The regulation of investment trust companies

Consultation document

November 2004

HM TREASURY

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ISBN: 1-84532-069-7

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PREFACE

This consultation paper seeks views on whether there is a need to introduce additional regulation for investment trust companies, and if so, possible options for doing so.

An Initial Regulatory Impact Assessment is attached at Annex A.

The Treasury would be grateful if any comments on the potential regulatory gaps and possible regulatory options discussed in this paper could be sent by **Friday 25 February** to the following address:

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Any queries concerning the consultation should be directed to Alexandra Hale at the above address, or by telephoning 020 7270 5079.

Respondents should provide the details of any organisation whose views they represent.

Unless respondents indicate to the contrary, it will be assumed that they have no objection to their response being made public.

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EXECUTIVE SUMMARY

During 2002 certain split capital investment trusts, which are a sub-sector of the investment trust company industry, experienced a major down turn in market value causing heavy losses to investors. The resulting public concern led the Treasury Committee of the House of Commons to conduct an inquiry into the events that led to the problems experienced by splits.

The Treasury Committee issued its report in February 2003. It recommended to the Treasury that investment trust companies be brought directly within the scope of investment product regulation by the Financial Services Authority. In response to this recommendation, the Government undertook to consult on whether there is a need to introduce additional regulation and, if so, some possible options.

For the purpose of discussing whether there is a need for additional regulation, we have taken as a starting point the regulatory differences between investment trust companies, and two other forms of pooled investment vehicle that are already regulated by the Financial Services Authority in the manner referred to by the Treasury Committee: unit trusts and open ended investment companies. We describe the current regulation of investment trust companies in Chapter 2, and that of unit trusts and open-ended investment companies in Chapter 4.

We identify four main differences in the regulation of these entities in Chapter 5.

The four main regulatory differences are:

- Investment trust companies are excluded from the definition of collective investment schemes under the Financial Services and Markets Act 2000, and they do not have to be 'authorised persons'. Nor are investment trust companies regulated as products, so the FSA has no direct power to make rules for them or intervene on their activities;
- As investment trust companies are not authorised persons, there is no requirement for the identification of 'controlled functions' or that those performing them be approved by the FSA and therefore meet the minimum standards that approval requires;
- The Financial Ombudsman Service is not available to investors for complaints against an investment trust company itself, or the company's fund manager (where there is one); and
- The Financial Services Compensation Scheme is not available in the event of an investor having a claim against an investment trust company, which the company cannot meet.

Throughout Chapter 5 we seek views on whether we have properly identified all of the significant regulatory differences between investment trust companies on one hand, and unit trusts and open-ended investment companies on the other. We also seek comment on whether, aside from the comparison between the three types of entity discussed in this paper, there are any other regulatory issues that interested parties believe should be weighed in the balance when considering whether there is a case for additional regulation.

In Chapter 6 we set out four possible regulatory options for investment trust companies, to discuss in the context of considering whether or not there is a case for additional regulation.

The possible regulatory options are to:

- Amend the Financial Services and Markets Act 2000 so as to put the regulation of investment trust companies on a similar basis to authorised unit trusts and OEICs. Investment trust companies would be regulated as products as well as having to be authorised persons;
- Amend secondary legislation so that investment trust companies would be brought within the definition of 'collective investment schemes', and become subject to general regulation under the Financial Services and Markets Act 2000. They would be regulated as authorised persons, but not as authorised products;
- Amend secondary legislation to create a new regulated activity of "establishing, operating or winding up an investment scheme based and listed in the UK, which has a stated objective of spreading risk such that no single holding exceeds 15 percent of the value of the scheme's assets". Investment trust companies would be deemed to be carrying on the new regulated activity and would therefore come within the scope of Part 4 of the Financial Services and Markets Act 2000. They would be regulated as authorised persons, but they would continue not to be collective investment schemes. Nor would they be regulated as products;
- Continue to rely on existing FSA rule making powers (e.g. the Listing Rules).

Throughout Chapter 6 we seek views on a range of matters relating to each option, including whether we have considered all significant implications, properly identified the possible types of cost and benefit, and whether there are any alternatives or variations to the possible options that we discuss that could achieve the same or similar outcome. We ask whether interested parties would support or oppose pursuing each option (including no additional regulation), and expect that responses to these questions will correspond to the views expressed in relation to each regulatory difference, or potential regulatory 'gap' discussed in Chapter 5.

The questions to which we seek responses are summarised in Chapter 7.

In Chapter 8 we set out 'next steps'. We intend to publish our feedback on this consultation in late Spring 2005. If, at that stage, we take the view that there is a case for additional regulation of investment trust companies we will prepare a more detailed set of proposals and a partial Regulatory Impact Assessment with a view to further consultation.

1 Introduction

1.1 Investment trust companies are pooled, risk-spreading investment vehicles constituted as limited liability listed public companies. Since they first appeared in the mid-19th century, they have provided investors with a way of gaining exposure to the stock market. There are currently around 350 investment trust companies in the UK with a total market capitalisation of around £44bn.[1]

1.2 In order to be an investment trust company, a company must meet certain criteria set out in the Income and Corporation Taxes Act 1988 and be approved by the Inland Revenue[2]. The tax requirements include (among other things) that:

- No holding in the company represents more than 15 percent by value of the investing companies assets;
- The company is resident in the UK;
- The company's ordinary share capital is listed on the Official List;
- The Memorandum and Articles of Association of the company prohibit the distribution as a dividend of surpluses arising from the realisation of investments; and
- The company does not retain more than 15 percent of its eligible investment income[3] (although there may be provision for the reinvestment of dividends).

1.3 Once a company has obtained Inland Revenue approval it will enjoy special tax treatment (as described in Chapter 2).

1.4 Investment trust companies cover a wide range of investment strategies from large generalist trusts to smaller trusts investing in niche areas. Although they were originally intended to provide small investors with the opportunity to gain diversified investments in stock markets, most shares have until recently been held by financial institutions. However, in recent years they have become increasingly popular with individual investors – at least in part because of the introduction of regular investment schemes – such that individual investors are now estimated to hold around 50 percent of shares in investment trust companies.[4]

1.5 Unlike other pooled investment vehicles such as unit trusts and open-ended investment companies (**OEICs**), investment trust companies do not require authorisation by the Financial Services Authority (**FSA**) under Part 4 of the Financial Services and Markets Act 2000 (**FSMA**).

1.6 As listed companies they are subject to the requirements of the Listing Rules. They are, however, free to pursue any investment strategy approved by the Board (subject to the Listing Rules and any limitations set out in the Memorandum and Articles of Association). This includes taking on debt financing (gearing).

[1] Statistics published on the Association of Investment Trust Companies (AITC) website, as at 30 September 2004.

[2] See section 842 of the Income and Corporation Taxes Act 1988.

[3] 'Eligible income' is defined in section 842(1AA) of the Income and Corporation Taxes Act 1988 and means, for present purposes, income deriving from shares or securities.

[4] According to AITC's research in this area.. The AITC notes that it is difficult to reach a precise figure because of the many different ways in which private shareholders may buy shares in investment trust companies.

1.7 The difference between the regulation of investment trust companies, and authorised unit trusts and OEICs, is discussed in more detail in Chapters 4 and 5 but of particular note is that some investor protection measures available to investors in authorised unit trusts and OEICs are not available, or only available in a limited form, to investors in investment trust companies.

1.8 Relevant to the differences in regulation is the design of FSMA. It sets out a regulatory regime that primarily targets people and firms that provide financial services and the activities that they undertake, rather than products. Unit trusts and OEICs are an exception to this overriding regulatory approach in that specific provisions, including rule-making powers vested in the FSA, are included in Part 17. These entities have been regulated in some form for more that sixty years, and the subject of certain EU obligations relating to the promotion of undertakings for collective investment in transferable securities (**UCITS**) since 1989. Their authorisation as products was built into FSMA in order to consolidate existing regulation of the financial industry.[5]

1.9 The problems that have arisen with some split-capital investment trusts in recent years have brought the regulatory differences between investment trusts and other similar investment vehicles into focus. Split-capital investment trusts (**splits**) have, as the name implies, more than one class of share with different classes being entitled to payments in a set order of priority. For example, a split might have two classes of shares – zero dividend preference shares (**zeros**) and ordinary income shares (**ordinaries**). The ordinaries will be entitled to all the dividend income, while the zeros will be paid in full at a pre-determined value (provided there are enough net assets) on the redemption date. Any capital surplus after paying the zeros (and any other prior ranking charges) is returned to the holders of the ordinaries. This is just an example of a simple share structure. There may be many other different classes of share besides zeros and ordinaries.[6]

1.10 Splits normally have a limited life. The intention is that the different classes of share capital enable different groups of investors to meet their investment needs and to accept a greater or lesser level of risk as they consider appropriate. Splits represent approximately 11 percent of market capital in the investment trust industry.[7]

1.11 The first such splits were launched in 1965. Investment in splits, and particularly in zeros, was originally seen as relatively low risk. However, in the past few years more than thirty splits have seen their market value virtually wiped out, causing heavy losses to investors, including holders of zeros (the Treasury Committee of the House of Commons estimates that holders of zeros in these companies have lost £667m out of £785m invested). The resulting public concern led to the Treasury Committee conducting an inquiry into the events that had led to the problems within splits.

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[5] Unit trusts and OEICs are both capable of being constituted as UCITS in terms of the UCITS Directive 85/611/EEC. Investment products that comply with certain UCITS requirements may be marketed throughout Europe provided they are registered with their domestic regulator.

[6] For example, 'income' shares aim to provide investors with regular returns in the form of share dividends generated from the trust's investment activities, but will not necessarily receive any capital surplus upon winding up. By contrast, 'capital' shares offer the potential for above average capital growth. They pay no income, but there is no limit on the return at wind up. They have the last call on the trust's asset at wind up, so carry relatively higher risk.

[7] Statistics published on the AITC website, as at 30 September 2004. Approximately 13 percent of total market assets is held by splits.

1.12 In its report to the House of Commons[8] the Treasury Committee concluded that many splits launched in the late 1990s were structured in such a way that in adverse market conditions, zeros were no longer relatively low risk and that this was not fully understood by their designers, or the company boards. The Committee believes that the high gearing of many splits and the substantial cross-holdings among them were the principal factors behind this increase in risk. As these increases in risk were not adequately brought to the attention of investors, the Committee believes that many shares in splits were mis-sold and some investors might have a claim to compensation. It stated that firms, the Financial Ombudsman Service (**FOS**) and the FSA must examine the circumstances of each case. The Committee was also concerned that there was evidence of collusion among some players in the splits sector.

1.13 The actions taken by the FSA and the FOS in response to the problems with splits, including those taken in response to the Committee Report, are set out in Chapter 3.

This consultation has been initiated in response to a recommendation by the Committee that investment trust companies should be brought directly within the scope of investment product regulation by the FSA. In response to this recommendation the Government undertook to consult on whether there was a need to introduce additional regulation, and possible options for doing so.

1.14 In light of the fact that certain parties have already taken steps in response to the problems within splits, we have not taken a view on whether investment trust companies should be subject to additional regulation. Instead, we ask throughout this paper (and in particular in Chapter 5) whether the potential ‘gaps’ in the existing regulation of these entities are of such significance that we should look further at possible ways to address them. We also ask, more broadly, whether there are other regulatory issues around investment trust companies that we have not identified but which should be taken into account in determining whether any additional regulation is necessary.

1.15 In Chapter 6 we discuss some options for addressing the potential gaps, and seek views in relation to each on a range of matters, including how well they would address the potential problems that we identify, whether there would be any unintended consequences and whether there might be any alternative way of obtaining the same or similar results. We expect the responses to questions in Chapter 6 will depend - at least in part - on the views expressed in response to Chapter 5 about the significance of the potential gaps and whether there is any need to address them.

1.16 It should be noted that although we focus for the purpose of this consultation on investment trust companies, if, following consultation, we were to take the view that additional regulation is required, our assumption is that it would also apply to ordinary investment companies. By ‘ordinary investment companies’ we refer to companies that have a risk spreading objective such that no single holding exceeds 15 percent of the value of the assets, have given notice to the Registrar of Companies as prescribed under section 266 of the Companies Act 1985, and which are listed on a UK stock exchange. We believe there are currently few (if any) such UK-listed, UK-based companies, but the possible regulatory options that we discuss in Chapter 6 should be read in this context.

[8] Treasury Committee Third Report of Session 2002-03: Split Capital Investment Trusts (published 13 February 2003) (“**Committee Report**”).

2 CURRENT REGULATION OF INVESTMENT TRUST COMPANIES

INTRODUCTION

2.1 Investment trust companies are limited liability listed public companies. They are not collective investment schemes for the purpose of FSMA. They do not carry on regulated activities[1] and therefore they are not required to be authorised persons.[2] The FSA's power to set, monitor and enforce standards for authorised persons does not apply. Nor are investment trust companies regulated as products[3], as explained in the Introduction to this paper. They are not subject to direct regulation by the FSA.

2.2 However, there are a number of areas where the FSA has some regulatory jurisdiction over investment trust companies and transactions in the shares of these vehicles:

- The FSA is, as the UK Listing Authority (**UKLA**), the competent body responsible for setting and ensuring compliance with the Listing Rules. Chapter 21 of the Listing Rules is specifically directed at investment entities. The UKLA also reviews and comments on draft prospectuses.
- The assets of most (but not all) investment trust companies are managed by fund managers who also provide trusts with most of their administrative functions. Investment fund managers must be authorised persons under FSMA, so they are subject to FSA regulation.
- Most (but not all) dealings in shares in investment trust companies are made through authorised persons (such as fund managers, stockbrokers or financial advisers), involve regulated activities and so are subject to the FSA's conduct of business rules contained in its Conduct of Business sourcebook (***COB***).

2.3 Investment trust companies are also subject to general company law.

2.4 The Association of Investment Trust Companies (**AITC**), a trade body for investment trust companies, has produced a voluntary Code of Corporate Governance to supplement the Combined Code of Corporate Governance annexed to the Listing Rules (discussed below). It also works with member companies to maintain high standards within the industry, and periodically issues advice, guidance and statements of recommended practice in a range of areas.[4]

2.5 The Treasury is mindful of the need to have regard to these existing regulatory measures when considering proposals for changing the regulation of investment trusts.

[1] 'Regulated activities' are 'specified activities' as defined in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (**RAO**).

[2] 'Authorised persons' are persons who are granted permission under Part 4 of FSMA to carry on regulated activities, or otherwise qualify for authorisation by a provision of, or made under, the Act (see section 31).

[3] Note that where we refer in this paper to "product regulation" in relation to investment trust companies, or to the possibility of regulating investment trust companies "as products", we refer to the regulation of the establishment and operation of these entities, and the conditions in which shares may be issued – even though, technically speaking, the "product" that an investor purchases is company *shares*.

[4] For example preparing financial statements, reports and accounts, applying the International Accounting Standards and calculating net asset values. (Note that complying with the International Accounting Standard becomes a legal requirement for all listed companies in the EU from 1 January 2005).

Listing Rules

2.6 The Listing Rules apply to companies that are admitted to the Official List – this, by definition, includes all investment trust companies.

2.7 The UKLA's regulatory objectives are to formulate and enforce listing rules that provide an appropriate level of consumer protection for investors in listed securities, facilitate access to listed markets for a broad range of enterprises and seek to maintain the integrity and competitiveness of the UK markets.

2.8 In broad terms, the Listing Rules reflect requirements that are compulsory under relevant European Community directives, and additional requirements under FSMA.

2.9 They set out the conditions for listing, the requirements for listing particulars, the application procedure, rules about transactions and the disclosure of financial information, rules that apply to various specific types of company and investment entities (including rules about investment strategy), and obligations imposed on issuers relating to directors – such as the disclosure of information about directors, directors' responsibilities, and rules governing transactions in which directors may be involved.

2.10 The Combined Code on Corporate Governance (July 2003) (**Combined Code**), annexed to the Listing Rules, replaces an earlier code that arose originally out of a review of financial reporting and accountability set up under Sir Adrian Cadbury in 1991.[5] The update in July 2003 is the result of two reviews - one of the role and effectiveness of non-executive directors[6] and the other of audit committees[7] - and contains main and supporting principles and provisions pertaining to governance.

2.11 The Listing Rules require listed companies to make a disclosure statement in two parts in relation to the Combined Code.[8] In the first part, the listed company must report on how it applies the Code's principles. In the second part, the company must either confirm that it complies with the Code's provisions or, where it does not, provide an explanation. The flexibility to take into account a company's size, complexity and particular circumstances, which is afforded by the 'comply or explain' approach, allows for departure from the principles as long as companies explain any such departure (and it is always open to shareholders to question the company's statement on this matter).

2.12 Nothing in the Combined Code overrides the general requirements of the law regarding the treatment of disclosure of information to shareholders and the market. It is not of itself legally binding, except insofar as the Listing Rules contain certain requirements in relation to it (as set out above).

2.13 The UKLA Guidance Manual provides guidance on a range of matters covered in the Listing Rules, such as applications for listing, interpretation, procedures relating to sponsors, the UKLA's information-gathering and investigative powers, disciplinary procedures relating to issuers, directors, former directors and sponsors for breaches of the rules, the suspension and cancellation of the listing of securities and the interaction of the rules with the market abuse regime.

[5] The Cadbury Committee looked into issues relating to financial reporting and accountancy and made a series of recommendations that led to the original code.

[6] Conducted by Sir Derek Higgs: "Review of the role and effectiveness of non-executive directors", published in January 2003.

[7] Conducted by Sir Robert Smith: "Audit Committees Combined Code Guidance", published in January 2003.

[8] See rule 12.43A.

2.14 Chapter 3 of this paper describes the changes made to the Listing Rules by the FSA in its capacity as the UKLA, following the Committee report and public consultation.

2.15 In summary, all listed companies (including investment trust companies) must meet certain basic requirements relating to information disclosure. Sponsors, issuers and directors are expected to conduct themselves according to certain standards. The FSA is charged with considering applications for listing and monitoring compliance with the rules on an ongoing basis, and has the appropriate investigative and disciplinary powers to carry out its responsibilities.

