

Protecting investors in authorised funds following the Russian invasion of Ukraine

Consultation Paper

CP22/8**

April 2022

How to respond

We are asking for comments on this Consultation Paper (CP) by **16 May 2022**.

You can send them to us using the form on our website at: www.fca.org.uk/cp22-08-response-form

Or in writing to:

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Please note that responses to this CP may be shared with HM Treasury.



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1 Summary

Why we are consulting

- 1.1** The Russian invasion of Ukraine on 24 February 2022 has affected financial markets in many ways. Sanctions have been imposed in response to Russia's invasion, and the Russian government has applied trading restrictions. Some securities, including some Ukrainian assets, have become illiquid or untradeable. Normal mechanisms for determining accurate and reliable valuation for some securities have stopped operating.
- 1.2** Affected assets include:
- equities and fixed-income securities issued by governments, public authorities and corporates in Russia, Belarus and Ukraine and securities listed, offered or placed in those countries
 - assets listed and traded on other stock exchanges and backed by such securities, for example depositary receipts
 - securities issued by companies whose operations are particularly severely affected by the current situation, or which are owned or controlled by individuals who are the subject of UK or international sanctions relating to Russia
 - units in other collective investment schemes that have suspended dealings because of exposure to such assets.
- 1.3** In this CP we refer to all these affected assets as "affected investments".
- 1.4** Authorised fund managers (AFMs) who have these affected investments in their funds are faced with the challenge of how to treat them, especially given the AFM's responsibility to ensure its actions do not breach any relevant sanctions regimes. In many cases the AFMs have written down the value of the affected investments to zero or near-zero as a prudent measure, to reflect the current situation and risks including the inability to deal in assets subject to sanctions.
- 1.5** Because accurate, reliable and regular prices are no longer available for these affected investments, it may not be possible for AFMs to produce an accurate unit price for the fund, meaning it may be difficult to treat unitholders fairly. Where the affected investments are a significant proportion of the fund's assets, some funds have suspended dealing. This means that investors are unable to further invest, or to redeem their units.
- 1.6** So, we are consulting on rules to give AFMs of UK authorised investment funds a way to deal with this situation. Our proposal will allow the AFM to structure the fund differently, using separate new classes of units to hold the affected investments. We refer to these unit classes as "side pockets".
- 1.7** Side pockets would give AFMs the option to separate affected investments from the fund's other investments. The fund's existing classes of units would no longer reflect the value of affected investments, but the value of units in a new unit class would be determined only by reference to the affected investments. The existing unitholders at the time the side pocket

is created would receive units in the side pocket class, giving them the right to a portion of the affected investments. Side pockets therefore could allow:

- new investors to enter the fund without sharing in the exposure to the affected investments
- existing investors to sell the units which relate to assets that are not affected investments
- some funds to end their current suspension of dealing.

1.8 The AFM would manage the side pocket class with the aim of terminating it as and when this could be done in the best interests of investors. There is no certainty that the affected investments will ever recover their lost value but, if this happens, investors holding units in the side pocket class would benefit.

1.9 Our proposals apply to investments that are subject to financial sanctions relating to Russia under the applicable regimes in the United Kingdom, other G7 countries and the European Union. Before deciding whether to create a side pocket class and determining the arrangements under which the class is to operate, the authorised fund manager will need to understand the legal requirements and obligations that apply under the relevant financial sanctions regimes and be satisfied that the class and the operational arrangements will comply.

1.10 If the AFM is satisfied, it will need to determine whether a side pocket would be the best way to deal with its fund's exposure to affected investments. The AFM would need to take the decision on whether this would be in the best interests of each fund they manage and the unitholders in those funds.

1.11 The proposed rules within this consultation are a limited emergency measure to deal with the impact of the Russian invasion of Ukraine. We are not considering allowing the wider use of side pockets in authorised funds – they would only be available for UK UCITS and non-UCITS retail schemes (NURS) (UK authorised retail funds) that hold affected investments which are subject to sanctions, or for which there are no accurate, reliable and regular prices. The proposed rules and guidance in this consultation should not be interpreted as meaning that the FCA will allow side pockets in retail funds for any other current or future situations.

Who this applies to

1.12 This consultation primarily affects:

- managers of UK authorised retail funds with exposure to affected investments
- depositaries of these funds
- ancillary service providers to authorised fund managers and depositaries
- providers of investment services offering access to these funds, including Self-Invested Personal Pension (SIPP) providers, as well as Individual Savings Account (ISA) managers
- distributors of these funds
- investment intermediaries who advise on or invest in these funds
- insurers who offer unit-linked insurance contracts linked to these funds
- discretionary wealth managers, including those who offer model portfolios
- other professional or institutional investors.

- 1.13** Consumers who have invested directly in UK authorised retail funds holding affected investments, or who are exposed to these funds through their pension contributions or their long-term life assurance policies, are affected by our proposals. We welcome views from individual consumers and groups representing their interests.

What we want to change

- 1.14** We are consulting on proposals to address the potential harm caused by the exposure that UK authorised retail funds have to affected investments. So that these funds can operate fairly and efficiently in the interests of all investors, we propose allowing these funds to use side pockets for their Russian, Belarusian and Ukrainian exposures.

- 1.15** Side pockets could allow some of the funds that have had to suspend dealing to reopen. This would allow investors to access some of their investment, that could otherwise remain locked up for a long time. Investors who redeem from the wider fund will also be able to retain their exposure to the affected investments in the side pockets.

Outcome we are seeking

- 1.16** We want the UK authorised retail funds with exposure to affected investments, to be resilient and to operate in a way in which all investors are treated fairly. We expect that by allowing the use of side pockets, a number of funds that have had to suspend dealing due to their exposure to affected investments will be able to resume dealing, so investors can access the rest of their investment.
- 1.17** We also want new investors to have confidence that they can invest into the funds without gaining exposure to Russian and Belarusian assets.
- 1.18** The government has been clear in its support for those firms that have committed to ending their financial relationship with Russia. But the government has also acknowledged that market conditions and trading restrictions make winding down these positions a long-term process. The FCA's proposals for introducing side pockets will help protect fund investors while empowering investment managers better to isolate their holdings of Russian and Belarusian assets, avoid new investors in the fund acquiring Russian and Belarusian assets, and facilitate winding down as opportunities to do so arise.

Measuring success

- 1.19** If we implement this proposed approach, we will seek to measure success in the short term through evidence of:
- the reopening of suspended funds with affected investments
 - other funds with affected investments setting up side pockets to protect investors' interests
 - confidence that investors have invested and redeemed at the right unit price.
- 1.20** In the longer term, the measure of success will be whether any eventual return of affected investments to market value is passed on to investors in side pockets.

Next steps

- 1.21** We welcome feedback on our proposals by Monday 16 May 2022.
- 1.22** We will consider all feedback and, depending on responses received, we aim to publish a final policy statement and final Handbook rules and guidance as soon as possible.
- 1.23** We are not proposing to set any time limit on when AFMs may elect to create a side pocket under these rules, since it is too early to know how the situation in Ukraine might develop. We intend to keep matters under review and consult further when we judge it is appropriate to withdraw this emergency measure. Any future decision to end the power to create a new side pocket would not affect any arrangement already set up under these rules.

2 The wider context

- 2.1** Russia's invasion of Ukraine is having a significant impact on financial markets.
- 2.2** Many investments have been affected both by the events themselves, and by the wide range of financial sanctions on Russia, Belarus, certain individuals and businesses that the UK and other nations have imposed in response. This has resulted in some authorised funds being prohibited from dealing in assets subject to sanctions. Some of the other affected assets that they own, including some Ukrainian assets, cannot be accurately and reliably valued or dealt in. Some funds with significant exposure to these assets have had to suspend unit dealing, meaning that investors cannot further invest into the fund, or redeem their fund holdings.

How it links to our objectives

Consumer protection

- 2.3** We consider that our proposals would further our consumer protection objective by helping to ensure that all unitholders are treated equitably.
- 2.4** Side pockets would allow AFMs to separate the affected investments from the rest of the fund. They would potentially offer those suspended funds with significant exposure to affected investments the ability to resume unit dealing. This would then mean that existing investors in the suspended funds would be able to redeem units that do not relate to affected investments.
- 2.5** Side pockets would also help to ensure that, as and when AFMs find opportunities to disinvest from the affected investments, they can do so fairly. Only those investors with units relating to the affected investments (which in many cases have been marked to zero value) would retain rights to a share of any eventual recovery in their value. New investors could enter the fund without gaining exposure to the affected investments and would not benefit if the affected assets should ever gain value.

Market integrity

- 2.6** We consider that our proposals will deliver an appropriate, stable and resilient structure for funds with exposure to affected investments. This will further our statutory objective of protecting and enhancing the integrity of the UK financial system. Side pockets will give new investors who do not wish to purchase a share of the affected investments, the confidence that they are not doing so as a result of investing into these funds.

