

UCIS - A threesixty View

Promoting or Advising on Unregulated Collective Investment Schemes

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Introduction

In recent years we have seen tremendous growth in interest in unregulated investments generally and unregulated collectives in particular.

There are many reasons for this but, primarily, it is the result of demand for investments which have the potential to provide performance in excess of that available through more conventional investments. This may be through specific tax 'breaks' or through taking advantage of asset types not available within regulated arrangements at a time when returns under more familiar investments are low and volatility is relatively high.

Looking forward, there is an additional factor which will encourage firms to look at Unregulated Collective Investment Schemes (UCIS) and that is the need for advisers to consider them and understand how they work if they are to be able to describe themselves as independent after the RDR comes into full force on 1st January 2013.

That there is a need which these investments can meet is self evident – advisers and their clients would never have used them otherwise – that there is confusion around how they can be used is equally evident.

The results of a 2009/10 'review' of UCIS by the FSA highlighted a number of regulatory concerns over advice and promotion processes used by the majority of the firms they reviewed and a tremendous lack of understanding over just what the term 'unregulated' actually means.

The other concern over UCIS and other unregulated investments is the additional risks which investors are exposed to when using them.

1. The FSA Review

The findings of the FSA 'review' were published in two reports which are available on the FSA website:

- Unregulated Collective Investment Schemes: Project Findings and,
- Unregulated Collective Investment Schemes: Good and Poor Practice Report

All staff who are involved in any part of the UCIS advice and/or promotion process in a firm should read both of these publications.

The 'review' was of a total of 14 firms active in the UCIS market and the FSA expressed concerns over the advice process in 12 of those firms. In the majority of cases this led to a variation of permissions while in others Section 166 (skilled persons) reviews were carried out.

The widespread problems which the project highlighted were:

- Lack of awareness of regulatory requirements for UCIS
- Lack of understanding of the UCIS market and their risks
- UCIS promoted and recommended to customers who were not eligible

Specific problems arising included:

How firms used/issued financial promotions
Quality of advice
Systems and controls
- Due diligence
- T&C / CPD
- Management Information

The report findings emphasised that all firms should review their processes for advising on or promoting UCIS to ensure that they are robust and prevent the 'poor practice' identified being repeated.

It is important to note that the FSA's findings did not suggest that UCIS were necessarily 'bad things'; the fact that some of the firms reviewed did demonstrate good practice confirms that UCIS can be sold to clients in a compliant manner provided that correct procedures are in place – and followed. This obviously includes elements of 'know your customer' and product due diligence which firms will already be familiar with.

2. Additional Risk Factors

It is generally accepted (although not always the case) that UCIS are riskier than most packaged investments. The main and most obvious risks faced here are the absence of protection under the Financial Services Compensation Scheme and generally, reduced liquidity.

Other risk factors which are quite common among UCIS can include:

- Liquidity
- Fixed and long term
- Limited/no cancellation/FOS/FSCS rights
- No guarantees (capital or income)
- Redemption on discretion
- High charges
- Complex charging structures
- Gearing
- Currency/geo-political risks
- Fraud/money laundering
- Conflict of interest
- Changes in tax rules

Appropriate due diligence (see section 3 on page 12) will identify which of these risk factors, if any, are relevant to a specific UCIS and of course, may identify additional risks specific to the investment being reviewed.

It is crucial that relevant risks are highlighted to the client (both verbally and in the suitability report) and that the adviser ensures that the client understands them and this must form part of the investment process.

3. A Possible Process

The process used to recommend UCIS within a firm

must be robust. It must be understood and followed by all relevant staff in the firm (not just advisers). It may be determined by the firm's investment committee but must be subject to oversight.

The CF1/CF4 (Directors/Partners) and the CF10 (compliance) person within the firm must sign off the process and any variations made to it. The UCIS process, as with processes around other specialist investments, should be an appendix to the firm's overall investment process. The actual process to be followed by the firm will be almost unique.

It will be based around the knowledge and experience of advisers and administrators and will be developed around the overall investment process. The process is the core of ensuring that advice around UCIS is compliant. It will also be hugely influential in determining whether the firm will be able to obtain PI cover for UCIS and at what cost. The chart below represents a possible process. It is only a guide and may well not be suitable for your firm in that it will require adaptation in order to match your other processes and the individuals involved.

