

CP12/19***

Financial Services Authority

Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes

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Contents

Abbreviations used in this paper	3
Glossary of useful terms and definitions	5
1. Overview	7
2. Non-mainstream pooled investments	15
3. Proposed changes to the marketing restriction	19
4. Other proposals	27
5. Existing customers	32
Annex 1: The current market	
Annex 2: Ongoing UCIS supervision and enforcement activity	
Annex 3: Cost benefit analysis	
Annex 4: Compatibility statement	
Annex 5: List of questions	
Appendix 1: Draft Handbook text	
Appendix 2: Designation of Handbook provisions	

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 14 November 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2012/cp12-19-response.shtml.

Alternatively, please send comments in writing to:

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Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

AIFMD	Alternative Investment Fund Managers Directive
CIS	Collective investment scheme(s)
COBS	Conduct of business sourcebook
COLL	Collective investment schemes sourcebook
EU	European Union
FCA	Financial Conduct Authority
FPO	FSMA 2000 (Financial Promotion) Order 2005
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
MiFID	Markets in financial instruments directive
PCIS Order	FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001
QIS	Qualified investor scheme(s)
RDR	Retail Distribution Review
SPV	Special purpose vehicle
TLPI	Traded life policy investment
UCIS	Unregulated collective investment scheme(s)

Glossary of useful terms and definitions

Non-mainstream pooled investments	Pooled investments or 'funds' characterised by unusual, speculative or complex assets, product structures, investment strategies and/or terms and features. They are unregulated collective investment schemes; securities issued by special purpose vehicles; qualified investor schemes; and traded life policy investments. Note that not all pooled investments meet the statutory criteria for a 'collective investment scheme'; pooled investment special purpose vehicles, notably, do not generally amount to a collective investment scheme.
Regulated collective investment scheme(s)	A collective investment scheme (CIS) is a type of pooled investment defined by section 235 of The Financial Services and Markets Act 2000 (FSMA). Regulated CIS are FSA-authorized or recognised non-UK CIS and, apart from qualified investor schemes, may be marketed to any UK investor. Regulated CIS must comply with detailed rules on how they are to be operated, including investment and borrowing powers, prudent spread of risk, information to investors, fees, and other provisions aimed at setting appropriate standards of investor protection.
Unregulated collective investment scheme(s) or UCIS	A UCIS is a CIS in relation to which the operator has not applied for FSA authorised or recognised scheme status. They are not generally subject to FSA or similar overseas rules on the operation of collective investment schemes. UCIS may not be promoted to the general public (including through advised sales). Authorised persons may only promote UCIS to an investor who falls within one of the categories in COBS 4.12 or an exemption in the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (PCIS Order).
The Promotion of Collective Investment Schemes) (Exemptions) Order 2001(PCIS Order)	Section 238 of FSMA prevents the promotion of UCIS by authorised persons except when undertaken in accordance with secondary legislation determined by HM Treasury (the PCIS Order) or rules made by the FSA (in the conduct of business sourcebook (COBS) 4.12). The PCIS Order is available at: www.legislation.gov.uk/uksi/2001/1060/contents/made and was amended in 2005: www.legislation.gov.uk/uksi/2005/270/contents/made .
The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (FPO)	Section 21 of FSMA prevents the promotion of financial services products by unauthorised persons except when undertaken in accordance with the FPO. The FPO is available at: www.legislation.gov.uk/uksi/2005/1529/contents/made .

Retail investor(s)	<p>A retail investor is a person who invests in their capacity as a retail client – that is, a client who is neither a professional client nor an eligible counterparty. Professional clients and eligible counterparties are defined in COBS 3 and, generally speaking, are institutional clients and individuals who invest by way of business. In this paper we distinguish between three types of retail customer:</p> <p>(i) Sophisticated investor(s) Retail clients meeting the criteria for categorisation as sophisticated investors under the relevant PCIS Order and FPO exemptions. These are retail clients with extensive investment experience and knowledge, who are better able to understand the risks of complex and unusual investments.</p> <p>(ii) High net worth individual(s) Retail clients meeting the criteria for categorisation as high net worth individuals under the relevant PCIS Order and FPO exemptions. Among the criteria are having an annual income of more than £100,000 or having investable net assets of more than £250,000.</p> <p>(iii) Average or ordinary retail investor(s) In this Consultation Paper we use the terms ‘average retail investor’ and ‘ordinary retail investor’ to refer to retail clients who are neither sophisticated investors nor high net worth individuals. These are the investors of ordinary means and experience who make up the vast majority of the retail market in the UK. As discussed in a recent consultation paper by the International Organization of Securities Commissions (IOSCO), such investors face difficulty understanding the terms and features of complex financial products.* Such investors are at particular risk in relation to inappropriate promotion of non-mainstream pooled investments.</p>
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* *Suitability requirements with respect to the distribution of complex financial products, Consultation Report, CR 03/12, IOSCO, February 2012*

1

Overview

Why we are consulting

- 1.1 We have found that the majority of retail promotions and sales of unregulated collective investment schemes (UCIS) that we have reviewed fail to meet our requirements, exposing ordinary investors to significant potential for detriment. This demands action. We are proposing to intervene in the market by changing our rules to ban the promotion of UCIS and close substitutes to ordinary retail investors in the UK. For more information on the current UCIS market please refer to Annex 1.
- 1.2 This consultation takes forward some of the proposals outlined in last year's product intervention Discussion Paper.¹ There, we raised the possibility of restricting marketing of certain products so they only reach customers for whom they are more likely to be suitable. This is the central proposal in this consultation.

Who should read this Consultation Paper?

- 1.3 This consultation will be of interest to:
- firms promoting UCIS and close substitutes to retail customers through marketing materials or advised sales;
 - product providers offering these products or which allow access to them through investment wrappers;
 - providers that create investments, including structured products, that take the legal form of securities issued by a special purpose vehicle;
 - compliance consultants and other firms that assist distributors;

1 *Product intervention*, Discussion Paper, DP11/1, January 2011

- consumers and consumer organisations; and
- as many of the products are operated from other jurisdictions, we invite feedback from overseas regulators, the EU Commission and any other interested regulatory bodies.

CONSUMERS

This paper focuses on meeting our consumer protection objective by reducing the risk of consumer detriment from inappropriate promotions of UCIS and close substitutes.

Our proposals ban firms from promoting these investments to ordinary retail customers.

Other retail customers – sophisticated investors and, to a lesser extent, high net worth individuals – may be better able to protect their own interests, so firms will still be able to promote these investments to them.

Background

- 1.4 In recent years returns on more traditional investments – such as investments in the shares and fixed interest securities of listed companies, or in pooled investments such as regulated collective investment schemes (CIS) – have been volatile and often disappointing for investors. This has prompted many consumers to consider alternative investment propositions in the hope of stronger returns or greater security. It is in this context that we have seen increased retail uptake of UCIS and close substitutes.² In this paper, we refer to UCIS and close substitutes collectively as ‘non-mainstream pooled investments’.
- 1.5 There are good reasons why these investments should not be considered mainstream. While many of them may appear at first sight to offer more competitive returns and may be promoted as – and appear – lower risk, very often they are higher risk, speculative investments. Many of these products are pooled investments or ‘funds’ but adopt legal structures such that rules on regulated CIS do not apply to them. This means these investments are not subject to the rules governing, for instance, investment and borrowing powers, disclosure of fees and charges, management of conflicts of interest, a prudent spread of risk and other investor safeguards. While this leaves the investment operators greater liberty to pursue new or unorthodox investment strategies, it also means investors generally place their capital at greater risk than would be the case for more mainstream investments.
- 1.6 Non-mainstream pooled investments also often invest in assets which typically are not traded in established markets and which are therefore difficult to value and may be highly

² As explained in the *Retail Conduct Risk Outlook 2012*.

illiquid.³ Risks to capital are generally opaque and performance information may be unavailable or unreliable. Governance controls may be weak, heightening the potential for a product to fail.

- 1.7** While professional investors and more sophisticated retail clients may be better able to protect their own interests, ordinary retail clients face significant risk of detriment. Generally speaking, UCIS and other non-mainstream pooled investments are niche products unlikely to be suitable for the average or ordinary retail investors who make up the vast majority of the retail market in the UK.
- 1.8** Though no restrictions are currently in place in relation to the promotion to retail investors of other non-mainstream pooled investments, the promotion of UCIS is already restricted by a combination of primary and secondary legislation and our rules.
- 1.9** UCIS may not be promoted to the general public and marketing of these products is only allowed where an exemption is available. Our supervisory and enforcement findings suggest that these restrictions are widely misinterpreted, poorly understood and sometimes simply ignored, undermining the consumer safeguards they are intended to provide.⁴ In particular, we have found that many distributor firms do not understand that providing financial advice generally includes making a financial promotion.
- 1.10** Our supervisory work has shown that many advised sales of UCIS are unsuitable and many advisers are not complying with the current rules. We are aware of distributors who have been promoting UCIS to consumers without first seeking to acquire the specialist knowledge needed to understand these products, their associated risk profile and the statutory requirements for their lawful distribution.
- 1.11** In a recent review of UCIS sales only one case in every four appeared suitable for the customer.⁵ Almost two-thirds of distributors in the review failed to understand the existing restrictions on the promotion of these products to retail customers. We have since taken enforcement action against seven firms and 13 individuals.⁶
- 1.12** At the same time, providers have not done enough to prevent inappropriate distribution of their products. In some cases, providers have actively encouraged promotion to the general retail market. For instance, some have offered high rates of commission to distributors without putting in place any accompanying measures to ensure their products are not marketed to a wider range of customers than would be appropriate or lawful.
- 1.13** Our work has identified situations where members of the general public have been invited to invest in pooled investments based on the performance of unusual assets such as traded life policy investments (TLPs), fine wines, crops and timber. Examples include:

³ Illiquid assets can be difficult to sell quickly or without reducing the price substantially.

⁴ We have published information on our work and findings on this page: www.fsa.gov.uk/smallfirms/your_firm_type/financial/investment/ucis.shtml

⁵ *Unregulated collective investment schemes: project findings*, July 2010

⁶ Our recent enforcement cases in this market: www.fsa.gov.uk/smallfirms/your_firm_type/financial/investment/ucis-enforcement-notice.shtml. See Annex 2 for further discussion of our enforcement activity.

- an 88-year-old being advised to switch 70% of her investments from mainstream investment bonds, totalling nearly £1m, into two UCIS funds;
- pensioners being advised to invest all of their wealth in a single, illiquid UCIS with a view to generating income;
- customers promoted securities in SPVs that invest in TLPs on the basis that they were as safe as deposits; and
- a customer advised to borrow money to invest in UCIS and servicing the debt with withdrawals from that investment.

1.14 Though the risks of these products may not be apparent to investors for a number of years, the Financial Ombudsman Service (FOS) has already reported an increase in complaints about UCIS.⁷

1.15 As indicated above, our concerns are not solely related to the promotion of UCIS. In recent years we have seen new products being brought to the market that employ various legal structures to provide access to the same investment strategies as are often seen in UCIS. For instance, we have seen securities issued by special purpose vehicles (SPVs) used to allow retail investment in TLPs. This poses serious challenges for consumer protection for two reasons:

- though the risks involved in these other product types can be equivalent to those presented by UCIS, the current restriction on the promotion of UCIS does not apply to them. So customers may be exposed to similar risks without the safeguards currently in place in relation to the promotion of UCIS; and
- secondly, there is a significant probability of arbitrage where different legal structures that provide similar investment opportunities face different rules. Any attempt to strengthen the rules for UCIS but not for close substitutes may simply push the problem from one part of the market to another.

Our new regulatory approach

1.16 The FSA's new regulatory approach favours intervention in problematic markets to prevent consumer detriment occurring in the first place rather than to remedy it after it arises. We expect this approach will be further developed and pursued in due course by the Financial Conduct Authority (FCA), one of the regulatory bodies that will succeed the FSA in 2013.

1.17 Historically our regulatory approach in relation to investments has relied heavily on distributors exercising the necessary care to ensure products are only promoted and sold to the right customers. This approach has not always worked well enough and the high proportion of mis-sales of UCIS found in our review demands action. We propose to

⁷ See the *Financial Ombudsman Service Annual Review 2011/2012* for more discussion on this subject. In cases referred to it, problems have been identified with record keeping, product classification, understanding the regulatory framework and consumers eager to invest in non-traditional investment opportunities at a time when returns on mainstream savings and investments were disappointing.

intervene more firmly by changing our rules to prevent the promotion of UCIS and close substitutes to ordinary retail investors in the UK.

- 1.18** Our proposals may limit choice for some consumers but, as we noted in our product intervention Feedback Statement, not all innovation or choice is in the interests of retail customers.⁸ We are making the judgement that the benefits of improving customer outcomes for most retail investors outweigh the costs to the minority for whom they may be suitable.⁹ We also note that the minority of retail investors for whom a UCIS or similar investment may be suitable are likely to be sophisticated investors, who will still be eligible to receive promotional communications about these products.

Summary of the proposals

- 1.19** The proposed rule changes aim to improve retail consumer outcomes by limiting the promotion of UCIS and close substitutes and ensuring that they are recognised as specialised products unsuitable for general promotion in the UK retail market. As providing financial advice generally includes making a financial promotion, by limiting the promotion of UCIS we aim to limit the number of retail clients being wrongly advised to invest in UCIS.
- 1.20** Specifically, we are proposing the following measures:
- changing the financial promotion rules to limit the type of customer to whom firms may promote financial promotions for UCIS and closely substitutable investments;
 - Handbook guidance on the effect of the financial promotion rules on advised sales to clarify that personal recommendations generally amount to a financial promotion and, as a result of the marketing restrictions, advice on a non-mainstream pooled investment may result in an unlawful promotion if no valid exemption is available;
 - a rule requiring firms to maintain a record of the basis on which the promotion has been made and requiring distribution firms to ensure their compliance oversight function (CF10) confirms the compliance of each financial promotion for products within scope of this consultation, including financial promotions in the context of advised sales, with the marketing restriction rules; and
 - updating the *retail investment product* definition to clarify the position on advice on UCIS and substitutable products in relation to Retail Distribution Review independence requirements.

⁸ *Product intervention*, Feedback Statement, FS11/3, June 2011

⁹ See the cost benefit analysis in Annex 3 for more detail.

Scope

Products within scope of the consultation

- 1.21** Our focus in this paper is on non-mainstream pooled investments, in particular UCIS. To address emerging risks in the retail investment space and to prevent regulatory arbitrage, we are proposing to implement a more comprehensive regime subjecting UCIS and close substitutes to equivalent restrictions. We regard investment in securities issued by many investment SPVs that are used to hold similar assets as UCIS and in qualified investor schemes as close substitutes to UCIS.
- 1.22** We are also taking this opportunity to consult on restricting the marketing of TLPIs to retail customers, no matter what legal form they take. UK consumer experience with these products has been poor and this action is necessary to guard against future detriment.¹⁰
- 1.23** In this paper and the draft rules on which we are consulting, we refer to UCIS and these other investments as non-mainstream pooled investments.

Retail customers who may still receive promotions

- 1.24** We propose that firms wishing to promote non-mainstream pooled investments to retail clients in the future must do so in accordance with the exemptions provided by secondary legislation: the PCIS Order (for UCIS) and the FPO (for other non-mainstream pooled investments). The exemptions allow non-mainstream pooled investments to be promoted where detailed conditions are met. The most relevant exemptions are those permitting promotion of these investments to:
- customers certified as sophisticated investors;¹¹
 - customers self-certified as sophisticated investors;¹² and
 - customers who meet the criteria to be regarded as high net worth individuals.¹³

Execution-only sales where no promotional communication was issued

- 1.25** The new rules proposed in this consultation do not include execution-only sales if there has been no financial promotion of the non-mainstream pooled investment. Where it is genuinely the case that a retail customer seeks out an investment, acting entirely on their own initiative (for instance, following their own research on investments) and not in

¹⁰ We promised to consult on these rules in the Finalised Guidance on the subject – *Traded Life Policy Investments*, FG 12/12, finalised guidance, April 2012 – in which we strongly recommended that TLPIs should not reach the vast majority of retail customers.

¹¹ See article 23 of the PCIS Order (for UCIS promotions) or article 50 of the FPO (for promotions of other non-mainstream pooled investments).

¹² See article 23A of the PCIS Order (for UCIS promotions) or article 50A of the FPO (for promotions of other non-mainstream pooled investments).

¹³ See article 21 of the PCIS Order (for UCIS promotions) or 48 of the FPO (for promotions of other non-mainstream pooled investments).

response to any promotional communications of any kind, then the proposals in this paper will not restrict investment.