General company law

2.16 Investment trusts are listed public companies formed under the Companies Act 1985 (or one of its predecessors), to which company law applies in full.

2.17 As such, they are required to have at least two directors, or such greater number as may be set out in the company's Articles of Association. The directors are subject to various legal requirements, including those set out in Part 10 of the 1985 Act (Enforcement of Fair Dealing by Directors). They are responsible for the preparation of the company's annual report and accounts, which must be signed by one or more of the directors in accordance with the requirements of the 1985 Act. They are also required to produce a Directors' Report and a Directors' Remuneration Report. Importantly, directors owe a fiduciary duty and other duties of care to the company and can be sued by it for breach of these duties.

FSA powers

2.18 The FSA's regulatory objectives under FSMA are to maintain confidence in the financial system, secure the right degree of consumer protection in the financial services industry, promote public understanding of the UK financial system, and reduce the scope for financial crime.

2.19 To assist it in attaining these objectives, the FSA has an extensive set of powers governing the application criteria and processes for authorising firms who wish to perform regulated activities, and approving individuals who wish to perform specified functions within these firms.[9] Its powers in relation to authorised persons also cover standard-setting, monitoring and enforcement.

2.20 Its powers with respect to investment trust companies are much more limited. As noted in the Introduction to this paper, these entities do not require FSA authorisation. It follows that their directors and management do not have to be approved by the FSA. That said, where a third party fund manager is used by an investment trust to manage its assets that party must be authorised and is subject to FSA rules, including those described below.[10]

[9] Under section 19 of FSMA, firms must be authorised by the FSA to carry on regulated activities. Individuals who carry on 'controlled functions', that is, functions specified in the FSA's rules which either enable a person to exercise significant influence over the conduct of an authorised person's affairs, or involve the person performing the function in dealing with the authorised person's customers (or their property) in a manner substantially connected with the carrying on of the regulated activity, must be approved by the FSA.

[10] As noted in the introduction to this chapter, not all investment trusts use third party fund managers for the day-to-day management of their assets. Some (a minority) are self-managed, and therefore none of the FSA powers that we describe below in relation to intermediaries apply. This consultation focuses on the majority of investment trust companies, which do employ third party fund managers.

2.21 Authorised persons are required to comply with the FSA's high level standards, including its Principles for Business (***PRIN***), and Senior Management Arrangements, Systems and Controls (***SYSC***).

2.22 When considering applications for authorisation or approval the FSA must ensure that the applicant will satisfy the Threshold Conditions (authorisation) or is a 'fit and proper person' (approval). The Threshold Conditions (***COND***) cover legal status, location, "close links", adequate resources (both financial and non-financial) and suitability.

2.23 The Principles for Business set out the fundamental obligations of all firms under the regulatory system. They express the main dimensions of the standard set for firms in Threshold Conditions. They cover integrity; skill, care and diligence; management and control; financial prudence; market conduct; customers' interests; communications with clients; conflicts of interest; relationships of trust with customers; client assets and relations with the regulator. The FSA may take disciplinary action against an authorised person who fails to comply with the Principles of Business.

2.24 The minimum standards for a person to carry on a controlled function are set out in the Fit and Proper test for Approved Persons (***FIT***). Also relevant are the Statements of Principle and Code of Practice for Approved Persons (***APER***).

2.25 The Statements of Principle, like the Principles for Business, cover, among other things, integrity, skill, care and diligence and observing proper standards of market conduct. The Code of Practice is intended to assist approved persons to know when they might be acting in breach of the general principles, by providing examples of types of behaviour that would tend to show breach of, or compliance with the Statements of Principle. The FSA may take disciplinary action against an approved person who fails to comply with the Statements of Principle, or who is knowingly involved in a breach by the relevant authorised person of the FSA's rules.

2.26 The purpose of the rules contained in Senior Management Arrangements, Systems and Controls is to set out clearly where management responsibilities lie, and to ensure that appropriate risk management systems are in place to monitor authorised persons' activities. The FSA's ongoing monitoring and enforcement is intended to ensure that firms organise and maintain their affairs in a responsible and effective manner. It has power to grant waivers of rules and provide firms with individual guidance, where appropriate.

2.27 The conduct of business rules contained in *COB* apply to the investment business activities of authorised persons, including the relationship between those firms and retail consumers. The *COB* rules impose more detailed requirements than the Principles for Business, and relate to matters such as conflicts of interest, financial promotions, suitability of advice and discretionary investment decisions, customers' understanding of risk, commissions and charges, product disclosure, dealing in and managing investments for customers, operating collective investment schemes and the activities of trustees and depositaries.

2.28 Authorised persons involved in managing investments for investment trust companies or advising on and dealing in their shares in the secondary market are subject to the FSA rules described above, and, accordingly, the FSA may take enforcement action against those who breach them.

2.29 The FSA's enforcement powers include powers to investigate, impose fines, vary or cancel authorisations, impose prohibitions or requirements in relation to the assets or activities of the firm, prosecute specified offences and institute insolvency proceedings. The FSA may also apply to the court for orders requiring authorised persons to make restitution where the firm's breach of the rules has resulted in profit to the firm or loss (or other adverse effect) to other persons.

2.30 In summary, although the FSA does not exercise any direct power over investment trust companies per se, it does have full powers to impose and enforce regulatory obligations on authorised persons involved with them.

2.31 It is also worth noting that Part 8 of FSMA sets out a market abuse regime, which introduces a civil penalty regime that is enforced by the FSA. It sits alongside the Listing Rules, Takeover Code and existing criminal law in relation to insider dealing and market manipulation.

2.32 Market abuse is behaviour which occurs in relation to qualifying investments traded on a prescribed market (of which the London Stock Exchange is one),[11] which is likely to be regarded by a regular user of that market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his or her position. The behaviour must also meet any one (or more) of the conditions set out in section 118(2) of FSMA.[12] It applies to all businesses and individuals whether or not they are regulated by the FSA, and has no territorial restriction.

2.33 The FSA's Code of Market Conduct (***MAR***) is intended to clarify the scope of the offence, and provides details on how the offence will be interpreted by the FSA.[13]

Tax treatment

2.34 As noted in the Introduction to this paper, in order to obtain investment trust status, companies must be approved by the Inland Revenue.

2.35 The tax rules require, among other things, that:

- No holding in the company represents more than 15 percent by value of the investing companies assets;
- The company is resident in the UK;
- The company's ordinary share capital is listed on the Official List;
- The Memorandum and Articles of Association of the company prohibit the distribution as a dividend of surpluses arising from the realisation of investments; and

[11] See the Financial Services and Markets Act 2000 (Prescribed Market and Qualifying Investments) Order 2001. 'Prescribed market' means any UK recognised investment exchange (RIE) and OFEX. 'Qualifying investment' means any investment traded on a UK RIE or OFEX.

[12] The conditions are that the behaviour is either: (a) based on information which is not generally available to market users but which, if available to a regular user, would be regarded by him or her as relevant when deciding the terms on which transactions should be effected; or (b) likely to give a regular user a false or misleading impression as to supply, demand, price or value of investments; or (c) likely to be regarded as behaviour that would or would be likely to distort the market.

[13] FSMA includes a 'regular user' test as well as expanding on the meanings of 'behaviour', 'misuse of information', 'false or misleading impressions', 'distortion' and 'requiring or encouraging'.

- The company does not retain more than 15 percent of its eligible investment income[14] (although there may be provision for the reinvestment of dividends).

2.36 Companies that meet these requirements and are approved by the Inland Revenue enjoy special tax treatment.

2.37 They pay corporation tax at the standard rate, but are exempt from corporation tax on realised capital gains.

2.38 Shareholders receive dividend distributions with an accompanying dividend tax credit.

2.39 We do not anticipate that any of the regulatory options set out in Chapter 6 of this paper will have implications for the treatment of investment trust companies for tax purposes.

AITC voluntary Code of Corporate Governance

2.40 The AITC is the non-profit making trade body of the investment trust company industry. It represents investment trust companies and their shareholders and works closely with the management groups that administer the companies. It is funded by individual member trusts and its activities are focused on providing value to them and their shareholders. Membership of the AITC comprises 70 percent of the investment trust industry.[15]

2.41 The AITC voluntary Code of Corporate Governance (**AITC Code**) was published in August 2003 and updated in January 2004 to take account of the revised Combined Code (mentioned above).

2.42 It is intended to provide boards of AITC member companies with a comprehensive framework for best practice in respect of the governance of investment trust companies and closed ended funds. There is some overlap with the Combined Code, but it is intended to focus on the additional factors that apply to investment trust companies and others where particular characteristics suggest that alternative practices to those set out in the Combined Code may be preferable.[16] The main areas that it seeks to address are board independence, the relationship with the fund manager and shareholder communications.

2.43 Although the AITC Code is voluntary, the AITC reports its belief that there is widespread compliance with the Code's recommendations. As with the Combined Code, the AITC Code is based on the principle that investment trusts should either comply or disclose where they do not, so that shareholders can judge for themselves whether they are satisfied with its practices. Although there is no formal sanction against members that do not comply with the AITC Code, the incentive to do so is the desire to be seen to follow best practice.

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[14] Eligible income' is defined in section 842(1AA) of the Income and Corporation Taxes Act 1988 and means, for present purposes, income deriving from shares or securities.

[15] Statistics published on the AITC website, as at 30 September 2004.

[16] First, the shareholders and the customers of an investment trust are the same people, magnifying the importance of this group's interests. Second, the roles of CEO, portfolio manager, administrator, accounting and company secretary are typically provided by a third party fund manager who may have created the fund in the first place and may have an influential role in deciding the composition of the Board. It may have an influence on Board composition that is disproportionate relative to shareholders' interests. Therefore the AITC Code focuses on matters such as Board independence, the relationship with the fund manager and shareholder communications.

3 Actions Taken to Address the Problems at Split Capital Investment Trusts

3.1 The FSA and the FOS have taken a series of actions in response to the problems with splits, including actions taken in response to the recommendations of the Treasury Committee's report. In general the FSA's actions apply more widely than just to investment trust companies, such as the changes it has made to the Listing Rules.

FSA actions

3.2 In December 2001 the FSA called for views on the regulation of Split Capital Closed End Funds (**SCCEFs**)[1], in response to public concern about splits and allegations of collusive behaviour by fund managers involved with them (DP10).[2] The FSA had gathered data earlier that year that suggested certain splits were particularly vulnerable to adverse market conditions, given their level of debt and cross-holdings.

3.3 DP10 focused on the issue of disclosure, governance, and the guidance offered to financial advisers who recommend SCCEFs. It sought views on whether any amendment should be made to the Listing Rules[3] or *COB* rules. The FSA also indicated that it was researching further the issues surrounding the allegations of collusion among certain management firms.

3.4 In May 2002 the FSA published an update of its enquiries into the splits market and provided feedback on the responses to DP10.[4] It undertook to investigate further those responsible for producing the marketing material for splits, the allegations of collusion, and possible mis-selling by advisors. It also undertook to consider further possible changes to the Listing Rules and FSA Handbook and to liaise with the FOS and the AITC in their respective work areas.

3.5 In 2002, owing to the suspension of the securities of a number of splits and potentially significant losses to investors from investments that had generally been marketed as relatively low risk, the Treasury Committee initiated its inquiry into the splits sector.[5] The FSA appeared before the Committee in November 2002 and committed to consult quickly on changes to the Listing Rules and *COB* rules.

3.6 In January 2003 the FSA published a consultation document on proposed changes to the Listing Rules, COB rules and the Model Code (CP164).[6]

3.7 It provided feedback to the consultation and set out the changes to these documents in October 2003.[7]

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[1] SCCEFs include split capital investment companies and split capital investment trusts (referred to as "splits" throughout this paper).

[2] Split Capital Closed End Funds (December 2001) (DP10).

[3] The FSA acting in its capacity as the UK Listing Authority (UKLA).

[4] Split Capital Investment Trusts (Splits): Update report on FSA's enquiry into the Split Capital Investment Trust Market (May 2002).

[5] This inquiry led to the Committee Report (see the Introduction, note 8).

[6] Investment companies (including Investment trusts): Proposed changes to the Listing Rules and the Conduct of Business Rules – Changes to the Model Code (January 2003) (**CP164**). Note that the proposed changes to the Model Code were not directly linked to the splits issue and are not relevant for the purpose of this paper.

[7] Investment companies (including investment trusts): Changes to the Listing Rules and the Conduct of Business Rules; Changes to the Model Code – Feedback on CP164 and made text (October 2003) (**"Feedback on CP164"**). Again, the changes to the Model Code were not directly linked to the splits issue and are not relevant for the purpose of this paper.

Changes to Listing Rules

3.8 The main changes that have been made to the Listing Rules as a result of the process set out above are:

- A UK listed investment company may not invest more than 10 percent of its gross assets (at the time the investment is made) in other UK listed investment companies that do not themselves have a stated investment policy to invest no more than 15 percent of their assets in UK listed investment companies
- Listing documents must have a specific "risk factors" section upfront, noting risk factors specific to the issuer, its industry, its investment policy and the securities it will issue, including:
  - A statement on the extent to which the company intends to borrow
  - An explanation of the risks to the value of the company's securities associated with any borrowing
  - An explanation of risks associated with investing in geared companies
- Enhanced information disclosure:
  - Within two business days of the end of each month, to disclose a list of all investments in other UK listed investment companies which do not have a stated investment policy to invest no more than 15 percent of their assets in other UK listed investment companies (as at the last day of the calendar month)
  - Within two business days of the end of each quarter, to disclose a list of all investments with a value greater than 5 percent of the company's investment portfolio and at least the top ten investments (as at the last business day of the quarter)
- Enhanced director independence:
  - Any director of an investment company who is also a director of another investment company managed by the same firm will not be regarded as "independent" for the purpose of the eligibility criteria in LR 21.9(d)
  - No more than one director or employee of or professional adviser to the investment management firm concerned may sit on the board of a given investment company. This person will not be considered "independent" and must be subject to annual shareholder election
  - The chairman of the board of the investment company must be independent
- Boards must report to shareholders annually on the performance of the fund manager, and must explain in a prominent place within the Annual Report and Accounts whether the continued use of a particular fund manager is in the shareholders' best interests, with reasons
- Boards must disclose in the Annual Report and Accounts a summary of the principal terms of any investment management agreement between the fund manager and the company

- Boards must seek shareholder approval to make a material change to the company's stated investment policy

Changes to COB rules

3.9 In addition to the changes to the Listing Rules, changes have been made to the COB rules (which apply to firms through which purchases of shares in investment trust companies are generally made) to provide further guidance on the risk warnings that should be provided to investors proposing to acquire shares in investment companies that significantly gear their investment portfolio, or investment companies that propose to invest in other investment companies that have that ability.

3.10 The main changes that have been made to the COB rules are that firms should warn investors that:

- Movements in the price of such investment companies might be more volatile than movements in the value of the underlying securities
- Investments might be subject to sudden and large falls in value
- The investor might get nothing back at all if the fall in value of the investment is sufficiently large

3.11 The definition of "gearing" has also been amended to include the gearing that arises from investment in financial products other than warrants and derivatives and the creation of structural gearing.

FSA investigations in relation to splits

3.12 In May 2002 the FSA launched investigations into allegations of collusion by fund managers and brokers within the splits sector, mis-selling by intermediaries, and the production and distribution of misleading marketing material.

3.13 The enforcement investigations following this announcement have become the largest the FSA has ever undertaken. The investigations have involved the review of a significant number of documents and conversations captured on dealing tapes. Many interviews have taken place. The FSA has undertaken detailed analysis of individual transactions within the split sector during 2000 and 2001 and reviewed considerable empirical evidence. There are currently 22 firms under investigation, as well as 32 individuals.

3.14 We are advised by the FSA that its investigations are beginning to draw to a close. It has concluded its investigations in relation to two firms, which have paid a financial penalty and agreed to pay compensation to investors.

3.15 The FSA's continuing work has three aspects. Firstly, it is beginning to present cases to the Regulatory Decisions Committee inviting the RDC to issue Warning Notices proposing regulatory sanctions, including restitution for investors.

3.16 Secondly, the FSA is continuing to discuss the possibility of achieving compensation on a global basis with the majority of the firms concerned.

3.17 Thirdly, and if a settlement cannot be reached with all of the firms concerned, the FSA will have settlement discussions with those who have said that they are prepared to try to reach agreement through mediation. So far five firms have said that they are willing to enter into such discussions. Several other firms have said that they would be interested in mediation if the FSA is unable to reach agreement through the ongoing settlement discussions.

Financial Ombudsman Service: assessing complaints concerning splits

3.18 Broadly speaking, the compulsory jurisdiction[8] of the FOS is limited by FSMA to complaints against firms that were regulated by the FSA as authorised persons at the date of the act or omission about which the complaint is made. As investment trusts are not authorised persons, they do not fall within the FOS's compulsory jurisdiction.

3.19 Where a firm does fall within the FOS's jurisdiction (as fund managers of investment trust companies do), complaints may only be brought by 'eligible complainants' as defined in rules made by the FSA under FSMA.[9] The current rules require complainants to be 'customers' or certain specified non-customers of the firm complained against.

3.20 This means that the FOS cannot hear complaints from shareholders in investment trust companies against the authorised person acting as manager of the investment trust (where there is one), because the manager's customer is the investment trust itself, not its shareholders.

3.21 The FOS can, however, hear complaints from shareholders in investment trusts against an authorised person who advised them on or arranged the purchase of the shares, or sold them the shares, or managed a 'wrapper' (such as an ISA) the investment component of which was shares in an investment trust company. In each of these cases the shareholder is the customer of the authorised person.

3.22 As at 10 October 2004 the FOS had received 5,157 complaints relating to splits, of which it had resolved and closed 2,451. The cases involve shares in approximately 160 different splits, launched by approximately 30 splits sponsors. Nearly half of the cases were against splits sponsors, and the rest were against intermediaries, including independent financial advisers and portfolio managers.

3.23 The complaints are generally very complex because splits-related products are inherently complex, and most cases combine issues specific to the individual case with issues specific to the particular splits shares involved (and therefore common to a number of cases). Much work is required to ensure consistency of treatment in like cases. The FOS periodically publishes updates for complainants (and interested parties) on its website.