Wider effects of this consultation

Effects of our proposals on unitholders

2.7 Our proposed rules potentially interfere with existing unitholders' property rights in the relevant fund and there are three main areas where this may be relevant. As explained below, we consider that any such interference would be proportionate.

Proposed changes to unitholder votes and notice

2.8 Under current rules, we would normally expect the creation of side pockets to constitute either a 'fundamental change' (requiring an extraordinary resolution to be passed at a meeting of unitholders), or a 'significant change' (requiring pre-event notification to unitholders). In some circumstances, our proposed rules would allow an AFM to create a side pocket without needing approval by an extraordinary resolution of unitholders and without giving prior notice of the change.

2.9 We recognise that unitholder meetings and votes are an important mechanism for enabling investors to give or withhold their consent to proposals that would affect their interests. But weighed against this, we have considered the following:

- AFMs have little discretion over how to treat affected investments and need a tool that can be adopted relatively quickly
- Meetings take time to organise, because of the need to prepare documentation, obtain clearance from the FCA and give sufficient advance notice to unitholders
- Giving unitholders notice of the intended creation of a side pocket through notice of the meeting could allow new investors to benefit from any future increase in value without having 'paid' for the exposure
- The alternatives which could be offered to unitholders at the meeting are unlikely to be attractive and so are unlikely to have any meaningful choice (see further Chapter 4)
- The costs of a meeting may also be significant and are sometimes charged to the fund.

2.10 Separately, if the AFM cannot be satisfied that the foreseeable costs of creating a side pocket are proportionate to the benefits, it would be reasonable to let unitholders vote on the matter, and our proposals provide for this.

2.11 Similar considerations apply as to whether the creation of a side pocket should constitute a significant change, normally requiring at least 60 days' prior notice. The point of 60 days' notice is to give the unitholder a meaningful choice and if there is no credible alternative, there is little point in delaying implementation of the action most likely to serve investors' interests (see also Chapter 4).

Effect of costs and charges

2.12 Although the creation of a side pocket has the potential to increase the fees and charges being paid by unitholders, we consider our proposals to be proportionate.

2.13 We consider it is fair for unitholders in the side pocket to bear a proportionate share of the costs which arise and are incurred for their benefit and our proposals include guidance on this. However, we do not expect AFMs to charge unitholders a preliminary charge (on issue of units in the side pocket class), an exit charge for selling units in the side pocket, or a performance fee. Our proposed rules will prohibit these charges in relation to the side pocket class.

Proposed changes to suspension rules

- 2.14** Our proposed rules would also allow AFMs to suspend dealings in a class of unit related to affected investments. This is different to the current position where suspension is undertaken at the fund or sub-fund level, rather than in relation to a particular class of unit.
- 2.15** To the extent that this constitutes an interference with existing investors' units, we consider our proposals to be proportionate. If we did not allow an AFM to suspend one class of unit relating to a side pocket, the AFM would either need to suspend the entire fund / sub-fund or not suspend it at all. If the fund / sub-fund were not suspended, this would crystallise the current valuation of the affected investments (in many cases, near zero) on a redemption of units. If the fund / sub-fund were suspended, and if the affected investments should ever regain any value, unitholders might receive the benefit but would not have access to any of their investment in the fund until then.

Unintended consequences of our intervention

- 2.16** The proposed rules create a framework to allow AFMs of UK authorised retail funds to create side pockets for holding affected investments and to take certain other related actions. The proposed regime is permissive and there is no requirement for AFMs to take such action. Before AFMs create side pockets they will (amongst other things) need to consider whether taking the action is necessary to protect the interests of unitholders and whether all unitholders in the fund will be treated fairly.
- 2.17** We have designed the permitted structure of the side pocket as a separate class of units within the fund to minimise the unintended consequences.
- 2.18** An AFM intending to issue units in a new class will need to consider the effect of section 235(4) of the Financial Services and Markets Act 2000 (FSMA). Broadly, this provides that if the contributions of the participants, and the profits or income out of which payments are to be made to them, are pooled in relation to separate parts of the scheme property, the arrangements are not to be regarded as constituting a single collective investment scheme unless the participants are entitled to exchange rights in one part for rights in another. The AFM of an authorised open-ended investment company (OEIC) will also need to consider the effect of section 236(3) of FSMA.
- 2.19** We are currently engaging with the Treasury and HMRC to understand the interactions between our proposals and the ISA Regulations, and will take this into account in our final decision. However, it will be up to the AFM to determine if there are any tax implications for the fund itself if they were to proceed with side pockets.
- 2.20** We are keen to hear of other potential unintended consequences as a result of our proposals, for example the emergence of secondary markets for side pocket units.

Q1: Do you have any comments on our assessment of the effects of our proposals on existing unitholders? If so, please provide details.

Equality and diversity considerations

- 2.21** We are required under the Equality Act 2010 in exercising our functions to 'have due regard' to the need to eliminate discrimination, harassment, victimisation and any other conduct prohibited by or under the Act; advance equality of opportunity between persons who share a relevant protected characteristic and those who do not; and foster good relations between people who share a protected characteristic and those who do not.
- 2.22** As part of this, we ensure the equality and diversity implications of any new policy proposals are considered. We have considered the equality and diversity issues that may arise from the proposals in this Consultation Paper.
- 2.23** We have considered the impact that our proposals might have on older consumers. According to HMRC data, consumers over 45 are more likely to invest in Stocks and Shares ISAs, and are therefore more likely to invest in open-ended funds, than consumers who are under 45. We recognise that side pockets might result in consumers needing to plan further ahead when they will need the proceeds of their investments, as they will not be able to access the portion of their assets held in the side pocket. However, the creation of side pockets will enable the affected funds to offer dealing in units without exposure to affected investments, facilitating the ability of investors to access at least some of their holdings.
- 2.24** Overall, we do not consider that the proposals materially 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 making the final rules. In the meantime we welcome your input.

Q2: Do you consider our proposals adversely impact any groups with protected characteristics under the Equality Act 2010? Do you consider there are any issues which may be relevant to our obligations under the Equality Act (see paragraph 2.24)? If so, please provide details.

3 Our proposal for side pockets

Why we are proposing this

- 3.1** This Chapter sets out proposed new rules and guidance in Chapter 7 of our Collective Investment Schemes sourcebook (COLL) for UK authorised retail funds that have exposure to Russian, Belarusian and Ukrainian assets, permitting them to establish 'side pockets'. Side pockets would enable a fund to issue separate units with exposure to those assets that cannot be traded because of sanctions, or are difficult to sell or hard to value, alongside units relating to the fund's other liquid investments.
- 3.2** Side pockets are commonly used in non-retail funds, such as hedge funds or institutional funds, either as a routine way of dealing with certain illiquid assets (e.g. distressed debt securities) or in response to unforeseen circumstances. However, they are not normally available to retail funds, which are meant to hold liquid assets so that they can offer redemption on demand.
- 3.3** We propose that managers of UK authorised retail funds with exposure to affected investments use their discretion to determine whether it is in unitholders' best interests to create a new class of unit relating only to the affected investments, distinct from other classes of unit relating to all the unaffected liquid assets.
- 3.4** After the new unit class is created, the existing investors will be given units which are linked to the value attributable to the affected investments, proportionate to the exposure they had immediately before the creation of the side pocket. The unit class linked to the affected investments will then close to subscriptions, and redemptions may be suspended. The AFM will manage the side pocket class in order to close it down as and when this can be done in the best interests of its unitholders.
- 3.5** Existing investors will also continue to have units in the fund which are linked to the value attributable to the liquid assets. Ultimately, existing investors' overall exposure to assets (both the affected investments and all liquid assets) and their ownership rights will not change as the result of creating a side pocket class.

The problem we are addressing

- 3.6** Fund managers are required under FCA rules to manage the liquidity risk of their funds and ensure that all unitholders are treated fairly.
- 3.7** Following the Russian invasion of Ukraine on 24 February 2022, a number of assets have become illiquid. This has happened in response to UK and international sanctions, or because Governments and other bodies or organisations in Russia and Belarus have taken actions, such as imposing capital controls, which have interrupted normal financial activities. Some Ukrainian assets are affected because of the economic impact of Russian actions.

- 3.8** Funds that have invested in those assets are now unable to sell them or value them accurately. A number of funds with material exposure to affected assets have had to suspend dealing because of the valuation uncertainty, meaning that investors are unable to buy or sell units in the fund. It is unclear how long the assets will be illiquid and how long these funds will need to remain suspended.
- 3.9** Funds with a limited exposure to the affected investments might remain open to dealing (meaning that new investors can invest into the fund, and existing investors can redeem). However, to reflect the impact of sanctions, changes in the market environment and the illiquid nature of the affected investments, the fund manager might make a fair valuation adjustment and write down those assets, potentially to 0% of their pre-invasion valuation. Given the circumstances there is a risk that this valuation is incorrect, which could cause harm to investors because:
- a subscribing investor is gaining exposure to those assets too cheaply
 - a redeeming investor will not benefit from any potential gain if the assets start performing again
 - an existing investor's exposure to any potential gain will be diluted by subscribing investors.
- 3.10** Side pockets could allow:
- new investors to enter the fund without getting exposure to affected investments
 - existing investors to redeem their units relating to liquid assets
 - some funds to end their current suspension of dealing.