Indirect retail investment

- 1.26** In this work we are focused on direct retail exposure to non-mainstream pooled investments. We recognise that many regulated investments, which may be marketed without restriction to retail investors, are legitimately able to hold the same products as part of their mix of underlying assets. For instance:
- unit-linked insurance funds sold to retail investors can hold up to 20% in UCIS, provided that all the assets inside them meet certain requirements as set out in our rulebook and they publish their prices regularly;¹⁴ and
 - regulated CIS may hold UCIS as a proportion of their underlying investments.
- 1.27** Given the additional controls and protections on these regulated products we are not considering changes to this type of indirect retail access.
- 1.28** However, to be clear – we do not regard investments that are merely 'wrapped' by another product to amount to indirect investment. Investment through products such as Individual Savings Accounts, self-invested personal pension schemes and platform services are, therefore, treated as direct investment for the purposes of this consultation. Under our proposals, investment via wrappers will be subject to the same marketing restriction as any other direct investment in non-mainstream pooled investments.

Non-retail sales

- 1.29** We are consulting on changes only in relation to retail investment. The proposals have no impact on promotions to other types of customer, such as professional clients or eligible counterparties.

Structure of this paper

- 1.30** This paper is structured as follows:
- Chapter 2 provides more detail on the products that are the subject of this consultation.
 - Chapter 3 outlines our proposals for the marketing restriction.
 - Chapter 4 summarises our other proposed changes.
 - Chapter 5 provides further information for customers who already hold investments in non-mainstream pooled investments.

¹⁴ The FSA Handbook is available at <http://fsahandbook.info/FSA/html/handbook>. See COBS 21

- Annex 1 summarises the current market for non-mainstream pooled investments.
- Annex 2 gives more detail on our ongoing supervisory and enforcement activity for UCIS.
- Annex 3 sets out the cost benefit analysis for the rules on which we are consulting.
- Annex 4 explains why our proposals are compatible with our general duties and our regulatory objectives.
- Annex 5 lists the questions posed in this Consultation Paper.
- Appendix 1 contains the draft Handbook text on which we are consulting.
- Appendix 2 shows how the Handbook provisions will be designated when the two new regulatory bodies, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), acquire their legal powers.

Equality and diversity issues

- 1.31** We have assessed the equality and diversity impact of our proposals and do not believe that they will give rise to any issues. However, we would welcome any comments on this.

Next steps

- 1.32** This consultation closes on 14 November 2012. We intend to publish a Policy Statement providing feedback and setting out the finalised rules and guidance in the first quarter of 2013.

2

Non-mainstream pooled investments

- 2.1 In this chapter we provide more detail on the non-mainstream pooled investments that are within scope of this consultation:
- unregulated collective investment schemes;
 - qualified investor schemes;
 - securities issued by special purpose vehicles; and
 - traded life policy investments.
- 2.2 See Annex 1 for information on the current market for these products.
- 2.3 These products commonly involve one or more of the following characteristics:
- they feature complex or opaque investment strategies, structure, features, or terms and conditions, such that ordinary retail investors are unlikely to fully understand or be able to adequately assess the investment proposition and its risks;
 - they are, or hold, inherently speculative, high-risk underlying assets;
 - they are, or hold, underlying assets that have a very limited or no secondary market and are therefore potentially illiquid;
 - they are difficult to value accurately (so that their valuations require specific skills or systems);
 - their product structures are less regulated and therefore likely to hold greater operational and governance risks for investors; or
 - underlying assets or investment strategies that are relatively new to the financial services market, or not commonly marketed to retail investors, who are therefore unable to use experience to guide their investment decisions.

- 2.4 Non-mainstream pooled investments may also present one or more of the following problematic features we identified in Chapter 3 of the product intervention Discussion Paper:¹⁵
- investment characteristics or performance risks which may not be apparent until a considerable time has passed from the date of investment;
 - inherent conflict of interests, such as those that arise where distributors have links to the product provider, that may be damaging to investors; or
 - charges that do not appear to reflect the level of service provided, or which may in themselves increase the investment risks involved.

Unregulated collective investment schemes

- 2.5 In the Overview to this paper, we explain our concerns with UCIS and the current regulatory framework that applies to them.
- 2.6 With their ability to invest in a potentially limitless range of assets and projects, risks will vary from fund to fund but are generally higher than those presented by regulated CIS, which are subject to more stringent rules on how they can operate. UCIS products are generally unsuitable for ordinary retail investors.
- 2.7 Our existing rules are intended to prevent UCIS from being marketed to the general public. However, it appears that inappropriate promotions are commonly made such that ordinary retail investors are being exposed to investments they do not properly understand and to risks they may be unable or unwilling to take with their capital.

Qualified investor schemes

- 2.8 The current regime is inconsistent in that, where non-mainstream pooled investments do not take the legal form of a UCIS, the restrictions on promotion to the general public do not apply. So there is potential for arbitrage if we act to improve UCIS standards but do not impose equivalent restrictions in relation to these other products.
- 2.9 Qualified investor schemes (QIS) represent one of the investment types that can expose investors to risks not dissimilar to UCIS investment. The QIS regime was set up to allow greater investment flexibility to more sophisticated investors and professional investors within a regulated investment framework.¹⁶ QIS fund managers must act as gatekeepers to ensure that only ‘qualified investors’ are able to buy units in the fund. The ‘qualified investor’ criteria are defined in our rules and are generally the same as the promotion categories for UCIS.¹⁷

¹⁵ *Product intervention*, Discussion Paper, DP11/1, January 2011

¹⁶ See COLL 8.1.2G and COLL 8.1.4G(1) of the FSA Handbook, available at www.fsahandbook.info/FSA/html/handbook.

¹⁷ See COLL 8 Annex 1 of the FSA Handbook available at www.fsahandbook.info/FSA/html/handbook.

- 2.10** However, QIS fund managers will not always be able to identify the end customer. This is particularly a problem where the QIS is wrapped in a platform or other nominee service. Fund managers may therefore be unable to prevent the registration of units to ordinary retail investors for whom they were not designed. In any event, in practice QIS fund managers tend to rely on distributors for the appropriate selection of investors.
- 2.11** We are proposing that QIS should be subject to similar marketing restrictions as UCIS to improve protection for ordinary retail customers. In this respect our proposals have the result of equalising the rules on promotion and registration of units in QIS. The current guidance in the Collective investment schemes sourcebook (COLL) 8.1 already explains that these investments are intended for sophisticated investors only.

Special purpose vehicles

- 2.12** SPVs are corporate bodies that can be set up for a number of purposes. Typically they are created to meet a specific short-term need. For example, a company may transfer assets into a SPV to facilitate a particular project.
- 2.13** Of concern to us in this consultation is the use of SPVs as an investment vehicle to pool investment assets traditionally found within UCIS, whether or not this is done deliberately to avoid the restrictions that apply to the promotion of UCIS. Pooled investment SPVs can and often do carry similar risks to UCIS in terms of operation, structure, governance standards and the choice of underlying assets. They can be used to effectively deliver an identical investment strategy as a UCIS fund. Any attempt to protect ordinary retail consumers from the risks associated with UCIS will fail unless the same rules apply to securities issued by SPVs.
- 2.14** We are aware that investment trusts, covered bonds and mainstream structured products can or do take the legal form of securities issued by SPVs. The proposed rules are drafted to ensure that these products are not caught by the marketing restriction on non-mainstream pooled investments. Some structured products should be caught. This is intentional; where a structured product's risk profile or investment strategy are non-mainstream by virtue of their reference assets, they should be subject to the same restrictions and consumer safeguards as other non-mainstream pooled investments.

Traded life policy investments

- 2.15** TLPIs invest in second-hand life insurance policies of US citizens. They are sometimes also known as Traded Life Settlements or Senior Life Settlements. TLPIs may take a variety of legal forms. Among those we have encountered are UCIS, QIS, and securities issued by SPVs, but it is possible that they could be structured in yet other legal forms.

- 2.16** We have found serious problems with how these products are designed, marketed and sold to retail investors. They are generally higher risk, complex and opaque products, but are often marketed as low risk on the basis of being uncorrelated with mainstream investments. Many ordinary retail investors have bought them looking for safe returns. But many of these products have failed, causing significant consumer detriment. So we do not think they are suitable products for ordinary retail customers. We have published guidance strongly recommending that these products should not reach the vast majority of retail investors in the UK.¹⁸
- 2.17** Although we are now consulting on new rules that will restrict the marketing of these products, the guidance is intended to address issues in the market in the meantime. In the FSA's view, TLPIs are not suitable for ordinary retail investors and should not be promoted to them. If an adviser is considering recommending one of these products to a retail investor, they should take careful account of our guidance.
- Q1:** Do you agree that we should look to impose restrictions on the promotion of non-mainstream pooled investments to ordinary retail investors?
- Q2:** Are there any other investments that should be treated in the same way?
- Q3:** Are there any investments caught by the non-mainstream pooled investment definition in the draft rules that you believe should not be?

¹⁸ *Traded Life Policy Investments*, FG 12/12, finalised guidance, April 2012

3

Proposed changes to the marketing restriction

- 3.1** Under current rules, whether sold with or without advice, promotions of UCIS should only reach the specific categories of customer for whom an exemption is available under the PCIS Order or in our rules. However, the flexibility allowed within our rules has often been misunderstood or exploited to the potential detriment of consumers. We intend to amend existing rules to address the risk of consumer detriment.
- 3.2** Other investment forms that are closely substitutable for UCIS are not currently subject to the same regulatory constraints on their promotion. This leads to potentially greater risks for retail investors. The differential treatment may incentivise firms to use non-UCIS legal structures to market the same assets, particularly as we look to improve consumer protection in relation to UCIS. We want to introduce rules that address the emerging risk to consumers posed by these other product structures and to prevent regulatory arbitrage.
- 3.3** We also propose to update the guidance in COBS 4.1.9G(3). This guidance relates to the application of the financial promotion rules to communications into the UK from another European Economic Area (EEA) State. We are changing this to note that the rules in COBS 4.12 are applicable in relation to such communications. For added clarity, we are removing the final sentence of this guidance, recognising that the rules in COBS 4.12 do apply to incoming communications.

Categories of customer to whom firms may promote UCIS

- 3.4** We intend to remove some of the categories of customer to whom firms may promote UCIS: existing investors (under COBS 4.12.1R(4) category 1); advised investors (under COBS 4.12.1R(4) category 2); and investors who have the expertise, experience and knowledge to be capable of making their own investment decisions (under COBS 4.12.1R(4) category 8).

- 3.5** Where firms wish to market UCIS to retail customers in the future they will need to consider whether an exemption in the PCIS Order is available or whether one of the remaining exemptions in COBS 4.12.1R applies. In effect, this should prevent firms from marketing UCIS to ordinary retail customers.
- 3.6** At present, category 1 in COBS 4.12.1R(4) allows firms to promote UCIS to people who are already participants in a UCIS or who have been in the last 30 months. As the quality of promotion and sales in the past has been so poor, this category could compound potential consumer detriment by allowing further promotion to investors on the basis of an investment that may have been unlawfully promoted and/or unsuitably recommended. In general, therefore, we propose to remove the ability of firms to promote UCIS to retail customers under this category.
- 3.7** In the future, we propose that this category will only be available where the UCIS being promoted is intended to absorb or take over the assets of the investor's existing holding, or where the investment is offered by the operator of the investor's existing product as an alternative to cash on its liquidation.
- 3.8** While there is still a risk that the original investment may have been mis-sold and the replacement investment may not be any more appropriate than the original one, we consider that it is preferable for customers to hear about the planned replacement product than have to accept a return of funds without any choice in the matter.
- Q4:** Do you agree that we should remove the general ability of firms to promote UCIS under COBS 4.12.1R(4) category 1?
- Q5:** Do you agree that firms should still be able to promote replacement UCIS to retail customers where the original product is being replaced or liquidated?
- 3.9** Category 2 of COBS 4.12.1R(4) allows authorised firms to promote UCIS to people for whom they have deemed the product to be suitable.
- 3.10** We propose to remove this category completely. Our supervisory work has found it to be the most often used exemption for inappropriate promotions of UCIS to retail clients, with many firms appearing to regard the exemption as allowing promotion to any retail client so as long as advice is given. Set against a background of generally poor quality UCIS advice by firms to retail clients, this exemption represents a particular weakness in the current regime which must be addressed.
- 3.11** We consider that the certified sophisticated investor, self-certified sophisticated investor and the certified high net worth category exemptions in the PCIS Order provide more appropriate measures for retail access to UCIS and would thus improve the level of protection for consumers.

Q6: Do you agree that we should remove the ability of firms to promote UCIS under COBS 4.12.1R(4) category 2?

- 3.12** Essentially, category 8 customers in COBS 4.12.1R(4) are intended to be sophisticated, highly-experienced investors. They were described as ‘expert private customers’ before MiFID-related changes to the conduct of business sourcebook were implemented in 2007.
- 3.13** With the removal of the suitability-based exemption currently applicable to category 2 customers, we are concerned that firms may turn to category 8 as a gateway to promote UCIS inappropriately to ordinary retail customers. The apparent inability of many distributors to perform a reasonable suitability assessment for UCIS, as currently required under category 2, leads to a concern that similar failings would materialise when assessing a customer’s expertise, experience and knowledge.
- 3.14** We believe it will improve customer outcomes if, for relevant customers, firms rely on the certified sophisticated investor exemption provided by article 23 of the PCIS Order instead of COBS 4.12.1R(4) category 8. The article 23 exemption sets out a number of procedural requirements and warnings to investors with which firms must comply and which should offer some protection against firms wrongly classifying retail investors for the purposes of marketing UCIS.
- 3.15** It is also important to note that retail clients can still elect to be treated as professional clients.¹⁹ If they meet the criteria and opt to be treated in this way, UCIS may be promoted to them under COBS 4.12.1R(4) category 7 (which allows promotion to professional clients and eligible counterparties).

Q7: Do you agree that we should remove the exemption in COBS 4.12.1R(4) category 8?

- 3.16** We are also taking this opportunity to update the wording in the second column of the table in COBS 4.12.1R(4) to refer to ‘unregulated collective investment schemes’ rather than ‘collective investment schemes’ to improve the clarity of the rules.

Extending the scope of the marketing restriction

- 3.17** We have found that other legal forms are increasingly being used that expose investors to substantially similar or the same risks as UCIS.
- 3.18** There is a high risk of regulatory arbitrage if we strengthen consumer protection measures in relation to the promotion of UCIS but not products that are closely substitutable. So we intend to introduce a new provision in COBS 4.12 to stop firms marketing certain investments (i.e. QIS, securities issued by SPVs and TLPIs) to ordinary retail customers.

¹⁹ For rules on the categorisation of clients as professional clients, see COBS 3.5.

- 3.19** Firms wishing to promote these products to retail customers will be able to do so if the customer meets the criteria in one of the exemptions in the FPO.²⁰ These are similar to those in the PCIS Order, so firms will be able to promote QIS, securities issued by SPVs and TLPIs to retail customers categorised as sophisticated or high net worth. An additional exemption is provided in our rules to allow promotion in circumstances equivalent to the category 1 exemption applicable for UCIS in 4.12.1R, as amended in the way explained above. This approach creates a broadly level playing field for UCIS and closely substitutable investments.
- 3.20** We have drafted the rules so that intermediaries may continue to provide advice to existing investors, including ordinary retail investors, on whether they should keep an existing investment or disinvest in favour of a more suitable, more mainstream investment.
- Q8:** Do you agree that we should limit the ability of firms to promote QIS, securities issued by SPVs and TLPIs in the retail market?

Qualified investor schemes

- 3.21** As QIS should only be sold to sophisticated investors at present, the proposal should help QIS fund managers meet their existing responsibilities. Under the proposed new rules, QIS may only be promoted to a retail investor where an exemption is available under the FPO order or where the person is an eligible investor under one of the categories in COLL 8 Annex 1 (as amended – see below).
- 3.22** Pending confirmation of changes as a result of the implementation of the AIFMD in summer 2013,²¹ we also propose to make the same changes to the qualified investor criteria as to the UCIS marketing categories.²² This will create a level playing field and avoid the possibility of regulatory arbitrage.
- 3.23** We still expect QIS fund managers to take care to ensure that ownership in units in their schemes is not registered to retail investors who are not sophisticated. Where they rely on information provided by, for instance, distributor firms, fund managers must act in the best interests of the customer and be able to show that such reliance is reasonable.

²⁰ In practice, firms that wish to promote non-mainstream pooled investments other than UCIS to sophisticated and high net worth retail investors will be able to do so if the promotion is an ‘excluded communication’. Excluded communications include financial promotions that would benefit from an exemption in the FPO if they were made by an unauthorised person. Essentially, this means that authorised persons can make use of the FPO exemptions, including those for sophisticated and high net worth retail customers. Authorised persons must still comply with our high-level requirements to act in the best interests of clients and, where advice is provided, to ensure the advice is suitable.

²¹ The detail on how AIFMD provisions will be implemented is still being developed. See *Policy options for implementing the Alternative Investment Fund Managers Directive*, HM Treasury, March 2012 and *Implementation of the Alternative Investment Fund Managers Directive*, FSA, Discussion Paper, DP12/1, January 2012.