[8] The FOS has two types of jurisdiction: compulsory and voluntary. The compulsory jurisdiction automatically covers firms regulated by the FSA for certain types of complaint. Firms that do not fall within the compulsory jurisdiction may sign up to the voluntary jurisdiction by contractual arrangement with the FOS.

[9] The rules are contained in the FSA's Handbook of rules and guidance, under Dispute resolution: complaints (***DISP***).

AITC Foundation

3.24 The AITC established the AITC Foundation in April 2003. The aim of the Foundation is to relieve those suffering severe financial hardship as a result of losses in splits, and the eligibility criteria are set accordingly. [10]

3.25 The Foundation is not designed to compensate investors in splits who lost money, and bears no relationship to the Financial Services Compensation Scheme (**FSCS**).[11] It is funded by firms that were involved in the launch and operation of the splits that collapsed and led to the Committee Report.

3.26 In addition to relieving hardship, the AITC intended this action to help restore confidence in the investment trust industry.

[10] For example, applicants must have lost money by investing in any form of income or zero dividend preference shares in a split capital investment trust company or certain other highly geared investment companies, have less than £16,000 in savings or other net investments, and be in immediate severe financial need as a result.

[11] See also Chapter 4 regarding the FSCS.

4 Regulation of Unit Trusts and Open Ended Investment Companies (OEICs)

Introduction

4.1 Investment trust companies are commonly perceived to be an alternative investment vehicle to authorised unit trusts[1] and OEICs[2], as a means of pooling funds and gaining exposure to stocks and shares. Investment trust companies, unit trusts and OEICS share in common that they enable smaller investors to spread relatively limited resources over a wider range of investments and diversify in a way that would otherwise not be economical.

4.2 However, there are differences in the form of all three investment vehicles, as well as a significant difference in the regulation of investment trust companies compared to authorised unit trusts and OEICs. As noted in the Introduction to this paper, the latter two have been regulated in some way for more than sixty years and are both capable of being constituted as UCITS schemes.

4.3 With regard to legal form, unit trusts are trusts, consist of units (rather than shares) and authorised unit trusts are open ended.[3] The number of units in an authorised unit trust may vary and is determined by the level of demand for new units purchased relative to those units redeemed.

4.4 OEICs incorporate aspects of both investment trust companies and unit trusts. They are not companies under the Companies Acts but, like investment trust companies, they issue shares. However, as the name indicates (and like authorised unit trusts) they are open-ended.

4.5 So whereas an investor in an investment trust company who wishes to realise their money must sell their shares on the stock exchange (where the price is determined by the market), investors in authorised unit trusts or OEICs can sell (redeem) their units or shares back to the fund manager as of right. The price of units in an authorised unit trust and shares in an OEIC is calculated by reference to the value of the underlying assets and there are detailed arrangements for the determination of prices, which are subject to FSA rules.[4]

4.6 With regard to regulatory differences, authorised unit trusts and OEICs fall within the definition of "collective investment scheme" in FSMA and are regulated as products under Part 17. Chapter 2 describes the existing regulatory measures relating to investment trust companies and the present chapter explains the regulation of authorised unit trusts and OEICs under FSMA.

4.7 With regard to the tax treatment of the different products, Chapter 2 sets out the existing tax treatment of investment trust companies and the present chapter sets out for completeness the current tax treatment of unit trusts and OEICs. As noted in Chapter 2, we do not anticipate that any of the regulatory options set out in Chapter 6 of this paper would have implications for the treatment of investment trust companies for tax purposes.

[1] 'Authorised' here refers to unit trusts that are regulated as products under Part 17 of FSMA – see section entitled 'unit trusts'. For the purpose of this paper we are mostly concerned with authorised unit trusts.

[2] OEICs are also known as investment companies with variable capital (ICVCs).

[3] "Open ended" refers to the fact that, unlike investment trusts, which may repurchase their own shares only in limited circumstances, the capital structure of authorised unit trusts is variable, not fixed. In particular, if investors wish to redeem their units, they may do so as of right by selling them back to the manager of the unit trust.

[4] See *CIS* and *COLL*, discussed in the next section of this chapter.

Unit trusts

4.8 Authorised unit trusts are collective investment schemes under FSMA.

4.9 They are regulated as products under Part 17 of the Act, and the FSA has a specific rule-making power (section 247) and powers of intervention (section 257) in respect of them.

4.10 Under section 257 the FSA may give directions relating to authorised unit trusts in certain circumstances.[5] Even where none of the specific listed circumstances exist, the FSA may give directions where it is 'desirable to give a direction in order to protect the interests of participants or potential participants in such a scheme'. Directions may require the manager of a scheme to cease the issue and/or the redemption of units, or require the manager and trustee of the scheme to wind it up (section 257(2)).

4.11 Depending on the choice made by the authorised fund manager, the FSA's collective investment schemes sourcebook (***CIS***) or new collective investment schemes sourcebook (***COLL***) will apply to the manager and trustee of an authorised unit trust.[6] *CIS* and *COLL* are specialist sourcebooks and although they do apply to all regulated collective investment schemes, they deal mainly with authorised unit trusts and OEICs and, as such, are tailored towards the particular characteristics of those products. *CIS* and *COLL* only apply to unit trusts that are authorised under Part 17 (section 243).[7]

4.12 The FSA's product regulations for authorised unit trusts set appropriate standards of protection for investors by specifying a number of features that the product must have and how it must be operated. An important effect of product authorisation is that authorised persons are permitted to promote authorised (but not unauthorised) collective investment schemes to the general public.[8]

4.13 Of particular relevance is that to gain authorisation as a product under section 243 of FSMA, both the manager and the trustee of a unit trust must be authorised persons under the FSA's authorisation regime. The manager of an authorised unit trust is appointed under the trust deed to carry on the day-to-day running of the trust. It is responsible for ensuring compliance with the FSA's investor protection rules, including its principles. The trustee is responsible for overseeing the manager's activities. It also holds the assets on trust for the unit holders and must act solely in their interests. Acting as a trustee of an authorised unit trust and managing investments are regulated activities.[9] The trustee and manager must be independent of each other.

4.14 As set out in Chapter 2, authorisation to perform regulated activities requires applicants to satisfy certain threshold conditions such as suitability, and adequacy of resources. Approval to perform controlled functions requires applicants to satisfy the 'fit and proper person' test.

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[5] For example, the circumstances listed in section 257 include where one or more of the requirements for the making of an authorisation order (under section 243) are no longer met, or where the manager or trustee of an authorised unit trust scheme has contravened a requirement imposed on them.

[6] *COLL* will replace *CIS* entirely from February 2007. As part of the transitional arrangements in the period leading up to that date, existing collective investment schemes may choose whether they follow *CIS* or *COLL*. *COLL* permits authorised unit trusts and OEICS to invest in a wider range of investments than previously allowed, and sets out a lighter touch regulatory and operational framework for those collective investment schemes classified as "non-retail".

[7] Note that *CIS* and *COLL* also apply to the operators of 'recognised' collective investment schemes. 'Recognised' schemes are schemes that are established in a country within the EEA, or in another overseas country designated under FSMA.

[8] Authorised persons are permitted to promote unauthorised collective investment schemes to people who fall within an exemption in the Financial Services and Markets Act 2000 (**Promotion of Collective Investment Schemes) Order 2001**, or the FSA's financial promotion rules.

[9] See articles 31 and 51(1) of the RAO.

4.15 Therefore the FSA's regulation of authorised persons (as described in Chapter 2 in relation to intermediaries who work with investment trust companies) applies not only to the brokers and advisers who work with authorised unit trusts, but also to the manager and trustee of the authorised unit trust itself.

4.16 As mentioned in Chapter 3, the FOS in general terms has jurisdiction to consider complaints against firms regulated by the FSA as authorised persons at the time of the act or omission to which the complaint relates. Therefore, the FOS may hear complaints about authorised unit trusts, including complaints against the trustee or manager, as long as the complainant is eligible and the complaint relates to a regulated activity carried on by the authorised person at a time when that person was subject to the FOS's compulsory jurisdiction.

4.17 The FSCS is available to investors where an authorised person becomes insolvent or is otherwise unable to meet all claims against it. It covers deposits, insurance, investments and mortgage advice and arranging. However, as with making complaints to the FOS, it is not available for mere fluctuations in investment performance that cause loss to investors.

4.18 Where a unit holder has a valid claim against the trustee or manager of a unit trust which the relevant party cannot meet, provided the unit holder is 'eligible' and the claim is a 'protected claim', the unit holder will have recourse to the FSCS. The FSCS will then assess the claim on its merits.[10]

4.19 In terms of tax treatment, unit trusts that are not authorised by the FSA are treated differently from those that are.

4.20 Unauthorised unit trusts are not subject to corporation tax. The income arising within the trust is regarded as the income of the trustees. The trustees are subject to income tax at the basic rate of tax (currently 22 percent). Capital gains are assessable to capital gains tax on the trustees, unless all of the unit holders are exempt by reference to their own status (e.g. a pension fund or charity). The rate applicable is the lower rate of income tax.

4.21 Unit holders are then treated as receiving annual payments made by the trustees in proportion to their rights, under deduction of income tax. They pay tax on capital gains on the sale of their units in the normal way.

4.22 Unit trusts that are authorised by the FSA are, for tax purposes, treated as companies except that they have a corporation tax rate of 20 percent. They are exempt from corporation tax on capital gains. Under certain circumstances they may make an interest distribution, instead of a dividend distribution, provided certain tests are met.

[10] The rules governing the eligibility under (and levies for) the FSCS are contained in the FSA's handbook of rules and guidance, under Compensation (***COMP***). In brief, in order for a claim to the FSCS to succeed, the claimant must be 'eligible', and the activity that gives rise to the loss and the firm against whom the complaint is made must both be 'protected' in accordance with the scheme rules.

OEICs

4.23 OEICs are also collective investment schemes under FSMA and are regulated as products under Part 17.

4.24 Section 262 of the Act provides for the constitution of OEICs.[11] Under that section, the Treasury has the power to prescribe detailed provisions to regulate OEICs and to confer functions on the FSA in relation to them. The Open-Ended Investment Companies Regulations 2001 empower the FSA to make rules with respect to OEICs in the same way as it may with respect to authorised unit trusts under sections 247 and 248 of FSMA. The Regulations also confer upon the FSA the same powers of intervention with respect to OEICs as it has with respect to authorised unit trusts under section 257 of FSMA.

4.25 The FSA's product regulations for OEICs set appropriate standards of protection for investors by specifying a number of features that the product must have and how it must be operated.

4.26 In order for a body to be incorporated as an OEIC, it must be authorised as a product by the FSA. OEICs do not have to have a board of individual directors to operate the company. Instead, the requirements for authorisation include the appointment of an 'authorised corporate director'. The authorised corporate director must be a company that is an authorised person in its own right, and has permission to act as the sole director of the OEIC in accordance with its Part 4 permission. Much like the manager of a unit trust, the authorised corporate director is responsible for the day-to-day running of the company and has specific functions with regard to the management of the OEIC in accordance with *CIS* or *COLL* (as applicable). It is responsible for ensuring that the OEIC complies with the FSA's investor protection rules, including its principles, and so carries most of the burden of compliance that would otherwise have to be borne by the OEIC itself.

4.27 A depositary must also be appointed to hold the OEIC's assets. Acting as the depositary or sole director of an OEIC is a regulated activity.[12] The depositary, like the authorised corporate director, must be an authorised person in their own right, and the two parties must be independent of each other. The OEIC itself is also an authorised person.[13]

4.28 Therefore, the FSA's regulation of authorised persons (as described in Chapter 2 in relation to investment trusts) applies not only to the brokers and advisors who work with OEICs, but also to the authorised corporate director, the depositary and the OEIC itself.[14]

4.29 As with unit trusts, the FOS has jurisdiction to consider most complaints about OEICs including in this case complaints against the authorised corporate director, the depositary and the OEIC itself, as long as the complainant is eligible and the complaint relates to a regulated activity carried on by the authorised person at a time when that person was subject to the FOS's compulsory jurisdiction.

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[11] As noted in the introduction to this chapter, OEICs are not companies under the Companies Acts.

[12] See article 51 of the RAO.

[13] See Schedule 5 to FSMA, paragraph 1(3).

[14] *CIS* also contains rules that apply to any other director of the OEIC.

4.30 As explained above, the FSCS is available to investors where an authorised person becomes insolvent or is otherwise unable to meet all claims against it. So where a shareholder in an OEIC has a claim against the OEIC itself, its corporate director or the depositary and the relevant party cannot meet the claim, provided the shareholder is 'eligible' and the claim and the activity to which it relates are 'protected', the shareholder will have recourse to the FSCS in accordance with the scheme rules (COMP).

4.31 In terms of tax treatment, as with authorised unit trusts, OEICs are treated as companies except that they have a corporation tax rate of 20 percent. They are exempt from corporation tax on capital gains, and under certain circumstances they may make an interest distribution, instead of a dividend distribution, provided certain tests are met.

5 Is There a Regulatory Gap?

5.1 As noted in Chapter 4, investment trust companies are commonly perceived by investors to be alternative investment vehicles to unit trusts and OEICs. This is because all three offer the pooling of investments and spreading of risk, enabling greater diversification for small investors.

5.2 Chapter 2 describes the current regulatory measures that apply to investment trust companies (where a third party fund manager manages the company's assets on a day-to-day basis), and Chapter 4 describes the regulation of unit trusts and OEICs.

5.3 The present chapter compares these regulatory measures and identifies the main differences that currently exist between the regulation of investment trust companies, and authorised unit trusts and OEICs. [1]

The main differences in regulation are:

i. Investment trust companies are excluded from the definition of collective investment schemes in FSMA,[2] and they do not have to be 'authorised persons'. Nor are investment trust companies regulated as products, so the FSA has no direct power to make rules for them or intervene on their activities;

ii. As investment trust companies are not authorised persons, there is no requirement for the identification of controlled functions or that those performing them be approved by the FSA and therefore meet the minimum standards that approval requires;[3]

iii. The FOS is not available to investors for complaints against an investment trust company itself, or the company's fund manager (where there is one); and

iv. The FSCS is not available in the event of an investor having a claim against an investment trust company, which the company cannot meet.

[1] The comparison proceeds on the basis that, in the majority of cases, there will be a third party fund manager managing assets on behalf of an investment trust company. For self-managed investment trust companies the regulatory differences are, of course, greater. We address this point in the introduction to Chapter 6.

[2] The Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (**FSMA 2000 (CIS) Order 2001**) excludes bodies corporate (except for OEICs and limited liability partnerships) from the definition of collective investment schemes. See article 3 of and paragraph 21 of the Schedule to the Order).

[3] See Chapter 2, note 9. Persons who wish to perform 'controlled functions' as specified in the FSA's rules must seek the FSA's approval. 'Controlled functions' are those which enable a person to exercise significant influence over the conduct of an authorised person's affairs, or which involve dealing with customers or their property. The FSA determines which functions are controlled, and who requires approval.

i. No direct regulatory action

5.4 One concern might be that the FSA has no power over investment trust companies as authorised persons. Therefore, investment trust companies do not have to meet the FSA's threshold conditions (*COND*), and the FSA has no power to approve (or prohibit) the directors or other persons who carry out key functions on behalf of the companies.

5.5 The FSA's powers to set, monitor and enforce standards and make rules for authorised persons do not apply. Nor does it have direct rule-making power over their investment and borrowing strategies, or powers of intervention (including the power to stop trading, freeze assets, or petition for insolvency proceedings), as it does for authorised unit trusts and OEICs.[4]

5.6 That said, as well as being subject to the requirements of the Companies Acts ,the directors of investment trust companies have certain obligations under the Listing Rules, which are enforced by the FSA.

5.7 It is worth noting, in addition, that in its capacity as the UKLA the FSA has used the Listing Rules to limit the amount of cross-holdings permitted for listed investment companies (including investment trust companies) and has specifically considered the question of limiting gearing (borrowing) by investment companies.[5] Although the FSA proposed not to limit gearing, and confirmed this position following consultation, it is relevant that, acting as the UKLA, it has the power to do so if it sees fit.

5.8 However, it is at least arguable that the FSA may exercise its rule-making powers for products that are required to be authorised, or in respect of authorised persons, in a more flexible manner than it may exercise its listing powers.

5.9 In any case, given the absence of direct power for the FSA to make rules for or intervene on investment trust companies, or approve their board members, we believe it is appropriate to invite discussion around both the fact that there is no requirement that investment trust companies be authorised persons, and that there is no requirement that they be authorised as products.

5.10 As we set out in the Introduction to this paper, the authorisation of unit trusts and OEICs as products under FSMA reflected the desire to consolidate regulation of the financial industry. Authorised unit trusts and OEICs are also the subject of certain EU obligations relating to the promotion of UCITS. Investment trust companies, as closed-ended vehicles, do not fall within the ambit of UCITS and no such obligation exists in relation to them. Therefore, in considering the question of product regulation for investment trust companies, we must first establish whether there is a regulatory gap of sufficient concern to warrant further attention. Leaving aside how and why authorised unit trusts and OEICs came to be regulated as products and the effect of community law on them, is product regulation of itself justifiable in relation to investment trusts? If so, what should it aim to achieve? We seek your views on this issue below.

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[4] The investigations and enforcement action being carried out by the FSA (noted above in Chapter 3) are being carried out in relation to the financial advisers and fund managers of splits that failed, rather than into the investment trust companies themselves.

[5] See Chapter 3, notes 6 and 7, CP164 and feedback on CP164.

Questions

5.i.1. Have we accurately described the potential gap that we have identified above? If not, please comment.

5.i.2. Do you think that the absence of a requirement that investment trust companies be authorised persons is significant enough that we should consider ways to address it? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

5.i.3. Do you think that the absence of a requirement that investment trust companies be authorised as products is significant enough that we should consider ways to address it? Might anything be gained by imposing a requirement for investment trusts to be authorised as products, with a specific rule-making power and powers of intervention vested in the FSA in relation to them? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

5.11 There might also be a concern that as investment trust companies are not required to be authorised persons under FSMA, there is no requirement for the identification of controlled functions or that those performing them - board members, employees or contractors - be approved by the FSA. So directors (or others) are not subject to the Statements of Principle and Code of Practice for Approved Persons (*APER*, discussed in Chapter 2).

