes activities relating to dealing, custody, and giving financial advice – but the list also includes a number of activities that apply to companies that wish to operate a collective investment scheme. Depending on the range of funds an authorised fund manager (AFM) intends to operate, an AFM will seek FCA authorisation for a combination of the following regulated activities:

- managing a UK UCITS
- managing an AIF
- establishing, operating or winding up a collective investment scheme
- establishing, operating or winding up a regulated collective investment scheme
- establishing, operating or winding up an unregulated collective investment scheme, and
- acting as the depositary or sole director of an open-ended investment company.

There are overlaps between these activities, and often the FCA will be satisfied that authorisation for one of the first two bullets is sufficient for an AFM to act in that capacity.

Authorisation requires the firm to comply with the FCA’s rules. The FCA Handbook is structured as a collection of Sourcebooks – each written to address a certain thematic aspect of the regulatory environment (eg, the **Conduct of Business Sourcebook (COBS)** or the Client Assets Sourcebook (CASS)). Each Sourcebook is known by a specific abbreviation (you will encounter several of these in this chapter). Each chapter is numbered, as is each section and paragraph, so any part of the Handbook can be identified by the abbreviation, followed by the chapter, section and paragraph numbers. For example, COBS 7.5.3 is a reference to the COBS, Chapter 7, Section 5, Paragraph 3.

The general purpose of the Handbook is to assist the regulator to meet its regulatory objective of the protection of consumers by providing a regime for the UK financial services sector. One of the shortest Sourcebooks is concerned with the FCA Principles for Businesses – a set of high-level obligations that each firm should satisfy within the detailed workings of their business (eg, acting in the customer's best interests; acting with integrity). Some parts of the Handbook are rules that must be complied with, while other parts offer guidance (an indication of good practice to aid firms in satisfying specific rules). The Handbook indicates Rules by use of a capital letter 'R', while Guidance is identified by a capital letter 'G'. Other letters are used in certain circumstances (such as 'E' to highlight 'Evidential Provisions'), but do not fall within the content of this workbook.

All FCA documentation is available, free of charge, on its website www.fca.org.uk. Before focusing on the rules specific to CISs and their managers, it is useful to consider two areas of FCA regulation that are applicable to most regulated investment firms.

1.2 The FCA Collective Investment Schemes Sourcebook (COLL)

While the AFM must itself be a regulated firm (even if the fund is not authorised), we have seen that Undertakings for Collective Investment in Transferable Securities (UCITS), Non-UCITS Retail Scheme (NURS), Qualified Investor Scheme (QIS), and Long-Term Asset Fund (LTAF) are categories of regulated CIS – and are subject to the rules in COLL. The COLL rules establish the core roles and responsibilities of the parties involved in running a CIS and define various processes and controls that must be applied. The COLL rules therefore cover aspects such as the investment limits applicable to different types of fund, the way a fund is valued, how investors can buy or sell units/shares in the CIS, what action the AFM might take if it becomes necessary to suspend dealing in the units/shares, how income should be allocated, and many other topics that will be discussed in the remaining chapters of this workbook.

Over time, prescription in the COLL Sourcebook has reduced, placing a greater burden on scheme documentation to clearly describe the operation and behaviour of the scheme. For example, the scheme documents should clarify when unit/share deals will be executed, and whether instructions must be received prior to any specific cut-off point. In many areas the COLL rules will note a certain type of control that should be implemented, but it is for the AFM to define the actual control, agree its application with the trustee/depositary, and document the control in the literature available to investors (eg, the prospectus of the CIS).

1.3 The FCA Investment Funds Sourcebook (FUND)

The FUND Sourcebook is relevant to AIFMs operating alternative investment funds (AIFs) – which includes a wide range of funds and other structures, many of which are outside the scope of this workbook. As noted earlier, while NURS and QIS are both types of authorised CIS (and so are subject to COLL rules), they are also types of AIF (and so are also subject to the rules in the FUND Sourcebook). Originally, FUND implemented into the UK regulatory structure those requirements from the EU AIFMD relevant to collective funds. Following the UK's exit from the EU, the FUND Sourcebook rules continue to evolve under the FCA's policy decisions. The FUND rules cover matters such as:

- information that must be provided to investors prior to investment (such as scheme structure and the use of borrowing)
- annual reporting to investors
- risk management
- valuation of scheme property, and
- delegation of operational tasks by the AFM to service providers.

1.4 The OEIC Regulations 2001

The OEIC Regulations are different from the FCA's rules in COLL and FUND, as they are not written by the FCA. The UK CIS industry had operated for many years using only the unit trust structure (either authorised or unauthorised), but this was perceived as more difficult to explain to investors in other countries – particularly investors within other EU Member States, where a corporate form of fund is more common.

The government responded to this need by creating the potential for a collective fund to have a corporate nature rather than a trust-based nature, and so made it possible for a UK company to operate as an open-ended investment company (OEIC).

One problem is that such a company cannot operate in exactly the same way as a normal UK company (the open-ended nature of its share capital being one example), and so the purpose of the OEIC regulations was to effectively replace certain parts of normal UK corporate law in order that an OEIC could behave in the manner required.

When OEICs were first introduced, there were a large number of differences between how an OEIC might operate relative to an AUT, but over the years those imposed distinctions have generally been relaxed. However, it remains important to an AFM operating an OEIC to not only satisfy the COLL rules (and FUND rules, if the OEIC is a NURS or QIS), but to also remain compliant with the OEIC Regulations.

2. Other Important FCA Sourcebooks

2.1 Conduct of Business Sourcebook (COBS)

2.2.1 Know the requirements of the Conduct of Business Sourcebook (COBS) relating to AFMs

The Business Standards block of the Handbook contains all of the detailed Sourcebooks relating to the way in which authorised businesses operate. COBS is part of this block and addresses the way that an authorised firm will satisfy its regulatory obligations – particularly with regard to its actions for its clients.

COBS focuses on regulatory outcomes rather than on the procedures and processes firms should use to achieve these. Some key areas of COBS include:

- classification of clients
- terms of business and client agreements
- communicating with clients, including **financial promotions** (discussed further in chapter 7)
- suitability (in respect of financial advice provided to a client)
- appropriateness (for non-advised services)
- dealing and managing investments on clients' behalf (including best execution)
- preparing product information and providing information to clients
- cancellation
- reporting information to clients, and
- distance communication.

While some of these areas are not likely to be relevant to an Authorised Fund Manager (AFM) (for example, AFMs tend not to give financial advice to investors, so they would not be subject to the 'Suitability' rules of COBS), an AFM must comply with any relevant COBS rules. We will explore some of these COBS requirements as this workbook progresses (particularly when discussing the processes by which an investor buys and sells units/shares of a CIS).

2.2 Client Assets Sourcebook (CASS)

2.2.2 Know the requirements of the Clients' Assets Sourcebook (CASS) relating to AFMs

The key purpose of the CASS rules is to ensure that any client safe custody assets and client money that the firm may hold on behalf of its clients are clearly distinct from any assets that the firm may hold for its own account – and that when a firm says it holds a given asset (or sum of money) for a particular client that it does indeed hold that asset/money. This is important for overall market confidence, as it protects investors against loss if the firm were to become insolvent.

CASS is a complex set of regulations, with CASS 6 setting out the necessary controls for safe custody assets and CASS 7 providing the controls required for client money. In respect of AFMs, it is important to note that where the investor is recorded as the unitholder/shareholder on the main register of the CIS, the AFM does not have a custody responsibility for those units/shares. Therefore, CASS 6 does not apply to the AFM of a CIS in respect of units/shares held on the main register (though CASS 6 could be relevant if the firm undertook a more diverse range of activities – such as holding assets within a nominee company). The following comments will, therefore, focus on CASS 7 rather than CASS 6 (though the same broad requirements arise for both money and assets held by the firm). The aspects most significant for an AFM relate to:

1. **segregation** (ensuring a clear separation between client money and corporate money)
2. **maintaining** clear and accurate records of the amount of money held for each client (allocation), and
3. **reconciliation** (ensuring that the firm does hold the money it thinks it does).

Client money is any money that the firm receives from (or holds for, or on behalf of) a client, if it is in respect of designated investment business and no exemption applies.

Segregation is fundamental. Under the 'normal approach' to segregation, a firm must ensure that any client money it receives is banked directly to a client bank account and protected by a trust acknowledgement letter signed by the bank concerned. This provides legal and physical separation of client money from the firm's corporate money (as client money is technically held under the terms of a statutory trust). The firm should perform due diligence in its selection of the bank or other third-party holding client money on its behalf.

The firm must ensure it has established:

'adequate organisational arrangements to minimise the risk of loss or diminution of client money'.

Such arrangements would include maintaining accurate records of any receipts/payments across client money bank accounts, and recording how much money the firm ought to be holding for each of its clients. There is no limit to the value of client money that a firm can deposit with a single entity unless the third party is part of the firm's corporate group. Where client money is held with an associated company of the firm (known as a relevant group entity), the total amount held by group entities must not at any point exceed 20% of the total client money held by the firm.

The firm must perform a daily internal client money reconciliation, which includes a check to ensure that the client money requirement (the aggregate amount of client money recorded as allocated to its client) matches the client money resource available (the aggregate balance the firm's ledgers say is being held in its client money bank accounts).

External client money reconciliations must be performed at least monthly, though it is common for firms to perform these daily where they trade frequently.

The client money rules are, however, highly technical, and the process of monitoring the firm's activities to ensure that the rules are being complied with can consume a lot of resources. In particular, CASS 7 includes a specific exemption that is only available to AFMs. Each AFM must, therefore, decide whether or not it will apply the delivery versus payment (DvP) exemption (which essentially enables the AFM to receive client money directly into a corporate account, while the 'Normal Approach to Segregation' set out in CASS 7 requires any client money to be received directly into a segregated client money account without first being received into a corporate account). While this DvP exemption can provide liquidity benefits to the firm, it is important that the firm's ledgers and internal records correctly apply the structure being implemented. The AFM should also note that specific written agreement should be obtained from each client before the DvP exemption is applied in respect of that client's money.

CASS 7 contains a list of breaches or failures that, if they arise, must be immediately reported to the FCA. Requiring the firm to formally notify the FCA that such a breach has arisen enables the regulator to become involved prior to any actual business failure taking place.

A firm must notify the FCA if:

- its internal records/accounts are materially out-of-date/inaccurate/invalid to the extent that the firm cannot distinguish client money held for different clients
- it is unable (or materially fails) to identify and resolve discrepancies having completed an external reconciliation
- it is unable to (or materially fails to) complete the daily internal client money reconciliation
- having completed the internal client money reconciliation, it is unable to (or materially fails to) resolve an identified shortfall or withdraw an identified excess
- it is unable to (or materially fails to) perform its external client money reconciliation per the firm's internal policy, or
- it becomes aware that, during the past 12 months, the amount of client money actually segregated was materially different from the amount required to be segregated.

As a company that receives and holds client money, the AFM must retain an external CASS auditor who will review its CASS processes and give an opinion on the state of the firm's compliance with the CASS rules. The CASS audit is performed according to an assurance standard defined by the Financial Reporting Council (FRC), and the completed report is issued by the CASS auditor directly to the FCA.

Note that this CASS audit relates to the accounts of the AFM and is separate from the annual financial audit of the fund's accounts.

These controls and processes are intended to minimise the risk of clients being exposed to loss in the case of a firm's insolvency. However, all firms holding safe custody assets or holding client money balances (including AFMs) are also required to maintain a CASS Resolution Pack, which contains information and material that would help an incoming insolvency practitioner return client money and safe custody assets (together referred to as 'client assets') more quickly if the investment firm was to fail.

The CASS Resolution Pack must include various elements, such as the following:

- Confirmation of all bank accounts and custody accounts holding client assets (including the legal agreements for the operation of those accounts).
- The firm's procedures for the management, recording, and transfer of client assets (so that the insolvency practitioner could instigate a collection and distribution of the assets).
- Information regarding the key systems relevant to CASS matters, including any necessary instructions for operating those systems.
- Internal policy materials relevant to the firm's records and how they should be interpreted.
- Information on how to retrieve copies of the most recent CASS reconciliations performed (so that the insolvency practitioner can assess the value of claim held by each client).
- Details of the key individuals within the firm who are 'critical or important' to the operational functions relating to the firm's CASS 6 and CASS 7 obligations.
- Key contracts with third parties.
- Client agreements (particularly any specific agreements by which the client acknowledges the use of any CASS exemption).

Firms are classified into CASS small firms, CASS medium firms and CASS large firms according to the highest value of client money and safe custody assets held in the prior year. All CASS medium and large firms must provide to the FCA a monthly Client Money and Asset Return (CMAR), which gives an overview of a company's client money and safe custody asset positions and holdings. This enables the regulator to make regulatory interventions in relation to client assets on a timely, firm-specific or thematic basis.

2.3 Senior Management Systems and Controls (SYSC)

2.2.3 Know the key requirements under Senior Management Systems and Controls (SYSC) relating to AFMs

Senior Management Systems and Controls (SYSC) contains rules on a wide range of topics, with the unifying theme being that they relate in some way to the firm's governance arrangements – ie, the way it goes about doing business led by the senior managers with responsibility for the company.

The Senior Managers and Certification Regime (SM&CR) requires that the firm allocate all aspects of the firm's operations to named individuals to ensure accountability is clear if some problem develops.

SYSC includes rules relating to the UCITS Remuneration Code and AIFM Remuneration Code intended to ensure that key members of staff are not earning bonuses and other remuneration in a way that would induce them to take undue risks that could have negative effects on investors.

The company's governance structures must be clearly defined, with sufficient accounting and operational controls in place. Data and information held by the firm must be protected. AFMs should consider establishing formal committees to address key areas of activity, such as an IT committee, a risk management committee, and a client assets committee.

The rules note that where a firm such as an AFM outsources performance of work to another company there should be a formal written contract, and the AFM must perform the necessary oversight to ensure that the outsourced service is being correctly performed.

SYSC also includes a requirement for a firm to maintain orderly records of its business and internal organisation, including all services and transactions undertaken by it. Such records must be sufficient to enable the regulator to monitor the firm's compliance with the requirements under the regulatory system and, in particular, to ascertain that the firm has complied with all obligations with respect to clients. FCA expects an AFM to retain such records for at least five years (though this is regulatory guidance rather than a specific rule).

A firm should take reasonable steps to ensure continuity of its regulated services and meet its regulatory obligations in the event of an unforeseen interruption. Business continuity is closely related to 'disaster recovery' – though different firms may use the two titles in different ways (due to the negative connotations of talking about disasters). More recently the FCA has added material requiring firms to consider operational resilience and understand whether key business services are vulnerable to disturbance.

2.4 Product Intervention and Product Governance Sourcebook (PROD)

2.2.4 Know the key requirements of the Product Intervention and Product Governance Sourcebook (PROD) relating to AFMs

The financial services marketplace includes a wide range of assets, products, and services. The FCA is keen that firms are purposeful in the evolution of their propositions, and so created the PROD Sourcebook to set out particular aspects a firm should consider (and some governance controls that a firm should establish) before launching a new product to clients. An AFM must therefore consider each of its funds as being a 'product' and must ensure that it satisfies the requirements of the PROD rules for each of the funds it operates.

For an AFM, one of the key actions is to establish the target market for each of its funds. PROD expects the firm to be confident that each product is designed to meet the needs of one or more identifiable target markets (rather than a firm creating an innovative product that might make it a nice profit, but that does not actually relate to the needs of any investor population).

Another key foundation is that the AFM should ensure that each fund is only being sold to investors that are within the target market applicable to that fund. In some cases, the fund might be of general use by a broad range of retail investors – but we will see within this workbook that a given fund might have certain features or an investment approach that might reduce the target market for who that fund might be relevant. This might affect the AFM's approach to the marketing of the fund.

However, it is common for CISs to be offered to investors via a range of financial intermediaries – such as financial advisers or investment platforms. An AFM must therefore consider what distribution channels it will enable to pass investment instructions for each of its funds – and receive information from those distribution channels to reassure the AFM that each intermediary is only selling each fund to investors that are within the AFM's stated target market.

The AFM should establish a formal governance process to review any new fund before it is marketed or distributed to clients. This will review the results of the product testing undertaken by the firm, which should identify any scenarios in which the product might be capable of producing a poor outcome for any particular category of clients. Such scenarios should not only explore the internal attributes and behaviours of the product, but also the potential for external factors (such as changes in the macro-economic environment) to affect the outcomes achieved by an investor.

Complying with PROD therefore requires the AFM to be thoughtful about the intended use of each fund it operates, to consider the information it needs to provide to anyone distributing any of its funds, but also to consider the information that the AFM will require from those distributors in order to be satisfied that each fund is only being sold or marketed to the correct target market.

3. The Consumer Duty and Fair Treatment of Customers

2.3.1 Know the FCA expectations relating to the fair treatment of customers: Consumer Duty

3.1 Consumer Outcomes

The FCA has repeatedly sought to increase the focus on the consumer outcomes delivered by financial services firms. All these various efforts have stemmed from FCA Principle 6:

'A firm must pay due regard to the interests of its customers and treat them fairly.'

This need to treat its clients fairly remains central to the FCA's expectations of firms' conduct, ie, that firms put the wellbeing of customers at the heart of how they run their businesses. The FCA identified six consumer outcomes that it expects regulated firms to achieve as part of satisfying Principle 6.

Outcome 1	Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
Outcome 2	Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
Outcome 3	Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale. This rule obliges platform operators to make sure that general marketing literature, platform service contracts and also specific confirmations of executed trades and other investment actions meet this standard.
Outcome 4	Where consumers receive advice, the advice is suitable and takes account of their circumstances.
Outcome 5	Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect. The regulator is looking for evidence that the outcomes are being achieved; firms might consider carrying out regular customer satisfaction surveys.
Outcome 6	Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim, or make a complaint. Firms should bear this outcome in mind when deciding pricing policies and fee levels. The FCA will not look favourably on a policy that has a low basic charge but very high charges for some actions, especially if it makes it difficult for consumers to change platform.

3.2 Consumer Duty

In July 2023, the FCA added a new Consumer Duty in the shape of an additional Principle for Business by firms that service retail clients: *'A firm must act to deliver good outcomes for retail customers.'* This is the first time that a Principle has been added since the FCA was founded, and the wording puts significant additional pressure onto a firm when it considers its approach to its clients and how it can justify the approaches taken in the design and delivery of its services. Where the firm's previous obligations focused on the need for a firm to not take action that would be detrimental to its clients (or a subset of its clients), the language of the new Principle obliges the firm to *'...act to deliver good outcomes...'*

It will no longer be sufficient for a firm to claim that it took no harmful action; it must instead show that it took all reasonable actions to achieve good outcomes for its clients.

The FCA also introduced three 'cross-cutting rules', which apply to the firm's interactions with its retail customers:

- A firm must act in good faith towards retail customers.
- A firm must avoid causing foreseeable harm to retail customers.
- A firm must enable and support retail customers to pursue their financial objectives.

In particular, firms should focus on four areas (referred to as the 'four outcomes'):

1. products and services
2. price and value
3. consumer understanding, and
4. consumer support.

Each firm should have appropriate systems and management information to ensure delivery of these outcomes, and the AFM is required to produce a report on an annual basis for consideration by the Board. Simply designing and offering a CIS that complies with COLL is no longer sufficient for a firm to demonstrate it complies with FCA requirements. FCA paper FG 22/5 provided extensive non-Handbook Guidance on this new duty, including the following bullets noting that the expectations on a firm are to:

- put consumers at the heart of their business and focus on delivering good outcomes for customers
- provide products and services that are designed to meet customers' needs, that they know provide fair value, that help customers achieve their financial objectives and which do not cause them harm
- communicate and engage with customers so that they can make effective, timely and properly informed decisions about financial products and services and can take responsibility for their actions and decisions
- not seek to exploit customers' behavioural biases, lack of knowledge or characteristics of vulnerability
- support their customers in realising the benefits of the products and services they buy and acting in their interests without unreasonable barriers
- continuously learn from their growing focus and awareness of real customer outcomes, and
- ensure that their board or equivalent governing body takes full responsibility for ensuring that the Duty is properly embedded within the firm, and senior managers are accountable for the outcomes their customers are experiencing, in line with their accountability under the SM&CR.

While financial services firms are commercial enterprises and exist to generate profits for their owners and/or shareholders, the challenge presented in the above bullets demonstrates that the FCA wishes to prevent (or at least be able to punish) cases where a firm is able to abuse its position by seeking to benefit itself rather than pursuing the needs of its clients. It might, however, be argued that this new wording effectively enables the FCA to find any firm to be in breach upon the discovery of any poor customer outcome arising from that firm's services. It will therefore be interesting to see what cases the FCA selects as the first enforcement actions it undertakes for breaches of the new consumer duty.

One strand of the work relates to value-for-money. While the FCA has emphasised for many years that it is not a price regulator, the consumer duty requires firms to ensure that their services are offered at a price that represents good value for the consumers using those services. The directors of all regulated firms therefore need to consider some key questions:

- What clients are the firm seeking to serve?
- Are the products and services suited to that target market?
- Do those services represent good value for money?

The 'value assessment' must be performed while the product/service is being designed, and so must be completed before any clients make use of the new product/service. The assessment should be reviewed regularly over the lifetime of the product to ensure that no cause of detriment has arisen in the interim.

Another area highlighted by the FCA in FG 22/5, and of importance to the AFM, is the need to apply the Consumer Duty across the distribution chain – given that a distribution chain might include a fund manager, a platform provider, and a financial adviser. The AFM must ensure it has defined and communicated the target market for which a given fund has been designed.

4. FCA Rules for Customer Complaints

2.4.1 Know: regulatory requirements for handling customer complaints; the role of the Financial Ombudsman Service (FOS)

4.1 Responding to Complaints

At times, a client will contact a firm to express their dissatisfaction at some aspect of the service provided, and allege that they have suffered financial loss, material distress, or material inconvenience. FCA rules require the firm to recognise any such dissatisfaction as a complaint – whether the dissatisfaction was justified or not.

FCA rules in the 'Dispute Resolution: Complaints' (DISP) Sourcebook require that it must be possible for a complaint to be raised by any reasonable means, including telephone and internet channels, in addition to postal complaints. As the complainant must be able to readily raise their complaint, the firm must ensure that any telephone number offered to accept complaint information must not apply premium rate charges.

Having received a complaint, the firm must assess the case in a competent and fair manner – deciding whether the complaint is upheld and whether any remedial action should be taken.

FCA rules provide a simplified process if the firm resolves the complaint within three **business days** of receipt. Within this timeframe, the firm can issue a 'summary resolution communication' to the complainant, explaining the firm's response and noting that the firm accordingly considers the matter closed. The complainant, however, retains the right to escalate their complaint to the **Financial Ombudsman Service (FOS)** if they are not satisfied by the firm's summary resolution communication. The FOS offers an independent review to ensure that firms are acting appropriately when dealing with client complaints, and they have the power to impose redress on the firm if appropriate.

Where the firm cannot provide a resolution within three business days it must apply a more detailed complaints management requirement. FCA rules require that the firm provides an acknowledgement that the complaint has been received and is being reviewed, and must keep the complainant informed of progress over the course of investigation. The firm should issue its final response within eight weeks of the complaint being received (such a response confirming whether the complaint is accepted, and whether any remediation is being offered). If the firm is unable at that time to provide a final response, it must instead provide to the complainant a written response explaining this fact and indicating when a final response is expected.

4.2 The Financial Ombudsman Service (FOS)

Regardless of whether the firm issues a final response or a written response after eight weeks, the complainant must be advised that they can from that point escalate their complaint to the Financial Ombudsman Service (FOS) – an independent body that reviews complaints made against financial services firms. The DISP rules specify how long the firm must retain records of the complaints received and the measures taken to resolve each complaint. Where the complaint relates to a firm's role as AFM of a UCITS scheme the complaint records must be retained for a minimum of five years following receipt of the complaint. In other cases, DISP requires the firm to retain the records for at least three years from the date of receiving the complaint.

The FOS will consider the circumstances of the case, including relevant law and codes of practice, and will determine what outcome would be fair and reasonable (which may include imposing a financial award for the complainant, to be paid by the firm). The FOS may however reject a claim it considers to be frivolous or vexatious, or if it considers that reasonable compensation has already been offered.

If the FOS rules in favour of the customer, it can make an award of up to £445,000 plus interest/costs (for complaints referred after 1 April 2025 about actions taken on or after 1 April 2019). The FOS can recommend that the firm pay a higher figure, but cannot force it to do so. In line with the nature of complaints that it can consider, the award could be for actual financial loss, pain and suffering, distress or inconvenience, or damage to reputation. Any decision reached is binding on the firm, and the customer cannot take legal action in court for additional redress for the same loss against the firm.

For more information, see the FOS website – www.financial-ombudsman.org.uk.

5. The Contribution of EU Regulations to the UK Financial Services Rules

2.5.1 Know the purpose of the following rules: Undertakings for Collective Investment in Transferable Securities Directive (UCITS); Eligible Assets Directive (EAD); Markets in Financial Instruments Directive (MiFID); Capital Requirements Directive (CRD); Distance Marketing Directive (DMD); Market Abuse Regulation (MAR); Alternative Investment Fund Managers' Directive (AIFMD); European Market Infrastructure Regulation (EMIR); The EU Money Market Fund Regulation (MMFR)

5.1 EU Regulations

The UK joined the European Economic Community (EEC) in 1973, and officially left the European Union (EU) in 2020. During the intervening years, many laws established across EU member states became part of the UK's laws. While the UK now has freedom to evolve its laws independently of those defined by the EU, many of the regulations applicable to the UK financial services sector remain aligned with the EU rules as of 2020. The FCA rules therefore continue to use the same terminology as these EU rules that are part of UK law post-Brexit.

EU rules are a mixture of 'directives' and 'regulations', each of which should govern behaviour in all member states:

- **Directive** – once agreed centrally, each member state must implement the requirements of a directive into their respective national laws.
- **Regulation** – once agreed centrally, the terms of an EU regulation directly become legally binding on all EU member states (without their national governments needing to create their own national law).

In this section, we will consider a number of EU Directives and Regulations that continue to shape the FCA's rules, and so are relevant for an AFM to understand:

- UCITS Directive
- Eligible Assets Directive (EAD)
- Markets in Financial Instruments Directive (MiFID)
- Capital Requirements Directive (CRD)
- Distance Marketing Directive (DMD)
- Market Abuse Regulation (MAR)
- Alternative Investment Fund Managers Directive (AIFMD)

- European Market Infrastructure Regulation (EMIR)
- Money Market Fund Regulations (MMFR), and
- Securities Financing Transactions Regulation (SFTR).

5.2 UCITS Directive

The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive established a common set of investment limits for funds, harmonised the role of collective portfolio management, and created a 'passport' so that a UCITS fund launched in one jurisdiction could be sold in another. As with all rules, the material is amended over time, and later updates to the UCITS Directive introduced a management company passport, so that a firm authorised in one jurisdiction was permitted to launch a fund domiciled in another. (A 'passport' means that an entity authorised by the regulator in one member state is allowed to operate in another member state without needing to be authorised again within that second member state. The standardised rules mean that each EU regulator is satisfied by the authorisation given by any other EU regulator).

The UCITS rules are discussed further in chapter 4, with particular reference to investment powers.

5.3 Eligible Assets Directive (EAD)

The UCITS Directive stated that a UCITS fund could invest in 'transferable securities and other liquid financial assets'. The eligible assets directive (EAD) clarifies the ability of a UCITS scheme to use derivative instruments or hedge funds (subject to certain requirements regarding diversification).

The AFM should of course carry out due diligence on any investment they propose to make.

5.4 Markets in Financial Instruments Directive (MiFID)

Whereas UCITS and the later AIFMD enable fund managers to passport their funds and services, MiFID enables other investment firms to passport their activities to other EU member states.

While the scope of MiFID specifically excludes the managers of CISs, other parties involved in transactions involving CISs (such as platform providers or financial advisers) are subject to MiFID.

MiFID firms are subject to detailed requirements governing their organisational arrangements and conduct of business. There are pre- and post-trade transparency requirements (ie, disclosure requirements) for equity markets and more extensive transaction reporting requirements.

The MiFID rules are primarily applicable to 'transferable securities' (ie, shares, bonds, units in CISs, money market instruments, and futures and options contracts). However, more sophisticated investment assets (such as commodity derivatives, credit derivatives and financial contracts for differences) are also subject to MiFID.

Two particular aspects of the MiFID requirements will be of interest to the AFM. Firstly, a MiFID firm selling an asset is usually required to perform an appropriateness test (confirming that the asset is appropriate for the individual client concerned). Some assets can, however, be viewed as non-complex, in which case the appropriateness test is not required. An AFM will, therefore, consider whether any fund it operates would need to be viewed as complex by a MiFID firm. Most UCITS schemes are automatically considered as non-complex, though this is not the case if the UCITS scheme is a 'structured UCITS' (which uses specific algorithms to manage the levels of return paid to investors – a topic which is outside the scope of this workbook). A NURS fund may also be viewed as non-complex if the fund does not contain embedded derivative contracts.

A second aspect of MiFID (introduced by MiFID II) is enhanced transparency over the fees and charges paid by an investor. The obligation requires the MiFID firm to clearly set out for the investor all fees and charges that would be applied at any point as a result of the proposed investment. MiFID firms therefore need to understand and communicate the shape of charges incurred due to trading and owning units/shares in a given CIS. While the AFM itself remains outside the scope of MiFID rules, the AFM will recognise the business importance of supporting those involved in the distribution of their funds to the end-investor.

5.5 Capital Requirements Directive (CRD)

All regulated firms are required to maintain a certain minimum level of capital resources to protect against the firm's insolvency. For banks and MiFID firms, these minimum capital standards are defined by the CRD. While not directly applicable to AFMs of CISs, some awareness is relevant in terms of the overall strength of the financial services market.

The rules seek to provide a strong prudential framework by setting out quantitative and qualitative measures regarding the capital adequacy of both credit institutions and investment firms. The FCA and the PRA collaborated in the implementation of the rules in the UK in relation to the respective firms that they oversee. The capital requirement for a given firm is determined according to factors such as:

- cash flow management and liquidity requirements
- any trading of complex financial products, such as derivatives, and
- the size of potential losses that the firm may experience.

5.6 Distance Marketing Directive (DMD)

The Distance Marketing of Consumer Financial Services Directive (known as the Distance Marketing Directive, or DMD) seeks to ensure that retail customers within the EU receive sufficient information before contracting at a distance for any financial product or service. As the definition of financial service includes effecting payments, the effect of this EU directive is wider than savings and investments.

The DMD relates to a retail customer acting at a distance (via a telephone, post or internet service) to enter into a financial contract, such as investing in a CIS. The product provider must ensure that an investor entering into a 'distance contract' has received the necessary information, such as the [Key Investor Information Document \(KIID\)](#) or [Key Features Document \(KFD\)](#), before entering into a binding contract. For postal investors, this information can be issued immediately after the deal is placed, though the KIID/KFD need not be provided if the firm knows the investor has already received a copy of the current information.

An investor can make an investment by telephone without first receiving the KIID/KFD, but the product provider must ensure that the investor is willing to deal on the basis of limited information. Otherwise, the deal should be refused as it might later be found legally unenforceable, exposing the product provider to financial risk.

While investors receiving advice have cancellation rights, there are no mandatory cancellation rights applying to distance deals in CISs, though a product provider can independently choose to provide cancellation rights.

5.7 Market Abuse Regulation (MAR)

Market expectations of the likely performance of a company (eg, its profitability) impact the perceived value of that company. The Market Abuse Regulation (MAR) prohibits individuals from making improper use of non-public information about a company, or spreading incorrect information about a company (which could impact the price of the company's shares). Such behaviour would enable one party to exploit other participants in the market (such exploitation being termed 'market abuse'). While collective investment schemes (CISs) are not market-listed, such funds are within the scope of MAR.

Any 'inside information' known by an investment firm is likely to fall into two categories:

- Precise non-public information that relates to a particular financial instrument or issuer which, were it to become public, would be expected to affect the price of that instrument.
- Information provided to a firm by its client in respect of order execution (such as an intended transaction sequence) which, were it to become public knowledge, would be expected to affect the price of the instruments concerned.

Insider dealing is another important focus which accompanies inside information. Those in possession of inside information should not be allowed to profit as a result (as this would reduce the overall fairness of the market and undermine trust and participation). People who hold inside information about a given firm (such as the directors of that firm who will frequently own shares in the company) are, therefore, restricted as to when and how they can buy or sell shares in their company. A person in possession of inside information is prohibited from using that information to deal, and this prohibition also prevents the insider from recommending or inducing another person to undertake such trading.

Issuers of securities are, therefore, required to maintain formal lists to record all individuals who are considered insiders at any given time.

5.8 Alternative Investment Fund Managers Directive (AIFMD)

AIFMD was created in the light of the 2008–09 financial crisis to regulate activity that falls outside both the UCITS Directive and MiFID. It therefore has implications for all non-UCITS funds and a range of other financial products. Consequently, AIFMD impacts the managers of NURS, QIS, and LTAF schemes, as well as other investment types outside the scope of this workbook (such as unauthorised unit trusts).

The Directive covers both the management and the administration of such funds, including the marketing of the funds by the manager and the custody of the assets by the depositary/custodian. AIFMD includes requirements for:

- authorisation of the fund manager
- conduct of business and marketing
- capital
- remuneration of the managers
- valuation and safekeeping of investments
- delegation and sub-delegation of certain activities, including delegation to third-country entities
- disclosure to investors, regulators and the market, and
- appointment of a depositary and their strict liability.

5.9 European Market Infrastructure Regulation (EMIR)

In order to address the roots of the financial crisis, the G20 countries committed to address risks related to the derivative markets. In order to make that commitment effective, the European Parliament and the Council have adopted a regulation that requires derivatives contracts to be cleared and reported and sets a framework to enhance the safety of central clearing counterparties (CCPs) and for trade repositories (TRs).

The main obligations under EMIR are:

- central clearing for certain classes of derivatives
- application of risk mitigation techniques for non-centrally cleared derivatives
- reporting to trade repositories for all derivative classes, including exchange-traded derivatives
- application of organisational, conduct of business, and prudential requirements for CCPs, and
- application of requirements for trade repositories, including the duty to make certain data available to the public and relevant authorities.

5.10 Money Market Funds Regulations (MMFR)

Money market funds (MMFs) are a subset of CISs which maintain a highly liquid investment portfolio (largely cash or **near cash**). All such funds traded in EU member states need to comply with the MMF Regulations.

The rules recognise that individual MMFs will adopt different features. For example, some MMFs are structured so that they maintain a constant price and pay any income earned to investors, similar to daily interest on a bank account. The controls required of such 'constant NAV' funds differ from those required of other MMF types.

At present, the FCA has not directly updated the COLL rules to reflect the individual requirements of the Money Market Fund Regulations, and so any AFM operating a CIS that is substantially invested in cash or cash-like assets will need to check both the COLL rules and the specific obligations arising from the MMFR as implemented in UK law. One key obligation is to register the fund with the domestic regulator as a money market fund (which should then be stated in subsequent scheme documentation and marketing materials).

5.11 Securities Financing Transactions Regulation (SFTR)

Within this workbook we primarily consider securities as being assets bought by a fund in order to generate an investment return. However, there are other ways in which a securities portfolio might be used as part of an overall investment management approach.

Securities might be used as collateral for other activity, or the assets might be lent to another entity in exchange for appropriate collateral (an activity known as 'securities lending'). In general, such types of transaction might be thought of as ways to obtain financing, and the EU's Securities Financing Transactions Regulation (SFTR) defines the sorts of controls and market reporting required to reduce the risk of abuse occurring within such transaction types.

Similar to the daily transaction reports that must be submitted for the normal buying and selling of listed assets, SFTR includes a transparency requirement for all SFTs to be reported to an approved Trade Repository. If the manager of a UCITS or AIF undertakes SFTs this must be reported to the unitholders/shareholders as part of the annual or half-yearly reports, noting the cost and return of performing such transactions.

6. Prevention of Financial Crime

2.6.1 Know how collective investment schemes manage regulatory requirements relating to: anti-money laundering; combating the financing of terrorism; bribery

6.1 Introduction

A successful financial services industry will always be a target for criminal activity for a number of reasons. Some people may try to steal the savings of a firm's clients (eg, fraud – perhaps using identity theft as a means to take over the client's account). Others might try to defraud the company, or use the services of the company in order to support terrorist organisations. There may be other individuals eager to disguise the fact that their wealth was gained through criminal activity (using money laundering techniques to make their money look 'clean' to anyone investigating their finances).

In recent years, a number of countries have taken action to try and reduce levels of bribery, particularly in connection with government officials, and so firms need to be aware of the risk that their personnel may inadvertently commit a criminal offence by becoming involved in actions legally classified as bribery.

In this workbook, we will focus upon three specific areas of financial crime where regulatory or legislative obligations apply. While a firm's controls to prevent other sorts of abuses are also important to good corporate governance and reducing financial loss (eg, controls to deter or prevent internal and external fraud), our focus here is the obligations on a firm to protect itself and its employees against regulatory or criminal consequences.

Key laws in this area are the Proceeds of Crime Act 2002 (POCA) and the Criminal Finances Act 2017, and criminal offences might be committed if a firm and its staff do not maintain the correct processes and procedures. Regulated firms will also focus upon the guidance issued by the Joint Money Laundering Steering Group (JMLSG). While not itself mandatory, this guidance has been approved by HM Treasury and, by satisfying the guidance, a regulated firm can be confident that it has satisfied its legal obligations (and the requirements of the FCA) to prevent money laundering.

We will also consider the criminal offences that could arise under the Bribery Act 2010.

6.2 Money Laundering

Money laundering is the process by which criminals attempt to disguise the origin of 'dirty' money (from burglary, drug trafficking, terrorism or other forms of crime) and exchange it for money which looks 'clean' and is used for legitimate purposes. There are three stages:

Placement	The dirty money is transferred into a bank account, making possible a range of transactions within the financial services market.
Layering	The money is passed through a number of transactions so that its origin is difficult to detect. For example, money may be transferred from abroad to an individual in the UK, where it may be used to invest in a CIS or to open an ISA. The investment is then cancelled, or simply redeemed, so that the criminal has now received a legitimate payment from a UK financial services firm.
Integration	With its origin now disguised, the dirty money is used in a bona fide operation, eg, the buying or control of a legitimate company or an investment portfolio.

The AFM of a CIS is, therefore, most at risk of criminals buying and selling units in their funds as part of layering.

Money laundering regulations require firms (including AFMs) to:

- establish and maintain specific internal controls, policies and procedures
- perform relevant customer due diligence (CDD) processes, obtaining satisfactory evidence of the identity of investors. Note that simplified due diligence (SDD) might be applied in lower-risk cases, although enhanced due diligence (EDD) might be required where the firm considers the risk is greater (including some cases required by the JMLSG guidance)
- keep records of customers and transactions to provide an audit trail for at least five years from the date when the relationship with the customer has ended
- report any suspicious transactions recognised, and
- educate and train 'relevant employees' (ie, all employees who might be dealing with customers or their transactions).

A regulated firm will appoint a specific person to act as Money Laundering Reporting Officer (MLRO), who is responsible for overseeing the firm's compliance with the FCA's rules on AML systems and controls.

The firm will therefore consider what types of investor behaviour, or transaction patterns, it considers could indicate an attempt to commit financial crime (including money laundering and potential fraud), and will train its staff to identify such activity. If an individual employee is suspicious, they must report their suspicions to the firm's MLRO or 'Nominated Officer' (the role created in POCA to be responsible for liaising with law enforcement agencies if any suspicious activity is identified and reported).

The internal suspicion will be assessed and, in the absence of satisfactory evidence to resolve the suspicion, the MLRO/Nominated Officer will formally report the matter to the National Crime Agency (NCA). If the NCA considers there are grounds for investigation, the matter is referred to the police or HM Revenue & Customs (HMRC). Reporting such suspicions does not constitute a breach of either client confidentiality or the Data Protection Act (DPA).

An important part of preventing money laundering is knowing the identity of your client, and so 'know your client' (KYC) processes are important when beginning a relationship with a new client. Many firms use an external service to check an applicant's personal data (particularly their name, address and date of birth) against electronic identity records, but alternatively might obtain relevant documentation from the investor (such as a passport or driver's licence, utility bills relating to the person's house, or a bank statement).

Many AFMs use the 'source of funds' concession noted in the JMLSG Guidance. When business is taken to a value of £50,000 or less, and payment is sent by cheque or electronically from an account in the investor's name, drawn on a UK or EU bank account or building society, no further evidence of identity is required. A record should be made of the customer's branch sorting code and account number.

However, in the absence of satisfactory evidence of a client's legal identity, or if any suspicion of money laundering is aroused, the company must freeze the transaction. This includes retaining any redemption proceeds until the matter is resolved. While the COLL rules normally require the AFM to release repurchase proceeds within a fixed number of days after the trade is dealt, COLL also allows the AFM and trustee/depositary to delay such actions if necessary.

Failing to do the right thing can lead to a criminal conviction:

Offence	Punishment (maximum)
Assisting a money launderer	14 years and/or fine
Tipping off (ie, informing the money launderer that he/she is under suspicion/being investigated)	two years and/or fine
Failure to disclose (ie, if an employee fails to report his/her suspicions)	five years and/or fine
Failing to comply with the rules including establishing and maintaining specific money laundering procedures	two years and/or fine

Firms need to, therefore, train their staff in the relevant corporate policies and processes, and raising suspicions to the firm's Nominated Officer is a key defence for an individual suspected of the above offences. The Nominated Officer is, however, at risk of an additional offence if they receive and investigate an internal report but fail to report unresolved suspicions to the authorities.

6.3 Combating Terrorist Financing

There are international concerns about the impact of terrorist organisations, leading to action to curtail the finances available to such groups. Efforts to combat terrorist financing are closely linked to the prevention of money laundering, though the subject has a more international flavour. The inter-governmental Financial Action Task Force (FATF) set out recommendations for individual governments to follow in areas such as money laundering, terrorist financing, and the potential proliferation of weapons of mass destruction.

Identification of a client and source of their wealth is again central, but it is also important for firms to ensure that they are not servicing investors who have been internationally recognised as being linked to terrorist activities or related concerns. Firms will therefore screen their client records against lists of individuals and companies that are subject to financial sanctions imposed by governments and bodies such as the United Nations.

Where a firm's sanction list screening finds that a client might be subject to financial sanctions their Nominated Officer will report this to the authorities.

6.4 Bribery Act 2010

Bribery is offering some form of benefit to another person or organisation in order to gain some corresponding advantage. Any form of trading and contract negotiation has the potential to be influenced by bribery, and so many firms have long-established controls over the giving and receiving of gifts and benefits.

International trade increases the potential exposure to bribery – partly because local customs and processes differ between countries. Suppose a given country has a strict import customs process involving the inspections of goods, but the customs officials advise that by filling in a certain form, and making a particular payment, your goods would be inspected ahead of other items already in the queue. Would such a process constitute bribery, or is it merely a feature of trading in that country? However, it might not be the official who initiates the conversation; a wealthy company might offer payments to a country's trade ministers or customs officials to expedite a particular transaction, effectively abusing a position of financial power.

These are only examples of scenarios in which bribery might occur, but international efforts have focused on the potential involvement of government officials. The OECD established a set of standards to criminalise the bribing of public officials involved in business transactions, and the UK government passed the Bribery Act 2010 to implement controls in this area.

It is important to note that the offences under the Bribery Act 2010 are balanced. While it is an offence for a UK person or company to try to bribe a government official, it is also an offence to receive a bribe. As such, a company involved in international trade needs to recognise whether a given process they are told to engage in would constitute the payment of a bribe to a government official or is rather a valid local tax.

If an employee, agent or subsidiary acting on behalf of a business pays a bribe, the company is liable unless it has adequate procedures in place to prevent this happening. The Ministry of Justice issued guidance on complying with the Act, which notes the following six principles:

- **Proportionality** – the action you take should be proportionate to the risks you face and to the size of your business.
- **Top-level commitment** – those at the top of an organisation are in the best position to ensure that their organisation conducts business without bribery.
- **Risk assessment** – think about the bribery risk you must face.
- **Due diligence** – know exactly who you are dealing with.
- **Communication** – communicate your policies and procedures to staff and others who will perform services for you.
- **Monitoring and review** – monitor the anti-bribery steps you have taken so that they keep pace with the changes in the bribery risks you face when, for example, you enter new markets.

Particular action a business could take to avoid contravening the Act would include the following:

- Businesses should show that rigorous steps have been taken to prevent agents from paying bribes in any form.
- Facilitation payments (ie, monies paid to public officials to speed up processes) must be covered by a reporting system. Where multi-national organisations pool their anti-corruption efforts, they can succeed in persuading local authorities to minimise the likelihood of bribe solicitation.
- Whistleblowing – in large multi-national organisations it is difficult to ensure that no corrupt practices are taking place. Employees should be made aware that it is their duty not just to decline external temptations but to report any concerns to senior management.
- Procedures and systems should be examined to ensure that employees do not merely sign forms saying they are aware of their duties and responsibilities. This should be backed up by training and an audit of procedures at regular intervals to ensure procedures are effective.
- Gifts, hospitality and tendering are all areas where businesses will have to give clear guidelines to those acting on their behalf. In the past, guidelines were usually well defined by public authorities in the UK, while generally businesses rarely spelled out to employees what was acceptable to give or receive. Implementation requires a register and a reporting system.