Proposed side pocket structure

- 3.11** Our proposal is to allow AFMs to establish a separate class, or range of classes, within the fund which would be valued purely by reference to the sanctioned and illiquid assets and not the remaining liquid investments in the fund. We refer to this class as the 'side pocket class'. Conversely, all other classes would be valued by reference to the liquid assets, but not the affected investments.
- 3.12** Units in the side pocket class would be issued to all unitholders at the point when the class is created, in proportion to their existing holding. We propose that the AFM should apply the limited issue rule (COLL 6.2.18R) so no further units in that class could be issued after that point. All further investments, whether made by existing or new investors, would receive units in a class valued only by reference to the liquid assets (the treatment of uninvested cash is considered in the next chapter).
- 3.13** The arrangement would not be retrospective, so holders of any units issued before or since the start of the Russian invasion of Ukraine on 24 February 2022, up to the point at which the side pocket class is created, would receive units in the side pocket class. Conversely, the former holders of any units redeemed between those dates would not retrospectively acquire a right to participate in the side pocket class.
- 3.14** The exact mechanics of unit issuance would be for each AFM to determine based on the current structure of unit classes in its fund. The AFM might decide to issue units in several new classes to match the existing structure (e.g. to reflect differing treatments of income or charging structures), or to create only one or two new classes.

- 3.15** We believe this arrangement offers benefits to both AFMs and unitholders in affected funds. From the point of view of existing investors, the fund itself would continue to operate with minimum disruption. The fund would remain a single entity for accounting purposes, so there should be no need to adjust the book cost of affected investments. As there would be no change to the fund's identity, the custody registration of the underlying assets in the fund would be unaffected with little or no impact on the depositary and its sub-custodians. Funds registered for sale outside the UK would not have to update their local registration, and the AFM would not need to publish new pre-sale disclosure documents.
- 3.16** The fund's investment performance record could also continue uninterrupted, though the AFM might need to explain in some cases that past performance is based on a materially different asset allocation profile.

How the proposal meets our principles for unit classes

- 3.17** We acknowledge that this is an unprecedented approach, given that our existing rules limit how unit classes may apply differing rights to investors in the same fund. We propose modifying COLL 3.3.5R (Rights of unit classes) to enable AFMs to issue classes with these characteristics. We have also considered whether this proposal is in line with our guidance in COLL 3.3.2G on the principles that should apply to any proposed unit class:
- it should not provide any advantage that would result in prejudice to investors in another class
 - its nature, operation and effect should be capable of being explained clearly to prospective investors
 - its effect should not appear to be contrary to the purpose of COLL rules.
- 3.18** The first principle is fundamental, as unit classes valued by reference to differing pools of assets within the same fund might be considered a cause of prejudice to investors' interests. Since the affected investments being transferred to the new class are likely to be valued at or near to zero, there should be no immediate impact. However, any potential future recovery in value would give unitholders in the side pocket class a greater entitlement to the total scheme property, compared with holders of a class valued without reference to the affected investments.
- 3.19** We consider that this can be justified, because the alternative approach of allowing all new investors to have exposure to the affected investments could also be regarded as a potential cause of prejudice. Those new investors would be participating in any potential future recovery of value, at the expense of the existing investors who previously suffered the effect of the write-down in value. It is for AFMs to judge how best to resolve the tension between these conflicts, so we accept that they may come to differing conclusions about the best approach to take, based on the characteristics of each fund and its investor make-up.
- 3.20** The second principle in the COLL guidance is less significant in this case, as new investors in other classes of the fund will not have any right to receive units in the side pocket class, but they may still want to understand how the class will work. The fund prospectus should give enough information so all investors can understand any impact the side pocket class might have in future.

- 3.21** Our proposals should meet the third principle by ensuring that AFMs are able to establish side pocket classes without contravening any existing COLL rule. To ensure fairness to investors, we will not allow any other type of change to class rights to be introduced to a fund at the same time as these changes, nor any changes to the charging structure of existing unit classes.
- 3.22** This approach would have a particular impact on intermediate unitholders, such as nominees of platform service providers and discretionary investment managers. These firms would be allocated a block of new units which they would then need to allocate proportionately between their clients, who are the beneficial owners of the units. We consider the impact of these proposals on platform providers and other intermediaries in more detail in Chapter 5.
- 3.23** Our proposals differ from the Opinion published by the European Securities and Markets Authority in 2015 concerning the use of class structures in UCITS. Although we continue to regard the Opinion as an appropriate set of principles for considering the use of unit classes when designing a fund, we believe it is reasonable to take a different view on the best way to address the situation arising from the Russian invasion of Ukraine.

Q3: Do you agree that the proposed unit class structure is a suitable way to create a side pocket in a retail fund? Are there any improvements that could be made to it?

Q4: Do you agree that the proposed side pocket class could operate without causing prejudice to the interests of other investors in the fund?

An alternative side pocket model

- 3.24** Some stakeholders suggested an alternative side pocket approach, which we have considered. This approach would involve establishing a new authorised fund (or sub-fund of an umbrella) which would have the same investment objective and policy as the existing fund, and potentially the same name (in which case the existing fund would need to change its name). The AFM would then carry out a scheme of arrangement to transfer the majority of the scheme property of the existing fund – all the liquid assets and most of the uninvested cash – to become the first property of the newly-created fund.
- 3.25** The existing fund would retain the affected investments and the rest of the uninvested cash. It would immediately be put into winding-up, which would probably be a long-term process given current market conditions. The winding-up would not be completed until the AFM can disinvest from the affected investments and pay out to the unitholders according to their stake in the fund. The uninvested cash would be used to meet ongoing costs related to the winding-up.
- 3.26** This method of creating a side pocket would have certain advantages for firms and investors. The new fund should be able to value its holdings and manage its liquidity normally, so there would be no further risk of inaccurate valuation or a reduction in liquidity, caused by events in Ukraine, affecting investors' ability to buy and sell units. It would ensure the new fund has no exposure at all to affected investments – this might

appeal to new investors who want to avoid any investment connected with Russia or Belarus. Putting the old fund into winding-up would allow it to operate for an extended period without contravening rules on maintaining a spread of risk or providing redemption on demand. At the same time, we believe the old fund could continue to enjoy the advantageous tax treatment given to authorised collective investment schemes (CIS) and could remain eligible for investors to hold in an ISA or a SIPP.

- 3.27** However, this method would also present significant and costly operational problems. It would be more expensive and time-consuming to set up than the unit class approach. A complex series of interactions between the AFM and the FCA would need to take place. We are required by law to approve the creation of the new fund, the scheme of arrangement and the commencement of the winding-up in the case of an OEIC. Some AFMs have told us that the timescales involved, both for themselves and other firms such as platform providers, would be unacceptably long given their desire to act quickly.
- 3.28** This method would also cause difficulties and costs for the fund's depository. It would be necessary to set up a new custody account for the new fund, including new bank accounts, and to re-register title to all the assets transferred under the scheme of arrangement. Most of the UK funds with exposure to illiquid affected assets are dedicated to investment in a range of emerging markets, where re-registration of title is time-consuming and costly. In some countries (other than Russia, Belarus or Ukraine), assets might even have to be sold in the market and reacquired, thus generating transaction costs for the fund.
- 3.29** There is also a high risk that some non-UK investors could incur a tax liability on the transfer to the new fund, which would not be in their interests. This could deter AFMs from proceeding, even where the majority of investors might benefit from the arrangement.
- 3.30** We consider on balance that the potential difficulties and costs in setting up a new fund under this model are likely to make it unattractive to most AFMs. For this reason, we are not consulting on allowing it. However, we are willing to engage with any firms that think it might offer a preferable alternative.

Q5: Do you have any comments on the side pocket model set out above? Should the FCA take steps to enable AFMs of funds holding affected investments to use this alternative model?

4 Creating a side pocket

4.1 In this Chapter we give more detail about the issues that the AFM would need to consider before creating a side pocket class, and the steps that the AFM would need to take to do so.

Scope of assets

4.2 As explained, we intend these rules to apply only to certain financial instruments that have been impacted by the consequences of the Russian invasion of Ukraine. It is not practicable for us to identify all the individual instruments that have been impacted already or that might be in the future. Our rules need to be specific about scope, while allowing AFMs enough flexibility to make the final decision on which assets are to be allocated to a side pocket, depending on the circumstances at the time.