5.12 However, as noted in Chapter 2 (and above in section i. of the present chapter) board members do have certain duties of care to the company and are subject to the requirements of the Companies Acts and the Listing Rules.

5.13 As noted in Chapter 3, the requirements relating to the independence of directors of investment trust companies contained in the Listing Rules have also been strengthened.

5.14 Nevertheless, the FSA's approved person regime could be considered more demanding than the requirements of company law and the Listing Rules. The 'fit and proper person' test requires approved persons to meet certain minimum standards of competence, and the FSA has the power to monitor and discipline approved persons as appropriate.

Questions

5.ii.1. Have we accurately described the potential gap that we have identified above? If not, please comment.

5.ii.2. Do you think that the absence, in relation to investment trusts, of a requirement for the identification of controlled functions or that those performing them (directors or others) be approved by the FSA is significant enough that we should consider ways to address it? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

iii. The FOS

5.15 The FOS is available for complaints that relate to firms that were regulated by the FSA as authorised persons at the time of the act or omission complained about and has the power in appropriate cases to make a money award against the firm concerned. All firms or persons that carry out regulated activities must seek FSA authorisation (unless they are exempt). Investment trust companies do not carry on regulated activities, so they are not required to be authorised persons, and the FOS has no jurisdiction over them.

5.16 In effect, this means that while the FOS cannot investigate complaints against an investment trust company itself, it can investigate complaints against financial advisers, brokers, and anyone who promotes investment trust shares - as long as the complainant is 'eligible' and the complaint relates to a specified activity carried on by the authorised person (including all regulated activities and ancillary activities).

5.17 Therefore, as many shares in investment trust companies are bought through authorised persons, investors who have a complaint against that party will have recourse to the FOS. As evidenced by the FOS's ongoing work on complaints relating to splits (set out in Chapter 3), it is often the adviser or broker involved in the sale of investment trust shares against whom shareholders have a complaint.

5.18 However, the FOS is not available to investors who wish to make a complaint against the investment trust company itself. Nor is it available to investors who wish to make a complaint against the company's fund manager about its management activities, because the eligibility criteria (that the complainant is a customer or certain specified non-customer of the authorised person) are not met. As a consequence, some of the complaints relating to splits (referred to in Chapter 3) have proved to be outside the FOS's jurisdiction.[6]

5.19 By contrast, as set out in Chapter 4, the FOS is available where an investor in a unit trust wishes to make a complaint against its trustee or manager. The FOS is also available where a shareholder in an OEIC wishes to make a complaint against the authorised corporate director, depositary, or the OEIC itself - as long as he or she is an eligible complainant and the complaint relates to a regulated or ancillary activity carried on by the authorised person.

[6] This is not to say that if jurisdiction permitted the FOS to consider such complaints, it would find in favour of complainants. We are, however, concerned here with the question as to whether the FOS should be able to consider the complaints in the first place.

5.20 We set out in Chapter 4 the differences in form between investment trust companies on the one hand, and authorised unit trusts and OEICs on the other. These differences have important practical effects in considering how shareholders in investment trusts might be given a greater degree of regulatory protection, including any enhancement of their ability to recover money by making a complaint to the FOS. The differences in form can be summarised as follows:

Table 5.1: Summary of differences in legal form between investment trust companies and OEICs and unit trusts

Investment Trusts	OEICs and Unit Trusts
Investors are shareholders	Investors are shareholders or unit holders
Shares purchased through new issue or through the market	Shares in an OEIC purchased from the manager or through the market and units in a unit trust purchased from the manager
Shares sold in the market	Shares in an OEIC sold back to the manager or through the market, units in a unit trust sold back to the manager
Legal relationship between shareholders and the company	Legal relationship between shareholders/unit holders, the OEIC/unit trust and the manager
Damages/compensation paid out of shareholders' own funds	Damages/compensation paid out of assets of manager

5.21 There are two points worth noting in relation to the question of redress for shareholders in an investment trust company.

5.22 First, as with shareholders in any other kind of listed company, they have a right of action against the company and its directors in respect of false information given in the company prospectus. Providing false information in the prospectus might also give rise to a claim for compensation under section 90 of FSMA[7].

5.23 Second, although a shareholder is unlikely to have a specific right of action against the company or its directors in respect of mismanagement of the company or its assets, a company does have a right of action against its directors, former directors or fund manager for wrongful or negligent discharge of their legal duties. Although individual shareholders have no way of ensuring that the company exercises these rights, they can try through the company structure to seek the removal of directors and the appointment of new directors, who could pursue an action against their predecessors for breach of duty with a view to recovering any loss sustained by the company.

5.24 Although such legal proceedings are often complex, costly and time consuming, and it can be difficult to make out the necessary breach of duty and cause of loss, it is important to note that shareholders are not completely without a mechanism for redress when they believe they have suffered loss as a result of acts of the company, directors or fund manager.

5.25 In considering the desirability of making the FOS available to shareholders for complaints against the company or its fund manager, we must also take account of the practical implications that any such measures would have.

[7] Section 90 of FSMA provides for the payment of compensation by persons responsible for listing particulars, if the particulars are found to be false or misleading and this results in loss to investors in the securities to which the particulars apply.

5.26 With regard to complaints against the company, perhaps the most important consideration is the impact on other shareholders of an award made by the FOS in favour of an individual shareholder. If the company were required by the FOS to pay a money award out of its funds, it is other shareholders who lose out. It is for this reason that the law used to prohibit shareholders from taking legal action against the company in which they held shares, although they are permitted to do so in limited circumstances under present law.[8] For this reason (among others) we are aware of the need to proceed carefully when considering the case for making the FOS available to shareholders for complaints against the company in which they hold shares.

5.27 It is possible that in circumstances where many shareholders might have eligible complaints to the FOS against a single investment trust on similar grounds, the surrounding facts could also give rise to an actionable breach of legal duty or contractual obligation by the company against the company's directors, fund manager or other advisers. If any such legal action were pursued successfully, the company might be able to recover some or all of its losses. Any reduction in the company's assets caused by the payment of money awards made by FOS to certain shareholders might, in this way, be mitigated. This possibility would always depend on the surrounding facts, but it is relevant to our consideration, in the context of FOS, of whether shareholders should have a right of redress against the company.

5.28 It is arguable that rather than think of how to open the way to individual investors to make complaints to the FOS directly against the company, directors or fund manager, the ability to take action should be left to the company (against the other parties) through the ordinary law courts. That way any damages or compensation for losses incurred by the shareholders will be recoverable through one channel (the company, using the courts) and benefit all shareholders, rather than through multiple channels (the shareholders, through making complaints to the FOS) with individual shareholders competing for the resources available to pay compensation and to the detriment of other shareholders.

5.29 It is difficult to determine how many complaints would be made to the FOS directly against an investment trust company, or its fund manager in relation to management activities, were the FOS's jurisdictional boundaries to permit it. However, as we have noted above, as a result of the present jurisdictional boundaries of the FOS some of the complaints relating to splits (referred to in Chapter 3) proved to be outside its jurisdiction. So it seems reasonable to suppose that in certain circumstances, were the FOS jurisdictional boundaries to permit, the appropriate party against whom to make a complaint might be the investment trust company itself or its fund manager.

5.30 As stated in the Introduction to this paper, we have not yet formed a view on whether any action should be taken to address any of the potential regulatory gaps, including whether to bring complaints by shareholders against the investment trust company itself, or the fund manager, within the FOS's compulsory jurisdiction. This question in particular might be difficult to answer until such time as the possible impact of the implementation of certain EU directives relevant to this area becomes clearer.[9] For example, a person who buys shares in an investment trust company relying upon material which misstates the risk associated with the investment may have a

8 In particular, section 111A of the Companies Act 1989 states: "A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to apply or subscribe for shares or to be included in the company's register in respect of shares."

9 The Unfair Commercial Practices Directive, Prospectuses Directive and Transparency Obligations Directive are all due to be implemented over the next two years.

claim to compensation following implementation of the Unfair Commercial Practices Directive. That right would normally be enforceable against the company, rather than the directors or fund manager, unless those parties had also signed the relevant publicity material. In any case, the impact of the directives on the issues raised in this consultation will require closer analysis in due course.

5.31 In addition, with respect to whether shareholders should have rights of redress through the FOS for claims directly against the fund manager, we appreciate that creating such a direct relationship would in legal terms be exceptional. However, at this stage we wish to open up for discussion all of the questions surrounding liability and the possible means of redress for shareholders where they suffer undue loss and we seek views from all interested parties on the potential advantages, as well as the difficulties, associated with widening the means of redress to include the FOS.

5.32 We will consider these questions further in light of the responses that we receive to this consultation. We will also consider further the position of self-managed investment trust companies in this context. We welcome your views on the seriousness of the potential gap (see questions at the end of this section, below) and on possible means of addressing it, if considered necessary (see questions at the end of option a) in Chapter 6).

Questions

5.iii.1. Have we accurately described the potential gap that we have identified above? If not, please comment.

5.iii.2. Do you think that the absence of recourse to the FOS for shareholders who wish to complain against the investment trust company itself is, given the possibility of recourse to other parties involved, significant enough that we should consider ways to address it? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

5.iii.3. Do you think that the absence of recourse to the FOS for shareholders who wish to complain against the fund manager about its management activities is significant enough that we should consider ways to address it? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

iv. The FSCS

5.33 Arguably the most significant regulatory difference between authorised unit trusts and OEICs on one hand, and investment trust companies on the other, is that the FSCS does not apply where a shareholder in an investment trust company has a claim against the company that it cannot meet.

5.34 It is worth noting that if an investor holds shares in an investment trust company through a wrapper product, such as an individual savings account (ISA), and the wrapper provider cannot meet all claims against it, the FSCS would be available to the investor. This is because the wrapper provider must be an authorised person. Again, provided the claimant is 'eligible' and the claim and the activity to which it relates are 'protected' the shareholder would have recourse to the FSCS in accordance with the scheme rules.[10]

Questions

5.iv.1. Have we accurately described the potential gap that we have identified above? If not, please comment.

5.iv.2. Do you think that the absence of recourse for shareholders to the FSCS when an investment trust company cannot meet all claims against it is significant enough that we should consider ways to address it? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

General questions relating to Chapter 5

5.v.1. Are there any other aspects to the differences in the regulation of investment trust companies, compared to authorised unit trusts and OEICs, that we have not explored and that you think are significant? What are they? Please provide details.

5.v.2. Setting aside the comparison between the regulation of investment trust companies, and authorised unit trusts and OEICs, are there any other areas relating to investment trust companies that could be improved by additional regulation? Are there any other potential regulatory gaps that we should consider?

5.v.3. We welcome any other comments of a general nature that you wish to make about what additional regulation of investment trust companies might seek to achieve.

[10] See Chapter 4, note 10, *COMP*.

6 Regulatory Options

Introduction

6.1 We are aware of the need to bear in mind that differences in the regulation of investment trust companies, compared with unit trusts and OEICs, are one part of what distinguishes them from the latter two products. A feature of investment trust companies is their ability to gear (both financially and structurally) and open the way to the possibility of greater returns, in exchange for accepting greater risk.

6.2 As stated in the Committee Report, one of the key concerns about splits in particular is that certain shares were, during the relevant period, marketed and promoted to the public as low risk, when in fact their structure and ability to gear made them extremely vulnerable in a weak market, and so potentially high risk.

6.3 In considering whether any additional regulation is necessary we realise the need, in conjunction with our consideration of the potential gaps identified in Chapter 5, to also focus on the root cause of the problems experienced by investment trusts (and identified by the Committee), as well as the results of those problems i.e. substantial losses to investors without recourse to compensation through the FSCS, and sometimes without recourse to the FOS.

6.4 It can be argued that if the promotion, advertising and information disclosure requirements of investment trust companies have been corrected and are now appropriate, it is up to investors to choose whether they take on greater risk along with greater possibility of positive returns. If investors are aware that investment trust companies sit outside the FSCS and the compulsory jurisdiction of the FOS, and they are adequately educated in the structure, operation, investment and borrowing strategies and performance of investment trust companies, greater regulation might then be disproportionate to the perceived problem.

6.5 We are also aware of the need to give due consideration to the measures outlined in Chapter 3, which have already been taken in response to the problems with splits - in particular changes to the Listing Rules and COB rules.

6.6 However, there is at least an arguable case for additional regulation of investment trust companies. With regard to the potential regulatory gaps identified in Chapter 5, it might be possible to increase regulation to improve investor protection and recourse to assistance in appropriate circumstances, while not compromising their fundamental shape and ability to offer investors a wider choice on the investment market. We are mindful of the concern to preserve the features of investment trust companies that distinguish them from other products, while striking a balance with the interests of the investing public.

6.7 Below we set out a range of options that vary in the degree to which regulation would change (including no change to current regulation at all).

6.8 Depending on the outcome of this consultation, it might be that we need to consider further the position of self-managed investment trust companies, and whether any of the options that we discuss would have more severe consequences for them.

6.9 We noted in the Introduction to the paper that in practical terms, and in the interests of consistency, if we were to take any of the possible options further it is intended that additional regulatory measures would also apply to UK-based, UK-listed ordinary investment companies.

6.10 We are interested in your views on each option, their implications, how well you believe they meet the potential regulatory gaps that we have identified, and any other comments that you might have relating to them. We have sought to identify the potential difficulties associated with each. However, the issues we raise are not intended to be exhaustive and we seek input from all interested parties on whether the options would be technically workable, as well as on the merits of what each seeks to achieve. We have set out a series of questions for your consideration following each option. We would also welcome your ideas about any alternative options that are not included among those set out below.

The possible regulatory options are to:

a. Amend primary legislation (FSMA) and secondary legislation (in particular the FSMA 2000 (CIS) Order 2001) so as to put the regulation of investment trust companies on a similar basis to authorised unit trusts and OEICs. Investment trusts would be brought within the definition of collective investment schemes, and become subject to general regulation under FSMA. New provision would be made in Part 17 of the Act to regulate investment trust companies as products;

b. Amend secondary legislation (in particular the FSMA 2000 (CIS) Order 2001) so that investment trust companies would be brought within the definition of collective investment schemes, and become subject to general regulation under FSMA. However, there would be no new provision in Part 17 of the Act to regulate investment trust companies as products. Under this option, consideration could also be given to amending secondary legislation (the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (Promotion of CIS Exemptions Order 2001)) to widen the class of persons to whom investment trust companies (as unauthorised collective investment schemes) could be promoted.

c. Amend existing secondary legislation (the RAO) so that investment trust companies are deemed to be carrying on a regulated activity and therefore come within the scope of Part 4 of FSMA. Under this option we would create a new regulated activity of "establishing, operating or winding up an investment scheme based and listed in the UK, which has a stated objective of spreading risk such that no single holding exceeds 15 percent of the value of the scheme's assets".[1] Investment trust companies themselves would have to be authorised persons. They would continue not to be collective investment schemes. Nor would they be regulated as products;

d. Continue to rely on existing FSA rule making powers (e.g. the Listing Rules). This would not require any legislative change.

[1] These criteria pick up some common aspects of the qualifying criteria for investment trust status in section 842 of the Income and Corporation Taxes Act 1988, and for investment companies in section 266 of the Companies Act 1985 (see the Introduction to this paper).

Discussion

6.11 In this section we discuss the four possible regulatory options identified above.

6.12 The merits of each option will depend at least in part on the responses that we receive to questions in Chapter 5, where we seek views on the significance of each potential gap and whether each raises sufficient concern that we should look at ways to address it. We also ask for any general comments about what additional regulation might seek to achieve. Responses to Chapter 5 will help us to form our own view of the need to pursue additional regulation.

a) Amend primary and secondary legislation: regulate investment trust companies on a similar basis to authorised unit trusts and OEICs

6.13 Option a) represents the fullest form of regulation that we might consider for investment trust companies. It is intended to bring them into line with the present regulation of unit trusts and OEICs.

6.14 It could address all four of the potential gaps that we have identified in Chapter 5.

i. FSA direct regulatory action

6.15 Option a) would require an amendment to the FSMA 2000 (CIS) Order 2001 to carve out investment trust companies from the exemption afforded to bodies corporate from the definition of collective investment schemes.[2]

6.16 Accordingly, the general requirements for the operation and regulation of collective investment schemes and regulated activities under FSMA, and in relevant secondary legislation, would apply to investment trust companies.

6.17 In particular, establishing, operating and winding up an investment trust company (as the means of providing a collective investment scheme) would become a regulated activity by virtue of section 22 of FSMA and Article 51 of the RAO. Therefore the investment trust company itself, as the person responsible to shareholders for the management of the property held for or within the scheme - and thus the operator of a collective investment scheme - would have to be an authorised person.[3] The FSA's powers to set, monitor and enforce rules relating to authorised persons would, therefore, apply to investment trust companies themselves.

6.18 The option would also require an amendment to Part 17 of FSMA to provide, as with unit trusts and OEICs, for the regulation of investment trust companies as products. Investment trusts would have to seek authorisation from the FSA, and the FSA would be empowered to make rules relating to authorised investment trust companies in the same way that it may for authorised unit trusts and OEICs.

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[2] OEICs are carved out from the exemption to the definition of collective investment schemes in the same way – see section 3 of the Order and paragraph 21(1) of the Schedule.

[3] The term 'operator' includes various categories of person, and relevant here: "…any person who, under the constitution or founding arrangements of the scheme, is responsible for the management of the property held for or within the scheme." Assuming that neither the memorandum nor articles of association of the investment trust company confer on any other person the responsibility for managing the company's assets, the company itself would be the operator of the collective investment scheme.

