

# **Consultation on proposed amendment of COBS 21.3 permitted links rules**

**Consultation Paper**

CP18/40\*\*

December 2018



## How to respond

We are asking for comments on this Consultation Paper (CP) by 28 February 2019.

You can send them to us using the form on our website at: [www.fca.org.uk/cp18-40-response-form](http://www.fca.org.uk/cp18-40-response-form)

Or in writing to:  
Roy Bartholomew  
Financial Conduct Authority  
12 Endeavour Square  
London E20 1JN

**Telephone:** 020 7066 1708

**Email:**  
[cp18-40@fca.org.uk](mailto:cp18-40@fca.org.uk)

### How to navigate this document onscreen



returns you to the contents list



takes you to helpful abbreviations

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# 1 Summary

## Why we are consulting

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- 1.1** We are consulting on potential changes to our permitted links rules in our Conduct of Business (COBS) sourcebook. The purpose is to address any unjustified barriers these may present to investment by retail investors in a broader range of long-term assets in unit-linked funds, while continuing to offer an appropriate degree of investor protection.
- 1.2** Our consultation follows recommendations by the Law Commission in their June 2017 report on Pension Funds and Social Investment (see below) and engagement with HM Treasury's Pension Scheme Investment Taskforce (see below) regarding potential regulatory barriers to investment in illiquid 'patient capital' assets. Patient capital refers to a broadly defined range of illiquid investments (including, for example, venture capital, infrastructure and corporate loans) intended to deliver long-term returns. These different elements of patient capital may have significantly different/higher risk profiles and this may in turn affect their suitability for retail investors.

## Who this applies to

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- 1.3** You should read this if you have an interest in unit-linked funds that may wish to hold illiquid or higher risk assets. Our consultation may therefore be of interest to:
- pension scheme operators and trustees
  - operators and investment managers of unit-linked funds
  - life assurance companies with exposure to illiquid assets such as property, either by direct investment or through holdings in investment funds
  - intermediaries, such as platform service providers, wealth managers or financial advisers, whose retail clients invest in funds holding illiquid assets
  - firms communicating to retail clients financial promotions relating to funds making significant investments in illiquid assets (these firms will be subject to the requirement in our Conduct of Business Sourcebook (COBS) to include a risk warning)
  - investors who have direct or indirect exposure to these funds



- 1.4** Others may have a less direct interest in the issues raised in this consultation but may also find the CP relevant. For example:
- managers of other types of fund such as undertakings for collective investment in transferable securities (UCITS), qualified investor schemes (QIS) or unauthorised schemes which may be affected by our proposals
  - insurance and investment trade bodies
  - consumer groups

### The wider context of this consultation

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- 1.5** Our 2016 review of property funds and liquidity risks and subsequent discussion and consultation papers found that liquidity risks in unit-linked and authorised funds were successfully managed. However, the proportion of illiquid assets (mainly commercial property) held in unit-linked funds was very low in proportion to overall assets (£27 billion compared with £914 billion in total).
- 1.6** The Law Commission's June 2017 report on Pension Funds and Social Investment ('the Law Commission report') recommended that we consider further guidance about the permitted links rules for unit-linked funds, in particular how pension funds can manage some element of illiquid investment in their funds. We said that we would review our rules in the light of this report and our engagement with the HM Treasury-led Pensions Scheme Investments Taskforce ('the Patient Capital Taskforce'<sup>1</sup>). The Patient Capital Taskforce has also been concerned that the rules as they stand may present regulatory barriers to illiquid patient capital investments. It identified areas where clarifying and updating our rules would allow further unit-linked investment in a broad range of patient capital assets (HM Treasury 'Financing growth in innovative firms: one-year on' October 2018).
- 1.7** In addition to this paper we have published a discussion paper which explores how effectively the UK's existing fund regime enables investment in patient capital. This will accompany the ongoing work of HM Treasury's Asset Management Taskforce to explore the feasibility of a new long-term asset fund. Both papers were announced in the Government's Budget Statement of 29 October 2018.
- 1.8** This paper sets out our proposals for amendments to our permitted links rules following our review.
- 1.9** Further details are provided in Chapter 2.

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<sup>1</sup> A working group of institutional investors, fund managers and regulators whose objective is to explore how to tackle barriers holding back Defined Contribution pension savers from investing in patient capital. The Taskforce was initiated by HMT in the Autumn Budget of 2017 as part of the Government's response to the Patient Capital Review.

## What we want to change

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**1.10** We are proposing amendments and additions to the permitted links rules in COBS 21.3 and relevant related rules in four broad areas (which we detail in Chapter 3).

### Clarification of existing requirements

**1.11** We are providing information around existing permitted links requirements to clarify our expectations in areas where the interpretation of our rules is perceived as a barrier to patient capital investment.

### Revised wording to broaden investment range

**1.12** For insurers which are able to meet conditions which provide an enhanced degree of investor protection, we propose to add additional conditional permitted links categories which supplement the existing range of permitted links (for example, a new category of conditional permitted immovables in addition to the existing category of 'permitted land and property'- COBS 21.3.1R(2)(d) to facilitate investment in, for example, a wider range of permitted infrastructure projects).

### New limits

**1.13** We also propose to set a new limit requiring that overall investments in illiquid assets in a linked fund should comprise no more than 50% of total assets for firms meeting the new conditions. Our proposed changes will remove, and therefore allow these firms to exceed, the current limits for individual permitted links categories as long as they don't exceed the overall threshold limit. This is to enable flexibility in the choice of illiquid assets. For firms which do not meet the investor protection conditions, there will be no change to current limits.

### Other proposals – risk mitigations

**1.14** We propose to introduce appropriate risk warnings to help consumers understand the investment and liquidity risks involved. We also propose a requirement on firms using the greater flexibilities afforded by our proposed changes to ensure that investments in more illiquid or risky assets are only offered/taken up where it is suitable and appropriate. This includes firms taking responsibility for ensuring that linked policyholders are not prevented from exercising their rights under their unit-linked policies because of the nature of the assets to which their policy returns are linked.

## Outcome we are seeking

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**1.15** We are seeking to remove some potential barriers to retail investors investing in a broader range of long-term assets in unit-linked funds. Our measures should:

- Benefit consumers by allowing funds to choose investment opportunities that match the investment needs of consumers more effectively.
- Enable a broader range of long-term investment through unit-linked funds, particularly in defined contribution pension funds where members invest via unit-linked funds.
- Increase confidence and participation in the market by providing an appropriate degree of protection for investors seeking to invest in illiquid or higher risk patient capital assets within unit-linked funds.



- Reduce potential harm from a lack of consumer understanding of the type of assets that they hold and reduce risks that consumers may invest in products that do not fully reflect their investment needs. This would be achieved by making investment and liquidity risks more transparent and requirements on authorised firms to take responsibility for ensuring that higher risk or more illiquid investments are only offered or taken up where it is suitable and appropriate for consumers and the purposes for which their investments are held.

## Measuring success

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- 1.16** If successful we should see greater investment in patient capital via unit-linked funds where such investments are appropriate and suitable for retail investors and their investment goals.