Is the investment a UCIS?

In theory this should be easy to check in that the Prospectus/Information Memorandum should disclose whether the investment is a UCIS within the first few pages. It is important not to rely on the sales literature when undertaking any element of research or due diligence on these funds.

In the event that the Prospectus/Information Memorandum does not make the position clear, the best approach is to contact the promoter/investment manager and ask them. Always seek written confirmation so that it can be held on file.

A DIY approach is as follows:

Is the client eligible?

The sub text to this heading is "is it a 'promotion'?" to which the answer is virtually always going to be "Yes".

Your start point really should be that if you are advising a client to invest in a UCIS you are in fact promoting that UCIS.

There is an overall prohibition on promoting UCIS under Sections 21 and 238 of FSMA but there are a number of exemptions to this.

The exemptions

There are three sources of exemptions to this prohibition offering around 20 exemptions between them. These are found in: 1. The FSMA 2000 (Financial Promotions) Order 2001 (FPO Order) –for unauthorised persons but can also be used by some authorised firms in certain circumstances. 2. Promotion of Collective Investment Schemes (PCIS) Order made by HM Treasury and 3. FSA Rules (COBS 4.12).

There are specific rules around all of these exemptions with advisers being required to obtain specific evidence and/or provide specific warnings. It is essential that advisers (and those involved in supervision and oversight) fully understand the rules surrounding any exemption they seek to utilise.

There is insufficient room in a publication of this nature to list all of the possible exemptions so we will only consider the COBS 4.12 exemptions here.

Category 1 person

Subject to certain conditions

- (1) A person who is already a participant in an unregulated collective investment scheme; or
- (2) A person who has been, in the last 30 months, a participant in an unregulated collective investment

Category 2 person

A person:

- (a) for whom the firm has taken reasonable steps to ensure that investment in the collective investment scheme is suitable; and
- (b) who is an 'established' or 'newly accepted' client of the firm or of a person in the same group as the firm

Category 3 person

A person who is eligible to participate in a scheme constituted under:

- (1) the Church Funds Investment Measure 1958;
- (2) section 24 of the Charities Act 1993; or
- (3) section 25 of the Charities Act (Northern Ireland) 1964.

Category 4 person

An eligible employee, that is, a person who is:

- (1) an officer;
- (2) an employee;
- (3) a former officer or employee; or
- (4) a member of the immediate family of any of (1) - (3), of an employer which is (or is in the same group as) the firm, or which has accepted responsibility for the activities of the firm in carrying out the designated investment business in question.

Category 5 person

A person admitted to membership of the Society of Lloyd's or any person by law entitled or bound to administer his affairs.

Category 6 person

An exempt person (other than a person exempted only by section 39 of the Act (exemption of appointed representatives) if the financial promotion relates to a regulated activity in respect of which the person is exempt from the general prohibition.

Category 7 person

An eligible counterparty or a professional client.

Category 8 person

A person:

- (1) in relation to whom the firm has undertaken an adequate assessment of his expertise, experience and knowledge and that assessment gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the person is capable of making his own investment decisions and understanding the risks involved;
- (2) to whom the firm has given a clear written warning that this will enable the firm to promote unregulated collective investment schemes to the client; and
- (3) who has stated in writing, in a document separate from the contract, that he is aware of the fact the firm can promote certain Unregulated Collective Investment Schemes to him.

Whilst these are all exemptions, it is imperative that advisers and all others in the firm realise that there are restrictions around what sort of UCIS can be promoted to each category of person.

For example, for a 'Category 1' person it is only permissible to promote the same UCIS or another UCIS whose underlying property and risk profile are both 'substantially similar' to the existing UCIS, a UCIS which is intended to absorb or take over the assets of the existing scheme or units in a UCIS which are being offered, by the operator, as an alternative to cash on the liquidation of the current UCIS.

The PCIS and FPO exemptions include 'certified high net worth individuals', 'self-certified high net worth individuals', 'certified sophisticated investors' and 'self-certified sophisticated investors'. Again, these terms all have strict definitions and there are restrictions as to the nature of the investments which can be promoted under these exemptions.