6.19 It could also have a power similar to that contained in section 257 of FSMA (for authorised unit trusts), to give directions to investment trust companies in certain circumstances (powers of intervention).[4] As mentioned in Chapter 4 with respect to unit trusts, even where none of the specific listed circumstances exist the FSA may give a direction where it is 'desirable … in order to protect the interests of participants or potential participants in the scheme.' Directions under section 257 may require the manager of a scheme to cease the issue and/or redemption of units, or require the manager and trustee of the scheme to wind it up. Similar powers of intervention with respect to investment trust companies could be vested in the FSA. Currently, in its capacity as the UKLA, the FSA has the power under the Listing Rules to suspend listed securities (including those of an investment trust).[5]

6.20 With respect to a specific rule-making power, the FSA would have the power to set appropriate standards of protection for investors by specifying a number of features that investment trust companies must have, and how they must be operated. This could include the ability to restrict the assets in which investment trust companies may invest and the extent to which they may gear (borrow). Arguably, it could exercise this power in a more flexible manner than its power as the UKLA to limit borrowing by investment companies via the Listing Rules.

6.21 Option a) would not of itself create rules relating to the investment and borrowing strategies of investment trust companies, but would empower the FSA to do so. It would then be for the FSA to consider and consult on its use of that power.

6.22 We noted in Chapter 4 that *COLL* is a specialist sourcebook and although it does apply to all regulated collective investment schemes, it deals mainly with authorised unit trusts and OEICs and, as such, is tailored towards the particular characteristics of those products.[6] Therefore if, following consultation, we were to pursue option a) further the FSA would need to consider whether it would be more effective to amend *COLL* to accommodate investment trust companies as 'new' collective investment schemes, or to develop a new sourcebook tailored to their particular characteristics.

6.23 To inform its decision the FSA is likely to consider which parts of *COLL* would be relevant to investment trust companies. For example, if investment trust companies were authorised collective investment schemes, as closed-ended vehicles they could not be regarded as UCITS compliant.[7] Therefore the FSA would need to consider whether it should apply the rules in *COLL* for non-UCITS schemes, or the qualified investor scheme rules,[8] or whether new rules might be required. In light of the differences in the governance of authorised unit trusts and OEICs, and investment trust companies, a further consideration might be whether the governance provisions for the latter should be aligned with those for the former, having regard to any wider implications such a step would have for investment trust companies.

6.24 As a broader point the FSA would be likely to consider how any new rules would impact on the existing framework of law and regulation affecting investment trust

[4] See Chapter 4, note 5. The circumstances listed in section 257 include where one or more of the requirements for the making of an authorisation order (under section 243) are no longer met, or where the manager or trustee of an authorised unit trust scheme has contravened a requirement imposed on them.

[5] See paragraphs 1.15 and 1.19 of the Listing Rules.

[6] Given that *COLL* will replace *CIS* entirely from February 2007, we are working from the basis that if regulatory change under option a) were to be taken further, *CIS* would no longer be relevant.

[7] See the Introduction, note 5. Investment products that comply with certain UCITS requirements may be marketed throughout Europe provided they are registered with their domestic regulator.

[8] 'Qualified investors' are, in general, investors who are prepared to accept a higher degree of risk in their investments or have a higher degree of experience and expertise than investors in retail schemes.

companies, as set out in Chapter 2. It might be that some of the existing regulation, such as the Listing Rules, already covers an area that appears in *COLL*. For example, Part 4 of *COLL* deals with investor relations, and in particular the information that must be provided to investors in prospectuses and before and after the sale of shares. This overlaps in part with Listing Rules requirements, and the FSA would need to be mindful of the risk of unnecessary duplication.[9]

6.25 It would also be important to recall the intended purpose of bringing investment trust companies within the regulatory jurisdiction of the FSA – bearing in mind the issues identified in the Committee report.[10] It would then be for the FSA to consider how, through its rule-making power, these issues and the potential regulatory gaps that we have identified would be best addressed.

6.26 An overriding consideration would be to strike an appropriate balance between preserving the distinguishing characteristics of investment trust companies, and improving investor protection. Regulation under option a) creates the greatest risk, among the options that we discuss, of investment trust companies losing their distinct identity and ending up as unit trusts or OEICs by another name.

6.27 Certain *COB* rules would also apply to investment trust companies under option a). Chapter 10 of the *COB* rules applies to firms that are operators of collective investment schemes. It modifies the operation of the *COB* rules insofar as they apply to operators. In particular, references to 'customer' are to be taken as references to any scheme in respect of which the operator is acting or intends to act and with or for the benefit of which the relevant activity is to be carried on. As a result, the operators of collective investment schemes have a set of obligations directly to the scheme itself.

ii. Board members 'approved persons'

6.28 If investment trust companies were authorised persons, it would be for the FSA to consult on whether and, if so, which of the functions performed on behalf of the company in relation to the scheme should be 'controlled functions', and consequently whether the directors, other employees or contractors would have to seek the FSA's approval.

6.29 We cannot anticipate what the outcome of any such consultation would be. However, it would seem likely that at least some of the functions performed by the directors or others would appropriately be considered 'controlled functions' for the purpose of the FSA's rules. In this event, the directors of investment trust companies would have to satisfy the 'fit and proper person' test and comply with the Statements of Principle and Code of Practice for Approved Persons.

6.30 If option a) were pursued, the FSA would consider consulting on the content of its proposed new rule-making powers with respect to investment trust companies at the same time as further consultation by the Treasury on more detailed proposals for developing the option.

iii. FOS

6.31 Investment trust companies, as authorised persons, would fall within the FOS's compulsory jurisdiction. Provided the complainant was eligible and the complaint related to a regulated or ancillary activity carried on by the investment trust company at

[9] Although we have not taken a view on whether and, if so, how additional regulation should be introduced, that there is room for duplication between the existing framework and product regulation might arguably count against pursuing this option. See the questions at the end of the discussion of option a).

[10] In particular, we refer here to the Committee's finding that the combination of gearing (borrowing) and cross-holdings among many splits were the principal factors behind an increase in risk that was not appreciated by the creators of the splits, and not communicated to investors.

a time when it was subject to the FOS's compulsory jurisdiction, the Ombudsman could consider complaints directly against the company.

6.32 With respect to the availability of the FOS for complaints against the fund manager of an investment trust company about its management activities, the relationship of 'customer' or certain specified non-customer between the shareholders (complainants) and the manager is still absent. However, it may be possible under this option to expand the definition of 'non-customer' in the FSA's rules, or to amend FSMA, in order to enable the FOS to hear such complaints.

6.33 We noted in Chapter 5 (section iii.) that an investment trust company has certain rights against its directors and fund manager in relation to the proper discharge of their respective legal duties to the company. Individual shareholders have no means of ensuring that the company enforces these rights, although they might in some circumstances have a claim for compensation under section 90 of FSMA.

6.34 In the context of the FOS, it might be that if a shareholder were to make a complaint to the FOS about the company and the FOS were to find in favour of the complainant, the company in turn could issue legal proceedings against its directors, the fund manager or other adviser who it considered had been responsible. While it could not defer payment of any award ordered by the FOS to the shareholders on the basis of its legal proceedings, it might still consider the loss to be great enough and its case against the directors or others to be strong enough to warrant taking court action to recover its loss. Fund managers might in this way be held indirectly responsible for losses unduly incurred by the company shareholders.

6.35 However, we have also noted that legal proceedings as described in the scenario above are often complex, costly and time consuming, and if fund managers are one of the parties whose actions (or omissions) could ultimately lead to undue losses to shareholders, it is arguable that the route for redress between the parties should be more accessible (the FOS) and direct.

6.36 As set out in Chapter 5, we have not yet formed a view on whether any action should be taken to bring complaints by shareholders against the fund managers of investment trust companies within the FOS's compulsory jurisdiction. We will consider further whether any such action should be taken in light of the responses that we receive to this consultation. We welcome your views on the seriousness of the potential gap with respect to shareholders' access to the FOS for complaints against fund managers (see questions at the end of section iii. in Chapter 5) and any unintended consequences or alternative means of addressing it, if considered necessary (see questions at the end of option a), below).

iv. FSCS

6.37 If a shareholder in an investment trust company had a valid claim against the company itself, which the company as an authorised person could not meet, the FSCS would be available provided the claimant was 'eligible' and the claim was a 'protected claim' in accordance with the scheme rules.

Other implications

6.38 There may be an unintended consequence under option a) relating to the shares in which UCITS schemes may invest. At present, UCITS schemes may invest in shares in investment trust companies, as they are classified as transferable securities and are therefore 'eligible investments'. We understand that there are a number of UCITS schemes registered in the UK that invest solely in investment trust company shares. If investment trust companies were to become collective investment schemes, it is likely that their shares would be classified differently, and under the UCITS scheme rules as they are implemented by FSA rules, they would no longer be eligible investments. Existing UK UCITS schemes that invest solely in investment trust company shares would have to be wound up.

6.39 Another consequence worth noting is that section 150 of FSMA provides that any breach by an authorised person of a rule is actionable in the courts by a private person who suffers loss as a result of the breach.[11] To take action under section 150 a shareholder in an investment trust company would have to establish that an FSA rule had been breached, and that the breach had caused them loss. [12]

6.40 Also relevant to investment trust companies is section 90 of FSMA, which, as we have noted, provides for the payment of compensation by persons responsible for listing particulars if the particulars are found to be false or misleading and this results in loss to investors in the securities to which the particulars apply. Arguably, section 90 applies with respect to a wider group of persons than section 150. However, the scope of section 90 might be considered more restricted than section 150 in that it only applies to the content of the listing particulars (and any supplementary listing particulars), and not to any other actions relating to the listed securities.

6.41 In any case, it might be that under option a) we would consider further the need to make provision to ensure that a person could only be liable under either section 90 or section 150, and not both, in respect of the same set of facts.

Benefits

6.42 The main benefit under option a) is that through direct regulatory power vested in the FSA, investors in investment trust companies could be better protected than they are at present.

6.43 The FSA would have the power to make rules relating specifically to the operation of investment trust companies, including their investment and borrowing strategies. It would also have powers of intervention where it considered such action necessary in the interests of shareholders. At least some of the board members would have to satisfy the 'fit and proper person' test in order to be approved by the FSA.

6.44 Eligible investors would also have access to the FOS if they were to have a valid complaint against the company itself, but possibly not against the manager for its management activities without an amendment to FSA rules or FSMA. If the company were to become unable to meet all claims against it the FSCS would be available to its shareholders, subject to the appropriate eligibility criteria.

Costs

6.45 The main cost under option a) would be the new burden imposed on investment trust companies by way of regulatory fees and compliance costs. The FSA, FOS and FSCS would have the power to levy fees on investment trust companies, and these new costs could be indirectly passed on to investors through the depletion of company assets.

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[11] This statutory right is subject to the defences and other rules that apply to actions for breach of statutory duty. There is also provision in section 150 for the disapplication of the right in certain circumstances.

[12] Note that 'rule' does not include a Listing Rule or rules about the financial resources of authorised persons.

6.46 Investment trust companies would also face the cost of ensuring that they met and maintained all of the necessary standards for authorisation (as products and as persons), and complied with all applicable FSA rules.

6.47 The FSA would also set new capital requirements for investment trust companies, as authorised persons.

6.48 To the extent that bringing the fund managers of investment trust companies within the compulsory jurisdiction of the FOS would give rise to increased risk of a requirement to pay compensation to shareholders, the cost of fund managers' professional indemnity insurance would be likely to increase.

6.49 By way of general cost to the investment company industry and consumers alike, the creation of detailed rules with respect to investment trusts could possibly stifle the use of innovation in their creation and operation. Reduced innovation could in turn lead to lower returns to investors, although equally, it could lead to safer investments and less risk to investors in the long term.

6.50 In addition, if UCITS schemes could no longer invest in investment trust company shares,there would be a cost to consumers, both in the winding-up of existing UCITS schemes that invest solely in these shares and potentially also in the inability of UCITS schemes to invest in them in future.

Questions

We welcome your views on regulation under option a):

6.a.1. Have we accurately captured the full implications of regulation under option a)?

6.a.2. Would there be any unintended consequences – implications that we have not identified? Please provide details.

6.a.3. Do you agree with the benefits that we have identified?

- If so, are you in a position to help us quantify any of the benefits? Please provide details.
- If not, please provide reasons. Do you think there any other benefits that we have not covered? Please provide details.

6.a.4. Do you agree with the main categories of costs that we have identified?

- If so, and you are in a position to do so, please provide us with detail of the quantity of likely cost or estimated cost to your business.
- If not, please provide reasons. Do you think there are any other costs that we have not covered? Please provide details.

6.a.5. Aside from the question of addressing the potential regulatory gaps that we have identified in Chapter 5, do you think that regulation under option a) would be a proportionate response to the problems with splits identified in the Committee report?

6.a.6. Do you think that regulation under option a) could be achieved without sacrificing the distinguishing features of investment trust companies? Please provide reasons.

6.a.7. Can you think of any variations on option a), which would achieve the same or a similar outcome? If so, please provide details.

6.a.8. If you support option a), what are your main reasons for doing so? In particular, we seek views on what product regulation might achieve that could not otherwise be achieved through the existing regulatory framework (for example, the Listing Rules), or one of the other possible regulatory options.

6.a.9. If you do not support option a), what are your main reasons for this?

b) Amend secondary legislation: investment trust companies as unauthorised collective investment schemes

6.51 Regulation in accordance with option b) could address three of the four potential gaps that we have identified in Chapter 5. The potential gap relating to the FSA's direct regulatory power would also be partly closed, in that investment trusts would have to be authorised persons (but not authorised as products).

i. FSA direct regulatory action

6.52 As with option a), option b) would require an amendment to the FSMA 2000 (CIS) Order 2001 to carve out investment trust companies from the exemption afforded to bodies corporate from the definition of collective investment schemes.[13]

6.53 Accordingly, the general requirements for the operation and regulation of collective investment schemes and regulated activities in FSMA, and in relevant secondary legislation, would apply to investment trust companies.

6.54 Establishing, operating and winding up an investment trust company (as the means of providing a collective investment scheme) would become a regulated activity by virtue of section 22 of FSMA and Article 51 of the RAO. Therefore, the investment trust company itself, as the person responsible to shareholders for the management of the property held for or within the scheme – and thus the operator of a collective investment scheme - would have to be an authorised person. The FSA's powers to set, monitor and enforce rules relating to authorised persons (as described in Chapter 2) would, therefore, apply to investment trust companies themselves.

6.55 The FSA would continue not to regulate investment trusts as products under Part 17 of FSMA. So the FSA would not have a specific rule-making power to set standards, features or rules of operation for investment trust companies. *COLL* would not apply, although the FSA's general rule-making powers with respect to regulated activities could extend to most of the major features of the operation of investment trusts.

6.56 Although the FSA's powers of intervention would not operate exactly like those contained in section 257 (with respect to authorised unit trusts), it would still have such powers in relation to investment trust companies as authorised persons. It would also have the enforcement powers as described in Chapter 2.

6.57 Certain *COB* rules would be made to apply to investment trust companies, although they differ from those that would apply under option a). For an unauthorised collective investment scheme (such as would be the case for investment trust companies under option b)), where the operator is required by a *COB* rule to provide information to or obtain consent from a 'customer', the operator must ensure that the information is provided to or consent is obtained from a participant or potential participant in the scheme, i.e. the shareholders.

6.58 *COB* 10.4 provides a modified suitability rule for the operators of unauthorised collective investment schemes. Here an operator must ensure, when undertaking scheme management activity, that each transaction undertaken with or for the scheme, and the scheme's portfolio, are suitable for the scheme. In determining suitability, the operator should have regard to the scheme's stated investment objectives.

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[13] As noted under option a) OEICs are carved out from the exemption to the definition of collective investment schemes in the same way – see section 3 of the Order and paragraph 21(1) of the Schedule.

ii. Board members as 'approved persons'

6.59 As noted under option a), if investment trust companies were authorised persons it would be for the FSA to consult on whether and, if so, which of the functions performed on behalf of the company in relation to the scheme should be 'controlled functions', and consequently whether the directors, other employees or contractors would have to be approved by the FSA. It would seem likely that at least some of the functions performed by the directors or others would appropriately be considered 'controlled functions' for the purpose of the FSA's rules, and that the directors would have to be approved by the FSA.

6.60 As with option a), if option b) were pursued, the FSA would consider consulting on the content of its proposed new rules with respect to investment trust companies at the same time as further consultation by the Treasury on more detailed proposals for developing the option.

iii. FOS

6.61 Investment trust companies, as authorised persons, would fall within the FOS's compulsory jurisdiction. Provided the complainant was eligible and the complaint related to a regulated or ancillary activity carried on by the investment trust company at a time when it was subject to the FOS's compulsory jurisdiction, the Ombudsman could consider complaints directly against the company.

6.62 As explained under option a), we will consider further whether any action should be taken to make shareholders eligible to bring complaints to the FOS about managers of investment trust companies (for their management activity) once we have received and analysed the responses to this consultation (see the questions at the end of section iii. in Chapter 5 and at the end of section iii. under option a) in the present Chapter).

6.63 We also noted the need to take into account the impact of certain EU directives, once they have been implemented by the UK.

6.64 We set out under option a) the possibility of amendments to the FSA's rules to extend the FOS's jurisdiction. We also raised the possibility of amending FSMA. If, following consultation, we take the view that the FOS's jurisdiction should be extended, each of these possible options (as well as any alternatives that are put forward in response to our questions) will require more detailed analysis.

iv. FSCS

6.65 If a shareholder in an investment trust company had a claim against the company itself that the company, as an authorised person, could not meet, the FSCS would be available, provided the claimant was 'eligible' and the claim was a 'protected claim' in accordance with the scheme rules.

Other implications

6.66 Under option b) there would be an unintended consequence relating to the promotion of investment trust companies as unauthorised products, owing to the restrictions on promotion of collective investment schemes set out in Part 17 of FSMA.

6.67 If the rules relating to authorised persons promoting collective investment schemes, as they apply to unit trusts and OEICs[14], were also to apply to investment trust companies, an unintended consequence would be that investment trust companies would not be permitted to promote themselves as unauthorised products to the general public. Given the attraction of investment trust companies to the general public (and in particular, smaller investors) as a means of pooling money to diversify and spread risk, such restriction would be an undesirable consequence.

[14] As discussed in Chapter 4.

6.68 If we were to pursue option b) further we would need to consider in more detail any available means to address this point. It might be that we could address it by considering an amendment to the Promotion of CIS Exemptions Order, to widen the class of persons to whom investment trust companies (as unauthorised collective investment schemes) may be promoted.