## Next steps

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### How to respond to our consultation

- 1.17** Please respond to this paper by 28 February 2019.
- 1.18** How to submit your response is set out on page 2.

### What we will do

- 1.19** We will consider feedback to this consultation and publish a Policy Statement and, where relevant, make our final rules and guidance in 2019.

## 2 The wider context

### The harm we are trying to address

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**2.1** If successful, our proposals will help markets to work well and secure better outcomes for consumers by:

- Addressing some barriers our rules may present to investment by retail investors in a broader range of long-term assets in unit-linked funds, particularly defined contribution pension funds where members invest via unit-linked funds
- Enabling investment choices to match more effectively the needs of consumers, particularly where the consumers' investment priority is maximising long-term returns rather than having access to short-term liquidity
- increasing confidence and participation in the market by providing an appropriate degree of protection for investors seeking to invest in illiquid or higher risk 'patient capital' assets within unit-linked funds
- Reduce potential harm from a lack of consumer understanding of the type of assets that they hold and reduce risks that consumers may invest in products that do not fully reflect their investment needs. This would be achieved by making investment and liquidity risks more transparent and ensuring that authorised firms take responsibility for ensuring that higher risk or more illiquid investments are only offered or taken up where it is suitable and appropriate for consumers and the purposes for which their investments are held.

**2.2** Our proposals were primarily informed by responses to our Discussion Paper on illiquid assets, the June 2017 Law Commission report on Pension Funds and Social Investment and the work of the Patient Capital Taskforce. These are summarised below.

### Our review of liquidity of property funds following the EU referendum

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**2.3** Our Discussion Paper (DP 17/1), which followed our review of the property fund suspensions and pricing adjustments immediately after the EU referendum in 2016, found that liquidity risks in unit-linked and authorised funds were successfully managed.

**2.4** However, the proportion of illiquid assets (mainly commercial property) held in unit-linked funds was very low in proportion to the total of unit-linked funds held overall (£27 billion compared with £914 billion in total). The reason for this was unclear, although the Law Commission report and the subsequent work of the Patient Capital Taskforce have indicated that the permitted links rules may present unintended barriers to less liquid investments in unit-linked funds.



- 2.5** As the majority (at least 85% - TR13/8, 'The governance of unit-linked funds') of unit-linked funds are in pension investments, investors in such funds are generally investing for the longer term, and need less on-demand liquidity than they might for shorter-term investment products. In that context, if our rules incentivise fund managers to sacrifice expected return for unused liquidity which is more than required to meet contractual obligations, this may be to the detriment of some investing consumers.
- 2.6** Our recent consultation on illiquid assets (CP18/27) has sought to address some of the issues around liquidity management in authorised funds. However, it has become apparent that there may be a need for additional rules and guidance more specifically focused on unit-linked funds and the operation of the permitted links rules.
- 2.7** The relevant FCA 'permitted links rules' in COBS 21.3 are designed to ensure that the investments underlying unit-linked policies are suitable for retail investors, by specifying the types of investment (the "permitted links") insurers can include within those policies. These rules apply only where it is policyholders who are natural persons that bear the investment risk.
- 2.8** This means that insurers are not restricted by COBS 21.3 in what they can offer defined benefit (DB) pension schemes. This is because the trustee of the scheme is regarded as the policyholder and the risks to individual members of the scheme are shared in aggregate. However, insurers offering unit-linked policies to defined contribution (DC) pension schemes are subject to COBS 21.3 because their members are likely to be 'policyholders' who are natural persons and ultimately bear the investment risk.

## The Law Commission report

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- 2.9** The June 2017 Law Commission report on Pension Funds and Social Investment was undertaken to look at how far pension funds may or should consider issues of social impact when making investment decisions. It recommended (The Law Commission, 'Pension Funds and Social Investment' (Law Com 374) June 2017, Option for reform 5) that the FCA should consider further guidance for unit-linked funds and the permitted links rules. In particular, 'how pension schemes can manage some element of illiquid investment within their funds and how they can produce unit prices for illiquid assets'. In our public response to that report, we said we would review our rules in the second half of 2018, engage with the Patient Capital Taskforce and continue our work following HM Treasury's Patient Capital Review.

## The Patient Capital Taskforce

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- 2.10** Following the Law Commission's recommendations, we have engaged with HM Treasury and the Patient Capital Taskforce, which has looked at how to deal with barriers holding back defined contribution pension savers from investing in patient capital. From our discussions with HM Treasury and the Patient Capital Taskforce, it appears that there may be a case to amend the permitted links rules and/or provide guidance to remove some regulatory barriers. Three areas of the permitted links rules where changes may be beneficial were identified:



- the liquidity requirement for permitted unlisted securities;
- the scope of the definition of 'land and property' as a permitted asset;
- the provisions relating to the threshold limits for permitted assets.

**2.11** We have proposed solutions to each of these areas in this paper, covering the five existing categories of permitted links most relevant to 'patient capital' investment. Our proposals aim to strike an appropriate balance between facilitating wider investment choices via unit-linked insurance contracts and maintaining an appropriate degree of consumer protection.

**2.12** We are also considering wider issues on patient capital, such as the potential for new authorised fund structures that enable wider investment choice. This is the subject of the separate Discussion Paper we have published. It explores how effectively the UK's existing fund regime enables investment in patient capital. This will accompany the ongoing work of HM Treasury's Asset Management Taskforce to explore the feasibility of a new long-term asset fund.

**2.13** Both papers were announced in the Government's Budget Statement of 29 October 2018. Measures on government support for pension funds to invest in growing UK businesses through the British Business Bank were also announced. In response, several of the largest DC pension providers have committed to explore pooled investment options for patient capital. The Department of Work and Pensions will also consult in 2019 on the function of the pensions charge cap in default pension schemes, to ensure that it does not unduly restrict the use of performance fees within default member schemes, while maintaining member protections.

## How our proposals link to our objectives

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**2.14** For further detail please see the Compatibility Statement in Annex 3 of this paper.

### **Well functioning markets**

#### ***Greater flexibility of investment choice within appropriate limits***

**2.15** Our proposals link to the FCA's strategic objective of ensuring that the relevant markets function well. They enable greater flexibility regarding the types of assets that may be invested in while placing appropriate limits on the overall level of illiquid assets within unit-linked investments where the investment risk is borne by retail investors.

### **Consumer protection**

#### ***Diversifying investment choice while maintaining consumer protection and information***

**2.16** Our proposals advance our consumer protection objective. If our current rules act to prevent investment in illiquid assets offering a higher expected return than more liquid alternatives, but short-term liquidity is not an investment requirement, this is likely to lead to poorer consumer outcomes. Rather than banning certain types of more illiquid or higher risk investment, we are proposing more flexibility while ensuring that firms must still consider the particular risks that may arise when unit-linked funds invest in illiquid and higher risk assets. We have sought to identify ways in which these risks may be mitigated in a proportionate way, while still allowing retail investors access



to products that can help to diversify their investment portfolios and ensuring that consumers have the information they need to understand fully the risks involved.