4.3 We propose to define a set of criteria which between them cover the range of assets that we think are most likely to be affected. Firstly, the asset must have a connection with an "affected country" – we propose that Russia, Belarus and Ukraine should be defined as affected countries.

4.4 Secondly, the asset must be an "affected investment", which means it must be either a transferable security (including a depositary receipt), a money-market instrument, a unit in a CIS or a share in an AIF that is not a CIS. Our informal pre-consultation engagement with stakeholders did not suggest that side pockets would be needed for other types of specified investment, such as bank deposits or derivative contracts used for investment purposes. We do not propose including those asset types in the definition, although this would not prevent hedging transactions from being applied to a side pocket class.

4.5 Our proposals would not be consistent with the Money Market Funds Regulation, so they do not apply to money market funds.

4.6 Thirdly, an affected investment must either be a 'sanctioned investment' or be impacted economically through its links to one of the affected countries. A sanctioned investment might be affected because directly or indirectly dealing it would contravene a financial sanctions regime relating to Russia or Belarus e.g. where the body that issued it, or a person that controls its issuing body, is named under the relevant sanctions legislation of the UK, another G7 country, or the EU. Or the investment might be affected because authorities of the affected countries are prohibiting its sale.

4.7 We propose several different types of economic links, any one of which would be sufficient to allow the AFM to allocate the investment to a side pocket. They include:

- being a Government or public security that has been issued or guaranteed by a Government, central, regional or local authority in an affected country, or by the central bank of such a country

- being listed or traded on a market or multilateral trading facility operating in an affected country, or being offered for private placement in an affected country
- being denominated in the currency of an affected country
- having such significant economic ties to an affected country, regardless of where the security is listed or traded, that fair valuation is no longer possible.

4.8 Units or shares of a CIS or open-ended AIF are also affected investments, if redemptions have been suspended because the fund's portfolio has significant exposure to affected investments.

4.9 Not all affected investments that fall within the definitions above will be illiquid or impossible to value. Some companies may have seen a fall in the price of their shares because of recent events, but normal price discovery mechanisms for those shares are still in place. The side pocket mechanism would not be appropriate for assets that can be both valued and traded normally, unless they are sanctioned investments. It is intended only for assets that are impacted by sanctions, restrictions on sale, or where the AFM is unable to determine accurate, reliable and regular prices for an affected investment.

Q6: Do you agree with our proposals to define the scope of affected investments? If not, which other assets would you allow to be included in a side pocket (or require to be excluded) and why?

Taking the decision to create a side pocket class

4.10 A side pocket class could have a significant long-term impact on the fund and its unitholders. Proper consideration must be given to the effect that creating a side pocket class would have on unitholders and there must be a sufficient cause to employ the side pocket class. The effect of UK and international sanctions against Russia must also be fully considered. So the decision to create a side pocket class will need to be taken by the governing body of the AFM, including the independent directors, and after having consulted the fund's depository.

4.11 Our proposed rule (COLL 7.8.4R) sets out the conditions which must be satisfied before a side pocket class can be created. It includes a non-exhaustive list of matters which the AFM's governing body should consider before taking a decision (COLL 7 Annex 1). We also propose that the AFM must have explicitly considered whether to suspend dealing in the fund, as an alternative to creating a side pocket. The aim of the list of matters is to ensure that the AFM has:

- identified and evaluated the investment, legal and operational risks involved in creating a side pocket class
- assessed the known and likely costs of the class and decided how they will be paid for
- compared the costs with the benefits for investors that the side pocket class is intended to achieve
- considered the longer-term implications of the ongoing management of the side pocket.

- 4.12** Having taken all these factors into account, the AFM's governing body must be satisfied that:
- a.** creating the side pocket class will protect the interests of unitholders (in particular, that it will be in the best interests of all unitholders to make arrangements to protect the interests of those unitholders that have borne the risk while the affected investments were marked down in value)
 - b.** the rights of any unit in a side pocket class will not be unfairly prejudicial to the interests of unitholders generally, or to the unitholders of any other class of units
 - c.** the issue of units in the side pocket class will be in the best interests of unitholders, the authorised fund and the integrity of the market
 - d.** all the unitholders in the authorised fund will be treated fairly.
- 4.13** The AFM must make a record of the governing body's decision and the reasons for it.
- 4.14** We will not require the AFM to make any explicit commitment at the outset to maintain the class for either a minimum or a maximum period of time, since we believe the AFM has to be able to respond to developments as they occur. However, the AFM must have first considered what different scenarios might arise, according to how long the class lasts for, and should have a risk management plan in place to deal with each scenario, including how ongoing costs and charges will be met.
- 4.15** We do not consider it necessary for the AFM and the depositary to conduct a review of the fund's eligible markets before setting up a side pocket class. Whether or not a market in an affected country continues to be eligible under COLL 5.2.10R is not an emergency issue and can be reviewed later under a separate process. Similarly, we are not asking AFMs to make determinations about whether any individual affected investment has ceased to meet the eligibility criteria under COLL 5.2 or 5.6 as a result of the recent events.
- 4.16** An AFM might initially set up a side pocket class for certain affected investments, then decide at a later date that additional affected investments should also be segregated from the fund's liquid assets. In that situation, the AFM would need to create a second side pocket class. It would not be possible to add further assets to an existing side pocket class, because the entitlements of unitholders would have changed where units have been issued or cancelled since the first side pocket was created. The AFM would need to go through the same preliminary process of considering whether a further side pocket class would be in the best interests of all unitholders at that point.

Q7: Do you agree with our proposed conditions for creating a side pocket class? If not, what conditions do you think should apply to the creation of a side pocket class and why?

Q8: Do you agree that the AFM's governing body should be required to consider the matters set out above before deciding whether to approve the creation of a side pocket unit class? Are there any other matters the governing body should consider?

Amendments to scheme documents

- 4.17** The ability to issue different classes of units in an authorised fund depends on the provisions set out in its constituting instrument and prospectus. COLL 3.2.6R (9) requires the scheme instrument to contain a statement specifying the classes of units that may be issued and a description of how rights in each class differ from the other classes. COLL 4.2.5R (5)(a) similarly requires the prospectus to state the name of each class in the fund and the rights that attach to it, in so far as they vary from the rights of other classes.
- 4.18** The instrument is the source of the AFM's authority to manage the scheme and it cannot issue new kinds of unit classes without explicit legal authority. Similarly, the prospectus sets the terms on which the AFM will enter into a contract with a unitholder. A prospectus would be misleading if it did not set out all material information which an investor would reasonably wish to know about the fund before investing.
- 4.19** We do not believe the instrument and prospectus of any UK authorised retail fund currently make provisions for side pockets. So the proposed rules (COLL 7.8.4R (2)(c) and 7.8.13R) would require the AFM to amend the instrument and prospectus before creating the side pocket. We have considered whether it is possible to waive or modify the rules requiring the scheme documents to make provision for classes operating as side pockets but, for the reasons of transparency to investors given above, we have concluded this would not be appropriate.
- 4.20** We recognise that these changes would take time and would require notification to and approval by our Fund Authorisations team. It is the AFM's responsibility to decide whether creating a side pocket class is in unitholders' best interests, so the approval process would not entail the FCA expressing a view on that matter. We would however wish to ensure the scheme documents empower the AFM to issue units in a side pocket class, and set out clearly the terms on which such a class would operate (COLL 7.8.4R (2)(c)).
- 4.21** We are willing to work with industry stakeholders to develop a process so the AFM of a fund invested in affected investments could apply for a fast-track approval of the changes to its scheme documents, provided there are no changes other than those necessary to establish the side pocket.

Q9: Do you agree with our approach to amending the instrument constituting the fund and the prospectus? If not, what alternative approach would you recommend?

Unitholder consent

- 4.22** COLL 4.3 sets out rules for engaging with unitholders when a change is made to the way an authorised fund is operated or managed. Changes are categorised into three types and the AFM must decide which category a change falls into, according to how material its impact will be on an individual fund:
- fundamental changes require prior approval by unitholders
 - significant changes require adequate prior notice to be given to unitholders
 - notifiable changes can be notified to unitholders at a later date.