6.69 There may be a further unintended consequence under option b) relating to the shares in which UCITS schemes may invest, as noted under option a). At present, UCITS schemes may invest in shares in investment trust companies, as they are classified as transferable securities and are therefore 'eligible investments'. However if investment trust companies were to become collective investment schemes it is likely that their shares would be classified differently and under FSA rules they would no longer be eligible investments for UCITS schemes. So existing UK UCITS schemes that invest solely in investment trust company shares would have to be wound up.

6.70 The same points concerning the effect of sections 90 and 150 of FSMA to which we refer under option a) (under 'Other implications') would also apply in respect of this option.

Benefits

6.71 As with option a), the main benefit under option b) is that through direct regulatory power vested in the FSA, investors in investment trust companies could be better protected than they are at present.

6.72 Although the FSA would not have the power to make rules relating specifically to the operation of investment trust companies as products, or the associated powers of intervention, it would regulate them as authorised persons and so would have available its usual powers in relation to authorised persons. It is likely that at least some of the board members would have to satisfy the 'fit and proper person' test in order to meet FSA approval.

6.73 Arguably shareholders in investment trusts, as participants in an unregulated collective investment scheme, would obtain stronger protections under COB 10 because at the very least there is a set of tailored obligations bearing on the operator, focussed on what the operator does in relation to scheme management activity.

6.74 Eligible investors would also have access to the FOS if they were to have a valid complaint against the company itself, but possibly not against the manager for its management activities without an amendment to FSA rules. If the company were to become unable to meet all claims against it, the FSCS would be available to its shareholders, subject to the appropriate eligibility criteria.

Costs

6.75 As with option a), the main cost under option b) would be the new burden imposed on investment trust companies by way of regulatory fees and compliance costs. The FSA, FOS and FSCS would have the power to levy fees on investment trust companies, and these new costs could be indirectly passed on to investors through the depletion of company assets.

6.76 Investment trust companies would also face the cost of ensuring that they met and maintained all of the necessary standards for authorisation, and complied with all applicable FSA rules. Compliance costs would be lower under option b) than a) bearing in mind that under option b) investment trust companies would not be regulated as products, removing an extra tier of rules that could be made by the FSA.

6.77 As with option a) the FSA would set new capital requirements for investment trust companies, as authorised persons.

6.78 To the extent that bringing the fund managers of investment trust companies within the compulsory jurisdiction of the FOS would give rise to increased risk of a requirement to pay compensation to shareholders, the cost of managers' professional indemnity insurance would be likely to increase.

6.79 In addition, as with option a), if UCITS schemes could no longer invest in investment trust company shares there would be a cost to consumers, both in the winding-up of existing UCITS schemes that invest solely in these shares and potentially also in the inability of UCITS schemes to invest in them in future.

Questions

We welcome your views on regulation under option b):

6.b.1. Have we accurately captured the full implications of regulation under option b)?

6.b.2. Would there be any unintended consequences – implications that we have not identified? Please provide details.

6.b.3. Do you agree with the benefits that we have identified?

- If so, are you in a position to help us quantify any of the benefits? Please provide details.
- If not, please provide reasons. Do you think there any other benefits that we have not covered? Please provide details.

6.b.4. Do you agree with the main categories of costs that we have identified?

- If so, and you are in a position to do so, please provide us with detail of the quantity of likely cost or estimated cost to your business.
- If not, please provide reasons. Do you think there are any other costs that we have not covered? Please provide details.

6.b.5. Aside from the question of addressing the potential regulatory gaps that we have identified in Chapter 5, do you think that regulation under option b) would be a proportionate response to the problems with splits identified in the Committee report?

6.b.6. Do you think that regulation under option b) could be achieved without sacrificing the distinguishing features of investment trust companies? Please provide reasons.

6.b.7. Can you think of any variations on option b), which would achieve the same or a similar outcome? If so, please provide details.

6.b.8. If you support option b), what are your main reasons for doing so?

6.b.9. If you do not support option b), what are your main reasons for this?

c) Amend secondary legislation (RAO) to create a new regulated activity: establishing, operating and winding up an investment scheme based and listed in the UK with a stated risk-spreading objective

6.80 Under option c) three of the four potential regulatory gaps that we have identified could be addressed. The potential gap relating to the FSA's direct regulatory power would also be partly addressed in that investment trusts would have to be authorised persons (but not collective investment schemes, and not authorised as products).

i. FSA direct regulatory action

6.81 As with option b), the FSA would continue not to regulate investment trust companies as products under Part 17 of FSMA. So the FSA would not have a specific rule-making power to set standards, features or rules of operation for investment trust companies. Nor would it have powers of intervention (akin to those contained in section 257) with respect to investment trusts.

6.82 Option c) differs from option b) in that under option c) investment trusts would also continue to not be collective investment schemes. So the companies themselves would not be carrying on the regulated activity of operating a collective investment scheme.

6.83 However, a new regulated activity of "establishing, operating or winding up an investment scheme based and listed in the UK, which has a stated objective of spreading risk such that no single holding exceeds 15 percent of the value of the scheme's assets" could be created.[15] Therefore, the companies themselves would have to be authorised persons under a new head.

6.84 Accordingly, the general provisions relating to regulated activities in FSMA, and in relevant secondary legislation, would apply to investment trust companies.

ii. Board members as 'approved persons'

6.85 As noted under options a) and b), if investment trust companies were authorised persons it would be for the FSA to consult on whether and, if so , which of its functions should be 'controlled functions', and consequently whether the directors, other employees or contractors would have to be approved by the FSA. It would seem likely that at least some of the functions performed by the directors or others would appropriately be considered 'controlled functions' for the purpose of the FSA's rules, and that the directors would have to be approved by the FSA.

6.86 As with options a) and b) it might be that if option c) were pursued further, the FSA could consider consulting on the issue of 'controlled functions' at the same time as further consultation by the Treasury on more detailed proposals for developing the option.

iii. FOS

6.87 Investment trust companies, as authorised persons, would fall within the FOS's compulsory jurisdiction. Provided the complainant was eligible and the complaint related to a regulated or ancillary activity carried on by the investment trust at a time when it was subject to the FOS's compulsory jurisdiction, the Ombudsman could consider complaints directly against the company.

[15] These criteria pick up some common aspects of the qualifying criteria for investment trust status in section 842 of the Income and Corporation Taxes Act 1988, and for investment companies in section 266 of the Companies Act 1985 (see the Introduction to this paper). It might also be necessary under this option to make further provision to exclude holding companies that might otherwise arguably fit the criteria, from falling within the proposed new regulated activity.

6.88 As explained under options a) and b), we will consider further whether any action should be taken to make shareholders eligible to bring complaints to the FOS about managers of investment trust companies (for their management activity) once we have received and analysed the responses to this consultation (see the questions at the end of section iii. in Chapter 5 and at the end of section iii. under option a) in the present Chapter).

iv. FSCS

6.89 As investment trust companies would be authorised persons under this option, the FSCS would be available where a shareholder in an investment trust company had a claim against the company that it could not meet, provided the claimant was 'eligible' and the claim was a 'protected claim' in accordance with the scheme rules.

Other implications

6.90 We have not identified any other significant implications under option c). However, we welcome comment on this point – see the questions at the end of this option.

Benefits

6.91 Similarly to option b), the main benefit under option c) is that investor protection could increase through the FSA's power to regulate investment trust companies as authorised persons.

6.92 Although the FSA would not have the power to make rules relating specifically to the operation of investment trust companies as products, and would not have the associated power of intervention, as the companies would be authorised persons the FSA would have available its usual powers in relation to authorised persons and it is likely that the companies' board members would have to meet the 'fit and proper person' test in order to meet FSA approval.

6.93 Eligible investors would also have access to the FOS if they were to have a valid complaint against the company itself, but again, possibly not against the manager for its management activities without an amendment to FSA rules. If the company were to become unable to meet all claims against it, the FSCS would be available to its shareholders, subject to the appropriate eligibility criteria.

Costs

6.94 As with option b), the main cost under option c) would be the new burden imposed on investment trust companies by way of regulatory fees and compliance costs. The FSA, FOS and FSCS would have the power to levy fees on investment trust companies, and these new costs could be indirectly passed on to investors through the depletion of company assets.

6.95 Investment trust companies would also face the cost of ensuring that they met and maintained all of the necessary standards for authorisation (again, as persons), and complied with all applicable FSA rules. As with option b), compliance costs under option c) might be less than a) bearing in mind that, under option c), investment trust companies would not be regulated as products - removing an extra tier of rules that could be made by the FSA.

6.96 As with options a) and b), the FSA would also set new capital requirements for investment trust companies.

6.97 To the extent that bringing the fund managers of investment trust companies within the compulsory jurisdiction of the FOS would give rise to increased risk of a requirement to pay compensation to shareholders, the cost of managers' professional indemnity insurance would be likely to increase.

Questions

We welcome your views on regulation under option c):

6.c.1. Have we accurately captured the full implications of regulation under option c)?

6.c.2. Would there be any unintended consequences – implications that we have not identified? In particular, does the wording that we propose adequately describe investment companies without also capturing entities other than investment companies within the scope of this option? Please provide details.

6.c.3. Do you agree with the benefits that we have identified?

- If so, are you in a position to help us quantify any of the benefits? Please provide details.
- If not, please provide reasons. Do you think there any other benefits that we have not covered? Please provide details.

6.c.4. Do you agree with the main categories of costs that we have identified?

- If so, and you are in a position to do so, please provide us with detail of the quantity of likely cost or estimated cost to your business.
- If not, please provide reasons. Do you think there are any other costs that we have not covered? Please provide details.

6.c.5. Aside from the question of addressing the potential regulatory gaps that we have identified in Chapter 5, do you think that regulation under option c) would be a proportionate response to the problems with splits identified in the Committee report?

6.c.6. Do you think that regulation under option c) could be achieved without sacrificing the distinguishing features of investment trust companies? Please provide reasons.

6.c.7. Can you think of any other variations on option c) which would achieve the same or a similar outcome? If so, please provide details.

6.c.8. If you support option c), what are your main reasons for doing so?

6.c.9. If you do not support option c), what are your main reasons for this?

d) Continue to rely on existing FSA rule-making powers

6.98 Under this option we would do nothing to change the status quo, which is set out in detail in Chapter 2.

6.99 The FSA, in its capacity as the UKLA, would continue to use its existing powers relating to the Listing Rules. We discussed in Chapter 5 (section i.) the fact that the FSA has used the Listing Rules to limit the amount of cross-holdings permitted for listed investment companies (including investment trust companies), and that it also has the power to limit gearing, should it consider such a move necessary.

6.100 Under the status quo, the FSA's current powers over intermediaries, general company law, and the voluntary AITC code would continue to apply.

6.101 It is important to recall (as we set out at the beginning of this chapter) that it can be argued that if the promotion, advertising and information disclosure requirements of investment trust companies have been corrected and are now appropriate, it is up to investors to choose whether they take on greater risk, along with greater possibility of positive returns. If investors are aware that investment trust companies sit outside the FSCS and the compulsory jurisdiction of the FOS, and they are adequately educated in the structure, operation, investment and borrowing strategies and performance of investment trust companies, greater regulation might then be disproportionate to the perceived problem.

6.102 We have also commented that we are aware of the need to give due consideration to the measures outlined in Chapter 3, which have already been taken in response to the problems with splits - in particular changes to the Listing Rules and COB rules.

6.103 Whether it is desirable to confer any additional powers on the FSA, or make the FSCS and FOS (for complaints against the company and fund managers) available to shareholders, will largely depend on the view that we take, following this consultation, on the significance of the potential regulatory gaps identified in Chapter 5.

Benefits

6.104 There would be no new burden imposed on investment trust companies by way of regulatory fees, capital requirements or compliance costs.

6.105 The impact of certain relevant EU directives on the financial services industry (and in particular on the operation of investment trust companies) could be properly considered before taking any further action.

Costs

6.106 The current regulatory structure around investment trust companies would remain in place, with no additional regulatory protections for shareholders.

6.107 The extent to which this would be a 'cost' depends on the view that we ultimately take on the significance of each potential regulatory gap.

Questions

6.d.1. We welcome your views on maintaining the status quo.

6.d.2. We also welcome your ideas for any alternative regulatory options that we have not identified in this paper, but that you think we should consider. Please provide as much information as possible on the implications of your suggested alternative(s), as well as their benefits and costs.

7 Summary of Questions

Chapter 5 Questions

End section i. No direct regulatory action

5.i.1. Have we accurately described the potential gap that we have identified [above]? If not, please comment.

5.i.2. Do you think that the absence of a requirement that investment trust companies be authorised persons is significant enough that we should consider ways to address it? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

5.i.3. Do you think that the absence of a requirement that investment trust companies be authorised as products is significant enough that we should consider ways to address it? Might anything be gained by imposing a requirement for investment trusts to be authorised as products, with a specific rule-making power and powers of intervention vested in the FSA in relation to them? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

End section ii. Board members do not have to be approved by the FSA

5.ii.1. Have we accurately described the potential gap that we have identified [above]? If not, please comment.

5.ii.2. Do you think that the absence, in relation to investment trusts, of a requirement for the identification of controlled functions or that those performing them (directors or others) be approved by the FSA is significant enough that we should consider ways to address it? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

End section iii. The FOS

5.iii.1. Have we accurately described the potential gap that we have identified [above]? If not, please comment.

5.iii.2. Do you think that the absence of recourse to the FOS for shareholders who wish to complain against the investment trust company itself is, given the possibility of recourse to other parties involved, significant enough that we should consider ways to address it? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

5.iii.3. Do you think that the absence of recourse to the FOS for shareholders who wish to complain against the fund manager about its management activities is significant enough that we should consider ways to address it? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

End section iv. The FSCS

5.iv.1. Have we accurately described the potential gap that we have identified [above]? If not, please comment.

5.iv.2. Do you think that the absence of recourse for shareholders to the FSCS when an investment trust company cannot meet all claims against it is significant enough that we should consider ways to address it? Please provide reasons for your response, including as much information as possible about the advantages and disadvantages that you believe would follow.

End of Chapter 5 – General Questions

5.v.1. Are there any other aspects to the differences in the regulation of investment trust companies, compared to authorised unit trusts and OEICs, that we have not explored and that you think are significant? What are they? Please provide details.

5.v.2. Setting aside the comparison between the regulation of investment trust companies, and authorised unit trusts and OEICs, are there any other areas relating to investment trust companies that could be improved by additional regulation? Are there any other potential regulatory gaps that we should consider?

5.v.3. We welcome any other comments of a general nature that you wish to make about what additional regulation of investment trust companies might seek to achieve.

Chapter 6 Questions

End option a) Amend primary and secondary legislation: regulate investment trust companies on a similar basis to authorised unit trusts and OEICs

6.a.1. Have we accurately captured the full implications of regulation under option a)?

6.a.2. Would there be any unintended consequences – implications that we have not identified? Please provide details.

6.a.3. Do you agree with the benefits that we have identified?

- If so, are you in a position to help us quantify any of the benefits? Please provide details.
- If not, please provide reasons. Do you think there any other benefits that we have not covered? Please provide details.

6.a.4. Do you agree with the main categories of costs that we have identified?

- If so, and you are in a position to do so, please provide us with detail of the quantity of likely cost or estimated cost to your business.
- If not, please provide reasons. Do you think there are any other costs that we have not covered? Please provide details.

6.a.5. Aside from the question of addressing the potential regulatory gaps that we have identified in Chapter 5, do you think that regulation under option a) would be a proportionate response to the problems with splits identified in the Committee report?

6.a.6. Do you think that regulation under option a) could be achieved without sacrificing the distinguishing features of investment trust companies? Please provide reasons.

6.a.7. Can you think of any variations on option a), which would achieve the same or a similar outcome? If so, please provide details.

6.a.8. If you support option a), what are your main reasons for doing so? In particular, we seek views on what product regulation might achieve that could not otherwise be achieved through the existing regulatory framework (for example, the Listing Rules), or one of the other possible regulatory options.

6.a.9. If you do not support option a), what are your main reasons for this?

End option b) Amend secondary legislation: investment trust companies as unauthorised collective investment schemes

6.b.1. Have we accurately captured the full implications of regulation under option b)?

6.b.2. Would there be any unintended consequences – implications that we have not identified? Please provide details.

6.b.3. Do you agree with the benefits that we have identified?

- If so, are you in a position to help us quantify any of the benefits? Please provide details.
- If not, please provide reasons. Do you think there any other benefits that we have not covered? Please provide details.

6.b.4. Do you agree with the main categories of costs that we have identified?

- If so, and you are in a position to do so, please provide us with detail of the quantity of likely cost or estimated cost to your business.
- If not, please provide reasons. Do you think there are any other costs that we have not covered? Please provide details.

6.b.5. Aside from the question of addressing the potential regulatory gaps that we have identified in Chapter 5, do you think that regulation under option b) would be a proportionate response to the problems with splits identified in the Committee report?

6.b.6. Do you think that regulation under option b) could be achieved without sacrificing the distinguishing features of investment trust companies? Please provide reasons.

6.b.7. Can you think of any variations on option b), which would achieve the same or a similar outcome? If so, please provide details.

6.b.8. If you support option b), what are your main reasons for doing so?

6.b.9. If you do not support option b), what are your main reasons for this?

End option c) Amend secondary legislation (RAO) to create a new regulated activity: establishing, operating and winding up an investment scheme based and listed in the UK with a stated risk-spreading objective

6.c.1. Have we accurately captured the full implications of regulation under option c)?

6.c.2. Would there be any unintended consequences – implications that we have not identified? In particular, does the wording that we propose adequately describe investment companies without also capturing entities other than investment companies within the scope of this option? Please provide details.

6.c.3. Do you agree with the benefits that we have identified?

- If so, are you in a position to help us quantify any of the benefits? Please provide details.
- If not, please provide reasons. Do you think there any other benefits that we have not covered? Please provide details.

6.c.4. Do you agree with the main categories of costs that we have identified?

- If so, and you are in a position to do so, please provide us with detail of the quantity of likely cost or estimated cost to your business.
- If not, please provide reasons. Do you think there are any other costs that we have not covered? Please provide details.