7. Data Protection

2.7.1 Know how AFMs address their responsibilities in relation to the Data Protection Act 2018

7.1 Principles

Financial services firms hold much personal data about a person. An AFM is likely to hold each client's name, address, date of birth, bank account details, National Insurance number, and contact details (such as an email address), and may increasingly collect 'online identifiers' (such as the person's IP address and location information). As such, the firm must satisfy the requirements of the UK's Data Protection Act 2018 (which remains broadly aligned to the General Data Protection Regulation (GDPR) which was implemented across the EU in 2018). The AFM will be viewed as the 'Data Controller' under the Act, while anyone processing the personal data on its behalf will be viewed as a 'Data Processor'. The person to whom the data relates (eg, the firm's client, but also its business contacts) is known as the 'Data Subject'.

The 2018 Act is based on seven key principles, summarised in the following table.

Number	Principle	Comment
1	Lawfulness, fairness, and transparency	Processing of personal data must be lawful, fair and transparent in relation to individuals.
2	Purpose limitation	The purpose for which personal data is collected must be specified, explicit, and legitimate – and the personal data should not then be used in a manner incompatible with that stated purpose. If the Data Controller wants to use the data for an additional purpose, they must receive fresh consent from the Data Subject.
3	Data minimisation	The personal data collected for that specified purpose must not be excessive to achieve that purpose. The data should be adequate, relevant, and limited to what is necessary for the stated purpose.
4	Accuracy	Personal data must be accurately processed and kept up to date. A firm should establish 'reasonable steps' to ensure that any inaccurate personal data identified in its records will be erased or rectified without delay
5	Storage limitation	This relates to the ability to identify the data subject due to the way in which the personal data is retained. The Data Controller should not retain data in such a form for longer than is necessary to achieve the processing objective.
6	Integrity and confidentiality (security)	The personal data should also be protected against accidental loss, damage, destruction, and unlawful/unauthorised processing.
7	Accountability	The Data Controller is accountable for complying with the other Principles, and for evidencing this to be the case.

An AFM will, therefore, establish processes and procedures to ensure that its activities comply with these principles. Most importantly, the firm needs to understand where and how any items of personal data are stored – a process that is potentially more complex given the increased use of computerised systems and the associated ranges of data stores and back-up services that maintain a commercial IT infrastructure.

The firm (or its corporate group) will appoint a Data Protection Officer (DPO) with overall responsibility for the firm's controls of personal data and for guiding the board of directors on the use of personal data and the actions required if a breach is discovered.

7.2 Penalties

If a UK Data Controller identifies that a breach has occurred – whether due to an internal failing or an external attack on their databases – it must notify the Information Commissioner's Officer (ICO) within 72 hours of the breach being identified. Failing to notify the ICO can result in a fine of up to the greater of £8.7 million or 2% of the Data Controller's global turnover from the previous financial year (note: turnover, not profit).

The same level of penalty can be applied if the Data Controller is considered guilty of various administrative breaches, including those relating to organisational obligations, and to data security.

Any breaches relating to infringements of the Data Subject's individual privacy rights can result in a fine of up to the greater of £17.5 million or 4% of the Data Controller's annual global turnover.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

- 1. In a sentence, describe what the Financial Services and Markets Act 2000 represents in connection with financial services.**

Answer reference: Section 1.1

- 2. What is the main legislation governing OEICs and what was its main purpose?**

Answer reference: Section 1.4

- 3. What is the purpose of a CASS Resolution Pack?**

Answer reference: Section 2.2

- 4. What new 'Principle for Business' was created under the Consumer Duty, and what are the three FCA cross-cutting rules?**

Answer reference: Section 3

- 5. What are the FCA requirements for complaints handling?**

Answer reference: Section 4.1

- 6. For what period do the DISP rules require a firm to retain complaint records?**

Answer reference: Section 4.2

- 7. What EU legislation enables the EU funds industry to operate with passports?**

Answer reference: Section 5.2

- 8. Explain the purpose and principal features of the Distance Marketing Directive.**

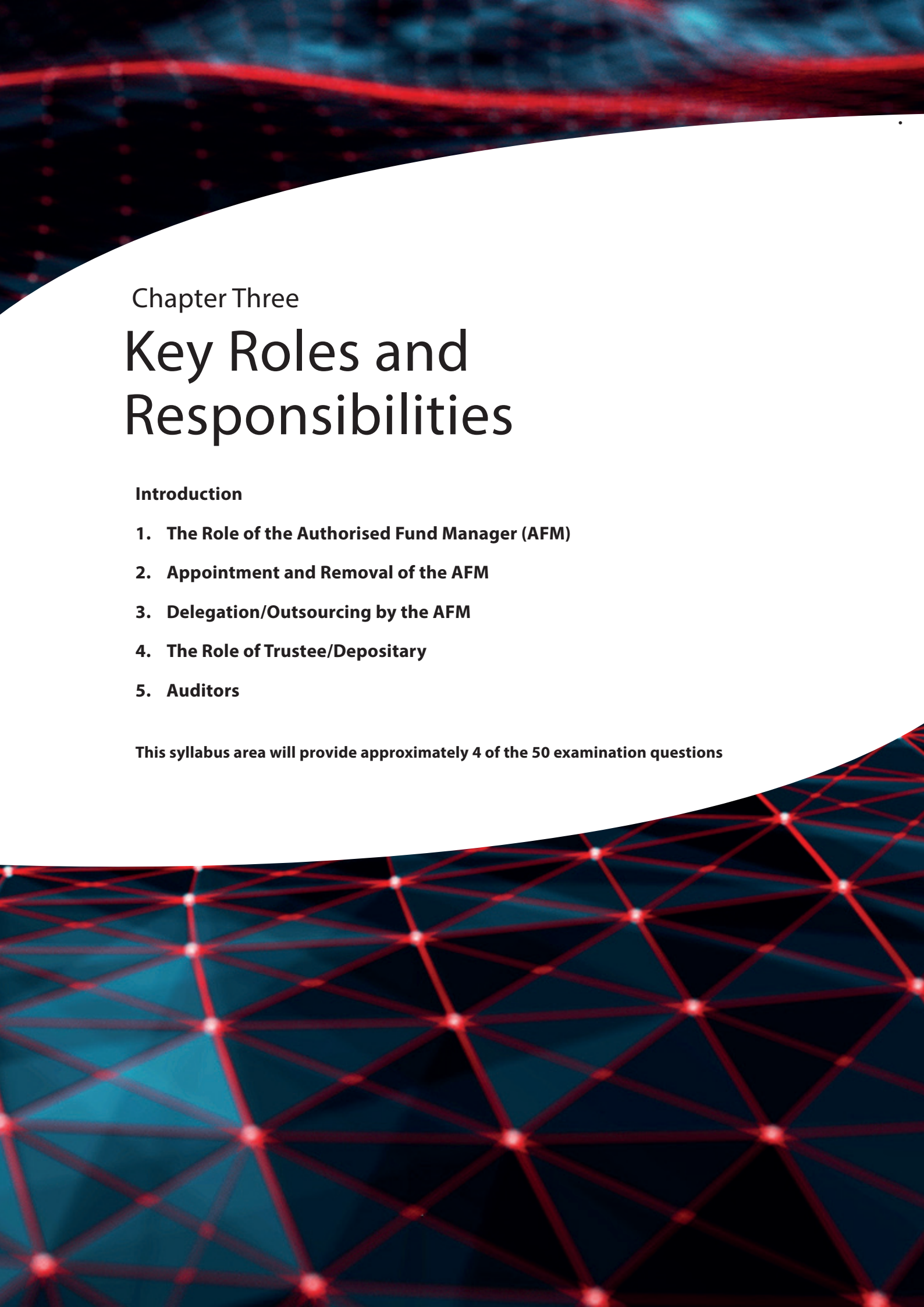
Answer reference: Section 5.6

- 9. What is the reporting procedure if a collective investment scheme operator is suspicious of potential money laundering, and to which body should they report it?**

Answer reference: Section 6.2

- 10. What are the seven principles for data protection under the Data Protection Act 2018.**

Answer reference: Section 7.1



Chapter Three

Key Roles and Responsibilities

Introduction

- 1. The Role of the Authorised Fund Manager (AFM)**
- 2. Appointment and Removal of the AFM**
- 3. Delegation/Outsourcing by the AFM**
- 4. The Role of Trustee/Depository**
- 5. Auditors**

This syllabus area will provide approximately 4 of the 50 examination questions



Introduction

In this chapter, we will consider the key roles that are required for a regulated CIS to operate. We will see the breadth of an AFM's responsibilities, and the following chapters will then focus in more detail on some of the key functions.

Aside from the AFM, we will also consider the role of the trustee/depositary, and the types of auditor oversight that are in place to review the running of a fund.

1. The Role of the Authorised Fund Manager (AFM)

3.1.1 Know the role of the AFM in relation to: legal position; investment decisions; valuation and pricing; issues and cancellations; investor transactions; maintaining register of holders; distribution of income; voting; issuing reports; marketing the fund; regulatory reporting; maintaining other client and scheme records

1.1 Responsibilities of the AFM

We have already noted that the AFM has overall responsibility for a COLL fund and will hold specific authorisation from the FCA in order to fulfil this role. The following table summarises the key responsibilities of an AFM, though there are some items that differ slightly according to the legal structure of the CIS (ie, whether it is an AUT, an OEIC, or an ACS).

Function	Responsibility
Creating the CIS (constitution and obtaining FCA authorisation)	<p>The AFM creates the 'instrument constituting the scheme' (Trust Deed for an AUT, Instrument of Incorporation for an OEIC, and Contractual Scheme Deed for an ACS) and writes the prospectus (which is intended to explain to potential investors how the scheme operates).</p> <p>Such items form part of the materials that the AFM will submit to the FCA when seeking authorisation of the new CIS.</p>
Investment of the scheme property	<p>The AFM is responsible for the way in which the scheme property is invested. This includes ensuring that the investments are in line with the CIS's investment objective and policy, but also that the portfolio of assets held by the CIS does not breach the regulatory investment limits applicable to the CIS (whether UCITS, NURS, QIS, or LTAF).</p> <p>The AFM might appoint a separate regulated company to act as investment manager to the CIS, but in such cases the AFM retains regulatory responsibility under the COLL rules for the actions of that investment manager.</p> <p>Note, however, that the AFM is not responsible for custody of the scheme property; that is a responsibility of the CIS's trustee/depositary.</p>
Valuation and pricing of the CIS	<p>The AFM must calculate the current value of the CIS's assets at the frequency noted in the constitutional documents. Most retail schemes have a daily valuation point (often at noon) and, having worked out the current net asset value (NAV) of the scheme property, the price of each unit/share can then be determined (being a mathematical proportion of the whole).</p> <p>Note that this pricing calculation will need to reflect any differences between the unit/share classes available for that fund.</p> <p>It is common for an AFM to retain the services of a specialist fund administrator to perform the valuation – though the AFM again retains responsibility for such an outsourced service.</p>

Marketing the CIS	<p>For the CIS to be effective, investors need to buy units/shares in the fund, and so the AFM will market the CIS to encourage investors to select this fund rather than a fund operated by a different AFM, or a different type of investment vehicle.</p> <p>FCA rules set out the expectations for the advertisements issued by regulated firms.</p>
Unit/share dealing with investors	<p>When an investor decides to invest using the CIS, they will apply to buy units/shares. The COLL rules show that investors normally buy and sell units with the AFM (which currently differs from the approach taken in many European markets, where the investor would transact with the CIS itself rather than with the AFM, although there are proposals to potentially change this, as noted at the end of this table).</p> <p>The AFM ensures that unit/share deals are performed at the correct price for the correct valuation point so that investors buy/sell the correct number of units/shares and pay/receive the correct settlement proceeds.</p> <p>It is again common for an AFM to retain the services of an outsourced service provider to perform unit/share dealing on their behalf, and the AFM retains regulatory responsibility for such outsourced work.</p>
Maintaining the register of unit/shareholders	<p>The register is the official record of the number of units/shares owned by each investor, effectively recording each person's proportionate ownership of the fund.</p> <p>In this case, responsibility for the register may either rest with the AFM or with the trustee/depositary, and the COLL rules state that the 'instrument incorporating the scheme' should state which of these two parties is responsible for the CIS's register.</p>
Issue/cancellation of units/shares via the trustee	<p>Having bought and sold units/shares with investors at a given valuation point, the AFM needs to check how many units/shares they hold. If the AFM has a negative balance of units/shares (having sold more than it bought), it is required to instruct the trustee/depositary to issue sufficient units/shares to cover that negative balance (and the AFM will pay the relevant cost to the trustee, who puts that value into the scheme property – thus increasing the size of the CIS). If the AFM has a positive balance of units/shares, it can choose whether to hold those units/shares into the next dealing day, or instruct the trustee/depositary to cancel some or all of those units/shares (in which case the trustee/depositary will pay the appropriate value to the AFM, and the value of the scheme property reduces).</p>
Distribution of income	<p>The asset portfolio will normally generate income, aside from the capital growth in the value of the portfolio.</p> <p>The AFM must decide the approach by which this income will be paid to the unit/shareholders. As mentioned earlier, this might involve the CIS issuing income units/shares (which will periodically pay the net income/expense to investors in proportion to the units/shares held) and/or issuing accumulation units/shares (for which the net income/expense is retained in the fund and periodically moved into the capital account of the fund).</p> <p>Note, however, that the distribution payments are generally made by the trustee (for a trust) or the CIS itself (where it has a corporate structure), and so the AFM does not receive or pay the income to the investors.</p>
Issuing reports and accounts of the CIS	<p>The AFM is required to produce a set of reports and accounts showing in detail how the performance of the CIS has been achieved. These adopt a standardised layout known as the Statement of Recommended Practice (SORP).</p>
Enabling unit/shareholders to exercise rights in respect of the CIS	<p>On occasion the AFM may want to change something about the structure or activities of the CIS. Such changes may require advance notice to investors, and on some occasions may require investors to agree to the change. The AFM is responsible for ensuring that all such communication and voting take place correctly.</p>
Regulatory reporting	<p>As AFM the firm is required to provide various types of report/communication to its clients (the unit/shareholders), and to provide information to the FCA about its regulated activity. Some reports must be submitted to tax authorities.</p>
Record-keeping	<p>The AFM must retain sufficient documentation and records to demonstrate that it has satisfied its regulatory obligations. The old compliance maxim remains: that a piece of work must be 'not just done – but seen to be done'.</p>

It should be noted that while the Authorised Corporate Director of an OEIC will be regarded as the AFM for COLL regulatory purposes, the OEIC might have other Directors alongside the ACD.

Note: at the time of writing this edition (July 2025), the FCA has begun a consultation process to introduce additional COLL rules by which investors would trade directly with the CIS rather than buying/selling units from/to the AFM.

For a fund that adopts this approach (referred to as a 'Direct Dealing Scheme'), the AFM would not perform unit dealing and issues/cancellations in the manner described above. However, as the 'Direct Dealing Scheme' rules remain under consultation, this workbook will continue to focus on the approach required by the existing COLL rules.

2. Appointment and Removal of the AFM

3.2.1 Know the process for: appointment of the AFM; removal of the AFM

2.1 Qualification to act as AFM

Any company seeking to be the AFM of a COLL fund must satisfy a number of requirements:

- It must be a corporate body, incorporated in the UK and have a place of business in the UK.
- It must be authorised by the FCA for the relevant regulated activity (according to the particular types of CIS it operates).

The requirement for FCA authorisation ensures that the AFM is subject to the FCA Handbook. This requires the AFM to act in compliance with COLL but also requires it to satisfy various rules applicable to each regulated firm (such as a minimum level of regulatory capital, paying the annual FCA fees and levies, and ensuring that its Senior Managers are fit and capable to run such a company).

We have just noted that the AFM must be in place for a CIS to be authorised by the FCA (as the AFM must compile and submit the relevant documentation), but it is possible for the existing AFM of a fund to be replaced by a different AFM.

2.2 Removal of an AFM

There may be circumstances in which the AFM no longer wishes to act in that role for certain funds, and such scenarios will normally reflect the firm's plans as a business. For example, the AFM may conclude that it no longer has the expertise required to operate a successful fund investing in a particular geographical area, but rather than simply closing the relevant funds it might prefer to retire as AFM of those funds. This enables the fund to continue in operation, but a replacement AFM must have been identified in order that the current AFM can retire.

Aside from voluntary retirement of an AFM, there are scenarios in which the trustee/depositary might be required to remove the current AFM, and until a replacement AFM has been identified and appointed then the trustee/depositary will temporarily assume the duties of AFM.

The specific details differ between the legal forms of CIS. In the case of an AUT or ACS, the trustee/ depositary might require the resignation of the AFM (AUTM/ACSM) in the following scenarios:

- if the AFM company is to be wound-up or dissolved
- if the AFM company is at risk of becoming insolvent (eg, if a receiver is appointed, or the AFM proposes forming a debt arrangement with one or more of its corporate creditors)
- if a unitholders' meeting is considering winding-up the AUT
- if unitholders pass a resolution to remove the AFM
- if the unitholders representing 75% of the units in the CIS request in writing to the trustee that the AFM should be removed, or
- where the trustee/depositary forms a reasonable opinion that it is in the interests of unitholders to remove the AFM.

For an OEIC, the list is shorter. The AFM (ACD) might be removed from office in the following circumstances:

- if the ACD ceases to be a director of the OEIC
- if the board of the OEIC approves a resolution to terminate the ACD's appointment
- if the ACD company is to be wound-up or dissolved, or
- if the ACD company is at risk of becoming insolvent (eg, if a receiver is appointed, or the AFM proposes forming a debt arrangement with one or more of its corporate creditors).

The OEIC Regulations enable the shareholders owning 5% of the OEIC to require a company meeting to discuss the removal of any director (though this level increases to 10% if such a meeting has already been held during the preceding 12 months).

Any change to the AFM responsible for a CIS must be immediately reported to the FCA. (Note also that, as the name of the CIS will generally include the name of the AFM, it would usually be necessary to change the fund name when the AFM retires or is removed).

3. Delegation/Outsourcing by the AFM

3.3.1 Know: the benefits and risks of outsourcing; scope for delegation; services provided by outsource service providers

3.1 Outsourcing

As noted in the table earlier in this chapter, the AFM may retain the services of third parties to perform duties for which the AFM is responsible. For example, investment management, pricing of the units/shares, their issue and redemption, fund accounting and registration/investor record-keeping are all obligations of the AFM which it might delegate to a third party.

Such cases are referred to as 'outsourcing', and the FCA is clear that while a firm can outsource the performance of actions relating to its regulatory obligations, the firm retains full regulatory responsibility for any errors made by the third party.

Functions are delegated for various business reasons, but the decision to outsource an activity would require consideration of factors such as:

- expertise requirements for specific functions
- technology costs (small firms can avoid having to invest in expensive systems by outsourcing to specialist firms with economies of scale)
- staff costs (for example, a firm in London could outsource administrative tasks to a less expensive geographical location), and
- premises costs (particularly as a firm grows and might otherwise require additional premises).

We can see that the key benefit a firm will wish to secure through the use of outsourcing is an increased profit through a reduction in its business costs, and this should be readily achieved provided the firm pays the outsourced service provider less than it would have spent in fulfilling the obligations using its own people, premises, and systems.

However, the firm faces the risk that as it is not directly managing the staff performing the work, it will have less visibility of the people and processes, and there is a risk that the quality of the work might reduce without the firm being aware. The firm will therefore implement oversight mechanisms to review the work being done on its behalf and ensure that any problems are identified, understood and resolved.

The firm will also need to negotiate a formal contract with the service provider, to ensure that the delivery obligations and standard of service are recorded. While such agreements are regulatory requirements, and will place financial liabilities onto the service provider if it fails to deliver the relevant service to the agreed standard, the firm must recognise the costs of setting-up and maintaining an outsourcing relationship as part of its decision to outsource.

While the term 'transfer agent' is used in various overseas financial markets to reflect a direct regulatory licence or role, the term does not have any regulatory meaning in the UK as there is no specific category of permitted business for performing such work. Therefore, in the UK, the AFM would be outsourcing the performance of investor dealing and administration tasks for which the AFM remains responsible; the AFM is not 'appointing' a specific transfer agent which would assume direct regulatory responsibility for such work.

SYSC 8 includes FCA requirements when a firm outsources activity. The following are key requirements for an AFM when outsourcing of critical or important operational functions:

- It must take reasonable steps to avoid undue additional operational risks and, indeed, ensure there is operational resiliency.
- The outsourcing must not impair materially (i) the quality of its internal control and (ii) the ability of the FCA to monitor compliance with regulations.
- The outsourcing must not result in the delegation by senior personnel of their regulatory responsibility.
- It must exercise due skill and care and diligence when entering into, managing or terminating any outsource arrangement.
- It must ensure the service provider has the ability, capacity and authorisations necessary to perform the outsourced functions.
- It must establish methods for assessing the performance of the provider, managing the risks of outsourcing, and retaining the necessary expertise to supervise the outsourced functions effectively.
- It must be able to terminate the arrangement, and both the firm and the provider must have a contingency plan for disaster recovery.

Therefore, the outsourcing contract will include a 'service level agreement' clarifying the obligations of the service provider (and any dependencies it has on actions/decisions of the AFM), as well as clauses confirming the extent of the service provider's liability for errors.

4. The Role of Trustee/Depositary

3.4.1 Know the role and responsibilities of the depositary and/or trustee

4.1 The Role of Trustee/Depositary

While the AFM role is important and is subject to a range of FCA rules, the regime includes a separate party which is responsible for holding the scheme property and overseeing the actions of the AFM (such as ensuring that the AFM is running the fund in accordance with the COLL rules and the stated investment objective). COLL rules refer to this party as the 'depositary' (which is defined by the FCA to include the term 'trustee' in respect of AUTs).

The depositary acts in the interest of the unitholders/shareholders of the CIS, and its oversight remit includes any functions outsourced by the AFM. (It should be noted that the work of the depositary itself is not an example of delegation or outsourcing by the AFM; the depositary is not working for the AFM but is instead appointed to fulfil its own regulated role in respect of the fund). The depositary fee is generally paid by the CIS.

Any depositary of a UK-authorised CIS must be a UK company with FCA authorisation to act as depositary (being a specific regulated activity). However, it is also important that the depositary be independent of the AFM and the fund (and so a given depositary cannot act in that role for COLL funds from within its own corporate group).

FCA rules impose a minimum regulatory capital figure of £4 million on any firm that wishes to be depositary of a COLL fund, and we have seen that it may be necessary for the depositary to temporarily assume the responsibilities of the AFM if the fund's AFM is removed from office.

4.2 The Work of the Depositary

On appointment, the depositary will examine the AFM's control systems and other procedures, including record-keeping. At least annually the depositary will review the AFM's valuation procedures, also reviewing the controls whenever major changes are made to existing procedures. These reviews may include visits to the AFM's offices (or the offices of outsourced service providers), telephone and video meetings, and preparation of written reports detailing any findings that require a formal response from the AFM.

The depositary must monitor the fund's cash movements and is responsible for safe custody of the fund's assets. While the depositary will generally use the services of a regulated custodian to hold the assets, it will maintain separate accounts for each CIS, so that in each case the assets are held in the depositary's name on behalf of the specific scheme. The depositary remains liable to the scheme for any loss or damage to the assets in its care.

Each year, the depositary must prepare a report to unit/shareholders confirming its opinion on whether the AFM has managed the scheme in accordance with COLL, and this report is included in the annual report and accounts.

In general, the depositary can delegate tasks to a third party – subject to the outsourcing rules in SYSC 8 – and a depositary would in general retain regulatory responsibility for any critical or important functions it outsources. However, the specific rules differ slightly according to whether the outsourcing relates to a UCITS or an AIF.

For a UCITS fund, the depositary cannot delegate its oversight or cash monitoring obligations. The depositary may use a third party to hold fund assets provided it uses due skill, care and diligence in the selection of that third party and performs ongoing monitoring of the custodian. Such a review should ensure that the custodian is subject to prudential regulation in the jurisdiction concerned, and that the assets of the depositary are clearly segregated from other assets held by the custodian.

For a NURS managed by a small AIFM (ie, an AIFM that in total manages less than €500 million of unleveraged assets, or less than €100 million of assets where the portfolios are leveraged) the depositary is able to delegate functions to third parties. While the depositary retains regulatory responsibility if delegating to the AIFM or its associates, delegating to other parties can enable the depositary to avoid COLL liability for that person's actions provided reasonable care was taken in the delegation and the party concerned was competent to perform the service for the depositary.

Responsibility for fund registers (and any sub-registers that may exist) is more complicated. While the UCITS Directive shows maintenance of the unit/share register to be the manager's role, the COLL rules allow responsibility for registers to be a function of either the AFM or the depositary (as stated in the scheme documentation). Therefore, the depositary will either have direct responsibility for the registers or will perform oversight of the AFM's work in maintaining the registers.

In parallel to its oversight work, the depositary provides a monthly report to the FCA summarising all breaches of FUND or COLL that came to its attention during the previous month. It will also inform the FCA of any significant circumstances or events – including significant errors in the valuation and pricing of the fund. We will discuss the fund valuation process in detail in chapter 5, but the two categories of pricing breach that the depositary must immediately report to the FCA are:

- Any pricing error the depositary considers to be ‘material’. An error is normally viewed as being material if it exceeds 0.5% of the price, though the depositary could determine other cases to be material according to the circumstances.
- Cases where the error exceeds 0.5% of the price and the depositary has determined that the AFM need not reimburse the affected unitholders/shareholders (ie, such a case would be reportable even if the depositary had concluded that it was not ‘material’).

4.3 Additional Rights for the Depositary of an OEIC

Schedule 1 to the OEIC Regulations 2001 gives the depositary the rights to:

- require from the company’s officers such information and explanations as it thinks necessary for the performance of its functions as depositary, eg, to ensure investment limits are complied with
- have access to all books, reports, statements etc, which are to be considered at any meeting of directors or shareholders in so far as they concern them as depositary
- receive the same notices as shareholders in relation to OEIC’s general meetings
- attend and be heard at any general meeting of the OEIC which concerns it as depositary, and
- convene a general meeting of the OEIC when it sees fit.

While the above apply to depositaries under the regulations as stated, similar rights attach to trustees of AUTs.

5. Auditors

3.5.1 Know the: role and responsibilities of auditors; timescale for completing an audit; obligations for reporting to the FCA; obligations for reporting to shareholders/unitholders; difference between the audit and the AFM’s obligation for compliance monitoring

5.1 The CIS Auditor

The accounts of each authorised CIS must be audited at least annually in order that the annual report and accounts published for the fund will contain the audited accounts (while any interim report and accounts published will usually reflect unaudited figures). As the annual report and accounts must be published within four months following the end of the accounting period, it follows that the audit must be successfully completed within that period. The auditor and AFM may agree an approach where some testing is performed over the course of the year to reduce the volume of year-end work.

Each authorised CIS must therefore have an auditor who is qualified as eligible to audit the accounts of companies governed by the Companies Acts. The auditor must be independent of the fund (so the role cannot be performed by an officer or employee of the CIS being audited). While the AFM’s compliance monitoring activity should ensure that processes and controls are functioning correctly, the auditor here is performing a financial audit of the books and records of the scheme (including the application of accounting policies). There is no connection between this fund audit and the separate audit that will be performed on the AFM company’s accounts.

In respect of an OEIC, the ACD will appoint/re-appoint the auditor each year (or remove the auditor if felt necessary) and agree the audit fees. For an AUT these actions also require the approval of the trustee. Where the role is left vacant the FCA can appoint a fund auditor.

While familiarity with a CIS’s processes is important to achieving a successful audit, there has been occasional unease that the relationship between a company and its auditor can become too close. EU rules introduced in 2016 impose an obligation on ‘public interest entities’ to re-tender the audit appointment every ten years, and rotate their auditor after 20 years. A public interest entity includes credit institutions and all entities with transferable securities listed on any regulated market in the EU. The Financial Reporting Council (FRC) has issued best practice material to support successful tender processes.

5.2 The Rights of the CIS Auditor

The auditor’s rights are specifically provided for under the OEIC Regulations 2001 and include the following:

- access at all times to the company’s books and accounts, while requiring from the company’s officers such information and explanations as they think necessary for the performance of their duties
- to receive all notices of general meetings of the company as shareholders are entitled to
- to attend any general meetings of the company and be heard at such meetings on any part of the business of the meetings which concerns them as auditors, and
- remuneration to be fixed by the ACD.

5.3 Report of the CIS Auditor

The AFM must ensure that the report of the auditor to the unit/shareholders includes a statement on:

- whether, in the auditor's opinion, the accounts have been properly prepared in accordance with the IA [Statement of Recommended Practice \(SORP\)](#) (see chapter 8), the rules in the COLL Sourcebook, and the instrument constituting the scheme
- whether, in the auditor's opinion, the accounts give a true and fair view of the net income and the net gains or losses of the scheme property of the authorised fund (or, as the case may be, the scheme property attributable to the sub-fund) for the annual accounting period in question and the financial position of the authorised fund or sub-fund as at the end of that period
- whether the auditor is of the opinion that proper accounting records for the authorised fund (or, as the case may be, sub-fund) have been kept, or whether the accounts are in agreement with those records
- whether the auditor has been given all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of their audit, and
- whether the auditor is of the opinion that the information given in the report of the directors or in the report of the authorised fund manager for that period is consistent with the accounts.

Therefore, the focus of the auditor's work is the accuracy of the financial accounting practices of the fund – particularly in respect of the annual accounting reference date. This contrasts with the wider scope of the compliance monitoring activity performed by the AFM, which is the ongoing effort to review the accuracy of processing in general, the adherence to procedures, and the correct performance of control functions over the course of the year.

We will see in chapter 7 that the annual report to shareholders (which contains the CIS Auditor's report) must be provided to the FCA, and must be offered free of charge to any member of the public.

5.4 The AFM's CASS Auditor

Separate from the financial audit, the FCA requires an annual audit to confirm that each regulated firm has complied with the Client Assets (CASS) Sourcebook. Each AFM will, therefore, ensure that a CASS audit is performed on its affairs.

This report is made in accordance with FCA rules, and the auditor will comply with the FRC standards for performing client asset audits. The report is addressed to the FCA and signed by the auditor. The audit firm chosen by the AFM to perform this CASS audit, might be different from the firm performing the financial audit of the firm.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. List the main duties of an authorised fund manager (AFM).

Answer reference: Section 1.1

2. What requirements must be satisfied for a company to be appointed AFM of a regulated CIS?

Answer reference: Section 2.1

3. Why might the depositary of an OEIC remove the ACD from its position?

Answer reference: Section 2.2

4. For what reasons may an AFM delegate duties to third parties?

Answer reference: Section 3.1

5. What are the two main responsibilities of the trustee of an AUT or the depositary of an OEIC?

Answer reference: Section 4.1

6. What types of pricing error must the trustee/depositary immediately report to the FCA?

Answer reference: Section 4.2

7. What additional rights does the depositary of an OEIC have under the OEIC Regulations?

Answer reference: Section 4.3

8. What specific rights do the OEIC Regulations give to the auditor of an OEIC?

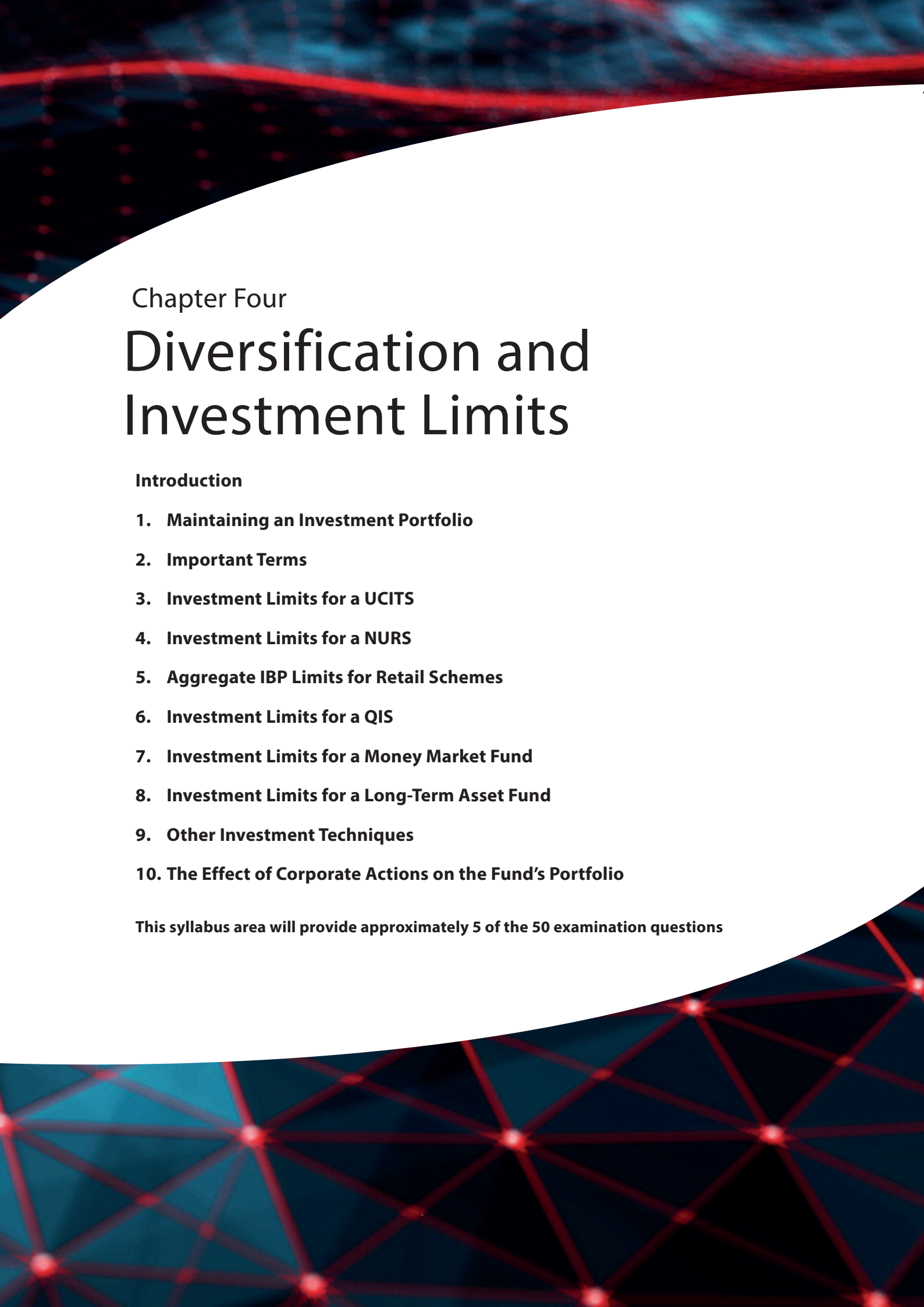
Answer reference: Section 5.2

9. Describe the contents of the auditor's report to unit/shareholders.

Answer reference: Section 5.3

10. Who defines the standard for the CASS audit performed on AFMs, and to who is the report submitted?

Answer reference: Section 5.4



Chapter Four

Diversification and Investment Limits

Introduction

1. **Maintaining an Investment Portfolio**
2. **Important Terms**
3. **Investment Limits for a UCITS**
4. **Investment Limits for a NURS**
5. **Aggregate IBP Limits for Retail Schemes**
6. **Investment Limits for a QIS**
7. **Investment Limits for a Money Market Fund**
8. **Investment Limits for a Long-Term Asset Fund**
9. **Other Investment Techniques**
10. **The Effect of Corporate Actions on the Fund's Portfolio**

This syllabus area will provide approximately 5 of the 50 examination questions



Introduction

In chapter 1, we considered asset classes and noted that an advantage of investing using a CIS is that a professional investment manager will make decisions about the asset portfolio. In this chapter we will consider how the diversification of investments affect the associated risks and will learn about the regulatory investment limits applicable to different COLL funds.

1. Maintaining an Investment Portfolio

4.1.1 Understand: the requirement for a prudent spread of risk; the principles of investment and diversification; managing liquidity

1.1 Investment Risk

Risk can be a provocative subject. Some people are more risk-averse than others – whether due to actual experiences or simply a desire to avoid negative outcomes where possible. However, when we consider investment risk we must recognise that the elimination of investment risk means that no positive growth can arise. The fact that someone wishes to invest indicates that they want the opportunity to benefit from the up-side of stock markets – but that inevitably brings the potential for loss. The question for most people is how aggressively they wish to pursue capital growth, and whether they are willing to accept the downside risks that accompany the search for capital gains.

In most cases, this investment risk relates to the fluctuating values of a listed asset (ie, if you sell at a higher price than you bought, you make a profit), but there are also risks related to the stability of the issuer. If a company collapses, its shares will often become worthless and so the shareholders lose the value that their shares had previously represented.

Of greater risk (and of course, a corresponding greater potential for gain) are financial contracts such as 'financial futures' and 'contracts for differences' that relate to the movements of asset prices. Such contracts – often referred to as 'derivatives' – enable the investor to effectively 'bet' on the market movement. However, it should be noted that retail investors would not usually use such contracts; they are more common for professional investors.

1.2 Prudent Spread of Risk

The aim of most CISs is to enable market gains to be generated while mitigating the potential for loss (though this risk can never be fully avoided), and the rules for UCITS, NURS, and LTAF schemes in particular require the AFM to apply a prudent spread of risk.

In simple terms, this means 'don't put all your eggs in one basket'. If you only use one asset, your returns will simply reflect the performance of that one asset; if its price increases you will gain, but if the issuer of that asset becomes insolvent you might lose the full value invested. If you instead construct a portfolio that includes different asset types and different economic sectors then the effect of any one asset becoming worthless does not have such a significant impact on the investor, yet the portfolio should still have a similar potential to gain from market price rises.

The basis of a prudent spread of risk is therefore to diversify the investment; to hold a range of assets (and asset types) in a way that seems reasonable given the fund's investment objective. We will see that the COLL rules set a number of investment limits that the AFM must satisfy when deciding which assets to buy and sell within the fund's portfolio.

1.3 Liquidity

Another important concept in structuring a portfolio is the liquidity of the assets. This means how easily the investment can be turned back into money. Many types of asset are generally liquid. Company shares that are listed on a stock exchange (such as the London Stock Exchange) can normally be sold (provided someone wants to buy them) and cash settlement will follow within two or three days. Yet if some problem affects the company then market confidence might reduce and the shares might be suspended or withdrawn from trading. In such cases it might not be possible to sell an asset.

By contrast, asset types such as commercial property are not liquid. It can take a long time for a new buyer to be identified if someone wants to sell physical property, and the legal process for changing ownership also takes time.

Such matters are important to the AFM of an authorised CIS, because such schemes are 'open-ended' – meaning that the AFM can instruct the depositary to issue or cancel units/shares in the fund in line with investor demand. This is beneficial to investors, but requires the fund portfolio to remain sufficiently liquid to pay the AFM for any units/shares being cancelled.

There have been cases – thankfully very few, given how long the UK's CIS industry has been in operation – when certain AFMs have experienced significant problems upon discovering that the assets in the fund's portfolio were not as liquid as had been believed. Such cases have generally related to whether certain assets could be traded as expected, or whether the prices recorded against certain holdings could realistically be achieved if the assets were sold. It is, therefore, vital that the AFM's work to review each portfolio against relevant investment limits correctly understands the nature and status of each asset; particularly whether it is freely traded on an eligible market (as discussed in the next section of this chapter).

In future chapters, we will consider in more detail the mechanisms for dealing in CIS units/shares and the issue and cancellation of units/shares, and what action the AFM and depositary might need to take if the fund's portfolio is not sufficiently liquid. For the current chapter, it is sufficient to recognise that 'prudent spread of risk' can be viewed as covering not only investment risk but also the liquidity risk of being able to turn assets back into money when required.

2. Important Terms

4.2.1 Know the definitions of: transferable securities; eligible markets; approved/unapproved securities; derivatives (exchange and OTC)

In order to understand and apply the investment limits we must first understand a number of ways in which assets might be grouped or classified. This section will outline these key categories, and then subsequent sections will record the relevant investment limits for different types of authorised CIS.

2.1 Transferable Securities

A 'transferable security' is essentially a security with transferable title, ie, the current holder can exchange it for its current value and no longer be the owner of the asset. This includes equities, bonds issued by governments or companies, warrants, and depositary receipts. However, 'transferable security' does not include all types of assets.

A UCITS may only invest in a transferable security if the following criteria are all fulfilled:

- the potential loss is limited to the amount paid for it
- its liquidity must not compromise the AFM's ability to redeem units/shares
- a reliable valuation must be available for it
- appropriate information is available for it, either as information available to the market or as regular and accurate information available to the AFM
- it is negotiable, and
- its risks are adequately captured by the risk management process of the AFM.

It should be noted that even though units/shares in another CIS would generally satisfy these requirements, where a UCITS/NURS holds such units they are not considered as 'transferable securities' for investment limit purposes.

2.2 Eligible Markets: Approved Securities

Transferable securities will often be traded on stock markets that operate in different locations around the world, and different securities are traded on (or listed on) different markets. The AFM will decide upon a list of stock markets that will be the main markets on which it will trade the securities that will form most of the fund portfolio and will identify those markets as being 'eligible' for the fund.

A list of eligible markets is stated in the prospectus. For example, a US growth fund will tend to name the main US markets as eligible (such as New York, NASDAQ, Philadelphia), while a Far East growth fund might specify the main markets from a larger number of countries (such as exchanges in Tokyo, Kuala Lumpur, Hong Kong, Singapore).

The regulations permit any official market in the UK or European Economic Area (EEA) to be declared as eligible. Additionally, any other global market can be declared as eligible providing that it satisfies the following list of requirements:

- The market must be regulated.
- It must operate regularly.
- It must be recognised by an overseas regulator.
- It must be open to the public.
- It must be adequately liquid.
- It must have adequate arrangements for the transmission of income and capital to and from investors.

The list of eligible markets is compiled by the AFM, though the depositary must be satisfied that each meets the FCA's requirements. The AFM's documentation to demonstrate the appropriateness of eligible markets is known as the Market Due Diligence review. The depositary must also be satisfied that it can provide safe custody of any assets purchased in a market designated as eligible.

Any transferable security traded or listed on an eligible market is known as an 'approved security'. If a scheme holds a transferable security that is not listed or traded on an eligible market, the holding is referred to as an 'unapproved security'.

2.3 Approved Money Market Instruments

A separate use of the term 'approved' arises in respect of money market instruments. A CIS might at times hold a significant level of cash, or might have an investment objective to focus on cash-like investment products. A money market instrument is an instrument which is normally dealt on the money market, is liquid, and has a value which can be accurately determined at any time.

A money-market instrument is regarded as 'normally dealt on the money market' if it:

- has a maturity at issue of up to 397 days
- has a residual maturity of up to 397 days
- undergoes regular yield adjustments at least every 397 days, and
- has a risk profile (including credit and interest rate risk) corresponding to that of an instrument which has a maturity of up to 397 days.

COLL uses the term 'approved money market instrument' to describe an instrument that satisfies the above and allows a CIS to hold such an instrument. However, the AFM must also consider whether the market on which the 'approved money market instrument' is traded has been included on the fund's list of eligible markets, as this will determine the investment limits applicable to the holding.

2.4 Derivatives

A CIS may use derivatives (the generic term for futures contracts, options contracts, contracts for differences, swaps) for the purpose of **hedging** its exposure to a certain investment/asset/market, but the COLL Sourcebook also permits derivatives to be used for investment purposes, as well as protection strategies. The derivative must be appropriate to the scheme's stated investment objective. Derivative positions will be either approved (where performed on an eligible derivatives market named in the prospectus – following a due diligence review similar to that for eligible securities markets) or over-the-counter, also known as OTC (an off-exchange transaction subject to tighter restrictions within the COLL Sourcebook).

Here is an example: an investor agrees a contract with a financial services firm to sell a given amount of a specific asset at an agreed future date at a price they agree now. The investor does this because they expect the price of the asset to fall below that price by the end of the agreed period. If this happens the investor will usually place a corresponding market trade to buy the same asset they have committed to sell – the result being that the investor might never actually own the asset, but they receive the profit by settling the pair of transactions.

But if the investor guesses wrong and the price of the asset rises instead of falling they will incur a capital loss. If the investor does already hold the asset they will need to release it for less money than the market price at the time. Alternatively they might need to place a buy trade to 'close out' their future contract and so the resulting net settlement would see the investor paying the price difference between their two contracts (but receiving nothing in return).

While considering the use of derivatives within CISs, we should discuss some particular ways in which these techniques might be applied, and a key requirement that the AFM must establish if using such techniques.

2.4.1 Hedging

Hedging is a process by which the AFM protects the overall fund from a loss of value of a certain asset or assets. There are two broad risks that give the potential for such loss: loss of value of the asset itself, or a change in a currency exchange rate that reduces the sterling value of the asset for valuation purposes (even if the asset itself is increasing in value).

The method used to protect the scheme's position will depend upon the risk and the breadth of cover required. For example, where a sterling-based scheme holds assets overseas and the AFM is concerned that the exchange rate will go against the scheme, they would perform a foreign currency transaction with a settlement date far in the future (common periods being three months, six months, or one year).

The transaction would 'sell forward' the currency being protected. When the settlement date approaches, the AFM has two main options on behalf of the scheme:

- Allow the deal to settle (paying away the currency sold, and receiving a pre-determined amount of sterling).
- Close the exposure – this involves performing an opposing transaction to cancel out the currency figure on the same settlement date. The sterling equivalent will be different from the original forward transaction, creating a profit/loss that will be exchanged with the counterparty concerned.

The AFM will then decide whether to also open a new forward position to protect the fund for the coming period.

2.4.2 Hedging of Unit/Share Classes

COLL 3.3.5R allows AFMs to apply hedging techniques to individual unit/share classes (rather than across the entire fund portfolio). This is particularly relevant if the fund has share classes denominated in different currencies (as the justification for hedging a portfolio against sterling may not apply if the share class owned by a given investor is denominated in another currency, such as euros).