- 4.23** Empowering an AFM to create a side pocket class under these proposals might be regarded as a fundamental change, by changing the nature of the fund or altering its risk profile. We have considered whether it is still appropriate to require the AFM to seek unitholder approval before creating a side pocket class.
- 4.24** Unitholder meetings are an important mechanism for enabling investors to give or withhold their consent to proposals that would affect their interests. However, meetings take time to organise, because of the need to prepare documentation, obtain clearance from the FCA and give sufficient advance notice to unitholders. The costs of a meeting may be significant and are sometimes charged to the fund.
- 4.25** We recognise that AFMs have little discretion over how they could treat the affected investments, given the impact of external events including the legal requirement to comply with sanctions. They need a tool that can be adopted relatively quickly, so to insist on holding a unitholder meeting first might delay its adoption.
- 4.26** Also, for a meeting to serve a useful purpose, we believe that the unitholders should be offered a meaningful choice, where each alternative might meet the needs of a reasonable investor depending on their individual circumstances and preferences. For example, if a fund's assets under management have not reached a viable size, its AFM may ask unitholders to choose between merging with another fund with broadly similar aims and better long-term prospects, or having their money returned.
- 4.27** In the current situation, the aim would be to set up an arrangement to protect the interests of investors by preventing the dilution of value to existing unitholders if the affected investments should ever recover their value, but without incurring material costs that would largely or entirely erode the benefit of any such recovery. The alternatives would be for the AFM to:
- take no further action
 - transfer the affected investments to another person at their current written-down value, foregoing any possibility for the fund to benefit if the assets ever regain value, or
 - propose to terminate the fund.
- 4.28** Since we do not think a majority of investors would be likely to prefer any of these alternatives to a side pocket, we see no strong case for requiring the meeting. However, if the costs of taking action might be disproportionately large compared with the potential benefits, it would be reasonable to let unitholders vote on the matter.
- 4.29** We propose that the AFM need not treat the introduction of side pocket unit classes as a fundamental change, provided it is satisfied on reasonable grounds that the foreseeable costs of this course of action are not disproportionate to the benefits (COLL 7.8.14R). The AFM must explain, in the information it is required to send unitholders, the basis on which it has reached this conclusion.
- 4.30** We have also considered whether the introduction of side pocket classes would constitute a significant change, which normally requires at least 60 days' prior notice. A change that affects unitholders' ability to exercise rights in relation to their investments is one type of significant change, and the proposed nature of the side pocket class would appear to impact on those rights.

4.31 As in the case of unitholder meetings, the point of 60 days' notice is to give the unitholder a meaningful choice. If there is no rational alternative course of action to deal with an emergency scenario, there is little point in delaying implementation of the action most likely to serve investors' interests. We think it is unlikely an investor would decide to exit a fund that has not yet suspended dealing, purely because of the introduction of side pocket classes.

4.32 We therefore propose in COLL 7.8.16R that if the AFM determines that implementing side pocket unit classes should be treated as a significant change, the requirement under COLL 4.3.6R (3) to give prior notice is disapplied. Instead, the AFM must inform unitholders in a timely way of what is happening. It may do this by announcing its decision in advance, or after the change has been implemented. We set out in paragraphs 4.43 to 4.48 below what information should be provided to unitholders.

Q10: Do you agree with our proposal to dispense with holding a unitholder meeting to approve the side pocket? If not, what benefit do you think holding a meeting would provide for unitholders in the current situation?

Q11: Do you agree with our proposals for AFMs to notify investors about the creation of the side pocket? If not, what steps should the AFM be required to take?

Issue of units in new classes

4.33 The issue of units in a new side pocket class to existing unitholders would need to be proportionate to the units they held immediately before it was created (COLL 7.8.5R). AFMs would have some flexibility about how to achieve this outcome.

4.34 The issue of units in each new side pocket class to existing unitholders could be *pari passu* to the units they held immediately before it was created. So, a unitholder would receive one new unit in the side pocket class in addition to each unit currently held. This is likely to be the simplest option for fund administrators to implement, for intermediate unitholders to apportion between their clients, and for investors to understand.

4.35 However, AFMs may decide a different approach would work better, such as converting each existing unit into two new units, one representing the value of liquid assets and the other representing the value of affected investments. In each case it will essentially be an accounting process, not a revaluation. Fundamentally, the combined value of the total units that unitholders hold immediately after the side pocket is created must exactly equal the value of their holding immediately prior to it being created.

Q12: Do you agree that AFMs should decide the best way of issuing units in new classes so that holdings are proportionate to the existing classes? If not, what alternative approach would you suggest?

Allocation of scheme property

- 4.36** The AFM will need to consider carefully how to apply a fair accounting treatment when the class is established. This is closely linked to decisions about how costs and charges should be handled in relation to any side pocket class and to how the rules of COLL 5 are to be applied (COLL 7.8.23R).
- 4.37** We propose guidance at COLL 7.8.8G to clarify how the AFM should allocate capital property and income property to the side pocket class. In particular, the AFM would need to decide whether to allocate a portion of uninvested cash to cover costs and charges. The AFM may also wish to be able to undertake derivative transactions attributable only to the side pocket class, in order to hedge foreign currency exposures back to the fund's base currency. These transactions would also require capital cash to be allocated to cover margin requirements.

Q13: Do you have any comments on how income property and capital property should be allocated to a side pocket class? What are your views on the allocation of uninvested capital cash and its use to carry out hedging transactions?

Costs and charges

- 4.38** We propose to give guidance on the treatment of costs and charges in a side pocket class (COLL 7.8.9G). The FCA accepts that the new class should bear a proportionate share of costs which arise and are incurred for the benefit of all unitholders, such as depositary expenses and fees, audit fees, and regulatory charges. The AFM, in managing and administering the fund, will also incur necessary expenses which it has a right in principle to recover from the fund's liquid assets. Unitholders in other classes without any interest in the affected investments should not be cross-subsidising the costs of managing that class. It is reasonable for such costs to be recovered in the first instance out of available income or capital attributable to the side pocket class, depending on the normal charging policy set out in the fund's prospectus.
- 4.39** Since it is not possible to know whether any income from affected investments will be receivable on an ongoing basis in future, the AFM will have to determine how to account for such income and for expenses attributable to the new class. The AFM may decide to accrue such charges indefinitely until sufficient cash is available to cover them, or to waive some charges or pay them from its own resources. The AFM's governing body should consider this when evaluating whether to proceed with side pocket arrangements.
- 4.40** The governing body should also consider whether the AFM should be remunerated for managing a class that is valued largely or solely by reference to affected investments. To ensure fair treatment of all investors in the fund, it may be more appropriate for the AFM to forego some or all remuneration from that class.
- 4.41** The FCA would not prevent the AFM from charging an annual management fee for managing the side pocket, but considers that any fee should fairly reflect the AFM's activities as agent for investors. It should not exceed what is reasonable to cover the necessary costs of the AFM (including any firm to which portfolio management

is delegated) and to reward the amount of work entailed in seeking opportunities to dispose of the affected investments in an orderly way. We would expect such a fee to be less than the annual fee the AFM charges for managing the rest of the scheme property.

4.42 We propose (COLL 7.8.30R) that the AFM should not be able to make any preliminary charge when it issues units in the side pocket class, nor receive payment from any charge if it redeems units (although a charge permitted by COLL 6.3.8R (Dilution) may be applied to a redemption if necessary to protect the interests of remaining unitholders). We also propose that the AFM should not be able to charge a performance-related annual management fee, which we would not consider to be appropriate in these circumstances.

Q14: Do you agree with the proposed guidance on how costs and charges should be allocated where a side pocket class is created?

Q15: Do you agree that an AFM should not charge preliminary or exit fees, or a performance fee, when managing a side pocket class?

Investor communications

4.43 As we mention above, the AFM must communicate its actions in a timely way to unitholders, either shortly before setting up the side pocket or as soon as practicable afterwards. In either case, the AFM will need to prepare a written notification that explains fully the reasons for its decision including the expected benefits and costs, the effect on unitholders' ability to exercise their rights, the main features of the side pocket class and the practical information unitholders will need about the changes to their investment (COLL 7.8.19R). We propose issuing guidance (COLL 7.8.20G) with further detail on the key points the notification should cover.

4.44 The AFM must write to unitholders as soon as practicable after the side pocket class has been established, confirming to each unitholder individually the number and type of units they hold in the fund as a result of the action taken (COLL 7.8.21R). The statement of holdings and the explanatory notification may be sent to existing unitholders as part of the same communication.

4.45 Side pockets, although sometimes found in institutional funds, are an unfamiliar concept to most investors (and probably to many financial advisers). Investors in retail funds will not be expecting an announcement that they now hold units in a side pocket class, and may have many questions about what it means for them. So AFMs should give careful consideration to the information needs of investors when preparing this communication. It should avoid excessive use of legalistic language or 'small print' that ordinary investors are unlikely to find engaging. It may be helpful to set out upfront the key points in a summary page, with an indication of where further detail may be found in the document.

