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Primary Market Technical Note

Class testing changes to an investment management agreement

The information in this note is designed to help issuers and practitioners interpret our UK Listing Rules, Prospectus Regulation Rules, Disclosure Guidance and Transparency Rules, and related legislation. The guidance notes provide answers to the most common queries we receive and represent FCA guidance as defined in section 139A FSMA

Rules

UKLR ~~11.1.2G(2)~~8.2, ~~LR 11.1.7R, LR 11.1.10R, LR 11.1.11R~~UKLR 11.5

The purpose of UKLR 8, amongst others,~~11~~ is to ~~guard against~~prevent both the perception and the risk of a related party taking advantage of its position (UKLR 8~~11~~.1.3~~2~~G~~(2)~~).

Unless a transaction with a related party falls within UKLR ~~11~~8.1.10~~6~~R ("Transactions to which this chapter does not apply"), ~~a premium listed~~an issuer with securities listed in the equity shares (commercial companies) or closed-ended investment funds categories ~~issuer~~ must comply with UKLR ~~11.1.7~~8.2~~R to LR 11.1.10R~~. In addition, listed closed-ended investment funds ~~have to~~must comply with the additional requirements for related party transactions set out in UKLR 11.5. Fundamentally, this requires the issuer to apply the appropriate class tests to the related party transaction to determine the relevant

percentage ratios.~~-~~ This will then determine the appropriate treatment of the transaction under the UK Listing Rules. For a closed-ended investment fund that enters into a relevant related party transaction, this may include the requirement to seek shareholder approval for the transaction. ~~(including whether the transaction requires shareholder approval)~~

Where there are quantifiable benefits

Where the maximum value of the change to an investment management agreement can be clearly calculated, the class tests provide an accurate indicator of the value of the variation. However, often the whole basis of the fee is changing and it is difficult to establish a comparison between the old and the new fee and therefore determine the maximum value of the variation. For example, this is the case when the hurdle rates of a performance fee change or where the annual management fee is no longer based on a percentage of net assets under management but instead on a percentage of gross assets. In such circumstances, advisers often argue that the impact of the variation on the issuer will be small or even result in a reduction in fee payable, having regard to the likely future performance of the issuer. However, our approach to classification generally rules out having regard to future performance assumptions and where there is no definitive way of calculating the maximum value of the variation, the variation will be treated as uncapped and require shareholder approval under ~~LR 11~~UKLR 11.5.5R.

In such circumstances, issuers ~~often~~may propose to cap fees in order to demonstrate that UKLR 11.5.5~~1.10~~R does not apply. If they choose to do so and if the maximum value of the variation is capped so that the total fee payable to the investment manager in any 12-month period is limited to less than 5% of NAV, we accept ~~that LR 11.1.10R will apply and~~ shareholder approval is not required and UKLR 11.5.4R applies if such limit is greater than 0.25% of NAV~~d.~~.

Where there are unquantifiable benefits

Occasionally, in the context of a change to an existing investment management agreement, the benefit of the transaction may be unclear and the class tests may be difficult to apply. If individual guidance is

required, we would ask questions about the transaction to determine whether there is any form of benefit which may be quantified and, consequently, class tested. As part of ensuring we have a complete understanding of the issue, these questions may include whether there is an incremental change in the total amount of fees receivable by the related party, whether the quality and levels of service prior to and following the transaction are equivalent, and whether there is any other impact (such as a change in regulatory status of either party).

The outcome may be that there is a benefit to the related party, but this is not a financial benefit that is capable of being quantified. In such a case, we accept that, in effect, the percentage ratio is zero. This means the ~~transaction would be considered a small transaction within the meaning of paragraph 1 of the Annex to LR 11 and the~~ related party transaction rules will not apply.

We would highlight that this is different to the situation where there can be a quantifiable benefit albeit only in certain circumstances (for example, where the new fee arrangements may lead to higher fees in comparison to the current arrangements, but only if a specific event occurs).

If the new fee structure is such that it cannot be directly compared with the previous structure and, consequently, the financial benefit to the related party from the change (i.e. the difference between the new and the old agreement) cannot be easily quantified, then we would expect the entire fee to be class tested afresh. Standard class test methodologies apply with market cap and the modified class test against NAV being the most appropriate measures.

We are occasionally asked for guidance where a change introduces or extends a minimum period of time before an investment management agreement may be terminated. We typically consider fees on an annual basis and so if there is no change to the level of fees, then the class test result may be zero. However, we are unlikely to challenge a more conservative approach to classifying the change if one is presented to us (e.g. aggregating the fee payable over a number of years).

We expect there to be continual development in the way fee arrangements are structured within an investment entity. This includes both how the fees are calculated and how the fees due are settled (i.e. in methods other than in cash).

Where the only change relates to a direct substitution by which payment of the fee will be made by something of the same value other than cash, then the class tests should still be applied in relation to the level of the fee to be paid if this level is capable of being quantified. This is regardless of whether, after the fee has been settled, there is potential for future value movements (eg. increase in value of shares) as any such benefit is purely speculative.

Conversely, if the level of fee is unquantifiable (for example, it is not subject to a cap) or if there is no definitive way to calculate the maximum value of the change to the fee (irrespective of how the fee will be settled), the variation will be treated as uncapped.

It remains that, if an amendment leads to any identifiable and quantifiable benefit in any potential scenario where fees become payable, then that is the benefit to be tested.

We would remind issuers that the aggregation rules in UKLR 11.5.6~~1.11~~R still apply even where a further related party transaction with the same related party has a percentage ratio of zero.