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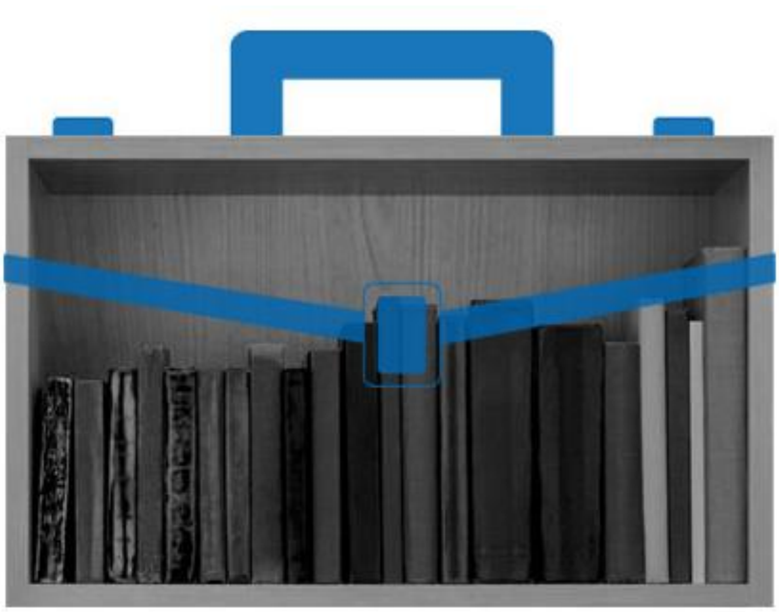
FCA consultation paper

CP22/8 – side pockets



The use of side pockets as liquidity management tools by funds holding investments affected by the Russian invasion of Ukraine: FCA consultation and CSSF FAQs

FCA consultation paper CP22/8 "Protecting investors in authorised funds following the Russian invasion of Ukraine" seeks views on proposed emergency measure to deal with the impact of the Russian invasion of Ukraine on authorised funds and retail investors. The Luxembourg Financial Supervisory Authority has recently published frequently asked questions on the application of liquidity management tools by investment funds.

The FCA Consultation

The FCA recognises that the Russian invasion of Ukraine has had a significant impact on financial markets and on FCA-regulated authorised funds. To address this, the FCA is proposing an unprecedented liquidity management tool ("LMT") for authorised funds, known as side pocketing. Side pockets are commonly used in non-retail funds, such as hedge funds, either to deal with illiquid assets or in response to unforeseen circumstances. To date, side pockets have not been permitted for FCA authorised funds, which are meant to hold liquid assets and offer redemption on demand.

The proposed use of side pockets should be seen in the context of the current emergency situation. Side pockets will be permitted for a limited time and only if a fund's assets are genuinely affected by the Russian invasion of Ukraine and resulting sanctions. The FCA say this consultation is not an indication that they will allow authorised funds to use side pockets more widely.

The FCA has truncated its usual consultation period to 18 days and the consultation closes on 16 May 2022.

Background to the consultation

Numerous Russian, Belarusian and Ukrainian assets have been rendered illiquid or untradeable due to the Russian invasion, international sanctions imposed on Russia and Belarus and Russian and Belarussian countermeasures. Normal mechanisms for accurately valuing these assets are therefore currently unavailable. CP22/8 and the proposed regulation refers to such assets as "affected investments".

Affected investments include:

- equities and fixed-income securities issued by governments, public authorities and corporates in Russia, Belarus and Ukraine and securities listed, offered or placed in those countries
- assets listed and traded on other stock exchanges and backed by such securities, for example depositary receipts
- securities issued by companies whose operations are particularly severely affected by the current situation, or which are owned or controlled by individuals who are the subject of UK or international sanctions relating to Russia
- units in other collective investment schemes that have suspended dealings because of exposure to such assets

Some authorised funds with material exposure to affected investments have suspended dealing because of valuation uncertainty, in line with the FCA's usual rules on suspension. Investors in those funds are currently unable to exit and redeem their investments. It is unclear how long these funds will remain suspended and, with no alternative measures, investors could be locked in for long periods.