²² The qualified investor criteria for QIS are in COLL 8 Annex 1 of the FSA Handbook: available at www.fsahandbook.info/FSA/html/handbook. We are taking this opportunity to update the wording in the second column of the table in this annex to refer to ‘qualified investment schemes’ rather than ‘collective investment schemes’ to improve the clarity of the rules.

Special purpose vehicles

- 3.24** As noted in Chapter 2, the SPVs of concern to us in this consultation are those that are used as means to pool investments, in a way not dissimilar to UCIS but not subject to the current protections of the UCIS regime. SPVs do however encompass a wide range of corporate and financial uses. We have sought to develop a definition that only captures pooled investment SPVs that are functionally most similar to UCIS. As such, investment trusts and covered bonds, both of which can take the legal form of securities issued by SPVs, are specifically carved out from the scope of our proposed rules.
- 3.25** Structured products also often amount to an SPV-issued security, albeit packaged together with a derivative or another feature transferring price or credit risk. As such, reference to SPV-issued securities would in principle capture most of these investments. We recognise that structured products encompass a wide range of instruments with varying levels of complexity and investment risk. The FSA has been working on improving standards in the structured products market and they are not the main subject of this consultation paper.
- 3.26** Nonetheless, as noted above, some structured products should be caught by our proposed rules. If these products are completely excluded from scope, product providers might structure similar offerings as would be seen in a UCIS or in other SPV-issued securities as a structured product so as to evade the marketing restriction. Ordinary retail investors would then be exposed to similar risks as seen in UCIS, defeating the aims of these proposals. We therefore propose that some structured products should be included in the scope of the rules on non-mainstream pooled investment. As noted above, we consider that where a structured product's risk profile or investment strategy are in effect non-mainstream by virtue of their reference assets, they should be subject to the same restrictions and consumer safeguards as other non-mainstream pooled investments.
- 3.27** Our draft rules only exclude from scope SPV-issued securities, whether or not they are structured products, where the returns are determined by reference to listed stocks (including baskets of stocks) or one or more stock market indices. Where the investment returns are calculated with reference to any other asset, the product will be subject to the marketing restriction.²³
- 3.28** We recognise that some structured products provide returns on indices other than stock markets (for example house prices or inflation). Where structured products are based on other mainstream indices and a provider wishes to market the product to ordinary retail investors, we will consider waiver requests under the normal process on a case-by-case basis, to ensure that the product is not in effect a non-mainstream pooled investment designed to circumvent the marketing restriction.²⁴ We note that structured deposits are not intended to be caught by our proposed rules.

²³ There were over 500 structured products launched with this legal form over the course of 2011. Of these, only 27 would fall within the draft definition of a non-mainstream pooled investment.

²⁴ More information on our waiver process is available here: www.fsa.gov.uk/doing/regulated/notify/waiver/. Firms requesting a waiver must be able to demonstrate that compliance with the rule would be unduly burdensome or would not achieve the rule's purpose; and anyone whose interests are protected by the rule would not be put at undue risk.

3.29 The ability of firms to market more speculative structured products to retail customers will be limited. Firms wishing to market products like these will be able to promote them to retail customers categorised as sophisticated or high net worth under the FPO. Generally speaking they will not be able to promote them to ordinary retail investors.

Q9: Do you have any comments or suggested improvements for our approach to SPV-issued securities, including structured products?

Traded life policy investments

3.30 Many TLPIs take the legal form of UCIS. Others are structured as QIS or securities issued by SPVs. Given our concerns about the promotion and sale of these products to ordinary retail investors, we propose to guard against the future development of new legal structures of investment that could bypass the rules we are consulting on here. So our proposed rules prevent the marketing of any designated investment that invests wholly or predominantly in life settlements to ordinary retail customers.²⁵

Guidance on the use of PCIS Order and FPO exemptions

3.31 We propose to introduce guidance in COBS to help firms understand their obligations when relying on the exemptions in the PCIS Order and FPO (the Orders). The guidance provided in the draft rules focuses on promotional communications. Where the promotion of non-mainstream pooled investments takes place in the context of advice, firms are also subject to the rules on suitability as set out in COBS 9.

3.32 Firms should note in particular that the availability of an exemption permitting promotion does not mean the product is suitable for a client. Generally speaking, the FSA considers that non-mainstream pooled investments are not suitable for distribution to ordinary retail investors. Promotions (including recommendations) of these products to ordinary retail investors are unlikely to be appropriate or suitable. Firms should not promote products, even where an exemption is technically available, if it would not be appropriate or in the customer's best interests.

Certified sophisticated investors

3.33 Firms looking to rely on one of the certified sophisticated investor exemptions in the Orders should ensure that clients genuinely have the requisite level of knowledge, experience and expertise if they are to be certified as sophisticated investors. These are not retail clients with only some experience with investments. They are seasoned investors with many years' experience and exposure to of a wide range of investments, including complex

²⁵ This approach applies to TLPIs only. It does not apply to traded endowment policies.

financial instruments. The investor and the firm should both be confident that the investor is well able to make their own assessment of the terms and conditions, the risks and the strategy of the investment proposition in contemplation.

- 3.34 We do not think retail customers should be certified as sophisticated if their investment experience is limited to mainstream investments and they lack substantial experience with or knowledge of complex financial instruments, unregulated investment structures or unusual or exotic investment assets.

Self-certified sophisticated investors

- 3.35 A firm intending to rely on these exemptions to promote a non-mainstream pooled investment should take reasonable steps to ensure that the client does in fact have the requisite experience, knowledge or expertise to understand the risks of the product in question.
- 3.36 Where a client has self-certified as a sophisticated investor, firms must still consider whether it is fair and in the client's best interests to promote a particular non-mainstream pooled investment to them.
- 3.37 Clients who self-certify as sophisticated must meet one of the categories of experienced investor outlined in the exemption and receive the required warnings. Not all non-mainstream pooled investments may be promoted under these exemptions. Firms must be careful in their analysis of whether a particular product may be promoted under the terms of the relevant articles in the Orders.

Certified high net worth individuals

- 3.38 For a certified high net worth individual, firms should take reasonable steps to check that the customer does in fact meet the income and asset criteria set in the PCIS Order and FPO to make use of the exemption.
- 3.39 Firms should also consider whether it is in the client's best interests and fair to promote a particular non-mainstream pooled investment. In particular, customers who meet the criteria to be considered high net worth but who do not also meet the criteria to be considered sophisticated may be unable to understand and evaluate the risks of the product in question. In other words, meeting wealth-based criteria does not necessarily mean the investor is any more sophisticated than a retail investor of ordinary means.
- 3.40 Firms should note that investment in non-mainstream pooled investments may be inappropriate for a wide range of high net worth investors, notably where the risks or investment strategy are not properly understood or where the investment horizons are longer than would be appropriate (for instance, in relation to elderly investors). The examples cited in paragraph 1.13 illustrate how high net worth customers may suffer detriment as a result of mis-sold non-mainstream investment products.

- 3.41 As with the self-certified exemptions, not all non-mainstream pooled investments may be promoted under the high-net worth investor exemptions. Firms must be careful in their analysis of whether a particular product may be promoted under the terms of the relevant articles in the Orders.

One-off communications

- 3.42 Another set of exemptions that may be relevant are the one-off communication exemptions.²⁶ These exemptions may be particularly relevant where a firm is asked to advise on a specific non-mainstream pooled investment upon a client's request, allowing them to discuss the investment without risking infringing the marketing restriction. They allow firms to make communications to one recipient – or one group of recipients who invest jointly – where the communication is not part of a marketing campaign. That is, the firm must not be regularly promoting the investment to customers as such communications are unlikely to meet the requirements of the exemption.
- 3.43 We expect any firm contemplating these exemptions to consider very carefully whether promoting non-mainstream pooled investments is in the client's best interests and fair in the circumstances. Unless the customer also meets the criteria to be considered high net worth or sophisticated, the promotion will almost certainly be inappropriate and not in the client's best interests. Similarly, where advice is provided, generally speaking we would expect advisers to conclude that the product is unsuitable for any customer who does not meet the criteria to be considered high net worth or sophisticated under the relevant exemptions.
- 3.44 On that basis, we do not expect there to be significant scope for appropriate use of the one-off exemptions in promoting non-mainstream pooled investments to retail investors.

Qualified investor schemes

- 3.45 Firms relying on one of the exemptions to market a QIS must also consider whether the promotion is in the best interests of the customer. As explained in COLL 8.1, these schemes are intended for sophisticated customers only.²⁷ So, unless the customer meets the criteria to be considered sophisticated the promotion is highly unlikely to be in their best interests.

Q10: Do you have any comments on the Handbook guidance we propose to add regarding the use of exemptions in the FPO and PCIS Order?

²⁶ See articles 15 and 15A of the PCIS Order and articles 28 and 28A of the FPO.

²⁷ COLL 8.1.4G(1)

4

Other proposals

- 4.1 To support the new marketing restrictions, we are also proposing to make additional changes to ensure firms take their responsibilities seriously and keep an appropriate record of any promotion of non-mainstream pooled investments to a retail investor. This reflects our view that these investments are generally unsuitable products for ordinary retail investors.

Confirming the basis of promotion and of compliance

- 4.2 We have existing requirement in the rules for Senior Management Arrangements, Systems and Controls (SYSC) 3 and 4 that mean firms must put in place systems and controls in order to comply with the rules on communicating with clients, including financial promotions, set out COBS 4.²⁸ So we expect firms already to have proper policies and procedures in place designed to ensure the compliance of financial promotions, including advised sales, with the marketing restrictions.
- 4.3 To improve compliance with the rules and thus secure better consumer outcomes, we propose to introduce a new, more specific rule requiring firms to document and retain records of the precise basis on which they make each promotion of a non-mainstream pooled investment to a retail client. This should set out which COBS 4.12 category, PCIS Order or FPO exemption or, for QIS, eligible investor category has been used and the basis for that decision. Where advice is given, firms should already record their detailed reasoning for recommending the investment to a retail investor.
- 4.4 Given the problems observed to date and building on existing high-level responsibilities for senior managers, we propose to introduce a new rule that requires the individual responsible for a firm's compliance oversight function (CF10) to confirm, in respect of each promotion of a non-mainstream pooled investment, that the promotion complies with the marketing restriction rules.

²⁸ SYSC sets out the responsibilities of directors and senior management. <http://fsahandbook.info/FSA/html/handbook/SYSC>. COBS 4.10.1G interprets the requirements in SYSC 3 and 4 with regard to client communications.

4.5 Together these new rules should help ensure that firms pay due regard to the marketing restriction and keep proper records in relation to these transactions, which inherently pose a higher risk of non-compliance with legal and regulatory requirements.

Q11: Do you agree that we should require firms to retain a record of the basis on which the promotion of a non-mainstream pooled investment has taken place for each financial promotion?

Q12: Should we require confirmation of compliance with the marketing restriction for each promotion?

Q13: Do you agree that the CF10 individual is the correct person to confirm compliance?

Guidance on advised sales

4.6 We have found that many distributor firms do not understand that providing advice generally includes making a financial promotion.²⁹ At present this can mean that firms are in breach of the marketing restriction in FSMA as well as the suitability rules when they give unsuitable advice on UCIS. This will become a wider issue with the proposed extension of the marketing restriction to products that are close substitutes for UCIS.

4.7 We therefore propose introducing guidance to explain that promotions in the context of advice are still financial promotions and subject to the marketing restriction rules.

Q14: Do you have any comments on the Handbook guidance we propose to add regarding the link between promotion and advice?

Updating the *retail investment product* definition

4.8 The Handbook Glossary term *retail investment product* (to come into force on 31 December 2012) has a wide scope. It includes any designated investment which offers exposure to underlying financial assets in a packaged form which modifies that exposure

²⁹ Financial promotions are invitations or inducements to engage in investment activity that are communicated in the course of business. Therefore, advice generally includes a financial promotion. Where advice is provided, the firm must ensure it complies with the marketing restrictions in order to avoid a breach of FSMA section 238. We have found that many firms are breaking the law when giving advice on UCIS.

when compared with a direct holding in the financial asset. Many of the products of concern to us in this consultation are likely to be captured by this term.

- 4.9 This term is used in respect to rules coming into force after 31 December 2012, as part of the Retail Distribution Review (RDR).³⁰ The term is relevant for rules on adviser charging, independence, and training and competence. In effect, these rules mean that:
- commission cannot be paid to advisers who recommend these products;
 - firms who give independent advice need to consider whether such products would be suitable for their clients, and to advise on them if they would; and
 - advisers must hold a relevant qualification.
- 4.10 There appears to be some misunderstanding about the effect of this. Some advisers appear to think that they must actually recommend all types of retail investment product in order to demonstrate that they offer independent advice. Some UCIS providers have advertised their products to distributors with comments that advisers who provide independent advice must recommend UCIS. This is incorrect.
- 4.11 As we note in our Finalised Guidance on independent and restricted advice, ‘we do not expect a firm to actually recommend all products captured by the broad definition of retail investment product as a matter of course. It may be possible for a firm to conclude for many clients, early on in the advice process, that certain product types are not going to be suitable, and therefore not consider these product types further for those clients’.³¹
- 4.12 In relation to UCIS, we have said that a ‘firm’s independent status will not be affected if it never recommends these products because it deems them to be unsuitable for its clients.’ In addition, the guidance says that ‘[w]here we have identified high-risk products and recommended that they should not reach retail investors in the UK, a firm would not need to consider them for its clients to meet the standard for independent advice.’
- 4.13 The requirement is that independent advice be based on a comprehensive and fair analysis of all product types that might be suitable for the firm’s retail clients. If a firm holding itself out as offering independent advice does not deal with the types of retail clients who may receive promotions for non-mainstream pooled investments, then it will not need to consider them in its review of product types when giving advice to its retail clients. Firms that do deal with clients who may receive promotions of these investments, on the other hand, may need to include the products in the review of the market for those clients, for instance if the clients have the requisite appetite for risk.
- 4.14 To clarify this in the Handbook, we propose to update the *retail investment product* definition to note the restrictions on the types of customer to whom the products may be marketed.

30 The Retail Distribution Review is a key part of our consumer protection strategy. Further information on it is available here: www.fsa.gov.uk/rdr.

31 Finalised Guidance 12/15, *Retail Distribution Review: Independent and restricted advice*, June 2012

- 4.15** This change should make clearer the interaction between the RDR independent advice requirements and the marketing restrictions in COBS 4.12, and so reduce the scope for misunderstanding and mis-sales.
- 4.16** If the rules in this Consultation Paper are implemented as proposed, there will be a period during which the RDR independent advice rules are in force but advisers may still promote non-mainstream pooled investments under the current rules. To reiterate, we generally view these investments as unsuitable for those ordinary investors who make up the vast majority of the retail market. Even under current rules these investments should not generally be promoted to retail investors who do not meet the criteria to be considered as sophisticated investors. The FSA will not consider firms that decide not to promote these products to ordinary retail customers to be in breach of the RDR independent advice rules.

Q15: Do you agree with our proposed update to the *retail investment product* definition?

Proposals we are not taking forward at this time

Adviser competence standards

- 4.17** We are not currently proposing any additional qualification requirements. Given our other proposals aim to reduce the retail exposure to these products, we do not expect demand for such a qualification to be sufficient to justify any qualification body developing an exam for it.

Permissions for firms

- 4.18** We are not proposing the introduction of a specific permission to promote or sell non-mainstream pooled investments. We believe that the impact of the other proposals in this consultation should be sufficient to reduce the scope for detriment to retail customers.
- 4.19** Introducing a new permission would also result in high costs for all distributors, whether or not they sell these products. It would mean changing existing permissions for all firms that currently hold the relevant permissions relating to arranging and advising on investments and, at present, we do not believe that it is necessary to impose these costs on the industry. We may revisit this decision, however, if the quality of promotions and of resulting sales does not improve.

Renaming 'unregulated' collective investment schemes

- 4.20** We have found that some firms do not understand the term *unregulated collective investment scheme*. They mistakenly regard UCIS as fully 'unregulated' and believe that our

rules do not apply to their promotion and sale, or to any aspect of their relationship with clients investing in these products.

- 4.21** At one stage we considered creating a different name to avoid this misinterpretation. We propose not to do this however as the term *unregulated scheme* is used in the PCIS Order. Renaming the product in our rules alone would therefore result in two terms for the same product and is therefore unlikely to improve clarity for these firms.
- 4.22** Our proposals instead create the concept of *non-mainstream pooled investments*, which include UCIS. In the future, we expect this term to be used more than the UCIS term and the potential for misunderstanding to be reduced.

5

Existing customers

- 5.1 In this chapter we summarise the position for retail consumers with existing exposure to non-mainstream pooled investments and the firms that advise these consumers.