### **Competition**

- 2.17** Our proposals will advance our competition objective by enabling investment in a broader range of long-term assets and potentially enabling firms to develop more suitable products for investors' needs. This will lead to product innovation and potential for new firms to enter the market.

## **Wider effects of this consultation**

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### **Longer-term impact on market for unit-linked funds**

- 2.18** The changes we are proposing should help firms to match investments to the long-term investment needs of consumers more effectively. They should also enable a broader range of long-term investment through pension funds and facilitate more product development and innovation, so widening consumer choice.
- 2.19** Our rules should also provide greater flexibility to enable fund managers to manage liquidity and investment risks in unit-linked funds more effectively.

## **What we are doing**

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- 2.20** In the following chapter, we set out in detail the proposed Handbook changes on which we are consulting. These take into account the Law Commission's recommendation and the views of HM Treasury's Patient Capital Taskforce. Our proposals include detailed additions and amendments across a range of areas within the permitted links rules in COBS 21.3 and related rules in other sourcebooks.
- 2.21** We are keen to have respondents' views on whether:
- our proposals are a sufficient and proportionate response to the issues identified regarding barriers to holding illiquid and/or higher risk 'patient capital' assets in unit-linked funds;
  - there are any potential unintended negative consequences of any of the measures set out in this CP;
  - we should consider taking any further measures to improve the framework of rules and guidance applying to this area of the market.

## Equality and diversity considerations

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- 2.22** We have considered the equality and diversity issues that may arise from our proposals in this CP.
- 2.23** Overall, we do not consider that the proposals adversely impact any of the groups with protected characteristics under the Equality Act 2010. But we will continue to consider the equality and diversity implications of the proposals during the consultation period, and will revisit them when publishing the final rules.
- 2.24** In the meantime, we welcome your input on these issues.



## 3 Proposed amendments to COBS 21.3

- 3.1** The relevant rules, in COBS 21.3, are designed to ensure the investments underlying unit-linked life policies are suitable for retail investors, by specifying the types of investment (the permitted links) insurers can include.
- 3.2** Five existing categories of permitted links in COBS 21.3 are the most relevant to 'patient capital' investment. They are:
- Permitted land and property (COBS 21.3.1R (2) (d))
  - Permitted unlisted securities (COBS 21.3.1R (2) (c))
  - Permitted scheme interests (COBS 21.3.1R (2) (g))
  - Permitted loans (COBS 21.3.1R (2) (e))
  - Approved securities (COBS 21.3.1R (2) (a))
- 3.3** We are proposing to add additional categories of conditional permitted links to supplement four of these five categories for those insurers who meet new conditions based on ensuring an enhanced level of investor protection.
- 3.4** No firm will be required to change its investment choices as a result of these proposed rules. Firms would, however, have scope to invest a greater proportion of overall funds in assets that are illiquid or offer higher expected returns to compensate for higher risk, providing these firms also take additional consumer protection measures.

### **Category 1: Permitted land and property (COBS 21.3.1R (2) (d))**

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- 3.5** Certain projects may be included within the existing category of 'land and property', which is further defined in our Handbook Glossary as 'any interest in land (and any buildings on it)', subject to a list of further conditions. We believe it is clear that this category already includes, for example, 'buildings' such as hospitals, schools, stadia and power plants, or similar, which can often be the subject of 'patient capital' investments. This is not an exhaustive list.
- 3.6** To allow for broader investment in the infrastructure elements of patient capital via this category, we propose:
- **Allowing for investment in 'immovable' structures or installations on any property situated within the United Kingdom by creating a 'conditional permitted link' for this category** (i.e. a new permitted link conditional on certain additional consumer protection measures being satisfied). This would align with a similar concept used in the Collective Investment Schemes Sourcebook (COLL). It would enable investment in assets such as rail track, bridges, roads, runways, wind turbines, hydroelectric schemes, solar farms, pylons, gas storage and sewerage plants or similar which are not currently regarded as buildings. This may entail more

risk for consumers than investment in the existing category of land and property and 'buildings' above, but is an area in which insurers already invest to a limited extent. As a safeguard, we recommend that these investments are also subject to the proviso (i.e. "condition") that the insurer ensures that the investments are suitable for retail investors in the investment context in which they are being used (see risk mitigation proposals in paragraph 3.17 below)

**3.7 Removing the current 10% limit on the proportion of fund assets that may be held in land or property for firms meeting the investor protection conditions.** Investments in this category would instead be limited by the overall amalgamated percentage limit for illiquid assets across all the permitted links of 50% (see paragraph 3.15 below). The 10% limit remains for firms not meeting the new conditions.

**3.8** These proposals may increase the risk exposure for consumers above the level the current rules allow, but we consider this will be mitigated by the investor protection conditions described in paragraph 3.17 below. Our proposal would be to set up a separate part of COBS 21 which would permit these additional types of investment only if the conditions in paragraph 3.17 were satisfied.

- Q1: Do you agree with our proposal to allow investment in immovable structures or installations as above? If not, how could we change it?**
- Q2: Do you agree with our proposal to remove, for firms that meet the conditions as above, the current 10% limit on the proportion of fund assets that may be held in land and property, relying instead on the overall limit on illiquid investments? If not, what percentage limit would you suggest is appropriate?**
- Q3: Do you agree with our proposals to allow additional investments only if the conditions in paragraph 3.17 are satisfied?**

### **Category 2: Permitted unlisted securities (COBS 21.3.1R (2) (c))**

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**3.9** The current permitted links rules allow unlimited investment in unlisted securities, but only when these securities are 'readily realisable in the short term'. Where an unlisted security is not readily realisable in the short term, investment is not permitted. This can restrict investment in unlisted securities which are more illiquid. However, we are mindful that permitting investment in unlisted shares and securities which are not realisable in the short term has the potential to expose retail investors to additional investment and liquidity risks. To address the issue, we propose:

- **Allowing investment by firms in permitted unlisted securities which are not 'realisable in the short term' provided that liquidity requirements at the level of the investment fund can be met.** This would make clear that a firm's ability to realise unlisted securities should be assessed against the time horizon over which the provider is obliged to ensure these unlisted investments can be realised in order to meet the needs of investors (including, for example, pension scheme providers), having taken into account the availability of other assets to meet liquidity needs.



Investment in these additional unlisted securities not realisable in the short term would, however, remain subject to the 50% overall amalgamated limit on investment in illiquid assets under 3.15 below. This is in line with the Law Commission recommendations.

**3.10** We have considered the option of imposing an asset level requirement for realisability of assets in this expanded category (for example that unlisted securities should be realisable 'in a timeframe appropriate to the notice period of the investing fund' or 'in a timeframe consistent with the tenor of the unlisted security') but do not think they will address the current barriers as effectively, although we welcome views on this.