Before undertaking a class hedging transaction, the AFM must:

- ensure the prospectus states such a transaction may be undertaken for the relevant class of units/shares
- explain the nature of risks that such a transaction may pose to investors of all classes
- consult the trustee/depositary about the adequacy of the systems and controls it uses to ensure compliance, and
- consult the scheme auditor and, where appropriate, the depositary to determine how a transaction will be treated in the scheme's accounts and how any consequential tax liability will be met.

2.4.3 Advertent and Inadvertent Breaches

As we turn our attention to the various investment limits that apply to different types of fund, it should be noted that investment limits generally apply both at the point of purchase and subsequently. As such, the AFM can incur a breach position either by accidentally purchasing too many shares (this is known as an 'advertent breach' arising from direct action of the AFM) or if subsequent movements of stock market prices increase the value of one holding relative to the rest of the portfolio increasing the percentage of the scheme represented by that asset. The term 'inadvertent breach' is used when an investment limit is breached as a result of price movements rather than specific action of the AFM.

3. Investment Limits for a UCITS

4.3.1 Know the specific limits applying to UCITS funds

3.1 Approved Securities

There is no limit to the aggregated investment a UCITS can make in approved securities, though there are limits over the percentage of fund value that can be invested in any single body. The general rule is that approved securities and money market instruments issued by a single body should not exceed 5% of the total scheme property, although this limit can be increased to 10% per body provided the aggregate value of such holdings over 5% does not exceed 40% of the fund value.

This limit has caused some problems for AFMs operating funds that aim to track the performance of a specific market index, such as the FTSE 100. At times, the shares of some companies have exceeded 10% of the value of the index, and so tracker funds (CISs that track an index) have found themselves in breach of the 10% limit if they buy shares in proportion to the index. FCA has therefore added a special provision within COLL for schemes replicating an index: the 10% maximum limit on approved securities issued by a single body can be increased to 20%, and up to 35% for a single body at any time where exceptional circumstances arise, but these increased limits are only available if the level of investment matches the proportion of the index that security represents.

Note that, as investments in a CIS do not count as 'approved securities', a separate investment limit applies when one CIS invests in the units/shares of another.

3.2 Unapproved Securities

The regulations enable a scheme to make investments in securities and 'approved money market instruments' that are not traded on eligible markets. A maximum of 10% of the scheme value can be invested in such unapproved securities, though individual holdings are also subject to the 5% maximum limit to ensure an appropriate spread of investment.

3.3 Government and Public Securities (GAPS)

As government debt is generally considered to be less risky than other market-listed securities, it is subject to a separate limit (and so is excluded from the 5%/10%/40% limits noted above). Provided that less than 35% of the scheme property is invested in debt issued by (or guaranteed by) any single government, there is no additional limit on investment spread, and so a scheme could, for example, invest 33% of its value in a single UK gilt issue (subject to the scheme's investment objective). The definition of GAPS includes not only local and national governments, but also any public international bodies of which the UK or any EEA state is a member.

One 'issue' differs from another if there is a difference as to the repayment date, rate of interest, guarantor or other material term of that issue. If a scheme's investment in issues from any single government exceeds 35% of the CIS's **net asset value (NAV)**, a number of additional rules come into force to ensure an investment spread:

- No individual position can exceed 30% of scheme property.
- The fund must hold at least six GAPS issues in total (issued by any issuer).
- The AFM must ensure that the scheme documentation (both the instrument incorporating the scheme and the current prospectus) names the states, local authorities, or issuing bodies in whose issues the fund will invest more than 35% of the scheme property.
- The AFM must consult with the trustee/depositary and conclude that the issuer is one which is appropriate in accordance with the scheme's investment objectives.

The regulations consider that any issue guaranteed by a particular government, local authority or international body should be treated as if it was issued by that government, local authority or international body.

3.4 Units/Shares in Regulated Collective Investment Schemes

A UCITS scheme can only invest in another scheme (the second scheme) if the following three requirements are met:

- The second scheme satisfies the conditions necessary for it to enjoy the rights conferred by the UCITS Directive.
- If the second scheme itself invests in schemes operated by the same firm, the first scheme must disclose the fact in its prospectus, ensuring that the first scheme is treated appropriately by the AFM of the second scheme.
- The second scheme must be prohibited from investing more than 10% of its value in collective investment vehicles to ensure that pricing always relates to assets that are held, rather than schemes that mutually invest in each other but hold no underlying investments.

No more than 20% of the scheme property can be invested in any single CIS, and there is no limit to the total proportion of a UCITS that can be invested in other UCITS schemes. A UCITS can, however, invest up to 30% of its value in units/shares in non-UCITS schemes – though the rules prevent a UCITS scheme from buying units/shares in a NURS that invests in assets not permitted by the UCITS Directive (such as gold or real estate).

3.5 Warrants and Shares Not Fully Paid

UCITS schemes can invest in warrants (securities with rights that can subsequently be exercised and converted into equity). There is no specific limit on the amount of the scheme that can be invested in warrants, although as warrants are a subset of transferable securities the spread requirements noted above apply. Also, the AFM must ensure that no breach of any other limit would arise if the warrants were all to be exercised into the related security.

Example

A scheme might hold 8% of its value in Vodafone and a further 1% of value in a Vodafone warrant. The total current exposure to Vodafone is 9% – but the exercise terms of the warrant must also be considered as these will tend to increase the value of the asset. If exercise of the warrants results in new shares worth 3% of the scheme the total proportion of the scheme property invested in Vodafone would be 11%. This would be acceptable if the scheme is an index-replicating scheme and Vodafone represents 11% of the respective index. However, if the scheme is not an index-replicating scheme, or if Vodafone represents, say, only 9% of the respective index, holding the warrants and shares would be a breach of the regulations, even though the unconverted combined total of the current holdings is only 9%.

Nil-paid and partly-paid securities produce a contingent liability on a scheme, a payment that will be required (or 'called') at a future date. UCITS may invest in such securities providing that such calls could be paid from the scheme and without any breach of the investment borrowing and powers (IBP) limits.

3.6 Deposits

A UCITS scheme is able to make deposits with an approved bank, providing that the money can be withdrawn on demand and matures in no more than 12 months. In order to ensure a spread of investments, not more than 20% of the scheme property may be deposited with a single bank.

3.7 Borrowings

A UCITS scheme can borrow money, provided this does not contravene any obligations in the scheme documentation. Borrowing cannot exceed 10% of the total scheme property on any day. Borrowing by a UCITS scheme must be temporary in nature, with the AFM requiring prior consent from the depositary before any borrowing extends beyond three months.

3.8 Derivatives

A UCITS scheme can have a total exposure of 5% of scheme value to a single market counterparty for OTC derivative transactions, though this limit is increased to 10% where the counterparty is an approved bank.

Hedging transactions entered into by a UCITS must not exceed the exposure created by the underlying asset or assets being hedged (ie, any derivative position is covered by the value of related underlying assets in the scheme). Therefore, if a Japan growth fund with 600 million yen of securities is to be protected against foreign exchange loss, the hedge should not exceed the value of those assets. Similarly, if a fund with £30 million invested in UK equities wishes to protect that value against a general fall in the FTSE100 index, the future or option contract should not exceed this figure. However, the COLL Sourcebook gives the AFM flexibility to effect such cover on a global basis (ie, a UK derivative position can be covered using non-UK assets).

3.8.1 The Risk Management Process

If the AFM wishes to use derivatives within any UCITS or NURS fund, the regulations require it to establish a risk management process to monitor and measure all open positions and the effect on the scheme's overall risk profile. Certain details of the risk management process must be notified to the FCA prior to any derivative transactions being performed. These include the methods for estimating the risks involved, and the types of derivatives to be employed. Guidance in the regulations indicates that the risk management process should enable analysis of open positions and the associated risks to be performed at least daily. The risk management process should also be reviewed by the depositary.

The IA together with the Depositary and Trustee Association (DATA) and the Futures Industry Association (FIA) prepared guidelines to assist AFMs to develop the relevant risk controls.

These guidelines propose the following:

- Each AFM nominates one or more senior individuals (referred to as a Committee), who maintain a significant degree of independence from the AFM, to be responsible for overseeing the AFM's use of derivatives.
- The AFM must ensure that the Committee understands derivative instruments.

The Committee should report regularly to the AFM's board on derivative positions and exposures.

- Use of derivatives to be monitored and reviewed regularly by persons independent of those involved in managing derivatives, to ensure these activities comply with the COLL Sourcebook.
- Qualifications and experience of senior managers are to be examined by the Committee to ensure there is sufficient knowledge and to prevent too few people understanding the derivatives.
- Where appropriate, the Committee should seek additional professional advice and/or support from external specialists.
- Staff responsible for controlling risks and administering transactions should be independent of those initiating the transactions. They are required to have the skills and experience to enable them to challenge the initiators effectively if necessary.
- As well as ensuring that procedures are adequately documented, and that contingency plans exist to cover key staff leaving the firm, there should be links with both internal and external audit processes.
- The FCA must be notified by the fund manager of details of the risk management process, in particular, methods and use of estimating risks in derivative transactions. Details of this process must be discussed with the depositary.
- The Eligible Assets Directive extended the requirement for a risk management process to include all types of investments. An AFM is expected to demonstrate more sophistication in its risk management process for a scheme with a complex risk profile than one with a simple risk profile. Only a risk management process relating to derivatives requires notification to the FCA.

3.9 Cash/Near Cash

It is necessary for a scheme to hold a level of cash or near cash (eg, in a current account or investment in highly liquid assets such as Treasury bills) in order to support unit cancellations. Income received but not yet distributed is also held in the form of cash. While there is no stated limit to the amount of cash that can be held, the nature of a CIS requires that it is invested in line with its investment objective. As such, the levels of cash should not be excessive when compared with the investment objective and the short-term need for cash.

3.10 Limits relating to Control of Voting Shares of Companies

3.10.1 Concentration

The regulations ensure that a UCITS scheme would not be in a position to affect the running of any company in which it invests. A UCITS scheme may not hold more than:

- 25% of the units/shares of any collective investment scheme
- 10% of the debt securities issued by a single body
- 10% of the money market instruments issued by a single body, or
- 10% of the voting shares of a company.

It must also be noted that a UCITS scheme is not permitted to purchase equities that do not carry voting rights.

3.10.2 Significant Influence

In addition to the concentration limits relating to individual UCITS schemes, each OEIC (ie, in aggregate across all its sub-funds) and the manager of an AUT are subject (at a corporate level) to significant influence regulations.

The manager of an AUT must aggregate all positions held in all trusts and ensure that they do not control more than 20% in total of the voting shares. For OEICs (which may have sub-funds within the single OEIC company) this 20% limit is applied to the OEIC as a whole.

4. Investment Limits for a NURS

4.3.2 Know the specific limits applying to Non-UCITS Retail Schemes (NURS)

Various regulations noted above for UCITS schemes do not apply to NURS. While the permitted categories of investment and aggregated limits on the various categories are broadly similar, the rules enable greater flexibility to NURS funds.

Given the wider investment possibilities for a NURS, after the launch of a new scheme the regulations allow a 12-month period before the investment limits of the NURS must be satisfied (compared with the 6-month period specified for UCITS schemes). Also, a NURS is not subject to any regulatory concentration/significant influence restrictions (though a scheme might choose to apply a limit within its scheme documentation).

4.1 Transferable Securities

The maximum holding in transferable securities or money market instruments issued by any single body remains at 10%, with the ability to increase it to 20% for schemes that replicate an index. However, this figure can be increased to 35% in respect of a single body if justified by exceptional circumstances. The total aggregated value of unapproved securities is 20% for NURSs (compared with 10% for UCITS schemes).

4.2 Units/Shares in Regulated Collective Investments

A NURS can invest up to 35% in the units/shares of another scheme, if that second scheme is a UCITS, a NURS, an individually recognised overseas scheme, or has similar restrictions as are applicable to a NURS scheme. Other CISs can be held, but such holdings must be within the 20% limit for unapproved securities. Note that this limit does not apply to a feeder NURS.

4.3 Units/Shares in Unregulated Schemes

A NURS is able to invest in unregulated schemes, but any such schemes are viewed as unapproved securities and, therefore, included in the aggregated limit of 20% of scheme property.

4.4 Physical Property

A NURS is able to invest in physical property. A maximum of 15% may be invested in any single property, though this figure can increase to 25% of the scheme once the property has been purchased.

In the case of real property held within a NURS, given the potential price movements associated with immovable property, the regulations therefore permit the proportionate value of a single asset to increase significantly after the purchase without incurring an inadvertent breach.

Not more than 20% of the scheme may be invested in mortgaged immovable assets, with no mortgage exceeding 100% of the independent valuer's valuation. Not more than 50% of the scheme property can consist of immovable property that is unoccupied or currently under development, redevelopment, or refurbishment.

Any property must be subject to an independent valuation, reviewed at least monthly.

Due to concerns that funds which substantially invest in immovable property are at greater risk of needing to suspend dealing due to political and other events, the FCA created a category of 'funds investing in inherently illiquid assets' (FIIA).

The AFM of any NURS determined to be an FIIA is required to:

- include additional risk warnings within financial promotions
- discuss the management of this risk within the fund's prospectus
- enhance its liquidity management approach, including the creation of a liquidity management contingency plan, and
- provide additional periodic information to the depositary to enable it to appropriately oversee the FIIA.

4.5 Gold

While the UCITS rules do not permit a fund to hold gold, many will buy shares in companies from the mining sector. A NURS, however, can invest up to 10% of scheme property in gold, but would need to ensure that the depositary can arrange for safe custody, though this can sometimes be arranged via gold depositaries.

4.6 Deposits

A maximum of 20% of the scheme property can be deposited with any single body.

4.7 Borrowings

A NURS is bound by the same 10% limit on borrowing, but (unlike a UCITS scheme) this borrowing need not be temporary in nature. This permits a small level of **gearing** in the fund's operation.

4.8 Significant Influence/Concentration

The regulations noted above in relation to concentration and significant influence do not apply to NURS, though any AUT manager running at least one UCITS scheme would still be subject to the 20% aggregate corporate limit across all the funds it manages.

4.9 Derivatives

Derivative transactions are permitted, but the exposure to the underlying assets cannot exceed the limits for transferable securities and other asset classes. Derivative positions must also be covered by assets held in the NURS.

The total exposure arising from OTC derivative transactions in respect of any single counterparty may not exceed 10% of the scheme property. The requirement for a risk management process is essentially unchanged from the UCITS scheme, requiring analysis at least daily, but also noting a requirement for increased sophistication in the approach as the risk profile of the NURS increases.

4.10 A Specific Type of NURS: Funds of Alternative Investment Funds (FAIFs)

A **fund of alternative investment funds (FAIF)** is a type of NURS that can invest up to 100% of its assets into other CISs with flexibility as to the proportion of assets invested in a particular type of undertaking. For example, a FAIF could invest up to 100% of its assets in a selection of hedge funds based in non-EU countries. This additional flexibility requires the manager to carry out initial and ongoing due diligence on the underlying schemes it is investing in. COLL 5.7 sets out the specific investment powers and limits for non-UCITS retail funds operating as funds of alternative investment funds.

The general position for a NURS fund is that only 20% may be invested in unregulated schemes. The additional flexibility for a FAIF, allowing investment of up to 100% in unregulated schemes, is therefore quite significant and, not surprisingly, the FCA has set out additional requirements for FAIFs investing in second (unregulated) schemes as follows:

1. The second scheme operates on the principle of a prudent spread of risk.
2. The second scheme is prohibited from investing more than 15% in the value of the property of that scheme in units/shares of collective investment schemes or, if there is no such prohibition, if the NURS's authorised fund manager is satisfied, on reasonable grounds and after making all reasonable enquiries that no such investment will be made.

3. The participants in the second scheme must be entitled to have their units/shares redeemed in accordance with the scheme at a price (a) related to the net value of the property to which the units/ shares relate; and (b) determined in accordance with the scheme.
4. Where the second scheme is an umbrella, these three provisions apply to each sub-fund as if it were a separate scheme.

A FAIF may invest in underlying schemes that have infrequent dealing periods; as such a FAIF may define redemption arrangements so that up to 185 days elapse between the acceptance and redemption of an order and the payment to an investor of the redemption proceeds. The FAIF's documentation will set out its unit/share sale and redemption arrangements.

A FAIF can normally not invest more than 35% of its value into any other scheme, though this limit is not applicable if the FAIF is a specific feeder fund.

5. Aggregate IBP Limits for Retail Schemes

As shown in the preceding sections, the rules regarding IBP limits for individual holdings are detailed and can differ between UCITS and NURS schemes. These limits ensure a scheme is not too heavily invested in a small number of assets/issuers. However, in addition there are some limits that apply to the aggregated exposure the scheme maintains in different asset types.

The following table summarises the investment types that an AFM might wish to purchase within a retail fund and shows whether that asset type is permitted within a UCITS or NURS scheme, together with any aggregated IBP limits that apply to these two types of retail fund authorised under COLL.

Scheme investments/techniques	Aggregated limits for UCITS schemes		Aggregated limits for non-UCITS retail schemes*	
	Permitted?	Max. Limit	Permitted?	Max. Limit
Approved securities	Yes	None	Yes	None
Transferable securities that are not approved securities	Yes	10%	Yes	20%
Government and public securities	Yes	None	Yes	None
Regulated schemes	Yes	None	Yes	None
Unregulated schemes	No	N/A	Yes	20%
Warrants	Yes	None	Yes	None
Investment trusts	Yes	None	Yes	None
Deposits	Yes	None	Yes	None
Derivatives	Yes	None	Yes	None
Immovable (ie, real property)	No	N/A	Yes	None
Gold	No	N/A	Yes	10%
Hedging	Yes	None	Yes	None
Stock lending	Yes	None	Yes	None
Underwriting	Yes	None	Yes	None
Borrowing	Yes	10% (temporary)	Yes	10%
Cash and near cash	Yes	None	Yes	None

*See section 4.10 for the specific limits relating to FAIFs.

Note that while the above table shows that there is no maximum percentage limit to items such as hedging, the level of hedging should not exceed the value of scheme property being hedged.

6. Investment Limits for a QIS

4.3.3 Know the specific limits applying to qualified investor schemes (QISs)

6.1 A Highly Flexible Regime

Compared with the many specific limits applicable to UCITS and NURS, QISs are placed in a very different regulatory position. As such schemes are not retail by nature, the FCA has not imposed extensive restrictions on their behaviour.

Instead, the FCA has imposed a high-level rule simply requiring the AFM to take reasonable steps to ensure there is a spread of risk, taking into account the scheme's investment objectives and policy. Suitable diversification of risk regarding capital depreciation and income stream into the fund is required and the means of spreading risk must be disclosed in the prospectus. Any limits adopted will be defined by the AFM and set out in its scheme documentation rather than in the COLL rules.

6.2 Main Features

The main features of QISs (relative to UCITS or NURS) are as follows:

- A QIS can invest using derivatives (eg, traded options, financial or currency futures), precious metals and commodity contracts (if normally and regularly traded on a regulated market), though the fund's exposure must be limited to the value of the net assets of the fund.
- Borrowing by the scheme cannot exceed 100% of the net asset value (NAV – effectively the value of the CIS) to ensure there is adequate cover. There must be the facility in place to close out quickly to avoid inadequate cover.
- Limited issue and redemption arrangements can be adopted for the fund, but this must be allowed for in the instrument of incorporation and the details set out in the prospectus.
- Prices of shares should be published in an appropriate manner. If the fund operates 'limited redemptions', an indicative price should be available on request before the dealing day so investors can see how the net asset value has moved and decide whether to exercise redemption rights.
- A depositary must be appointed to oversee the AFM on valuation, pricing, income calculation and investment requirements.
- Only fundamental changes to the fund (eg, investment objective) will require approval by investors.
- The instrument of incorporation and the prospectus will require more detail than for retail funds.

Overall, while the QIS rules allow AFMs greater freedom to act, full details of the fund will be available to the institutional investors who will be able to interpret and use that information more easily and readily than ordinary members of the public.

7. Investment Limits for a Money Market Fund

4.3.4 Know the specific limits applying to Money Market Funds

7.1 Money Market Funds

EU rules created a standardised approach for CISs dedicated to investment in money market instruments, and the relevant rules remain part of the UK structure. A money market fund (MMF) may be a UCITS or an AIF, and the rules require that any CIS dedicated to money market investments must be authorised as an MMF.

An MMF is only permitted to invest in the following types of asset:

- money market instruments
- eligible securitisations and asset-backed commercial paper
- deposits with credit institutions
- financial derivative instruments
- certain repurchase agreements
- certain reverse repurchase agreements, and
- units/shares of other MMFs.

Specific investment limits would be set out in the instrument constituting the money market fund. An MMF cannot take any stake in equities or bonds (whether directly or indirectly), though it can use derivatives provided such positions are covered and the MMF would be allowed to hold the relevant underlying asset.

8. Investment Limits for a Long-Term Asset Fund

4.3.5 Know the specific limits applying to Long-Term Asset Funds (LTAFs)

8.1 The Long-Term Asset Fund (LTAF)

The LTAF is the fourth regulatory category of fund and was created in order that a type of CIS would be able to invest in assets that may effectively be illiquid in the short/medium term, such as investment in infrastructure projects.

COLL states that an LTAF should demonstrate a prudent spread of risk, reflecting diversification of financial exposure and the spread of different risk types, such as market risks, credit risks, liquidity risks, and counterparty risks.

An LTAF can invest in the types of assets we discussed for UCITS and NURS, including shares, other CISs and derivatives, and has broader scope to loan money in return for income.

An LTAF can invest in other CISs. However, if more than 20% of the LTAF's scheme property will be invested in QIS, other LTAFs, or unregulated CISs then the AFM must carry out appropriate due diligence on each of those schemes.

If derivative contracts are used, the exposure must be suitably covered. Stock lending (discussed in section 9.1 of this chapter) is permitted provided the depositary has received sufficient collateral in return.

An LTAF can borrow up to 30% of the value of the scheme property, though must take reasonable care over its plans to close out any such borrowing positions if required.

An LTAF can invest in an 'immovable' asset (ie, land and buildings) provided:

- it is situated in a country/territory listed in the prospectus
- the AFM takes reasonable care to ensure there is good marketable title to the asset, and
- an appropriate valuer gives the AFM sufficient confirmation of the value of the proposed interest in that immovable.

Overseas immovable assets can be purchased through an intermediate holding vehicle but only if the LTAF wholly owns that intermediate vehicle.

The total value of a mortgage over any immovable must not exceed 100% of the latest valuation of that property. If the LTAF buys options to purchase immovable assets the total value of all option premiums paid in a rolling 12-month period cannot exceed 10% of the LTAF value.

9. Other Investment Techniques

4.4.1 Know the scope available to AFMs in relation to: stock lending; repurchase agreements; underwriting; collateral management

In addition to the types of investments discussed above, there are certain other activities that may be undertaken to provide additional returns for the fund. We will discuss three types of transactions which may provide such additional returns and also explore the relevance of collateral to those transactions. It should be noted that such transactions are forms of securities financing transactions (SFTs), which firms must report to trade repositories, and firms must disclose information on the use of SFTs to investors in regular reports and pre-investment documents.

9.1 Stock Lending

The regulations allow schemes to use stock lending with a view to generating additional income for the scheme with an acceptable degree of risk.

Stock lending is a disposal of specific securities in return for an obligation to transfer back securities of the same kind and amount at a later date. The borrower (also known as the 'counterparty') is required to provide collateral (in the form of either money or other assets) to mitigate the risk that in the future the promised return of the shares may not be completed. When the loaned stock is returned to the depositary, the collateral will be returned to the counterparty.

Legally, a stock lending transaction is not a loan but a type of arrangement described in section 263B of the Taxation of Chargeable Gains Act 1992. The depositary (acting on the AFM's instructions) or an OEIC may enter into such a transaction on behalf of the scheme provided certain underlying requirements are satisfied:

- The collateral must be liquid, high quality, and acceptable to the depositary.
- The value of collateral held by the depositary must at all times be at least equal to the current value of assets on loan to the counterparty (and for a UCITS the value of collateral should exceed the loan value by an agreed premium).
- The counterparty must be an authorised firm (with the COLL rules recognising for this purpose authorisation by the FCA, any EU Member State Regulator, or the American Securities and Exchange Commission) or a bank authorised by US banking authorities to perform derivative trades as principal.

The arrangements with the counterparty will be set out in a stock lending agreement which must be accepted by the depositary.

There is no limit on the value of property that may be used for stock lending.

9.2 Repurchase Agreements

A 'repurchase agreement' (or 'repo' as it is commonly called, including within the FCA Handbook) is an agreement between two parties that at some specified future date the buyer of an asset agrees to sell the asset back to the seller, and/or the seller agrees to buy the asset back from the original buyer. The outcome is broadly similar to a stock lending position, though the legal structures are different and the ability to profit from a repo flows from the expected price movement in the asset and whether the parties have pre-agreed the price at which the repurchase would be conducted.

COLL generally applies the same expectations to repo contracts as are applicable to stock lending arrangements.

9.3 Underwriting

When a new share is to be offered, it is common for institutions to be given the opportunity to take up any excess shares at a pre-agreed price – subject to the overall demand generated. This gives the company confidence that there will be sufficient interest in the shares being offered. The institutions that agree to take up excess shares are said to 'underwrite' the issue of the new shares (sometimes described as the 'placing' of new shares). While any market investment carries the risk of price movement, one advantage of participating in a placing/underwriting is that the share is acquired at a discounted price – which can benefit the fund's investment performance.

A separate advantage is that the fund may receive an underwriting fee for holding the potential obligation to buy those shares if required (any such fee being accounted for as income of the fund). However, if the share issue is successful, the firm may not be required to take up its underwriting promise (though it would retain any underwriting fee applicable).

COLL puts no limits on the amount of underwriting that a fund can perform, although the AFM should ensure that taking up an underwriting would not put the portfolio in breach of any other investment limits. The AFM must, therefore, ensure it understands the impact if every underwriting obligation was met in full. The potential exposure (ie, the cash required to effect those purchases, if called upon to do so) should be included within the AFM's calculation of cover necessary for derivative transactions.

9.4 Collateral Management

'Collateral' describes the temporary handing over of an asset from one party to another in order to reduce the overall exposure of the second party as a result of future promises by the first party. For the AFM of a CIS, collateral would be received if the fund loans stock to protect the fund against the risk that the lender does not return the asset. Similarly, if the AFM undertakes a derivative contract on behalf of the CIS, the counterparty to that derivative contract is likely to require collateral from the fund to mitigate the risk that the AFM fails to settle the financial exposure created by that derivative. An important point therefore is that while collateral is a transfer of an asset between parties, the intention of those parties is always that the asset will revert back to the original owner once the financial exposure has itself been resolved.

If the AFM undertakes such types of activity then it must manage the consequences of certain assets being held as, or replaced by, collateral. In most cases collateral will be held separately from the bulk of the scheme property, and it will normally not be possible for the AFM to sell or otherwise trade an asset which constitutes collateral at that time.

Therefore, an important part of managing the fund's collateral position is ensuring that the party holding the collateral is reliable and secure. The AFM should hold clear records of the items on loan, any collateral held, and any assets being used as collateral including the relevant custodian or other third party holding any collateral.

Another important feature of managing a collateral position is, therefore, ensuring that the investment manager has a clear understanding of what assets are available for trading and which are not. Contracting to sell an asset which cannot then be delivered could incur additional costs for the fund, which will erode (or may even exceed) the financial benefit sought from the investment technique responsible for the collateral position.

10. The Effect of Corporate Actions on the Fund's Portfolio

4.5.1 Know the types of corporate actions which may be received by the fund, the AFMs process to execute and the risks and regulatory requirements associated with these

On occasion, assets held by the fund may undergo a 'corporate action'. Corporate actions fit into three broad categories:

1. **Income** – actions that result in each registered holder receiving a proportionate amount of the income generated by the asset during the relevant accounting period.
2. **Structural changes to the assets held** – at times a company might change its capital structure, affecting the listed assets that a fund might hold. Such changes may include conversions, mergers, closures, stock splits, and rights issues. (Similar events may arise in any CISs that are holdings in the portfolio.)

3. **Matters on which the registered holder is asked to give their opinion** – either a decision affecting their own holding, or as part of a vote across the ownership of the company. Often, a structural change proposed by the company will require approval via such a vote before it takes effect.

AFMs need to be aware of these types of corporate action and establish the processes necessary to ensure that the fund (and its underlying investors) does not lose an opportunity to benefit.

While corporate action information can be identified from market information sources, notification of a corporate action is generally passed down the custody chain such that the fund's custodian will advise the AFM when a corporate action will affect a holding in the portfolio. As noted above, some types of corporate action will require the AFM to decide its preferred option from a range offered, and this choice must be confirmed to the custodian in sufficient time for the information to be included in the custodian's overall choice back up the chain towards the company's [registrar](#).

The AFM should not choose an outcome from a corporate action if that outcome would create a breach of the investment and borrowing powers (for example, the AFM should not choose to accept shares under a rights issue if doing so would result in the fund holding too many unapproved securities). However, if the corporate action does not offer a choice of outcomes it could be that the corporate action puts the fund into an inadvertent breach position (ie, a breach that arose as a result of market-driven changes, rather than because the fund manager made an incorrect investment decision which led to a breach).

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. Why are authorised CISs referred to as being 'open-ended'?

Answer reference: Section 1.3

2. Distinguish between a transferable security and an approved security.

Answer reference: Sections 2.1 and 2.2

3. How do AFMs determine the eligibility of markets to invest in?

Answer reference: Section 2.2

4. What proportion of a UCITS can be invested in transferable securities that are not approved securities?

Answer reference: Section 3.2

5. With whom must the AFM of a UCITS consult over the eligibility of government and public securities if the aggregated position invested with a single issuer is to exceed 35% of the scheme property?

Answer reference: Section 3.3

6. What is 'hedging' in respect of CIS investments, and what limits apply to the use of OTC instruments?

Answer reference: Section 3.8

7. Explain the limits on a UCITS scheme regarding the maximum percentage holdings of units/shares, debts securities and voting shares that may be held.

Answer reference: Section 3.10.1 and 3.10.2

8. In a NURS, there are limits on the holding of real property. Set out these limits.

Answer reference: Section 4.4

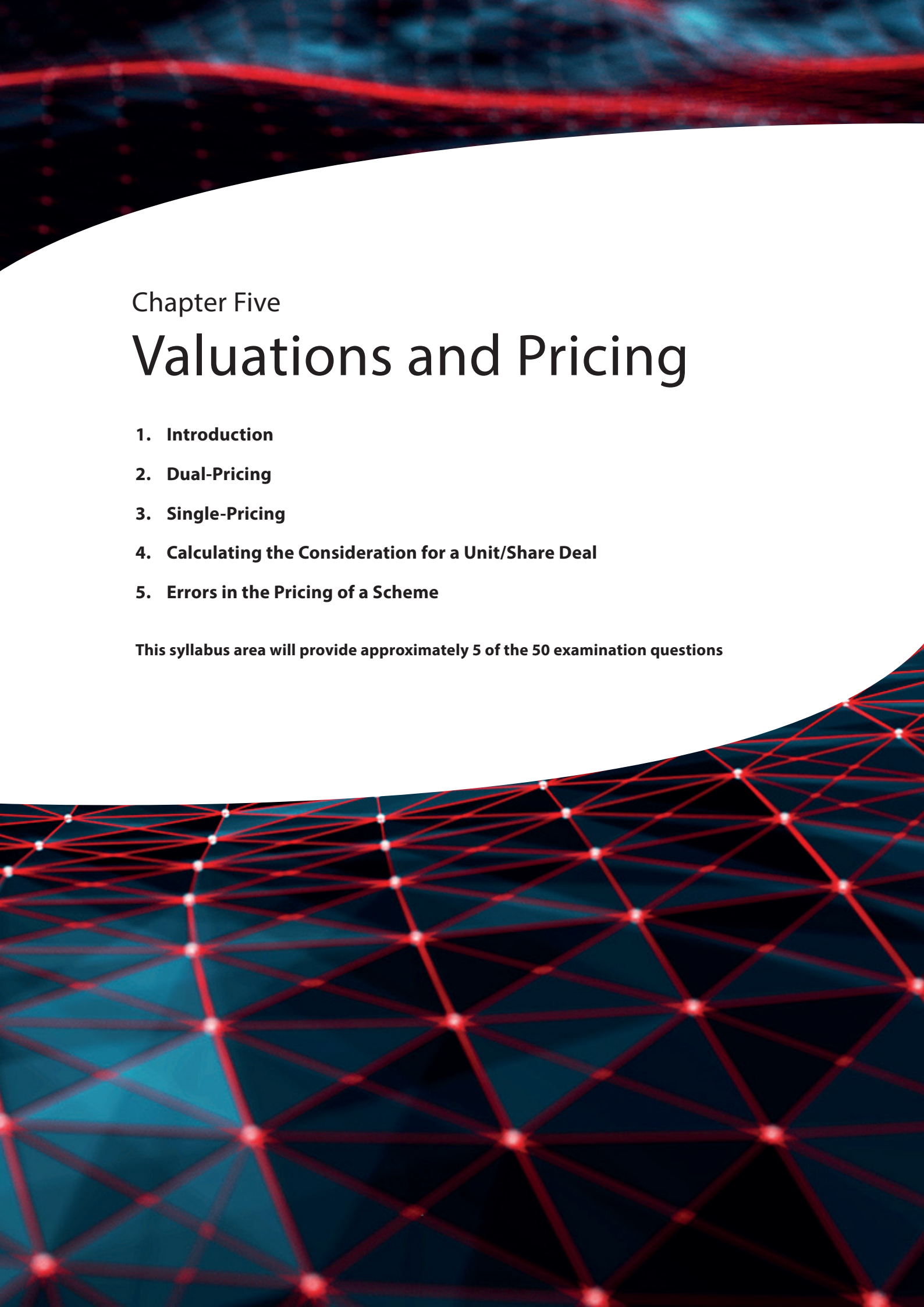
9. What limits apply to an LTAF in respect of mortgages and options for immoveable property?

Answer reference: Section 8.1

10. The regulations allow stock lending by a scheme.

- a. define this term, and
- b. set out what the borrower is required to provide.

Answer reference: Section 9.1



Chapter Five

Valuations and Pricing

1. Introduction
2. Dual-Pricing
3. Single-Pricing
4. Calculating the Consideration for a Unit/Share Deal
5. Errors in the Pricing of a Scheme

This syllabus area will provide approximately 5 of the 50 examination questions



1. Introduction

- 5.1.1 Know how and when valuations are made including required frequency
- 5.1.2 Know the permitted pricing methodology
- 5.1.3 Know the requirements for price publication

The next two chapters look at two key subjects that are closely related:

- How is the CIS valued (which determines the price of each unit/share)?
- How are units/shares traded?

This chapter focuses on the valuation process, though it is inevitable that some comments will be made about the unit/dealing processes that will only be detailed in the following chapter. While brief comment about types of unit/share deals is included in this chapter, the different transaction types will be fully discussed in chapter 6.

Each unit/share in a CIS represents a proportional part of the property of the scheme. Therefore, the price of each unit/share is the corresponding proportion of the value of the whole scheme (unaffected by any supply/demand considerations, as the CIS is open-ended).

In broad terms, the price of a unit/share is obtained by valuing the property of the scheme and dividing that value by the number of units/shares in existence. While that sounds straightforward, the calculation of unit/share prices for an operational scheme is complex. The AFM must establish a valuation at a specific point in time, including all assets held within the scheme. The pricing process may also include adjustments to ensure that investors buying or selling units/shares meet the costs that may be incurred by the CIS when purchasing/selling underlying investments as a result of the expansion/contraction of the scheme (such as dealing charges for underlying security transactions).

There are various pricing methods available for the AFM. The method selected must be recorded in the prospectus to ensure that investors and potential investors are aware of how the price of units/shares will be determined.

At all stages the fundamental aim of scheme pricing is to ensure that investors deal at a price that truly reflects the value of the scheme property. This ensures fairness to both those investors buying/selling units/shares and those who remain invested in the fund.

Once the calculation is completed, the regulations require that a price be quoted to an accuracy of at least four significant figures. The first non-zero digit is the first significant figure; subsequent digits are the second, third, etc, significant figures – including zeros and decimals where required. Any remaining places prior to the decimal point would be shown as zero. For example, here are some numbers expressed to four significant places:

Number	To four significant figures
12345	12350 (rounded up)
10001	10000
9.8765	9.877 (rounded up)
0.013579	0.01358

The important point to note is that significant figures are not the same as decimal places. In terms of unit/share prices, the key point is that a figure of 56.3458p per unit/share would be quoted as 56.35p per unit/share.

1.1 Valuation Points

The prospectus of each CIS will specify when the fund will be valued (known as the valuation point). Most retail funds are valued daily basis (with midday historically being a common time selected for these daily valuation points). The COLL rules require that authorised funds be valued at least twice each month, and if the fund does have only two valuation points, then they must be at least two weeks apart (though if the fund makes use of limited redemption arrangements, this requirement is softened and the fund's valuation points must not be more than six months apart).

For most funds, each valuation point is also a point at which investor transactions to buy and sell units/shares is performed (with those transactions being dealt at the fund prices calculated for that valuation point). However for some types of fund (such as the LTAF discussed in the previous chapter), investor transactions might only be performed less frequently, and the frequency of dealing days will also be documented in the prospectus.

At the other extreme, COLL rules require that higher volatility funds and money market funds have at least one valuation point per business day.

The official prices must then be published to enable investors and potential investors to assess the performance of each scheme over time. COLL includes a requirement to ensure that the prices are made public in an appropriate manner.

An appropriate manner of making prices public means that:

- an investor can obtain prices at a reasonable cost
- prices are available at reasonable times
- publication is consistent with the manner and frequency at which units/shares are dealt in, eg, using a daily newspaper to publish the prices of funds that offer daily dealing
- the manner of publication is disclosed to investors in the prospectus, and
- prices are published in a consistent manner (eg, in the same daily newspaper if published in that way) which allows the assessment of performance over time.

The AFM should also make previous prices available to any investor. Historically, AFMs would publish their prices in certain daily national newspapers. It is now more common for prices to be made available via internet sites, or by telephoning the AFM directly.

1.2 Single-Pricing and Dual-Pricing

COLL recognises two overall methodologies for pricing a CIS – referred to as ‘single-pricing’ or ‘dual-pricing’. These will be explained in detail in the coming sections, but in simple terms this choice determines whether each valuation point will result in one price (used for both buying and selling units/shares), or separate prices for buying and selling of units/shares.

For an umbrella scheme, the same method must be used for all sub-funds (though there are other choices that an AFM might make which apply to individual sub-funds and classes, such as whether the class will be priced using the base currency of the umbrella or a different currency).

It is possible for a dual-priced scheme to change to a single-pricing approach and vice versa, though this requires a minimum of 60 days' prior notification to unit/shareholders.

1.3 Forward Pricing

The price calculated at the valuation point will be used for all investor trades that were received by the AFM for action at that valuation point. The unit/share price is therefore unknown at the time the investor submits their trade order; the trade is pointed forward to the next price that will be calculated – an approach known as **forward pricing**. The COLL rules require that sales and repurchases in authorised funds must be done using forward pricing (as this is considered to be fair to all investors as no investor can act in the knowledge of a published price). The only exception is that a money market fund may use historic prices (due to EU rules).

Suppose a UK-domiciled UCITS fund has daily noon valuation points (and no earlier dealing cut-off point). An investor who phones at 09:30 on Monday receives the price determined as at the noon valuation the same day. An investor who phones at 15:30 on Monday will be dealt as at the valuation at noon on Tuesday, the next business day.

2. Dual-Pricing

5.2.1 Be able to calculate prices for funds with a single share class

5.2.2 Know the AFM's discretion in setting dealing prices under single and dual pricing

5.2.3 Know the charges that may be made by the AFM

2.1 Introduction

In various stock markets around the globe, an investor buying a security pays a higher price than an investor selling that same security. There is a 'spread' between the cost of buying and the proceeds of selling. A dual-priced fund reflects this position by also having separate prices for buying and selling units/shares of the fund. As a CIS's value represents the value of the underlying assets, two portfolio values are calculated in a dual-priced fund: one representing the cost of purchasing the entire portfolio (known as the offer side), and another representing the proceeds of selling the entire portfolio (known as the bid side).

To perform dual-pricing of a fund, the AFM must therefore obtain a bid and **offer price** for each asset held. In some cases, the relevant stock market might use the same price for both buying and selling the asset, in which case the AFM will use that price on both the bid and offer sides of the valuation.

Cash held and any income received by the scheme simply have a cash value, which is the same on the bid and offer sides of the valuation.

Likewise, the number of units/shares in existence is the same on both sides of the valuation, leading to the following simplified example:

Example

Asset		Bid		Offer	
		Price per share (£)	Value (£)	Price per share (£)	Value (£)
Portfolio					
1,000	ABC Ltd	1.50	1,500	1.55	1,550
1,500	XYZ Ltd	1.80	2,700	1.85	2,775
2,000	HAL Ltd	1.45	2,900	1.50	3,000
Total Portfolio value			7,100		7,325
Cash			300		300
Total Capital Assets			7,400		7,625
Net income/expenses			1,000		1,000
Total Asset Value			8,400		8,625

The 'net income/expenses' figure will be calculated as the total accrued income received (or due) less the total accrued expenses paid (or payable) by the fund. Any expenses being paid by the scheme (rather than being paid by the AFM) would be included as expenses in the CIS's accounts and so reduce the amount of 'income for distribution'. A key expense is the AFM's annual management charge, though various expenses are discussed in section 2.2 below.

It is important to include income on an 'accrued' basis (rather than only including income that has been physically received) because the generation of income will often reduce the market value of the portfolio asset that is paying the income, even though the income payment may itself not be paid for a period of time. By accruing the declared income into the valuation, such potential distortions are removed. Similarly, fund expenses are accrued to each valuation – netted against the accrued income.

Assuming there are 10,000 units/shares in existence, the **bid price** per unit/shares would be 84.00p and the offer price per unit/share would be 86.25p.

The above example is useful, though it is of course simplified to illustrate the valuation process. A real fund would have more holdings, and the total value would be larger in order to be commercially viable for the AFM. There are some additional aspects that an AFM would include in a dual-priced fund valuation, and we will now add these into our simplified example.

2.2 Fund Expenses

Separate from the charges which AFMs may levy on existing and potential unit/shareholders when they buy or sell units/shares, the FCA rules permit certain payments to be recovered from the scheme property (ie, from the cash and investments held by the fund).

The only payments which may be recovered in this way are those to pay for:

- the parties involved in operating the fund (such as the AFM and the depositary)
- the administration of the fund (including fund accounting, maintaining the register, and auditors), or
- the investment or safekeeping of the scheme property (including the investment manager or adviser, and the custodian).

The FCA has specifically excluded payments to other third parties for the safekeeping and administration of units/shares on behalf of unit/shareholders rather than the fund. Accordingly, platform providers cannot be paid for their services out of the scheme property.

All such expenses are recorded in the financial accounts of the fund, and each valuation will include an accrual to reflect each expense to avoid the unit/share price experiencing a sudden change when an expense is paid. The accrued expenses are netted off against the accrued income received/to be received.

Details of these charges are set out in the prospectus.

2.2.1 The AFM's Periodic Charge

The AFM will normally make a **periodic charge**, often referred to as the annual management charge (AMC) and usually expressed as a percentage figure. This is deducted from the scheme property (rather than paid directly by the investor) and is reflected in the valuation of the assets and therefore the price of units/shares. An AFM might create different classes of unit/share to apply different AMC rates (such as charging a lower rate of AMC to institutional investors). AMC rates can vary depending on the type of fund and the investment management approach, with passive tracker funds often having lower charges (some passive trackers feature an AMC less than 0.1%).

2.2.2 Performance Fee

For many schemes, a simple AMC accruing at a fixed percentage rate of the scheme property will provide an adequate mechanism to pay the AFM. However, the COLL rules do permit AFMs to adopt a more complex approach (either alongside or in place of a standard AMC). This is particularly relevant to AFMs of funds that seek to generate higher returns than a benchmark index.

Subject to the details being included in the prospectus, payments made to an investment adviser from the scheme property (or the AMC, in whole or in part) may be performance-related. Instead of the AFM/ investment manager receiving a fixed percentage, an increased level of income may be received if the investment performance of the fund is above a certain level. The level may be determined either by reference to an index or another factor designated for the purpose.

The performance fee must be consistent with the permitted payments rules and the AFM should consider the following factors in determining the fee:

- it is paid only after consideration of all other payments
- the benchmark must be reasonable given the fund objectives and consistently applied
- it may be based on a defined positive rate of return (referred to as the hurdle rate) which may be fixed or variable
- the benchmark or hurdle rate may be carried forward to future accrual periods
- the period over which it accrues and the frequency with which it crystallises should be reasonable, and
- the price of sale or repurchase transactions are not adjusted within the accrual period.

The prospectus should contain the maximum amount or level of performance fee that can be levied in any annual accounting period, together with examples of the operation of the performance fee.

2.2.3 Other Charges

While the fees of the AFM (the AMC and/or any performance fee) are probably the most significant expenses paid from the scheme property, there are other expenses that might be paid directly by the fund, and the net income/expense figure within each valuation will reflect a current accrual for such expense items.

Typical expenses would include the depositary fee and audit fee, but there may also be taxation charges to consider. Note that where the AFM has outsourced some of its administrative tasks (such as to a fund accountant) that party will generally be paid by the AFM rather than resulting in an extra deduction paid by the CIS. In some cases, a distinct registrar fee might be paid directly from the fund, but in other cases it may be included within the AFM's periodic charge or the depositary fee.