Many authorised funds with limited, but not material, exposure to affected investments remain open for dealing but face other issues. In many cases, as a prudent measure, authorised fund managers ("**AFMs**") have written down the value of affected investments to zero or near-zero in light of the current situation, risks and inability to deal in assets subject to sanctions.

The FCA believes that permitting side pockets will allow:

- new investors to enter funds without being exposed to affected investments
- existing investors to redeem that part of their investment which relates to liquid assets
- some suspended funds to recommence dealing

Overview of the proposal

Side pocketing separates illiquid, hard to value and high risk assets from other assets of a fund. The FCA's chosen side pocket model is to create one or more new unit classes in the existing fund to hold the affected investments.

AFMs will be allowed to establish a separate class, or a range of classes, within the fund which will be valued purely by reference to the affected investments. All other classes will be valued by reference to the liquid assets only. The number of side pocket unit classes and their features will be at the AFM's discretion. AFMs might consider it helpful to issue units by reference to the existing structure of unit classes in the fund. Alternatively, AFMs might decide to issue a single side pocket unit class for simplicity.

On creation of the side pocket, investors will receive units linked to the value attributable to the affected investments, proportionate to the exposure they had immediately before the creation of the side pocket. The side pocket unit class will not accept further subscriptions. The AFM will manage the side pocket with an eye to realising the value in the assets as and when this can be done in the best interests of its unitholders as part of an orderly wind down.

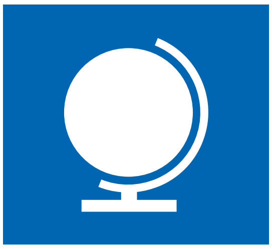
Existing investors will also continue to have regular units in the fund which are linked to the value of the liquid assets, which they will be able to realise on the usual basis. Ultimately, existing investors' overall exposure to assets (both affected investments and liquid assets) and their ownership rights will not change as a result of creating a side pocket unit class, this is simply an alternative structuring model aimed at creating temporary separation.

There is an alternate side pocket model which involves setting up a new fund with the same investment objective and using a scheme of arrangement under COLL to transfer the liquid assets to it, leaving the affected investments behind in the original fund. The FCA rejected this approach on the basis of cost and complexity. Currently, the new fund model is feasible without any regulatory amendments, but would require an extraordinary resolution by investors at an EGM, which would have both time and cost implications.

Overview of the rules

Scope

The side pockets rules will be set out in COLL 7. They will apply to transferable securities including depositary receipts, money market instruments, units in collective investment schemes and shares in AIFs which are:



- sanctioned by one or more of Canada, the EU, France, Germany, Italy, Japan, the United Kingdom or the United States

- issued or guaranteed by the government, central authority, regional authority, local authority or central bank of Russia, Belarus or Ukraine

- issued or guaranteed by an issuer which has its principal place of business in or has significant economic ties to Russia, Belarus or Ukraine, such that fair valuation of the investment is no longer possible

To fall within the scope of the rules a fund must meet a three step test:

- it must hold an affected investment within the categories set out above
- the affected investment must be connected with one or more of the three affected countries
- the affected investment must either be sanctioned or impacted economically through its connection to the affected countries.

The side pocket rules apply to UK UCITS and NURS, but do not apply to regulated money market funds.

Initial considerations

The AFM must understand the legal requirements and obligations under the applicable sanctions regimes and be satisfied that the creation of the side pocket and associated operational arrangements will comply.

New guidance in COLL 7.8.3G will note that contravention of the UK sanctions regime constitutes a criminal offence. Further guidance on issues to be considered by AFMs will be set out in COLL 7.8.7G.

