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CabinetOffice
Office of the **Third Sector**



Consultation on charity pooled funds: summary of responses

December 2009



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1

Introduction

1.1 This report summarises the responses to the consultation on charity pooled funds, which was launched on 30 July 2009 and closed on 31 October 2009. The consultation document is available on the HM Treasury website at www.hm-treasury.gov.uk/consultations.

1.2 The consultation asked for comments on the general proposal to move the regulation of certain charity pooled funds away from the Charity Commission and bring it more fully under the Financial Services Authority (FSA). The document set out a specific proposal for achieving this aim, by setting up a new type of authorised investment fund (AIF), the charity AIF, which would be open only to charity investors, and which would seek to preserve the existing favourable tax regime.

1.3 Four broad categories of charity pooled funds were considered: Common Investment Funds (CIFs), Common Deposit Funds (CDFs), church exempt funds and pooling schemes. Pooling schemes are outside the scope of the consultation because they are not open to charities that do not have exactly the same trustees as those trustees of the pooling scheme.

1.4 **CIFs** are collective investment schemes. They are similar to authorised unit trusts (AUTs), but unlike AUTs, they are not authorised by the FSA. They were first established in 1960 to give smaller charities the opportunity to invest collectively in order to benefit from increased investment opportunities and wider diversification. They operate as investment vehicles and are deemed by statute to be charities themselves. There are currently 47 CIFs managed by 22 fund managers with charity assets under management in excess of £8 billion.

1.5 **CDFs** operate as deposit-takers and differ from CIFs in that they do not offer unitised investments; depositing charities own the capital they have placed on deposit together with the interest earned attributable to that capital. CDFs are also deemed by statute to be charities themselves. There are currently two CDFs managed by two fund managers with assets under management of over £1 billion.

1.6 **Church exempt funds** are collective investment funds and deposit funds established under statutes or measures concerned with certain church denominations. These have historically been exempt from registration with the Charity Commission. However, the Charities Act 2006 changed this regime and exempt charities for which a principal regulator cannot be appointed will become excepted charities. Excepted charities must register with the Charity Commission if their gross income exceeds a specified level (currently £100,000). As a result of the provisions of the 2006 Act, the church investment and deposit funds which are currently exempt charities will become excepted charities. No date has yet been set for the commencement of these provisions.

The consultation questions

Questions from July 2009 consultation on charity pooled funds

Question Number	Question
4i	Are there any adverse consequences of the proposal that existing CIFs and CDFs, regulated by the Charity Commission, would become charity AIFs under the regulation of the FSA. How might these consequences be mitigated?
4ii	Are there any funds which would be better off as an Open Ended Investment Company (OEIC) than as an Authorised Unit Trust (AUT), and if so, why?
4iii	When church exempt funds cease to be exempt from registration as charities, should they be brought within the charity AIF regime, and if not, how best should they be regulated?
4iv	Unlike CDFs and CIFs, charity AIFs would not be charities in their own right. Would this have any adverse impacts on charity pooled funds and if so, how might they be minimised?
5i	How would the current governance structures of charity pooled funds need to change, given that the funds will possibly be structured as AUTs or OEICs?
5ii	All AIFs fall into one of three categories defined by the FSA, UCITS ¹ , non-UCITS (often referred to as NURS funds) and Qualified Investor Schemes (QIS). Would it be preferable to specify that charity AIFs must take the form of NURS rather than the UCITS or QIS formats?
5iii	Which requirements of the COLL ² sourcebook would be unduly burdensome for charity AIFs? Please explain why and provide details of compliance costs, where possible.
5iv	Which requirements of the FSA Handbook outside COLL would be unduly burdensome for charity AIFs? Please explain why and provide details of compliance costs, where possible.
5v	What, if any, transitional arrangements should be made for charity pooled funds converting to charity AIFs? Please explain why and provide details of compliance costs, where possible.
6i	Would the proposal to tax charity AIFs' income at 20 percent if that income is not applied for charitable causes have any adverse consequences in practice for either the investors or the charity AIFs themselves? If so, why?
6ii	Are there any circumstances where the requirement that the charity AIF does not withhold tax from distributions work to the detriment of the charity investors?
6iii	Are there any other adverse tax consequences arising from the charity AIF proposal?