**Q4: Do you agree with our proposal to relax the requirement for unlisted securities to be 'realisable in the short term' and to replace this with a liquidity test at the level of the investment fund, as set out above? If not, how could we change it, if at all? Do you think either of the alternative asset-level restrictions would work better?**

### **Category 3: Permitted scheme interests (COBS 21.3.1R (2) (g))**

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**3.11** The rules for 'permitted scheme interests' (i.e. other funds, including, for example, authorised funds, UCITS, Qualified Investor Scheme (QIS) and Unregulated Collective Investment Scheme (UCIS) assets) require the underlying funds to publish their prices **regularly** yet it appears that industry perception is that **daily** pricing is required. To address this concern, we are clarifying in this paper that the regular publication of pricing does not limit permitted scheme interests to those which are priced daily.

**3.12** There is also currently a limit of 20% on the proportion of a unit-linked fund which can be invested in Qualified Investor Scheme (QIS) and Unregulated Collective Investment Scheme (UCIS) assets. This was put in place because there are fewer investor protection requirements applied to these schemes compared with Undertakings for Collective Investments in Transferable Securities (UCITS), or Non-UCITS Retail Schemes (NURS). This is because QIS are by definition for 'qualified investors' not retail investors. Patient Capital taskforce representatives have suggested that the level at which the limit is set is a barrier to investment in patient capital. We propose:

- **Removing the current 20% limit on holdings of assets through QIS/UCIS for firms meeting the investor protection conditions.** Investments in this category would instead be limited by the overall amalgamated percentage limit across all illiquid assets of 50% (see paragraph 3.15 below).

**Q5: Do you agree with our proposal to remove, for firms meeting the investor protection conditions, the current 20% on holdings of assets through QIS/UCIS and instead rely on the overall limit of 50%? If not, how could we change it?**

### Category 4: Permitted loans (COBS 21.3.1R (2) (e))

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- 3.13** Under this permitted link, firms may include loans that, among other conditions, are fully secured by a mortgage or charge on permitted land or property. In addition to the proposed additions to the scope of 'permitted land and property' to include immovables as outlined above, we are also creating a new category of conditional permitted loan for firms. This will include loans secured on immovables included in the new conditional permitted immovables category. This increased scope will also be subject to the overall limit and the additional conditions in 3.17 below.

### Category 5: 'Approved securities' (COBS 21.3.1R (2) (a))

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- 3.14** The existing permitted link above as further defined in the Glossary includes securities or loans guaranteed by any government, public or local authority. Any patient capital investment which comprises a security or loan with a government guarantee would be an approved security and, therefore, could be held. This is not new policy, and we are not consulting on changes. However, we think it is appropriate in the context of the proposed changes above to remind firms of what is already possible in this category.

### Amalgamated overall threshold limit

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- 3.15** Rather than the current combination of limits to holdings under some of the permitted links categories (and no limits on others), we propose **introducing an overall limit of 50% on illiquid assets held as permitted links or conditional permitted links for firms meeting the investor protection conditions**. This new limit would be consistent with the threshold we recently consulted on for NURS investing in inherently illiquid assets in authorised funds.<sup>2</sup> It would be defined as the total of categories of:

- permitted land and property (as currently defined)
- permitted scheme interests which consist of investment in QIS or UCIS schemes (as currently defined)
- the new conditional permitted links categories of immovables, unlisted securities, scheme interests and loans (categories 1-4 above).

- 3.16** We are proposing that one of the conditions which must be met in order to access this more flexible limit is a requirement on the product provider to ensure that the securities held can at all times be realised to satisfy the reasonable needs of investors, including allowing them to switch funds, take benefits or to withdraw or transfer their unit-linked investments in a timeframe which is appropriate to their needs. In this way, an appropriate balance may be maintained between meeting investors' liquidity needs and earning a return for investors, so that the fund is able to meet liquidity demands with a high degree of confidence, in the context of assets in the fund portfolio overall.

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<sup>2</sup> CP18/27 as above at paragraph 3.7



- Q6: Do you agree with our proposal to set an amalgamated overall threshold limit for firms meeting the conditions as above? If not, what could we change? Do you agree with the percentage level proposed, or if not, what should it be and why?**

## Consumer Risk Mitigation

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**3.17** In order for firms to access the above proposed changes, we propose new obligations on firms to mitigate the potential additional risks to retail investors. These rules would require:

- **Firms to provide consumers with adequate risk warnings about liquidity and investment risk** in relevant disclosures at an appropriate point in the investor's decision-making process.
- Where we propose extensions to current permitted links categories, limits or requirements, firms must ensure that any investment in the new permitted link categories should not prevent a retail investor from exercising rights under the unit-linked contract within the timeframe envisaged in that contract and, in any event, within a reasonable timeframe, notwithstanding any contractual terms. When considering a reasonable timeframe for these purposes, firms should take into account the needs of investors, including the purpose for which the investment is held. Examples of investor rights to be covered by this requirement would include allowing investors to switch funds, take benefits or to withdraw or transfer their unit-linked investments.
- Use of the expanded categories is also subject to a pre-condition **that the provider firm** ensures that the investments are suitable and appropriate for retail investors in the investment context in which they are being used. This includes consideration of expected period to maturity of the investment and the purpose for which the investment is being used by the retail investor. This would mean that the new permitted links would be limited to retail investors with a long-term investment strategy aligned with the duration of the patient capital investment. One example of investors who might have an investment strategy that prioritised long-term returns over short-term liquidity is investors in default pension funds or trust-based pension schemes. In the context of pension scheme default funds, the FCA expects the insurer to have arrangements in place with the provider of the pension fund so that the insurer can satisfy themselves that appropriate life-styling options and other appropriate measures are in place to ensure that a linked fund with illiquid and higher risk assets remain suitable and appropriate for a particular cohort of pension savers. This obligation is additional to the requirement for unlisted securities under Category 2 above to ensure that there is sufficient overall liquidity to meet investors' needs. This requirement is consistent with existing obligations for insurance products in PROD. These require that products must be suitable for the investor and, where there is a risk that they are not, appropriate action must be taken to avert the risk of consumer detriment (PROD 4.3.12G, 4.4.3.G).



- Q7:** Do you agree that the obligation on firms to provide adequate risk warnings about liquidity and investment risk would contribute to better understanding of those risks by investors in unit-linked funds?
- Q8:** Do you agree with our proposal to require provider firms to ensure that any unit-linked investment does not interfere with retail investors rights to switch funds, take benefits or to withdraw or transfer funds? And our proposal that links to the new categories of investment are only offered/ taken up in suitable and appropriate investment contexts? If not, how would you change it?