In some cases, it has been agreed between the AFM and depositary that a fixed annual charge would be applied to the fund rather than individual charges being applied for different parties. Such an approach might be particularly useful if there are a large number of classes, as it is easier to allocate the relevant proportion of charges to each class, though the AFM must satisfy the expectations of the Consumer Duty, and the depositary will need to consider the interests of unit/shareholders before agreeing to such an approach.

2.3 Notional Dealing Charges

The pricing regulations seek to prevent existing unit/shareholders being disadvantaged by others buying or selling units/shares of the fund. Suppose that one investor holds 2,000 of the units/shares in the above example and wishes to redeem these units/shares. The AFM will pay the repurchase proceeds from their own money (retaining the repurchased units in the manager's box), or might instruct the cancellation of the repurchased units/shares (with the AFM receiving the corresponding cash from the fund). Paying cancellation proceeds to the AFM might require the fund to sell assets. Similarly, new monies paid into a fund when issuing units/shares need to be invested in portfolio assets.

The purchase and sale of assets within the portfolio incurs charges (such as stockbroker fees) which are generally paid by the fund. For UK equity-based transactions this might be 0.2% of the bid value and 0.7% of the offer value (the difference being due to a stamp duty tax of 0.5% on UK equity purchases). It seems fair that the costs of buying or selling shares due to one investor's investment into a fund should be paid for by that investor (and not the existing investors), and so the regulations enable a dual-priced fund to add a notional dealing charge (though other names are sometimes used) to its price calculation. The notional dealing charge is the theoretical average cost that the fund would suffer if the portfolio was either rebuilt from no holdings (an offer calculation, as it involves the purchase of securities) or sold if the scheme were to be wound up (sale of securities being a bid figure). As every investor's deal includes the notional dealing charge calculated that day, each investor receives fair treatment both buying and selling.

For example, to consider the bid side first, the AFM has established that the fund suffers 0.2% when it sells UK equities. Assuming that all the shares held in the example fund above are UK equities, the AFM knows that selling all holdings would cost £14.20 (being 0.2% of £7,100). Therefore, the effective value of those shares is not £7,100 but £7,085.80. The notional dealing charge on the bid side reduces the value of the portfolio.

What of the offer side? The AFM has established the average charge to be 0.7% on purchases of UK equities, and the current value is £7,325. Therefore, to buy this portfolio using cash would incur a dealing charge of £51.28 (rounding up to the nearest penny) – meaning that to purchase the full portfolio would actually cost the fund £7,376.28 (the cost of the investments plus the dealing charges). The notional dealing charge on the offer side increases the value of the portfolio.

Our example valuation now looks like this:

Example

Asset		Bid		Offer	
		Price per share (£)	Value (£)	Price per share (£)	Value (£)
Portfolio					
1,000	ABC Ltd	1.50	1,500.00	1.55	1,550.00
1,500	XYZ Ltd	1.80	2,700.00	1.85	2,775.00
2,000	HAL Ltd	1.45	2,900.00	1.50	3,000.00
Total Portfolio Value			7,100.00		7,325.00
Notional Dealing Charge					
UK equities		0.2%	-14.20	0.7%	51.28
Cash			300.00		300.00
Total Capital Assets			7,385.80		7,676.28
Net income / expenses			1,000.00		1,000.00
Total Asset Value			8,385.80		8,676.28

The bid price is now 83.86p and the offer price 86.76p. Notional dealing charges have the effect of increasing the spread between prices.

2.4 Initial Charge

The other item to be added to the valuation is the AFM's initial charge. The initial charge is unique in that it is applied only to one side of the valuation. It is only relevant to investors buying units/shares, so will it affect the bid or offer price?

Hopefully, you recognised that the AFM sells units at the offer price (the investor buys at the higher price). Suppose the initial charge is 5%. Adding this to our example valuation gives the following result:

Example

Asset		Bid			Offer		
		Price per share (£)	Value (£)	ppu*	Price per share (£)	Value (£)	ppu*
Portfolio							
1,000	ABC Ltd	1.50	1,500.00		1.55	1,550.00	
1,500	XYZ Ltd	1.80	2,700.00		1.85	2,775.00	
2,000	HAL Ltd	1.45	2,900.00		1.50	3,000.00	
Total Portfolio Value			7,100.00			7,325.00	
Notional Dealing Charge							
UK equities		0.2%	-14.20		0.7%	51.28	
Cash							
Total Capital Assets			7,385.80			7,676.28	
Income for distribution							
Total Asset Value			8,385.80	83.86		8,676.28	86.76
Initial Charge					5%	433.81	
Scheme Value			8,385.80	83.86		9,110.09	91.10

* ppu = pence per unit

The bid price is, therefore, unchanged at 83.86p while the maximum offer price increases to 91.10p.

The initial charge, sometimes referred to as the initial service charge, is designed typically to cover promotional expenses and the actual cost of putting new unit/shareholders on the register. While the above example illustrates an initial charge of 5%, it should be noted that many funds no longer apply an initial charge (or might apply an initial charge only to certain share classes). Some funds will apply an exit charge which would reduce the bid price (while an initial charge increases the offer price).

2.5 Issue and Cancellation Prices

The prices at which units/shares are issued (created) and cancelled in a dual-priced fund are determined by the calculation above. In order to ensure that the issue and cancellation of units/shares have no impact upon any investor these prices are not subject to any initial charge or exit charge. The issue and cancellation prices are the figures shown as 'Total Asset Value' in the above example. Units/shares will be cancelled at 83.86p and units/shares will be issued at 86.76p. The AFM has no power to vary these figures.

2.6 Dealing Spread: the Pricing Basis

5.2.2 Know the AFM's discretion in setting dealing prices under single and dual pricing

While the AFM is obliged under the regulations to always use the issue and cancellation prices for the purpose of increasing and reducing the number of units/shares that exist in the fund, there is some flexibility in the bid and offer prices for the purpose of selling and redeeming units/shares with investors.

Referring back to our worked example, the bid and offer prices shown have a total **bid/offer spread** of 8.6% – meaning that the fund value would need to rise by 8.6% before the investor could sell their units/shares without losing money.

Many investors would be discouraged by this and so the AFM is able to vary these prices, within certain limits. Where the AFM intends to employ such flexibility they will state, in the scheme documentation, the spread that will be used on the fund. Let us suppose that the AFM wants to set the spread at 7% and see how this affects the prices in our calculation.

If the AFM has received net redemption instructions during a given dealing day (more sellers of units/ shares than buyers), the AFM is likely to make a cancellation instruction. The cancellation price is fixed, and the AFM will not wish to lose money when performing the cancellation. The AFM will therefore want to pay redeeming unit/shareholders the same price to investors as they receive from the trustee/depositary for the cancellation of units/shares (rather than paying investors at a higher price than the AFM would receive when cancelling those units/shares).

The AFM will therefore set the quoted bid price (ie, the price paid to redeeming unit/shareholders) to the lowest allowable price, which is the cancellation price (ie, the price determined on the bid side of the valuation). The AFM is not permitted to redeem a unit at a price lower than the cancellation price. The AFM would then reduce the calculated maximum offer price (the one including the full initial charge) until the difference between the bid and offer prices is 7% – the stated spread. This is known as quoting the fund on a bid basis. The four prices for our example fund when quoted on a bid basis are:

Cancellation	83.86
Quoted bid	83.86
Issue (creation)	86.76
Quoted offer	89.73 (being 1.07 x the quoted bid)

No deals are performed at the calculated maximum offer price of 91.10p. The AFM is essentially sacrificing just over 1p per unit/share of the available initial charge in order to reduce the price differential. While the AFM does not collect the maximum initial charge on those units/shares it sells, it does not lose money on the units/shares redeemed (hence the bid basis is used when the AFM is a net redeemer of units).

The offer basis is used when the AFM is a net seller of units/shares. In order to gain the maximum possible initial charge, the AFM will set the quoted offer price at the maximum offer price (91.10p). The issue and cancellation prices are unchanged (as these cannot be varied). The quoted bid price will therefore be fixed at a level so that 1.07 multiplied by the quoted bid will equal the quoted offer price.

Therefore, if our example fund were quoted on an offer basis the prices would be as follows:

Cancellation	83.86
Quoted bid	85.14 (being the quoted offer price divided by 1.07)
Issue (creation)	86.76
Quoted offer	91.10 (being the maximum offer price calculated)

While the AFM essentially makes a small loss on each unit/share redeemed, the gain made by receiving the full initial charge is sufficient to cover that loss. The AFM will, therefore, use the offer basis when they are a net seller of units/shares.

A natural consequence of dual-pricing is that the AFM collects an investment spread on each investor trade it executes, even though the investor might be purchasing units/shares just sold by another investor. This creates a form of inadvertent profit for the AFM. Consider the case where one investor buys 10,000 units/shares while another sells 10,000 units/shares. Based on the prices above, the AFM would collect £9,100 from one investor while paying the redeeming holder £8,514 for those same units/ shares. The AFM makes a total profit of £596 without any investment activity taking place within the fund, and without the AFM being exposed to any market risk.

While the generation of such 'risk-free box profit' is a natural consequence of dual-pricing, the FCA determined that it is not appropriate for the AFM to retain such a 'risk-free box profit'. While the AFM can retain any initial charge applied (which in this example amounts to £434 of the AFM's profit), any risk-free box profit must either be paid into the fund or returned to the relevant unitholders/shareholders. In retail fund operations it is not practical to 'pair off' deals to determine which individual investor paid a needless spread, and doing so raises questions of why one investor might receive a refund where another would not. Therefore, many

firms calculate the daily risk-free box profit figure and pay those sums to the fund for the overall benefit of unitholders/shareholders – though others instruct the trustees/depositary to both issue and cancel units (rather than only making a single decision based on the net movement in the box) as this prevents units/shares being recycled to a new investor at the same valuation point, and so automatically passes the market spread to the trustee/depositary.

The third pricing basis is called the full or maximum spread. It is used when the AFM has not specified a dealing spread, or where the prices calculated lie within the spread. Suppose that the AFM of our example fund was operating a spread of 9%.

The prices would be set as follows:

Cancellation	83.86
Quoted bid	83.86 (the calculated minimum redemption price)
Issue (creation)	86.76
Quoted offer	91.10 (the calculated maximum offer price)

As the difference between the bid and offer prices does not exceed the stated 9% spread of the scheme, the AFM can set the prices as wide as the calculation will permit. Whichever basis is used, all four prices must be notified to the trustee/depositary in order that they can confirm any issue/cancellation required by the AFM, and also for subsequent use in testing the AFM's unit/share dealing records as part of its oversight responsibilities.

3. Single-Pricing

5.2.1 Be able to calculate prices for funds with a single share class

5.2.2 Know the AFM's discretion in setting dealing prices under single and dual pricing

3.1 Introduction

The dual-pricing system outlined in section 2 has both good and bad aspects. Investors pay an appropriate price for their investment, and the AFM is limited in its use of the bid/offer spread, yet quoting two prices can be confusing to investors. In many markets (particularly continental Europe), the stock markets only use a single price when trading assets, and so a dual-priced model for fund valuations appears out of place. AFMs seeking to market their schemes abroad needed a simpler pricing mechanism, which led to the single-pricing method being made available for authorised CISs.

A single-pricing method means that the AFM calculates one price at each valuation point. This price will be used for issue/cancellation with the depositary, and also used when selling/repurchasing units/ shares to/from investors at that valuation point (though any initial/exit charges would affect the overall price of an investor trade).

3.2 How Single-Pricing Differs from Dual-Pricing

The cause of the dealing spread in a dual-priced fund is the spread on the underlying portfolio of investments, the dealing costs on those investments, and the initial charge.

Rather than using the bid and offer prices of the underlying securities, a single-pricing fund will use a single price for each asset. Some securities markets quote only a single price for equities (the New York Stock Exchange (NYSE) being one example), and if bid and offer prices are quoted for an asset, the AFM will use an arithmetic average of the two prices. Single-pricing is therefore sometimes referred to as 'using the mid-price'.

While the AFM's initial charge is contained within the offer price calculated for dual-pricing, for a single-priced fund the initial charge will be shown as a discrete charge, applied separately to each investor's purchase of units/shares.

Notional dealing charges also affect the spread (albeit slightly) and so a different means of reflecting dealing costs must be used. The regulations for single-pricing permit two methods by which the cost of dealing in underlying investments can be appropriately factored into the price. These are the 'dilution levy' and the 'dilution adjustment'; a single-priced fund may apply one or other of these, but not both.

Unlike the bid/offer spread on underlying investments and the notional dealing charge (which were part of the price calculation for dual pricing), the dilution levy is an additional cost which may be made to each investor's transaction. The AFM will determine the conditions in which a dilution levy will apply – generally based on the size of the deal (a threshold value of £15,000 is commonly used) – and will calculate an appropriate rate for the dilution levy. The policy on charging the dilution levy is set out in the prospectus. The depositary will review these calculations (as with the calculations of the notional dealing charge percentages) to ensure that the AFM's rates are appropriate to the fund's investments and the actual dealing (brokerage) charges suffered.

Therefore, if a dilution levy is applied, the investor’s **contract note** will detail the transaction based on the single price, but with an additional levy charged to the investor. While there is officially a single price, an investor subject to the levy will effectively pay a different overall price from an investor whose transaction is small enough not to require the levy. The dilution levy method is, therefore, able to distinguish between larger and smaller investors.

The dilution adjustment is more subtle. Here, the AFM determines the expected net effect of the dealing activity during the day and establishes an approximate cost of the resulting underlying portfolio transactions within the fund. The single price calculated from the scheme property is then adjusted up or down to reflect the expected dealing costs. It is this adjusted price which becomes the single price applied to all transactions for that valuation point. Each investor deals at the same price at each valuation point, as the quoted price already reflects the necessary dilution adjustment. This approach is sometimes referred to as a ‘swinging single price’ (and the resulting price may be referred to as the ‘swung price’).

We can now revisit the example of a dual-pricing calculation in section 2, and draw up an equivalent example for a single-priced fund (prior to dilution):

Example

Asset		Mid		Pence per unit/share
		Price per share (£)	Value (£)	
Portfolio				
1,000	ABC Ltd	1.525	1,525.00	
1,500	XYZ Ltd	1.825	2,737.50	
2,000	HAL Ltd	1.475	2,950.00	
Total Portfolio Value			7,212.50	
Cash			300.00	
Total Capital Assets			7,512.50	
Net income / expenses			1,000.00	
Total Net Asset Value			8,512.50	85.13

In the above example, the price on the valuation date is 85.13p per unit/share (compared to the issue and cancellation prices of 86.76p and 83.86p, respectively).

A levy for dilution might be applied on particular investor deals. Alternatively, the AFM may adopt the dilution adjustment pricing method and adjust the single price in line with the aggregated dealing position of the AFM.

Again, the finalised price under any single-pricing method must be notified to the depositary.

While the examples shown in this chapter do not illustrate an exit charge, the regulations do allow for an AFM to levy such a charge on redemptions. Very few AFMs have introduced an exit charge, but the most frequent use of this ability is to apply a charge that decreases the longer the units/shares are held. For example, redemptions within the first year may suffer a 5% charge, reducing to 4% in the second year, and so on. Often under such charging structures no exit charge would be payable on units/shares held for five years or longer.

Those AFMs applying an exit charge will probably not apply an initial charge, enabling an investor to avoid both initial and exit charges by retaining their units/shares for the necessary period, though the AFM will collect their annual management charge (AMC) during that time.

3.3 Classes of Units/Shares

5.3.1 Be able to calculate prices for funds with multiple share classes

COLL funds are able to issue multiple classes of unit/share, each designed to meet the different requirements of investors. For example, a retail class might have a low initial investment level as retail investors may have smaller sums available. A class intended for institutional investors may have a higher initial investment requirement, though would probably apply a lower rate of charges.

This creates an important distinction in the calculation of the scheme price. Capital assets are allocated in proportion to the investments made in each class of unit/share. However, the net income and expense accrued since the previous valuation point is apportioned in accordance with the rules for each class. The apportionment between different classes is therefore affected by the number of units of each class at that valuation point, so the apportionment ratio may change daily.

This is in contrast to those CISs with only income and accumulation units/shares, where the **accumulation factor** reflects the income previously retained within the scheme. Such a factor is only changed at an accounting date where a distribution is payable. Remember that income units/shares receive a payment representing their proportion of the net income/expense accrued over the period, while the income due to accumulation units/shares remains in the fund. This means that after the first income distribution has taken place, the value of an accumulation unit/share must be higher than the corresponding income unit/share (to represent the income that was earned by the accumulation unit/ share but was not paid out).

To demonstrate this effect, let us consider the dual-priced valuation from earlier. The NAV on the bid side was £8,385.80 and there were a total of 10,000 units in existence (resulting in a bid price of 83.86 pence per unit).

Suppose that instead of having one unit/share class, this fund had 5,000 income units/shares and 5,000 accumulation units/shares. Suppose also that as a result of past distributions the 'accumulation factor' for this fund was 1.1 (effectively meaning that each accumulation unit/share is worth 1.1 times the value of the corresponding income unit/share). In such a scenario, the process for calculation will include an extra step.

While there are a total of 10,000 units/shares, those units/shares are not the same. The AFM must calculate the 'notional number of units/shares' – which is calculated as:

$$\text{Actual number of income units/shares} + (\text{Actual number of accumulation units/shares} \times \text{Accumulation Factor})$$

In our example: $5,000 + (5,000 \times 1.1) = 10,500$ notional units/shares.

The income unit/share price is then calculated by dividing the NAV by this notional number of units/shares (ie, $£8,385.80 / 10,500 = 79.86$ pence per unit/share).

The price of an accumulation unit/share is found by multiplying this income price by the accumulation factor. In this case, that results in an accumulation price of $79.86p \times 1.1 = 87.85$ pence per unit/share.

You can validate this result by working out the total value represented by these units/shares:

5,000 income units/shares @ 79.86p = £3,993.24

5,000 accumulation units/shares @ 87.85 = £4,392.56

This gives £8,385.80 (which we know to be the current value of the fund).

The value of the accumulation unit/share is higher to reflect the earlier distributions contained within those units/shares.

4. Calculating the Consideration for a Unit/Share Deal

5.4.1 Be able to calculate the purchase consideration and redemption proceeds

4.1 Dual-Priced Funds

We can now summarise what price would be applied to an individual trade. The position differs between single-priced funds and dual-priced funds.

For a dual-priced fund, this is simple: the published bid and offer prices include all necessary components (as dual-prices include notional dealing charges and any applicable initial charge or exit charge):

- An investor buying units/shares from the AFM will pay: number of units/shares x offer price
- An investor selling units/shares back to the AFM will receive: number of units/shares x bid price
- In respect of units/shares issued, the AFM will pay the depositary: number of units/shares x issue price
- For units/shares cancelled, the AFM will receive from the depositary: number of units/shares x cancellation price.

4.2 Single-Priced Funds

The core component is the single-price calculated at the valuation point. However, we have seen that this price would exclude any initial charge or exit charge being applied. If the fund applies a dilution levy this would also be outside of the price (though a dilution adjustment would have been applied within the calculated price).

Therefore, an investor buying units/shares from the AFM would pay the following:

$$(\text{Number of units} \times \text{single price}) + \text{any applicable dilution levy} + \text{any initial charge}$$

An investor selling units/shares back to the AFM would receive:

(Number of units x single price) LESS any applicable dilution levy LESS any exit charge

In respect of units/shares issued/cancelled, the consideration will be the number of units multiplied by the price, but the AFM must also pay to the depositary the total of any dilution levy collected on investor trades (this total being paid into the fund's bank account to enable investment in assets).

5. Errors in the Pricing of a Scheme

5.5.1 Know the minimum requirements relating to the controls around valuations (including fair valuation techniques)

5.5.2 Know what constitutes a pricing error, the consequences and the action to be taken by the AFM and depositary

5.5.3 Know the requirements for reconciling assets and units between the AFM, custodian and depositary

The valuation example shown earlier in this chapter is simple. In practice, the number and complexity of different investments which may be held can present problems in ensuring accurate price information and so make the valuation more complicated. Incorrect pricing of investments happens and cannot be avoided completely – the regulations provide guidance on the actions to be taken when these complex calculations are found to be incorrect. The regulations also outline various controls that the AFM should have in place in order to minimise the impact of pricing errors.

The regulatory provisions covering these problems can be found in COLL 6.3. These specific regulations give the depositary wide discretion to determine whether or not the AFM should compensate either the investors who dealt, and/or the fund as a whole. Subject to the AFM and depositary having appropriate controls in place to prevent incorrect pricing, it is necessary only to carry out the detailed investigation if an incorrect unit/share price is different from the correct price by plus or minus 0.5% (known as the *de minimis* level). The regulations cover the following areas:

- pricing controls by the AFM
- review of the AFM's systems and controls for pricing by the depositary
- the regulatory position of the AFM, and
- any action required if incorrect prices are found.

5.1 Valuation and Pricing Controls of the AFM

The AFM is required by regulations to exercise due diligence in connection with valuation and pricing, and to show that they have complied with the minimum control requirements set out by the FCA. It will be difficult for an AFM to argue that it has met the requirements if:

- persistent or repetitive errors occur, or
- errors occur which are consistently in the manager's favour.

The COLL rules offer guidance to the AFM on the controls it should be able to demonstrate over the pricing of units/shares. These include:

- ensuring asset prices are accurate and current
- ensuring portfolio transactions executed are promptly reflected in the valuation
- regular reconciliation of valuation components (eg, stock, cash, and units/shares in issue)
- regular review of any prices not obtained from primary pricing sources
- review of compliance with investment and borrowing limits
- prompt accounting for income items (such as dividends declared)
- regular review of the fund's tax positions
- tolerance limits to detect large movements in key components of the valuation
- review of the portfolio valuation by the fund manager, and
- valuation of any over-the-counter derivatives to be in line with the process agreed with the depositary.

As the above is FCA Guidance, each AFM will consider the thresholds and frequencies appropriate to these controls. For example, the tax position might be reviewed quarterly, while the fund manager might review the portfolio weekly. Checks on the accuracy of pricing in a daily-priced CIS will generally focus on static prices (ie, those which have not changed from the previous valuation point) or those which have moved by, say, more than 2% since the previous valuation.

The reconciliation of both the scheme assets and the units in existence are key to ensuring an accurate valuation and price calculation but are also important to ensuring that the CIS operates efficiently. The AFM must be confident that investment decisions are taken based on a correct view of the assets held by the fund. Similarly, if the AFM and the depositary do not agree on the number of units/shares in existence, the AFM might not recognise if a negative box position breach was to arise (which is significant as it is reportable to the FCA).

While many AFMs outsource the valuation process to a third-party administrator, the AFM remains responsible for the valuations and must ensure that the controls described above are effective.

Also, the money market instruments in which a money market scheme invests should be valued on an amortised (depreciated) basis with regular comparisons (at least weekly) to the market price to ensure they are broadly in line. The FCA provides guidance on appropriate action where the prices vary significantly.

5.2 Fair Value Price

Circumstances may arise where the AFM is unable to obtain a reliable price for a security at a valuation point. This may result from a failure of the price source to provide their data file, or may occur if the most recent price available does not reflect the AFM's best estimate of the value of a security at the valuation point. This second scenario may occur, for example, if no recent trade in the security has taken place, or where some significant political or economic event has occurred after the close of business of the market on which a security is listed.

In such circumstances, the AFM should value an investment at a price which, in its opinion, reflects a fair and reasonable price for that investment (the fair value price). Such **fair value pricing (FVP)** must be clearly documented and applied consistently. AFMs will normally have a pricing committee which, as part of their remit, will review such markets/securities for fair value pricing applications. The methodology used and rationale for fair value decisions will be reviewed by the depositary. If subsequent information comes to light that indicates the actual price was different from the fair value price, the latter will not normally be regarded as an incorrect price.

5.3 Pricing Checks a Depositary Should Make

The following sets out the types of checks that the FCA expects the depositary to perform to satisfy itself that the AFM's pricing operation is adequately controlled and the risk of incorrect prices is minimised.

- A thorough review and analysis of the AFM's pricing system and controls should be made to ensure they are satisfactory and to assess their reliability. This review should be conducted when the depositary is appointed and thereafter when appropriate, given its knowledge of the robustness and stability of the systems and controls and their operation, eg, on any major change in the valuation system, or where a series of minor changes could have a significant effect on accuracy.
- If the AFM's controls are found to be satisfactory, further review of these controls should be carried out at least annually.
- At least annually, a check of the valuation of each fund should be made. All assets, liabilities and accruals should be checked on a sample basis if the fund portfolio is very large, together with units/shares in issue and the **conversion factor** between unit/share classes. Also, in particular, a check of the prices of unapproved securities and the basis for the valuation of unquoted securities should be made.
- Checks will need to be increased if:
 - the manager's systems are manual, new and unproven, or otherwise regarded as weak, or
 - a number of occurrences of incorrect pricing have been identified.
- Any issues which are identified must be properly followed up and resolved.

5.4 How the AFM and Depositary Deal with Incorrect Prices

An AFM has a professional duty to ensure that prices used to value the investments are correct. The AFM also has a duty, if incorrect pricing has taken place, to take action to rectify the valuation. As was noted in the introduction to this chapter, the regulations require a price to be quoted to four significant figures. Many errors will be so minor as to not change the fourth significant figure. For instance, the single-pricing example in section 3.2 of this chapter calculated a fund value of £8,512.50 (and a price of 85.13p per unit/share). If the cash at bank figure of £300 was incorrectly calculated, adding 50p to the figure, the total fund value would have been stated as £8,513.00, still resulting in a price of 85.13p per unit/share.

Where the fourth significant figure is not affected, no pricing breach is recorded.

However, suppose the error had increased the cash figure from £300 to £320. The fund value would have been calculated as £8,532.50 (a price of 85.32p per unit/share). The fourth significant figure is changed and so the event is recorded as a pricing error. You will note that the error was large enough to also affect the third significant figure of the price, but the important feature in assessing a pricing error is the percentage by which the calculated figure differs from the correct figure.

Where the magnitude of the error is less than 0.5% the error is described as being below *de minimis* (the minimum level at which the AFM is required to recalculate all deals performed). The error here is £20 divided by £8,512.50 – being 0.23% and so this error would be below *de minimis*.

If the magnitude is greater than 0.5%, the error is above *de minimis* and all deals performed on that valuation point must be recalculated. This requires the AFM to both:

- reimburse or compensate any unitholder/shareholder that lost money because their trade was performed at the incorrect price, and
- recalculate any issue or cancellation of units/shares performed at the wrong price, with any AFM paying any shortfall or receiving back any excess payment it made.

All these steps are taken with the agreement of the depositary.

However, the regulations grant some flexibility to the depositary to judge an event appropriately. If the depositary is satisfied that the incorrect pricing is of minimal significance, the valuation must still be corrected but reimbursement need not be made. Equally, if the depositary considers that an investor who dealt during a below *de minimis* error has suffered material loss, it can require the AFM to compensate the investor. If the depositary considers the reimbursement or payment made by the AFM to be inappropriate it should report the matter to the FCA, together with its recommendation and justification.

The requirements can be summarised as follows:

- On discovery, incorrect prices (to the fourth significant figure) must be recorded by the AFM.
- The errors should also be reported to the depositary.
- Action should be taken to avoid repetition of the breach.
- Any significant pricing errors (eg, incorrect pricing of plus/minus 0.5% or more of the unit/share price) must be reported to the FCA by the depositary.
- Unit/share deals must be corrected in line with the following table. Correction is required even if the correct price would have been within the maximum and minimum prices permitted by the regulations.

Example

Compensation Decisions	Prices Incorrect By	
	Less than 0.5%	More than 0.5%
1. Dealings between fund and manager		
Fund Gains (issue – too high or cancellation – too low)	Normally no action	Depositary compensates AFM from fund
Fund Loses (issue – too low or cancellation – too high)	Normally no action (1)	Depositary directs AFM to compensate fund
2. Dealings between unitholder/shareholders and manager		
Incoming Unitholder/Shareholder Gains (price is too low)	No action	See (2)
Incoming Unitholder/Shareholder Loses (price is too high)	Normally no action (1)	AFM to compensate incoming unit/shareholders
Outgoing Unitholder/Shareholder Gains (price is too high)	No action	See (2)
Outgoing Unitholder/Shareholder Loses (price is too low)	Normally no action (1)	AFM to compensate outgoing unit/shareholders

Notes

1. In any of these cases, the depositary could, if they felt it appropriate, require the AFM to pay compensation, but this would be unlikely.
2. It may not be practical or even legally permissible for the AFM to seek compensation from unit/shareholders that benefited from an incorrect price. The AFM needs to consider its legal position and the commercial implications when deciding whether to seek compensation.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. What are the COLL requirements for the frequency of valuation points?

Answer reference: Section 1.1

2. What is forward pricing?

Answer reference: Section 1.3

3. Summarise the component elements in a CIS valuation.

Answer reference: Sections 1, 2 and 3

4. Explain single- and dual-pricing.

Answer reference: Sections 2.1 and 3.2

5. What payments may the AFM charge to the fund?

Answer reference: Section 2.2

6. What requirements relate to the use of a performance fee?

Answer reference: Section 2.2.2

7. What is the purpose of notional dealing charges?

Answer reference: Section 2.3

8. How is the issue (creation) price calculated?

Answer reference: Section 2.5

9. Explain the two ways in which a single-price fund can mitigate dilution.

Answer reference: Section 3.2

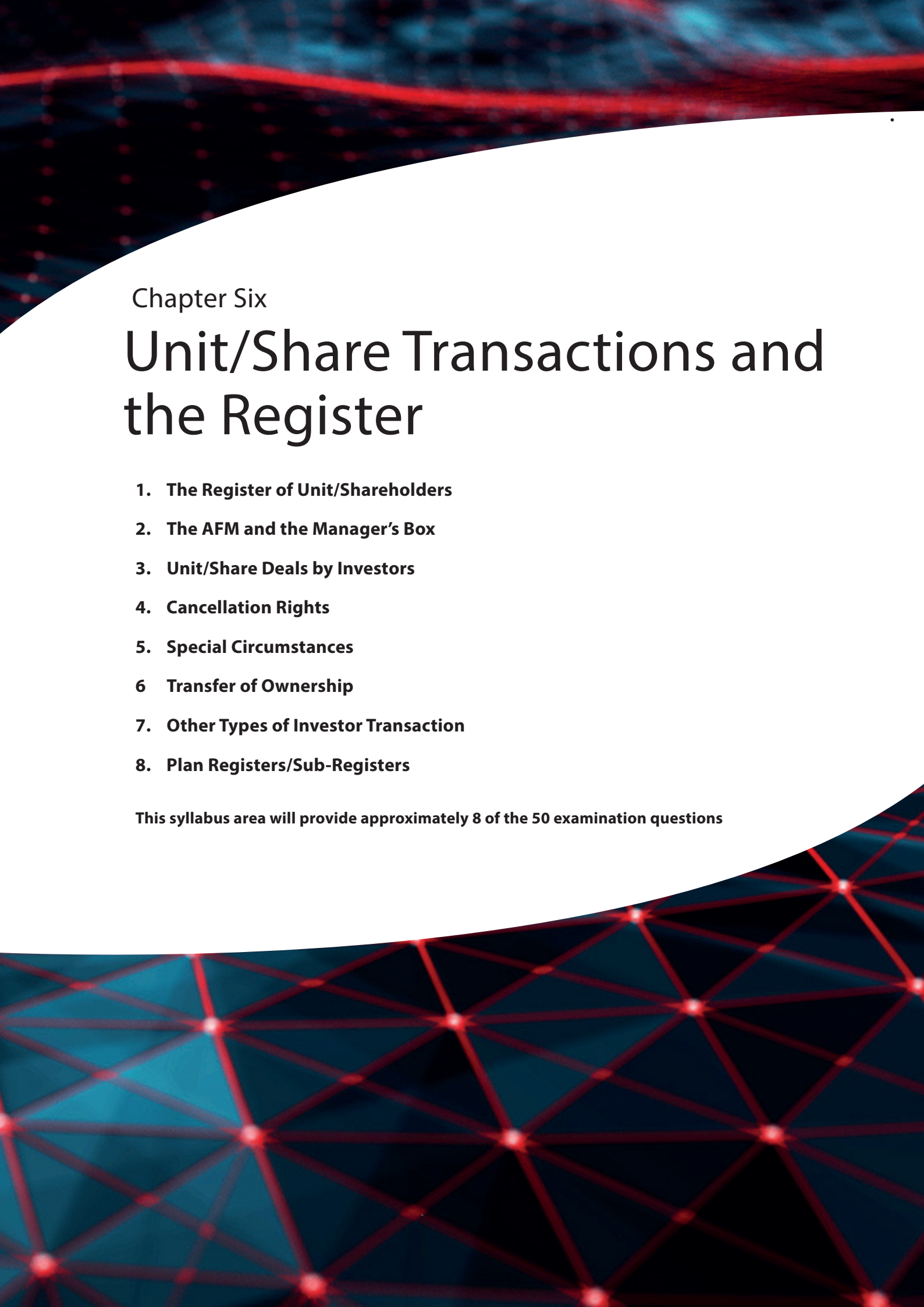
10. By how much does the price need to be incorrect for a manager to have to pay compensation to unitholders/shareholders?

a. plus or minus 1%

b. plus or minus 0.5%

c. plus or minus 0.05%

Answer reference: Section 5.4



Chapter Six

Unit/Share Transactions and the Register

1. The Register of Unit/Shareholders
2. The AFM and the Manager's Box
3. Unit/Share Deals by Investors
4. Cancellation Rights
5. Special Circumstances
6. Transfer of Ownership
7. Other Types of Investor Transaction
8. Plan Registers/Sub-Registers

This syllabus area will provide approximately 8 of the 50 examination questions



1. The Register of Unit/Shareholders

6.1.1 Know: the requirements for the establishment, maintenance and contents of a register; the entitlement to inspection; the process for rectification of registration errors; who can be registered as a holder of units/shares; the status of the register as proof of ownership; the registration treatment of third-party interests; the requirements for the collection of beneficial holder details

1.1 Overview

We have seen that a CIS exists in order to enable investors to gain as a result of the scheme's investment activity – both any capital growth arising from increases in the value of the portfolio (reflected in an increase over time in the unit/share price) and the income generated from the fund.

It is therefore essential that a clear record is maintained of how many units/shares are owned by each investor. That record is known as the register of the CIS. Being recorded in the register as the unit/shareholder is proof of owning those units/shares. Where unit/share certificates are issued to the holders, these are regarded as prima facie (on first appearance/face value) evidence, ie, holding a certificate is indicative of ownership, but is not conclusive.

(Note that it is possible for a UK CIS to issue [bearer units/shares](#), for which ownership is demonstrated by possession of a unit/share certificate. The register will record the number of bearer units/shares in issue, but will not record the identity of the holders of those units/shares. As it is very rare for a COLL fund to issue bearer unit/shares, this workbook will focus upon registered unit/shares).

For an authorised unit trust, COLL 6.4 states that either the AFM or the depositary must establish and maintain the register. The trust deed should state which of these parties has this responsibility. For an OEIC, the ACD is responsible for the register of shareholders (under Schedule 3 of the OEIC Regulations) – though it is common in either case for the work to be outsourced to a specialist third-party administrator.

As part of its own oversight responsibility, the depositary will carry out periodic inspections to ensure that the register is being maintained in accordance with COLL and the OEIC regulations.

The register must be in legible form at all times. In practice, the register is kept on a computer system with facilities to produce a printed copy when required. The COLL rules specify that the register must be accessible to holders free of charge at a location within the UK, giving holders the right to not only inspect how their own units/shares are registered, but to see the register entries for all other registered holders in that fund. The location at which the register can be reviewed will be stated in the scheme documentation, and will usually be the head office of the AFM (though offices of a third party might be used for this purpose).

While the FCA regulations require firms to act with due skill, care and diligence in relation to investors' accounts, errors will at times arise when maintaining the register. If an error is found in the register, the data must be corrected. Such corrections may require units/shares to be issued or cancelled, which requires the appropriate instruction from the AFM. The AFM should, therefore, ensure that it has established a proper internal checking/audit system for registering entries and changes.

1.2 Content and Maintenance of the Register

The entries on the register must contain the following:

- the name and address of each holder – up to four names may be registered per holding, as with property generally under English law and as specified under the OEIC Regulations
- the date each unit/shareholder's name was entered on the register
- number of units/shares of each type held by each holder. Note that COLL funds will usually enable investors to hold fractions of a unit/share (while listed equity trades in whole shares only)
- the number of bearer certificates issued, and the numbers of those certificates
- dates of change of unit/shareholdings, and
- date(s) of cessation of the unit/shareholding.

Any units/shares held in the manager's box must also be recorded.

The information contained in the register must always be complete and up to date. As unit/share dealing is a responsibility of the AFM, the AFM must ensure that the necessary details are added to the register for any new unit/shareholder. This usually involves the new holder completing a registration details form, accompanied by any documentation needed to complete KYC/AML verification ('Know Your Customer' and 'Anti Money Laundering').

The AFM will also ensure there are processes for the register to be updated as required (eg, when a unit/shareholder changes their name or address). Supporting evidence may be required for such changes to ensure the accuracy of the information and mitigate the risk of attempted fraud.

No notice of any trust (express, implied or constructive) is binding on the AFM and trustee. Although such notice may be entered on unit trust registers, such practice is prohibited in the case of a company register and most unit trusts adopt the same approach. This means that only the registered holder(s) can instruct the AFM to repurchase their units/shares.

The AFM will also ensure that the total number of units/shares recorded on the register reconciles with the total number of units/shares in issue. These reconciliations should, as a matter of good practice, be carried out at least monthly. The depositary is likely to expect evidence of satisfactory completion of these reconciliations.

1.3 Who can be a Registered Unit/Shareholder?

As investing in a CIS requires entering into legal contracts, the registered holder must be someone with what contract law calls 'contractual capacity'. This includes people and incorporated companies, but would not include unincorporated entities (such as clubs, trusts and partnerships). Note that there are some types of entity which are called 'trusts' but are actually incorporated (an example being an NHS Trust), so care must be taken to ensure that any such cases are treated correctly.

The following table summarises the position:

Requested holder	Acceptable of the Register?	Rationale
John Robert Smith	Yes	A person
John Smith Limited	Yes	A limited company is incorporated
John Smith plc	Yes	A plc is incorporated
... NHS Trust	Yes	While called a 'trust', an NHS Trust is a legal entity with contractual capacity
The Smith Partnership	No	Partnerships are not incorporated
The Trustees of...	No	As a collective, 'the trustees' have no incorporated identity
The ... Bowls Club	No	Not acceptable if the club is not incorporated
The Secretary of the ... Bowls Club	No	The title of 'secretary' does not have capacity
XYZ Trustees Limited	Yes	An incorporated company that specialises in providing trustee services can be a holder as it is incorporated

In cases where the listed item is not acceptable, it would be necessary to register the holding in a different way. For example, while 'the trustees of...' is not acceptable, the individual trustees of that trust could jointly become named holders of the units/shares.

It may be that a given holder is therefore responsible for different holdings, each having a different purpose, such as a parent wanting to have distinct holdings intended for their three children. A holding can be 'designated' at the request of the unit/shareholder; an alpha-numeric code can be added to each holding so that the holder can distinguish between those different holdings. While initials might be used, names should not be used as designations because of the potential of creating an implied trust.

Where units/shares are bought by a regulated firm on behalf of its own customers, it is common for those units/shares to be registered in the name of a **nominee** company; a type of limited company that has no other business activities and so distinguishes the firm's own assets from any assets it holds for its clients.

1.4 Other Types of Role

Aside from the registered holder of units/shares, there are other types of role that become legally important to the register. For example:

Role	Relevance
Attorney	A power of attorney is a legal authority by which a person authorises a specific person to act on their behalf. They might be used when a person is seriously ill, but might equally be used if someone was going to be travelling for a period and needed someone to look after their financial affairs during that period.
Executor	A person with legal responsibility for the estate of a deceased person. The executor must gather together the assets of the deceased person and see to their disposal in accordance with the will (or as they see fit, if no will was made).

A person holding such a role might be given authority over a given holding (once the AFM has completed the relevant checks to validate the identity of the party and the accuracy of their appointment). Money laundering rules require that any person identified as having a 'beneficial interest' in a holding must be verified, which is another reason why the AFM will not wish to acknowledge any 'trust' arrangements established, and will simply wish to deal with the registered holder as the owner of the units/shares.

2. The AFM and the Manager's Box

6.2.1 Know: how investors can buy and sell units from the AFM; the requirements for notification to the depositary or trustee; the AFM's responsibilities for issue and cancellation of units/shares

2.1 The Role of the AFM in Investor Deals

The UK rules for investor transactions in a CIS differ from the approach taken in many other fund jurisdictions (in which the investor effectively applies to the fund to become a shareholder). In the UK, the investor transacts with the AFM, buying and selling units with the AFM (who generally acts as principal in such contracts). Note: as mentioned earlier, the FCA is currently consulting on plans to introduce a 'direct to fund' approach for unit dealing in a UK CIS. As that approach has not yet been added to COLL, the following discussion of unit transactions is based on the existing COLL rules by which the AFM generally deals as principal).

As the investor's trade is executed by the AFM as principal, the investor's sale/repurchase transaction is settled by the AFM rather than by the fund. As a result, the investor will have a counterparty exposure to the AFM for a short period of time – though as the dealing process is defined by COLL regulations and the prospectus this should have no impact on the investor unless the AFM happened to become insolvent.

It should be noted that the COLL rules recognise that the AFM might in some cases act as agent rather than principal in respect of investor deals, and this tends to be used in cases where the investor will pay or receive assets to settle their trade (rather than paying or receiving cash settlement). Where the investor's deal is being settled by using assets (generally known as an *in specie deal*) the assets will be reregistered between the investor and the depositary account in which scheme property is held – thus avoiding the need for in specie proceeds to pass through the books and records of the AFM.

2.2 The Manager's Box

The AFM buys and sells units/shares at the price determined in line with the regulations (as described in chapter 5). A consequence of the CIS being open-ended is that the AFM should always be able to sell units to anyone who wishes to buy them (as additional units/shares can be created if required). Similarly, the AFM is obliged to repurchase units/shares from the registered holders – and can either retain such repurchased units/shares or might ask the depositary to cancel any excess balance arising.

Therefore, the AFM is said to have a 'manager's box' in which repurchased units/shares can be held until they are either cancelled by instruction of the AFM or are sold to another unit/shareholder. The balance of units/shares in the manager's box is effectively the difference between:

- the total number of units/shares that exist (used to calculate the prices at the valuation point), and
- the total number of units/shares that have been registered to holders.

The AFM is effectively the holder of any such units/shares, so retaining a balance in the manager's box means that the AFM is investing its own capital in its fund and is exposed to the same market price movement that affects all other holders.

During the dealing day the AFM will receive and process unit deals against this 'manager's box' without needing to track the rolling balance of available units/shares. As such, the AFM might at times process a deal to sell units/shares that at the time do not yet exist.

For many years it was usual for an AFM to maintain a balance of units/shares in each fund – partly to mitigate the implications of errors when performing investor trades – and in some cases the AFM would specifically seek to make profit from the price movements on their box units/shares. However, it is now common for an AFM to return to a nil box position at the end of each valuation point; issuing only as many units/shares as are needed to clear a negative balance, and cancelling any residue.

2.3 Notification/Instruction to the Depositary

Once the valuation point is reached (which ends the dealing day), the AFM is required to check the result of its investor dealing activity and determine the balance of the manager's box. Technically, the AFM of an OEIC will itself issue or cancel shares (and notify the depositary of this action), while in other cases, the AFM will instruct the depositary to issue or cancel units/shares as required:

Position as at the Valuation Point	Action by the AFM
Manager's box balance is negative	Must instruct/notify the issue of additional units/shares – at least sufficient to clear the negative position.
Manager's box balance is nil	No action required, though the AFM can choose to instruct/notify the issue of additional units/shares if desired.
Manager's box balance is positive	No action required, though the AFM can choose to instruct/notify to either: <ul style="list-style-type: none">cancel any quantity of the units/shares held in the box, orissue any number of additional units/shares if desired.

It is a serious COLL breach to leave the manager's box position negative rather than ensuring that sufficient units are issued, because the result would be that more units/shares would be held by investors than actually exist in the CIS, exposing the scheme to risk of loss if the AFM was to become insolvent without ensuring that sufficient units existed.

Note that as the box position can only be confirmed after the valuation point, there is a risk that the AFM's decision to issue or cancel might be influenced by how stock market prices have moved since that valuation. COLL rules require the AFM and depositary to agree a period following the valuation point (VP) by which the AFM will give an instruction to issue or cancel units. Where the AFM is seeking to generate profit from its manager's box, COLL states that the period should be short (eg, a couple of hours after the VP), but in other cases the notification period might be longer.

As such, most AFMs need to initially inform the depositary of issue/cancellation instructions based on estimated fund prices and provide a confirmed instruction once the fund prices have been calculated.

2.4 Settlement of Issues/Cancellations

COLL requires issues and cancellations to settle within four business days of the relevant valuation point. However, it is common for an AFM to choose to settle all types of unit/share transaction (including sales and repurchases with investors) within a shorter period. The settlement period for any CIS should be stated in the prospectus. (Many equity funds adopt a settlement period one day longer than the settlement period of the equities in which they invest. When major equity markets move to 'T+1' settlement in 2027, it is expected that many CISs will amend their prospectus documents to adopt a 'T+2' settlement period.)