¹ UCITS: Undertakings for Collective Investment in Transferable Securities

² The Financial Services Authority regulatory regime for Authorised Unit Trusts and Open-ended Investment Companies is referred to as the COLL sourcebook.

2

Summary of responses to the consultation

Respondents

2.1 The Government received 28 responses to the consultation, largely from professional fund managers, financial advisers and representative bodies, but also some from individual charities, CIFs and advisory boards. The full list of respondents is at Appendix 1.

General comments

2.2 Nearly all the responses were generally positive about the desire to move to greater regulation by the FSA but concerns were expressed about the detailed tax and regulatory implications and the potential costs and increases in administrative burdens involved.

2.3 Some respondents suggested alternative proposals to the Government's charity AIF proposal. For example, two respondents thought it might be possible to extend the powers of the FSA to regulate existing CIFs and CDFs without the need to create a new AIF for charities. Some respondents supported an option of CIFs and CDFs being exempt charities with the FSA as principal regulator. They considered this could strengthen the financial regulation while retaining charitable status.

2.4 The Government will fully consider these alternative proposals alongside the charity AIF proposal.

2.5 The Government recognises that there are other charity pooled funds that were not specifically addressed in the consultation (as highlighted by some respondents) and these will be taken into account when preparing the policy response to the consultation.

2.6 Some responses highlighted issues that had not been raised in the consultation. One respondent pointed out that the document did not consider charity pooled funds in Scotland and Northern Ireland, and suggested a UK-wide approach could be taken. Another issue raised was the future role of the Charity Commission in setting up pooled funds, if the charity AIF proposal was taken forward.

Costs and administrative burdens

2.7 Some respondents expressed concern about the cost of transferring to the new regulatory regime. The cost of introducing new computer systems, the legal costs associated with the transformation of funds into charity AIFs and accountancy costs would be of concern to some fund managers.

2.8 Another concern was that it would be important to keep ongoing costs down so as to retain the low management fees of CIFs – typically around 0.5% of the investment, compared to a typical 1.5% for Retail funds. One respondent suggested that changes to the governance structure of CIFs could affect the level of management fees charged, with a risk of fees increasing as a result of the proposed changes.

Views on regulatory roles of the FSA and the Charity Commission

2.9 Most respondents were positive about the FSA as a regulator of charity pooled funds. However a number of concerns were raised, both by those who would prefer to see the Charity Commission remain as regulator and those who were in favour of FSA regulation.

2.10 There was general recognition that the Charity Commission may not have the appropriate expertise to regulate increasingly complex financial products. One respondent said that the current arrangements of the Charity Commission being responsible for CIFs and CDFs made it difficult to set up new CIFs and CDFs to meet charities' needs and that the FSA would be better placed to help broaden the range of funds available to charities in the UK.

2.11 There appeared to be misconceptions over the current role of the Charity Commission in regulating funds. One respondent referred to there being a feeling in the charity sector that the Charity Commission's role in some way validated CIFs as being suitable investments for charities, and that this may provide "something of a false comfort" as the Commission's involvement does not reduce charity trustees' fiduciary responsibility.

2.12 Some of the responses suggested there may be a lack of understanding among charity investors about the CIFs and CDFs they were investing in, for example the fact that CIFs and CDFs do not have to pay out all the income they receive in the same year, but can "smooth" distributions over several years. However, other responses suggested charities were aware of and welcomed smoothing of income distribution in helping them to plan their budgets.

Church funds

2.13 Twelve respondents commented on church exempt funds and their future regulation. Ten of those responses advocated the regulation of church exempt funds by the FSA under the charity AIF system. Only one respondent argued that the charity AIF was not appropriate for church exempt funds and one other respondent felt the matter needed to be subject to a separate detailed review.

The charity AIF proposal

2.14 The majority of respondents were positive about the charity AIF proposal. Many felt that a charity AIF open only to charity investors would maintain the special status of CIFs and CDFs, whilst coming within an existing and familiar framework.