## Annex 1

### Questions in this paper

- Q1:** Do you agree with our proposal to allow investment in immovable structures or installations as above? If not, how could we change it?
- Q2:** Do you agree with our proposal to remove, for firms that meet the conditions as above, the current 10% limit on the proportion of fund assets that may be held in land and property, relying instead on the overall limit on illiquid investments? If not, what percentage limit would you suggest is appropriate?
- Q3:** Do you agree with our proposals only to allow additional investments if the conditions in paragraph 3.17 are satisfied?
- Q4:** Do you agree with our proposal to relax the requirement for unlisted securities to be 'realisable in the short term' and to replace this with a liquidity test at the level of the investment fund, as set out above? If not, how could we change it, if at all? Do you think either of the alternative asset-level restrictions would work better?
- Q5:** Do you agree with our proposal to remove, for firms meeting the investor protection conditions, the current 20% on holdings of assets through QIS/UCIS and instead rely on the overall limit of 50%? If not, how could we change it?
- Q6:** Do you agree with our proposal to set an amalgamated overall threshold limit for firms meeting the conditions as above? If not, what could we change? Do you agree with the percentage level proposed, or if not, what should it be and why?
- Q7:** Do you agree that the obligation on firms to provide adequate risk warnings about liquidity and investment risk would contribute to better understanding of those risks by investors in unit-linked funds?
- Q8:** Do you agree with our proposal to require provider firms to ensure that any unit-linked investment does not interfere with retail investors rights to switch funds, take benefits or to withdraw or transfer funds? And our proposal that links to the new categories of investment are only offered/ taken up in suitable and appropriate investment contexts? If not, how would you change it?

## Annex 2

# Cost benefit analysis

### Introduction

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1. The Financial Services and Markets Act 2000 (FSMA), as amended by the Financial Services Act 2012, requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made'.
2. This analysis presents estimates of the impacts of our proposal where these are significant. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide analysis of outcomes in other dimensions. Our proposals are based on carefully weighing up these multiple dimensions and reaching a judgement.

### Problem and rationale for intervention

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**Problem Outline:** We have been informed by the work of the Law Commission and the Patient Capital Taskforce that our permitted links rules may present barriers to investment by retail investors in a broader range of assets and may need updating. Amending our rules will address these barriers and may be beneficial in enabling the longer-term investment choice and needs of investors to be matched more effectively and allow a broader range of long-term investments through unit-linked funds.

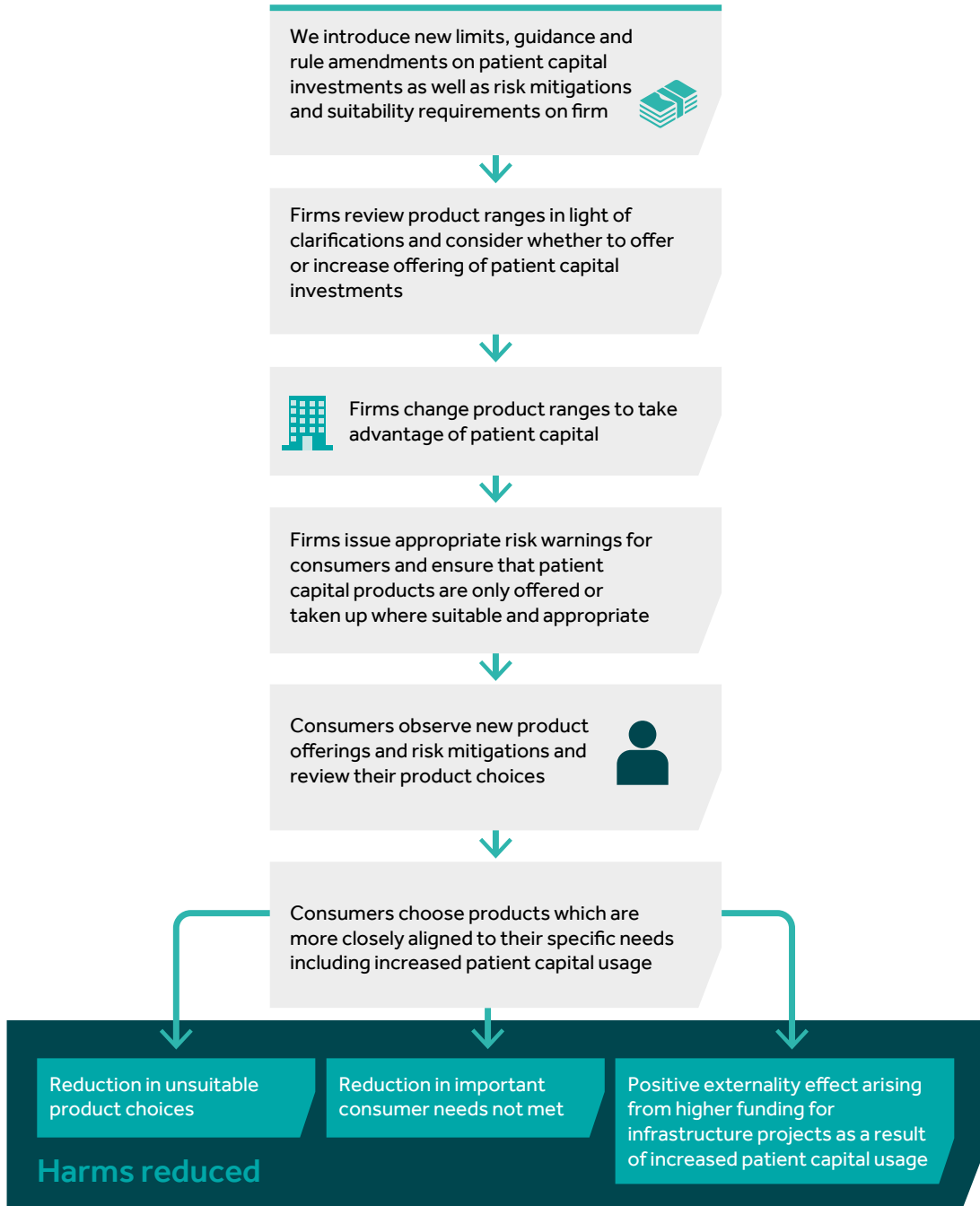
**Driver of Harm:** The driver of this harm is categorised as: Regulatory failures – which is where existing rules prove ineffective or even detrimental and need to be removed or amended.

**Harm:** The harm we have identified is: Important consumer needs are not met because of the limitation in the existing range of underlying investments in unit-linked products. As a result, consumers may currently be choosing products which do not align fully with their investment needs.

## Our intervention

Figure 1: Permitted Links Proposals Causal Chain

3.



**4. Intervention:** We are proposing amendments to the permitted links rules in COBS 21.3 and related rules as appropriate, which will include:

- guidance where appropriate for new permitted links category terms to clarify our expectations.
- amending and adding to rules where appropriate, for example to enable a wider permitted investment range and to amend the application of quantitative limits where firms meet qualifying conditions.
- appropriate risk mitigation including risk warnings to consumers to ensure they understand the investment risks involved and a requirement on firms using the greater flexibility afforded by our proposed changes to ensure that investments are offered/taken up in appropriate contexts and that retail investors are able to exercise contractual rights within a timeframe appropriate to their needs.

### Baseline and key assumptions

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**5.** Without intervention, we expect the market to continue as it currently operates. We do not consider this an appropriate option for all consumers given the continuing potential for the harm identified ie some customers' needs not being met or the potential sale of products which do not align with their investment goals because of the limitation in the existing range of investments underlying unit-linked products.