By the end of this settlement period, the AFM must pay the depositary for any shares issued. If the scheme has insufficient cash in the relevant currency to effect a cancellation payment, COLL allows the settlement period to be extended until the shortage of currency is rectified. (Note that this flexibility delays the AFM's receipt of settlement of the cancellation, but does not affect the AFM's obligation to pay any redeeming holder.)

2.5 Box Management Errors

There are occasions when the AFM will make an error in calculating the box position. The FCA regulations permit that, providing that an effective control system is in place and with the agreement of the depositary, an isolated error in calculating the box may be corrected without paying compensation.

A common reason for box management errors is the tight deadlines on the AFM to notify the depositary of issues or cancellations; these deadlines are intended to protect investors from unscrupulous AFMs taking advantage of market movements. The guidance provided by the FCA:

- requires the AFM to be able to demonstrate that it has effective controls over its calculations of what units/shares it owns and that it can comply with requirements to prevent a negative box
- requires AFMs to record all negative box errors as soon as they are discovered and to report the fact to the trustee/depositary, together with details of corrective action to avoid repetition.

To correct the error, without paying compensation, the AFM must demonstrate to the depositary that it has effective controls. The error must be an isolated one and, except in exceptional circumstances, the adjustment to correct the original issue or cancellation instructions must be given to the depositary by the end of the day on which the issue or cancellation payment is due (usually three or four days after the relevant valuation point). While this provides potential flexibility for the AFM to correct an error without direct financial cost (as they can issue or cancel the intended units/shares at the original relevant price) making such a modification more than one day after the valuation point brings greater administrative implications as the box management position for each intervening valuation point must also be reviewed. The AFM must remember that any unresolved negative box positions are FCA-reportable by the depositary.

As a result of an error in the box calculation, an AFM may effect a late issue settlement. In such cases the AFM must reimburse the fund for any lost interest unless the trustee/depositary agrees the amount is not material.

3. Unit/Share Deals by Investors

6.3.1 Know how investors can buy and sell units from the AFM

6.3.2 Know how investor transactions are instructed: direct; via an intermediary firm

3.1 Instructions to Buy and Sell Units/Shares

Many investors will send instructions directly to the AFM when they wish to buy or sell units/shares. Most AFMs offer internet or telephone channels for such instructions, though paper remains a common medium for instructions.

Some investors retain the services of an intermediary to help their investment activity – such as an Independent Financial Adviser (IFA) – and so AFMs will also receive instructions from such intermediary firms.

Given the potential that an investor will hold units with a number of different AFMs (and possibly a portfolio that includes other types of asset too) it is also frequent for an investor to have an account with an investment platform. In such a case the investor's contract is with their chosen platform, and the investor will send their deal instruction to the platform rather than the AFM. The platform will perform a process to aggregate the trade orders of all of its own clients and will submit a single aggregated instruction to the AFM of each relevant fund.

As a result, where an investor deals through a platform it is the platform's nominee company that becomes the registered holder of the units/shares, and the AFM will have no direct client relationship with the underlying investor. This results in a more efficient service for the AFM (fewer deal instructions to process, usually transmitted via an electronic message, and less register maintenance), and so many AFMs will allow platforms to purchase unit/share classes that feature a reduced AMC.

Whoever submits the instruction to the AFM, it will usually take one of three forms:

- instruction to buy a stated value of units/shares
- instruction to sell a stated value of units/shares, or
- instruction to sell a stated quantity of units/shares.

Remember that as the trades are subject to 'forward pricing' the investor does not know the price of the units/shares when they submit their instruction. The AFM will process the trades to know whether the fund is growing or contracting, and once the prices for that valuation point are determined the correct price will be applied to each transaction.

Most AFMs offer a regular **savings plan** by which a monthly direct debit would be collected automatically from the investor's bank account and used to buy the types of units as instructed by the investor.

The COLL rules do not prevent an AFM from selling units/shares to a particular client at a discounted price (ie, a price lower than the price calculated as at the valuation point concerned). However, any AFM offering such discounts should ensure that its discounting can be defended within the bounds of treating customers fairly (TCF) and the Consumer Duty.

3.2 Dealing Cut-off Points

In general, an instruction received by the AFM will be dealt at the next valuation point. Therefore, if the fund has a noon valuation point, any instruction received by the AFM up until noon will be processed at that valuation point. This determines the 'trade date' of the deal.

However, it is possible for the AFM to state a cut-off point earlier than the valuation point by which any dealing instruction needs to be received in order to be dealt at that valuation point. Therefore, if a fund has a daily noon valuation point with an 11:00 cut-off, an instruction received at 11:30 on Monday will be dealt at the Tuesday valuation point.

3.3 Confirmation and Settlement

6.3.3 Know: the regulatory requirements for settlement; different methods of settling investor transactions

Once the prices are confirmed, the AFM is able to provide each holder with 'trade confirmation information' (also known as a 'contract note') stating the quantity and price of units/shares bought or sold, any additional charges applicable, and so confirm the cash payment that will settle the transaction.

When selling units/shares to investors, it is usual for the AFM to collect a means of payment with the purchase instruction. Payment might be accepted by debit card or direct debit, though cheques are still commonly accepted. An AFM will generally agree that an institutional investor will provide settlement by bank account transfer (in which case, the investor would be 'pushing' the payment to the AFM rather than the AFM 'pulling' the relevant value per the investor's original instruction).

Where the AFM has bought units from the holder (sometimes known as a 'repurchase') the AFM will effect a payment to the investor's bank account or issue a cheque to the investor.

Settlement is due a certain number of days after the 'trade date'. COLL regulations require that the AFM pay a redeeming investor no later than four business days after the price has been calculated (provided there is no outstanding KYC/AML check) though the prospectus can stipulate that settlement would occur in a shorter period. It is common for AFMs to apply the same settlement period when selling units/ shares to holders and for settlement of issues and cancellations.

3.4 Large Deals

6.3.4 Understand the AFM's discretion in relation to large investor deals: in specie transactions; dilution levy/dilution adjustment

The regulations permit an investor to pay for their units/shares by providing assets rather than cash, as long as these assets comply with the investment and borrowing powers of the fund. Such deals are referred to as '*in specie*'.

This may suit both the investor and the AFM by avoiding the cost and effort of market transactions in the securities. An AFM has the power to impose this approach on a large deal (generally one larger than 5% of the portfolio value) in order to avoid the existing holders from effectively bearing some of the brokerage costs of the fund trading a large value of assets as a result of another investor's actions.

Effectively, the AFM acts as agent so that units/shares are issued directly to the investor (rather than passing through the manager's box), with the investor settling the agreed assets directly with the depositary (rather than through the AFM) so that the investor effectively becomes party to the issue of units (rather than buying their units from the AFM).

Similarly, if an investor wishes to place a large redemption the AFM might instead insist that an in specie cancellation takes place instead, with the investor receiving directly from the depositary their proportion of the assets of the scheme.

The intention of in specie transactions is to avoid any undue costs being incurred by the other holders of the CIS, while also potentially reducing the market costs of a large investor.

Separately, we saw earlier that a single-priced CIS might feature a dilution levy to represent the costs associated with the portfolio trading within the scheme. It is common for AFMs to only apply a dilution levy to large deals (a typical threshold for applying the dilution levy is a deal value of £15,000). Note however that while a dilution levy may be applied to individual trades, a dilution adjustment is made within the price and so is applied to all deals at that valuation point.

4. Cancellation Rights

6.4.1 Know: the circumstances under which cancellation rights are available to investors; the circumstances where shortfall may be charged; how to calculate cancellation proceeds including shortfall

4.1 An Investor's Right to Change their Mind

In certain circumstances, the FCA rules permit an investor to cancel a financial services contract within a short period (normally within 14 days of the contract). These rules are set out in COBS 15 and are primarily intended to protect an investor against receiving poor treatment from an adviser or other intermediary who misrepresents the product/asset being sold.

Exercising a cancellation right allows the investor to be released from the contract – though they may still suffer any negative market movement that occurs over the period (to avoid potential for people to abuse cancellation rights to achieve quick no-risk profits) and may still be required to pay any appropriate charges relating to the service provided during the period.

However, in some circumstances, no such rights are applicable – such as where CIS units/shares are sold ‘at a distance’ (as defined under the DMD, discussed in section 5.6 of chapter 2). This is because the pre-contractual disclosure material is considered sufficiently clear that the investor should be fully aware of the instrument being bought. However, many AFMs voluntarily grant an equivalent cancellation right to all retail investors.

4.2 Firms Notify the Investor of the Right to Cancel

Firms are required by the COBS rules to explain to investors what cancellation rights are applicable, and the consequences of exercising those rights.

Cancellation rights may be communicated by providing:

- a summary of cancellation rights pre-sale, eg, in marketing material
- full details of those rights post-sale, eg, in a letter or brochure, together with a form in which the investor may give instructions to cancel, or
- a cancellation notice (a specific document which the investor would return to the firm if it wishes to cancel the specified contract).

4.3 Does the Investor Get All Their Money Back?

For a single-priced fund, an investor exercising cancellation rights will receive their money back unless the unit/share price has fallen since the units were bought. If the price has fallen they will receive the current price, and the difference between the original total cost and the cancellation proceeds is known as ‘shortfall’.

In the case of a dual-priced CIS, the shortfall on cancellation is calculated on an offer to offer basis. For example, if 1,000 units/shares are purchased at 209p, and the offer price is 196p at the time when the firm receives the notice from the investor that they wish to cancel, the shortfall is calculated as:

$$(209 - 196) \times 1000 = £130$$

The AFM has the right to charge shortfall unless:

- the firm fails to provide pre-sale cancellation rights information, or
- there is no mention of shortfall in the pre- or post-sale notice of cancellation rights.

5. Special Circumstances

6.5.1 Know the following scheme characteristics: limited issue; limited redemption; deferred redemption; notice periods

5.1 Limited Issue

COLL permits the AFM to limit the issue of units/shares in any class of unit/share, provided that the prospectus details the circumstances in which new shares can be issued. By preventing the issue of new shares, the AFM effectively removes its ability to sell units/shares if the manager’s box is empty. The prospectus must set out the ways in which the issue of units/shares might be limited (for example, the prospectus might specify a maximum number of units/shares, or a maximum fund value above which no issues will be performed).

Use of limited issue to manage the size of the fund should in theory make it easier and more cost effective for the fund manager to devise a capital protection method for investors. However, it raises additional considerations for the administration of unit/share dealing processes.

5.2 Limited Redemption

The investments made by certain NURS funds might make it difficult for the fund to retain sufficient liquidity to meet frequent redemption instructions from investors. Therefore, COLL rules allow NURS that invest substantially in physical property to apply ‘limited redemption’ arrangements. Such arrangements must be recorded in the fund’s constituting documentation, and the scheme must enable redemptions at least once in any six-month period. Different classes within a scheme can adopt different redemption arrangements.

5.3 Deferred Redemption

For daily-priced funds there is a risk that a significant redemption might force the AFM to cancel the units, requiring scheme assets to be sold quickly at less than their true economic values. In these circumstances, the unit/shareholders remaining in the scheme would be disadvantaged. To try to protect against this effect, COLL enables daily-priced retail funds to use a process of deferred redemption.

If redemptions at a valuation point are significant (eg, the value of redemptions exceeds a pre-disclosed figure, such as 10% of the NAV), the AFM may defer some or all of those redemptions to the next valuation point. COLL does not specify the exact method to be used (either pro rata dealing or holding all repurchases over to the next day) but does require the method to be fair to investors and disclosed in the prospectus.

5.4 Notice Periods and LTAF Redemption Deals

We noted earlier that a fund might feature a 'cut-off point', a stated time by which a holder's dealing instructions need to be received by the AFM in order to be dealt at the next valuation point. Such a cut-off is defined as a specific time of day; a fund with a noon VP might have a cut-off point of 10:00 that morning. Any deal order is therefore applied to the next cut-off point after receipt, and will be executed at the corresponding VP for that cut-off point. This ensures that holders retain the general right to deal without delay.

Separate from cut-off points, QIS and LTAF funds may include features known as 'notice periods' – though it must be noted that the term has a different meaning in these two scenarios.

For a QIS, COLL notes that the Prospectus might state that redemption instructions must be submitted to the AFM a number of days prior to the relevant VP. As usual for QIS funds, COLL is not prescriptive over the specific details of such a notice period – only that its definition and use must be clearly documented in the Prospectus.

The position for LTAF redemptions is different. Being a type of retail fund, the FCA rules impose a more prescriptive approach for holder redemptions – due to the reduced levels of asset liquidity that such a fund is expected to maintain. As we will see, a key part of understanding the LTAF redemption rules is distinguishing a redemption request from an accepted redemption order.

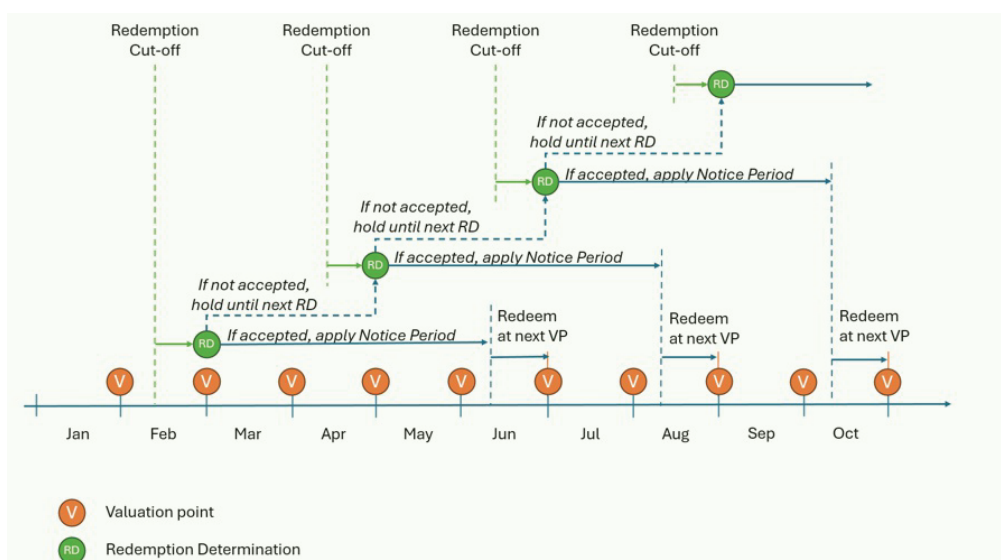
In contrast with other fund types, the AFM of an LTAF is not obliged to accept and act upon all repurchase requests at the next valuation point. A decision-making stage (known as the 'redemption determination') requires the AFM to either accept a redemption request, reject the redemption request (if justified), or make some other decision (which might for example be to allow part of the withdrawal to be accepted, while the rest of the request will be parked until the next redemption determination).

The LTAF rules also include an optional cut-off point (being a date prior to a redemption determination by which a given repurchase request must be received in order to be considered at that redemption determination), and a mandatory notice period (a period of at least 90 days between the point the redemption request was accepted (at a redemption determination) and the valuation point at which the accepted redemption will be executed and priced). Such mechanisms are the defining characteristics of LTAF dealing and have been prescribed into the rules to mitigate the liquidity risks arising as a result of the types of assets that an LTAF is allowed to invest in.

An LTAF must have at least one valuation point in each month (at which prices will be calculated and units can be sold to investors) – but there can be fewer redemption determinations than valuation points (the rules do not permit more than one redemption determination each month).

The following diagram illustrates the resulting redemption arrangements for an LTAF that has the following features:

- A monthly valuation point
- A redemption determination every two months
- A redemption cut-off period of two weeks
- A notice period of 100 days.



Note that the redemption cut-off is optional, but the notice period is required by the regulations (and must last at least 90 days after the 'acceptance' of the redemption request at a redemption determination).

From a perspective of fairness across the holder population, any holder is allowed to withdraw a redemption request until the point at which that redemption request has been accepted by the AFM (at a redemption determination) – but once accepted the redemption order becomes irrevocable. This gives the AFM certainty of the level of committed redemptions during the notice period and so enables the AFM to begin the relevant arrangements to liquidate fund assets in readiness for the resulting cancellation of units/shares.

5.5 Suspension of Dealing

6.5.2 Know the circumstances when dealing may be suspended

We have seen that the AFM is involved in two types of unit/share transaction: sales and repurchases with unitholders; issues and cancellations with the depositary. Provided that the fund's assets are sufficiently liquid, the AFM will readily be able to balance these two dealing activities. However, a problem can arise if the AFM experiences a large value of repurchase deals (which should be settled with the investor) but the fund is unable to sell enough of its assets in the normal market and so cannot pay the AFM the proceeds of any cancellation instructed.

This is one example where the AFM's own capital becomes at risk as they might for a period of time have the financial resources to hold an increased number of units/shares in the manager's box before instructing the cancellation of extra units/shares. However, if the market problem is expected to continue there will come a point at which the AFM will no longer be able to accept the risk of accepting further redemption deals from holders – even if the scheme is using techniques such as limited redemption or deferred redemption.

In such a situation, the AFM can seek the depositary's agreement to suspend dealing in the fund. The consequence is that the AFM's dealing obligations are effectively suspended. There will be no issue, cancellation, sale, or repurchase transactions performed during the suspension (though the AFM must still continue to manage the fund in accordance with other areas of COLL, including the obligation to calculate fund prices and satisfy the investment limits). Suspension might also be considered if some systemic problem is identified within the fund's records (such as an error that significantly affects the accuracy of fund pricing or the unit/share register), and so it is not a course to be taken lightly. In any scenario, the depositary must agree that the proposed suspension is in the interests of investors, and if required the depositary can impose suspension on a fund. The fund should re-open for dealing once the problem has been resolved.

Once the depositary has agreed to (or imposed) suspension, the FCA must be notified. The AFM must notify investors of the suspension, and must keep investors informed during the period of suspension. If the suspension lasts for a long time, the depositary and AFM must formally review the situation at least every 28 days to confirm that suspension remains the appropriate action. The suspension must end once the unusual circumstances have been resolved, and the FCA must be advised accordingly.

Suspension brings operational challenges. A key administrative decision that COLL requires the AFM to make is whether any investor transactions received during the period of suspension will be: (a) held in a queue, waiting for the dealing processes to resume; or (b) rejected on the basis that the AFM is not at that time dealing in the suspended fund. If the AFM chooses to accept the orders and place them in a queue, there are two important consequences. Firstly, investors must be given a right to subsequently cancel an order from that queue (at their choice). Secondly, the AFM is storing up a large volume of transactions – all of which will need to be processed on the first valuation point after dealing resumes. The AFM will also need to decide whether it will hold onto any client money received from investors during this period, or will return any such monies to the investor concerned. While suspension of dealing is a rare event, high-volume retail AFMs are likely to simply reject orders they receive during a suspension.

6. Transfer of Ownership

6.6.1 Know the processes and information requirements for transfers from the holder: to the AFM; to third parties; by electronic transfer; by operation of law

As a registered security, title to units/shares is transferable either by the holders or by what is called 'operation of law' (such as following the death of the holder).

6.1 Transfers by the Holder

There are two common types of transfer initiated by the holder of units/shares in a CIS.

The first type reflects a transfer from the holder to a third party, in accordance with the Stock Transfer Act 1963. Units/shares may be transferred by the current holder completing a stock transfer form which is sent to the AFM/depositary and accompanied by the unit/share certificate (where issued). If the transfer form is completed correctly, and any appropriate stamp duty is paid, the register will be updated, and a new certificate (where issued) will be issued in the name of the third party to whom the units/shares have been transferred.

As the AFM must verify the identity of all registered holders, underlying beneficial owners or other controllers (as required by money laundering regulations), the Investment Association (IA) developed a bespoke transfer form for UK funds. Other provisions relating to the transfer of legal title between registered holders continue to apply as set out in the Stock Transfer Act 1963.

The second type of transfer occurs when the unit/shareholder sells their units/shares back to the AFM. While usually described as units/shares being repurchased by the AFM, in practice, the holder needs to renounce their claim to ownership of the units/shares; effectively, the holder transfers such rights to the AFM (even though the AFM does not become the registered holder of those units/shares).

Most AFMs will require some manner of written confirmation from the investor, and some AFMs will request the use of a specific form (usually known as a renunciation form). A template form of renunciation would be approved by the AFM/depositary and may be provided to the investor with the contract note or on the reverse of any unit/share certificate previously issued.

In either case, the form must be signed by the person transferring the holding (or any person legally acting on their behalf, such as under a power of attorney). This person is known as the transferor. In the case of a 'joint holding' (units/shares registered in the names of two or more holders) all holders must sign. If the holder is a corporate body, the transfer may be executed either under seal or signed by authorised officials of the company. It is normal for two signatures to be required in such cases, either from two directors or one director and the company secretary.

All instruments of transfer must be retained for six years from the date of registration. Where a system is used for taking/recording images, the firm should ensure that such images will be acceptable by the courts and the regulatory authorities under best evidence rules.

6.2 Electronic Transfer of Title/Renunciation

The FCA rules permit the acceptance of electronic communications for transfer and renunciation of title where the person responsible for the register takes 'reasonable steps' to ensure the authenticity of the instruction. Those steps are not prescribed in legislation or regulations, but are instead left to FCA-confirmed industry guidance prepared by the IA. The objective is to:

- permit more automated and efficient processing for investors, while
- providing adequate protection to the AFM and to investors against fraud.

Holders therefore have a choice whether to authorise the transfer of title by use of physical documents (such as a stock transfer form or form of renunciation) or an electronic message, subject to the AFM being willing to act without the relevant documents, and accepting the associated business risk. A properly appointed agent (such as an IFA) would have authority to use an electronic means to transfer title.

The IA introduced a model Electronic Renunciation Agreement which is available from the association website together with explanatory notes. This aims to satisfy the requirements where units/shares held in a nominee name are being redeemed by a financial institution.

In particular, electronic transfer instructions might be sent to the AFM via message carriers such as Calastone, EMX, TeX, or STAR. These are particularly relevant in enabling efficient and automated platform-to-platform re-registration (with the AFM needing to record the units/shares as being held by a different nominee).

6.3 Transfers by Operation of Law

In the case of a joint holding of units/shares, on the death of one of the holders the surviving holder(s) is (are) recognised as having title to the units/shares. The death certificate must be provided, together with unit/share certificates (where a certificate was issued). The register is then updated and (where applicable) a new certificate is issued in the survivors' names.

If either a sole holder or the last surviving holder dies, authority to deal with the holding rests with the executors or administrators of the deceased holder. A 'Grant of Probate' or 'Letters of Administration' will be required in such cases to establish title. The executors or administrators of the estate can complete a simple Letter of Request form to have the holding placed in their names as holder, without reference to the deceased. Alternatively, they may transfer the units/shares to beneficiaries by means of the usual stock transfer process outlined above, or sell the units/shares back to the AFM.

This type of transfer may also take place in the event of the bankruptcy or liquidation of the current holder. It will be necessary to provide satisfactory evidence of the appointment of the person claiming title to the units/shares (such as a receiver) before any transfer is registered.

7. Other Types of Investor Transaction

6.7.1 Know: the meaning of a conversion and exchange of units/shares; how to calculate the number of units following conversion; the IA's suggested formula to ensure proper and fair exchange of shares/units

7.1 Unit/Share Conversion

The term 'conversion' is used to describe a transaction by which a holder asks the AFM to change income units into accumulation units (or vice versa) of the same fund/sub-fund. The COLL regulations allow for conversions providing that there are appropriate provisions in the prospectus.

The holder will instruct the conversion, which will be performed by the AFM/depositary based on the current accumulation factor (which has been discussed in respect of valuations and pricing).

If a holder converts their units/shares, the cash value of their holding at that valuation point should remain unchanged – and so the number of units held by the investor must change. Each accumulation (acc) unit is worth more than an income (inc) unit, and so converting from acc to inc will result in the holder having an increased number of units from that day onward. The AFM will normally issue a confirmation letter giving the details of the conversion and the number of new units/shares held.

As there has been no change in the assets held in terms of the undivided shares in the property of the scheme, conversions are not regarded by HM Revenue & Customs (HMRC) as a disposal and acquisition for capital gains tax (CGT). We will see in chapter 9 that units/shares are categorised into either Group 1 or Group 2 for equalisation purposes (which affects the taxation of the following distribution), and so a conversion will not change the grouping of the holder's units/shares. For example, if 30% of the investor's units/shares were Group 1 before the conversion, that same proportion would be Group 1 after the conversion.

Technically, under the COLL rules, conversions result in the units/shares changing their nature (rather than being a sale and repurchase of units/shares performed through the manager's box).

Example

A unitholder wishes to convert his 400 accumulation units/shares of the XYZ dividend fund to income units/shares. The conversion factor at the last ex-distribution date for the fund was 2.1250.

To establish the number of income units/shares to be allocated, multiply the number of accumulation units/shares by the conversion factor:

$$400 \times 2.1250 = 850 \text{ income units/shares}$$

To complete a conversion from income units/shares to accumulation units/shares, the income units/shares are simply divided by the conversion factor to produce the number of accumulation units/shares to be allocated.

If the price of an income unit/share in this example were 60 pence per unit/share then the price of the corresponding accumulation unit/share would be 127.5 pence per unit/share (being the income price multiplied by the current factor to reflect the income which has been retained over time within the accumulation unit/share). This shows that the value of the units held immediately before and immediately after the conversion is unchanged at £510.

7.2 Exchange of Units/Shares

Where there are more classes of unit/share than a simple pair of income and accumulation units/shares, the process is different. The term 'exchange' refers to an investor exchanging one class of a fund/umbrella for any other class (in contrast to a 'conversion' between income and accumulation units/shares). Unlike a 'conversion', an exchange does result in units being repurchased and sold, though exchanges between classes of a single fund/sub-fund are not subject to CGT.

On receipt of a completed instruction, the AFM will exchange the units/shares through the manager's box. To ensure that a proper and fair exchange is used between units/shares of different classes, the following formula is suggested in the model instrument to be applied to work out the number of units/shares to be issued:

$$N = O \times \frac{(CP \times ER)}{SP}$$

where:

N is the number of new units/shares to be issued or sold (rounded down to nearest whole number of smaller denomination shares).

O is the number of original units/shares specified (or deemed to be specified) in the exchange. Notice the units/shares that the holder has requested to exchange.

CP is the price at which a single original unit/share may be cancelled or redeemed as at the valuation point applicable to the cancellation or redemption as the case may be.

ER reflects the currency exchange rate (and so is 1 if the original and new units/shares are designated in the same currency). Otherwise, the AFM will determine the effective rate of exchange between the two relevant currencies, as at the date the exchange notice is received by the scheme and adjust the rate to reflect costs incurred by the scheme making any transfer of assets as may be required.

SP is the price at which a single new unit/share may be issued or sold as at the valuation point applicable to the cancellation or redemption as the case may be. The AFM may adjust the number of new units/shares to be issued or sold to reflect the imposition of an exchange charge or other levies to cover the costs involved. After the above has been completed, the appropriate alteration to the register will be made.

Details of the arrangements for exchange or conversion of units/shares will be included in the prospectus/trust deed.

8. Plan Registers/Sub-Registers

6.8.1 Know the requirements governing the sub-registers for savings plans and ISAs

Many AFMs offer their CISs within other financial services products, most commonly a stocks and shares ISA. The ISA regulations limit how assets held by an ISA manager can be registered; the ISA manager might simply hold an aggregated position containing all its client's assets, or it could hold a set of positions each being jointly registered between the ISA manager and the relevant ISA client.

Where the AFM is the ISA manager, it is therefore possible that the main register of the fund will reflect a single nominee position of the ISA manager with the investor-level records of each ISA being held in a different part of the AFM's systems. In such a situation, the record of asset entitlement of each ISA holder might be referred to as a 'sub-register'. The main register confirms how many shares are held by the nominee company in respect of the ISAs, and the sub-register records how many of those units/shares are held on behalf of each plan investor (both levels of records being the responsibility of the same regulated firm).

Section 6.4 of COLL permits the cost of maintaining any savings plan sub-registers operated by the AFM to be paid out of the property of the scheme, provided the plan holders are afforded the same rights as those investors who hold units/shares directly on the main register (ie, not through a plan). Such rights include receipt of the fund manager's reports and the right to attend and vote at unit/shareholder meetings.

Such sub-registers are subject to oversight by the depositary (as the AFM is running the savings plan and charging associated expenses to the fund) and will be included in the depositary's monitoring programme (including monitoring of any third-party administrator retained). Consequently, the depositary will require that periodic reconciliations are performed, matching the units/shares on the sub-registers against the nominee's holding(s) on the main register, and will generally review such items during regular monitoring visits.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. What details of a unit/shareholder must be entered on the register?

Answer reference: Section 1.2

2. In which of the following names could units/shares be registered?

- a. John Smith
- b. Smith & Co
- c. J. Smith Ltd
- d. The Trustees of J. Smith deceased

Answer reference: Section 1.3

3. Who is responsible for the issue and cancellation of units/shares in a CIS?

Answer reference: Section 2.3

4. How and when are issue and cancellation instructions settled?

Answer reference: Section 2.4

5. What should happen if an AFM makes an error in the number of units/shares cancelled?

Answer reference: Section 2.5

6. When an investor is buying units via a platform, how will that order be communicated to the AFM?

Answer reference: Section 3.1

7. What is the regulatory settlement period for redemptions?

Answer reference: Section 3.3

8. For in specie cancellations, at what percentage are these normally chosen to be applied by the AFM?

Answer reference: Section 3.4

9. Under what circumstances has an investor the right to change their mind and cancel their investment?

Answer reference: Section 4.1

10. Explain why a fund might offer a limited issue of units/shares?

Answer reference: Section 5.1

11. If an AFM wishes to suspend dealing in a fund, which of the following must agree in order for the suspension to take effect?

- a. The Investment Association
- b. The PRA
- c. The FCA
- d. The trustee/depositary

Answer reference: Section 5.4

12. What is required from the executors of a holder before such executors may have units/shares transferred into their own names?

Answer reference: Section 6.3

13. When converting from accumulation units to income units, will the number of units held by the investor increase or decrease – and why?

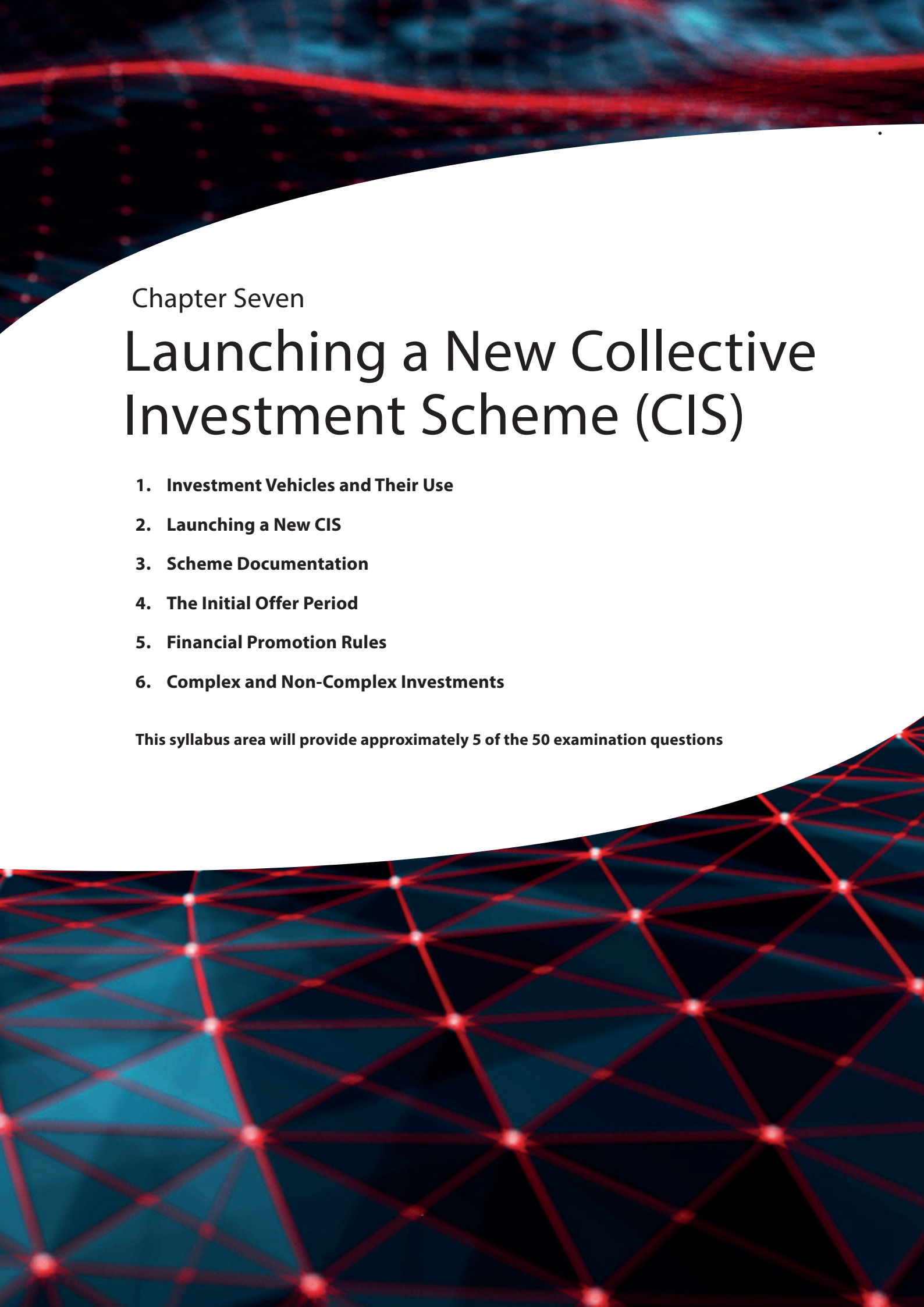
Answer reference: Section 7.1

14. Explain the formula for an exchange of unit/share classes.

Answer reference: Section 7.2

15. What obligation arises if the AFM wishes the costs of a sub-register to be paid from the property of the scheme?

Answer reference: Section 8



Chapter Seven

Launching a New Collective Investment Scheme (CIS)

1. Investment Vehicles and Their Use
2. Launching a New CIS
3. Scheme Documentation
4. The Initial Offer Period
5. Financial Promotion Rules
6. Complex and Non-Complex Investments

This syllabus area will provide approximately 5 of the 50 examination questions



1. Investment Vehicles and Their Use

7.1.1 Know why collective investment schemes are relevant to investors today: comparative features, advantages and disadvantages in contrast to other forms of investment (direct and indirect); the key differences between onshore and offshore funds

We can now reflect on what we have learned about COLL funds to see how they compare with other types of investment options that might be available to an investor.

1.1 Advantages to Investing via a Regulated CIS

There are many advantages to investing via a regulated CIS – particularly for the retail investor:

- **A specific investment objective** – each CIS has a stated purpose, and a geographical area in which it will seek to invest money. One CIS might seek capital growth by buying shares of companies based in the Asia-Pacific region; another might seek high rates of income by investing in government stocks and corporate bonds.
- **A professional investment manager** – the AFM is responsible for selecting the assets in the CIS's investment portfolio to achieve the investment objective.
- **Financial efficiency** – by pooling the money of many investors, a CIS is able to perform larger trades and so reduce charges as a proportion of the total value.
- **Easy regular investment** – most AFMs enable investors to make monthly investments using a direct debit to pay for the units/shares bought.
- **Breadth of asset types** – the greater values available for investment enable the investment manager to access some types of asset that would not be available (or might be too risky) for an individual investor acting alone, such as investment in commercial property. As part of a diversified investment portfolio such assets can generate substantial growth, while the impact of loss can be reduced (compared with putting all your eggs in that particular basket).
- **Legal Structure** – the CIS has a legal structure that gives rights to the Investor; it is more structured and formal than (for example) an 'investment club'.
- **Regulatory protections** – the FCA sets rules for how UK authorised CISs should operate, and so mitigates the risk to investors.
- **Liquidity** – trading on financial markets requires a willing buyer to agree a price with a willing seller; the job of a broker is to bring about such agreements, but if nobody wants to buy your asset when you want to sell it, you may have to accept a lower price, or might find yourself unable to sell the asset. By contrast, regulated CISs tend to be 'open-ended' meaning that the company operating the scheme can issue new units/shares in the scheme if people want to buy into the scheme and can cancel unused units/shares if the scheme is contracting. In rare circumstances, the company operating the CIS may need to suspend dealing in the units/shares of the CIS, in which case investors can neither buy nor sell the CIS, but at other times they should receive a reliable price representing their portion of the overall property of the scheme.
- **Transparency** – often a consequence of regulatory obligations, there is much information available to potential investors in CISs. The prices at which CIS units/shares can be bought and sold are published daily. A set of reports and accounts (effectively the financial accounts) is published for each regulated CIS, and other disclosure materials and factsheets give investors an overview of the Scheme's investment approach and activity. In particular, such disclosures should enable a potential investor to understand the level of costs and charges arising in a particular regulated CIS and compare the level of charges between different authorised funds.

1.2 Comparison with Similar Forms of Investment

While investors can choose from a range of different types of investment product, the regulated CIS offers a combination of attributes that distinguishes it from other alternatives. The result is that authorised funds have for many years been a popular type of asset within tax-efficient savings products (such as ISAs). As a result, a large number of funds are available, with many AFMs competing to sell funds that have similar investment aims and similar levels of charges.

Here are some brief comments about some other types of investment products and how they compare with regulated CISs.

1.2.1 Investment Trust Companies (ITC)

These are listed companies whose business activity is investing for profit – ie, they have a corporate structure rather than being constituted as a ‘trust’, and so the ITC is owned by its shareholders. The share capital of an ITC is fixed (ie, it is ‘closed-ended’ rather than ‘open-ended’), meaning that an investor can only buy ITC shares if an existing shareholder is willing to sell. As a result, the price of an ITC share does not directly reflect the value of the underlying portfolio of assets held by the ITC but is affected by the supply and demand for the ITC shares themselves.

As the ITC is not regulated, it is not subject to the COLL investment limits so may therefore have greater flexibility over the investment strategy it will follow, though whether such flexibility results in higher profits is of course a matter of the investment manager’s success.

An investor wishing to invest in ITC shares will need a custodian service to hold those listed shares, which adds a distinct cost and might make the asset type less appealing to smaller investors. Many firms that operate ITCs offer an investment trust savings scheme which is essentially a packaged dealing and custody service that enables investors to buy and hold shares in one or more of that firm’s ITCs.

1.2.2 Exchange Traded Funds (ETFs)

ETFs are an attempt to balance the attributes of ITCs and regulated CISs. As the name suggests, ETFs are traded on investment exchanges (similar to ITC shares). Most ETFs are designed to track the price performance of a specific market index, though the way this might be achieved can differ. Some ETFs buy an actual portfolio of assets reflecting the index they intend to track (known as having a ‘physical structure’), while others use financial derivatives (such as futures and options contracts) to gain a corresponding market exposure without actually buying the assets (known as having a ‘synthetic structure’).

This choice affects the investment risk faced by the investor. Where a physical structure is used, the investor’s risk relates to the specific assets bought in the ETF, and how effectively those assets track the benchmark index. Where a synthetic structure is used the costs may be lower, but the ETF (and so also the investor) is exposed to counterparty risk if the party entering into the derivative contracts with the ETF was to fail.

ETFs therefore offer a set of benefits that are popular with both institutional investors and retail investors:

- **Lower costs** – ETFs tend to have lower charges than many traditional pooled funds.
- **Reduced risk** – ETFs provide diversification of exposure – normally related to a market index.
- **Transparency** – ETFs offer a high degree of transparency regarding the ETF portfolio holdings, the ETF performance and costs.
- **Flexibility** – there is a wide choice of ETFs available, and they can be bought and sold through a stockbroker or financial adviser.
- **Access** – intra-day trading at, or close to, net asset value is possible, and ETFs can give access to a whole market by the purchase of just one share.
- **Structure** – ETFs can be structured as UCITS schemes (though would remain outside of the COLL which govern regulated CISs).

1.2.3 Endowment Policies

These are financial promises from the firm writing the policy, which generally guarantee to pay a lump sum upon maturity (normally 10–25 years after issue), plus annual bonuses. Capital gains tax is incurred by the life fund on its investment activity, and not by the investor when surrendering their investment. By contrast, a regulated CIS is exempt from CGT on its investment activity, but the investor is subject to CGT when selling their units/shares (though the investor might be able to mitigate or avoid actual CGT liability through use of their personal allowance, or by holding the CIS units/shares within an ISA).

There are often heavy penalties if the policy holder surrenders their policy in the early years after purchase, while exit charges in a regulated CIS are rare.

The value of a CIS unit/share can be readily checked (such as by telephone or the internet). A notice of bonuses is sent to the endowment policy holder only annually.

1.2.4 Insurance Bonds

These are insurance policies that act as a form of ‘tax wrapper’ around certain investments. They have similar tax treatment as noted above for endowment policies.

1.2.5 Offshore Funds

While a regulated CIS would be domiciled in the UK, an offshore fund is domiciled elsewhere, such that the income generated by the fund would be subject to the tax regime of the relevant country. Offshore fund domiciles such as the Isle of Man, Channel Islands, Luxembourg or the Republic of Ireland are popular as a result of their domestic tax rules which are often perceived as advantageous for the investor, though the effect of then paying UK tax on the gains must also be considered. Offshore funds have therefore been popular with investors who are non-domiciled in the UK for tax purposes, as such investors would avoid any UK tax liability on their offshore bond investments provided the proceeds/profits are not remitted into the UK.

As with all types of investment product, investors should ensure they understand the products they are using; the charges for offshore funds, and tax costs, may be higher than for UK funds, and offshore funds may offer less legal protection than applies to a UK fund. Offshore funds can only be marketed to investors in the UK once they have been recognised by the FCA.

Investors should be aware that offshore funds can have unusual impacts on their tax position. If a fund has received ‘Reporting Fund’ status from HMRC, any gains or losses arising to the investor from their trading in the fund are treated as capital gains or losses for UK tax purposes. However, if the fund does not hold Reporting Fund status, any gain is instead treated as income and is subject to UK income tax at the investor’s marginal rate.

2. Launching a New CIS

7.2.1 Know the regulatory requirements for the establishment of a scheme: the process and requirements of authorisation; required documentation

2.1 FCA Authorisation of a CIS

In chapter 2, we saw that a financial services firm active in the UK needs to be authorised by the Financial Conduct Authority (FCA) for the specific types of investment activity it performs for its clients, such as dealing, giving financial advice, or acting as a custodian.

A notable feature of a regulated CIS is that the product itself is subject to FCA authorisation, in addition to the AFM that is operating the CIS. Once the fund is authorised, the AFM must ensure that it manages the fund in line with the relevant COLL rules.

The authorisation process requires the AFM to submit various documents to the FCA in order to demonstrate that the fund will be operated in a way that complies with these regulations. The application form itself (which differs according to the legal structure of the CIS) asks questions on topics such as:

- the investment strategy to be followed
- how the fund's name was chosen
- the key parties responsible for the CIS – including the AFM, the depositary, the fund's auditors, and any separate investment adviser being retained
- how and when the AFM intends to launch the fund, or
- how the fund will be sold/marketed.

In addition to the relevant application form, the AFM must also provide a number of supporting documents:

- Draft trust deed/instrument of incorporation/contractual scheme deed (according to the legal structure of CIS being created). This is normally based on a model template created by the IA, and any deviations/omissions should be highlighted.
- Draft prospectus, noting where specific items required by regulation are located.
- A solicitor's certificate confirming the above matters.
- An example asset portfolio.
- A draft of the KIID/NURS-KII/PRIIPS KID that will be applicable.

Some extra information is required for certain types of schemes (eg, a money market fund or a Fund of Alternative Investment Funds (FAIF)).

This information should help the FCA be confident that the AFM understands its obligations in respect of the new scheme. FCA will review the material, discuss any queries with the AFM, and provided the FCA is satisfied, it will grant authorisation to the new CIS. FCA is required to complete the authorisation process for a UCITS within two months, with this period increasing to six months for NURS, QIS, and LTAF.

Once the fund has been authorised, the AFM can then progress its plans for launching the scheme.

3. Scheme Documentation

7.3.1 Know the AFM's responsibilities to make available and/or supply to potential investors in what form and with what timeframe: Prospectus; Key Investor Information Document (KIID), NURS-KII and PRIIPS KID; Supplementary Information Document; Report and accounts; Trust Deed/Instrument of Incorporation/Contractual Scheme Deed; Assessment of value report

An AFM must create a number of documents in respect of each COLL fund it operates. Some of these documents need to be provided to the FCA as part of the FCA authorisation pack, while others are part of the AFM's governance process for creating a new fund. Some types of document need to be offered or provided to potential investors, while others (such as the report and accounts) are periodic publications.

In this section, we will consider the purpose, content, and use of these different documents.

3.1 Prospectus

The COLL rules require that the AFM must draw up a detailed prospectus to provide information for investors. This document must be up to date and be made available, free of charge, to help investors and their advisers make a balanced and informed decision as to any investment prior to purchase.

The prospectus contains details of the fund's constitution, investment objectives, operation, and the companies performing the key roles. It will also contain details about the fund's investment policy, investment and borrowing restrictions, eligible markets, valuation and pricing policies, any dilution levy/adjustments arrangements, and the expenses deductible from the scheme property. A copy of the original prospectus and any alterations must be sent to the FCA.

The detailed requirements for publishing are:

- A prospectus must be drawn up in English and published as a document by the AFM. For an OEIC, it must be approved by the director(s).
- The AFM must ensure that the prospectus:
 - contains the comprehensive information required by the COLL Sourcebook (noted above)
 - does not contain any provision which is unfairly prejudicial to the interests of unit/shareholders generally or to the unit/shareholders of any class of units/shares
 - does not contain any provision that conflicts with any rule in COLL, and
 - is kept up to date and that revisions are made to it whenever appropriate.