It is not straightforward.

Once the relevant exemption(s) has been identified and confirmed with the client it must be logged and relevant evidence placed on file using the prescribed wording, where relevant to identify the exemption.

It is important to understand that no UCIS should be promoted to a client prior to this categorisation process including the collection of full 'know your client' information.

Due Diligence

Under no circumstances should advice be given on any UCIS without the firm undertaking adequate due diligence on the investment and on the key parties to the investment.

Firms cannot rely on third party due diligence alone. They must ensure that they understand and agree with the processes used by any provider of due diligence and, indeed, undertake due diligence on that provider to ensure that it has the requisite knowledge and experience and, importantly, that there are no conflicts of interest due to ownership etc.

It is important that the firm records all the due diligence it undertakes for each UCIS which it promotes or advises on. This should be held, in durable form, by the investment committee.

Because all UCIS schemes, even those using the same underlying asset class, are different it follows that the due diligence process itself will also be different.

The following highlights the sort of areas which should be considered. A detailed reading of the prospectus or Information Memorandum will highlight possible additional questions or, indeed, questions which need not be asked.

- Structure
- Asset type
- Jurisdiction
- Tax – fund
- Tax – investor
- Term
- Charges – what, when, how much
- Key parties – corporate and individual
- Projections – how realistic are they?
- Performance of relevant index, similar funds etc

The investment committee

The firm will already have an investment committee in place as part of its general investment process. In the context of UCIS there are additional functions which the investment committee is well placed to take on for the firm.

Clearly the investment committee will set the guidelines for product research and establish any limitations on advisers looking at schemes themselves. A panel of reviewed schemes may be established but this must be reviewed on a regular basis in the light of changes to the parties involved, charges, performance and legislation etc.

The investment committee should also set asset allocation limits dictating the maximum proportion of a client's assets which can be invested in UCIS. This should be relatively flexible to allow the firm to reflect the fact that some schemes are less illiquid than others and some are riskier than others. A process for non-standard allocations should be put in place.

The committee should be familiar with the PI cover in place for the firm.

4. MiFID status

Your firm's MiFID status will impact on which of the above exemptions are available to you and on some additional factors.

Any firm which is not a full MiFID firm must check the MiFID status of any entity to which it transmits a UCIS order. Any firm which is currently "Article 3 MiFID Exempt" may lose its status as an exempt MiFID firm by transmitting UCIS orders to an entity which is not 'MiFID allowed' – broadly a full MiFID firm.

Article 3 MiFID Exempt firms and Exempt CAD firms would also lose their audit exemptions by transmitting orders to non-allowed entities.

Top 10 UCIS Hints

Always ensure that the firm has relevant PI cover prior to making any recommendation. This may need to be checked on a case by case basis.

All relevant staff and management should read and be familiar with the output of the FSA review. They should receive training and their CPD should be documented in detail.

The firm must have a robust process for promoting or advising on UCIS which must be known and followed, by all relevant staff.

The firm's process should include arrangements for pre-approval.

The firm should maintain management information showing full details of exemptions used and the results of pre-approval requests.

Supporting evidence for exemptions claimed should be retained.

Full due diligence should be undertaken on any UCIS which the firm is considering using.

The firm should consider advice on UCIS to be a 'promotion' and should follow the financial promotion rules at all times.

The risks, general and investment specific, of a UCIS should be made clear to clients.

The firm, if an Article 3 MiFID Exempt firm or an Exempt CAD firm should ensure that orders are transmitted only to entities allowed by MiFID unless the firm is prepared to opt into MiFID itself.

Glossary

CF – Controlled Function

This identifies those approved by the FSA to perform certain specific functions in the firm– e.g. CF10 – Compliance Officer.

Collective Investment Schemes (CIS)

As defined by section 235 FSMA 2000.

“ Any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

The arrangements must be such that the persons who are to participate (“participants”) do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.

The arrangements must also have either or both of the following characteristics:

- (a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;
- (b) the property is managed as a whole by or on behalf of the operator of the scheme. “

FSMA 2000

The Financial Services and Markets Act 2000.

MiFID

Markets in Financial Instruments Directive.

Unregulated CIS

A CIS which is neither regulated nor recognised by the FSA.

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