Distributor firms

- 5.2 Distributor firms might be concerned that the proposed changes to the rules mean they cannot provide ongoing advice to retail customers who already have exposure to one of the products covered in this consultation. This is not the case.
- 5.3 The proposed marketing restrictions are drafted specifically so as to permit advice on the ongoing suitability of an investment which a customer already owns. Advice to keep a current investment unchanged or to disinvest in favour of a more suitable, more mainstream investment would not be caught by the marketing restriction. However, a recommendation for further investment into an existing non-mainstream pooled investment *will* be subject to the marketing restrictions.³²

Customers with existing investments

- 5.4 Customers who already have exposure to non-mainstream pooled investments may want to consider their next steps.
- 5.5 For existing customers who invested in a non-mainstream pooled investment following advice, their financial adviser should be able to explain why they thought the investment was suitable. Customers who invested without advice may wish to seek independent advice on the investment and on what their options might be. If they no longer think the investment is right for them, they should speak to a financial adviser to discuss their options.

³² Where the existing product is being wound-down or liquidated, firms will be able to promote or advise on the replacement product under our rules.

- 5.6** We are conscious that existing customers wishing to disinvest from a non-mainstream pooled investment may find that there are delays in accessing their funds or, for certain products, that early surrender is difficult, costly or not possible. Such delays and difficulties will be due at least in part to the illiquid assets often held in non-mainstream pooled investments. Customers for whom these are suitable investments should understand that such issues may arise and should not be dependent upon the product for income or immediate access to capital.
- 5.7** If customers believe they were mis-sold the product, for instance as a result of unsuitable advice or of misleading promotional literature, they should contact the firm that arranged the investment for them and raise their concerns. The firm should have a procedure to follow to resolve matters. If the customer is not satisfied with the answer or proposed resolution, they can take the complaint to the FOS. If the firm is based in the UK and has gone out of business, the Financial Services Compensation Scheme (FSCS) might be able to help.
- 5.8** Consumers should be clear, though, that recourse to the FOS and FSCS in relation to product providers might be limited and will depend on where the product provider is based. Many firms that run non-mainstream pooled investments are based offshore and so are outside the FSA's regulatory scope. This means investors are unlikely to be protected by the FSCS if things go wrong, for instance if a fund is mismanaged. They may also not have access to the FOS for this reason. It will generally be possible to complain to the FOS or FSCS about advice given or marketing material produced in the UK by an authorised firm.
- 5.9** We have heard that some advisers have tried to dissuade their customers from taking eligible complaints about UCIS to the FOS. We recommend that customers who believe there were problems with advice or marketing material from a UK-based firm should get in touch with the FOS and check whether they have an eligible complaint.
- 5.10** We have a telephone helpline for existing investors. For further information, please call 0845 606 1234.
- 5.11** A range of other customer literature is available on our website at www.fsa.gov.uk.

Q16: Do you have any comments on the impact of our proposals on existing customers and the distributor firms serving them?

Annex 1

The current market

1. In this annex, we summarise our analysis of the current market for non-mainstream pooled investments.

Unregulated collective investment schemes

2. Our regulatory oversight of this market is to some extent limited as UCIS are not subject to the same regulatory and data gathering requirements of other investments such as UK-authorised CIS. With so many firms in this market operating outside our jurisdiction it is impossible to gather full sales data, even where the transaction involves a UK-regulated firm providing advice. The following information is based on our supervisory and enforcement action to date.

Firms operating in the market

3. A relatively small number of firms acting as providers of UCIS operate in the retail market and retail sales only amount to a small proportion of the overall UCIS market. However, we are being made aware of UCIS schemes being actively targeted at retail investors.
4. In 2011 we conducted a survey of the UK UCIS market. Out of the 50 firms known to operate UCIS that took part in the survey, only five told us that they had retail investors not categorised as sophisticated or high net worth. Between them, these firms had 13 funds distributed to these clients. Three operators responding to the survey dealt with high net worth retail investors, selling nine funds to customers categorised in this way. Only four operators had retail customers categorised as sophisticated, each firm with one fund sold to such investors.
5. As the survey did not cover the full market, there are likely to be more firms involved in it. Scaling up from the survey results to the market as a whole, we estimate that there are in excess of 100 UCIS operators and 500 schemes being promoted to retail investors.

6. There are many more distributor firms promoting UCIS than there are UCIS operators. From our supervisory work looking to help consumers who have lost out following product failures, we have found that distributor firms of all sizes are involved. This work suggests the number of distributor firms active in this market to be between 1,000 and 3,000.

UK retail sales

7. The following table shows our estimate of the total amount held in UCIS funds at present. These figures, extrapolated from data supplied in our 2011 survey, confirm the estimate in the 2011 *Retail Conduct Risk Outlook*, where we said there were total retail UCIS funds under management in the low billions.¹

Investor type	Minimum amount held in UCIS
Sophisticated retail customers	£20m
High net worth customers	£280m
Retail customers not categorised as high net worth or sophisticated	£2bn

8. Including non-retail holdings we estimate the total UK market size for UCIS to be around £55bn.
9. The data suggests that retail investors account for only a relatively small proportion of the total funds under management in UCIS. However, looking only at retail sales of UCIS, retail investors not categorised as high net worth or sophisticated account for the majority of investment. This may indicate that the rules relating to the promotion of UCIS in the UK are not working as they should.²
10. If the proposals in this paper are implemented, we would expect the number of customers categorised as sophisticated or high net worth to increase. At present we expect that a number of these investors are being advised to invest in UCIS under COBS 4.12 category 2, which we propose to remove. It may be that some of the uncategorised retail customers would meet the requirements of the relevant high net worth or sophisticated exemptions in the PCIS Order but firms have not sought to categorise them due to the ease with which they can promote UCIS via category 2. In future, firms would only be able to promote UCIS to customers properly categorised as sophisticated investors or high net worth individuals.

Supervisory findings

11. Our supervision of retail UCIS promotions and sales has identified significant problems. In 2010, we published the results of a review into the quality of sales.³

¹ *The Retail Conduct Risk Outlook*, February 2011

² We are unable to determine if the non-high net worth and non-sophisticated customers were average retail investors or if the firms involved had simply not carried out a client categorisation exercise (in which case it is possible that at least some of those customers might have been legitimately categorised as sophisticated or high net worth).

³ *Unregulated collective investment schemes: project findings*, July 2010

- The review found that, of the 14 firms sampled, nine (or 64%) did not understand or were not aware of the rules restricting promotion of UCIS in the retail market. Of the 131 UCIS transactions that were reviewed, at least 90 transactions (or 76%) had been inappropriately promoted to retail investors. Distributors did not know about, or ignored, the scheme promotion restriction.
- The review also considered the quality of advice on UCIS. Again, findings here were that industry practice is very poor. Only a minority of advice reviewed (26%) appeared to be suitable, having regard to individual retail customers' needs and requirements. We rated 22% as clearly unsuitable and in relation to 52% of cases, firms' records for the transaction were too poor or insufficient to establish suitability.

Products that are close substitutes for unregulated collective investment schemes

12. Although our concerns have focused mainly on UCIS in the past, the market is evolving and we are beginning to see increasing use of other legal forms of investment. We expect this trend to grow in the future, particularly if our focus remains exclusively on UCIS, leading to increased promotion and sales of substitutable products that are not subject to the same consumer protection measures.
13. Unless we introduce rules focused on these substitutable products, we expect to see arbitrage as firms adapt and restructure their products so that they fall outside the scope of the new rules. These investments can expose retail customers to the same or similar risks as UCIS so we need to ensure that they are subject to adequate consumer protections.

UK retail sales

14. As with UCIS, substitutable investments are not generally subject to the same data gathering requirements as more mainstream investments typically sold to ordinary retail investors. This limits our ability to produce a comprehensive picture of the market, but we estimate the total direct retail investment as follows. To provide these estimates, we have assumed a similar distribution pattern as for UCIS, since these products are close substitutes. Therefore, in line with UCIS distribution, we assume that most investors in these products are institutional and only around 4% of investment is made by retail investors.
 - There are nine QIS providers. Morningstar Direct shows that a total of some £10bn is held in QIS funds. Of this we estimate that £420m is held by retail investors.
 - In our experience the SPV structures of concern in this paper are not used as frequently as UCIS. Based on our observations, we estimate that they are used less than half as often as UCIS. Based on the amount of UCIS investment, this puts the total investment in securities issued by SPVs investing in assets traditionally held within UCIS at around

£27bn with approximately 50 providers. Of this, we estimate that slightly over £1bn is held by retail investors.

- In the cost benefit analysis for the TLPI guidance we estimated total direct retail investment of around £1bn.⁴ We are aware of five providers who have targeted TLPI promotions and sales at retail customers. These schemes are currently structured as UCIS, QIS or securities issued by SPVs. The total market size, including institutional investment will be much larger. Making the same assumptions as set out above, we put the total market at approximately £25bn.

Product type	Total market size	Retail investment
QIS	£10bn	£420m
SPV	£27bn	£1bn
TLPI	£25bn	£1bn

15. In total, therefore, we estimate the size of the direct retail market in the UK for investments that are closely substitutable for UCIS to be approximately £1.5bn.⁵

Total direct retail investment in non-mainstream pooled investments

Total investment

16. In total we calculate that retail customers hold approximately £4bn at present in UCIS and closely substitutable investments.
17. Looking at the wider investment market, there is a total investment of approximately £700bn (including retail and non-retail investment) in regulated and non-regulated investment funds.⁶ So, we estimate that direct retail investment in non-mainstream pooled investments accounts for less than 1% of the total investment amount under management.⁷
18. Adding the number of UCIS operators to the number of providers of substitutable investments, we calculate that there are approximately 160 provider firms affected by this consultation.

4 The cost benefit analysis for the TLPI guidance is available here: www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/guidance/gc11_28_cba.pdf.

5 Note that TLPIs are currently structured as UCIS, QIS or securities issued by SPVs. The table illustrates total and retail investment in QIS and SPV-issued securities, incorporating TLPIs where relevant. UCIS TLPI investment is included in the previous section.

6 This figure is derived from data supplied by the Investment Management Association, *funds under management, May 2012* and our estimates of the size of the UCIS, QIS, SPV and TLPI markets

7 In total, regulated funds have around £600bn under management. Extrapolating from our survey results to the market as a whole we have calculated the total UCIS market in the UK, for institutional and retail clients, at £55bn. In the previous section we have calculated the funds under management in QIS, SPVs and TLPIs at around £40bn.

Distributors active in the market

19. In our supervisory work to date, we have found that distributor firms involved in the promotion of one UCIS often have been active in promoting other non-mainstream pooled investments. Based on our supervision work, we therefore estimate that between 1,000 and 3,000 distributors, including firms of all sizes, are involved in the promotion of all types of non-mainstream pooled investments to retail customers.
20. As most distributors in the retail market deal with ordinary retail investors, the proposals in this consultation are expected to reduce the number of distributors promoting these investments. We anticipate a reduction to between 250 and 750 firms as a result of the proposals.⁸

Number of customers

21. From the work cited earlier, we estimate that there are currently approximately 142,000 uncategorised retail investors with direct holdings in non-mainstream pooled investments.
22. As noted above, if the proposals in this paper are implemented, we would expect some of these customers to be re-classified as sophisticated or high net worth. Firms may be deciding at present that it is easier to use COBS 4.12 category 2 rather than to fulfil the steps needed to market UCIS to sophisticated or high net worth customers.
23. Given the variability of client bases of distributor firms, it is impossible to estimate with accuracy how many uncategorised retail customers do in fact meet the requirements for certification as sophisticated investors or as high net worth investors. However, as a very broad estimate based on our experience reviewing client files, we would expect that around 20% overall could be categorised as sophisticated or high net worth.
24. In total, therefore, we estimate that the number of uncategorised retail investors who are ordinary retail investors to be around 114,000 (this implies that some 28,000 retail customers will be classified as sophisticated or high net worth in the future). A proportion of these investors may seek to disinvest from non-mainstream pooled investments over the following months or years as their advisers reassess the suitability of their holdings or as the investors themselves gain a better understanding of the risks and characteristics of these products.

Q17: Do you have any comments on our analysis of non-mainstream pooled investments?

Q18: Do you have any further data on the size of the market?

⁸ Approximately 13% of UCIS customers are currently assessed as high net worth or sophisticated. If only 13% of distributors currently active in the market remain in it, this would reduce the number of distributors to between 130 and 390. However, we believe that a number of customers not currently assessed as high net worth or sophisticated do in fact meet the criteria. For that reason, we have assumed here that one-quarter of firms will stay in the market.

Consumer detriment

25. Over the course of 2011, 189 UCIS cases were reported to the FSA's Unauthorised Business Department. This represents an increase of 15, or 8.6%, on the previous year. These cases involve firms that are acting illegally and are not eligible to operate a CIS in the UK or to promote a UCIS to UK consumers. In a number of other cases the investment structure was not clear and the investments may have been SPV-issued securities or other forms. Due to the poor documentation typically available in relation to unlawfully operated or marketed investments, their legal form may not always be identifiable other than through court decisions.

26. These cases involved the following types of underlying assets:

Investment type	Number of cases reported in 2011
Land banking	60
Overseas forestry and crops	39
UK and overseas property / hotel development schemes	24
Wine investment schemes	14
Various security-based UCIS	52

27. The estimated average loss for land banking is in the region of £30,000 per investor, with overseas tree and crop schemes leading to a loss of between £12,000 and £15,000 on average per investor.

28. The total value of the schemes against which the FSA has taken civil and criminal proceedings in the past five years is approximately £150m. This comprises ten land banking schemes and a foreign exchange trading fund.

29. We are not always the correct agency to take action in these cases. For example, the police will take forward cases where a scheme appears to be inherently fraudulent. A conservative estimate would put the total detriment for the last five years at around £200m when combined with the schemes where we have taken action.

30. Customer detriment can arise from a range of problems with these products quite apart from unlawful operation or marketing. A number of non-mainstream pooled investments have failed completely in recent years, leading to total investment loss for customers. For example:⁹

- the £115m Business Consulting International fund in 2008;
- the £300m K1 Hedge fund in 2009;
- the £350m Keydata Lifemark life settlement investment bonds in 2009;
- the £47m Bentley-Leek property investments in 2011;

⁹ Note that the quoted figures show the estimated total fund value. Retail exposure to the fund is generally less than the total amount held in each investment.

- the £80m British Real Estate fund in 2011;
 - the £60m Arck property investments in 2012; and
 - the £1.5m Centaur Sports funds in 2012.
- 31.** In such cases, investors only have limited ability to recover any capital. Where advice was provided by a UK firm, or the customer made the investment after receiving other promotional communications from a UK firm, the customer may be able to complain to the FOS about that firm's promotion of the product. There may be no recourse in other situations and customers may receive only whatever amount is recovered from the market value of underlying investments, if any at all.
- 32.** Such losses will be most severe for customers who have invested a substantial proportion of their portfolio; who borrowed to invest; or who have limited ability to restore lost capital and had invested in order to generate income from their capital. We have found a worrying trend for retail customers to use, or be advised to use, one or more of these investment strategies.

Annex 2

Ongoing UCIS supervision and enforcement activity

1. The inappropriate design, marketing and sale of UCIS to retail clients is a supervisory priority for the FSA. We will continue to intervene in this market until we are satisfied that risks to retail clients have been appropriately mitigated.
2. Our ongoing work with providers (including firms that establish, manage or operate UCIS) and distributors has three broad strands, as outlined below.

Raising awareness of UCIS risks

3. Work here is directed at helping firms identify areas of their UCIS business which pose a risk of future detriment for retail investors. We have issued several publications explaining our expectations to help firms active in this market to ensure compliance with the current rules.¹

1 We have published extensive material to help firms understand our concerns, including:

- [*Unregulated collective investment schemes: project findings*](#), July 2010
- [*Unregulated collective investment schemes: good and poor practice report*](#), July 2010
- [*FSA factsheet for financial advisers, unregulated collective investment schemes*](#), July 2011
- [*Promoting unregulated CIS – Communicating with clients, including financial promotions*](#)
- Chapter 4 of the [*MiFID Permissions and Notifications Guide – Update*](#), September 2007
- PERG 13 ‘Guidance on the scope of the Markets in Financial Instruments Directive and the recast Capital Adequacy Directive’, in particular [*PERG 13.5 ‘Exemptions from MiFID’*](#) Q49 and Q50
- [*Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection*](#), Finalised Guidance 11/05, March 2011
- [*The Responsibilities of Providers and Distributors for the Fair Treatment of Customers*](#) (RPPD)

Engaging directly with firms

4. The second arm of our work involves closer scrutiny of provider firms that direct UCIS to the retail market and distributor firms selling UCIS to retail clients.

Information requests

5. In June 2012 we issued over 250 supervisory letters to UCIS providers and distributors that have been active in the retail market since 2008.² The letters reinforce our view that UCIS are specialised products unsuitable for general promotion in the UK retail market and repeat our key concerns. We also asked for details of the systems, controls and governance arrangements that are in place. We have asked providers and distributors to consider carefully how they are meeting their responsibilities and to attest to us that they are confident that they are complying with the current rules.
6. We are currently analysing the responses that we have received from firms and will take strong action to protect consumers where we identify risks. We will also use the data that we have received to continue to develop our supervisory approach.