A new rule under COLL 7.8.4R will provide that a side pocket unit class can be created if:

- an AFM determines that:
    - the affected investments meet the three step test

  - creating the side pocket unit class will protect the interests of unitholders
  - the rights of side pocket units will not be unfairly prejudicial to the interests of unitholders generally
  - the issue of units in the side pocket unit class will be in the best interests of unitholders, the fund and the integrity of the market
  - all unitholders in the fund will be treated fairly
- the fund's prospectus and instrument provide for the issue of units in a side pocket unit class and set out the terms on which that class will operate

In order to reach a final decision, the AFM must also:

- consult with the depositary
- consider a list of non-exhaustive matters and guidance in COLL 7 Annex 1
- consider whether to suspend dealing in the fund as an alternative to creating a side pocket

The decision to create a side pocket unit class must be taken by the AFM's governing body. If, after setting up a side pocket, further affected investments need to be segregated from the fund's liquid assets, a second side pocket must be created, as it will not possible to add further affected investments to an existing side pocket.

The draft rules suggest an AFM should seek legal advice on certain initial considerations, including whether the side pocket and the rest of the fund should together constitute a single collective investment scheme under FSMA. It would be preferable if the FCA was able to provide firms with more certainty.

Limited issue

Side pocket unit classes will be limited issue under COLL 6.2.18R, so no further units in that class can be issued after the initial pro rata issue to existing shareholders.

Any further investments in the fund, whether made by existing or new investors, can only receive units in classes valued by reference to liquid assets.

Allocation of scheme property

The FCA expects AFMs will need to consider how to apply a fair accounting treatment when the side pocket unit class is established, in addition to the obligations imposed by COLL 7.8.4R. No rules have been drafted, but new guidance at COLL 7.8.8G clarifies how the AFM should allocate capital property and income property to the side pocket unit class.

The AFM will need to decide whether to allocate a portion of uninvested cash to cover costs and charges of the side pocket. The side pocket may also need to undertake derivative transactions to hedge its foreign currency exposures back to the fund's base currency.

Costs and charges

The FCA accepts that a side pocket unit class should bear a proportionate share of costs which are incurred for the benefit of all unitholders, such as depositary fees, audit fees, regulatory charges and expenses incurred by the AFM managing and administering the fund. AFMs will have some discretion to determine how to allocate such costs and charges, including recovering these from any income or capital attributable to the side pocket unit class. The AFM may decide to accrue such costs and charges indefinitely until sufficient cash is available to cover them, or to waive some charges or pay them from its own resources.

The FCA also accepts that AFMs should not be prevented from charging for managing the side pocket, but it warns that any such management fee should fairly reflect the AFM's activities. In the circumstances, the FCA believes that it might be more appropriate for the AFM to charge a reduced or nil fee for managing side pocketed affected investments. Under COLL 7.8.30R, AFMs will be prevented from charging preliminary, exit or performance fees to side pocket unit classes.

If an AFM's approach to costs and charges deviates from FCA guidance, we anticipate that the FCA will scrutinise and question that deviation, particularly as part of assessment of value reporting.

Updating scheme documents

The FCA takes the view that, notwithstanding the usual rules on ability to issue unit classes permitted under the instrument, instruments and prospectuses of authorised funds do not currently allow for side pocket unit classes. AFMs will need to amend fund documents before creating side pockets. Those amendments must include the terms on which such classes will operate under COLL 7.8.4R(2)(c).

Amending fund instruments requires prior approval by the FCA's Fund Authorisations team. The FCA plans to develop a fast-track approval process for amendments which are limited to those necessary to permit a fund to create side pockets and we await the detail of this process.

Notifying investors

The FCA plans to treat implementing side pocket unit classes as a significant change (rather than fundamental) provided the foreseeable costs of the side pocket are not disproportionate to its benefits.

Despite being classified as a significant change, the FCA under COLL 7.8.16R will disapply the usual requirement under COLL 4.3.6R(3) to give prior notice. Instead, the AFM will be required to inform unitholders in a timely way, either by announcing its decision in advance, or after the change has been implemented.