**6.** Our assumptions under this CBA are as follows.

- Firms will offer an increased investment in patient capital only if they deem it profitable to do so.
- Consumers will choose to invest in funds which include a higher proportion of patient capital investment if it aligns more closely with their investment needs.
- Confidence and participation in the market will be increased by providing appropriate protection for investors seeking to invest in patient capital through unit-linked funds.
- Consumer harm will be reduced by promoting greater understanding among consumers of the type of assets they hold.
- Facilitating greater development of and investment in a broader range of assets will enable firms to develop products appropriate to some consumer needs.

### Costs of our proposals

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#### Costs to firms

**7.** Our proposed guidance and clarification of rules, as well as changes to the category thresholds for investment, are 'permissive'. They allow firms to change their practices, in this case increasing investment holding of patient capital, but don't oblige them to do so. As firms don't have to change their practices in response to these rule changes, we believe that familiarisation costs, that is reading and learning about the rules, will be



the only direct costs to firms resulting from the proposals. We estimate familiarisation costs using standard assumptions.<sup>3</sup>

8. We expect firms affected by our intervention will read relevant changes put forward as part of the proposals in this consultation paper and will familiarise themselves with the detailed requirements of the new rules and guidance.
9. We have estimated the costs of this to firms using assumptions on the time taken to read the document, which is 35 pages long. We assume that there are 300 words per page and reading speed is 100 words per minute.<sup>4</sup> This means that the document would take 1.75 hours to read. We convert this into a monetary value by applying an estimate of the cost of time to firms, as set out in Table 1.
10. Table 1 sets out the total familiarisations costs by firm type, along with the assumptions to calculate these costs based on firm size.<sup>5</sup> In total, we estimate that the oneoff industry cost of familiarisation would be around £56,000.

**Table 1: Familiarisation cost staff numbers and hourly salaries assumptions**

Firm Size	Number of firms	Number of compliance staff required to read the document	Hourly compliance staff salary (£)	Total familiarisation cost (£)
Large	22	20	£56	43,427
Medium	24	5	£60	12,537
Small	0	2	£43	-
<b>Total Industry</b>	<b>46</b>			<b>55,963</b>

11. As mentioned, our proposed amendments to the permitted links rules are permissive changes. If firms do choose to use them, then they may incur further costs. These include, for example:

- training (one-off)
- administrative (ongoing)
- systems (one-off and ongoing)
- research (ongoing)
- monitoring (ongoing)

3, 4 The assumptions used to estimate these costs have been derived from a research project on compliance costs that involved consultation with firms and trade bodies, discussions with vendors, a review of previous CBAs, internal FCA consultation, and desk-based research. To put a cost on time, we have sourced salary information for a range of occupations in financial services. Figures for large and medium firms are based on the 2016 Willis Towers Watson UK Financial Services Report. Small firm salaries were sourced from a systematic review of adverts on the website of Reed, cross-referenced with other publicly available sources. We add an allowance for overheads of 30% to all time costs to account for non-wage labour costs, as advocated by the HM Treasury Green Book. See FCA, How we analyse the costs and benefits of our policies, July 2018.

5 Size of firms is determined using a ranking system based on the FCA fee structure paid by each firm

- distribution (ongoing)
- and other one-off and ongoing costs.

- 12.** However, firms may incorporate these costs within similar costs that they already incur. Some larger firms already invest, to a certain extent, in patient capital-type assets in other areas of their group and have existing systems and procedures in place which may reduce these costs in this respect. Where firms already have systems and processes in place to invest in the holding of patient capital, they are not obliged to change them in a prescriptive way to increase that holding. So, we do not anticipate significant costs will arise to firms because of the change in patient capital thresholds.
- 13.** We do not believe that it is reasonably practicable for us to quantify and monetise these compliance costs. There would be limited incremental value of new evidence that we could generate from such data relative to the information we already have.

### Costs to consumers

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- 14.** We do not believe that consumers (i.e. investors) will incur direct or indirect costs from our proposals.
- 15.** We acknowledge the potential risk of liquidity mismatch. This is where consumers are unable to access funds in patient capital (long term assets) to cover more immediate expenses (shorter term liabilities). However, we do not anticipate this to be a significant risk. If liquidity mismatch happens, consumers may be unable to access their money temporarily. We have set out a number of proposals in this consultation paper to mitigate this. For example, risk warnings to consumers and a requirement on providers to have systems and controls in place to ensure that any linked investment is only offered or taken up in suitable and appropriate contexts.
- 16.** These measures are dependent on firms deciding to increase their investment in patient capital. As firms are not obliged to do this, these measures are not subject to a CBA here.

### Benefits of our proposals

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#### Benefits to firms

- 17.** Benefits to firms may include increased revenue from investors investing to increase patient capital offerings. Improvement in guidance may increase the flexibility of firms to offer different investment products to better target the needs of their investor-base and so raise more revenue.
- 18.** As benefits to firms will be highly dependent on internal practices, we believe that it is not reasonably practicable to quantify these benefits.

#### Benefits to consumers

- 19.** The proposed rule changes will benefit consumers insofar as they allow firms to provide a broader range of long-term investment choices. Consumers could be offered a wider range of products and, with these increased options, it's more likely that consumers will be better able to select a fund which meets their investment needs. For example,



matching their preference for the balance of investment longevity and on-demand liquidity more appropriately. To the extent that consumers who do not require short term liquidity in a portion of their invested assets have been foregoing investment returns on these investments because of the lower return on more liquid assets, the new rules create opportunities to earn higher returns. Moreover, with greater investor choice, we believe that there will be greater competition in the market, contributing to markets working well.

- 20.** Benefits to consumers are dependent on firms adopting new practices and the degree to which consumers take advantage of the new products offered. We don't think it is reasonably practicable to estimate wider economic benefits.

**Benefits to the wider economy**

- 21.** With an increase in the maximum threshold, there is a greater opportunity for firms to invest more in patient capital and therefore, more investment funding is likely to flow into long-term UK projects.

We don't think it is reasonably practicable to estimate wider economic benefits.



## Annex 3

# Compatibility statement

### Compliance with legal requirements

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1. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation. This includes an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under the Financial Services and Markets Act 2000 (FSMA).
2. When consulting on new rules, the FCA is required by section 138I(2)(d) FSMA to include an explanation of why it believes making the proposed rules is (a) compatible with its general duty, under s. 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, and (b) its general duty under s. 1B(5)(a) FSMA to have regard to the regulatory principles in s. 3B FSMA. The FCA is also required by s. 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.
3. This Annex also sets out the FCA's view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (s. 1B(4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.
4. In addition, this Annex explains how we have considered the recommendations made by HM Treasury under s. 1JA FSMA about aspects of the economic policy of Her Majesty's Government to which we should have regard in connection with our general duties.
5. This Annex includes our assessment of the equality and diversity implications of these proposals.
6. Under the Legislative and Regulatory Reform Act 2006 (LRRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions such as making rules). This Annex sets out how we have complied with requirements under the LRRRA.

### The FCA's objectives and regulatory principles: compatibility statement

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7. The proposals set out in this consultation are primarily intended to advance the FCA's operational objective of protecting consumers. They are also relevant to the FCA's strategic objective of ensuring that relevant markets function well.