6.c.5. Aside from the question of addressing the potential regulatory gaps that we have identified in Chapter 5, do you think that regulation under option c) would be a proportionate response to the problems with splits identified in the Committee report?

6.c.6. Do you think that regulation under option c) could be achieved without sacrificing the distinguishing features of investment trust companies? Please provide reasons.

6.c.7. Can you think of any other variations on option c) which would achieve the same or a similar outcome? If so, please provide details.

6.c.8. If you support option c), what are your main reasons for doing so?

6.c.9. If you do not support option c), what are your main reasons for this?

End option d) Continue to rely on existing FSA rule-making powers

6.d.1. We welcome your views on maintaining the status quo.

6.d.2. We also welcome your ideas for any alternative regulatory options that we have not identified in this paper, but that you think we should consider. Please provide as much information as possible on the implications of your suggested alternative(s), as well as their benefits and costs.

8 NEXT STEPS

8.1 We have requested that all responses to this consultation be made by **Friday 25 February 2005.**

8.2 We intend to publish our feedback on the consultation in late Spring 2005.

8.3 If, as a result of this consultation, we take the view that there is a case for additional regulation of investment trust companies, we will prepare a more detailed set of proposals with a view to further consultation.

8.4 It is intended that this second phase consultation, if required, would take place in Autumn 2005.

A INITIAL REGULATORY IMPACT ASSESSMENT

THE REGULATION OF INVESTMENT TRUST COMPANIES INITIAL REGULATORY IMPACT ASSESSMENT

PURPOSE

Objective

A.1 The purpose of this consultation is to consider whether, and if so how, additional regulation for investment trust companies should be introduced to remove or minimise the potential regulatory gaps that we have identified or otherwise improve investor protection.[1]

BACKGROUND

The problem

A.2 As set out in the Introduction to the consultation paper, the failure of more than thirty split capital investment trusts (splits) in 2001/2002 caused heavy losses to investors, estimated at totaling £667m (out of £785m invested).

A.3 The resulting public concern led the Treasury Committee of the House of Commons to conduct an inquiry into the events that had led up to the problems at splits.

A.4 In its report to the House of Commons[2] the Treasury Committee concluded that many splits launched in the late 1990s were structured in such a way that, in adverse market conditions, a particular type of share, zero dividend preference shares (zeros), were, despite the advertising and marketing to the contrary, not a relatively low risk investment. It found that the high gearing (borrowing) of many splits and the substantial cross-holdings among them were the principal factors behind the increase in risk. As these increases in risk were not adequately brought to the attention of investors, the Committee said it believed many shares in splits were mis-sold and some investors might have a claim to compensation. Firms, the Financial Ombudsman Service (FOS) and the Financial Services Authority (FSA) were directed to examine the circumstances of each case.

A.5 The Committee made a number of recommendations to the FSA and the industry as a result of its inquiry. It also made one recommendation to the Treasury: that investment trust companies should be brought directly within the scope of investment product regulation by the FSA. In response to this recommendation the Government undertook to consider and consult on whether to introduce additional regulation and possible options for doing so.

[1] See Chapter 5 of the consultation paper.

[2] Treasury Committee Third Report of Session 2002-03: Split Capital Investment Trusts (published 13 February 2003) (**Committee Report**).

The current regulatory framework

A.6 The current regulatory framework around investment trust companies is set out in more detail in Chapter 2 of the consultation paper. Investment trust companies are not collective investment schemes for the purpose of the Financial Services and Markets Act 2000 (FSMA). They do not carry on regulated activities and, therefore, they are not required to be authorised persons. Nor are investment trust companies regulated as products, as is the case with authorised unit trusts and open-ended investment companies (OEICs).[3] They are not subject to direct regulation by the FSA.

A.7 However, there are a number of areas where the FSA has some regulatory jurisdiction over investment trust companies and transactions in the shares of these vehicles:

- The FSA is, as the UK Listing Authority **(UKLA)**, the competent body responsible for setting and ensuring compliance with the Listing Rules, which include rules specifically directed at investment entities. It also reviews and comments on draft prospectuses.
- The assets of most (but not all) investment trust companies are managed by fund managers who also provide trusts with most of their administrative functions. Investment fund managers must be authorised persons under FSMA, so they are subject to FSA regulation.
- Most (but not all) dealings in shares in investment trust companies are made through authorised persons (such as investment fund managers, stockbrokers or financial advisers), and involve regulated activities, so are subject to the FSA's conduct of business rules contained in its Conduct of Business sourcebook **(COB).**

A.8 Investment trust companies are also subject to general company law.

A.9 The Association of Investment Trust Companies **(AITC)**, a trade body for investment trust companies, has produced a voluntary Code of Corporate Governance to supplement the Combined Code of Corporate Governance annexed to the Listing Rules (discussed below). It also issues periodically advice, guidance and statements of recommended practice in a range of areas.

A.10 Investment trust companies must also seek approval from the Inland Revenue.

Differences in the regulation of investment trust companies, and authorised unit trusts and OEICs

A.11 Investment trust companies are commonly perceived by investors to be alternative investment vehicles to unit trusts and OEICs. This is because all three offer the pooling of investments and spreading of risk, enabling greater diversification for smaller investors.

A.12 Chapter 2 of the consultation paper sets out the current regulatory measures that apply to investment trust companies, and Chapter 4 sets out the regulation of unit trusts and OEICs.

[3] FSMA sets out a regulatory regime that primarily targets people and firms that provide financial services and the activities that they undertake, rather than products. Unit trusts and OEICs are an exception to this overriding regulatory approach, and were included in FSMA in order to consolidate existing regulation of the financial industry.

A.13 These regulatory measures are compared in Chapter 5, which identifies and discusses in more detail the main differences that currently exist between the regulation of investment trust companies, and authorised unit trusts and OEICs.

A.14 The main differences in regulation are:

i. Investment trust companies are excluded from the definition of collective investment schemes under FSMA,[4] and they do not have to be 'authorised persons'. Nor are investment trust companies regulated as products, so the FSA has no direct power to make rules for them or intervene on their activities;

ii. As investment trust companies are not authorised persons, there is no requirement for the identification of controlled functions or that those performing them be approved by the FSA and therefore meet the minimum standards that approval requires;[5]

iii. The FOS is not available to investors for complaints against an investment trust company itself, or the company's fund manager (where there is one); and

iv. The FSCS is not available in the event of an investor having a claim against an investment trust company, which the company cannot meet.

A.15 It should be noted that while this consultation uses the regulatory differences described above as a starting point for its consideration of whether additional regulation for investment trust companies should be introduced, we also seek views in the consultation paper on whether there are any other areas of concern around the regulation of these entities which we should take into account when reaching a view as to whether there is any need to take additional regulation further.

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[4] The Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 **(FSMA 2000 (CIS) Order 2001)** excludes bodies corporate (except for OEICs and limited liability partnerships) from the definition of collective investment schemes.

[5] Persons who wish to perform 'controlled functions' as specified in the FSA's rules must seek the FSA's approval. 'Controlled functions' are those which enable a person to exercise significant influence over the conduct of an authorised person's affairs, or which involve dealing with customers or their property. The FSA determines which functions are controlled, and who requires approval.

Risk Assessment

The probability of harm: why regulate?

A.16 The Committee report focussed on one particular group within a certain sub-sector of the investment trust industry: splits. The harm caused to investors in splits was financial – many small investors in splits, and in particular in zeros, lost heavily. The loss was not caused by the ordinary ebb and flow of the financial markets, but by an increase in risk beyond that which the designers and marketers of shares in splits appreciated.[6] The principal factors behind the increase in risk were identified by the Committee to be the high gearing (borrowing) of many splits, and the substantial cross-holdings among them. The combination of gearing and cross-holdings magnified the effect of a downturn in the market, virtually wiping out the value of many investments.

A.17 The probability of the same harm occurring again is relatively low. This is because various steps have been taken to address the particular problems highlighted by the Committee. For example, the Listing Rules have been amended to limit the amount of cross-holdings permitted for listed companies, and to improve risk-warnings to investors. Director independence has also been strengthened, as has the accountability of directors for the use of a particular fund manager. The actions taken by the FOS and the FSA in response to the particular problems identified by the Committee are discussed in more detail in Chapter 3 of the consultation paper.

A.18 However, as set out in the Background section of this paper, the Committee also recommended to the Treasury that it should bring investment trust companies directly within the scope of investment product regulation by the FSA and, in response, the Government undertook to consider and consult on whether to introduce additional regulation, and possible options for doing so. To that end, we have identified four differences in the regulation of investment trust companies, compared to authorised unit trusts and OEICs, as a starting point for considering whether to take any of the options for additional regulation further.

A.19 We are not in a position to quantify the potential harm that might arise if these regulatory differences were not addressed. We cannot know, for example, how many eligible complainants there might be with complaints against investment trust companies, if the FOS's jurisdiction were to extend to these entities. It is even more difficult to estimate whether any harm might occur if the FSA were to remain unable to make rules specifically relating to investment trusts, either as authorised products or as authorised persons.

A.20 But it should be noted that, as well as averting a potential harm, a possible point in favour of addressing the regulatory differences around investment trust companies could be to align the investor protections that support them more closely with those that are in place for other pooled investment vehicles: unit trusts and OEICs.

A.21 In summary, the consultation on possible regulatory options for investment trust companies is not concerned solely with preventing a potential harm, but also with seeking views on whether the differences in the regulation of authorised unit trusts and OEICs, and investment trust companies, are justified.

[6] Loss such as this, which cannot be attributed to ordinary market behaviour, might also be considered to cause reduced public confidence in the industry and, as a consequence, diminished earnings.

Options

A.22 We have not taken a view on whether additional regulation should be introduced for investment trust companies - part of the aim of this consultation is to hear views on whether the potential regulatory gaps that we have identified, or any other regulatory issues that respondents might wish to raise, are significant enough to warrant further action. Each of the possible options that we discuss below should be read in this context. The potential merits of each will, at least in part, depend on the view that we ultimately take about the level of concern (if any) that each potential gap (or other regulatory issue presented by respondents) raises.

a) Amend primary and secondary legislation: regulate investment trust companies on a similar basis to authorised unit trusts and OEICs

A.23 Under option a) we would amend primary legislation (FSMA) and secondary legislation (in particular the FSMA 2000 (CIS) Order 2001) so as to put the regulation of investment trust companies on a similar basis to authorised unit trusts and OEICs. Investment trusts would come within the definition of collective investment schemes, and become subject to general regulation under FSMA. New provision would be made in Part 17 to regulate investment trust companies as products.

A.24 All four of the potential regulatory gaps that we have identified would be addressed.

A.25 The main risk associated with this option is that it would be disproportionate to any harm that might otherwise come to shareholders in investment trust companies, if lesser or no additional regulation were introduced. The new costs that option a) would impose on investment trust companies (discussed in the next section) would therefore be unnecessary.

A.26 The difficulty with ascertaining the likelihood of this risk occurring is that, as noted at the start of the present section, we are not in a position to quantify the potential harm that might otherwise arise if the regulatory differences between investment trusts, compared to authorised unit trusts and OEICs, were not addressed.

A.27 Once we have analysed the responses to this consultation, in particular the responses to Chapter 5 of the consultation paper where we seek views on the significance of the potential regulatory gaps, we will be in a better position to assess the likelihood that option a) would be disproportionate to any concern raised by the regulatory differences.

b) Amend secondary legislation: investment trust companies as unauthorised collective investment schemes

A.28 Under option b) we would amend secondary legislation (in particular the FSMA 2000 (CIS) Order 2001) so that investment trust companies would come within the definition of collective investment schemes, and become subject to general regulation under FSMA. However, there would be no new provision in Part 17 of the Act to regulate investment trust companies as products. Under this option, consideration could also be given to amending secondary legislation (the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (**Promotion of CIS Exemptions Order 2001**)) to widen the class of persons to whom investment trust companies (as unauthorised collective investment schemes) could be promoted.

A.29 Three of the four potential regulatory gaps that we have identified would be addressed. The potential gap relating to the FSA's direct regulatory power would also be partly closed, in that investment trusts would have to be authorised persons (but not authorised as products).

A.30 As with option a) the main risk associated with this option is that it would be disproportionate to any harm that might otherwise come to shareholders in investment trust companies, if lesser or no additional regulation were introduced. The new costs that option b) would impose on investment trust companies (also discussed in the next section) would therefore be unnecessary.

A.31 Again, the difficulty with ascertaining the likelihood of this risk occurring is that we are not in a position to quantify the potential harm that might otherwise arise if the regulatory differences between investment trusts, compared to unit trusts and OEICs, were not addressed.

A.32 Once we have analysed the responses to this consultation, we will be in a better position to assess the likelihood that option b) would be disproportionate to the concern raised by the regulatory differences.

c) Amend existing secondary legislation (the RAO) so that investment trust companies would be considered as carrying on a regulated activity (establishing, operating or winding up an investment scheme based and listed in the UK, with risk spreading objective)

A.33 Under option c) we would amend existing secondary legislation (the RAO) so that investment trust companies would be carrying on a regulated activity, and, therefore, come within the scope of Part 4 of FSMA. A new regulated activity of "establishing, operating or winding up an investment scheme based and listed in the UK, which has a stated objective of spreading risk such that no single holding exceeds 15 percent of the value of the scheme's assets" could be created. Investment trust companies themselves would be considered as carrying on the activity, and would have to be authorised persons under a new head.

A.34 Investment trust companies would continue not to be collective investment schemes. Nor would they be regulated as products.

A.35 Three of the four potential regulatory gaps that we have identified would be addressed. Similarly to option b), the potential gap relating to the FSA's direct regulatory power would also be partly addressed in that investment trusts would have to be authorised persons (but not collective investment schemes, and not authorised as products).

A.36 As with options a) and b) the main risk associated with option c) is that it would be disproportionate to any harm that might otherwise come to shareholders in investment trust companies, if no additional regulation were introduced. The new costs that option c) would impose on investment trust companies (also discussed in the next section) would, therefore, be unnecessary.

A.37 The same difficulty with regard to the quantification of potential harm that arises under options a) and b) also applies here. We will be in a better position to assess the likelihood that option c) would be disproportionate to the concern raised by the regulatory differences following this consultation.

d) Continue to rely on existing FSA rule-making powers

A.38 Under this option we would do nothing to change the status quo, which is set out in detail in Chapter 2 of the consultation paper.

A.39 The FSA, in its capacity as the UKLA, would continue to use its existing powers relating to the Listing Rules. The FSA has used the Listing Rules to limit the amount of cross-holdings permitted for listed investment companies (including investment trust companies), and it also has the power to limit gearing should it consider such a move necessary.

A.40 Under the status quo, the FSA's current powers over intermediaries, general company law, and the voluntary AITC code would continue to apply.

A.41 None of the four potential regulatory gaps that we have identified would be addressed.

A.42 The main risk under option d) is that some harm would come to shareholders in investment trust companies that would not, or would be less likely to otherwise occur, if we were to introduce additional regulation under one of options a) to c).

A.43 Again, the difficulty with ascertaining the likelihood of this risk occurring is that we are not in a position to quantify the potential harm that might otherwise arise if the regulatory differences between investment trusts, compared to unit trusts and OEICs, were not addressed.

A.44 We will be in a better position to assess the likelihood that option d) would expose shareholders in investment trust companies to harm which might otherwise be avoided by introducing additional regulation, once we have received and analysed responses to this consultation.

A.45 It is worth noting that even if, following consultation, we were to consider one or more of the regulatory differences between investment trusts, and authorised unit trusts and OEICs, to be significant, it might be that the risk of harm to shareholders could be mitigated by the FSA through the use of its existing rule-making powers (such as its power to draft and amend the Listing Rules).

COSTS AND BENEFITS

Business sectors affected

A.46 The business sector that would be most affected by the regulatory options discussed in the consultation paper is the investment trust company industry.

A.47 There are currently around 350 investment trust companies in the UK with a total market capitalisation of around £44bn.[7] Conventional trusts comprise 75 percent of the industry (89 percent of total market capitalisation), and splits comprise the remaining 25 percent of the industry (and the remaining 11 percent of market capitalisation).

Assumptions

A.48 As stated in the consultation paper and at the start of the section above, we have not taken a view on whether additional regulation should be introduced for investment trust companies. Therefore, we have made no assumption that additional regulation is necessary in the interests of enhanced investor protection.

General note on costs and benefits

A.49 Part of the aim of this consultation is to hear views on whether the potential regulatory gaps that we have identified - or any other regulatory issues that might be raised by respondents - are of sufficient significance that we should consider further action. The discussion of costs and benefits under each option should be read in this context. The benefits that we refer to, and quantifying them, will ultimately depend on the view that we take of the level of concern (if any) that each potential regulatory gap (or other regulatory issue) raises.

A.50 With regard to the costs, although we are not at this stage in a position to quantify these, we can identify the main types of new cost that would arise under each option.

A.51 Some of the costs, such as regulatory fees, would have to be determined by the FSA following separate consultation and analysis of the investment company industry. The FSA would not undertake such an exercise until further down the track, if we were to take the view that additional regulation is required. With regard to compliance costs, we have included questions about this in the consultation paper. We intend to take any information provided on the possible quantification of costs under each option into account when forming our own view on whether or not to pursue additional regulation further.

A.52 It should also be noted that the FSA is required under FSMA to provide a cost benefit analysis for any rules or guidance that it proposes. Therefore if, following this consultation, one of options a) to c) (or a variation of one of these options) were pursued such that the FSA were empowered to make rules and issue guidance with respect to investment trust companies, it would prepare its own cost benefit analysis in relation to any proposed rules, as required. As with the consultation and analysis that would be required for setting regulatory fees, any such cost benefit analysis would be carried out by the FSA at a later stage in the development of additional regulation, if that were pursued.

[7] Statistics published on the AITC website, as at 30 September 2004.

BENEFITS

a) Amend primary and secondary legislation: regulate investment trust companies on a similar basis to authorised unit trusts and OEICs

A.53 Under option a) all four of the potential regulatory gaps that we have identified would be addressed.

A.54 A more detailed analysis of how this would occur appears at pages 39 - 42 of the consultation paper.