- 4.46** The document should be published in a durable medium, and AFMs should ensure it is accessible (e.g. by publishing a copy in a prominent location on their website). We realise that the majority of investors will probably hold their units through a platform provider or other intermediary, so those providers will need to be able to pass on the information to their customers, and to handle and respond to enquiries from them.
- 4.47** We are also considering how we can support firms in ensuring investors are appropriately informed. We are minded to publish material on the consumer section of our website explaining the key features of the side pocket regime.
- 4.48** Because units in a side pocket class are not offered to potential investors in exchange for a subscription, we consider that their issue does not fall within the requirement to make a UCITS key investor information (KII) document, or a NURS-KII document, available to investors. We propose modifying the application of COLL 4.7.2R accordingly (COLL 7.8.18R).
- Q16:** **Do you agree that our proposed rules and guidance will ensure unitholders receive adequate and timely information about the side pocket class structure? If not, what further steps should firms take to meet investors' information needs?**
- Q17:** **Do you agree that the FCA should publish consumer-facing material to explain the use of side pockets? If so, what matters should it cover?**

Managing the transition to a side pocket

- 4.49** Once the AFM has decided that establishing a side pocket class is appropriate, it should consider how to manage the process to protect the interests of all investors. In particular, it should consider how the timing of an announcement of its intention might impact investor behaviour.
- 4.50** Some existing investors might be concerned about the possible impact on them – for example that they might in some way be trapped in the fund – and seek to redeem as soon as possible. On the other hand, some people might seize the opportunity to invest in order to share any future gain if the affected investments recover in value.
- 4.51** The AFM may conclude that the safest way to deal with these risks would be to make no announcement until the point at which it is ready to launch the new class, having obtained clearance from us and made all the necessary operational preparations. We assume that dealing in the fund would need to be suspended for a short period of time while the new units are issued. This is similar to when a fund merger or reconstruction takes place.
- 4.52** Alternatively, the AFM may decide to make an earlier announcement, in which case it must consider whether to suspend dealing from the point when the announcement is made. This is likely to be the surest way to protect the interests of all investors by preventing inappropriate decisions to buy or sell units, even though it might be inconvenient and commercially unattractive from the AFM's point of view.

4.53 We consider that the rules already give sufficient scope to AFMs to decide how to proceed, provided their decision is based on their judgement of the best interests of investors.

Q18: Do you agree that AFMs should be allowed to decide how to manage the transition process? Are there any other investor protection issues arising from the process of setting up a side pocket class, that we should address in rules or guidance?

5 How side pockets affect other firms

- 5.1** Introducing the proposed side pockets may cause UK UCITS schemes and NURS to be treated differently under some other regulations and will impact other market participants, as well as investors in these funds. This Chapter sets out some of the potential consequences we have identified and explains our proposed approach to them, where they are in our control, and what we are able to do where they are outside our control.

Stocks and shares ISAs

- 5.2** Our proposals involve making rules providing AFMs with the option to introduce side pockets to deal with their affected investments within their funds. Existing investors will have invested in these funds on the basis that they can redeem their units on a daily basis (or as otherwise specified in the instrument constituting the fund and its prospectus). One effect of the proposed rules would be to change the basis on which existing investors can redeem their units from the side pocket unit class.
- 5.3** Under current tax legislation, authorised funds only qualify to be ISA eligible under certain conditions. The ISA Regulations do not look through to the unit class level, but we are currently engaging with the Treasury and HMRC to understand the interactions between our proposals and the ISA Regulations, and whether they would change the eligibility of the units in the affected funds under the ISA Regulations 1998 (as amended). We will take this into account in our final decision.
- 5.4** Where a Stocks & Shares ISA consisting of a current year's ISA subscription is transferred to another ISA manager, the ISA regulations require that it is transferred in full. Such transfers must be to the same beneficial owner and not a third party. To ensure full transferability of ISAs, we would expect ISA managers to permit transfers to another ISA manager of units of funds with side pockets, during the tax year in which the ISA was created.
- 5.5** There could also be wider tax implications of introducing a side pocket through a unit class structure, so we welcome feedback on this area.

Q19: Do you have any comments on the implications of creating a side pocket for ISA managers and for investors holding units in an ISA?

Investment intermediaries

- 5.6** We are aware that investment intermediaries may have previously given advice to clients to invest in funds with affected investments. Where the terms of the relationship with the client involve providing ongoing advice, advisers will need to consider the suitability of continued or ongoing investments in such funds.

- 5.7** Funds are typically viewed as long-term investments, and the side pocket will mean that investors will retain their economic exposure to the affected investments even if they redeem their units relating to unaffected liquid assets. However, some investors may pay regular subscriptions into the fund, and the fund may no longer be suitable for them. Investment advisers will need to ensure that they have considered the effect of the side pocket before advising existing and new investors into the fund.

Q20: Do you have any comments on the implications of creating a side pocket for firms giving financial advice?

Distributors

- 5.8** Distributors and other service providers would also need to consider the operational impacts of introducing side pockets. Distributors would need to engage in consumer communications to ensure that investors are aware of and understand the implications of the creation of the side pocket. They may need to amend systems to ensure that deals are recorded and processed correctly under the new terms.
- 5.9** Distributors, such as investment platforms, who make these products available on a non-advised basis would also need to consider the appropriateness of continuing to make such funds available, and how they are described. These funds will still be regulated, and as new investors would not have exposure to the side pocket we think it could be appropriate for the funds to continue to be offered.
- 5.10** Investors may also need additional information to help them understand the side pocket. Some distributor stakeholders have emphasised to us their need for clear and comprehensive information from AFMs that they can easily repackage and pass on to their clients.

Q21: Do you have any comments on the implications of creating a side pocket for platform service providers and other firms involved in fund distribution?

Unit-linked insurance

- 5.11** We have also considered the potential impact on unit-linked insurers who have exposure to the affected funds. Unit-linked products are sold by life insurance companies which have underlying pooled investments (fund-type structures) linked to an insurance policy. In unit-linked funds the investor is allotted nominal units in the fund according to the premium paid and the unit price on date of purchase, and receives returns based on the performance of the fund's investments. Unit-linked funds must be purchased within an insurance wrapper, unlike authorised funds which can be purchased directly. The wrapper is in most cases an insurance-based pension, but can also be self-standing life insurance.
- 5.12** Unit-linked funds are in general explicitly long-term investments (pensions, life insurance cover), in which most investors, for most of the investment period, are focused on long-term returns.

- 5.13** In the case of unit-linked funds, the obligations of the insurer are backed by capital requirements on insurers imposed under Prudential Regulation Authority rules which reflect the Solvency II Directive. The obligations of the insurer include contractual obligations to pay out under the policy (on death or maturity, for example), as well as regulatory obligations imposed on insurers by our rules.
- 5.14** Many unit-linked insurance contracts offer investment into authorised funds. For these specific contracts, insurance firms would need to decide how to process transactions into funds with side pockets, which could include treating the side pocket as they would any other suspended fund or share.

Q22: Do you have any comments on the implications of creating a side pocket for providers of unit-linked life funds and for policyholders of those funds?

SIPP provider capital rules

- 5.15** Many investors invest in these funds through their self-invested personal pension schemes (SIPPs). A SIPP provider is required by FCA rules to hold adequate capital, in the event that it seeks to close to new business and run off or transfer its book of pension schemes to another administrator.
- 5.16** Our rules mitigate the risk that an operator may not have sufficient financial resources, which may not be immediately apparent to consumers when they set up a SIPP plan, as well as the ongoing risk that the operator may fail in the future, at a time when the consumer has less time to rebuild their pension assets. If SIPP providers do not hold adequate capital there is a significant risk that investors can end up funding an administration out of their own pension assets, which undermines market confidence and can cause significant consumer harm.
- 5.17** The amount of capital that SIPP providers are required to hold is determined by a combination of the amount and nature of the assets that they administer. Some SIPP providers administer schemes that allow clients to invest in less easily realisable asset classes, that can be difficult or costly to transfer to another provider or to wind up. A SIPP provider that administers such schemes is required to hold more capital than a SIPP provider administering "standard assets".
- 5.18** The capital adequacy rules for SIPP providers therefore distinguish between standard assets and non-standard assets. To be treated as a standard asset, the rules require any investment held in a SIPP to be capable of being readily realisable within 30 days. Where a SIPP provider administers client plans that contain non-standard assets, it must hold additional capital (a capital surcharge) to provide additional client protection in the event of the firm exiting the market.
- 5.19** The SIPP rules do not look through to the unit class level of authorised funds, but do consider whether an asset (e.g. fund) is capable of being readily realisable within 30 days. Therefore they do not treat the presence of a side pocket unit class as meaning that a fund is (automatically) a non-standard asset.

Q23: Do you have any comments on the implications of creating a side pocket for SIPP providers and for consumers holding fund investments in a SIPP?

6 Managing side pockets over the long term

- 6.1** Although the side pocket class is intended to be temporary, so that the arrangement could be terminated as soon as it is in investors' interests to do so, it might be in existence for some time to come. Once it is set up, the AFM has an ongoing responsibility to manage it in the best interests of unitholders, having regard to its special purpose. In this Chapter we set out some of the issues that an AFM may have to address during the life-cycle of a side pocket class.