3.2 Key Investor Information Document (KIID), NURS-KII, and PRIIPS KID

Although AFMs are obliged to publish and make available the detailed prospectus, in practice few investors have the time or inclination to read such documents. Over the years, regulations have evolved in an attempt to create a simple single document to provide all investors with the most important information needed to compare one fund with another. This evolution process means that some forms of document apply to specific types of fund, though the underlying purpose is broadly the same.

The FCA rules in COBS 14 and COLL 4.7 reflect different types of 'key information' document, each of which is applicable in different contexts. For each UCITS, the AFM should create a Key Investor Information Document (KIID). The KIID must adopt a standardised format (based on the EU UCITS rules), be concise and be updated annually. Many AFMs make their KIIDs available online, so students might wish to view some examples.

For a NURS, the FCA rules offer a choice. The AFM can either:

- create a 'Key Information Document' ('KID' with one 'I'), which is defined by the EU PRIIPS rules covering Packaged Retail and Insurance-based Investment Products (so is expected to become a recognised document layout for various types of products sold across Europe), or
- declare the NURS to be a 'KII-compliant NURS' and so create a 'NURS-KII Document' instead of a KID.

The following table summarises the content that the FCA has specified as being required for inclusion within a KIID or NURS-KII Document. In either case the information must be concise, written in non- technical language, and presented in a common format that enables investors to compare the funds offered by different AFMs.

Topic	Required Content
Purpose of the document	Clearly state that the document is 'key investor information'.
Investor understanding – particularly of risks	Appropriate information about the essential characteristics of the scheme enabling investors to understand the nature and risks of the investment product and so take informed investment decisions.
Core facts (which must be understandable to the investor without reference to other documentation)	<ul style="list-style-type: none">• Name/identification of the scheme• The investment objective and policy• Name the FCA as the regulator of the CIS• Information on past performance• Information on costs and charges• A risk/reward profile of the fund, including relevant risk warnings.
Availability of additional information	Specify where and how additional information can be obtained, including, but not limited to, the ability to receive without charge a copy of the prospectus and/or the CIS's reports and accounts.

Remuneration and benefits paid to AFM's staff	<p>Confirmation that the remuneration policy is available, setting out how remuneration is calculated (including the composition of any applicable remuneration committee).</p> <p>Note: for a UCITS, this information must be made available via a website with a paper copy being provided on request.</p>
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COBS 14.2 requires the AFM to provide the KIID/NURS-KII Document to each investor without charge. However, this obligation can be satisfied by publishing the KIID/NURS-KII Document on the AFM's website, provided a paper copy will be offered on request.

Regulations also talk about 'Key Features Documents' (KFDs) being required for various types of packaged product; however, the FCA rules state that a KFD is not required for regulated CISs.

3.3 Supplementary Information Document

Note that as the KIID/NURS-KII Document must be concise, most AFMs create an extra document in which they can provide additional information that they want to highlight to their clients. This 'Supplementary Information Document' has no regulatory definition, and is generally a way of confirming various matters relevant to the investment relationship – such as operational practicalities (eg, how to pay for a deal), contractual considerations (eg, the use of the 'delivery versus payment' (DVP) exemption), and the resolution of problems (eg, how the investor can raise a complaint).

3.4 Reports and Accounts

Each regulated CIS must publish its reports and accounts twice each year:

- within four months after the annual accounting reference date, and
- within two months after the half-yearly interim accounting reference date.

It is not required to send a copy of the report and accounts to each unit/shareholder, but the document must be offered free of charge to any member of the public. A copy must also be provided to the FCA by the deadlines noted above.

The contents of the reports and accounts will be discussed in detail within chapter 8 of this workbook.

3.5 Trust Deed/Instrument of Incorporation/Contractual Scheme Deed

The trust deed for an AUT, instrument of incorporation for an OEIC and contractual scheme deed for an ACS sets out the powers and limitations of the scheme and defines the roles and responsibilities/accountabilities of all parties involved – including investors, the fund manager, the depositary, the auditor, and the FCA. The document will show how the scheme will be managed and provides a foundation for those with oversight responsibilities to ensure the AFM operates the scheme as intended.

The constitutional document will include comments confirming matters such as the following:

- The name of the CIS and its COLL category (UCITS, NURS, QIS, or LTAF).
- That the CIS will invest in line with the COLL rules for investment and borrowing powers (or any more restrictive rules imposed specifically on the scheme).
- That the holder has no liability for any debts of the company – so their potential for loss is limited to the price paid for the units/shares bought.
- The basis for valuation and pricing of the CIS.
- The investment objective and policy to be followed.
- For a UCITS, any government or other public security issuer in which more than 35% of the scheme property might be invested.
- The classes of unit/share available and the differences in the rights of each class. This will include the number of decimal places of fractional unit/share that can be traded.
- The basis of the AFM's periodic charge.
- How and when investor's unit/share deals will be settled (whether in cash or *in specie*).
- Any restrictions on the sale and redemption of units/shares.
- Which party has responsibility for the CIS's register.
- The basis for distribution of income to holders (including a provision for equalisation, where appropriate – see chapter 9).
- The role and responsibilities of the depositary.

In addition to items such as the above (specified in COLL), the AFM of an OEIC must also satisfy some items required by the OEIC Regulations. The Investment Association (IA) has prepared model documents that its member firms can use when launching a new fund, though the main city law firms that perform such work will also maintain their own templates.

While some items must be included in all cases, others may only be required if the CIS is going to adopt certain regulatory flexibility. However, the document must not contain any provision that:

- conflicts with any rule in COLL
- prevents units/shares being marketed in the UK, and
- is unfairly prejudicial to the interests of the holders generally or to the holders of any class of units/shares.

The contractual scheme deed is made between the authorised contractual scheme manager and:

1. the depositary, in the case of a co-ownership scheme, or
2. the nominated partner, in the case of a limited partnership scheme.

While the prospectus and Key Investor Information should give a potential investor all the information required to decide whether to invest using the scheme, the AFM must state an address at which the constitutional document can be inspected and a copy obtained. Again, many AFMs also enable the documents to be accessed via a website.

3.6 Assessment of Value Report

While the fund's expenses will be summarised in the prospectus, COLL rules require the AFM to assess for each CIS whether the payments made from the scheme property are justified in the context of the overall value delivered to holders. While the AFM must decide how to perform this assessment, the FCA has set out some considerations that should be included as a minimum requirement, including:

- the range and quality of services provided to the holders
- the performance of the scheme (after charges have been taken), in view of the scheme's investment objectives and policy
- any divergence between the sums taken from the CIS and the payments made to third parties for the associated services
- any economies of scale generated by the AFM across its fund range, and
- whether any divergence of charges between different classes of unit/share is appropriate.

The 'assessment of value' must be performed at least annually, and a summary statement of its conclusions must be published within the 'annual long report' (though many AFMs also publish the position on their website). Such a statement should include points such as:

- discussion and a conclusion on each of the bulleted items noted above
- an explanation of any scale economies not passed onto investors
- an explanation of any cases in which an investor holds units/shares in a class subject to higher charges than others providing equivalent rights
- whether the AFM therefore considers the charges are justified, and
- if the AFM's assessment is that the charges are not justified, a clear explanation of the action that will be taken to address the situation.

FCA highlights the obligation of a CIS Operator to act in the best interests of its clients and considers that delivering poor value would constitute a failure to act appropriately. Such a position could put the AFM at risk of being penalised for a breach of the Consumer Duty.

4. The Initial Offer Period

7.4.1 Understand the treatment of the following in respect to the initial offer period: pricing; large market movement; unit/share transactions; settlement

We have seen the complexity of ensuring that the CIS's portfolio satisfies the investment and borrowing powers, and the work involved in valuing and pricing a fund. It can be difficult to apply these rules in full to a new fund – particularly where the AFM will be hoping for substantial levels of investment in the first weeks of the fund being available.

For this reason, the rules enable the AFM to declare an 'initial offer period' during which certain usual CIS regulatory obligations do not apply (or apply in a slightly different way).

COLL requires that the arrangements during an initial offer period must be set out in the prospectus, and that the length of an initial offer period should not be unreasonable when considered alongside the characteristics of the fund. For example, the initial offer for a scheme operating limited issues or limited redemption arrangements, or intending to invest in illiquid assets, may be longer than one for a scheme that does not have these features.

4.1 Pricing

In normal conditions, the AFM would be required to calculate the price of units/shares at each relevant valuation point. When preparing to launch a fund, the AFM will determine an initial price at which the units/shares will be sold during the initial offer period (the chosen price is often £1 per unit/share). This price must be notified in writing to the depositary before the start of the initial offer period and will remain the price during the whole of the initial offer period.

The **initial offer price** will usually be set in the base currency of the fund. If, however, the AFM is making the fund available in different countries, then they might also offer units/shares in other currencies during the initial offer period. The COLL rules require that the prospectus must state whether units/ shares will be offered in additional currencies, along with other information about the initial offer (such as the circumstances in which the initial offer period will end). An initial offer of units/shares may also be made for any sub-fund subsequently added to an umbrella scheme.

4.2 Large Market Movement

COLL rules require that the initial offer period must end ahead of schedule if there has been a significant change in market valuations even though formal valuation processes need not be performed during an initial offer period. If the AFM believes that the value of the assets purchased would result in a unit/share price more than 2% different from the initial offer price, then the initial offer period must end and normal valuation processes commence to determine the unit/share price for future dealing.

For example, suppose the new fund is investing in UK assets and is building up an asset portfolio during the initial offer period. If the UK equity index was to rise by more than 2% from its value at the start of the initial offer period, the AFM should recognise the likelihood that continuing to use the initial offer price would create unfairness between the first investors (who provided investment to enable the fund to benefit from that market price rise) and those investors now joining. Similarly, if the index value fell by 2% or more the new investors should not incur a loss for movements that preceded their investment in the fund. In the normal course of events, the AFM cannot close the offer prematurely.

4.3 Unit/Share Transactions and Settlement

Once the initial offer period has begun, the AFM will accept orders to buy units/shares. Those orders will be accompanied by payment from the investor, though the AFM is only required to pay the depositary for those issues as soon as practicable after receiving the investor's money (and no later than the fourth business day after the end of that initial offer period). While this offers the AFM operational flexibility (compared with the normal obligation to pay for issued units/shares by the fourth business day after the issue), the AFM will often be keen to start building the fund's portfolio even though COLL allows the fund to be entirely invested in cash/near cash during the initial offer period.

5. Financial Promotion Rules

7.5.1 Know the relevant aspects for the financial promotion of CISs by the AFM

Having prepared a new CIS for launch, the AFM will want to encourage potential investors to buy units/shares in the fund. Marketing material will be created – but it is important for the AFM to comply with relevant FCA rules when marketing its products.

5.1 Key Obligations

Any communication that a regulated firm sends to its customers must be fair, clear, and not misleading – and that is particularly relevant when producing marketing material. FCA Guidance in COBS notes that any growth/yield projection should be balanced across the short- and long-term, and it should make clear if the client's capital is at risk. Where marketing material is addressed to the client, FCA requires that the material be identified as such.

5.2 FCA's General Rule for Financial Promotions

FCA requires that any firm, such as an AFM, issuing/approving a financial promotion must ensure that the communication:

- identifies the firm issuing the promotion (and which approved the promotion as being compliant)
- includes the date of approval (where relevant)
- is accurate and gives a prominent and fair indication of the risks relevant to the investment
- will be understood by an average member of the target market to whom the message is directed
- does not try to hide or obscure important statements or warnings
- has a layout that makes risk warnings prominent and does not use a smaller font when talking about risks, and
- is up to date and is relevant to the means of communication being used.

Any comparative information provided must be meaningful and presented in a fair and balanced way.

5.3 Specific Requirements on an AFM

As the FCA recognises the need for an investor to be able to consider whether an AFM has been effective in its management of a CIS, it places certain obligations on an AFM to comment upon the fund's benchmark within its promotional material. The promotion should give a short explanation of the chosen benchmark (consistent with the wording in the prospectus) and include past performance of that benchmark when giving any past performance data relating to the fund.

Where the fund has no stated benchmark, FCA requires the AFM to include a short explanation of how the investor should assess the performance of the scheme.

5.4 ESG and Sustainability Considerations

For many years, it has been common that an investor retaining a personal investment management service would specify certain personal preferences within the investment management mandate. The investor might, for instance, instruct that no investment be made in tobacco-related companies, or those involved in military equipment.

A few years ago, there was much discussion about the extent to which investors using retail investment products might similarly wish to target their investment into funds that would try to minimise the environmental and social harms arising through the businesses in which they were invested (either by avoiding certain companies perceived as causing harm, or through strong shareholder engagement with the leadership of the companies in which they had invested).

While it is unclear to what extent such concerns do and will impact the investment decisions of the mass retail market, the FCA recognised the potential that firms might try to market funds based on unclear 'green' credentials and so introduced the 'Environmental, Social, and Governance Sourcebook' (ESG) to set standards about the implications of 'sustainability' claims within marketing materials.

AFMs and AIFMs are within the scope of these ESG rules if the total value of funds they manage exceeds £5 billion (average value over a rolling three-year period).

ESG4 outlines the acceptable use of 'sustainability labels'. The FCA has defined three ways in which a fund manager might seek to achieve a positive sustainability outcome through its investment activities:

- **Sustainability focus** (where the product has an objective consistent with investing in assets that are environmentally and/or socially sustainable).
- **Sustainability improvers** (where the product has an objective consistent with investing in assets that have the potential over time to improve environmental and/or social sustainability).
- **Sustainability impact** (where the product has an objective consistent with achieving a pre-defined, positive, and measurable impact on an environmental and/or social outcome).

Where a fund manager believes that one of these three 'sustainability labels' is applicable (or a fourth label referred to as 'sustainability mixed goals', applicable if the AFM is targeting more than one area of impact), it must notify the FCA and must at least annually perform a review to ensure that the fund still satisfies the requirements for the label. In such a case, the AFM is then allowed to use the corresponding standardised image label within its marketing material and so seek to highlight the environmental merits of that fund's investment approach. Firms that do not satisfy the requirements are not permitted to use such labels or seek to sell their funds on the basis of environmental credentials.

6. Complex and Non-Complex Investments

7.6.1 Understand the differences between complex and non-complex funds

When creating a new CIS, the AFM will want to consider the ease with which investors will be able to buy units/shares in the fund, including where they transact via an intermediary. Some choices made by the AFM when designing the fund can have an effect on the obligations when units/shares in that fund are being sold.

EU rules within the 'Markets in Financial Instruments Directive' (MiFID) impose an obligation on a firm to check that an asset it sells to a customer is 'appropriate' for that investor. For firms such as AFMs and platforms (which generally offer execution-only dealing services), performing an appropriateness check adds operational costs, as the firm needs to request additional information from the investor in order to substantiate the view that the asset is appropriate for that investor.

The MiFID rules, however, offer certain exemptions from the 'appropriateness' test. UCITS schemes are generally exempt (provided the fund is not a 'structured UCITS', which is defined as a fund that uses an algorithm to determine what redemption payment would be made to an investor selling their units/shares), but other types of fund might also be exempt if they fit into the category of 'other non-complex financial instruments'. This requires a number of tests to be satisfied, including:

- the actual/potential liability faced by the investor should not exceed the cost of buying the instrument
- the instrument does not include a feature that would fundamentally affect the risk or repayment approach (eg, an asset that might convert into a different asset)
- the asset does not include any exit charges that would effectively make the asset illiquid, and
- the characteristics of the instrument need to be clearly documented and communicated so that an average retail investor could make an informed decision on their use of the asset.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. In what way might an investor benefit by investing using a regulated CIS?

Answer reference: Section 1.1

2. Outline the differences between a regulated CIS and an Investment Trust Company.

Answer reference: Section 1.2.1

3. What documentation must the AFM provide to the FCA to support the application for authorisation of a fund?

Answer reference: Section 2.1

4. What information is contained in the prospectus of a fund?

Answer reference: Section 3.1

5. To whom, apart from unit/shareholders, must a fund manager make available a copy of their report?

Answer reference: Section 3.4

6. a. How often must reports and accounts be produced?

b. What is the timescale involved?

Answer reference: Section 3.4

7. Explain the purpose and content of the Instrument of Incorporation.

Answer reference: Section 3.5

8. What impact can large market movements have on initial offers of units to investors?

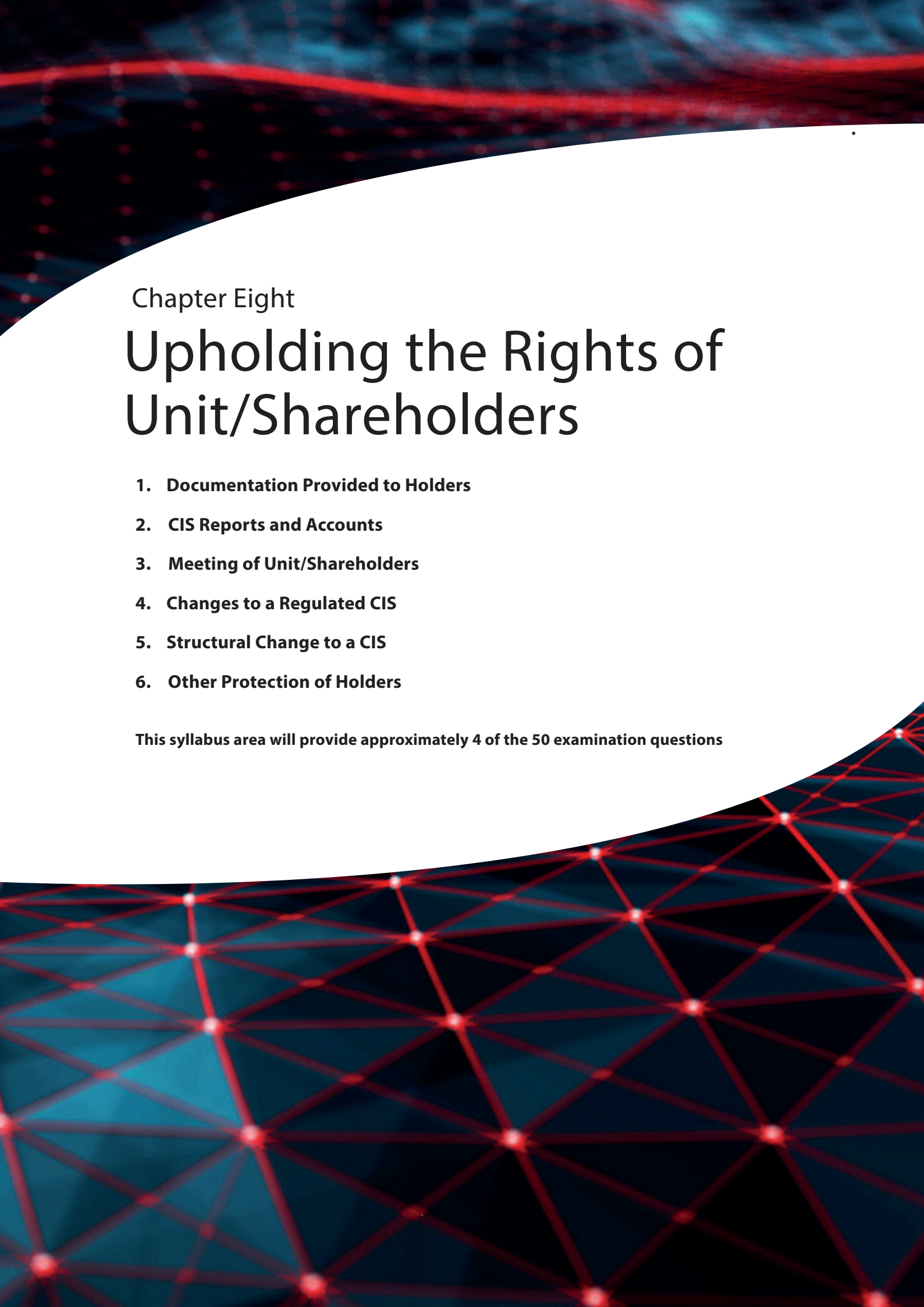
Answer reference: Section 4.2

9. What circumstances would cause an initial offer period to end?

Answer reference: Section 4.2

10. What expectations does the FCA impose on the approver of a financial promotion?

Answer reference: Section 5.2



Chapter Eight

Upholding the Rights of Unit/Shareholders

1. **Documentation Provided to Holders**
2. **CIS Reports and Accounts**
3. **Meeting of Unit/Shareholders**
4. **Changes to a Regulated CIS**
5. **Structural Change to a CIS**
6. **Other Protection of Holders**

This syllabus area will provide approximately 4 of the 50 examination questions



The previous chapter focused on clarifying the behaviours of a CIS when it is to be launched, and what material is needed to inform potential investors. It is possible that the AFM might later wish to change some of these behaviours, and so there needs to be a process to communicate such events to the holders, and in some cases seek their approval.

This chapter will consider some of the mechanisms that protect the ongoing position of holders.

1. Documentation Provided to Holders

8.1.1 Know general and occasional client reporting requirements: dealing confirmations; periodic statements

1.1 Dealing Confirmations

In chapter 5, we noted that an investor will receive a contract note confirming the key information about their transaction. The purpose of providing this 'trade confirmation information' (as the COBS rules refer to it) is to enable the investor to check that their trade has been processed in the correct manner, though it is likely that most investors use the confirmation for information purposes rather than seeking to actively validate the AFM's actions.

The COBS 16 rules for 'trade confirmation information' vary according to the type of business being performed, and when the AFM deals with a holder for units/shares in a UCITS, the following information should (where applicable) be included within the confirmation issued to a retail client:

- the identity of the AFM
- the name/designation of the holder
- the date and time when the AFM received the trade order
- the method of payment
- the date of execution (ie, the date of the valuation point at which the units/shares were bought/sold)
- the identity of the UCITS scheme
- whether the order was to subscribe or redeem
- the number of units/shares traded
- the unit/share price for the trade
- the reference valuation date (note that this would usually be the same as the date of execution, but might be a different date if the AFM is correcting an earlier error)
- the settlement payment required (after any fees and levies have been considered), and
- the total sum of the commissions and expenses charged (with a breakdown being provided if requested by the holder).

Assuming that the holder has understood earlier disclosures confirming the time of the valuation point and any dealing cut-off period in place, the above fields should enable an investor to confirm that a given instruction was processed by the AFM in a timely manner, being applied to the correct valuation point, and given the correct price for that valuation point (as the prices for each valuation point are published separately).

Where the holder has agreed with the AFM that a series of deals will be performed periodically (such as where the investor will invest a certain cash value each month via direct debit payments) then the AFM is permitted to not send a contract note for each monthly trade. However, if using this flexibility the AFM must instead send a summary report at least every six months which contains the data items listed above (which would have been included as relevant had the contract note been issued as normal). Some AFMs therefore continue to send a six-monthly transactional statement to each investor, even though for many holders this may not be a regulatory requirement.

1.2 Periodic Statements

While the AFM is responsible for managing the assets of the CIS, this does not mean that it is managing the assets of the holder (and it is very rare for an AFM company to separately offer an investment management service to retail investors). As a result, the 'periodic reporting' obligations in COBS 16 are not applicable to the AFM.

However, as the AFM may at times hold client money for investors it is subject to a separate COBS 16 obligation to provide a statement at least once each year confirming the balance of client money held for that investor. There are a couple of points to highlight:

- The regulatory obligation includes any money or designated investments held by the firm for its client, but where the units/shares are held on the CIS register they are in the investor's own name and are not being held by the AFM on behalf of the investor. As such, while the AFM might choose to include in this statement the number of units/shares held by that investor on the register, there is no regulatory obligation to do so (and the AFM should ensure the communication is clear how those units/shares are registered).
- Unlike the six-monthly transactional statement noted earlier, this annual statement of client assets held does not need to provide transactional information. The regulations simply require confirmation of the balances held, and so some AFMs might choose to include this information within any transactional statements being issued.

It is becoming increasingly common for AFMs to use electronic means to provide trade confirmation information and periodic statements to holders, though the rules still require that the investor should choose electronic communications in preference to paper (and that paper communications must remain available without additional charge).

2. CIS Reports and Accounts

8.2.1 Know regulatory requirements in relation to the content of the annual and half-yearly report and accounts and Statement of Recommended Practice (SORP)

We noted in chapter 7 that formal reports and accounts must be published for each CIS following its annual and half-yearly accounting date; here we consider the content of these documents. Candidates may wish to view some example CIS reports and accounts online while studying this section, noting that for an umbrella scheme the report and accounts will contain discrete material for each sub-fund within that umbrella scheme.

(Note: the COLL 4 rules use the term 'long report' when speaking of the interim and annual reports and accounts. This is because previous rules enabled a smaller document to be published in some instances, known as the 'short-form report and accounts'. As the 'short-form' version is no longer applicable, in this chapter we will simply refer to the interim report and the annual report.)

The financial accounts included in the annual report or interim report (whether audited or not) must be presented in accordance with a standard defined by the Investment Association (IA) and known as the Statement of Recommended Practice (SORP).

2.1 Content of the Annual Report and Interim Report

The following table summarises the elements that must be contained in the annual report and the interim report:

Annual Report	Interim Report
Audited financial accounts (at sub-fund level for an umbrella scheme)	Unaudited financial accounts (at sub-fund level for an umbrella scheme)
Notes to the financial accounts	N/A
AFM Report (including a portfolio statement, by sub-fund where applicable)	
Statement of the AFM's responsibilities	N/A
Depository's report, including a statement of whether there was any material non-compliance for unit/share dealing or investment limits during the period	N/A
Auditor's report, giving the auditor's opinion of the financial accounts	N/A
A comparative table (for each sub fund, where relevant)	The number of units/shares in circulation, and the NAV per unit/share

In most cases, the AFM must include a summary of its 'Assessment of Value' within the annual report. However, this requirement can be achieved through the creation of a separate composite report which provides the equivalent information in respect of at least two funds managed by that AFM and which is published in the same manner as the annual report.

The annual report of a UCITS Scheme must include information about the remuneration paid by the AFM to its staff. This must include the respective levels of fixed and variable remuneration and a description of how such benefits are calculated.

Additional disclosures apply if the fund is subject to the Securities Financing Transactions Regulation (such as if it takes part in stock lending transactions, which involve collateral). These disclosures are detailed and specific, including items regarding the overall proportion of assets put on loan, the type and quality of collateral used, and where the various amounts of collateral are held for safekeeping.

The AFM's Report

The AFM's report must specify the following:

- confirmation of the names and addresses of the main parties (the AFM, trustee/depositary, party responsible for the register, investment adviser, auditor, and any standing independent valuer for a scheme investing in immovable property)
- portfolio statement (prepared according to the SORP)
- a statement of the scheme's authorised status
- the investment objectives of the scheme and its policy for meeting those objectives
- a review of the investment activities during the reporting period
- details of any fundamental or significant changes to the scheme's operations made since the last report
- for an OEIC, the names of any directors other than the ACD, and a statement that the shareholders of the OEIC are not liable for the debts of the OEIC, and
- any other information necessary to enable investors to make an informed judgement on the activities of the scheme during the period, and the results as at the end of the period.

Other requirements apply to certain types of funds. For a UCITS fund, the AFM must include the Synthetic Risk and Reward Indicator (SRRI) quoted in the most recent KIID. For a UCITS scheme that invests in other schemes, the report must include a statement detailing the maximum proportion of management fees charged to the scheme itself and to the schemes in which it invests. For an umbrella scheme, the report must provide the above information in respect of each sub-fund, including details of any holdings one sub-fund holds in a second sub-fund.

The Depositary's Report

The depositary's report (only required for an annual accounting period) should state whether, in their opinion, the AFM has managed the scheme during the period in accordance with:

- the investment and borrowing restrictions applicable to the CIS scheme, and
- the provisions of the trust deed, instrument of incorporation, prospectus and the appropriate COLL Sourcebook.

The depositary signs the report. If the depositary cannot confirm that the scheme has been managed in accordance with the conditions above, they must describe any material failures and state what steps they have taken as a result of those failures.

It is unlikely that an AFM will make serious breaches of regulations. However, if such a breach is discovered, the depositary has a duty to take certain actions. They must ensure that the breach is rectified in such a way that neither the fund nor any investor is materially prejudiced. This requirement arises because the role of the depositary is to protect the interests of investors – not only those affected by the breach (such as if the wrong price is used for dealing units/shares) but also those investors that remain in the fund (and would otherwise bear any costs, eg, for correcting any holding that breaches an investment and borrowing powers limit). This requirement is regulatory, though for the trustee of a unit trust it also applies because of trust law.

The Auditor's Report

The auditor is the independent financial watchdog for the investors and will be a registered firm of accountants. Its report includes the basis of their opinion (how it has reached its decision) and confirms that it has received sufficient evidence that accounts are accurate. The report will be signed by the auditor, and state:

- whether, in the auditor's opinion, the accounts for that period have been properly prepared in accordance with generally accepted accounting principles, the SORP, the regulations, and the trust deed/instrument of incorporation
- any material departure from the standard expected above, detailing any such departure and the reasons for it
- whether, in the auditor's opinion, the accounts give a true and fair view of:
 - the review and net capital gains/losses on the property of the scheme, and
 - the financial position of the scheme at the end of that period
- whether they have received all the information and explanations considered necessary for the purposes of the audit
- whether the information in the AFM's report is consistent with the financial statements.

If the auditor is of the opinion that:

- proper accounting records for the scheme have not been kept by the AFM, or
- the accounts are not in agreement with the AFM's records, or
- they have not received all the information and explanations necessary to complete the audit satisfactorily, or
- the information given in the report of the AFM for that period is inconsistent with the accounts then the auditor must report these facts in their report. A report highlighting such concerns is referred to as a 'qualified report'.

Note that this audit report relates to the scheme property, so it is separate from the CASS audit discussed in chapter 3 (which relates to the AFM's accounts when handling client money).

The following data should be provided for the last three annual accounting periods (or each annual period where the scheme is less than three years old). The data should be shown as 'per unit/share' figures (unless otherwise stated), for each sub-fund and class of unit/share:

- an illustrative performance of unit/share value over the period
- the opening net asset value (NAV)
- operating charges
- return (before and after applying those operating charges)
- distributions on income units/shares (where applicable)
- closing NAV
- retained distributions on accumulation units/shares (where applicable)
- the number of units/shares of each class in existence/issue
- percentage return after charges
- closing NAV in sterling terms
- closing number of units/shares
- operating charges in percentage terms, with any performance-related fee disclosed separately, and
- the highest and lowest unit/share price during the period.

2.2 The Financial Accounts and the SORP

The SORP specifies that the financial statements for an annual report must include the following items:

- statement of total return
- statement of change in net assets attributable to unit/shareholders
- balance sheet
- statement of cash flows (although many UK investment companies qualify for an exemption)
- notes to the financial statements including material accounting policies used in preparing the financial statements
- distribution policies
- risk management policies, and
- a distribution table.

Brief comments on all of these items follows, though the SORP itself contains detailed comments on how various assets and receipts should be shown in the accounts.

Comparative figures should be given for all items in the statement of total return, statement of change in unit/shareholders' funds and the balance sheet, and the notes to each, and for sector percentage totals in the portfolio statement.

An interim report need not include notes to the financial statements, or the distribution policies and risk management policies.

Statement of Total Return

This statement summarises the net investment gains or losses, together with the revenue earned after tax and expenses. It identifies that part of the total return which is to be distributed in accordance with the regulations.

The statement of total return must show:

- income: net capital gains/(losses)
- net revenue (expenses)
- total return before distributions for the period
- distributions, and
- change in net assets attributable to unit/shareholders from investment activities.

The statement of total return must also include comparative figures for the equivalent period last year.

Statement of Change in Assets Attributable to Unit/Shareholders

This statement reconciles the changes in net assets during the period in summary form. It draws on the statement of total return for the change in net assets attributable to unit/shareholders from investment activities and shows the extent to which the fund has grown or contracted as a result of the issue or cancellation of units/shares.

The statement should be presented on the same page as the financial statement of total return, thereby providing unit/shareholders with a summary of the principal features of the scheme's results for the period.

It should also include comparative figures for the previous equivalent period (ie, the previous interim figures for an interim report; the previous annual figures for an annual report). The interim report will therefore include a note explaining that, as the previous and current periods are not consecutive, the closing net assets for the earlier period do not equal the opening figures for the current period.

The balance sheet provides a consolidated statement of the scheme's assets and liabilities, including:

- total investments valued at bid market price (investments should be analysed between investment assets and investment liabilities); there is an exception, with any 'short' investment positions valued at the offer market price
- cash and bank balances
- amounts payable to/receivable from brokers for buying/selling securities, and
- any other sundry debtors and creditors (amounts due or payable).

Comparative figures from the previous year should be included.

Statement of Cash Flows

This statement is intended to provide additional information about where a fund's investment strategy could restrict its cash flow, such as where it is highly invested in physical property.

An authorised fund need not prepare a statement of cash flows if it meets all of the following conditions:

- substantially all of the fund investments are highly liquid (eg, cash, shares but not buildings)
- substantially all of the fund investments are carried at fair value, and
- the fund provides a statement of change in net assets.

For example, a UK equity fund would not need to produce such a statement, while a property fund would be required to do so.

Notes to the Financial Statements

The notes should include any other information required by the OEIC regulations or the FCA COLL Sourcebook, together with the accounting policies, distribution policies and risk management policies, and any other information that is required for the accounts to give a true and fair view.

Note	Comment
Accounting Policies	Each material accounting policy should be disclosed. The notes should state the title of the SORP, whether the accounts have been prepared in accordance with the SORP and details of any departures from the SORP.
Distribution Policies	Each material distribution policy should be disclosed and can include the treatment of expenses for the purposes of the distribution.
Risk Management Policies	<p>Disclosures are required to enable the user of the financial statements to:</p> <ul style="list-style-type: none"> • assess and understand the risks of financial instruments, and • understand how those risks are managed. <p>Risks will include:</p> <ul style="list-style-type: none"> • market risk • liquidity risk, and • credit risk. <p>The AFM should ensure that suitable narrative and numerical risk disclosures are provided.</p>

Distribution Table

The financial statements include a table detailing the distribution payable or allocated for both Group 1 and Group 2 units/shares of each unit/share class in issue (note: distributions and unit/share grouping are discussed in chapter 9 of this workbook). The distribution table will show the following items in pence per unit/share:

- gross income
- any income tax deducted/withheld
- net income
- equalisation, where applicable
- distribution payable, and
- distribution paid in the equivalent comparative period (annual or interim) 12 months earlier.

While funds now issue gross interest distributions to all investors, many firms will continue to show a gross and net figure in their reports and accounts to emphasise this treatment, particularly as comparisons might be made against earlier periods.

If there is a significant difference between net income shown in the statement of total return and the amount distributed, a reconciliation of the difference should be included.

This statement (required within the AFM's report and defined by SORP) essentially lists all the investments of the scheme, reconciling the total to the total net asset value of the scheme as per the statement of change in net assets and the balance sheet. It must show the portfolio according to the most appropriate criteria to assess the assets (eg, by country or by industrial/market sectors such as retail, pharmaceuticals and manufacturing).

The statement must show the:

- number, quantity, description and value of each asset
- percentage of value of property of the scheme each holding represents
- net value of each derivative position, and
- total value of all assets in the scheme (which should agree with the balance sheet).

The portfolio statement should distinguish between assets that are approved securities and unapproved securities, and also identify any asset not admitted to official stock exchange listing. It is considered that a geographical analysis of the portfolio would give an adequate indication of the official stock exchanges on which the securities are listed, provided that any individual securities traded on a different exchange (or not listed) are clearly indicated.

The portfolio statement must include comparative figures for each category at the end of the proceeding financial year, though need not provide comparative figures for each security.

2.3 Importance for Investors

8.2.2 Know what investors should look for in the reports and accounts

An investor may consider the following questions when reviewing the reports and accounts of a CIS:

- What is the growth record of the fund?
- Are the objectives of the fund the same as those of the investor? For example, an older investor is often looking for income rather than growth.
- Are the aims of the fund being met?
- How successful has management been in achieving performance?
- What are the management charges?
- Although not discussed in the report and accounts, are there any other benefits or features (such as share exchange) available?

As noted previously, the regulations require that certain basic information is included in the report. However, managers usually present additional information to clarify the fund's performance. This information may be quite useful in helping to answer some of the above questions.

From time to time the depositary or auditor of a scheme changes, and the report is required to name these parties so any such change would be visible. However, any such change that takes place without an explanation being offered should be investigated.

3. Meeting of Unit/Shareholders

8.3.1 Know the requirements for a unit/shareholders' meeting, including the use of proxies

3.1 Holding a Meeting

A meeting of the holders of a CIS is generally called when there are some specific business decisions that require the agreement of the holders. Such a meeting might be called by the AFM or depositary, but the holders of at least one-tenth of the total units can request a meeting, and the AFM or depositary must then hold that meeting within eight weeks of receiving a valid request.

Once the AFM has set a date for the meeting the AFM must invite the holders, giving at least 14 days' notice of the meeting and noting what resolutions are to be discussed. The notice will also state arrangements for attending the meeting, whether held in person, virtually, or as a hybrid of both approaches. As the registered holders may change every day due to investor trading, COLL allows the AFM to set a cut-off point at a reasonable period prior to issuing notice of the meeting, and to invite those who were holders on that cut-off date.

The invited holders may attend, or might appoint someone else to attend on their behalf (known as appointing a 'proxy'). The term **quorum** is used to denote the minimum number of attendees for the meeting to be valid (either the holders or their proxies), and no business can be conducted if the quorum is not achieved. In a CIS, only two holders (or their proxies) are required for a quorum.

Provided a quorum is present, the depositary will nominate a chairman to conduct the meeting (usually an authorised representative of the AFM). The chairman's main function is to ensure that the meeting is conducted according to the notice and agenda, unless the meeting consents to a variation in the order. The chairman may decide points of order and other incidental matters which require a decision at the time.

3.2 Voting

After each resolution has been discussed there will generally be a vote of the holders present. In general this is decided by a simple majority of votes cast (ie, each holder has one vote, regardless of how many units/shares they hold). However, if the chairman, the depositary, or a minimum of two holders (or their proxies) require it, a given resolution will instead be decided using a poll (where votes are weighted according to the proportion of the scheme units/shares held by each holder). Note that as the registered holder might be a nominee company holding units/shares on behalf of many underlying investors, it may be that during a poll a given holder might vote some units/shares for the motion and others against – according to any instructions already received from its clients.

If a given resolution is declared to be an extraordinary resolution then it will only be passed if 75% vote in favour (whether by show of hands or by poll). The chairman has a casting vote, if required.

In some cases, the depositary may consider that it is necessary to have separate meetings for the holders of different unit/share classes, particularly if there may be conflict between those populations. In these circumstances, only if the unit/shareholders at each separate meeting duly pass the same extraordinary motion is the resolution considered passed.

3.3 Records of the Meeting

Minutes must be made at every meeting of unit/shareholders, being a written record of the business transacted (including all resolutions and proceedings). The AFM is responsible for the expense of keeping and recording the minutes.

When the minutes of meetings are completed, they are signed by the chairman as conclusive evidence of the matters stated in the minutes, including the resolutions passed, which decisions will then be carried out as agreed.

4. Changes to a Regulated CIS

8.4.1 Know the rights of unit/shareholders in relation to changes to the CIS

8.4.2 Know the consequences of changing the fund's investment objective or valuation process

4.1 Three Categories of Change

COLL recognises three categories of change affecting a CIS:

1. **Fundamental** – requiring prior approval of investors.
2. **Significant** – requiring 60 days' notice to investors.
3. **Notifiable** – requiring notification to all investors, though the change may take place before that notification is completed.

Any fundamental change will therefore require a resolution to be passed at a meeting of unit/ shareholders. Examples of fundamental changes include:

- modification of the constitutional document (eg, trust deed)
- a change of investment objectives or policy (eg, from investing in one country to another)
- reconstruction of a scheme – such as merging one CIS into another
- removal of the AFM, and
- a change in investment policy to allow the CIS to invest in derivatives as an investment strategy, which increases volatility.

If, for example, the AFM intended to change the investment objective of a fund, there would be a number of consequences that may cause concern for unitholder:

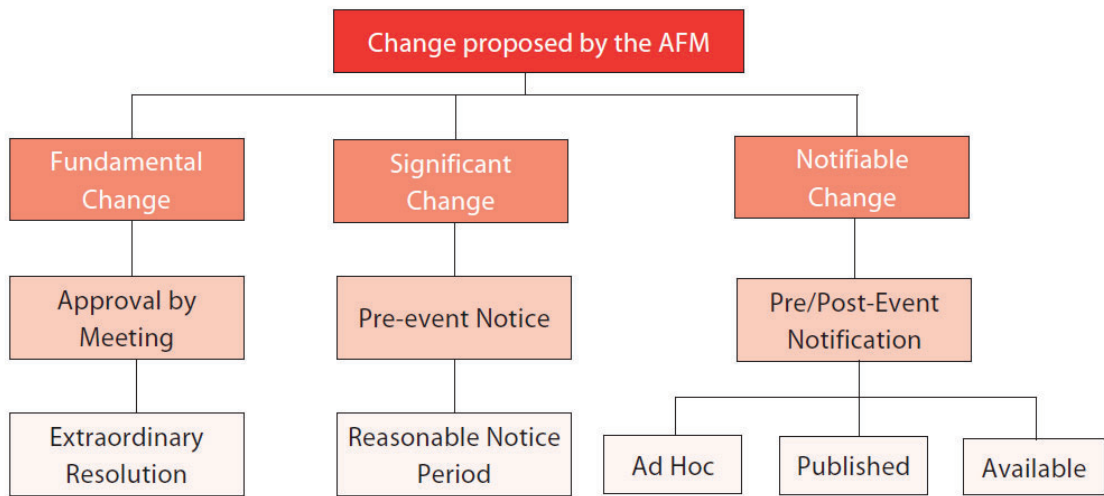
- The fund might no longer satisfy their investment needs (causing the unitholders to need to sell their units and select a different fund to satisfy their needs).
- The fund may need to sell a large proportion of the investments held within the portfolio (in order to fit the new investment objective) – which would incur dealing costs that could erode the performance of the fund, effectively imposing that inflated short-term cost onto the current unitholders.
- The increased trading levels would also artificially increase the portfolio turnover rate (which represents the proportion of the scheme that is bought/sold over the course of an average year, and is used to estimate future dealing impacts).

Examples of significant change include cases where the value of payments being made from the scheme property would significantly increase (and so have a detrimental effect on the value of units/shares). COLL states that the prior written notice of such a change must be of a reasonable length (and must not be less than 60 days).

An example of a notifiable change is a change in the time of the valuation point. The manner and timescale of notification would depend on the nature of the change but could involve:

- sending an immediate communication to unit/shareholders
- publishing the information on a website, or
- noting the implemented change in the next report and accounts published.

The following diagram from COLL 4.3.3G provides an overview of the requirements for treating proposed changes.



It should be noted that some business changes would not need to be reported. While a change to the fund’s accounting policies should be communicated (as these policies are usually summarised in the Report & Accounts), it would not be necessary to communicate a business change to the system used to calculate the fund price, or a change to the price source used to value certain assets.

5. Structural Change to a CIS

8.5.1 Know the process and relevant regulatory requirements in relation to: termination; amalgamation/mergers

8.5.2 Know how a structural change to a CIS might impact the fund’s: portfolio turnover; performance

5.1 Winding up/Terminating a CIS/Sub-Fund

The process for winding up a CIS differs slightly according to its legal structure and whether the scheme is solvent (ie, able to pay all its debts) or insolvent. COLL 7 provides the general processes. While it is rare for an OEIC to become insolvent, the process for winding up an insolvent OEIC is instead outlined in the OEIC Regulations.

The following table taken from COLL 7.3 summarises the main steps in winding up a solvent OEIC/sub-fund.

Notes: N = the day notice is given to the FCA under regulation 21 of OEIC Regulations

Step number	Explanation	When	COLL rule (unless stated otherwise)
1.	Commence preparation of solvency statement	N – 28 days	7.3.5 (2)
2.	Send audited solvency statement to the FCA with copy to depositary	By N + 21 days	7.3.5 (4) and (5)
3.	Receive FCA approval	N + one month	Regulation 21 of OEIC Regulations
4.	Normal business ceases; publish notices	Commencement of the winding-up/termination process	7.3.6

5.	Realise proceeds, wind up, instruct depositary accordingly	ASAP after the winding-up/ termination process begins	7.3.7
6.	Prepare final accounts or termination accounts and have account audited	On completion of winding-up or termination	7.3.8
7.	Send final accounts or termination accounts including the auditor's report to the FCA and unit/shareholders	Within 4 months of the final accounting period	7.3.8 (6)

(An equivalent table in COLL 7.4 summarises the process for terminating an AUT).

Note that normal business (such as fund pricing at valuation points, or unit dealing with investors) ends at step 4. After that time, the portfolio is liquidated so that each investor who at that time remained a holder will receive their proportionate share of the net assets and liabilities of the fund.

5.2 Amalgamation/Merger

An amalgamation or merger of a CIS (or a sub-fund) into another must first be approved by extraordinary resolution in a general meeting of the unit/shareholders of the classes/funds that are affected.

However, no corresponding meeting or resolution is required of any fund into which another CIS is to be amalgamated provided the AFM and depositary are reasonably satisfied that the inclusion of the extra assets:

- is not likely to result in any material prejudice to the interests of the current unit/shareholders of the continuing CIS
- is consistent with the objectives of the continuing fund, and
- would not breach any investment and borrowing powers.