8. In formulating our proposals for consumer protection, we have considered the particular risks that may arise when unit-linked funds invest in illiquid assets. We have sought to identify ways in which these may be mitigated in a proportionate way, while still allowing retail investors access to products that can help to diversify their investment portfolios and enable them to optimise long-term returns. A key element of the package of remedies we are proposing is ensuring that consumers have the information they need to understand fully the risks involved in funds that invest in inherently illiquid assets.
9. We believe these proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well. They enable greater flexibility regarding the types of assets that may be utilised, while continuing to place limits on the overall level of illiquid assets under permitted linked investments. We also believe that providing retail investors with greater information about the risks involved in such assets will enable them to make better investment choices. For the purposes of the FCA's strategic objective, "relevant markets" are defined by s. 1F FSMA.
10. In preparing the proposals set out in this consultation, the FCA has had regard to the regulatory principles set out in s. 3B FSMA. We cover the most relevant of these below.

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

11. The CBA of our proposals is outlined in Annex 2 of this CP. They complement existing requirements under FCA rules in COBS. Our proposals are permissive in enabling greater flexibility of use of 'patient capital' investment in illiquid assets as part of the permitted links rules while continuing to ensure an appropriate degree of consumer protection. They are proportionate to the risks that these assets present to consumer protection.

#### **The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term**

12. The asset management industry is one of the most important providers of capital needed for economic growth. Currently, funds investing in inherently illiquid assets mainly invest in commercial property. However, the Government is seeking to promote sustainable long-term growth by encouraging greater private investment in 'patient capital', for example through infrastructure and venture capital funds. By maintaining the ability of retail clients to invest in such funds, within a more robust regulatory framework, our proposals permit investments that could contribute towards the sustainability of UK economic growth.

#### **The general principle that consumers should take responsibility for their decisions**

13. Our proposals do not remove investors' responsibility for their financial decisions. They improve the information to be disclosed to investors and advisors on the risks of investing in a fund that invests in inherently illiquid assets and what the consequences may be for investors. We are also proposing enhanced obligations on firms to ensure that policyholders are only offered products which are suitable for retail investors and for the context in which the investment is made. Policyholders are also being protected by ensuring that they are not prevented from exercising rights to switch funds, take benefits or withdraw or transfer funds in a timeframe appropriate to their needs. We expect the proposals to enable consumers to take better-informed investment decisions and make it more likely that they will invest in products which are suitable for

their individual needs. However, the final responsibility for their decisions will remain with them.

### **The principle that we should exercise our functions as transparently as possible**

14. We will continue to engage with stakeholders throughout the consultation process, before making any rules.
15. In formulating these proposals, the FCA has had regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime (as required by s. 1B(5)(b) FSMA). However, our proposals simply build on existing rules which already take account of this requirement.

### **Expected effect on mutual societies**

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16. The FCA does not expect the proposals in this paper to have a significantly different impact on mutual societies as they apply equally to all firms engaged in linked long-term insurance business.

### **Compatibility with the duty to promote effective competition in the interests of consumers**

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17. In preparing the proposals as set out in this consultation, we have had regard to the FCA's duty to promote effective competition in the interests of consumers.
18. By allowing unit-linked funds to invest in a broader range of long-term illiquid assets while continuing to place limits on the overall level of illiquid assets under permitted linked investments, we are providing retail investors with an appropriate level of protection, and creating more scope for unit-linked funds to compete by offering differentiated investment strategies. Further, to the extent that the enhanced disclosure of the risks associated with investing in more illiquid assets enables retail investors to make better-informed investment decisions, our measures will also help to promote more effective competition and improve outcomes for consumers.

### **Equality and diversity**

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19. 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.
20. The outcome of the assessment in this case is stated in paragraph 2.22 of the CP.



## Legislative and Regulatory Reform Act 2006 (LRRRA)

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- 21.** We have had regard to the principles in the LRRRA for the parts of the proposals that consist of general policies, principles or guidance. We believe that they are proportionate and promote our statutory objectives of consumer protection and effective competition and our strategic objective to ensure that markets function well, without creating undue burdens on the asset management industry, nor adversely impacting competition.
- 22.** We have had regard to the Regulators' Code for the parts of the proposals that consist of general policies, principles or guidance and believe that the proposals are proportionate to the potential harm to consumers or risks to our statutory objectives identified.

## Annex 4

### Abbreviations in this document

<b>AIF</b>	Alternative Investment Fund
<b>AIFMD</b>	Alternative Investment Fund Managers Directive
<b>AIM</b>	Alternative Investments Market
<b>CBA</b>	Cost-benefit analysis
<b>CIS</b>	Collective Investment Scheme
<b>COBS</b>	Conduct of Business sourcebook of the FCA Handbook
<b>COLL</b>	Collective Investment Schemes sourcebook of the FCA Handbook
<b>CP</b>	Consultation Paper
<b>CRE</b>	Commercial real estate
<b>DP</b>	Discussion Paper
<b>EU</b>	European Union
<b>FCA</b>	Financial Conduct Authority
<b>FIIA</b>	Fund investing in inherently illiquid assets
<b>FSB</b>	Financial Stability Board
<b>FSMA</b>	Financial Services and Markets Act 2000, as amended by the Financial Services Act 2012
<b>FUND</b>	Investment Funds sourcebook of the FCA Handbook
<b>FVP</b>	Fair value pricing
<b>IOSCO</b>	International Organisation of Securities Commissions
<b>ISA</b>	Individual savings account
<b>KIID</b>	Key investor information document
<b>MiFID</b>	Markets in Financial Instruments Directive
<b>NAV</b>	Net asset value



<b>NURS</b>	Non-UCITS retail scheme
<b>PAIF</b>	Property authorised investment fund
<b>PRIIPs</b>	Packaged retail and insurance-based investment products
<b>QIS</b>	Qualified investor scheme
<b>REIT</b>	Real estate investment trust
<b>RICS</b>	Royal Institution of Chartered Surveyors
<b>SIPP</b>	Self-invested personal pension
<b>SSAS</b>	Small self-administered scheme
<b>UCITS</b>	Undertakings for collective investment in transferable securities
<b>UK</b>	United Kingdom

#### Disclaimer

We have developed the policy in this Consultation Paper in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

You can download this Consultation Paper from our website: [www.fca.org.uk](http://www.fca.org.uk).

All our publications are available to download from [www.fca.org.uk](http://www.fca.org.uk). If you would like to receive this paper in an alternative format, please call 020 7066 9644 or email: [publications\\_graphics@fca.org.uk](mailto:publications_graphics@fca.org.uk) or write to: Editorial and Digital team, Financial Conduct Authority, 12 Endeavour Square, London E20 1JN.



# Appendix 1

## Draft Handbook text

**CONDUCT OF BUSINESS SOURCEBOOK (CONDITIONAL PERMITTED LINKS)  
INSTRUMENT 201[9]**

**Powers exercised**

- A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137A (The FCA’s general rules);
  - (2) section 137T (General supplementary powers); and
  - (3) section 139A (Power of the FCA to give guidance).
- B. The rule-making provisions listed above are specified for the purposes of section 138G(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 FCA Handbook 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

**Citation**

- E. This instrument may be cited as the Conduct of Business Sourcebook (Conditional Permitted Links) Instrument 201[9].