Aims and investor value

- 6.2** The AFM will not be managing the side pocket class in line with the fund's investment objective and policy, but with a view to closing down the side pocket class when this can be done in the best interests of unitholders, depending of course on developments in Ukraine and their impact on affected investments (COLL 7.8.30R). The AFM will therefore need to implement a regular review process to ensure that the situation is being pro-actively monitored and is not allowed to drift. It may be convenient to do this by linking it to the annual value assessment conducted under COLL 6.6.21R.
- 6.3** The AFM's responsibility to assess value continues to apply to a side pocket class, so the governing body should periodically review the impact of costs and charges on the class and whether it is offering good value for investors. The actions which the AFM is able to take to deliver value may be more limited than for other classes of the fund or other funds. For example, fixed costs will have a disproportionately large impact on a class of low absolute value, if the AFM is not able or willing to subsidise that impact out of its own capital. However, this should not reduce the AFM's accountability to investors through the annual value reporting requirement.

Q24: Do you agree that the AFM should continue to apply the assessment of value rules to side pocket classes?

Investment and borrowing powers

- 6.4** The rules in COLL 5 on investment and borrowing powers continue to apply to a side pocket class, but we propose (COLL 7.8.23R) that the AFM must comply with as much of the relevant sections of that Chapter as is practicable, having regard to the limited purpose of the class. So, for example, derivatives for class hedging purposes must comply with all relevant rules on using derivatives, and the usual limitations on holding cash, borrowing and lending still apply. However, we consider it would not be practicable to apply a prudent spread of risk to the affected investments. We explain in guidance (COLL 7.8.24G) that this is a limited modification of the rules and the AFM cannot take any action that would increase the fund's overall risk profile.
- 6.5** We also propose to clarify how the defined term 'scheme property' should be interpreted in relation to the unaffected liquid assets in a fund with a side pocket class (COLL 7.8.25R).

Q25: Do you agree with our proposed rules and guidance on how investment and borrowing powers should apply to a fund with a side pocket class?

Valuation and pricing of units

- 6.6** The price of a unit in a side pocket class must relate only to the net value of the affected investments and uninvested cash allocated to the class. The valuation rules in COLL 6.3 are modified accordingly (COLL 7.8.28R).
- 6.7** Many funds that might want to use a side pocket class offer daily dealing in units, backed by a daily valuation of scheme property. Although the AFM will need to keep market developments on affected investments under close review, it might not be practical or desirable to value the affected investments on a daily basis. The AFM will need to specify the valuation frequency for side pocket units in the fund prospectus.

Q26: Do you have any comments on the process for valuing and pricing a fund with a side pocket class?

Dealing in the side pocket class

- 6.8** As long as the affected investments are valued at zero or are illiquid, the unit price of the side pocket class must reflect this because funds are valued at their net asset value. Without prices based on fair and accurate asset valuations, allowing an investor to buy or sell units would be unfair both to that person and to other unitholders in the fund.
- 6.9** If the AFM is satisfied that the asset valuations are correct, it could allow unitholders in the side pocket class to sell their units at that value should they wish to do so. The AFM could offer to write the amount off (i.e. cancel the units without debiting the scheme property of the fund) if it is of minimal value. Or, at the unitholder's request the AFM could undertake to donate any resulting proceeds to charity, instead of paying the redemption proceeds to the unitholder. This might appeal to some investors who, as a matter of principle, would like to divest themselves of any exposure to Russian or Belarusian assets.
- 6.10** The AFM would need to cancel any units repurchased in this way – they could not be resold or held on the "manager's box". If the affected investments subsequently recover value, the remaining investors in the class would benefit since each remaining unit would then have a proportionately greater interest in the property attributable to the class.
- 6.11** However, there may be insufficient liquidity in the property allocated to the side pocket class to support any redemptions. So an alternative approach would be to enable the AFM to suspend all dealing in the side pocket class, while continuing to deal normally in all other classes of the fund.

- 6.12** This would require changes to COLL rules which do not allow dealing to be suspended at class level. The AFM would have to meet the normal conditions for suspending dealing, including that the suspension should be temporary in nature and undertaken to protect the interests of investors. It would result in all unitholders in the side pocket class being treated alike, so all of them would share in any potential recovery in the value of the affected investments.
- 6.13** We propose rules allowing AFMs to adopt either of these models according to their own judgment of what is in investors' best interests (COLL 7.8.27R and 7.8.32R).

Q27: Do you agree with our proposal to allow AFMs to choose whether to offer redemptions at zero / minimal value or to suspend dealing in units of the side pocket class? If not, what approach to redemption would you suggest?

Alternatives to redemption

- 6.14** For investors who hope to see some sort of return on the side pocket class before they sell it, the option to redeem at zero value is likely to be unattractive. For some, a prolonged period of suspension may be acceptable in principle, but a point may come when they wish to exit the side pocket but cannot redeem.
- 6.15** An alternative may be for the unitholder to transfer the units in the side pocket class to a third party. AFMs must register transfers by operation of law, which arise on the death or bankruptcy of a unitholder, in favour of the deceased person's personal representatives or the bankrupt's trustee in bankruptcy. Beyond these situations, any unitholder could currently offer to sell their interest in the side pocket units to a third party, for a price to be agreed between them, and then arrange for the units to be re-registered in the third party's name.
- 6.16** Of course, the offer could come from a third party with a commercial interest in buying up 'distressed assets' from unitholders. A third party might operate entirely independently, or it might seek to work in co-operation with the AFM to make a collective offer to unitholders. We note that any future Government proposals to legislate to prevent new investment in Russia and allied countries could interfere with or even prevent such arrangements.
- 6.17** We have concerns about consumers being exploited in these situations, especially if there is an asymmetry of information between buyer and seller. Some investors may be enticed to sell their interest for a small sum at a time when the buyer has good reason to believe the affected investments might stage a significant recovery in value. We could take steps to warn consumers about this risk, to alert them to possible scams, or to recommend they seek advice before entering into an agreement; but we do not believe we could, or should, try at all costs to prevent unitholders from entering into arrangements of this kind.

- 6.18** Therefore, we propose to let each AFM determine what steps it should take to allow or prevent transfers to third parties, working within relevant legislation and rules. We would however expect an AFM to notify us in advance of any active steps it intends to take to promote or facilitate an offer by another person to purchase unitholders' interests in units in a side pocket class, or if it becomes aware of a person seeking to do so without its co-operation.

Q28: Do you agree that AFMs should decide the extent to which transfers of side pocket units to third parties may be allowed? If not, what approach would you recommend and why?

Options for terminating the side pocket class

- 6.19** Setting up a side pocket class would be an irrevocable decision in the sense that simply cancelling all the units, as though it had never existed, would not be in investors' interests. The AFM would need to make a specific proposal about how best to terminate it in the interests of all investors.
- 6.20** In fact, the class structure may allow the AFM to offer a choice to unitholders if and when the affected investments regain some value or appear likely to do so. Different groups of investors might well want different outcomes: some will want to sell their Russian exposures as soon as possible, while others might want to retain their holdings. The AFM could address this by calling a unitholder meeting and proposing options for holders to vote on.
- 6.21** It might be possible to allow unitholders to make individual choices at the point when affected investments can be traded at a reliable price. Those who want to redeem at that point could be allowed to do so, while others could continue to hold their units.
- 6.22** Offering choices to investors that meet their needs is good in principle, but the AFM would need to be careful that the preferences of one group of investors do not result in prejudice to the interests of another group. Any possible recovery in value might not happen in a uniform way – some affected investments might quickly regain value while others remain illiquid – and sanctions might still prevent the sale of some assets. Allowing some investors to redeem immediately, by selling the liquid element of the portfolio, risks creating a form of 'first mover advantage' in which other investors could end up unable to exit because only illiquid assets remain.
- 6.23** The AFM might be able to overcome this risk by allowing only partial redemptions in proportion to the element of underlying liquidity, though this could result in some investors being left with "rump" holdings that are inconvenient to them and not cost-effective for firms to administer.
- 6.24** We think any AFM that wishes to establish a side pocket class should consider these issues from the outset and explain in its initial investor communications how it might address them. Doing so at the point of creating a side pocket should not require the AFM to commit to a firm plan for winding it up. The AFM must be allowed to develop its plans in response to events as they unfold, but it should at least indicate to unitholders at the outset its understanding of what future options might be open to them and what factors (including current and projected legislation) might constrain it from offering them a particular option when the time comes.

Q29: Do you agree that AFMs should be able to offer unitholders a choice of ways of exiting the class if future circumstances allow? Are the options described above appropriate and are there other options that could be offered?