A.55 In summary, investment trust companies would be regulated as products. They also would be required to be authorised persons. As such, the FSA's rule-making powers, with respect to authorised products and authorised persons, would apply to investment trust companies.

A.56 The main benefit under option a) is that through direct regulatory power vested in the FSA, investors in investment trust companies could be better protected than they are at present.

A.57 The FSA would have the power to make rules relating specifically to the operation of investment trust companies, including their investment and borrowing strategies. It would also have powers of intervention where it considered such action necessary in the interests of shareholders. At least some of the board members would have to satisfy the 'fit and proper person' test in order to be approved by the FSA.

A.58 Eligible investors would also have access to the FOS if they were to have a valid complaint against the company itself, but possibly not against the manager for its management activities without an amendment to FSA rules or FSMA. If the company were to become unable to meet all claims against it, the FSCS would be available to its shareholders, subject to the appropriate eligibility criteria.

b) Amend secondary legislation: investment trust companies as unauthorised collective investment schemes

A.59 Under option b) three of the four potential regulatory gaps that we have identified would be addressed. Part of the first potential gap discussed would also be addressed (see 'Options' section of this paper).

A.60 A more detailed analysis of how this would occur appears at pages 46 - 47 of the consultation paper.

A.61 In summary, although investment trust companies would not be regulated as products, they would be collective investment schemes under FSMA. They would be required to be authorised persons. The FSA would have no specific rule-making power for investment trust companies as products, but its rule-making powers with respect to authorised persons would apply.

A.62 As with option a), the main benefit under option b) is that through direct regulatory power vested in the FSA, investors in investment trust companies could be better protected than they are at present.

A.63 Although the FSA would not have the power to make rules relating specifically to the operation of investment trust companies as products, or the associated powers of intervention, it would regulate them as authorised persons and so would have available its usual powers in relation to authorised persons. It is likely that at least some of the board members would have to satisfy the 'fit and proper person' test in order to meet FSA approval.

A.64 Arguably, shareholders in investment trusts, as participants in an unregulated collective investment scheme, would obtain stronger protections through the application of the appropriate COB rules because, at the very least, there would be a set of tailored obligations bearing on the operator and focussed on what the operator does in relation to scheme management activity.

A.65 Eligible investors would also have access to the FOS if they were to have a valid complaint against the company itself, but possibly not against the manager for its management activities without an amendment to FSA rules. If the company were to become unable to meet all claims against it, the FSCS would be available to its shareholders, subject to the appropriate eligibility criteria.

c) Amend existing secondary legislation (the RAO) so that investment trust companies would be considered as carrying on a regulated activity (establishing, operating or winding up an investment scheme based and listed in the UK, with risk spreading objective)

A.66 Under option c) three of the four potential regulatory gaps that we have identified would be addressed. Part of the first potential gap discussed would also be addressed (again, see 'Options' section of this paper).

A.67 A more detailed analysis of how this would occur appears at pages 50 - 51 of the consultation paper.

A.68 In summary, although investment trust companies would not be collective investment schemes and they would not be regulated as products under FSMA, they would be considered as carrying on a regulated activity and, as such, they would be required to be authorised persons. The FSA would have no specific rule-making power for investment trust companies as products, but its rule-making powers with respect to authorised persons would apply.

A.69 Similarly to option b), the main benefit under option c) is that investor protection could increase through the FSA's power to regulate investment trust companies as authorised persons.

A.70 Although the FSA would not have the power to make rules relating specifically to the operation of investment trust companies as products, and would not have the associated power of intervention, as the companies would be authorised persons the FSA would have available its usual powers in relation to authorised persons and it is likely that the companies' board members would have to meet the 'fit and proper person' test in order to meet FSA approval.

A.71 Eligible investors would also have access to the FOS if they were to have a valid complaint against the company itself, but again, possibly not against the manager for its management activities without an amendment to FSA rules. If the company were to become unable to meet all claims against it, the FSCS would be available to its shareholders, subject to the appropriate eligibility criteria.

d) Continue to rely on existing FSA rule-making powers

A.72 Under this option we would do nothing to change the status quo, which is set out in detail in Chapter 2 of the consultation paper.

A.73 There would be no new burden imposed on investment trust companies by way of regulatory fees, capital requirements or compliance costs.

A.74 The impact of certain relevant EU directives on the financial services industry (and in particular on the operation of investment trust companies) could be properly considered before taking any further action.

COSTS

Types of cost – to the industry and consumers

A.75 Potential costs to the investment trust company industry and consumers alike could be the possibility of less innovation in the creation and operation of these entities, depending on the level of detail of any new regulation. Reduced innovation could, in turn, lead to lower returns to investors - although equally, it could lead to safer investments and less risk of losses to investors in the long term.

A.76 The additional costs that individual investment trust companies face (discussed below) could also be passed on, at least in part, to consumers. Therefore the industry as a whole, as well as consumers, could arguably share the additional regulatory costs.

A.77 To the extent that bringing the fund managers of investment trust companies within the compulsory jurisdiction of the FOS would give rise to increased risk of a requirement to pay compensation to shareholders, the cost of managers' professional indemnity insurance would be likely to increase. There is a possibility that this increased cost could also be passed on, at least in part, to consumers.

Types of cost – to individual investment trust companies

A.78 There are two main types of cost that individual investment trust companies would incur if they were regulated under one of options a) to c): regulatory fees and compliance costs.

A.79 Regulatory fees would relate to the running of the FSA, the FOS and the FSCS. A further potential cost relating to the FOS, in addition to its fees, is the payment by firms of money awards where the FOS finds a case against them.

A.80 Compliance costs would be the costs incurred by investment trust companies in ensuring that they met and maintained all of the necessary standards for authorisation (as products and/or as persons, including the standards required of approved persons where applicable), and complied with all applicable FSA rules. The FSA would also impose new capital requirements on investment trust companies if they were authorised persons.

A.81 We consider which fees and compliance costs would apply under each option below, under 'Cost implications for each option'.

A.82 First, by way of background, we set out how the FSA, FOS and FSCS presently levy (and in respect of the FSA and FOS, fine or make money awards against) firms that are already regulated under FSMA.[8]

The FSA

A.83 The FSA is funded through fees charged to the financial services industry, which are generally set according to a structure of "fee blocks". Each fee block applies to a different sector, with the aim that each sector pays for the costs it creates for the regulator.[9]

A.84 The fees fall into two main categories: application fees and periodic fees.

A.85 Application fees contribute to the cost of processing applications from new firms seeking authorisation. They are payable by firms seeking to be authorised persons, as well as with respect to authorised products. Existing authorised persons (firms) are also charged when they seek significant variations to their permissions.

A.86 There are three main types of application fee: straightforward; moderately complex; and complex. Complexity is determined by reference to the activities for which permission is sought.[10]

A.87 Periodic fees are payable annually and provide most of the FSA's funding to undertake its statutory objectives. Three main factors determine the calculation of periodic fees for authorised persons: the fee block to which a firm belongs; the costs of regulating those activities; and the scale and size of the particular firm's activities. Periodic fees are also payable with respect to product authorisation.

A.88 Special project fees are also charged for regulatory work performed primarily for the benefit of a single firm or group of firms.

The FOS

A.89 The FOS is funded by a general levy on all firms that are subject to its jurisdiction (which currently covers about 30 percent of its costs) and a case fee charged on a 'pay as you go' basis (which currently covers about 70 percent of its costs).

A.90 The FSA sets the general levy each financial year, following consultation. All firms are allocated to a fee group called an 'industry block'. The total amount to be raised by the general levy is apportioned to each industry block in proportion to the number of complaints that are expected to be generated by that block. The sum allocated to each industry block is then divided among the firms in that block, by reference to a 'tariff base'. A tariff base is a measure of the scale of 'relevant business'[11] conducted by each firm within the block. There is a minimum general levy within each industry block, and no maximum.

[8] The FSA , FOS and FSCS levy rules are set out in **the FSA Handbook.**

[9] The sectors, or 'fee blocks', are determined by reference to the category of business for which a firm seeks to be authorised. The regulated activities that a firm wishes to undertake will determine its category of business.

[10] At present the FSA's application fees are as follows: straightforward £1,500; moderately complex £5,000; and complex £25,000.

[11] 'Relevant business' is business done with private individuals.

A.91 The FOS, following consultation, sets the case fees that apply each financial year. Firms are only required to pay the case fee for the third and any subsequent complaint against them in any financial year. There are two types of case fee: standard and special.

A.92 Standard case fees are payable by most firms in respect of each chargeable case against them.[12] The special case fee is payable by firms that for any reason are not required to pay the general levy. For example, when a new group becomes regulated by the FSA and subject to the FOS (such as mortgage and insurance intermediaries in October 2004 and January 2005 respectively), they may not have to pay a general levy for a given financial year and so the special case fee will apply.[13]

A.93 Where the FOS finds in favour of a complainant, it may make a money award against the firm concerned. The money award will be set at an amount that the FOS considers fair in the circumstances of the case. In addition, or alternatively, the FOS may make a money award for the pain and suffering, damage to reputation, distress or inconvenience experienced by the complainant. The maximum money award that the FOS may make is £100,000.[14]

The FSCS

A.94 The FSCS is funded by levies on participating firms authorised under FSMA. For levying purposes, the FSCS comprises three 'sub-schemes'[15] in which there are one or more 'contribution groups'.[16]

The present sub-schemes are:

- Accepting deposits;
- Insurance business; and
- Designated investment business.

A.95 Levy payers are allocated to a contribution group in a sub-scheme according to their permissions under Part 4 of FSMA, as with the FSA fee blocks. A firm can be allocated to one or more contribution group, and therefore sub-scheme, depending on its permitted activities.

A.96 For levying purposes the cost structure of the FSCS is comprised of management expenses, and compensation payments. Management expenses are made up of base costs (the core costs of running the scheme) and specific costs (the costs of assessing and making compensation payments).[17] Compensation payments are the actual money paid out in compensation.

[12] The standard case fee for the 2004/05 financial year is £360.

[13] The special case fee for the 2004/05 financial year is £550.

[14] The FOS may recommend money awards that exceed this figure, but any amount over £100,000 is not binding on the firm. It may also require that reasonable interest be paid, as well as reasonable costs incurred by the complainant (but the latter is rare).

[15] The sub-schemes broadly correspond to the three former compensation schemes that were replaced by the FSCS on 1 December 2001, when FSMA came into force. The number of sub-schemes will increase to five when the FSCS becomes responsible for claims arising from mortgage business (31 October 2004) and general insurance intermediaries (14 January 2005).

[16] The contribution groups largely correspond with the FSA's fee blocks.

[17] Establishment costs also form part of the management expenses at present, but the last element of these is included in the 2004/05 levy and is not relevant for the purpose of this costs assessment.

A.97 In terms of allocation, firms contribute to the base costs element of the management expenses by reference to their FSA periodic fee. The specific costs and the compensation payments levies are allocated to contribution groups, so that levies are only raised against firms that are authorised to carry on the same type of business as those failed firms that cause the FSCS to pay out compensation.

A.98 There are limits on the amounts the FSCS can levy in a financial year. For compensation purposes the limits for each sub-scheme are:

- Accepting deposits – no more than 0.3 percent of a participant firm's protected deposits, cumulative;
- Insurance business – no more than 0.8 percent of a participant firm's net premium income on protected policies; and
- Designated investment business – the total levy must not exceed £400m.

A.99 The annual management expenses levy is also subject to an annual limit, following consultation with the industry by the FSA.[18]

A.100 The amount levied for compensation payments reflects the compensation costs that the FSCS expects to pay, based on estimated claims for the 12 months following the levy date (allowing for current fund balances).

A.101 The amount levied for management expenses is based on the FSCS's budget requirements for each year, subject to the levy limit that has been set.

Cost implications for each option

a) Amend primary and secondary legislation: regulate investment trust companies on a similar basis to authorised unit trusts and OEICs

Regulatory fees

A.102 Under option a) investment trust companies would face costs under all three of the categories that we have identified above.

A.103 In particular, they would have to pay a fee to the FSA to apply for authorised person status. They would also have to pay a fee for product authorisation. We are not in a position to quantify the application fees. With respect to the fee to apply to be an authorised person, the FSA would determine the appropriate fee block for investment trust companies, and decide on the complexity of applications in that category. The amount of the application fee would be determined accordingly. With respect to the fee for product authorisation, this would also be for the FSA to determine.

A.104 Investment trust companies would also have to pay a periodic fee to the FSA, both as authorised persons and with respect to product authorisation. Again, we cannot quantify this cost, but the amount set by the FSA for the periodic fee relating to being an 'authorised person' would depend on the fee block to which investment trust companies would belong, as well as the cost of regulating the relevant activities to that fee block and the scale and size of individual firm's activities. It would also be for the FSA to determine the periodic fee associated with product regulation.

[18] The FSCS has appointed the FSA to act as its agent to collect relevant data, raise and issue the levy invoices and collect all payments due, on behalf of the FSCS.

A.105 In relation to the FOS, the new upfront cost to investment trust companies would be the general levy, the amount of which we cannot quantify but which would be set by the FSA in accordance with the appropriate industry block, and the tariff base of individual firms.

A.106 The FOS case fees would not be an immediate cost, but would ultimately be set by the FOS following consultation with the industry. Special case fees might apply at an early stage, depending on the circumstances. The payment of any such fees by individual firms would, of course, depend entirely on the number of complaints made against them – recalling that firms pay only for the third and any subsequent complaint against them in a given financial year.

A.107 In relation to the FSCS, investment trust companies would be allocated to an appropriate sub-scheme and an appropriate contribution group, in accordance with their permitted activities. They would contribute to the base costs of the Scheme's management expenses by reference to their FSA periodic fee, and would pay specific costs and compensation payments depending on the contribution group(s) to which the would belong. Again, we are not in a position to quantify these costs. The annual management expenses levy would depend on the FSCS's budget, subject to the annual limit on levies for management expenses. The compensation cost levy would depend on the FSCS's estimates, again, subject to the overall limits on levies set out above.

Compliance costs

A.108 Compliance costs would be greatest under option a). Investment trust companies would have to ensure that they met all requirements of product regulation, as well as those imposed on authorised persons.

b) Amend secondary legislation: investment trust companies as unauthorised collective investment schemes

Regulatory fees

A.109 Under option b) investment trust companies would, again, face costs under all three of the categories that we have identified above.

A.110 However, the FSA's application and periodic fees associated with product authorisation would not apply.

Compliance costs

A.111 Compliance costs under option b) would be lower than under option a), because under b) there would be no requirement to comply with the FSA's product regulations.

c) Amend existing secondary legislation (the RAO) so that investment trust companies would be considered as carrying on a regulated activity (establishing, operating or winding up an investment scheme based and listed in the UK, with risk spreading objective)

Regulatory fees

A.112 Under option c) investment trust companies would, as with options a) and b), face costs under all three of the categories that we have identified above.

A.113 However, as with option b), the FSA's application and periodic fees associated with product authorisation would not apply.

Compliance costs

A.114 Compliance costs under option c) would be similar to those under option b), because like option b), there would be no requirement to comply with product regulations. Nor would there be any requirement to comply with rules for unauthorised collective investment schemes.

d) Continue to rely on existing FSA rule-making powers

A.115 As we note in Chapter 6 of the consultation paper, the current regulatory structure around investment trust companies would remain in place, with no additional regulatory protections for shareholders.

A.116 The extent to which this would be a 'cost' depends on the view that we ultimately take of the significance of each potential regulatory gap, and any other regulatory issue identified in Chapter 5 of the paper or raised through the consultation.

SMALL FIRMS' IMPACT TEST

A.117 We will consider, if appropriate, whether there would be any significant or disproportionate impact on small businesses, once we have completed this consultation and have more evidence about whether or not additional regulation should be introduced. We have consulted the Small Business Service and they agree with this approach.

A.118 We have formed an initial view that if, following consultation, we were to take further any one of the possible regulatory options that we raise, none of them would have a significant or disproportionate impact on small businesses.

A.119 As part of this consultation, we welcome representations from any small businesses and their representative organisations if they think that they are likely to be adversely affected.

COMPETITION ASSESSMENT

A.120 We will consider, if appropriate, whether there would be any impact on competition once we have completed this consultation and have more evidence about whether or not additional regulation should be introduced. We have consulted the Office of Fair Trading and they agree with this approach.

ENFORCEMENT AND SANCTIONS

A.121 If, following this consultation, we were to take the view that additional regulation should be introduced in accordance with one of the options that we discuss, it would be for the FSA to enforce its rules to the extent that they would apply to investment trust companies.

CONSULTATION

A.122 We have prepared the consultation paper with the assistance of the FSA.

SUMMARY

A.123 We have not taken a view as to whether investment trust companies should be regulated differently to how they are at present. The purpose of this consultation is to hear views on whether we should introduce additional regulation, and, if so, what that additional regulation might look like. Therefore we are not making any recommendation at this stage.

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B GLOSSARY OF TERMS

*indicates that this item is part of the FSA's Handbook of rules and guidance

AITC	Association of Investment Trust Companies
AITC Code	AITC voluntary Code of Corporate Governance
APER*	Statements of Principle and Code of Practice for Approved Persons
CIS*	Collective Investment Scheme Sourcebook
COB*	Conduct of Business Sourcebook
COLL*	New Collective Investment Scheme Sourcebook
Combined Code	The Combined Code on Corporate Governance (July 2003), annexed to the Listing Rules
COMP*	Compensation
DISP*	Dispute resolution: Complaints
FIT*	Fit and Proper test for Approved Persons
FOS	Financial Ombudsman Service
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
FSMA 2000 (CIS)	Financial Services and Markets Act 2000 Order 2001 (Collective Investment Schemes) Order 2001
MAR*	Code of Market Conduct
OEIC	open-ended investment companies
Ordinaries	ordinary income shares
PRIN*	Principles for Business
Promotion of CIS Exemptions Order 2001	Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001
RAO	Financial Services and Markets Act 2000 (Regulated Activities) Order 2001
SCCEFs	split capital closed-ended funds
Splits	split-capital investment trusts
SYSC*	Senior Management Arrangements, Systems and Controls
UCITS	undertakings in collective investment transferable securities
UKLA	United Kingdom Listing Authority
Zeros	zero dividend preference shares