Firm assessments

7. We have visited a number of provider and distributor firms selling UCIS in the retail market. The purpose of these visits was to assess how well firms are meeting their regulatory obligations and whether they are taking into account the guidance in the FSA's Regulatory Guide 'The Responsibilities of Providers and Distributors for the Fair Treatment of Customers' (RPPD).³ While the visits are part of our general supervisory activities and we will not necessarily publish detailed findings, we are taking this opportunity to set out some of our initial conclusions.

Providers

8. Firms providing UCIS to the retail market have responsibilities in respect of the fair treatment of the clients that ultimately invest in their UCIS.⁴ A number of the provider firms we visited were falling well short of our expectations.
9. Particular concerns that we identified at provider firms include:
 - firms being unaware that they could be classed as 'providers' under the RPPD and having a poor understanding of the guidance in RPPD and their obligations under the Principles for Businesses;

2 Templates of the letters are published on our dedicated UCIS website to ensure that they reach the widest possible audience: http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/investment/ucis.shtml

3 http://media.fsahandbook.info/Handbook/RPPD_20070716.pdf

4 See Principles 2, 3, 6 and 7 of the Principles for Businesses and paragraphs 1.7 and 1.14 to 1.21 of the RPPD.

- firms telling us that they class distributors or investment partners as their ‘customer’ and therefore pay less attention to the end investor;⁵
- firms failing to identify a target market for their UCIS and failing to identify the types of customer for whom each UCIS was likely to be suitable (or unsuitable);⁶
- providers failing to stress test their product to identify how it would perform in a range of market environments and how the customer could be detrimentally affected, e.g. exposing customers to underlying assets that were entirely illiquid, resulting in poor outcomes;⁷
- providers failing to undertake adequate due diligence on investment partners or investment opportunities before establishing UCIS and failing to monitor investment partners’ activities during the product lifecycle to check that funds were being invested appropriately;⁸
- firms focusing entirely on the viability and profitability of the investment opportunity that an individual UCIS was designed to fund rather than focusing on whether the product is suitable for the target market and has product features and a risk profile that is suitable for customers’ needs;⁹
- providers failing to put in place systems and controls to manage adequately the risks posed by product design.¹⁰ Policies and procedures governing UCIS design and development generally related exclusively to operational matters, were informal and did not include any focus on retail investor outcomes;
- all firms that we visited agreed that UCIS were unlikely to be suitable for the vast majority of retail investors. Despite this, a number of provider firms relied entirely on third parties to identify potential distributors and UCIS investors resulting in instances of unexpected retail investment into the products;
- providers failing to monitor distribution channels to check whether what was occurring in practice corresponded to what had been planned or envisaged given the target market.¹¹ For example, a number of firms could not provide evidence that they had gathered any management information or intelligence to check that the product had not been promoted in breach of relevant restrictions.

10. Our interest in how provider firms are treating their retail clients in respect of UCIS investments will necessarily continue into the foreseeable future. UCIS are often viewed as medium or longer-term investments, so problems with the products and the way they have

⁵ We draw firms’ attention to paragraph 1.11 of the RPPD and Principles 6 and 7 of the Principles for Businesses.

⁶ See paragraph 1.17(1) of the RPPD.

⁷ See paragraph 1.17(2) of the RPPD.

⁸ See paragraph 1.17(3) of the RPPD and SYSC 4.1.1R.

⁹ See Principles 6 and 7 of the Principles for Businesses and paragraph 1.17(1) of the RPPD.

¹⁰ See paragraph 1.17(3) of the RPPD.

¹¹ See Principles 2, 6 and 7 of the Principles for Businesses and paragraph 1.20(2) of the RPPD

been sold may not be identified until some time after the point of investment. Problems may, for example, only become apparent when the investor seeks to redeem their investment.

Distributors

11. We identified the following concerns in some of the firms we visited:
- some of the distributor firms have connections to the UCIS provider or fund manager. This has led, in some cases, to conflicts of interest appearing to drive unsuitable advice. A firm must manage conflicts of interest between itself and its customers fairly; and
 - we have come across cases where the distributor firm's professional indemnity insurance does not cover their UCIS sales. Given the potential for product failure and customer detriment, this lack of insurance can be a significant issue for distributors and customers if anything goes wrong.

Addressing hidden or crystallised risk

12. The third strand of our current supervisory work focuses on risk that has already crystallised or is about to crystallise. It recognises that our proactive communications and work with firms will not always result in the risk being mitigated for retail clients before detriment occurs.
13. Some risks can be more difficult to spot earlier than others. For example, if a UCIS product provider is based offshore we may not become aware of a problem until it begins to surface in the form of consumer detriment. If such cases arise, our focus will be on minimising any detriment that ordinary retail investors may incur or finding the best method to provide redress.

Summary of recent enforcement action

14. Our enforcement activity has primarily focused on concerns over:
- firms failing to comply with the financial promotion rules;
 - firms communicating promotions in breach of the scheme promotion restriction in section 238 FSMA; and
 - firms failing to demonstrate the suitability of their advice.
15. These failings often arise as a result of training and competence failings and inadequate systems and controls at the firms.

16. Since September 2010, we have published 20 Final Enforcement Notices in relation to UCIS failures.¹² We have imposed penalties of over £300,000 on firms and individuals found to be in breach of the rules. The penalties have been significant for some of the smaller firms and individuals. Our action has also led, in some cases, to the removal of the permission to carry on regulated activities and prohibitions on certain individuals.

The overall strategy

17. We consider that our work offers a multi-dimensional approach aimed at providing a proportionate response in the short, medium and longer terms.
18. Taken together, the work aims to achieve:
- redress for customers who have lost out as a result of poor quality advice or inappropriate marketing by UK-based distributors;
 - action against firms that have failed to comply with relevant obligations, including section 238 FSMA, COBS 9 and the Principles for Businesses;
 - improved sales practices for distributors and providers under the current regulatory framework; and
 - in the longer-term, rule changes following this consultation that aim to stop detriment arising from inappropriate marketing of UCIS to ordinary retail investors.

Q19: Do you have any comments on our overall strategy to deal with the risks to retail customers of investing in UCIS?

12 Details of these notices: www.fsa.gov.uk/smallfirms/your_firm_type/financial/investment/ucis-enforcement-notices.shtml.

Annex 3:

Cost benefit analysis

1. FSMA requires us to publish a cost benefit analysis (CBA) of our proposed rules, defined as an estimate of the costs together with an analysis of the benefits that will arise if the proposed rules are made. The CBA assesses, in quantitative terms where possible and in qualitative terms where not, the cost and benefits of the proposed requirements relative to the situation where these proposals were not introduced.
2. In summary, the proposals on which we are consulting are:
 - changing the financial promotion rules to limit the type of customer to whom firms may promote UCIS and closely substitutable investments;
 - Handbook guidance on the effect of the financial promotion rules on advised sales to clarify that personal recommendations generally amount to a financial promotion and, as a result of the marketing restrictions, advice on a non-mainstream pooled investment may result in an unlawful promotion if no valid exemption is available.
 - a rule requiring firms to maintain a record of the basis on which the promotion has been made and requiring them to ensure the compliance oversight function (CF10) confirms the compliance of each financial promotion for products within scope of this consultation, including advised sales, with the marketing restriction rules; and
 - updating the *retail investment product* definition to clarify the position on advice on UCIS and other non-mainstream pooled investments in relation to Retail Distribution Review independence requirements.

Market failure analysis

3. Non-mainstream pooled investments have complex risks and it can be difficult for investors to judge their quality until long after the sale. These features – combined with providers and distributors having greater information, expertise and experience on these investments – puts ordinary retail investors at a serious disadvantage (information asymmetry) when dealing with promotions inviting investment in these products. Where distributors have

strong incentives to promote these investments, this market failure can motivate promotions that lead to unsuitable sales.

4. There is also a clear regulatory failure, shown in our thematic work, of non-compliance with current rules limiting promotions. This appears to be due to lack of information and/or understanding among distributors, as well as the presence of perceived incentives for non-compliance such as the attractiveness of the products to consumers and high commission rates. We have found that many firms, when challenged on their mis-selling activity, did not understand the existing rules, did not apply them correctly and/or failed to understand the complicated structures and risk profiles of these products. This misunderstanding or misinterpretation undermines the effectiveness of existing rules.
5. Non-mainstream pooled investments can invest in a potentially unlimited range of underlying assets. This means risks can vary greatly from product to product. We are concerned about ordinary retail customers being exposed through these products to exotic or non-traditional assets carrying risks they do not understand and which are unsuitable for them. Underlying or reference assets may be illiquid, difficult to value accurately and subject to catastrophic loss of value. They may also be subject to different kinds of risks to those with which the average retail investor is more familiar.
6. In particular, we have found that too many people focus on volatility when assessing risk. Inherently illiquid investments can appear to be less volatile simply because the secondary market is limited or lacks transparency. It does not mean the investment is necessarily of lower risk. Furthermore, volatility is not the only type of investment risk and an investment that appears less volatile than a mainstream investment may be subject to a range of other risk factors that make it higher risk. For example, many non-mainstream pooled investments are subject to lighter governance controls than more mainstream investments. The terms and conditions of these investments may be complex and/or increase risks to the investor independently of the type of underlying or reference assets.
7. Where a retail consumer seeks professional financial advice they will generally rely upon their financial adviser's judgement in making their investment decisions. They have a reasonable expectation that their adviser will understand the product they are recommending and that the adviser's conduct and any transaction will be compliant with FSA rules. Our supervision of this market, however, has found that this is not generally the case.
8. We consider that there is a 'principal-agent' problem in this market. Distributors face significant costs if they are to undertake sufficient due diligence prior to making a recommendation. Our work suggests they often do insufficient analysis. At the same time, it can be easier to promote products marketed as uncorrelated with troubled mainstream markets to customers who are looking for low risk and high return products so the rewards for sale can be high. Low-risk, high-return products do not exist in reality.
9. Given the information asymmetry between the adviser and the customer, the customer does not know that this assessment has not been made, reinforcing the incentive to avoid these

costs. In addition, at present, adviser remuneration from these investments can be substantial, leading to conflicts of interest. Adviser charging rules are expected to address this in due course but poor practices may have already become embedded.

10. Were we to focus regulatory attention exclusively on UCIS, we could expect to see the same UCIS investment strategies repackaged in other legal forms to allow promotion and sales patterns to continue unchecked. Product providers that do not currently offer non-UCIS investments could easily switch away from UCIS to these other products. Therefore, unless we apply similar restrictions to a wider range of products than UCIS, ordinary retail investors could continue to be induced to make inappropriate investment into non-mainstream pooled investments. Put simply, regulating one part of the market only could lead to the problem simply moving from UCIS to other investment forms and achieve little in the way of improved standards.

Direct costs to the FSA

11. As discussed in Annex 2, a significant amount of supervisory resource is targeted at addressing problems in the UCIS market.¹ In the short to medium term we estimate that there will need to be a further increase in the amount of resource, particularly as the scope widens to cover all non-mainstream pooled investments. Much of this will come from a continuation of existing projects. In the longer term, we expect the need for FSA resource to reduce as our supervision and enforcement activity encourages improved promotion and sales quality, the market adapts to the new regime and the risks to retail customers recede.

Incremental compliance costs to firms

12. Compliance costs are the direct costs firms incur in order to comply with our proposals. As our proposed rule changes relate only to distribution models, there are unlikely to be direct compliance costs for providers unless providers promote their products directly to retail customers or they need to make changes to literature that makes reference to our existing rules.
13. Overall, we expect the main compliance costs on distributor firms to be in relation to changing promotion processes (client categorisation) and in amending literature and training if they wish to continue to promote non-mainstream pooled investments. Specifically, distributors who market to retail customers will need to make sure that their systems ensure customers are properly classified and that our rules and guidance are complied with, with compliance confirmation procedures and appropriate record keeping. Marketing literature

¹ At present, we estimate that FSA resource of £400,000 is being directed here each year. We expended 450 staff days in the first six months of the year and have calculated the overall cost by applying a cost of £450 per day per person, which is the average cost for FSA employees, including overheads. There is an opportunity cost to the FSA: resources directed at this issue cannot be used to investigate problems elsewhere. This ongoing supervision is expected to lead to improvements in the market as it helps to ensure compliance with the rules.

and other promotional communications may need to be amended to ensure that the implications of investment are explained adequately. Firms are also likely to incur new training costs. Where a distributor firm's client base is made up exclusively by ordinary retail investors, they will need to ensure that these investments are no longer promoted.

14. The following table shows our estimates of the total industry-wide incremental compliance costs.

Incremental costs	One-off costs	Ongoing costs per year
Client categorisation	£3m to £9m	£130,000 to £170,000
Compliance confirmation	Included in the training costs	£480,000 to £795,000
Record keeping	Minimal	£50,000 to £150,000
Amending literature	£10m	Minimal
Training	£4.5m to £13.5m	Minimal

Client categorisation

15. In 2007 MiFID-derived client categorisation standards were introduced to the Conduct of Business Sourcebook.² There are similarities between this exercise and the current proposals as both involve a re-assessment of the client category. We are therefore using the MiFID changes as an approximation of the likely costs to be incurred by the proposals in this paper.
16. The one-off cost of introducing systems to categorise customers was estimated to be £10,000 per firm. For the 250 to 750 firms that we estimate will continue to promote non-mainstream pooled investments, with inflation the one-off systems cost is likely now to be close to £12,000 per firm. For other distributors we expect minimal costs, since they deal only with ordinary retail investors and would no longer promote these investments. On this basis, we estimate a total industry cost of between £3m and £9m.
17. In the MiFID consultation, the ongoing cost of categorising more 'ambiguous' customer categories, who sit at the boundary between categories, the average cost was estimated at between £20 and £25 per customer. Under the proposals in this paper, there will be an obligation on firms to categorise consumers as sophisticated or high net worth if they are to promote non-mainstream pooled investments. We consider that the cost of performing this certification is likely to be similar to the cost for categorising ambiguous customers in the 2006 consultation. With inflation since then, the cost is likely now to be between £23 and £30 per customer.
18. As noted in Annex 1, we assume that the number of customers categorised as sophisticated or high net worth will increase from current numbers. We estimate that as many as 5,600 customers will be categorised as sophisticated or high net worth each year in the future.

² See *Reforming Conduct of Business Regulation*, CP06/19, October 2006

This suggests an aggregate cost of between £130,000 and £170,000 each year to certify customers as sophisticated or high net worth.

Compliance confirmation

19. In the future, we propose that the compliance director at each distribution firm should confirm compliance with the marketing restriction for each promotion of a non-mainstream pooled investment to retail clients.
20. This will lead to significant costs for the distribution firms that remain active in these markets. We estimate that compliance directors will need to spend approximately two hours per case to determine that the criteria are met and to sign off the promotion.
21. Assuming that there are 5,600 new retail customers each year, and assuming a cost per hour of a compliance director's time of £42.60 for a large firm manager and £71 for a large firm senior manager, this will lead to aggregate costs each year for the industry of between £480,000 and £795,000.³

Record keeping

22. Firms are already subject to record-keeping requirements in SYSC and COBS 4.11 in relation to marketing. The proposals in this consultation paper will specifically require them to maintain detailed records of the basis on which a non-mainstream pooled investment has been promoted and the confirmation of compliance with the marketing restriction.
23. As firms are already obliged to keep records and will have processes in place for them, we estimate that there will only be minimal one-off costs for changing the record keeping. Some of the costs will be included in the training costs, to train staff on the new requirements.
24. From the earlier CBA in the *Reforming conduct of business regulation* consultation paper, which included analysis of the costs of additional record keeping requirements, we estimate aggregate additional ongoing costs for the industry of between £50,000 and £150,000 per year as a result of the proposals.⁴

Literature costs

25. Distributor firms with a varied client base may need to update their literature to help ensure non-mainstream pooled investments are targeted only at sophisticated or high net worth clients in the retail market.

³ Standardised hourly rates for management costs are drawn from *Estimation of FSA administrative burdens*, June 2006, Real Assurance Risk Management. To account for growth in income since then, hourly costs have been increased in line with average earnings as per the Office of National Statistics *Index of labour costs per hour*, Q4 2011.

⁴ In CP06/19 we calculated a median cost of £400 per firm a year for additional paper storage costs. As firms are already subject to high-level record keeping requirements, will already be maintaining records in relation to non-mainstream pooled investment marketing and may already choose to retain the records specified in this consultation, we assume as a rough estimate an average incremental annual cost per firm from the proposals of £200.