The key points to be covered by this notification will be set out in FCA guidance under COLL 7.8.20G. The notification must:

- explain what a side pocket is
- avoid excessive use of legalistic language
- summarise the key features and risks of the side pocket unit class
- say where further detail may be found

The FCA are considering publishing material on the consumer section of their website explaining the key features of the side pocket regime in order to help demystify the concept.

There will be no requirement to produce UCITS KIIDs and NURS KIIs for side pocket unit classes as they will not be offered to potential investors in exchange for new subscriptions.

Managing the side pocket

The FCA proposals include guidance on the long term management of side pockets.

COLL 7.8.30R will explicitly recognise that AFMs will not be managing side pocket unit classes in line with fund's investment objectives and policies, but with a view to closing down the side pocket class as and when this can be done in the best interests of unitholders.

AFMs will need to implement regular review processes to assess the impact of costs and charges on side pocket unit classes and whether they are offering good value for investors.

The investment and borrowing powers under COLL 5 will continue to apply, however they will be relaxed by COLL 7.8.23R and AFMs will only have to comply with the relevant sections of COLL 5 to the extent practicable.

The FCA recognises that there are a number of possible redemption scenarios depending on developments impacting the liquidity and valuation of the affected investments. If the AFM is satisfied that valuations are accurate, it could allow unitholders in the side pocket to sell their units at that value should they wish to do so. If the value is negligible, it could be written off by cancelling the units without debiting the scheme property of the fund. If it is not, but the unitholder does not wish to receive proceeds from the fund's exposure to Russian or Belarusian assets, the AFM could donate the proceeds to charity. However, if the affected investments in the side pocket are insufficiently liquid to support redemption, the AFM should consider suspending all dealing in the side pocket unit class under an exception in COLL 7.8.32R permitting dealing to be suspended at class level.

The hope is that side pocket unitholders will be offered a choice regarding exit, if future circumstances allow. The FCA expects AFMs to provide timely information to investors and to ensure that information can be easily passed on to investors with whom they do not have a direct relationship.

In due course, AFMs will need to make specific proposals for termination of side pockets.

Duration

There is no requirement in the draft rules for AFMs to make any explicit commitments to maintain the class for a minimum or a maximum period. The FCA expects AFMs to keep this under review and to respond to developments. AFMs should develop an appropriate risk management plan and determine how ongoing costs and charges will be met.

While the rules themselves will be temporary, at this time the FCA does not intend to set a time limit on duration. They will consult in due course on the timing of the withdrawal of the emergency measures. Any withdrawal of the power to create side pockets will not compromise those side pockets already in existence.

Developments in Luxembourg

The Luxembourg Financial Supervisory Authority ("**CSSF**") also recognises the impact of the Russian invasion of Ukraine on the asset management industry. On 31 March 2022, the CSSF published frequently asked questions on the application of liquidity management tools by investment funds ("**FAQs**"). The FAQs aim to provide guidance on temporary and structural measures for dealing with assets rendered illiquid by the invasion and sanctions imposed by the EU and others on Russia and Belarus. The FAQ also address questions raised by market participants.

Overview

Scope

The FAQs apply mainly to UCITS governed by the Luxembourg Law of 17 December 2010 on undertakings for collective investment in transferable securities, however the CSSF notes they are also applicable to Luxembourg alternative investment funds.

Preliminary considerations

The FAQs emphasise that it is the responsibility of the governing body (a management company or a board of directors) of the impacted investment fund to choose appropriate LMTs and the valuation to be applied to affected assets. The CSSF expect the governing body to take into account provisions of the fund documents, its investment strategy and policy and the overall exposure to illiquid assets when considering the application of LMTs.

General clarifications on LMTs

The CSSF expect governing bodies of funds with a limited exposure to illiquid assets to first apply fair valuation adjustments or close the fund to new subscriptions. Side pocketing can be considered only as a subsequent measure depending on the level of exposure to illiquid assets.

Separately, the CSSF expect funds with higher exposure to illiquid assets to be suspended immediately and apply side pockets subsequently in order to resume activities. The CSSF must be formally notified of the suspension in the usual manner.