5.3 Effect on Portfolio Turnover and Performance Data

There are certain times in which historic data about a CIS needs to be given – such as if quoting historic price performance within marketing literature. A consequence of structural change (such as a fund merger) is that the CIS that results is not the same as either of the CISs that existed prior to the merger. To what extent therefore is the past performance of either fund representative of the potential future price behaviour of the merged fund?

The AFM must consider this question given the specific circumstances of a given merger (and must not simply choose to use the historic data that shows the higher performance. In some cases – particularly if the investment objective of the fund has materially changed – it might be more appropriate for the AFM to generate simulated historic price performance data based on the new fund's investment strategy. The COBS rules about the use of past performance data recognise that on occasion some non-MiFID scenarios might require the use of simulated performance data. Any use of past performance data (whether simulated or not) should clearly state to what fund (or simulation) that data related, to ensure the communication remains fair, clear, and not misleading.

Another consideration that relates to overall investor fairness is the extent to which a fund merger might result in a spike of portfolio asset trades – particularly if assets previously held by one of the funds do not fit within the investment objective of the merged fund and must therefore be sold off. Such a dealing spike can result in two types of outcomes:

- If the costs of re-trading the portfolio are significant, this might be considered an undue cost to be imposed on the unitholders of the fund. The FCA might challenge an AFM about such a position and whether it is fair for such costs to be passed on to the unitholders.
- Certain other disclosures make use of the portfolio turnover rate (eg, to project likely cost of trading activity in future periods), and so if the merger (or change in investment objective) will result in a short-term exaggeration of normal trading patterns, it might be reasonable for the AFM to ignore such distortions when projecting potential future activity levels.

6. Other Protection of Holders

8.6.1 Know the role of the Financial Services Compensation Scheme (FSCS)

6.1 Financial Services Compensation Scheme (FSCS)

The FSCS is an industry-wide compensation scheme, applicable when an FCA-authorised firm is unable to meet its liabilities to its clients. It is therefore important to note that the regulated CIS is itself authorised. While the FSCS will not provide compensation for poor market performance, it may be able to intervene if a regulated firm becomes insolvent and investors incur losses as a result.

The current compensation limit for the scheme for investments or deposits is £85,000 (with additional protection available for 'temporary high balances' on deposit). However, in March 2025, the PRA issued a proposal that this limit would increase to £110,000 with effect from 1 December 2025. At the time of writing (July 2025), the decision had not yet been confirmed. Further details can be found at www.fscs.org.uk.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. What does the auditor's report to unit/shareholders state?

Answer reference: Section 2.1

2. What information is included in:

a. an annual long report?

b. an interim or half-yearly long report?

Answer reference: Section 2.1

3. How should the AFM's report document the affairs of an umbrella scheme?

Answer reference: Section 2

4. How many years of fund history should be included in the comparative table?

Answer reference: Section 2.1

5. What financial statements does the SORP require an AFM to include in the long report for either an annual or interim reporting period?

Answer reference: Section 2.2

6. Under the SORP requirements for financial statements, what does the statement of total return contain?

Answer reference: Section 2.2

7. Name three types of risk that the AFM should explain within the risk management policies.

Answer reference: Section 2.2

8. Following a vote on a show of hands at a meeting of unit/shareholders, who may demand a vote by poll?

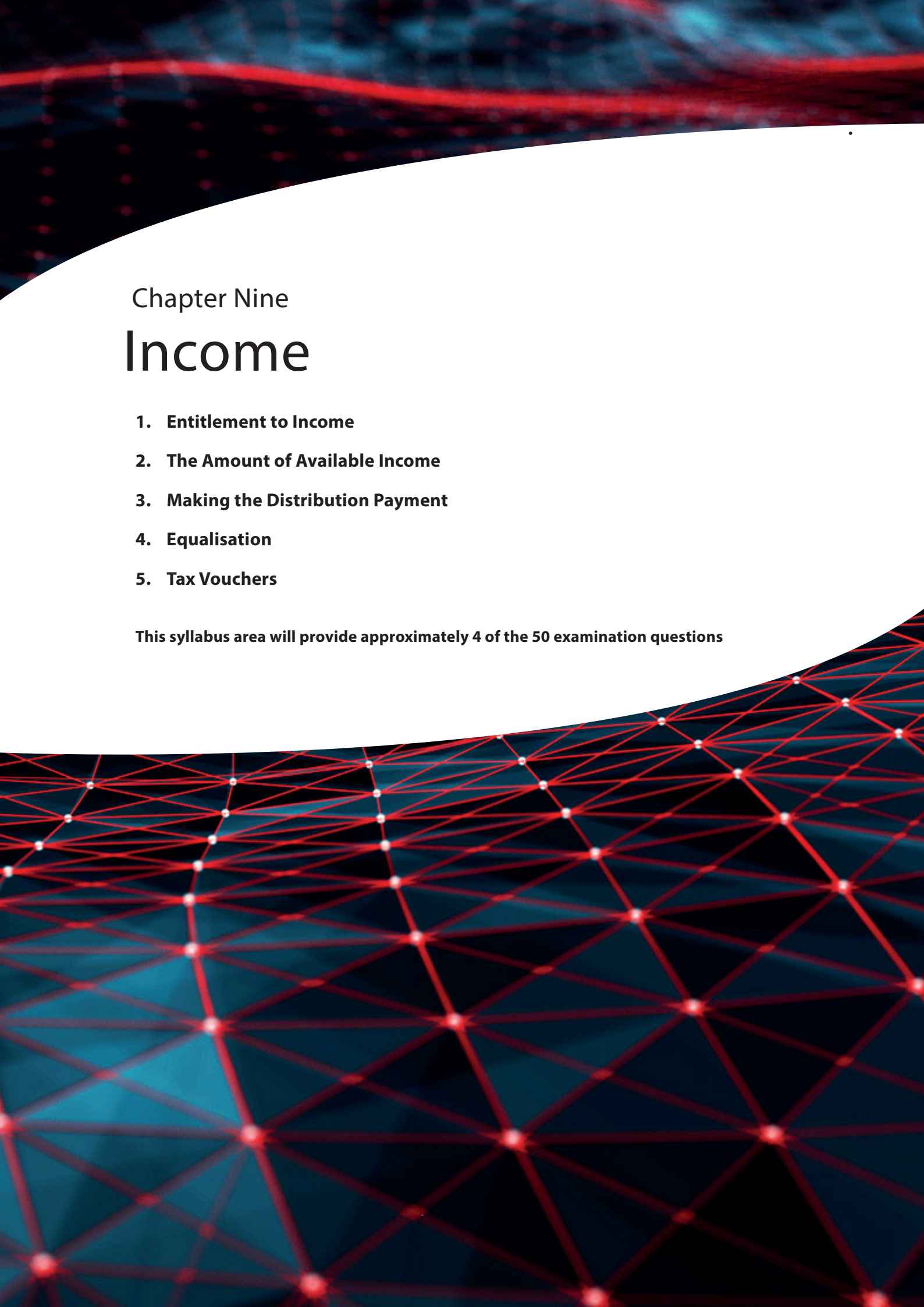
Answer reference: Section 3.2

9. Give an example of a 'significant change' for a COLL fund, and outline the process to implement such a change.

Answer reference: Section 4.1

10. What are the main steps in winding up a solvent OEIC?

Answer reference: Section 5.1



Chapter Nine

Income

1. Entitlement to Income
2. The Amount of Available Income
3. Making the Distribution Payment
4. Equalisation
5. Tax Vouchers

This syllabus area will provide approximately 4 of the 50 examination questions



1. Entitlement to Income

- 9.1.1 Know: the sources of income and relevant criteria; the different treatment of income and accumulation shares/units; the timetable for distribution of income
- 9.1.2 Know the requirements of the tax elected fund regime
- 9.1.3 Know the requirements of the property authorised investment funds (PAIF) regime

1.1 Overview of CIS Distributions

The net income of a scheme is a combination of:

- dividends and/or interest received from investments held on behalf of the CIS, and
- additional sources of income (eg, from underwriting or stock lending), less
- the total expenses paid by the fund.

Occasionally, the fund might receive additional assets in lieu of an income entitlement (eg, if an asset held by the fund pays a scrip dividend). In such cases a corresponding transfer may be made from the fund's capital account to its income account (to recognise the additional value as income in the fund's accounts).

The net income will be allocated to unit/shareholders following each annual accounting period, though the AFM may specify additional income allocation dates (eg, half-yearly, quarterly, or monthly – according to whether the CIS is seeking to generate higher levels of income). Each sub-fund of an umbrella-type CIS will all have the same annual accounting reference date and the same annual income allocation date, though they may have different frequencies of interim distributions.

Income may be allocated as either:

- an income distribution paid to the holder as cash
- an income distribution which is reinvested into the CIS by purchasing additional units/shares that are allocated to the holder, or
- an accumulation of income, which updates the accumulation factor so that the value of each accumulation unit/share increases relative to an income unit/share.

Note that the net income allocated to the holders of income units is removed from the fund valuation (as that money is paid to the holders, usually as a cheque or a bank account transfer which COLL requires be completed within four months after the end of the accounting period), while the net income allocated to holders of accumulation units moves from the income account to the capital account and is used to buy assets within the fund.

The value of income being distributed or accumulated is updated in the first valuation point after the relevant accounting date, and the unit/share price is now said to be quoted 'ex-distribution' (as new purchases of units/shares have no entitlement to the distribution payment now in process).

The CIS might pay different types of distribution according to the underlying source of the income, and the type of distribution paid may affect the tax that the holder must pay on that income. (The personal taxation impacts for a holder are discussed in chapter 10). The types of distribution that an authorised CIS might pay are as follows:

- **A dividend distribution** – this is the normal case where, for instance, income has been earned from company dividends.
- **An interest distribution** – this is paid by a fund that has throughout the accounting period invested 60% or more of the scheme property in gilts, UK or overseas bonds and/or money market deposits.
- **A property income distribution** – this is only paid by a Property Authorised Investment Fund (PAIF) to reflect the income arising from investment in physical property (eg, commercial buildings) and UK Real Estate Investment Trusts (UK REITS).

In most cases, all the income earned by a CIS will be paid as either a dividend distribution or an interest distribution. However, there are a couple of special cases to note.

1.2 Tax-Elected Funds (TEFs)

The purpose behind the tax elected fund (TEF) regime is to put the holder into a similar tax position as if they had invested directly into the underlying assets of the CIS. Therefore, rather than all income being paid out as either a dividend distribution or an interest distribution, a TEF makes two types of distributions:

- dividend distributions, and
- non-dividend distributions (interest).

UK and overseas dividend income are distributed as a dividend. All other income is distributed as interest, for which a full UK corporation tax deduction is allowed.

The TEF regime can only be adopted by an alternative investment fund (AIF), and TEFs are able to distribute or accumulate income gross of tax to all tax-exempt UK investors and to those overseas. The regime puts AIFs on a similar footing to funds in jurisdictions such as Luxembourg and Ireland and may be of particular benefit to tax-exempt UK investors (such as pension funds, charities, and ISAs) and overseas investors where the AIF would otherwise have a UK tax liability.

TEFs are allowed to hold property indirectly, and income distributions that a TEF receives from either a UK real estate investment trust (UK REIT) or a PAIF have to be received net of tax deducted at source. TEFs are not allowed to hold property directly.

1.3 Property Authorised Investment Funds (PAIFs)

A property authorised investment fund (PAIF) is a form of authorised investment fund whose investment portfolio comprises predominantly real property or shares in UK REITs and certain other similar entities. The aim of the distribution regime for a PAIF is similar to that of a TEF, but where a TEF pays two types of distribution a PAIF will also pay a property income distribution.

A PAIF may have a mix of income (being required to derive at least 60% of its net income from property business), and so the accountant must distinguish property income as it passes through the fund to ensure that it remains identifiable (and distinct from any dividend income and interest income). While the PAIF pays no tax on property income, the investor may pay tax on the property income distribution paid out by the PAIF.

In general, investors in PAIFs will pay approximately the same level of tax as if they had invested directly in the underlying assets. In order to achieve this, the fund must make distributions to investors in a way that enables the investor to identify the amount attributable to the different types of income, and to pay tax on them accordingly. A single PAIF distribution therefore includes separate 'streams' reflecting:

1. property income
2. interest income, and
3. dividend and other income.

2. The Amount of Available Income

9.2.1 Be able to calculate available income

9.2.2 Be able to calculate bond income on an 'effective yield' basis

2.1 Calculating Available Income

Available income is calculated as in the following example (which is effectively part of the valuation process undertaken by the AFM at each valuation point).

Example

Income Available for Distribution: 1 May 20XX to 30 April 20XX

	£000
Income brought forward (note 3)	200
Gross income (received or receivable during the period) – including franked investment income (eg, dividends received and stock dividends) and unfranked income (such as interest on debt securities, bank deposit interest, and underwriting commission)	3,800
Equalisation: add the amount received on shares issued during the period (note 1)	<u>100</u>
	4,100
Deduct:	
Charges and expenses of the company paid or payable out of income (note 2) This may include the AFM's periodic charge, registrar's and depositary's fees, safe custody fees	(1,000)
Equalisation: deduct the amount paid on shares cancelled during the period (note 1)	(10)
Taxation (tax credits, corporation tax, withholding tax)	(600)
Income carried forward: any income it is agreed should be carried forward to a subsequent accounting period (note 3)	<u>(300)</u>
Amount available for distribution (note 4)	<u>2,190</u>

Notes

1. Equalisation is the proportion of the price received or paid for units/shares that are related to income. It is included only if provision for equalisation is included in the trust deed/instrument of incorporation.
2. The charges and expenses must also be covered in the prospectus if they are to be taken out of the income or capital property of the trust/company. Certain charges and expenses may be charged to the fund's capital account. If the objectives of the fund are to provide income or a balance between income and growth the AFM's periodic charge can be treated as a charge against capital. Taking this charge from income to capital increases the amount available for distribution but could have an adverse impact on capital. The prospectus must state which charges are taken from income or capital and, if capital, it must include appropriate risk warnings on the effect of this on capital.
3. This may include income that is unlikely to be received until 12 months after the income allocation date.
4. This includes any amount to be transferred to the capital account in respect of accumulation units/shares.

The question is how much of this available income will be distributed to holders at the end of the accounting period.

At an annual accounting date, all net income must be distributed/accumulated (unless the amount available is smaller than some minimum amount stated in the prospectus – a '*de minimis*' for distribution payments).

There is more flexibility for interim distributions as the AFM can decide what portion of the current net income will be distributed for that period (with any residual remaining as net income when carried into the next interim period).

The position is different for a type of COLL fund known as a charity authorised investment fund (CAIF), a type of fund specifically designed to enable investment by registered charities. The CAIF rules permit the CAIF to operate an 'income reserve account' to minimise large swings in the level of income generated each year. Up to 15% of the income available for distribution at the end of the year can be transferred into the fund's income reserve account and so would not be included in the distribution for the year ended (though must be included in the income distributed at the end of the following year).

(Note: equalisation will be explained in section 4 of this chapter).

2.2 Effective Yield

The term 'effective yield basis' applies to the accounting approach taken for income received on bond investments. The calculation of effective yield is shown in the following simplified examples. While a real fund might buy and sell many bonds, and may not therefore hold any to the actual maturity of the bond, the simplified example assumes that the fund holds only one bond and holds it to maturity. In example A, a fund purchases a bond at a premium to its redemption value. In example B, a bond is purchased at a discount.

Example A

A fund buys a bond for £102. The bond is due to redeem in one year's time for £100 and pays an annual coupon of £8. The total return on holding this bond over the year is, therefore, £6 (that is, £8 of coupon minus the £2 loss when the bond is redeemed). The effective yield basis would calculate the fund's income as being £6 (rather than the £8 actually received). Therefore, if the fund's accounting policy was to distribute on an effective yield basis, the holders would share a distribution of £6 (the net yield expected at redemption), with no need to record a capital loss for the £2 maturity loss.

Example B

A fund buys a bond for £98. The bond is due to redeem in one year's time for £100 and pays an annual coupon of £4. The total return on holding this bond over the year is, therefore, £6 (that is, £4 of coupon plus the £2 gain when the bond is redeemed).

In this example, the fund's income on an effective yield basis is £6 (combining the redemption gain with the coupon received). The holders would share a distribution of £6.

It is important to note that these examples relate to only one bond with only one year to maturity; funds will have a mix of bonds in their portfolio, all of which, taken together, will determine an investor's net income. It is only those funds whose portfolios predominantly contain either high coupon bonds or low coupon bonds where the effective yield basis would differ significantly from the values received. Typically, high-income bond funds will be heavily invested in bonds bought at a premium and/or with high coupons. For these funds, coupon income will generally be above effective yield, so such funds may be more likely to distribute on the basis of received income rather than effective yield.

3. Making the Distribution Payment

9.3.1 Know the customary payment processes and their associated requirements

9.3.2 Know the treatment of unclaimed distributions

3.1 Methods of Payment

Distribution payments are made from a specific distribution bank account. As the distribution is a payment of scheme property to the holders, the distribution bank account will normally be in the name of the depositary rather than the name of the AFM (though in respect of an OEIC the account might be in the OEIC's name).

Any income due to the AFM (ie, in respect of units/shares held in the manager's box) is paid to the AFM, along with any associated tax credit.

Traditionally, distribution payments were made by a cheque drawn on the distribution bank account in favour of the sole or first-named holder and sent to that holder's registered address by post. Over time, it has become common for the distribution to be paid directly into the holder's bank account, which has advantages for both holder and CIS.

For the holder:

- **Convenience** – the holder does not need to pay the cheque into their bank account
- **Postal risk is mitigated** (as a cheque might be delayed or lost in the post)
- **Timeliness** – the income is available for use by the holder on the day of receipt, with no delay for the cheque to clear.

For the CIS:

- Paper handling is reduced
- Reconciliation problems are reduced, and
- Costs are reduced significantly.

The AFM must ensure that the distribution payments are made by the regulatory deadline of four months after the corresponding accounting reference date (or any shorter period stated in the prospectus).

3.2 Unclaimed Distributions

Whether the distribution is attempted via bank transfer or by cheque, there is potential that the payment to some holders will be unsuccessful, for instance:

- The holder has not provided their bank account details, or has changed their bank account without telling the AFM (who maintains such records).
- A distribution cheque has been lost in the post, or was received by the holder and not paid into their bank account.

The depositary remains responsible for any distribution payment until that payment has been successfully completed to the relevant holder. Where a bank transfer is not completed it is common for the AFM to contact the holder to check it has the correct details on file for the holder, and so help the depositary resolve the exception item. Where a cheque is issued, it is generally considered good for a period of six months, and may of course be banked at any time during that period.

Where any given distribution remains unpaid six months after the payment was attempted, it is common for the depositary to move the monies into a separate 'unclaimed distributions' bank account (to keep the exception cases operationally separate from the next set of distributions being issued). The holder may at any time contact the AFM to ask the depositary to pay any outstanding distributions due to that holder, and such instructions will be acted upon once relevant verification controls have been completed.

If a given distribution payment remains unpaid after a period of six years (or any longer period specified in the prospectus) the COLL rules instruct that the money would at that point cease to be due to the individual holder concerned, and the sum is instead passed into the capital property of the fund. As a result the fund as a whole benefits from the unclaimed distribution, and the holder to whom the payment had been due is no longer able to claim the missed payment.

4. Equalisation

9.4.1 Be able to calculate an equalisation rate

A CIS typically receives income throughout the accounting period, and the current level of net income forms part of the unit/share price. Therefore, most investors will purchase units/shares at a price that includes an element of income – meaning that to some extent an investor buying units/shares is buying part of their future income receipt (on which they will then suffer income tax). 'Equalisation' is the name given to the accounting treatment to mitigate the risk that an investor ends up paying income tax on a distribution amount that was already included in the price of the units/shares that the investor bought.

Equalisation is a portion of the distribution figure, deemed by HM Revenue & Customs (HMRC) to be a return of capital rather than a receipt of income. As such, the equalisation amount is not liable to income tax, and for capital gains tax purposes the equalisation amount should be deducted by investors from the purchase cost of those units/shares. However, rather than tracking the income included in each individual unit/share trade, for retail funds it is common to apply an average equalisation rate to all units/shares bought during the accounting period. Such an average equalisation rate for the accounting period is calculated as follows:

$$\frac{\text{Sum of the income amount included in the price of each unit/share bought by investors during the accounting period}}{\text{The total number of units/shares purchased by investors during the period}}$$

Equalisation is only applied to the first distribution paid to the holder after buying the units/shares. Units/shares purchased during the distribution period are referred to as Group 2 units/shares, and the equalisation rate is applied (meaning that a portion of the distribution is viewed as a 'return of capital' rather than a receipt of earned income). Units/shares held from a prior period are referred to as Group 1 units/shares, and no further equalisation will be applied to such units/shares.

An individual investor may therefore hold a combination of Group 1 and Group 2 units at the end of a distribution period. The distribution statement/voucher must confirm the breakdown of Group 1 and 2 units/shares held by that investor so the amount of equalisation applicable to those Group 2 units/shares can be recognised.

In the case of a fund of funds, Group 1 units may be allocated an equalisation rate to reflect equalisation being received by the fund on the investments it has made.

Technically, the adoption of equalisation by a CIS is optional and so it should only be used where stated in the scheme documents.

A Simplified Example

Existing investors have 100,000 units/shares at 50p invested in a fund holding fixed interest securities earning 12% pa. No capital appreciation is assumed. A new investor purchases 10,000 shares on the last day of month 2, and a second new investor purchases 10,000 shares on the last day of month 4, with new units/shares issued in both cases. Equalisation would be calculated as follows:

End of Month	Group 1 Shares	Group 2 Shares	Income		Price (p)	Equalisation	Capital (£)
			Group 1	Group 2			
0	100,000				0.500		50,000
1	100,000		500		0.505		
Purchase		10,000			0.510	100	5,000
2	100,000	10,000	500		0.510		
3	100,000	10,000	500	50	0.515		
Purchase		10,000			0.520	200	5,000
4	100,000	20,000	500	50	0.520		
5	100,000	20,000	500	100	0.525		
6	100,000	20,000	500	100	0.530		
Distribution			3,000	300	0.530	300	60,000
			-3,000	-300	-0.030	-300	0
			0	0	0.500	0	60,000

In the absence of expenses (this being a simplified example), the total amount available for distribution is £3,600:

Group 1 income	3,000
Group 2 income	300
Equalisation	<u>300</u>
Total distribution	<u>3,600</u>

The distribution rate would be this total income figure divided by the total number of units/shares in issue at the end of the period, ie, $3,600 / 120,000 = £0.03$ (or 3 pence per unit/share).

However, if we use the formula to determine the average equalisation rate:

- Aggregate income included in the price of units/shares issued or reissued: £300.
- Total number of units/shares purchased by investors during the period: 20,000.
- Equalisation rate $(300 / 20,000) = £0.015$ per unit/share (or 1.5 pence per unit/share).

All unitholders/shareholders will receive a distribution of 3 pence per unit/share. However:

- For 'Group 1' unitholders/shareholders, the entire distribution is treated as income.
- For 'Group 2' unitholders/shareholders, 1.5 pence per unit/share is treated as a return of capital, which is not subject to income tax.
- The fact that one investor bought their units/shares at the end of month one, while the other bought units/shares two months later is important to the underlying accounting and the calculation of the rate (as it determines the amount of income that was included in the respective unit/share prices), but both investors receive the same equalisation rate.

5. Tax Vouchers

9.5.1 Know the contents of tax vouchers in relation to: methods of delivering tax voucher information; distributions; streaming requirements; equalisation

As we will see in the following chapter, most CIS distributions are paid without any income tax being deducted at source. This enables each investor to establish through their own self-assessment or corporate tax calculation whether any tax is payable on the income received.

The AFM will send a communication to each holder (or the first-named joint holder) confirming the type of distribution (dividend distribution or interest distribution), total income allocated to that holder, any equalisation applicable, and any tax that has been deducted on behalf of the investor. This communication is generally referred to as a 'tax voucher', and it might be issued for each separate income payment or as a composite tax voucher including all income amounts paid/allocated to that holder during the year.

The tax voucher can be sent as an electronic communication provided the following three points are satisfied:

- The payer (eg, CIS) must have indicated to the holder that they intend to use electronic communications.
- The proposed recipient must have consented to information being delivered by the sender in this way, and that consent has not been withdrawn.
- The electronic statement format allows it to be stored and permits a copy to be printed, but does not allow alteration of the contents.

The FCA requires a retail investor must specifically choose to receive this communication electronically rather than in paper format.

Certain types of fund raise variations to this general communication approach. We noted earlier that PAIFs will pay a 'streamed distribution' that may contain up to three separate types of income distribution. The tax voucher should provide the relevant information for each type of distribution paid by the PAIF.

Further obligations arise in respect of 'Tax Elected Funds'. Statute requires that each holder of a TEF should be notified of:

1. the amount allocated to the investor (before the deduction of any tax)
2. the number and class of units/shares on which the income is allocated to that investor
3. the net amount of the distribution per unit (ie, after any tax has been deducted)
4. whether any tax has been deducted
5. the date the distribution was made, and
6. the percentage of the gross distribution attributable to the TEF distribution (dividend) and the percentage attributable to the TEF distribution (non-dividend).

This information might be provided in a personalised communication, but alternatively the AFM might provide the holders with basic confirmation of the distribution combined with an online calculator enabling them to accurately determine the required items.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. List the types of income a CIS may receive.

Answer reference: Section 1.1

2. What are the different types of distribution that may be paid by a CIS?

Answer reference: Section 1.1

3. A CIS must make a dividend distribution if it holds less than what percentage of scheme property in interest-bearing assets?

Answer reference: Section 1.1

4. What are the three streams of income an investor in a property authorised investment fund may receive as a distribution?

Answer reference: Section 1.3

5. Who is responsible for calculating the amount of income received by a CIS during an accounting period?

Answer reference: Section 2.1

6. When must income be distributed by?

Answer reference: Section 3.1

7. How is an income distribution paid by a CIS to a unit/shareholder?

Answer reference: Section 3.1

8. After what period does any unclaimed income distribution cease to be due to the individual investor?

Answer reference: Section 3.2

9. Explain:

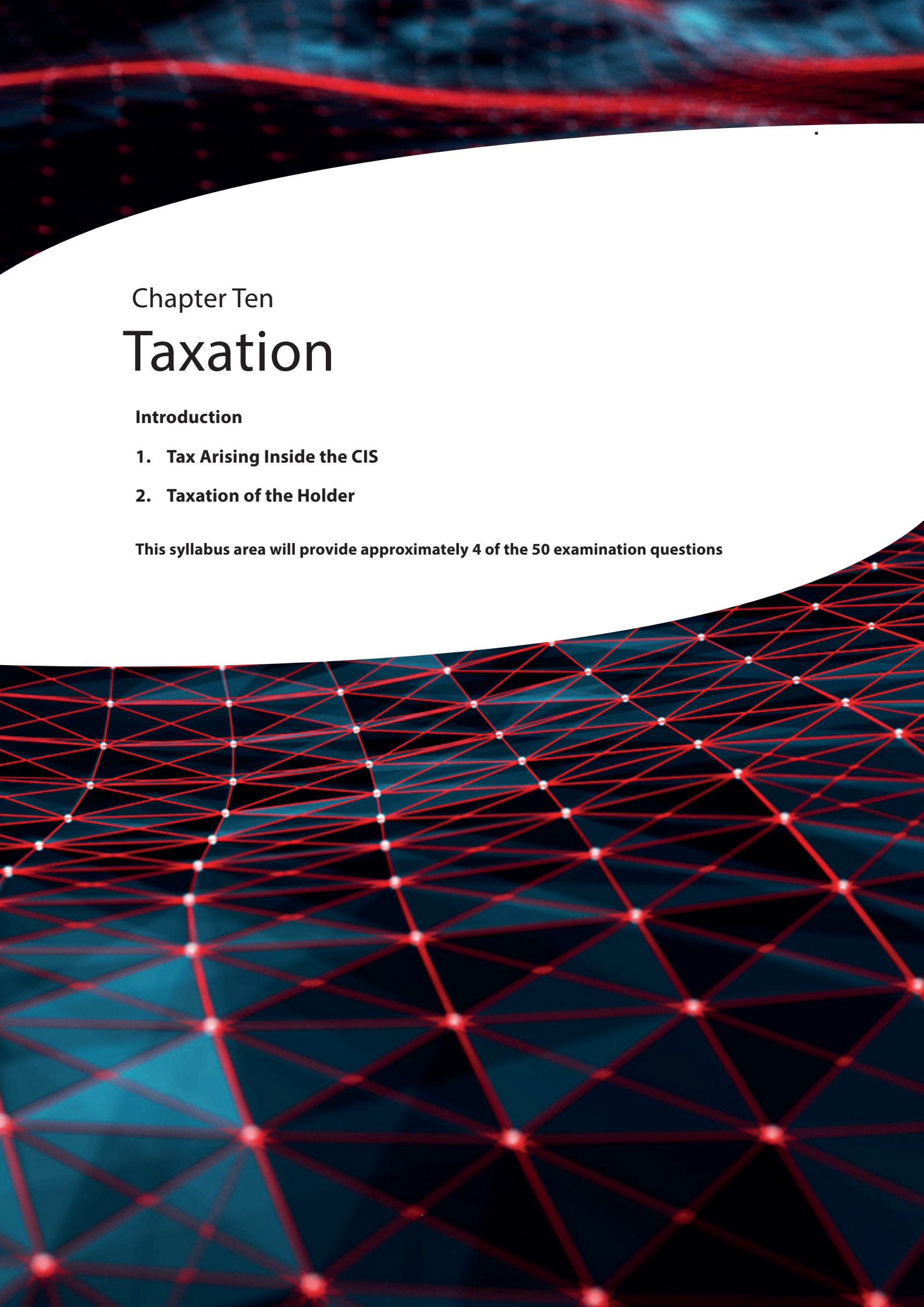
a. What is equalisation?

b. How is it calculated?

Answer reference: Section 4

10. What will be shown on the statement and tax voucher (or the certificate) sent to the unit/shareholder?

Answer reference: Section 5



Chapter Ten

Taxation

Introduction

1. Tax Arising Inside the CIS
2. Taxation of the Holder

This syllabus area will provide approximately 4 of the 50 examination questions



Introduction

This chapter provides an introduction to the complex subject of taxation as it relates to collective investment schemes (CISs) and to investors in such schemes. It is not intended to provide a comprehensive guide to relevant taxation. For more detailed information on taxation, students should refer to an appropriate tax guide.

Statutory references, unless otherwise specified, are to the Income and Corporation Taxes Act 1988 (the 1988 Tax Act).

Since the personal savings allowance was introduced, income tax is no longer deducted from most distributions paid by authorised CISs. Each investor must determine any income tax due on the income they have received.

1. Tax Arising Inside the CIS

10.1.1 Know the basis on which authorised Collective Investment Schemes are taxed: income received; deductible and non-deductible expenses; periodic fee charges to the capital account; foreign income; corporation tax payable; payment dates and returns made; capital gains tax

10.1.2 Know the treatment of umbrella-type schemes

First, we explore taxes arising inside the workings of the CIS. Each OEIC and AUT is taxed as if it is an ordinary company resident in the UK, giving similar rights to the holders of units/shares.

For a unit trust, the trustee is the formal taxpayer, while for an OEIC it is the OEIC itself that pays tax (with the AFM being responsible for the completion and submission of the fund's tax returns).

For an umbrella scheme, each sub-fund is treated for tax purposes as if it were a separate scheme (and the umbrella company is not considered as a distinct taxable entity).

1.1 Corporation Tax

The CIS's liability to corporation tax is calculated on the balance of taxable income after the deduction of chargeable expenses. This is therefore very similar to the net income/expense for the period (which gives rise to the distribution), but in some matters the tax treatment is slightly different from the general accounting treatment.

One aspect is that the corporation tax liability is only reduced by 'chargeable expenses' (rather than all expenses incurred). The following table distinguishes chargeable expenses from non-chargeable expenses:

Chargeable Expenses	Non-Chargeable Expenses
AFM fees	Stockbroker's fees
Trustees/depositary's fees	Foreign exchange losses
Safe custody fees	
FCA fees	
Auditor's fees	
Interest expenses*	

Registration fees	
Interest distributions	
Interest payable (eg, overdraft)	

* Relief can be obtained providing the borrowing is within that permitted under the FCA regulations.

On the income side, the key taxation question is whether any tax has already been applied to the income received by the fund. When a UK company pays a dividend, it effectively deducts the applicable tax (and the holder receives a tax credit). Income that has been taxed at source is referred to as **franked investment income (FII)**. For a CIS, the FII includes UK dividends received, and no corporation tax will be payable by the CIS on this income. Income received by a CIS without tax being deducted is referred to as **unfranked investment income (UFII)** – such as:

- distributions received from other CISs (as these are now paid gross)
- interest on debt securities
- bank deposit interest
- underwriting fees, and
- foreign income.

A CIS's taxable profit is therefore determined by calculating the total amount of unfranked income received from the fund's investments, less any allowable expenses.

In some cases, the AFM might charge some or all of its periodic charge to the CIS's capital account (rather than it being netted off against income earned). However, the value of the period charge remains a chargeable expense that can reduce the Corporation Tax due.

Foreign Income

While foreign income is listed above as UFII, it should be noted that such amounts may be subject to two types of local tax:

- **Underlying tax** – the local country equivalent of UK corporation tax, which reduces the profits available for distribution by the company.
- **Withholding tax** – the foreign tax paid directly as a result of remitting the interest or dividend overseas.

The UK government enters into agreements with foreign governments for the purpose of preventing double taxation (ie, two countries both applying taxation in respect of the same income). These are referred to as double taxation agreements (DTAs). A further objective of these agreements is to render reciprocal assistance in the prevention of tax evasion.

CISs are unlikely to obtain UK tax relief for underlying tax paid unless the unit/shareholder owns more than 10% of the voting share capital of the dividend-paying company. They can, however, obtain relief from withholding tax.

Under the UK DTR system, income which would have been doubly taxed may be relieved by:

- exemption of income from UK taxes
- deduction of foreign tax from the income liable to UK tax, or
- credit of foreign tax suffered against the UK tax on the income.

Most DTAs restrict the relief from withholding tax to a certain rate (say 15%) and anything above this rate has to be recovered from the tax authority in the foreign country concerned (where possible). The AFM in the case of an OEIC or the depositary of an AUT would submit such claims on behalf of the CIS. In some countries (eg, Italy), there have been problems in obtaining repayment under the DTAs. As a result, Italian withholding tax refunds are generally recognised on a 'received' basis rather than an 'accrued' basis.

Example – Corporate Tax Calculation

The following is a simplified example of a tax calculation in respect of a CIS paying an interest distribution (assuming no overseas tax has been suffered).

	£ (000s)	£ (000s)
Unfranked income:		
Interest on debt securities	20	
Bank deposit interest	80	
Underwriting commission	20	
Less expenses		120
AFM's fee	10	
Depository's fee	5	
Safe custody charges	5	
		–20
Income before taxation		100
Corporation tax at 20%		20
Net distributable income		80

Paying Corporation Tax

The rules for paying corporation tax depend on the value of taxable profits made:

- **Taxable profits up to £1.5 million** – Corporation tax must be paid within nine months and one day of the end of the accounting period.
- **Taxable profits between £1.5 million and £20 million** – Corporation tax must usually be paid electronically and by quarterly instalments, with the first payment earlier, within 6 months and 13 days of the first day of the accounting period, and quarterly thereafter.
- **Taxable profits over £20 million** – Corporation tax first payment is even earlier, within two months and 13 days of the first day of the accounting period, and quarterly thereafter.

(Note: the calculation of the instalments is outside the scope of this workbook.)

1.2 Capital Gains Tax

Capital gains made by CISs on investment transactions in the UK are exempt from tax (Taxation of Capital Gains Act 1992 S.100[1]). A CIS invested in overseas securities may be liable to any applicable overseas CGT (subject to any double taxation agreement between that country and the UK).

In some cases, the CIS can make local disclosures to avoid/reduce the local CGT applied. It is therefore important that the AFM and/or depository ensures that all applicable tax registrations are maintained with each tax jurisdiction.

However, if HMRC considers that a CIS's activities constitute dealing or trading in securities (rather than investment), then any gains from these activities will be subject to CGT. Similarly, the use of derivatives will be considered: are such investments used to protect gains made in the portfolio, or to generate additional income?

The rate of portfolio turnover (ie, the percentage or number of times the assets of the fund are bought and sold in a year) is an indication of whether there is active trading, though is not conclusive and the only real determinant is the intention of the AFM.

1.3 VAT

10.1.3 Know the treatment of VAT on CISs

A CIS may be subject to VAT on charges it pays for services provided to it, such as fees paid to the depositary and Auditor. However, there is an exemption of VAT for investment management services, so the legal process has needed to determine what services can be considered as eligible for this VAT exemption.

The legal position is that the services of Depositaries are not covered by the concept of 'management' and are therefore excluded from exemption. For fund accounting and administration services, the Court found that they would qualify as management of special investment funds for the purpose of the VAT exemption if, 'viewed broadly, they form a distinct whole and are specific to, and essential for, the management of those funds'.

The Court considers that the following tasks (defined by the UCITS Directive as comprising 'administration') are capable of coming within the scope of the exemption:

- legal and fund management accounting services
- customer enquiries
- valuation and pricing (including tax returns)
- regulatory compliance monitoring
- maintenance of a unitholder/shareholder register
- distribution of income
- unit/share issues and redemptions
- contract settlements (including certificate dispatch), and
- record-keeping.

To be exempt, it is necessary for the service to be distinct as a fund administration service. This 'distinctiveness' is normally achieved by bundling numerous operations necessary for the administrative management of a fund into a single supply. In deciding whether the overall service is distinct as fund administration, both the number of specific operations and their individual characteristics need to be taken into account. For example, the daily valuation of assets is of particular importance and relevance to CISs in determining the price of shares or units, so this, together with related accounting and reporting functions, would be sufficiently distinctive as a fund administration service.

The maintenance of a register of shareholders does not, in isolation, represent a fund administration service. However, if the service is combined with the issue and redemption of the units or shares and collating the number of shares in issue for the purpose of establishing the daily price of the units/shares, such a package takes on the distinct characteristics of fund administration and will be exempt.

2. Taxation of the Holder

10.2.1 Know the income tax, corporation tax and capital gains tax implications for the following investors: corporate (including other Collective Investment Schemes); individuals (taxpayers, non-taxpayers, and ISA investors)

2.1 Taxes on Income

While a dividend distribution or income distribution paid by the CIS will be a gross figure (ie, without any tax being deducted), the investor must determine whether their overall levels and types of income mean that some tax liability is due. This position will be determined as part of their Self-Assessment calculation.

Note, however, that where the CIS units/shares are held within an ISA any income received is excluded from the person's Self-Assessment calculation and so no tax liability will arise for that income. Similarly, if the investor is a non-taxpayer (in the light of all income received during their tax year), then no tax liability would arise from the distribution income received.

Where the holder is a corporate entity (including where units/shares of one CIS are held by a second CIS), the income received will form part of the receiving company's corporation tax calculation.

The rest of this section relates to income earned by an individual taxpayer outside of an ISA.

Dividend Distribution

Each UK taxpayer has a dividend allowance, set at £500 for the 2025–26 tax year. Therefore, up to £500 of dividend income can be received before any tax liability might arise. If the taxpayer does earn more than £500 of dividend income, the amount of tax they will need to pay depends on their personal allowance and marginal rate of tax:

- If the person is a basic rate taxpayer, the excess dividend income is taxed at 8.75%.
- If the person is a higher rate taxpayer, the excess dividend income is taxed at 33.75%.
- If the person is an additional rate taxpayer, the excess dividend income is taxed at 39.35%.

Savings interest (which includes interest earned from bank accounts as well as investments) is subject to two distinct allowances. Each person is allowed to earn £5,000 of interest without paying tax – but this ‘starting rate for savings’ is reduced by £1 for each £1 by which the person’s other income increases above their Personal Allowance. Once the taxpayer is earning £5,000 above their personal allowance, the ‘starting rate for savings’ is reduced to zero and so does not affect their tax liability.

The second allowance is called the ‘personal savings allowance’, and works independently of the first. It grants a separate tax-free allowance, which varies according to the marginal rate of income tax paid by the investor. For the 2025–26 tax year:

- If the person is a basic rate taxpayer, the personal savings allowance is £1,000.
- If the person is a higher rate taxpayer, the personal savings allowance is £500.
- If the person is an additional rate taxpayer, the person does not receive any personal savings allowance.

Any excess interest earned by the individual above their relevant allowances will be taxable at the individual’s marginal rate.

Property Income Distribution

Property income is viewed differently from either dividend income or interest. The distribution will generally be subject to a 20% tax credit. The consequences of this for different investors are as follows:

- If the person is a basic rate taxpayer, the investor’s 20% tax liability has already been paid (so no further tax is due).
- If the person is a higher rate taxpayer, the investor must pay 40% of the income, but has already paid half of this sum (the 20% tax already deducted).
- However, if the person is a non-taxpayer, then they are able to recover the 20% of tax already deducted from the income received.

2.2 Taxes on Capital Gains

We have seen that investment transactions within a CIS are exempt from CGT if the fund is not seen as ‘trading’. The holder may, however, be subject to CGT on the disposal of units/shares. For the 2025–26 tax year, an individual’s first £3,000 of gains on disposals of assets are exempt from CGT. Gains above this level are subject to CGT at the following rates:

	Basic rate taxpayers	Higher/Additional rate taxpayers
Gains from residential property	18%	24%
Gains from assets carrying interest	32%	32%
Gains from other assets	18%	24%

The capital gain on income units/shares is calculated by deducting the original purchase cost, less the amount of any equalisation shown in the first tax credit voucher following the purchase, from the sale proceeds.

The capital gain on accumulation units/shares is calculated by deducting the total amount of reinvested net income added to the original cost (including any equalisation, since this was not repaid) from the sale proceeds.

The calculation is relatively simple if a person buys a quantity of shares on one day and sells the same quantity at least 30 days later, but investment activity is usually more complex, with shares being bought at various times and sold in different quantities. The CGT tax rules set out how the costs and proceeds of different trades are apportioned for CGT purposes depending on when the individual transactions took place, though such calculations are beyond the scope of this workbook.

Note that assets bought and sold within an ISA are not subject to CGT. If a holding is transferred between husband and wife, any CGT liability is transferred to the spouse with the holding. There is no gain or loss incurred at the point of transfer. Any gain arising on a subsequent sale by the receiving spouse would be calculated by reference to the original cost and any applicable indexation. The receiving spouse who subsequently sold the holding would be liable for any CGT. Thus, it is possible to maximise the use of CGT allowances of both spouses.

2.3 Offshore Funds Regime

10.2.2 Know the relevance of the Offshore Funds Regime on the taxation of a UK investor

An offshore fund is defined for tax purposes by HMRC as:

‘any non-UK tax resident company, trust or other vehicle where the participants do not have day-to-day control of the management of the property, and a reasonable investor would expect to be able to realise any investment based entirely by reference to the net asset value (NAV) of the property or an index of any description’.

HMRC collects tax from UK investors in such funds according to whether the fund elects for 'reporting fund' status.

An offshore fund which elects for 'reporting fund' status is required to report 100% of the income attributable to its investors, whether this income is distributed or not.

A UK investor who sells their holding in a reporting fund will be subject to:

- CGT on any gain realised, and
- income tax on their share of the offshore fund's income regardless of whether this is distributed or not.

A UK investor who sells their holding in a non-reporting fund will be subject to income tax on any gain realised.

End of Chapter Questions

Think of an answer for each question and refer to the appropriate section for confirmation.

1. How is an authorised CIS's taxable profit determined?

Answer reference: Section 1.1

2. In taxation terms, what is meant by FII and UFII?

Answer reference: Section 1.1

3. When would corporation tax be payable for a fund/company with taxable profits up to £1.5 million?

Answer reference: Section 1.1

4. What CGT liabilities can an authorised CIS incur?

Answer reference: Section 1.2

5. What services are considered to be 'administration' and so are exempt from VAT when paid for by a CIS?

Answer reference: Section 1.3

6. If an investor receives dividend distributions that exceed their dividend allowance, what rate of income tax applies to the excess amount?

Answer reference: Section 2.1

7. In respect of savings interest earned by an investor, what is the value of the 'personal savings allowance'?

Answer reference: Section 2.1

8. In what way would an investor pay tax on a property income distribution?

Answer reference: Section 2.1

9. How is a shareholder's CGT liability calculated on a disposal of income shares?

Answer reference: Section 2.2

10. What type of tax liability arises for a UK investor who sells their holding in a non-reporting offshore fund?

Answer reference: Section 2.3



Glossary

Accumulation Factor

A type of conversion factor, reflecting the amount of income retained by each accumulation unit/share relative to an income unit/share. The factor changes each time a distribution is made, to reflect the additional value retained by the accumulation units/shares.

Accumulation Units/Shares

Units/shares where net income remains in the CIS and within the price of the units/shares.

Alternative Investment Fund (AIF)

Various types of non-UCITS collective investment scheme, as defined by the Alternative Investment Fund Managers Directive (AIFMD).

Alternative Investment Fund Manager (AIFM)

A regulated firm acting as manager of an alternative investment fund.

Annual Management Charge (AMC)

A charge payable to the AFM, deducted from the assets of the CIS, accrued in the valuation, and disclosed in the prospectus.

Authorised Contractual Scheme (ACS)

A CIS legal structure which differs from both, an AUT and an OEIC, and enables tax-transparency.

Authorised Corporate Director (ACD)

The term in the OEIC Regulations for the AFM of an OEIC.

Authorised Fund Manager (AFM)

A regulated firm acting as manager of an authorised UK collective investment scheme.