By order of the Board  
[*date*]



## Annex A

### 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>conditional permitted immovables</i>	a <i>conditional permitted link</i> that is any <i>permitted immovable</i> and which is: (a) not <i>permitted land and property</i> ; and (b) either: (i) owned directly by the <i>firm</i> ; or (ii) held in a structure, or a series of structures, that do not pose a materially greater risk to <i>linked policyholders</i> than a direct holding.
<i>conditional permitted links</i>	where the relevant conditions are met, the property in <i>COBS</i> 21.3.1R(2)(m).
<i>conditional permitted loan</i>	a <i>conditional permitted link</i> that is a loan with any person, provided that the loan: (a) is documented in a written agreement setting out the rate of interest and the amount of, and due dates for, repayments; and (b) is fully secured by a mortgage or charge on <i>conditional permitted immovables</i> that, if made to someone other than a body corporate, is not used wholly or mainly for domestic purposes.
<i>conditional permitted scheme interests</i>	a <i>conditional permitted link</i> which, in respect of a <i>firm's</i> business with <i>linked policyholders</i> , is a <i>qualified investor scheme</i> or its <i>EEA</i> equivalent, or any <i>unregulated collective investment scheme</i> that: (a) is not a <i>permitted scheme interest</i> ; (b) invests in <i>conditional permitted links</i> , either exclusively or in combination with <i>permitted links</i> ; and (c) publishes its prices regularly.
<i>conditional permitted unlisted securities</i>	a <i>conditional permitted link</i> which is any investment (including a share, debt security, Treasury Bill, Tax Reserve Certificate or Certificate of Tax Deposit) that is not a <i>permitted unlisted security</i> or listed security, but provided always that the <i>insurer</i> is able to demonstrate, on a continuing

basis, that the investment is realisable in a timeframe necessary to meet the liquidity requirements of the *linked fund* in which it is held.

Amend the following definitions as shown.

- permitted land and property* in relation to *permitted links*, any interest in land (and any buildings situated on it) provided that:
- ...
- (c) it is not geared either:
- (i) in excess of 10% of the gross asset value of the *linked fund* excluding any amounts represented by holdings in property detailed in *permitted scheme interests* (b)(i) to (iv). But this percentage restriction does not apply if the relevant *policyholder* or *trustee* or *operator* acting on behalf of an individual beneficiary requests, directly or indirectly, the *firm* to hold those investments based on the risk profile and objectives, stipulated by and specific for that individual under an investment management agreement with that individual; or
- (ii) provided that the *firm* meets the conditions in COBS 21.3.1BR, so as to exceed the aggregated limit in COBS 21.3.1FR.
- permitted links* the property in *COBS 21.3.1R(1) and (2)(a) to (l)* that an *insurer* may use for the purposes of determining *property-linked benefits* or *index-linked benefits* under *linked long-term contracts of insurance*.
- permitted scheme interests* ...
- (b) in respect of a *firm's* business with *linked policyholders*, any of the following:
- ...
- (v) a *qualified investor scheme* or its *EEA* equivalent or any *unregulated collective investment scheme* that invests only in *permitted links* and publishes its prices regularly, provided that either:
- (A) no more than 20% of the gross assets of the *linked fund* are so invested; or

(B) provided that the *firm* meets the conditions in COBS 21.3.1BR, so as to comply with the aggregated limit in COBS 21.3.1FR.

## Annex B

### Amendments to the Conduct of Business sourcebook (COBS)

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

#### 21.3 Further rules for firms engaged in linked long-term insurance business

...

...

##### Permitted links

21.3.1 R An *insurer* must not contract to provide benefits under *linked long-term contracts of insurance* that are determined:

...

(2) wholly or partly by reference to the value of, or the income from, or fluctuations in the value of, property other than any of the following:

...

(k) *permitted stock lending*; ~~and~~

(l) *permitted derivatives contracts*; and

(m) where an *insurer* satisfies the conditions in COBS 21.3.1BR, the property in COBS 21.3.1ER.

21.3.1A R A *firm* must classify the types of property listed in COBS 21.3.1R(2)(a) to (2)(~~l~~)(m) according to their economic behaviour ahead of their legal form.

Insert the following new provisions. The text is not underlined.

##### Conditional permitted links

21.3.1B R The conditions referred to in COBS 21.3.1R(2)(m) are that an *insurer* must ensure, on a continuing basis, that:

(1) a *linked policyholder* is not prevented by the nature of any *conditional permitted link* from exercising any right under the *linked long-term contract of insurance* within the timeframe specified in that contract or, in any event, within a reasonable timeframe, taking into account the needs of the *linked policyholder*; and

- (2) the investment risks of any *conditional permitted links*, both individually and in combination with other investments within a *linked fund*, are suitable and appropriate for:
- (a) circumstances where investment risk is borne by a *linked policyholder*;
  - (b) the expected period to maturity of the *linked long-term contract of insurance*; and
  - (c) the purpose for which the *linked policyholder* holds the *linked long-term contract of insurance*.
- 21.3.1C G Rights under a *linked long-term contract of insurance* which may be relevant for the purposes of COBS 21.3.1BR(1) would include a *linked policyholder's* right to:
- (1) change the property to which the benefits of the *linked long-term contract of insurance* are linked; or
  - (2) take benefits under the *linked long-term contract of insurance*; or
  - (3) withdraw or transfer the proceeds of, or benefits under, the *linked long-term contract of insurance*.
- 21.3.1D G The assessment in COBS 21.3.1BR(2), in relation to a *linked fund* which is included in a default or similar arrangement for a pension scheme, would include ongoing consideration of whether the investment risks of any *conditional permitted links* remain suitable and appropriate for a particular cohort of *linked policyholders*, including as that cohort moves toward retirement.
- 21.3.1E R The property referred to in COBS 21.3.1R(2)(m) is any of the following:
- (1) *conditional permitted unlisted securities*;
  - (2) *conditional permitted immovables*;
  - (3) *conditional permitted loans*; and
  - (4) *conditional permitted scheme interests*.
- 21.3.1F R When aggregated together, no more than 50% of the gross assets of a *linked fund* can be invested in:
- (1) *permitted land and property*;
  - (2) *permitted scheme interests* in (b)(v) of the Glossary definition of that term; and
  - (3) *conditional permitted links*.

- 21.3.1G R Where a *linked fund* is invested in any *conditional permitted link*, the information that a *firm* must give a *linked policyholder* under COBS 21.2.4R must also prominently include, in language capable of being understood by a *linked policyholder*:
- (1) an explanation of the risks associated with any *conditional permitted links*, how these might crystallise and how they might impact on a *linked policyholder*;
  - (2) a description of the tools and arrangements which the *insurer* would propose using, including those required by *FCA rules*, to mitigate the risks in (1); and
  - (3) an explanation of the circumstances in which these tools and arrangements would typically be deployed and the likely consequences for *linked policyholders*.