26. There is no requirement to send updated material to existing customers, so the impact of this change will only be on potential new customers. We expect that distributors will be able to amend their literature as part of the regular review of their material. The financial promotion rules in COBS 4.10 already require firms to stop using promotions if they become aware that they no longer comply with our rules.
27. Provider firms may also choose to alter promotional material to reflect the new rules. This will be needed, particularly, if literature currently sets out in detail the types of customer who may invest in the product and this needs to be updated.
28. From previous work with providers, we estimate one-off costs of at most £60,000 per firm to update literature in line with the rule changes.⁵ We have assumed in Annex 1 that 160 providers will be affected by the proposals in this paper. This gives total industry-wide one-off costs for changes to literature of just under £10m. After that, we would expect ongoing costs to fall within existing business-as-usual literature budgets.
29. Many distributor firms will have no clients who meet the criteria to be able to receive promotions for the products within scope of this consultation. These firms should face much lower costs. They may have no costs to update their literature if they have no material that suggests that these investments might be appropriate for their clients.

Training

30. There will be training costs for firms that expect to continue to promote non-mainstream pooled investments. Using information from previous CBA involving a broadly comparable scenario, we estimate a need for two hours of training per member of staff, at a cost of £71 per hour.⁶ This gives an average cost of approximately £150 for each member of staff.
31. Only staff involved in advice, sales, marketing and compliance functions in relation to non-mainstream pooled investments will need to be trained as a result of the proposals in this Consultation Paper. We estimate the incremental one-off training costs for the industry of between £4.5m and £13.5m.⁷
32. After that, we would expect ongoing training costs to fall within existing business as usual training budgets as distributors need to demonstrate their continuing professional development and understanding of market changes. So there should be no incremental costs as a result of the proposals in this consultation.

⁵ In *Compliance costs of proposed changes to the investment product disclosure regime*, November 2006, we noted that the cost implications of an overhaul of disclosure documents for fund managers selling to the retail market would be, in total, no more than £50,000. This figure has been updated in line with inflation.

⁶ Information is drawn from background research undertaken before MiFID implementation in the UK, as reported in CP06/19. As investment firms required training on a new regulatory regime, we consider the training costs for the proposals in this consultation will be broadly equivalent. Costs have been increased in line with inflation.

⁷ Our research shows a mean of 240 members of staff per firm. Not all of a firm's staff will be involved in the sale of these products, even if they work in one of the functions identified here. Many will be involved only in the sale of more mainstream products. If all staff were to be retrained there would be incremental one-off training costs for the industry of between £9m and £27m. We have assumed that, at most, for firms who continue to sell these products, half of a firm's staff will be involved in non-mainstream pooled investments.

33. Where a distributor firm's client base is made up exclusively by ordinary retail investors, training costs should be much lower. Such firms should not be promoting non-mainstream pooled investments so staff will not need to know so much about them: staff will need to know that marketing restrictions apply so they cannot be promoted. We would therefore expect that training could be incorporated into business as usual procedures at these firms.

Indirect costs

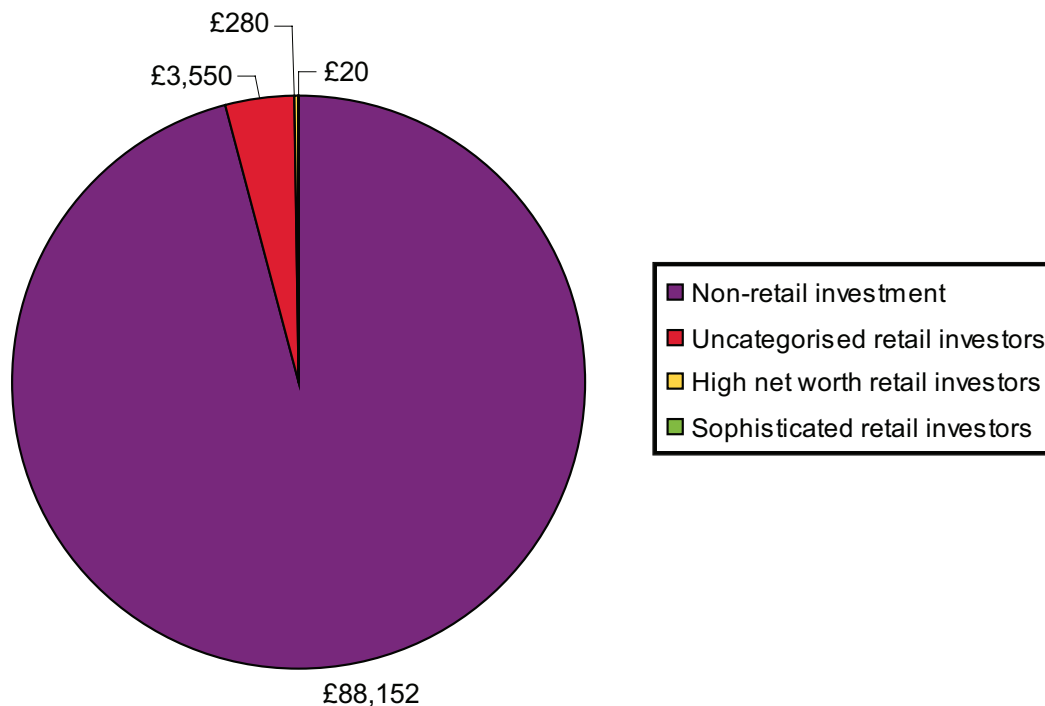
34. The main indirect effects and costs expected are as follows:
- Retail use of non-mainstream pooled investments will reduce if ordinary retail investors no longer receive promotions inviting investment in them. We expect advisers to channel these ordinary investors into more mainstream investments; so, while non-mainstream pooled investments could potentially lose funding, other, more traditional investments could see a corresponding increase in funding. This impact should be limited, however, since, as set out in Annex 1, we estimate retail investment represents approximately 4% of all investment into non-mainstream pooled investments.
 - There may also be a few ordinary retail investors who lose access to suitable investments as a result of these proposals. Instead, their choice will be limited to more mainstream investments. We do not expect many customers to be affected by this. Retail investors for whom a non-mainstream pooled investment may be suitable are likely to meet the criteria to be categorised as sophisticated or high net worth and will still be eligible to receive promotional communications about these products.
35. We expect providers and distributors to make fewer promotions and sales of non-mainstream pooled investments to retail customers as a result of the proposals in this consultation.
36. In Annex 1 we have estimated that 28,000 retail investors will be categorised as sophisticated or high net worth under our new proposals. In our work to date, we have found that the average investment by customers of ordinary means is around £25,000 and the average investment for high net worth customers is around £90,000.

37. The table below sets out our estimates of current future retail investment.⁸

Retail investor group	Number of investors		Amount invested	
	Current estimate	Estimate with proposals	Current estimated	Estimated with proposals
Sophisticated	200	14,000	£20m	£365m
High net worth	3,000	14,000	£280m	£545m
Uncategorised	142,000	0	£3,550m	£0

38. At present, our estimates of total investment in non-mainstream pooled investments are as follows:

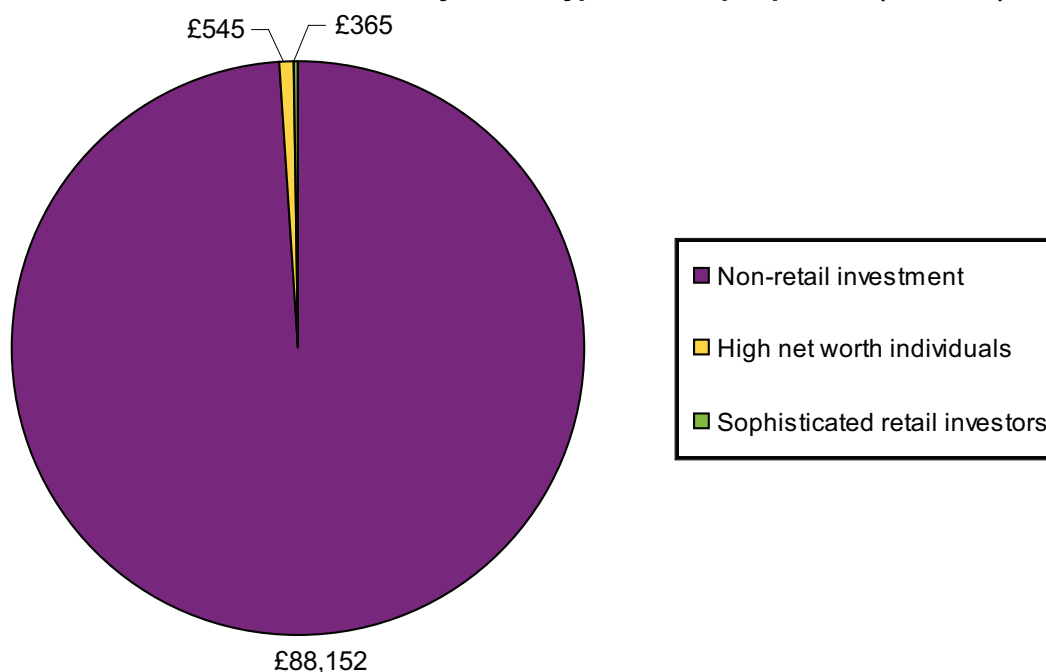
Current estimate of amount invested by client type (millions)



⁸ We have assumed investors newly categorised as high net worth or sophisticated under our proposals invest £25,000 on average rather than the average invested by customers already categorised in these groups. Given the higher wealth and/or income of these groups relative to ordinary retail investors this may be lower than the amount invested in practice. As a result, these estimates are cautious in that they will tend to overestimate somewhat the impact on investment of the proposals.

39. To put in perspective the rules proposed in this consultation, we expect total investment to look as follows:

Estimated amount invested by client type under proposals (millions)



40. As retail investment is a small part of the total investment in these products, we do not expect significant impacts on the products in general as a result of the reduction in retail investment. It is also important to note that reduction in retail investment in these products is not a loss of investment since it is likely to be redirected at other investment products.

Indirect costs to providers

41. In the main, non-mainstream pooled investments are not targeted at retail customers. Where they are, providers will need to consider their options. They could target a wider market, including institutional or non-UK investors if their product is not viable when targeted only at sophisticated or high net worth retail investors in the UK.
42. It may be that some products are not commercially viable in the longer-term if they are not desirable to institutional and non-UK investors. Providers with such products would need to wind up the product, amend the investment strategy to suit the new market or to set it up as an authorised collective investment scheme. Where these investments are not taken up by institutional, professional or high net worth or sophisticated investors, this may well signal deeper flaws in the investment strategy or proposition.
43. Our proposals introduce restrictions to the promotion to retail clients of investments that are not currently subject to such limits. This approach has the benefit of minimising the

scope for regulatory arbitrage but it also introduces a regulatory barrier to providers and may hamper innovation in the retail market. In practice, however, we think this is unlikely to be significant, since providers can still develop new investments targeted at sophisticated or high net worth retail investors and non-retail investors.

Indirect costs to distributors

44. Generally, distributors should not be adversely affected by the rules. Although they will see a reduction in the volume of non-mainstream pooled investments they distribute, we would expect that they will promote more suitable products to ordinary retail investors instead of the restricted investments. Under the RDR adviser charging rules, there should be no impact on remuneration for them: adviser remuneration should not be affected by the type of investment recommended to their customers.

Indirect costs to customers

New customers

45. The recommendations set out in this paper aim to reduce inappropriate investment in UCIS or close substitutes by ordinary retail investors. Clearly, any retail consumer for whom one of these products is suitable may be worse off. In practice, however, we expect this cost to be limited for a number of reasons.
- As noted earlier, we anticipate that a number of customers not currently classified as sophisticated or high net worth would meet the requirements to be categorised as sophisticated or high net worth.
 - For other customers, the choice of more mainstream investments is likely to better meet their needs.
 - Retail customers will still be able to gain some exposure to these products via indirect investment, where a professional fund manager includes some exposure within a regulated product.
46. For these reasons, we expect that the number of consumers for whom a non-mainstream pooled investment may be suitable and who may suffer detriment as a result of our proposals will be very small.
47. Where non-mainstream pooled investments carry tax relief, any restriction on future promotions will reduce tax planning options for customers. However, this cost must be set in context. Tax is not the only consideration in assessing suitability and the availability of tax relief may not, on its own, be sufficient to make an investment suitable, in particular where the investment itself can pose very significant risks to the capital invested. Furthermore, the proposed rules only affect a relatively narrow range of products and a number of other investments will remain available for tax planning purposes for ordinary retail investors.

Given that suitability is only demonstrated in a small minority of cases we have seen, we consider that the benefit to customers of reducing detriment from poor advice significantly outweighs the potential costs of loss of tax relief in relation to some customers.

Existing customers

48. As noted above, there may be a few firms with non-mainstream pooled investment products that are dependent on continuing investment from retail investors. These firms will need to adapt to changes in their investor base. In the short term, at least, this may lead to liquidity issues for some products where new investment is reduced but outgoings continue. Existing customers in these products may find that there are delays, costs or other difficulties in accessing their funds.
49. Such delays and difficulties will be due at least in part to the illiquid investments often held in non-mainstream pooled investments. Often the products will include contractual terms and conditions that allow them to delay payments to customers where necessary.
50. Customers for whom these are suitable investments should understand that such issues may arise with the product and should not be dependent upon the product for income or capital. However, many existing customers hold unsuitable investments and this may lead to detriment for them. We consider that the benefit to consumers from not being exposed to the same type of mis-sale in the future outweighs these costs. Retail investors who have been mis-sold a non-mainstream pooled investment should consider complaining to the firm that advised them or promoted the product if they suffer detriment.
51. There is a risk that existing customers may react to the consultation and request redemptions that may in turn lead to liquidity problems and, possibly, to capital losses for customers. However, as the majority of investment in non-mainstream pooled investments is by customers unaffected by proposals in this consultation, such as institutional investors, we do not expect liquidity problems to arise in many cases if at all. We also note that our proposals are forward looking and do not require any changes to existing investments.

Wider implications

52. Where non-mainstream pooled investments are used to raise capital for enterprises, particularly start-up entities raising capital, there may be some reduction in the amount of capital raised.
53. As noted in Annex 1, we estimate that only approximately 4% of funds raised via these products is derived from the customers of concern in this paper. As institutional investment accounts for the majority of funds raised, we do not expect there to be a significant impact on capital for these firms.
54. Nor is it the case that all non-mainstream pooled investment products are used to raise capital in this way. Our work looking at UCIS, for example, found that mostly these

products are not used to raise capital for enterprises. Only approximately 10% appears to be used for this purpose. So, of the £4bn current total direct retail investment in the products on which we are consulting, we estimate that approximately £400m is invested in capital-raising ventures.

Benefits

55. Our proposals aim to mitigate market and regulatory failures. In particular, there are serious information asymmetries between consumers and firms operating in this market. Previous rules sought to ensure that distributors marketed UCIS only to customers who genuinely understood the risks (to sophisticated customers) or where the adviser had undertaken sufficient due diligence to ensure the investment was suitable. Principal-agent issues mean that distributors often failed to undertake sufficient diligence or analysis, however. Therefore, the rules did not work adequately and still left scope for consumer detriment.
56. By drawing a stronger line so that only the customers least likely to suffer from the information asymmetry can gain exposure to the products, we expect to better mitigate the market failures in the future.
57. The proposals introduce marketing restrictions for investments not currently subject to any promotional restriction. This approach has the benefit of addressing emerging risks in relation to these other products while minimising the scope for regulatory arbitrage, where providers could use alternative legal forms to continue to promote and sell less mainstream investments to ordinary retail investors.
58. We expect the proposed rules will clarify responsibilities for distributors operating in this market and reduce the scope for regulatory failure. The clearer message that these products should not be marketed to ordinary retail investors should lead to a significant reduction in mis-sales. Our supervisory project of 2010 suggests that only 26% of UCIS sales are suitable (with 22% rated clearly unsuitable and with firms' records too poor or insufficient to establish suitability in 52% of cases). Our subsequent work suggests that promotion and sales quality has not improved, in spite of our work to raise standards. If this proportion is replicated across all sales, reducing direct retail investment from £4bn to £900m should reduce the amount of unsuitable investment by between approximately £680m and £2.3bn (between approximately £135m and £460m each year). The benefits in terms of improved consumer protection outcomes are therefore expected to be very substantial.
59. As professional indemnity insurance does not always cover the promotion or sale of UCIS, some firms have been bankrupted when dealing with complaints and paying redress. Liability can then fall on the FSCS leading to costs for the wider industry. Reducing mis-sales may therefore have wider benefits for the industry.
60. We are acting to prevent ordinary retail investors from being invited to invest in products that we regard as unlikely to be suitable for them. This should lead to improved outcomes

in the longer term, with fewer ordinary retail investors losing capital due to risks they were not prepared or able to accept. With less exposure to products that fail, consumer confidence in financial services as a whole may improve in the future.