Use of side pockets

The CSSF point out that the asset segregation methods described in the FAQs apply only if assets became illiquid as a result of the crisis in Ukraine and should not be used as precedent in other circumstances.

1 Option I – creation of a new share class

Under this option, the illiquid assets are allocated to a newly created share class suspended for redemptions and closed to new subscriptions.

2 Option II – split of the affected sub-find

Under this option the affected sub-fund is split and the liquid assets transferred into the new sub-fund, leaving the illiquid assets behind in the original sub-fund. The original sub-fund is closed to redemptions and new subscriptions. After the split, the existing investors will hold pro rata shares of both sub-funds. Alternately a fund may split into two separate funds (rather than sub-funds). The general rules of Luxemburg company law need to be followed when splitting sub-funds or funds.

3 Option III – split of the affected sub-find and liquidation of the new sub-fund

This option also involves splitting the affected sub-fund, although in this scenario, the original sub-fund retains the liquid assets while the illiquid assets are allocated to the new sub-fund which is liquidated. Alternately a fund may split into two separate funds (rather than sub-funds) with the fund holding the illiquid assets being liquidated. The general rules of Luxemburg company law need to be followed when splitting sub-funds or funds.

Other options

The FAQs provide that the CSSF may allow additional asset segregation methods subject to case by case assessment and approval.

Implementation of the side pockets

Initial steps

The CCSF requires the governing body to consider the legal framework, the fund's constitutional documents, costs and tax implications before implementing a side pocket. The governing body must inform affected investors in accordance with the rules relating to investor communications in the fund's prospectus.

Approval process

The FAQs set out the information that must be submitted to the CSSF to create a side pocket, including:

- detailed information about the illiquid assets
- a description of the segregation option chosen
- fees charged
- amended constitutional documents (if applicable)

Developments elsewhere

We understand that in Ireland the Central Bank of Ireland is also discussing a side pockets exception for retail funds.

How can Eversheds Sutherland help?

Eversheds Sutherland is widely recognised as one of the leading advisers to the investment funds industry, with one of the leading fund, asset management and regulatory teams. We have over 40 years' experience of investment funds work and, in particular, authorised funds.

If you would like further information on the FCA and CSSF side pocket proposals, or would like guidance in responding to the FCA's consultation or the CSSF FAQ please get in touch. If there are points you would like to make as part of either consultation but do not want to make your own submission, we can include your comments in our submission on an attributed or anonymous basis.

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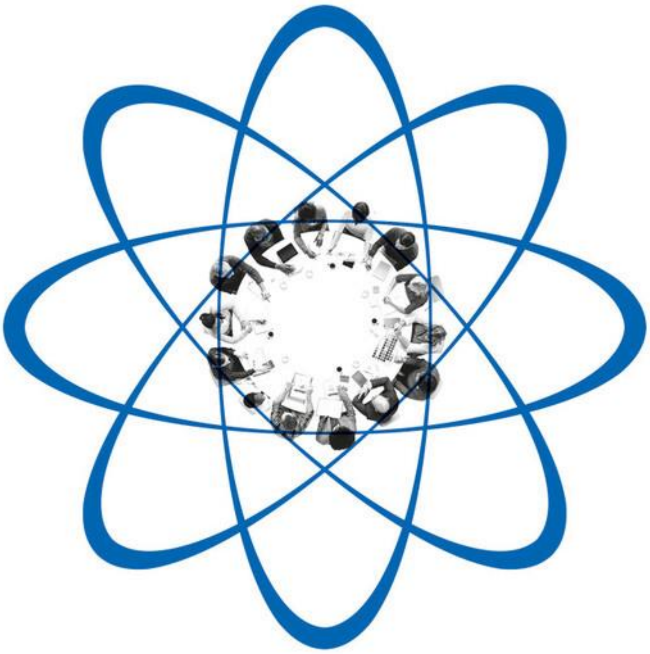

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