Charitable status

2.15 Many respondents favoured retaining the charitable status currently enjoyed by charity pooled funds, even if the proposed charity AIF could be designed with the aim to preserve the existing tax treatment of charity investors.

2.16 The main reasons given were that the charity "badge" is a useful marketing tool and reassures potential investors, who generally have a high opinion of the Charity Commission in its role as the principal charity regulator in England and Wales.

2.17 Another reason given by some respondents was that it could be difficult to reflect all the domestic and international tax advantages enjoyed by charities when designing the charity AIF, and that there could be a risk of a particular area being overlooked.

Governance

2.18 Another common issue raised was how to preserve what is generally seen as an advantageous and flexible governance arrangement for CIFs. For example, many, but not all CIFs have experienced advisory boards that provide a useful go-between in representing the interests

of individual charity investors to the CIF trustees and fund managers. The expertise and independence of these boards was cited as their main advantage, especially as many smaller charities lack the financial expertise themselves to hold fund managers to account.

2.19 Some respondents were keen that advisory boards should continue if the charity AIF proposal is taken forward. Others wanted to preserve the role of the current named individuals as CIF trustees, and were concerned what would happen if charity AIFs took on a corporate rather than trust structure.

2.20 The changes required to the governance structures of charity investment funds represented an opportunity, according to one respondent, to replace the CIF advisory boards with a requirement for two general meetings each year to provide a useful forum where charity investors themselves could directly voice their concerns to the corporate trustees and fund managers. The majority of respondents however were keen for advisory boards (or other forms of non-executive oversight boards) to continue to provide a level of investor representation. Some respondents also wanted to see some role for the Charity Commission under the new regime, as many charities see the involvement of the Commission as an assurance of the charity investment funds legitimacy.

2.21 Charity AIFs, under the regulation of the FSA, might place additional requirements upon board members. Two respondents highlighted that currently unpaid board members would need to receive remuneration for their services. Another respondent pointed out that the personal liability of board members would increase under the new charity AIF.

Legal structure

2.22 Responses were mixed as to whether charity AIFs should be set up as open-ended investment companies (OEICs) or as authorised unit trusts (AUTs). Of the thirteen responses given, four respondents made a qualified endorsement of the AUT category, two felt that OEICs were better suited and six argued that fund managers should have the option to decide for themselves.

2.23 Those that supported the AUT category did so because they preferred what they saw as the more relaxed reporting and regulatory requirements or felt that trustees would find it easier to understand the system. Those in favour of the OEIC category did so because they thought that this option offered greater flexibility to managers and would allow trustees to take an active governance role within the charity AIF.

2.24 The six respondents that recommended both categories were made available for the charity AIF were concerned with providing fund managers with as much flexibility as possible. One respondent said that forcing AIFs to comply with any particular category would be detrimental to the charitable sector.

2.25 There was a range of suggestions for extra enhancements to the proposal set out in the consultation. There was one recommendation that charity AIFs would continue to be subject to the same Statutory Objectives Test as CIFs and CDFs. Another respondent also expressed a hope that the opportunity would be taken to remove the requirement for compliance with the Charity Commission's guidance - CC14¹.

Transition to new charity AIF framework

2.26 There was no general agreement on the best length of time required for a transition from the Charity Commission regulated CIFs and CDFs to the FSA regulated charity AIFs. Estimates

¹ Investment of Charitable Funds: Basic Principles

varied from a year to three years. A number of respondents were concerned about the costs of the changes. Two respondents requested tax reliefs for the transition period to help keep costs down whilst another respondent proposed that transition costs could be reduced by grandfathering the structure of current CIFs and CDFs.

2.27 There were also concerns about gaining the consent of investors before a CIF and CDF was converted into a charity AIF. Some respondents presumed that the transition would have to be automatic without investor consent. Others felt that investor consent would be vital, but questioned whether that consent would be forthcoming.

2.28 There were also concerns on how the transition itself would take place. One respondent felt that the reorganisation of existing funds into charity AIFs through enabling legislation was highly preferable to the costs and impact of closing CIFs and CDFs and starting charity AIFs. The same respondent also proposed that some CIFs and CDFs should be offered the possibility of converting into normal AIFs.