61. To help provide a more concrete illustration of the possible benefits of the proposals, we end with an example of how they would affect ordinary retail investors who may have been exposed to an unregulated investment in an overseas property development under the current rules.
62. Property investments were one of the most popular asset classes in our 2010 UCIS review, accounting for around 20% of investment. Unregulated investment in overseas property development should not generally be regarded as low risk, low-to-medium risk or, even, medium risk. However, around one-third of customers in our review had risk profiles rated low or low-to-medium and almost half were prepared to take only a medium level of risk. While the investment may in some cases have been acceptable as a small component within a wider portfolio that balanced out the risks, we have too often found that the investment remains unsuitable even within the context of the full portfolio.
63. We have found problems with firms recommending customers invest a significant proportion, or even all, of their available capital. This is a problem we have had to cite in many of our enforcement notices. These customers suffer particular detriment from mis-sales and may be left in very vulnerable circumstances indeed. A number of the cases we have seen involved elderly individuals who met the criteria for high net worth investors being induced to invest the bulk of their capital in few or even one single non-mainstream pooled investment for retirement income, leaving them at risk of destitution if those investments failed.
64. The mean age of customers in our review was 53, but around 25% of customers were in retirement, with 15% in their 70s. If these investors are reliant on the product to generate retirement income, they are particularly hard hit if it fails: they lose the income itself, the ability to generate income with the loss of capital, and have little chance of being able to save up the lost money again in the future.
65. By stopping the promotion of investment products like these to ordinary retail investors, where there are so many unsuitable sales, we expect clear benefits in reduced consumer detriment by reducing the detrimental outcomes that follow from unsuitable investments.

Annex 4

Compatibility statement

1. This annex explains the reasons for concluding that our proposals and draft rules in this consultation are compatible with our general duties under section 2 of FSMA and our regulatory objectives, which are set out in sections 3 to 6 of FSMA. This section also outlines how our proposals are consistent with the principles of good regulation (also in section 2 of FSMA) to which we must have regard and with our responsibilities under the Equality Act 2010.

Our regulatory objectives

2. The proposals set out in this consultation are primarily designed to help us meet our objective of securing the appropriate degree of consumer protection. They are also relevant to our objectives of market confidence and reducing financial crime.

Consumer protection

3. Our work in this market has uncovered unacceptably high levels of inappropriate promotion and sales. Many promotions are in breach of current regulatory requirements and only a minority of advice is suitable. The potential for customer detriment is significant and has already crystallised for many customers. Our draft rules aim to address the potential for further mis-sales in this market and to reduce detriment.
4. We are acting under the product intervention strategy and judgement-based approach set out for the future of conduct regulation. We consider that investments within scope of this consultation are more likely to be inappropriately distributed, face problems and fail. We therefore expect that our proposals will lead to a significant reduction in retail customer detriment in the future.

Market confidence

5. The proposed rules aim to simplify our requirements where firms are dealing with retail clients. Except in specific circumstances, non-mainstream pooled investments should not reach retail customers. As these products carry higher investment and governance risks, the potential for detriment arising from inappropriate promotions and resulting unsuitable sales can lead to significant detriment. We expect our proposals will bring long-term benefits for the market, with retail customers exposed to fewer catastrophic product failures and becoming more confident in their use of investment products and services.

Reducing financial crime

6. Products within scope of this consultation do not face the same level of regulatory scrutiny as more mainstream regulated products. Retail investors and their advisers are likely to struggle to ascertain that governance structures within these products are adequate. This means there is greater potential for financial crime with some of these investments, including unlawful operation or marketing and even fraud. Limiting retail access will help reduce financial crime for retail investors.

Compatibility with the principles of good regulation

7. Section 2(3) of FSMA requires that, in carrying out our general functions, we must 'have regard' to a number of specific matters. We believe the proposals set out in this consultation fulfil all seven of our principles of good regulation.

The need to use our resources in the most economic and efficient way

8. In recent years, UCIS promotions and sales to retail clients have become a regulatory priority for the FSA. Standards in this sector of the market are so poor that significant Supervision and Enforcement resource is currently directed at identifying problems and providing redress for customers affected.
9. The proposals on which we are consulting aim to limit promotions to retail clients where there is greatest risk of mis-selling and detriment and to raise standards for the remaining promotions. The proposals also seek to address emerging risks from close substitute products and to reduce the scope for regulatory arbitrage, which should avoid, to at least some extent, the need for ongoing intervention in the market as similar issues arise with different product structures. In the medium to long-term, this should reduce the need for regulatory resource in this market.

The responsibilities of those who manage the affairs of authorised persons

10. Firms are not always meeting their current obligations in this market and too often are placing retail customers at risk of significant detriment. So our proposals aim to help firms understand their responsibilities and improve their standards.

The principle that a burden or restriction should be proportionate to the benefits

11. The proposals in this paper aim to protect ordinary retail customers from inappropriate promotions and potential detriment arising from resulting unsuitable sales. As we noted in Discussion Paper 11/1 on product intervention:

A more intrusive approach may lead to a reduction in the number of products available to consumers. But limiting consumer choice may be acceptable when the resulting benefits to the majority of consumers from not being mis-sold a product outweigh the costs to the minority who might benefit from being able to access it.¹

12. The CBA in Annex 3 outlines the expected costs and benefits of our proposals in more detail and supports our judgement that the costs from the proposals are proportionate to their benefits.

The desirability of facilitating innovation in connection with regulated activities

13. As we noted in the product intervention Feedback Statement, not all innovation and choice is in the interests of the retail market.² Our supervision of these investments shows a high proportion of promotion and sales have been unlawful, inappropriate and/or unsuitable, and there is significant potential for customer detriment.
14. We still want to see innovation, but only where it is in the interests of consumers. Given the higher levels of complexity typical of the products within the scope of our proposals, there is a high risk that novel products are distributed to ordinary retail investors, who are ill-equipped to judge the investments' nature and risks. In this context, the benefits of innovation are outweighed by the potential for detriment to ordinary retail customers.
15. Our proposals do not, however, affect the promotion of non-mainstream pooled investments to institutional and professional investors. As these investors contribute the vast majority of investment in these products in any event, we consider that it is unlikely that our proposals will significantly harm innovation in the non-mainstream pooled investments market overall. Firms will also continue to be able to promote these investments to retail investors who meet the criteria for certification as high net worth or sophisticated under the relevant exemptions.

¹ *Product intervention* Discussion Paper, DP11/1, January 2011

² *Product intervention* Feedback Statement, FS11/3, June 2011

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK

16. While many non-mainstream pooled investments are based overseas, and are therefore not subject to our direct regulation, the proposals achieve a level playing field for UK-based and offshore funds as well as distributor firms, wherever based, by focusing on distribution to UK retail investors. Generally speaking, all communications to such investors are treated alike.

The need to minimise adverse effects on competition and the desirability of facilitating competition between those who are subject to any form of regulation

17. The proposals should minimise adverse effects on competition arising from the currently differential regulatory treatment of different types of non-mainstream pooled investment. In future, these products will be subject to broadly the same marketing restrictions. Our proposals do not affect competition for institutional, professional or high net worth and sophisticated retail investors.

Enhancing the understanding and knowledge of members of the public of financial matters (including the UK financial system)

18. Distributors as well as ordinary retail customers clearly struggle to understand the implications of investing in non-mainstream pooled investments. The high rate of failure to follow current restrictions on promotions of UCIS or to provide suitable advice shows a need to improve understanding and knowledge in this market.
19. Acting under our more interventionist and judgement-based approach, however, we recognise that there are limits as to what can be achieved through improved transparency and disclosure. Improving financial capability among investors remains a long-term goal but, at present, we consider that the option most likely to achieve the desired reduction in consumer detriment is to limit promotion of these investments to those categories of customer most likely to understand their features, investment proposition and risks.

Why our proposals are the most appropriate way to meet our statutory objectives

20. For the reasons stated above we believe that our proposals are the most appropriate option for the purpose of meeting our objective of securing the appropriate degree of protection for consumers.

Equality and diversity implications

21. We are required under the Equality Act 2010 to 'have due regard' to the need to eliminate discrimination and to promote equality of opportunity in carrying out our policies, services and functions. As part of this, we conduct an equality impact assessment to ensure that the equality and diversity implications of any new policy proposals are considered.
22. Our initial assessments suggest that our proposals do not result in direct discrimination for any of the groups with protected characteristics i.e. age, disability, gender, pregnancy and maternity, race, religion and belief, sexual orientation and transgender, nor do we believe that our proposals could give rise to indirect discrimination against any of these groups.
23. Although, in the future, non-mainstream pooled investments may only be promoted to specified customer groups, the impact will not be discriminatory under equality legislation. These customer groups are not the protected groups under the Equality Act but refer to groups such as sophisticated or high net worth customers, regardless of whether or not they have protected characteristics. Customers in the protected groups should not be disadvantaged relative to any other customers.
24. We do not consider that there is any scope to reduce discrimination, promote good relations or to promote equality. We would not want to encourage the promotion of non-mainstream pooled investments to any particular groups of retail customers.

Annex 5

List of questions

- Q1:** Do you agree that we should look to impose restrictions on the promotion of non-mainstream pooled investments to ordinary retail investors?
- Q2:** Are there any other investments that should be treated in the same way?
- Q3:** Are there any investments caught by the non-mainstream pooled investment definition in the draft rules that you believe should not be?
- Q4:** Do you agree that we should remove the general ability of firms to promote UCIS under COBS 4.12.1R(4) category 1?
- Q5:** Do you agree that firms should still be able to promote replacement UCIS to retail customers where the original product is being replaced or liquidated?
- Q6:** Do you agree that we should remove the ability of firms to promote UCIS under COBS 4.12.1R(4) category 2?
- Q7:** Do you agree that we should remove the exemption in COBS 4.12.1R(4) category 8?

- Q8:** Do you agree that we should limit the ability of firms to promote QIS, securities issued by SPVs and TLPIs in the retail market?
- Q9:** Do you have any comments or suggested improvements for our approach to SPV-issued securities, including structured products?
- Q10:** Do you have any comments on the Handbook guidance we propose to add regarding the use of exemptions in the FPO and PCIS Order?
- Q11:** Do you agree that we should require firms to retain a record of the basis on which the promotion of a non-mainstream pooled investment has taken place for each financial promotion?
- Q12:** Should we require confirmation of compliance with the marketing restriction for each promotion?
- Q13:** Do you agree that the CF10 individual is the correct person to confirm compliance?
- Q14:** Do you have any comments on the Handbook guidance we propose to add regarding the link between promotion and advice?
- Q15:** Do you agree with our proposed update to the *retail investment product* definition?
- Q16:** Do you have any comments on the impact of our proposals on existing customers and the distributor firms serving them?
- Q17:** Do you have any comments on our analysis of non-mainstream pooled investments?

Q18: Do you have any further data on the size of the market?

Q19: Do you have any comments on our overall strategy to deal with the risks to retail customers of investing in UCIS?

Appendix 1:

Draft Handbook text

UNREGULATED COLLECTIVE INVESTMENT SCHEMES AND CLOSE SUBSTITUTES INSTRUMENT 2012

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of:
- (1) the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
 - (a) section 138 (General rule-making power);
 - (b) section 145 (Financial promotion rules);
 - (c) section 156 (General supplementary powers);
 - (d) section 157(1) (Guidance);
 - (e) section 238(5) (Restrictions on promotion); and
 - (2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.
- B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on *[date]*.

Amendments to the Handbook

- D. The modules of the FSA’s Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Conduct of Business sourcebook (COBS)	Annex B
Collective Investment Scheme sourcebook (COLL)	Annex C

Notes

- E. In Annex A to this instrument, the “note” (indicated by “**Note:**”) is included for the convenience of readers but does not form part of the legislative text.

Citation

- F. This instrument may be cited as the Unregulated Collective Investments Schemes and Close Substitutes Instrument 2012.

By order of the Board
[date]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

<i>certified high net worth investor</i>	a <i>retail client</i> who meets the requirements set out in article 21 of the <i>Promotion of Collective Investment Schemes Order</i> or in article 48 of the <i>Financial Promotions Order</i> .
<i>certified sophisticated investor</i>	a <i>retail client</i> who meets the requirements set out in article 23 of the <i>Promotion of Collective Investment Schemes Order</i> or in article 50 of the <i>Financial Promotions Order</i> .
<i>non-mainstream pooled investment</i>	any of the following <i>investments</i> : <ul style="list-style-type: none"> (a) a <i>unit</i> in an <i>unregulated collective investment scheme</i>; (b) a <i>unit</i> in a <i>qualified investor scheme</i>; (c) a <i>security</i> issued by a <i>special purpose vehicle</i>, other than: <ul style="list-style-type: none"> (i) an <i>investment trust</i>; (ii) a <i>covered bond</i>; (iii) a <i>security</i> whereby the issuer's payment obligations to the investor are linked to, contingent on, highly sensitive to or dependent on, the performance of or changes in the value of <i>shares</i> or <i>bonds</i> admitted to or <i>dealt</i> on a <i>regulated market</i> or on a market that is recognised as a market or exchange by an <i>overseas regulator</i>, whether or not such performance or changes in value are measured with reference to specific <i>shares</i> or <i>bonds</i> or via a market index or indices; (d) a <i>traded life policy investment</i>; or (e) <i>rights to or interests in investments</i> that are any of (a) to (d).
<i>one-off promotion</i>	a communication meeting the requirements set out in articles 15 or 15A of the <i>Promotion of Collective Investment Schemes Order</i> or in articles 28 or 28A of the <i>Financial Promotions Order</i>
<i>Promotion of Collective Investment Schemes Order</i>	the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001.
<i>self-certified</i>	a <i>retail client</i> who meets the requirements set out in article 23A of

<i>sophisticated investor</i>	the <i>Promotion of Collective Investment Schemes Order</i> or in article 50A of the <i>Financial Promotions Order</i> .
<i>traded life policy investment</i>	<p>an <i>investment</i> in relation to which one of the following conditions applies:</p> <ul style="list-style-type: none"> (a) it is a <i>traded life policy</i> other than an <i>endowment assurance policy</i>; or (b) its underlying assets are wholly or predominately <i>traded life policies</i> other than <i>endowment assurance policies</i>; or (c) its investment returns, or the issuer's payment obligations, are linked to, contingent on, or highly sensitive to, the performance of <i>traded life policies</i> other than <i>endowment assurance policies</i>.

Amend the following as shown.

<i>retail investment product</i>	<p>...</p> <p>(h) ...</p> <p>whether or not any of (a) to (h) are held within an <i>ISA</i> or a <i>CTF</i>.</p> <p><u>[Note: Section 238 of the Act and COBS 4.12.3R set out certain restrictions on the promotion of <i>non-mainstream pooled investments</i>. See also: COLL 8.1.3R and COLL 8 Annex 1R (Qualified investor schemes: eligible investors) in relation to recording ownership of <i>units</i> in the register of a <i>qualified investor scheme</i>, and COBS 9.3.5G (Non-mainstream pooled investments).]</u></p>
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Annex B

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

4.1.9 G ...

- (3) The *financial promotion rules* do not apply to incoming communications in relation to the *MiFID business* of an *investment firm* from another *EEA State* that are, in its *home member state*, regulated under *MiFID* ~~in another *EEA State*~~ other than to the extent *COBS 4.12 (Restriction on the promotion of unregulated collective investment schemes and other non-mainstream pooled investments)* applies. ~~For the purpose of article 36 of the *Financial Promotion Order* the *FSA* does not make any *rules* in relation to such incoming communications.~~

...

Non-mainstream pooled investments: record keeping requirements

4.11.4 R If a *firm* promotes a *non-mainstream pooled investment* to a *retail client*, the person allocated the *compliance oversight function* in the *firm* must make and retain a record certifying that the *financial promotion* complies with the restrictions set out in section 238 of the *Act* and in *COBS 4.12.3R*, as applicable.

4.11.5 R In addition to the requirement in *COBS 4.11.4R*, if a *firm* promotes a *non-mainstream pooled investment* to a *retail client*, it must comply with the following requirements:

- (1) if the *non-mainstream pooled investment* is an *unregulated collective investment scheme*, it must make and retain a record of which exemption in the *Promotion of Collective Investment Schemes Order* or in *COBS 4.12.1R* was relied on for the purposes of the promotion, together with the reason why the *firm* is satisfied that that exemption applies;
- (2) for any other *non-mainstream pooled investment*, it must make and retain a record of which exemption in *COBS 4.12.4R* was relied on for the purposes of the promotion, together with the reason why the *firm* is satisfied that that exemption applies;
- (3) where the *firm* relies on an exemption that requires investor certification and warnings to investors, it must retain a copy of any certificate or investor statement and of any warnings or indications required by the exemption.