Authorised Unit Trust (AUT)

A unit trust scheme authorised by the FCA. Authorised unit trusts can be offered for sale to the general public.

Bearer Units/Shares

Units or shares which transfer by hand without the need for registration of the change of ownership.

Bid/Offer Spread

The percentage difference between the bid and offer prices of a dual-priced CIS.

Bid Price

The price paid to unit/shareholders redeeming their units/shares in a dual-priced CIS.

Business Day

Any day other than a Saturday, Sunday, Christmas Day, Good Friday or a bank holiday under the Banking and Financial Dealings Act 1971.

Collective Investment Schemes (CISs)

A generic term encompassing authorised unit trusts, common investment funds, OEICs and investment trust companies.

Collective Investment Scheme Sourcebook (COLL)

Part of the FCA Handbook covering those rules relating to the operation of authorised collective investment schemes.

Conduct of Business Sourcebook (COBS)

Part of the FCA Handbook covering those rules relating to the conduct of business by companies authorised by the FCA to conduct investment and other business under the Financial Services and Markets Act.

Contract Note

A document sent to the investor confirming details of a purchase or sale being made.

Contractual Scheme Deed

The legal instrument by which an ACS is normally constituted.

Conversion Factor

A numeric factor between the prices of different unit/share classes of a fund, usually reflecting the effect of the classes having different charges and/or different entitlement to income.

De Minimis

A minimum threshold below which certain actions are not required, eg, where the amount of income available for distribution to unit/shareholders in a CIS is below the minimum laid down by scheme regulations, no distribution need be performed.

Depositary

A regulated firm (such as a bank or insurance company) that protects the interests of CIS unit/shareholders by providing independent oversight of the AFM and acting as custodian of the fund's assets.

Fair Value Pricing (FVP)

The process by which the AFM determines an estimated price of a portfolio asset where a normal market price is not available or considered reliable.

Financial Conduct Authority (FCA)

Regulatory body responsible for overseeing the UK financial services sector and associated products.

Financial Ombudsman Service (FOS)

Independent body that adjudicates consumer complaints in the financial services sector.

Financial Promotions

Financial adverts and other promotional material covered by the FCA's financial promotions rules, such as:

- adverts in newspapers and magazines (including leaflet inserts)
- product brochures, leaflets and other sales literature
- direct mail shots
- posters
- TV and radio adverts
- promotional emails and text messages, and
- adverts on websites, including product providers' own sites.

Forward Pricing

The approach to CIS pricing in which investors sell or buy at the price that will be determined on the next valuation point of the CIS.

Franked Investment Income

Income received from investments on which an amount of tax has already been deducted by the payer.

Funds of Alternative Investment Funds (FAIFs)

A type of NURS that has wider powers to invest in other NURS.

Gearing

A term describing the ratio between borrowing and capital. 'High gearing' indicates substantial borrowing relative to fund size.

Hedging

A process to protect a CIS's value from the effects of currency fluctuations or other investment risks. This is achieved via forward currency transactions or the use of derivatives (such as futures and options).

Income Units/Shares

Units/shares where net income is payable to the investors at a fixed frequency, so that the accrued income is removed from the value of the CIS.

Initial Charge

A charge levied on investors when investing in a unit trust/OEIC and calculated as a percentage of the unit/share price.

Initial Offer Price

The price at which units/shares are available to the public in a new CIS for a limited period which is set by the AFM.

In Specie Deal

Unit/share transactions that are settled by a transfer of assets rather than a payment of cash.

Instrument of Incorporation

Legal document which sets out the constitution and internal regulations of an OEIC. Broadly similar to a Companies Act company's Memorandum and Articles of Association.

Investment Company with Variable Capital (ICVC)

Another name for an open-ended investment company (OEIC).

Key Features Document (KFD)

A document drawn up for all potential investors containing essential information about a CIS to enable them to determine whether they should invest and what their rights are.

Key Investor Information Document (KIID)

A standardised document containing fundamental information about a UCITS.

Long-Term Asset Fund (LTAF)

A type of retail COLL fund that can invest in assets that are less liquid than normal investment assets (eg, infrastructure projects).

Money Market Fund (MMF)

A CIS which invests specifically in deposits and other money market instruments, eg, Treasury bills.

Near Cash

Assets which may be converted into cash very quickly, eg, Treasury bills and Certificates of Deposit.

Net Asset Value (NAV)

This is the value of the underlying shares held in the portfolio based on quoted market prices, together with other assets, less liabilities.

Nominee

This usually refers to a legal entity which holds shares on behalf of others.

Non-UCITS Retail Scheme (NURS)

A type of retail COLL fund that has greater flexibility than a UCITS fund in its operational features and investment limits.

Offer Price

The price paid by unit/shareholders buying units/shares in a dual-priced CIS.

Open-Ended Investment Companies (OEICs)

Open-Ended Investment Companies (pronounced 'oiks') are corporate bodies established for collective investment purposes.

Periodic Charge

Another name for the AFM's annual management charge (AMC).

Prospectus

Formal document containing details which investors and professional advisers would reasonably require before making a judgement about the merits of investing in a company.

Prudential Regulation Authority (PRA)

The UK regulatory body responsible for the prudent regulation of significant firms (principally banks and insurers) with the objective of ensuring the stability of the firms that it regulates.

Qualified Investor Scheme (QIS)

A category of CIS intended for sophisticated investors, ie, those with significant knowledge of investment, either private individuals or businesses. They are less heavily regulated than retail schemes.

Quorum

The minimum number of persons entitled to vote who must be present or represented at a meeting in order for it to transact business. The quorum requirements will be set out in the fund prospectus.

Registrar

The company which maintains the register of shareholders and may issue share certificates where applicable.

Savings Plan

Arrangements enabling investors to purchase a fixed value of units/shares on a regular basis (usually monthly). Similar facilities are offered for some investment trusts.

Statement of Recommended Practice (SORP)

A SORP provides standards for the preparation of accounts. The SORP for CIS is published by the Investment Association (IA).

Trust Deed

The legal instrument by which a unit trust scheme is normally constituted.

Undertakings for Collective Investment in Transferable Securities (UCITS)

A type of retail COLL fund which is aligned with the European standard for retail CISs. The name is derived from the EU Directive for 'Undertakings for Collective Investment in Transferable Securities'.

Unfranked Investment Income (UFII)

Income received on which no tax has been deducted, though the recipient may need to pay tax on it.



Multiple Choice Questions

The following questions have been compiled to reflect as closely as possible the standard that you will experience in your examination. Please note, however, that they are not actual CISI examination questions.

- 1. Who is responsible for granting 'Reporting Fund' status to an offshore fund?**
 - A. The AIFM
 - B. The FCA
 - C. The Regulator in the fund's home jurisdiction
 - D. HMRC

- 2. Dilution levy and dilution adjustment are two mechanisms to reduce the effects of dilution in a CIS. What is the third mechanism that might be used in certain funds?**
 - A. Income accumulation
 - B. Notional dealing charge
 - C. Deducting expenses from capital
 - D. Gaining offshore fund status

- 3. When an initial offer of shares is made, how long after the AFM has received the price from the purchaser must the AFM pay the depositary for those shares?**
 - A. By the close of the third business day after the monies are received
 - B. By the close of the fourth business day after the monies are received
 - C. At the end of the third business day after the initial offer period expires
 - D. At the end of the fourth business day after the initial offer period expires

- 4. The annual accounting period of XYZ ICVC ends on 30 June each year. What is the latest date by which the AFM must publish the annual report?**
 - A. 31 August
 - B. 30 September
 - C. 31 October
 - D. 30 November

- 5. An investor purchases 1,000 units/shares in a dual-priced CIS at a price of 209p. They later cancel the deal. If the offer price is 196p when the AFM receives the investor's notice to cancel, what would be the shortfall applied?**
 - A. £1.30
 - B. £10.30
 - C. £103.00
 - D. £130.00

6. Which of the following statements regarding the share register for an OEIC is TRUE?

- A. It is maintained by the trustees
- B. It is updated only twice a year
- C. It is not subject to FCA rules
- D. It is not available for inspection by the general public

7. To whom is the AFM required to send a copy of the long report?

- A All current unitholders / shareholders
- B The Fund Auditor
- C The Financial Conduct Authority
- D All of the above

8. Under a qualified investor scheme, what is the MAXIMUM proportion of net asset value which the scheme is allowed to borrow?

- A. 51%
- B. 75%
- C. 90%
- D. 100%

9. In respect of a unit trust, who has ultimate responsibility for the register of unitholders?

- A. The manager
- B. The trustee
- C. A registrar appointed by the manager
- D. Either the manager or the trustee, as nominated in the trust deed

10. Within what period after receiving a complaint should an AFM issue its final response?

- A. Three business days
- B. Four weeks
- C. Eight weeks
- D. Three months

11. Above what percentage impact is a pricing error normally considered 'material'?

- A. 0.1%
- B. 0.25%
- C. 0.5%
- D. 1.0%

12. Having identified a data protection breach, within what period must a UK data controller notify the Information Commissioner's Office?

- A. Immediately
- B. 24 hours
- C. 48 hours
- D. 72 hours

13. Which of the following must be included in an Interim long report?

- A. Trustee/Depository Report
- B. AFM's Report
- C. Auditor's Report
- D. Comparative table

14. The maximum penalty for infringing a data subject's rights under the GDPR is the greater of what figures?

- A. £8.7m or 2% of the data controller's global turnover
- B. £8.7m or 2% of the data controller's global profit
- C. £17.5m or 4% of the data controller's global turnover
- D. £17.5m or 4% of the data controller's global profit

15. Which of the following enables the passporting of funds between EU jurisdictions?

- A. DMD
- B. UCITS
- C. EAD
- D. CRD

16. An AFM is required to cover which of the following in a CASS Resolution Plan?

- A. Details of individuals who are 'critical or important' to the firm's CASS obligations
- B. A list of breaches identified in the previous six months
- C. A copy of the most recent audited accounts
- D. A copy of the company's balance sheet

17. Which of the following must be included in any financial promotion issued for an authorised CIS?

- A. Information about the fund's benchmark
- B. A list of the AFM's directors
- C. Past performance data
- D. All of the above

18. An AFM wishes to launch a fund called the Guaranteed Performance Fund. In order to satisfy FCA rules, the guarantee must be:

- A. Explained in a document which is separate from the key features
- B. Enforceable and applicable to all investors
- C. Reviewed on a six-monthly basis
- D. Maintained for a minimum of five years

19. What is the aggregate limit on borrowing by a UCITS (as a percentage of the value of the scheme)?

- A. 2%
- B. 5%
- C. 10%
- D. 20%

20. What MINIMUM proportion of unitholders is required, expressed in terms of unit value, in order to formally request the trustees to remove the unit trust manager?

- A. 51%
- B. 75%
- C. 80%
- D. 90%

21. An OEIC's annual accounting reference date is 31 December. What is the latest annual income payment date it may have?

- A. 31 March
- B. 30 April
- C. 31 May
- D. 30 June

22. Who is/are required to conduct regular compliance audits on the operation of an OEIC fund manager?

- A. The financial auditor
- B. The depositary
- C. The authorised corporate director
- D. The majority shareholder

23. What proportion of the 'income available for distribution' in a CAIF can be transferred into the 'income reserve account' instead of being distributed to holders?

- A. 15%
- B. 20%
- C. 25%
- D. 33%

24. What is the general limit on the proportion of total scheme property which a UCITS is allowed to hold in approved securities issued by a single body?

- A. 2.0%
- B. 2.5%
- C. 3.0%
- D. 5.0%

25. What is the maximum penalty on conviction for assisting a money launderer?

- A. Unlimited fine
- B. Five years' imprisonment and/or fine
- C. 10 years' imprisonment and/or fine
- D. 14 years' imprisonment and/or fine

26. Which type of UCITS fund is specifically permitted, under exceptional circumstances, to hold 35% of its value in approved securities issued by a single body?

- A. Growth fund
- B. Emerging markets fund
- C. Fund replicating an index
- D. Higher income fund

27. Excluding FAIFs, what is the MAXIMUM proportion of the value of a NURS which can be invested in the units/shares of another regulated scheme?

- A. 10%
- B. 20%
- C. 25%
- D. 35%

28. If the net assets of a single priced fund are worth £162,168.55, and there are 100,000 units in issue, what is the unit price to 4 significant figures?

- A. 162.1685p
- B. 162.1686p
- C. 162.1p
- D. 162.2p

29. Which of the following situations in a single price fund is MOST likely to trigger the application of a dilution levy?

- A. An increase in the manager's charges
- B. An unexpected rise in the value of the underlying investments
- C. A large one-off investment by a client
- D. A change of depositary

30. At what level of an OEIC's structure is the annual management charge applied?

- A: Umbrella OEIC
- B: Fund
- C: Sub-fund
- D: Class

31. What proportion of scheme property is the usual threshold for a large redemption to be settled 'in specie'?

- A. 1%
- B. 2%
- C. 2.5%
- D. 5%

32. In order for a distribution from a unit trust to be treated for tax purposes as an interest distribution, what MINIMUM proportion of the scheme property must be invested in interest-bearing assets?

- A. 40%
- B. 50%
- C. 60%
- D. 70%

33. Which of the following is NOT an item of 'trade confirmation information' that must be included on the contract note for an AFM's CIS trade with a holder?

- A. Time the AFM received the order
- B. Method of payment
- C. Amount of dilution adjustment applied
- D. Reference valuation point

34. Assuming no significant changes take place, how often, as a minimum, must a fund manager review the contents of the Key Investor Information Document (KIID) for its European unit trust?

- A. Six-monthly
- B. Yearly
- C. Every two years
- D. Every three years

35. Units in a unit trust held in the manager's box must be:

- A. recorded in the unit register
- B. sold at mid-price
- C. reconciled on a twice daily basis
- D. renamed while in the box

36. Which of the following are normally permitted to appear as registered holders on a unit trust register?

- A. The trustees of a sports club (in their official capacity)
- B. The treasurer of a local society (in his/her official capacity)
- C. Unincorporated bodies
- D. Limited companies

37. Under money laundering regulations, financial institutions are required to keep records of customers and transactions for a minimum period after the relationship with the customer has ended. This period is:

- A. three years
- B. five years
- C. seven years
- D. twelve years

38. The term 'renunciation' relates to a holder's decision to:

- A. dispose of units/shares by stock transfer
- B. sell units/shares back to the fund manager
- C. reinvest the dividends payable
- D. waive the tax credit on future dividends

39. For what MAXIMUM period following the payment date is a cheque normally considered valid?

- A. Two months
- B. Three months
- C. Six months
- D. Twelve months

40. A unit trust investor has just converted 500 income units to accumulation units. The conversion factor at the last ex-distribution date was 2.50 and will be 2.55 at the next ex-distribution date. How many accumulation shares will be provided?

- A. 196
- B. 200
- C. 1,250
- D. 1,275

41. In what way did the introduction of the Personal Savings Allowance impact distribution payments?

- A. Payments can be made by electronic methods
- B. Income is now exempt from income tax
- C. Dividend distributions are now paid gross by funds
- D. Distributions are now paid in three streams, reflecting the sources of the income

42. In what circumstances can distribution information be provided electronically to a retail unitholder?

- A. When stated in the trust deed
- B. When the unitholder chooses electronic communications
- C. When the distribution is deemed *de minimis*
- D. When the fund is a PAIF

43. Following the death of the last surviving joint holder of units, the grant of probate or what other document will be required to establish title?

- A. Deed of variation
- B. Stock transfer form
- C. Form of renunciation
- D. Letters of administration

44. If a distribution payment from an OEIC remains unclaimed after the six-year threshold period, it will be:

- A. Donated to charity
- B. Paid to an industry compensation fund
- C. Forwarded to HMRC
- D. Transferred into the scheme property

45. An annual long report is being issued in 2025 in respect of an OEIC fund. What 2023 share price(s) in respect of the income shares of this fund must appear in the comparative tables within this report?

- A. The beginning and end of year price
- B. The highest and lowest price
- C. The mode price for the year
- D. The median price for the year

46. Which offence under the money laundering regulations has a MAXIMUM punishment of five years imprisonment and/or a fine?

- A. Failing to establish money laundering procedures
- B. Assisting a money launderer
- C. Failing to report a suspicion
- D. Tipping off a suspect

47. If a unit trust fund manager discovers an error in calculating the box position, by what regulatory deadline must it provide the corrective adjustment details to the trustees?

- A. Within a maximum of three hours
- B. Within a maximum of six hours
- C. By the relevant valuation point
- D. By the end of the day on which the issue/cancellation payment is due

48. Which of the following expenses under a unit trust will be deemed non-chargeable for corporation tax purposes?

- A. Stockbroker fees of £2,700
- B. Registration Fees of £1,600
- C. Overdraft interest of £860
- D. Auditor fees of £2,200

49. What is the maximum award (plus interest and costs) that the FOS can require a firm to pay to a customer for complaints referred after 1 April 2024 for actions since April 2019?

- A. £375,000
- B. £415,000
- C. £430,000
- D. £450,000

50. What is an individual's CGT allowance for 2025–26?

- A. £2,000
- B. £3,000
- C. £4,000
- D. £5,000

Answers to Multiple Choice Questions

1. Answer: D Chapter 7 Section 1.2

If a fund has received 'Reporting Fund' status from HMRC, any gains or losses arising to the investor from their trading in the fund are treated as capital gains or losses for UK tax purposes.

2. Answer: B Chapter 5 Section 2.3

The notional dealing charge in a dual-priced fund is the theoretical average cost that the fund would suffer if the portfolio was either rebuilt from no holdings (an offer calculation, as it involves the purchase of securities) or sold if the scheme were to be wound up (sale of securities being a bid figure). As every investor's deal includes the notional dealing charge calculated that day, each investor receives fair treatment both buying and selling.

3. Answer: D Chapter 7 Section 4.3

Within an initial offer, the AFM is only required to pay the depositary for unit/share issues as soon as practicable after receiving the investor's money (and no later than the fourth business day after the end of that initial offer period).

4. Answer: C Chapter 3 Section 5.1

The AFM must prepare and publish a long report for each scheme within four months of the end of the annual accounting period.

5. Answer: D Chapter 6 Section 4.3

When exercising cancellation rights an investor deals at the offer price rather than bid. The difference between the original purchase price and the price of that deal being cancelled is 13p per unit. For the 1,000 units originally purchased, the total shortfall is £130.

6. Answer: D Chapter 6 Section 1.1

The COLL rules specify that the register must be accessible to holders free of charge at a location within the UK (not to all members of the general public).

7. Answer: C Chapter 7 Section 3.4

The AFM is not required to send a copy of the reports and accounts to each unit/shareholder, but the document must be offered free of charge to any member of the public. A copy must also be provided to the FCA.

8. Answer: D Chapter 4 Section 6.2

Borrowing by a QIS cannot exceed 100% of the net asset value.

9. Answer: D Chapter 3 Section 1.1

Responsibility for the register may either rest with the AFM or with the trustee/depositary – and the COLL rules state that the ‘instrument incorporating the scheme’ (the trust deed, in the case of a unit trust) should state which of these two parties is responsible for the CIS’s register.

10. Answer: C Chapter 2 Section 4.1

The final response should be issued within eight weeks of the complaint being received.

11. Answer: C Chapter 3 Section 4.2

A pricing error is normally viewed as ‘material’ if it exceeds 0.5% of the price.

12. Answer: D Chapter 2 Section 7.2

A data controller must notify the ICO within 72 hours of the breach being identified.

13. Answer: B Chapter 8 Section 2.1

The interim report will include the AFM’s report (including a portfolio statement).

14. Answer: C Chapter 2 Section 7.2

Any breaches relating to infringements of the data subject’s individual privacy rights can result in a fine of up to the greater of £17.5 million or 4% of the data controller’s annual global turnover.

15. Answer: B Chapter 2 Section 5.2

The UCITS Directive created a ‘passport’ so that a UCITS fund launched in one jurisdiction could be sold in another.

16. Answer: A Chapter 2 Section 2.2

The CASS RP must include details of the key individuals within the firm who are ‘critical or important’ to the operational functions relating to the firm’s CASS 6 and CASS 7 obligations.

17. Answer: A Chapter 7 Section 5.3

The promotion should give a short explanation of the chosen benchmark (consistent with the wording in the prospectus) and include past performance of that benchmark when giving any past performance data relating to the fund.

18. Answer: B Chapter 1 Section 2.4

The COLL rules note that the FCA is unlikely to approve a fund that has the word ‘guaranteed’ in its name – unless there is an enforceable guarantee offered by a party other than the AFM or the depositary, which will be applicable to all investors and covers the full value they invested.

19. Answer: C Chapter 4 Section 3.7

The borrowing limit for a UCITS is 10%.

20. Answer: B Chapter 3 Section 2.2

The AFM of a unit trust may be removed if the unitholders representing 75% of the units in the CIS write to the trustee requesting their removal.

21. Answer: B Chapter 9 Section 3.1

The AFM must ensure that the distribution payments are made by the regulatory deadline of four months after the corresponding accounting reference date (or any shorter period stated in the prospectus).

22. Answer: B Chapter 3 Section 4.1

The depositary is responsible for holding the scheme property and overseeing the actions of the AFM (ie, ensuring that the AFM is running the fund in accordance with the COLL rules and the stated investment objective). Its oversight remit includes any functions outsourced by the AFM.

23. Answer: A Chapter 9 Section 2.1

For a CAIF, up to 15% of the income available for distribution at the end of the year can be transferred into the fund's income reserve account and so would not be included in the distribution for the year ended.

24. Answer: D Chapter 4 Section 3.1

The general rule for a UCITS is that approved securities and money market instruments issued by a single body should not exceed 5% of the total scheme property, although this limit can be increased to 10% per body provided the aggregate value of such holdings over 5% does not exceed 40% of the fund value.

25. Answer: D Chapter 2 Section 6.2

The maximum penalty for assisting a money launderer is 14 years' imprisonment and/or a fine.

26. Answer: C Chapter 4 Section 3.1

For a scheme replicating an index the 10% maximum limit on approved securities issued by a single body can be increased to 20%, and up to 35% for a single body at any time where exceptional circumstances arise, but these increased limits are only available if the level of investment matches the proportion of the index that security represents.

27. Answer: D Chapter 4 Section 4.2

A NURS can invest up to 35% in the units/shares of another scheme, if that second scheme is a UCITS, a NURS, an individually recognised overseas scheme, or has similar restrictions as are applicable to a NURS scheme.

28. Answer: D Chapter 5 Introduction

The calculated price would be £1.6216855 per unit. Quoted to four significant figures this would be £1.622 (or 162.2 pence per unit).

29. Answer: C Chapter 5 Section 3.2

The dilution levy is an additional cost which may be made to each investor's transaction. The AFM will determine the conditions in which a dilution levy will apply – generally based on the size of the deal.

30. Answer: D Chapter 1 Section 2.3

It might also be the case that the AFM will offer a range of share classes – perhaps retaining a share class with a higher AMC rate that can be used for any investors still paying commission to an IFA for financial advice given prior to the RDR. Some AFMs have created share classes with slightly lower AMC rates that can be used by particular investment platforms.

31. Answer: D Chapter 6 Section 3.4

An AFM has the power to impose an in specie approach on a large deal (generally one larger than 5% of the portfolio value) in order to avoid the existing holders from effectively bearing the brokerage costs of the fund investing a large amount of cash.

32. Answer: C Chapter 9 Section 1.1

An interest distribution is paid by a fund that has throughout the accounting period invested 60% or more of the scheme property in gilts, UK or overseas bonds and/or money market deposit.

33. Answer: C Chapter 8 Section 1.1

Dilution adjustment is applied within the price calculation, not to an individual trade. All other items listed are required pieces of trade confirmation information.

34. Answer: B Chapter 7 Section 3.2

The KIID must adopt a standardised format (based on the EU UCITS rules), be concise, and be updated annually.

35. Answer: A Chapter 6 Section 1.2

Any units held in the manager's box must be recorded in the unit register.

36. Answer: D Chapter 6 Section 1.3

Limited companies are acceptable as registered holders.

37. Answer: B Chapter 2 Section 6.2

The AFM should keep records of customers and transactions, providing an audit trail for at least five years from the date when the relationship with the customer has ended.

38. Answer: B Chapter 6 Section 6.1

Renunciation relates to the holder renouncing their claim to ownership of the units/shares – effectively transferring such rights to the AFM.

39. Answer: C Chapter 9 Section 3.2

Where a cheque is issued, it is generally considered good for a period of six months and may of course be banked at any time during that period.

40. Answer: B Chapter 6 Section 7.1

For conversion from income units to accumulation units, the holding is divided by the conversion factor at the last ex-distribution date, ie, $500 \div 2.50 = 200$ shares.

41. Answer: C Chapter 10 Introduction

Since the personal savings allowance was introduced, income tax is no longer deducted from most distributions paid by authorised CISs. Each investor must determine any income tax due on the income they have received.

42. Answer: B Chapter 9 Section 5

The FCA requires a retail investor must specifically choose to receive distribution communications electronically rather than in paper format.

43. Answer: D Chapter 6 Section 6.3

If either a sole holder or the last surviving holder dies, authority to deal with the holding rests with the executors or administrators of the deceased holder. A grant of probate or letters of administration will be required in such cases to establish title.

44. Answer: D Chapter 9 Section 3.2

If a given distribution payment remains unpaid after a period of six years (or any longer period specified in the prospectus) the COLL rules instruct that the money would at that point cease to be due to the individual holder concerned, and the sum is instead passed into the capital property of the fund.

45. Answer: B Chapter 8 Section 2.1

The comparative table must show the highest and lowest price for each period.

46. Answer: C Chapter 2 Section 6.2

The offence of failure to disclose (ie, if an employee fails to report his/her suspicions) carries a penalty of five years and/or fine.

47. Answer: D Chapter 6 Section 2.5

The error must be an isolated one and, except in exceptional circumstances, the adjustment to correct the original issue or cancellation instructions must be given to the depositary by the end of the day on which the issue or cancellation payment is due (usually three or four days after the relevant valuation point).

48. Answer: A Chapter 10 Section 1.1

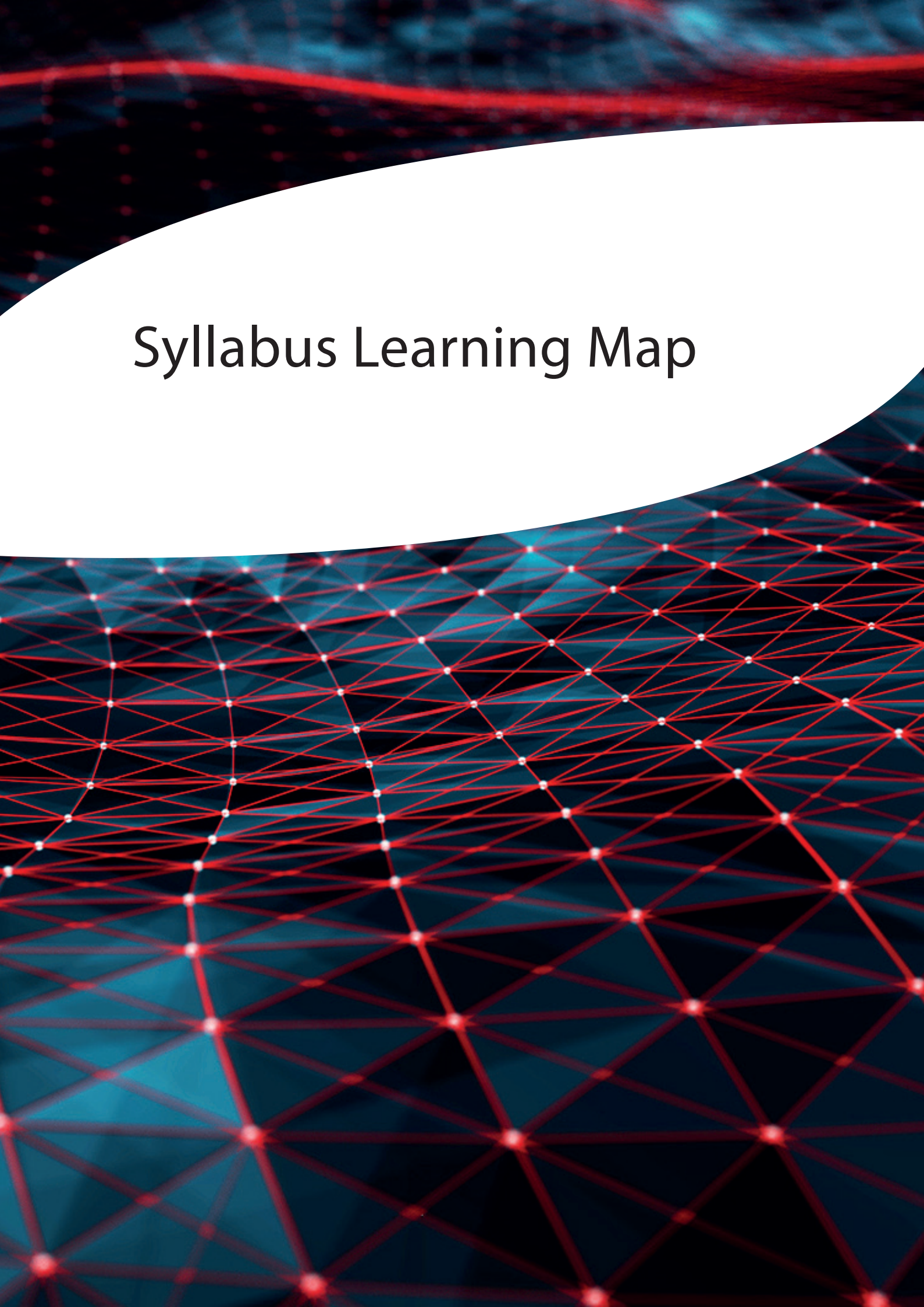
Stockbroker fees are deemed non-chargeable, whereas all the other items are classed as chargeable.

49. Answer: C Chapter 2 Section 4.2

If the FOS rules in favour of the customer, it can make an award of up to £430,000 plus interest/costs (for complaints referred after 1 April 2024 about actions taken on or after 1 April 2019).

50. Answer: B Chapter 10 Section 2.2

For the 2025–26 tax year, an individual's first £3,000 of gains on disposals of assets are exempt from CGT.



Syllabus Learning Map

Syllabus Unit/ Element		Chapter/ Section
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Element 1	Collective Investment Schemes	Chapter 1
1.1	Overview On completion, the candidate should:	
1.1.1	Know why Collective Investment Schemes are relevant to investors today: <ul style="list-style-type: none"> Principal types of fund available by fund type, asset class and the Investment Association sectors Typical investment strategies The role of property funds and funds of funds 	1.1
1.2	Structural Aspects On completion, the candidate should:	
1.2.1	Know the constitutional structures of authorised Collective Investment Schemes	2.1
1.2.2	know the four regulatory types of authorised CIS: <ul style="list-style-type: none"> UCITS NURS QIS LTAF 	2.2
1.2.3	Know: <ul style="list-style-type: none"> the differences between single funds, umbrella schemes and master feeder schemes the permissible share and unit classes issued by schemes 	2.3
1.2.4	Know the following scheme characteristics: <ul style="list-style-type: none"> guaranteed protected 	2.4
1.2.5	Understand the differences between physical and synthetic investment structures	2.5

Element 2	The Regulatory Framework	Chapter 2
2.1	The UK Regulatory Framework for CISs On completion, the candidate should:	
2.1.1	Know the framework of UK regulation and the purpose of the following: <ul style="list-style-type: none"> The Financial Services and Markets Act 2000 The Collective Investment Schemes Sourcebook (COLL) The Investment Funds Sourcebook (FUND) The OEIC Regulations 2001 	1

Syllabus Unit/ Element		Chapter/ Section
2.2	Other Important FCA Sourcebooks On completion, the candidate should:	
2.2.1	Know the requirements of the Conduct of Business Sourcebook (COBS) relating to AFMs	2.1
2.2.2	Know the requirements of the Clients' Assets Sourcebook (CASS) relating to AFMs	2.2
2.2.3	Know the key requirements under Senior Management Systems and Controls (SYSC) relating to AFMs	2.3
2.2.4	Know the key requirements of the Product Intervention and Product Governance Sourcebook (PROD) relating to AFMs	2.4
2.3	The Consumer Duty and Fair Treatment of Customers On completion, the candidate should:	
2.3.1	Know the FCA expectations relating to the fair treatment of customers: <ul style="list-style-type: none"> • Consumer duty 	3
2.4	FCA Rules for Customer Complaints On completion, the candidate should:	
2.4.1	Know: <ul style="list-style-type: none"> • Regulatory requirements for handling customer complaints • The role of the Financial Ombudsman Service (FOS) 	4
2.5	The Contribution of EU Regulations On completion, the candidate should:	
2.5.1	Know the purpose of the following rules: <ul style="list-style-type: none"> • Undertakings of Collective Investment in Transferable Securities Directive (UCITS) • Eligible Assets Directive (EAD) • Markets in Financial Instruments Directive (MiFID) • Capital Requirements Directive (CRD) • Distance Marketing Directive (DMD) • Market Abuse Regulation (MAR) • Alternative Investment Fund Managers' Directive (AIFMD) • European Market Infrastructure Regulation (EMIR) • The EU Money Market Fund Regulation (MMFR) 	5

Syllabus Unit/ Element		Chapter/ Section
2.6	Prevention of Financial Crime On completion, the candidate should:	
2.6.1	Know how collective investment schemes manage regulatory requirements relating to: <ul style="list-style-type: none"> • Anti money laundering • Combating the financing of terrorism • Bribery 	6
2.7	Data Protection On completion, the candidate should:	
2.7.1	Know how AFMs address their responsibilities in relation to the Data Protection Act 2018	7

Element 3	Key Roles and Responsibilities	Chapter 3
3.1	The Role of Authorised Fund Manager (AFM) On completion, the candidate should:	
3.1.1	Know the role of the AFM in relation to: <ul style="list-style-type: none"> • Legal position • Investment decisions • Valuation and pricing • Issues and cancellations • Investor transactions • Maintaining register of holders • Distribution of income • Voting • Issuing reports • Marketing the fund • Regulatory reporting • Maintaining other client and scheme records 	1
3.2	Appointment and Removal of the AFM On completion, the candidate should:	
3.2.1	Know the process for: <ul style="list-style-type: none"> • Appointment of the AFM • Removal of the AFM 	2
3.3	Delegation/Outsourcing by the AFM On completion, the candidate should:	
3.3.1	Know: <ul style="list-style-type: none"> • The benefits and risks of outsourcing • Scope for delegation • Services provided by outsource service providers 	3

Syllabus Unit/ Element		Chapter/ Section
3.4	Role of the Trustee/Depository On completion, the candidate should:	
3.4.1	Know the role and responsibilities of the Depository and/or Trustee	4
3.5	Auditors On completion, the candidate should:	
3.5.1	Know the: <ul style="list-style-type: none"> • Role and responsibilities of auditors • Timescale for completing an audit • Obligations for reporting to the FCA • Obligations for reporting to shareholders/unitholders • Difference between the audit and the AFM's obligation for compliance monitoring 	5

Element 4	Diversification and Investment Limits	Chapter 4
4.1	Maintaining an Investment Portfolio On completion, the candidate should:	
4.1.1	Understand: <ul style="list-style-type: none"> • The requirement for a prudent spread of risk • The principles of investment and diversification • Managing liquidity 	1
4.2	Important Terms On completion, the candidate should:	
4.2.1	Know the definitions of: <ul style="list-style-type: none"> • Transferable securities • Eligible markets • Approved/unapproved securities • Derivatives (exchange and OTC) 	2
4.3	Investment Limits On completion, the candidate should:	
4.3.1	Know the specific limits applying to UCITS funds	3
4.3.2	Know the specific limits applying to Non-UCITS Retail Schemes (NURS)	4
4.3.3	Know the specific limits applying to Qualified Investor Schemes (QIS)	6
4.3.4	Know the specific limits applying to Money Market Funds	7
4.3.5	Know the specific limits applying to Long-Term Asset Funds (LTAFs)	8

Syllabus Unit/ Element		Chapter/ Section
4.4	Other Investment Techniques On completion, the candidate should:	
4.4.1	Know the scope available to AFMs in relation to: <ul style="list-style-type: none"> • Stock lending • Repurchase agreements • Underwriting • Collateral management 	9
4.5	Corporate Actions On completion, the candidate should:	
4.5.1	Know the types of corporate actions which may be received by the fund, the AFMs process to execute and the risks and regulatory requirements associated with these	10

Element 5	Valuations and Pricing	Chapter 5
5.1	Introduction On completion, the candidate should:	
5.1.1	Know how and when valuations are made including required frequency	1
5.1.2	Know the permitted pricing methodology	1
5.1.3	Know the requirements for price publication	1
5.2	Pricing On completion, the candidate should:	
5.2.1	Be able to calculate prices for funds with a single share class	2, 3
5.2.2	Know the AFM's discretion in setting dealing prices under single and dual pricing	2, 2.6, 3
5.2.3	Know the charges that may be made by the AFM	2
5.3	Classes of Units/Shares On completion, the candidate should:	
5.3.1	Be able to calculate prices for funds with multiple share classes	3.3
5.4	Calculating the Consideration for a Unit/Share Deal On completion, the candidate should:	
5.4.1	Be able to calculate purchase consideration and redemption proceeds	4

Syllabus Unit/ Element		Chapter/ Section
5.5	Errors in the Pricing of a Scheme On completion, the candidate should:	
5.5.1	Know the minimum requirements relating to the controls around valuations (including fair valuation techniques)	5
5.5.2	Know what constitutes a pricing error, the consequences and the action to be taken by the AFM and Depositary	5
5.5.3	Know the requirements for reconciling assets and units between the AFM, custodian and Depositary	5

Element 6	Unit Dealing and the Register	Chapter 6
6.1	The Register of Unit/Shareholders On completion, the candidate should:	
6.1.1	Know: <ul style="list-style-type: none"> The requirements for the establishment, maintenance and contents of a register The entitlement to inspection The process for rectification of registration errors Who can be registered as a holder of units / shares The status of the register as proof of ownership The registration treatment of third party interests The requirements for the collection of beneficial holder details 	1
6.2	The AFM and The Manager's Box On completion, the candidate should:	
6.2.1	Know: <ul style="list-style-type: none"> How investors can buy and sell units from the AFM The requirements for notification to the Depositary or Trustee The AFMs responsibilities for issue and cancellation of units/ shares 	2
6.3	Unit/Share Deals by Investors On completion, the candidate should:	
6.3.1	Know how investors can buy and sell units from the AFM	3
6.3.2	Know how investor transactions are instructed: <ul style="list-style-type: none"> Direct Via an intermediary firm 	3
6.3.3	Know: <ul style="list-style-type: none"> The regulatory requirements for settlement Different methods of settling investor transactions 	3.3

Syllabus Unit/ Element		Chapter/ Section
6.3.4	Understand the AFM's discretion in relation to large investor deals: <ul style="list-style-type: none"> In specie transactions Dilution levy/dilution adjustment 	3.4
6.4	Cancellation Rights On completion, the candidate should:	
6.4.1	Know: <ul style="list-style-type: none"> The circumstances under which cancellation rights are available to investors The circumstances where shortfall may be charged How to calculate cancellation proceeds including shortfall 	4
6.5	Special Circumstances On completion, the candidate should:	
6.5.1	Know the following scheme characteristics: <ul style="list-style-type: none"> Limited issue Limited redemption Deferred redemptions Notice periods 	5
6.5.2	Know the circumstances when dealing may be suspended	5.5
6.6	Transfer of Ownership On completion, the candidate should:	
6.6.1	Know the processes and information requirements for transfers from the holder: <ul style="list-style-type: none"> To the AFM To third parties By electronic transfer By operation of law 	6
6.7	Other Types of Investor Transactions On completion, the candidate should:	
6.7.1	Know: <ul style="list-style-type: none"> The meaning of a conversion and exchange of units/shares How to calculate the number of units following conversion The IA's suggested formula to ensure proper and fair exchange of shares/units 	7
6.8	Plan Registers/Sub Registers On completion, the candidate should:	
6.8.1	Know the requirements governing the sub-registers for savings plans and ISAs	8

Syllabus Unit/ Element		Chapter/ Section
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Element 7	Launching a New CIS	Chapter 7
7.1	Investment Vehicles and Their Use On completion, the candidate should:	
7.1.1	Know why Collective Investment Schemes are relevant to investors today: <ul style="list-style-type: none"> Comparative features, advantages and disadvantages in contrast to other forms of investment (direct and indirect) The key differences between onshore and offshore funds 	1
7.2	FCA Authorisation of CIS On completion, the candidate should:	
7.2.1	Know the regulatory requirements for the establishment of a scheme: <ul style="list-style-type: none"> The process and requirements of authorisation Required documentation 	2
7.3	Scheme Documentation On completion, the candidate should:	
7.3.1	Know the AFM's responsibilities to make available and/or supply to potential investors in what form and with what timeframe <ul style="list-style-type: none"> Prospectus Key Investor Information Document (KIID), NURS-KII and PRIIPS KID Supplementary Information Document Report and accounts Trust Deed/Instrument of Incorporation/Contractual Scheme Deed Assessment of value report 	3
7.4	The Initial Offer Period On completion, the candidate should:	
7.4.1	Understand the treatment of the following in respect to the initial offer period: <ul style="list-style-type: none"> Pricing Large market movement Unit/share transactions Settlement 	4
7.5	Financial Promotion Rules On completion, the candidate should:	
7.5.1	Know the relevant aspects for the financial promotion of CISs by the AFM	5

Syllabus Unit/ Element		Chapter/ Section
7.6	Complex and Non Complex Investments On completion, the candidate should:	
7.6.1	Understand the differences between complex and non-complex funds	6

Element 8	Unit/Shareholder Rights	Chapter 8
8.1	Documentation Provided to Holders On completion, the candidate should:	
8.1.1	Know general and occasional client reporting requirements: <ul style="list-style-type: none"> • Dealing confirmations • Periodic statements 	1
8.2	CIS Reports and Accounts On completion, the candidate should:	
8.2.1	Know regulatory requirements in relation to the content of the annual and half yearly report and accounts and Statement of Recommended Practice (SORP)	2
8.2.2	Know what investors should look for in the reports and accounts	2.3
8.3	Meeting of Unit/Shareholders On completion, the candidate should:	
8.3.1	Know the requirements for a unit/shareholders meeting, including the use of proxies	3
8.4	Change to a Regulated CIS On completion, the candidate should:	
8.4.1	Know the rights of unit/shareholders in relation to changes to the CIS	4
8.4.2	Know the consequences of changing the fund's investment objective or valuation process	4
8.5	Structural Change to a CIS On completion, the candidate should:	
8.5.1	Know the process and relevant regulatory requirements in relation to: <ul style="list-style-type: none"> • Termination • Amalgamation/mergers 	5
8.5.2	Know how a structural change to a CIS might impact the fund's: <ul style="list-style-type: none"> • Portfolio turnover • Performance 	5

Syllabus Unit/ Element		Chapter/ Section
8.6	Other Protection Holders On completion, the candidate should:	
8.6.1	Know the role of the Financial Services Compensation Scheme (FSCS)	6

Element 9	Income	Chapter 9
9.1	Entitlement to Income On completion, the candidate should:	
9.1.1	Know: <ul style="list-style-type: none"> The sources of income and relevant criteria The different treatment of income and accumulation shares/units The timetable for distribution of income 	1
9.1.2	Know the requirements of the tax elected fund regime	1
9.1.3	Know the requirements of the Property Authorised Investment Funds regime (PAIF)	1
9.2	The Amount of Available Income On completion, the candidate should:	
9.2.1	Be able to calculate available income	2
9.2.2	Be able to calculate bond income on an 'effective yield' basis	2
9.3	Making the Distribution Payment On completion, the candidate should:	
9.3.1	Know the customary payment processes and their associated requirements	3
9.3.2	Know the treatment of unclaimed distributions	3
9.4	Equalisation On completion, the candidate should:	
9.4.1	Be able to calculate an equalisation rate	4
9.5	Tax Vouchers On completion, the candidate should:	
9.5.1	Know the contents of tax vouchers in relation to: <ul style="list-style-type: none"> Methods of delivering tax voucher information Distributions Streaming requirements Equalisation 	5

Syllabus Unit/ Element		Chapter/ Section
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Element 10	Taxation	Chapter 10
10.1	Tax Arising Inside the CIS On completion, the candidate should:	
10.1.1	Know the basis on which authorised Collective Investment Schemes are taxed: <ul style="list-style-type: none"> • Income received • Deductible and non-deductible expenses • Periodic fees charges to the capital account • Foreign income • Corporation tax payable • Payment dates and returns made • Capital gains tax 	1
10.1.2	Know the treatment of umbrella-type schemes	1
10.1.3	Know the treatment of VAT on CISs	1.3
10.2	Taxation of the Holder On completion, the candidate should:	
10.2.1	Know the income tax, corporation tax and capital gains tax implications for the following investors: <ul style="list-style-type: none"> • Corporate (including other Collective Investment Schemes) • Individuals (tax payers, non-tax payers, and ISA investors) 	2
10.2.2	Know the relevance of the Offshore Funds Regime on the taxation of a UK investor	2.3

Examination Specification

Each examination paper is constructed from a specification that determines the weightings that will be given to each element. The specification is given below.

It is important to note that the numbers quoted may vary slightly from examination to examination as there is some flexibility to ensure that each examination has a consistent level of difficulty. However, the number of questions tested in each element should not change by more than plus or minus 2.

Element Number	Element	Questions
1	Collective Investment Schemes	2
2	The Regulatory Framework	9
3	Key Roles and Responsibilities	4
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