Regulatory issues

2.29 Respondents were divided on the best regulatory framework to apply to the proposed charity AIFs. One respondent expressed a preference for the UCITS format but five respondents expressed a clear preference for the NURS format instead. Six respondents felt that fund managers should be able to choose which category of charity AIFs they should be able to follow and three others proposed that a completely new category should be created in the FSA handbook on Collective Investment Schemes (COLL). There was also a concern that forcing charity AIFs to conform to a particular category would cause significant restructuring costs.

2.30 The majority of respondents felt that some aspects of the COLL would prove burdensome for charity AIFs.

2.31 One respondent noted that CDFs were not unitised and that the Financial Services and Markets Act 2000 would need to be amended to accommodate them as charity AIFs.

2.32 The current regulatory regime for CIFs and CDFs allows for the smoothing of income across financial years. AIFs however are expected to pay out all their income annually and many respondents were concerned that income smoothing, a useful feature of CIFs and CDFs, would not be carried through to the charity AIF system. A number of respondents have suggested the smoothing of income distribution could be provided for in a bespoke set of COLL rules specifically written for charity AIFs.

2.33 Some respondents were concerned about the increased communications burdens under COLL.

2.34 Several respondents made points on governance structures that related to specific types of CIFs and CDFs.

2.35 A number of FSA handbook requirements outside of COLL were also identified as potentially burdensome for charity AIFs. Several respondents believed that the approved persons regime would be detrimental to CIF advisory boards, their membership and the funds themselves, particularly if trustees were to be paid. Authorised status for charity AIFs would bring them under the packaged products regime. At least two respondents felt that charity AIFs should be excluded from the packaged products regime.

2.36 Many respondents felt that the requirement to write Key Features Documents for marketing to retail investors would be burdensome for charity AIFs. One respondent further pointed out that any charity AIF operating under NURS would be required to write both long and short reports, increasing the workload for the funds. One respondent felt the Conduct of Business requirements to be unnecessary. Several respondents felt that there should be an

exemption from the requirement to produce a Key Features Document for potential customers, though one respondent did state that Key Information Documents given to those considering an investment in UCITS were useful.

2.37 One respondent did note that if CIFs and CDFs were converted to charity AIFs, then they would need to reapply for permission to market to different types of investors. There was also concern that if required to work under UCITS, fund managers would have difficulty obtaining the capital resources required to operate.

2.38 Some respondents however did not feel there were any onerous burdens in the FSA handbook outside of COLL.

Tax Issues

2.39 The majority of the respondents expressed concerns over the loss of charitable status for charity pooled investment funds and potential adverse consequences. The main concern focused on the domestic and international tax advantages of charitable status. All respondents were clear that the advantageous tax regime had to be maintained for charity AIFs.

2.40 Whilst some respondents did not anticipate any adverse tax consequences at all for charity AIFs, others pointed out a number of detailed concerns that they felt required further scrutiny or consideration by the Government.

3

Next steps

3.1 The Government will carefully consider the issues raised during the consultation and expects to give its policy response at Budget 2010.

3.2 If the Government is minded to take forward the charity AIF proposal, or any of the alternatives suggested during the consultation, then a further detailed consultation would follow, including if appropriate, draft legislation and regulatory rules.

A

List of respondents

Table 3.A: List of Respondents

Respondents
Aberdeen Asset Managers Limited
Alpha Funds
Association of Chartered Certified Accountants
Boon Tong Yew
Barclays
BlackRock
Charities Aid Foundation
Cazenove
CCLA Investment Management Limited
Charity Finance Directors Group
Charibond
Charities Investment Managers Limited
Charity Investors Group
Charity Law Association
Charifaiith
Depositary and Trustee Association
Epworth Investment Management Limited
Eversheds LLP
Institute of Chartered Accountants in England and Wales
Investment Management Association
Independent Services Agency Limited
JP Morgan
LionHeart
M&G Securities Limited
Mercer
National Association of Almshouses Common Investment Scheme
Paramount Group Limited
Schroders Charity Equity Incorporated

HM Treasury contacts

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If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London

SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: public.enquiries@hmtreasury.gsi.gov.uk

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