4.11.6 R For the purposes of COBS 4.11.5R(2):

- (1) if the exemption relied on is that for an *excluded communication* under COBS 4.12.4R(2), the *firm* must identify in the record which exemption in the *Financial Promotion Order* was relied on for the purposes of the promotion, together with the reason why the *firm* is satisfied that the exemption applies;
- (2) similarly, if the *firm* is relying on COBS 4.12.4R(3) for the purposes of promoting *units* in a *qualified investor scheme*, it must identify in the record which eligible investor category in COLL 8 Annex 1R was applicable, together with the reasons why the *firm* is satisfied the *client* receiving the promotion is eligible under that category.

4.11.7 R The records required under COBS 4.11.4R and COBS 4.11.5R should be retained for the same periods as set out in COBS 4.11.1R(3).

4.12 **Unregulated Restriction on the promotion of unregulated collective investment schemes and other non-mainstream pooled investments**

Restriction on the promotion of unregulated collective investment schemes

4.12.1 R ...

(4) Promotion to:	Promotion of an unregulated collective investment scheme which is:
Category 1 person (1) a person who is already a participant in an unregulated collective investment scheme; (2) A person who has been, in the last 30 months, a participant in an unregulated collective investment scheme.	A. that collective investment scheme; or B. any other collective investment scheme whose underlying property and risk profile are both ‘substantially similar’ (see Note 1) to those of that collective investment scheme; or C. a A. an unregulated collective investment scheme which is intended to absorb or take over the assets of that unregulated collective investment scheme; or D. a B. an unregulated collective investment scheme, units in which are being offered by its operator as an alternative to cash on the liquidation of that

	<i>unregulated collective investment scheme.</i>
<p>Category 2 person [deleted]</p> <p>(1) A person</p> <p>(a) for whom the firm has taken reasonable steps to ensure that investment in the collective investment scheme is suitable; and</p> <p>(b) who is an ‘established’ or ‘newly accepted’ client of the firm or of a person in the same group as the firm (see Notes 2 & 3).</p>	That collective investment scheme
<p>Category 3 person</p> <p>...</p>	Any such <i>unregulated</i> collective investment scheme-
<p>Category 4 person</p> <p>...</p>	<p>1. A <i>An unregulated collective investment scheme</i> the instrument constituting which:</p> <p>A. ...</p> <p>B. ...</p> <p>2. Any <i>unregulated collective investment scheme</i> provided that the participation of eligible employees is to facilitate their co-investment:</p> <p>(i) ...</p> <p>(ii) ...</p>
<p>Category 5 person</p> <p>...</p>	...
<p>Category 6 person</p> <p>...</p>	Any <i>unregulated collective investment scheme.</i>
<p>Category 7 person</p> <p>...</p>	Any <i>unregulated collective investment scheme</i> in relation to which the <i>client</i> is categorised as a <i>professional client</i> or <i>eligible counterparty</i> (see Note 5).
<p>Category 8 person [deleted]</p>	Any collective investment

<p><i>A person:</i></p> <p>(1) in relation to whom the <i>firm</i> 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 <i>person</i> is capable of making his own investment decisions and understanding the risks involved;</p> <p>(2) to whom the <i>firm</i> has given a clear warning that this will enable the <i>firm</i> to promote <i>unregulated collective investment schemes</i> to the <i>client</i>; and</p> <p>(3) who has stated in writing, in a <i>document</i> separate from the contract, that he is aware of the fact the <i>firm</i> can promote certain <i>unregulated collective investment schemes</i> to him.</p>	<p><i>scheme</i> covered by the assessment.</p>
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The following Notes explain certain words and phrases used in the table above.

Note 1	The property of a <i>collective investment scheme</i> is ‘substantially similar’ to that of another <i>collective investment scheme</i> if in both cases the objective is to invest in the same one of the following sectors:	
	(a)	<i>on-exchange derivatives</i> or <i>warrants</i> ;
	(b)	<i>on-exchange</i> (or quoted) <i>securities</i> ;
	(c)	the property market (whether in <i>security</i> of property <i>companies</i> or in property itself);
	(d)	collectable items of a particular description (such as works of art, antique vehicles, etc);
	(e)	artistic productions (such as films, television, opera, theatre or music);
	(f)	unlisted <i>investments</i> (including unlisted <i>debt securities</i>). [deleted]

The risk profile of a <i>scheme</i> will be substantially similar to that of another <i>scheme</i> only if there is such similarity in relation to both liquidity and volatility.	
...	

...

...

Restriction on the promotion of other non-mainstream pooled investments

- 4.12.3 R (1) A firm must not communicate or approve an invitation or inducement to acquire, convert or underwrite a *non-mainstream pooled investment* where that invitation or inducement is addressed to or disseminated in such a way that it is likely to be received by a *retail client*.
- (2) The restriction in (1) is subject to COBS 4.12.4R and does not apply to *units in unregulated collective investment schemes* (which are subject to a specific restriction as described in COBS 4.12.1R).

Exemptions from the restriction on the promotion of other non-mainstream pooled investments

- 4.12.4 R The *financial promotion* restriction in COBS 4.12.3R does not apply if:
- (1) the communication only amounts to a *financial promotion* because it is a *personal recommendation* on a replacement product as set out in COBS 4.12.5R and the *non-mainstream pooled investment* is not a *unit* in a *qualified investor scheme*; or
- (2) the *financial promotion* is an *excluded communication*; or
- (3) in relation to *qualified investor schemes* only, if the *retail client* is an eligible investor under categories 1, 3, 4, 5 or 6 in COLL 8 Annex 1R.
- 4.12.5 R For the purposes of COBS 4.12.4R(1), a *personal recommendation* on a replacement product is a communication that meets the following conditions:
- (1) the *client* already owns or holds rights to or interests in a *non-mainstream pooled investment* that is being liquidated or wound down; and
- (2) the *personal recommendation* concerns a *non-mainstream pooled investment* which is intended to absorb or take over the assets of that *non-mainstream pooled investment*, or which is being offered by the *operator* of that *non-mainstream pooled investment* as an alternative to cash on its liquidation.
- 4.12.6 G Where a *firm* communicates any promotion of a *non-mainstream pooled*

investment in the context of advice, it should have regard to and comply with its obligations under COBS 9. Firms should also be mindful of the appropriateness requirements in COBS 10 which apply to a wide range of non-advised services.

Sophisticated and high net worth investors: guidance on certification by authorised person and reliance on self-certification

- 4.12.7 G (1) A firm which wishes to rely on the certified high net worth investor exemption provided by the Promotion of Collective Investment Schemes Order or the equivalent excluded communication under the Financial Promotion Order should have regard to its duties under the Principles and the client's best interests rule. In particular, the firm should take reasonable steps to ascertain that the retail client does, in fact, meet the income and net assets criteria set out in the relevant statement for certified high net worth investors (see Part I of the Schedule to the Promotion of Collective Investment Schemes Order and Part I of Schedule 5 to the Financial Promotions Order).
- (2) In addition, the firm should consider whether the promotion of the non-mainstream pooled investment is in the interests of the retail client and whether it is fair to make the promotion to that client on the basis that the client is a certified high net worth investor, having regard to the generally complex nature of non-mainstream pooled investments. A retail client who meets the criteria for a certified high net worth investor but not for a certified sophisticated investor may be unable to properly understand and evaluate the risks of the non-mainstream pooled investment in question.
- 4.12.8 G (1) A firm which is asked to or proposes to assess and certify a retail client as a certified sophisticated investor should have regard to its duties under the Principles and the client's best interests rule. In particular, the firm should carry out that assessment with due skill, care and diligence, having regard to the generally complex nature of non-mainstream pooled investments and the level of experience, knowledge and expertise the retail client being assessed must possess in order to be fairly and reasonably assessed and certified as a sophisticated investor.
- (2) (a) For example, a retail client whose investment experience is limited to mainstream investments such as securities issued by listed companies, life policies or units in regulated collective investment schemes (other than qualified investor schemes) is generally unlikely to possess the requisite knowledge to adequately understand the risks associated with investing in non-mainstream pooled investments.
- (b) In exceptional circumstances, however, the retail client may have acquired the requisite knowledge through means other than his own investment experience, for example, if the retail client is a professional of several years' experience

with the design, operation or marketing of complex investments such as *options, futures, contracts for differences* or *non-mainstream pooled investments*.

- 4.12.9 G (1) A firm which wishes to rely on the *self-certified sophisticated investor* exemption provided by the *Promotion of Collective Investment Schemes Order* or the equivalent *excluded communication* under the *Financial Promotion Order* should have regard to its duties under the *Principles* and the *client's best interests rule*. In particular, the *firm* should consider whether the promotion of the *non-mainstream pooled investment* is in the interests of the *client* and whether it is fair to make the promotion to that *client* on the basis of self-certification.
- (2) For example, it is unlikely to be appropriate for a *firm* to make a promotion under either *self-certified sophisticated investor* exemption without first taking reasonable steps to satisfy itself that the investor does in fact have the requisite experience, knowledge or expertise to understand the risks of the *non-mainstream pooled investment* in question.

One-off promotions

- 4.12.10 G (1) A firm which wishes to rely on one of the *one-off promotion* exemptions provided by the *Promotion of Collective Investment Schemes* or the *Financial Promotion Order* to promote a *non-mainstream pooled investment* to a *retail client* should have regard to its duties under the *Principles* and the *client's best interests rule*. In particular, the *firm* should consider whether the promotion of the *non-mainstream pooled investment* is in the interests of the *client* and whether it is fair to make the promotion to that *client* on the basis of a *one-off promotion* exemption.
- (2) The *one-off promotion* exemptions permit the promotion of investments to clients under certain conditions (see *PERG* 8.14.3G to 8.14.13G for guidance on the scope of the one-off exemptions in the *Financial Promotion Order*). *Firms* should note that, in the *FSA's* view, promotion of a *non-mainstream pooled investment* to a *retail client* who is not a *certified high net worth investor*, a *certified sophisticated investor* or a *self-certified sophisticated investor* is unlikely to be appropriate or in that *client's* best interests.

Qualified investor schemes

- 4.12.11 G (1) A firm which wishes to rely on one of the exemptions provided by way of the *excluded communications* exemption in *COBS* 4.12.4R(2) promote *units* in a *qualified investor scheme* to a *retail client* should have regard to its duties under the *Principles* and the *client's best interests rule*.
- (2) As explained in *COLL* 8.1, *qualified investor schemes* are intended

for sophisticated investors only. Firms should note that, in the FSA's view, promotion of units in a qualified investor scheme to a retail client who is not a certified sophisticated investor or a self-certified sophisticated investor is unlikely to be appropriate or in that client's best interests.

...

9.3 Guidance on assessing suitability

...

Non-mainstream pooled investments

- 9.3.5 G (1) Firms should note that section 238 of the Act and COBS 4.12.3R set out restrictions on the promotion of non-mainstream pooled investments to retail clients.
- (2) (a) Firms should bear in mind that the provision of advice or information may involve the communication of a financial promotion (see PERG 8). In particular, making a personal recommendation that a client should enter into a non-mainstream pooled investment will generally amount to a financial promotion of that investment because a personal recommendation typically includes an invitation or inducement to engage in investment activity.
- (b) If no valid exemption is available and relied upon by the firm in promoting the investment, the promotion will be unlawful. Firms should therefore first satisfy themselves that an exemption is available in relation to the promotion of the non-mainstream pooled investment before recommending the investment to a retail client.
- (3) In addition to assessing whether the promotion is permitted, a firm giving advice on a non-mainstream pooled investment should comply with their obligations in COBS 9 and ensure any personal recommendation is suitable for its client.

...

Schedule 1 Record keeping requirements

...

Sch 1.3G

Handbook reference	Subject of record	Contents of record	When record must be made	Retention period
...				

COBS 4.11.2G	...			
<u>COBS 4.11.4R</u>	<u>Non-mainstream pooled investments: certification of compliance</u>	<u>Certification by the firm's compliance oversight function that the financial promotion is compliant with the restrictions in section 238 of the Act and COBS 4.12.3R, as applicable</u>	<u>Date of certification</u>	<u>See COBS 4.11.7R</u>
<u>COBS 4.11.5R</u>	<u>Non-mainstream pooled investments: financial promotion restriction</u>	<u>Which exemption applies and the reason why that exemption applies. Where the exemption requires a certificate, investor statement, warning or indication, a copy of that certificate, investment statement, warning or indication.</u>	<u>The date the promotion is made to the client</u>	<u>See COBS 4.11.7R</u>

..

Annex D

Amendments to the Collective Investment Schemes sourcebook (COLL)

In this Annex, underlining indicates new text and striking through indicates deleted text.

8 Annex 1R Qualified Investor Schemes: eligible investors

This Annex belongs to *COLL* 8.1.3R

For the purposes of the *rule* on ~~qualified investor schemes~~ qualified investor schemes: eligible investors (*COLL* 8.1.3R) a *firm* must only record ownership of *units* in the register of a *qualified investor scheme* in accordance with the following table:

Issue or transfer of units to:	Issue or transfer of units (see Note 1) in a qualified investor scheme which is:
<p>Category 1 person</p> <p>A person:</p> <p>(1) who is already a <i>participant</i> in an unregulated collective investment scheme or a <i>qualified investor scheme</i>; or</p> <p>(2) who has been, in the last 30 months, a participant in an unregulated collective investment scheme or a qualified investor scheme.</p>	<p>(1) that collective investment scheme; or</p> <p>(2) any other collective investment scheme whose underlying property and risk profile are both ‘substantially similar’ (see Note 2) to those of that collective investment scheme; or</p> <p>(3) (1) a collective investment <u>qualified investor</u> scheme which is intended to absorb or take over the assets of that collective investment scheme; or</p> <p>(4) (2) a collective investment <u>qualified investor</u> scheme, units in which are being offered by its operator as an alternative to cash on the liquidation of that collective investment scheme.</p>
<p>Category 2 person [deleted]</p> <p>A person:</p> <p>(1) for whom the authorised fund manager or an associate has taken reasonable steps to ensure that investment in the collective investment scheme is suitable; and</p> <p>(2) who is an ‘established’ or ‘newly accepted’ client of the authorised fund manager or of an associate (see Notes 3 & 4).</p>	<p>that collective investment scheme.</p>
<p>Category 3 person</p> <p>...</p>	<p>any <u>Any</u> such <i>collective investment qualified investor scheme</i>.</p>

<p>Category 4 person ...</p>	<p>(1) A collective investment <u>qualified investor scheme</u> of which the <i>instrument constituting the scheme</i>: (a) ... (b) ... (2) Any collective investment <u>qualified investor scheme</u> provided that the participation of eligible employees is to facilitate their co-investment: (a) ... (b) ...</p>
<p>Category 5 person ...</p>	<p>Any collective investment <u>qualified investor scheme</u>.</p>
<p>Category 6 person ...</p>	<p>Any collective investment <u>qualified investor scheme</u> in relation to which the client is categorised as a <i>professional client</i> or <i>eligible counterparty</i>.</p>
<p>Category 7 person</p> <p>(1) in relation to whom the <i>authorised fund manager</i> or an <i>associate</i> 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 <i>person</i> is capable of making his own investment decisions and understanding the risks involved;</p> <p>(2) to whom the authorised fund manager or an associate has give a clear written warning of the protections he may lose; and</p> <p>(3) who has stated in writing, in a separate document from the contract, that he is aware of the consequences of losing such protections.</p> <p><u>A person to whom a <i>qualified investor scheme</i> may be promoted under COBS 4.12.4R(2).</u></p>	<p>Any <i>collective investment scheme</i> covered by the assessment—</p> <p><u>Any <i>qualified investor scheme</i>.</u></p>

The following Notes explain certain words and phrases in the table above.

...

Note 5	...
<u>Note 6</u>	<u>Firms should note that <i>qualified investor schemes</i> are <i>non-mainstream pooled investments</i> in relation to which a restriction on <i>financial promotions</i> is imposed by COBS 4.12.3R. See COBS 4.12.11G for guidance on the promotion of <i>qualified investor schemes</i> by way of the <i>excluded communications</i> exemption in COBS 4.12.4R(2). See also COBS 9 for rules and guidance on <i>firms'</i> obligations when advising <i>clients</i> to invest in <i>qualified investor schemes</i>. The appropriateness requirements in COBS 10 may also be applicable where non-advised services are provided.</u>
<u>Note 7</u>	<u>Firms wishing to promote <i>units</i> in a <i>qualified investor scheme</i> to <i>Category 7</i> persons on the basis that they are <i>certified sophisticated investors</i> or <i>self-certified sophisticated investors</i> should refer to COBS 4.12.9G and 4.12.10G for guidance on certification by authorised persons and reliance on self-certification.</u>

Appendix 2:

Designation of Handbook provisions

1. FSA Handbook provisions will be ‘designated’ to create a FCA Handbook and a PRA Handbook on the date that the regulators exercise their legal powers to do so. Please visit our website for further details about this process.¹
2. We plan to designate the Handbook provisions which we are proposing to create and/or amend within this Consultation Paper as follows:

Handbook Provision	Designation
All provisions for this consultation paper	FCA

¹ <http://media.fsahandbook.info/latestNews/One-minute%20guide.pdf>

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