Ongoing investor communications

- 6.25** All the issues discussed in this Chapter point to the need for AFMs to ensure that sufficiently regular and detailed communications are issued to unitholders in the side pocket class. Unitholders will need to know the AFM's current thinking about the prospects of being able to sell the affected investments at a reliable valuation, and how this will affect their options for exiting the side pocket class.
- 6.26** The periodic managers' reports and accounts are the principal means of keeping investors informed, and the financial reports for the fund will need to set out the position of affected investments and their valuation at the accounting period end. Likewise, the manager's review should refer to any important developments affecting the side pocket class during the reporting period.
- 6.27** However, managers' reports are not sent to investors who hold units indirectly via a platform or other intermediary, and they are published some time after the end of the period to which they relate. We would expect AFMs to consider additional steps to provide timely information about any developments, such as emailing unitholders and publishing updates on their website. The AFM should continue to take account of the information needs of investors with whom it does not have a direct relationship, by ensuring that communications are clearly presented and can be easily passed on by firms that own the customer relationship.
- 6.28** Any future changes affecting the side pocket class should be treated in the usual way in accordance with COLL 4.3 – the exemptions from holding a unitholder meeting or giving 60 days' prior notice of a significant change apply only to the establishment of the side pocket class and not to any future modifications to it.

Q30: Are the information needs of investors over the life of the side pocket class adequately met by existing rules and guidance? Are there any other steps that AFMs or other firms should take to keep investors informed?

Q31: Are there any other matters not covered in this consultation, that the FCA should consider in making rules and guidance to allow side pocket unit classes?

Annex 1

Questions in this paper

- Q1:** Do you have any comments on our assessment of the effects of our proposals on existing unitholders? If so, please provide details.
- Q2:** Do you consider our proposals adversely impact any groups with protected characteristics under the Equality Act 2010? Do you consider there are any issues which may be relevant to our obligations under the Equality Act (see paragraph 2.24)? If so, please provide details.
- Q3:** Do you agree that the proposed unit class structure is a suitable way to create a side pocket in a retail fund? Are there any improvements that could be made to it?
- Q4:** Do you agree that the proposed side pocket class could operate without causing prejudice to the interests of other investors in the fund?
- Q5:** Do you have any comments on the side pocket model set out above? Should the FCA take steps to enable AFMs of funds holding affected investments to use this alternative model?
- Q6:** Do you agree with our proposals to define the scope of affected investments? If not, which other assets would you allow to be included in a side pocket (or require to be excluded) and why?
- Q7:** Do you agree with our proposed conditions for creating a side pocket class? If not, what conditions do you think should apply to the creation of a side pocket class and why?
- Q8:** Do you agree that the AFM's governing body should be required to consider the matters set out above before deciding whether to approve the creation of a side pocket unit class? Are there any other matters the governing body should consider?
- Q9:** Do you agree with our approach to amending the instrument constituting the fund and the prospectus? If not, what alternative approach would you recommend?
- Q10:** Do you agree with our proposal to dispense with holding a unitholder meeting to approve the side pocket? If not, what benefit do you think holding a meeting would provide for unitholders in the current situation?

- Q11:** Do you agree with our proposals for AFMs to notify investors about the creation of the side pocket? If not, what steps should the AFM be required to take?
- Q12:** Do you agree that AFMs should decide the best way of issuing units in new classes so that holdings are proportionate to the existing classes? If not, what alternative approach would you suggest?
- Q13:** Do you have any comments on how income property and capital property should be allocated to a side pocket class? What are your views on the allocation of uninvested capital cash and its use to carry out hedging transactions?
- Q14:** Do you agree with the proposed guidance on how costs and charges should be allocated where a side pocket class is created?
- Q15:** Do you agree that an AFM should not charge preliminary or exit fees, or a performance fee, when managing a side pocket class?
- Q16:** Do you agree that our proposed rules and guidance will ensure unitholders receive adequate and timely information about the side pocket class structure? If not, what further steps should firms take to meet investors' information needs?
- Q17:** Do you agree that the FCA should publish consumer-facing material to explain the use of side pockets? If so, what matters should it cover?
- Q18:** Do you agree that AFMs should be allowed to decide how to manage the transition process? Are there any other investor protection issues arising from the process of setting up a side pocket class, that we should address in rules or guidance?
- Q19:** Do you have any comments on the implications of creating a side pocket for ISA managers and for investors holding units in an ISA?
- Q20:** Do you have any comments on the implications of creating a side pocket for firms giving financial advice?
- Q21:** Do you have any comments on the implications of creating a side pocket for platform service providers and other firms involved in fund distribution?
- Q22:** Do you have any comments on the implications of creating a side pocket for providers of unit-linked life funds and for policyholders of those funds?

- Q23:** Do you have any comments on the implications of creating a side pocket for SIPP providers and for consumers holding fund investments in a SIPP?
- Q24:** Do you agree that the AFM should continue to apply the assessment of value rules to side pocket classes?
- Q25:** Do you agree with our proposed rules and guidance on how investment and borrowing powers should apply to a fund with a side pocket class?
- Q26:** Do you have any comments on the process for valuing and pricing a fund with a side pocket class?
- Q27:** Do you agree with our proposal to allow AFMs to choose whether to offer redemptions at zero / minimal value or to suspend dealing in units of the side pocket class? If not, what approach to redemption would you suggest?
- Q28:** Do you agree that AFMs should decide the extent to which transfers of side pocket units to third parties may be allowed? If not, what approach would you recommend and why?
- Q29:** Do you agree that AFMs should be able to offer unitholders a choice of ways of exiting the class if future circumstances allow? Are the options described above appropriate and are there other options that could be offered?
- Q30:** Are the information needs of investors over the life of the side pocket class adequately met by existing rules and guidance? Are there any other steps that AFMs or other firms should take to keep investors informed?
- Q31:** Are there any other matters not covered in this consultation, that the FCA should consider in making rules and guidance to allow side pocket unit classes?
- Q32:** Do you have any comments on our cost benefit analysis?

Annex 2

Cost benefit analysis

Summary

- 1.** This Annex sets out our assessment of the costs and benefits of new rules to protect investors in authorised funds following the Russian invasion of Ukraine. The Russian invasion of Ukraine on 24 February 2022 has affected financial markets in many ways and some securities have become illiquid or untradeable. Our proposals allow authorised fund managers (AFMs) the option to separate affected investments – set out in paragraph 1.2 of the CP – from the fund’s other investments through the use of side pockets.
- 2.** We consider that our proposals will deliver an appropriate, stable and resilient structure for funds with exposure to affected investments and could have benefits for investors. We consider the potential benefits of our proposals are:

 - Funds that have suspended reopen earlier than they would otherwise have done, allowing investors to access investments
 - Existing investors are able to sell the units which relate to assets that are not affected investments
 - Side pockets avoid the potential transfer of value from one group of investors to another. They would allow new investors to enter the fund without gaining exposure to the affected investments while they are marked down (at the expense of existing investors)
 - New investors can enter the fund without sharing in the exposure to the affected investments. This may be of benefit if investors have ethical concerns about buying funds with exposure to Russia.
- 3.** However, benefits will be highly dependent on the degree to which firms choose to use side pockets. Our proposed rules allow firms to change their practices, in this case creating side pockets, but don’t oblige them to do so. We therefore do not think it is reasonably practicable to quantify the benefits to firms and investors.
- 4.** As firms don’t have to change their practices, we believe that familiarisation costs, that is reading and learning about the rules, will be the main direct costs to firms resulting from the proposals. We estimate total familiarisation costs for AFMs and depositaries to be £88,800. For AFMs that choose to create side pockets, we would expect them to incur per fund legal costs as they seek to understand and comply with the rules. Additionally, we have had feedback from firms that one-off costs of setting up a side pocket as a share class would be approximately £25,000 per fund.
- 5.** If AFMs choose to create side pockets, we consider further ongoing costs will be incurred by AFMs and depositaries, as well as costs potentially by administrative service providers such as transfer agents and fund accountants, and by distributors including investment platforms, advisers and life assurers. We do not believe that it is

reasonably practicable for us to quantify and monetise further one-off and ongoing costs. Our rules do not oblige AFMs to make changes, and firms will only choose to incur the cost of setting up side pockets if they consider it beneficial.

6. There are likely to be some additional costs to investors if side pockets are created. AFMs will have to decide how to charge for managing the side pocket unit class. If investors obtain some benefit from a recovery in value of affected investments, there may be tax or other costs arising from the creation of a side pocket. We welcome feedback on further potential cost implications of creating side pockets as part of the consultation.
7. Overall, we consider that there are benefits in terms of greater efficiency of the management of funds that have investments in affected investments. We also consider there will be benefits from greater confidence in the valuation of fund assets. We judge that even with uncertainties, AFMs will only create side pockets if they perceive the expected benefits to outweigh the expected costs. But if no value can be realised it is unlikely that there will be a financial net benefit to investors, and there could be a net cost, from side pockets being created. There are also non-financial benefits to our proposals such as contributing to market integrity.

Introduction

8. 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'.
9. This analysis presents estimates of the significant impacts of our proposal. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide estimates of outcomes in other dimensions. Our proposals are based on carefully weighing up these multiple dimensions and reaching a judgement about the appropriate level of consumer protection, taking into account all the other impacts we foresee.

Problem and rationale for intervention

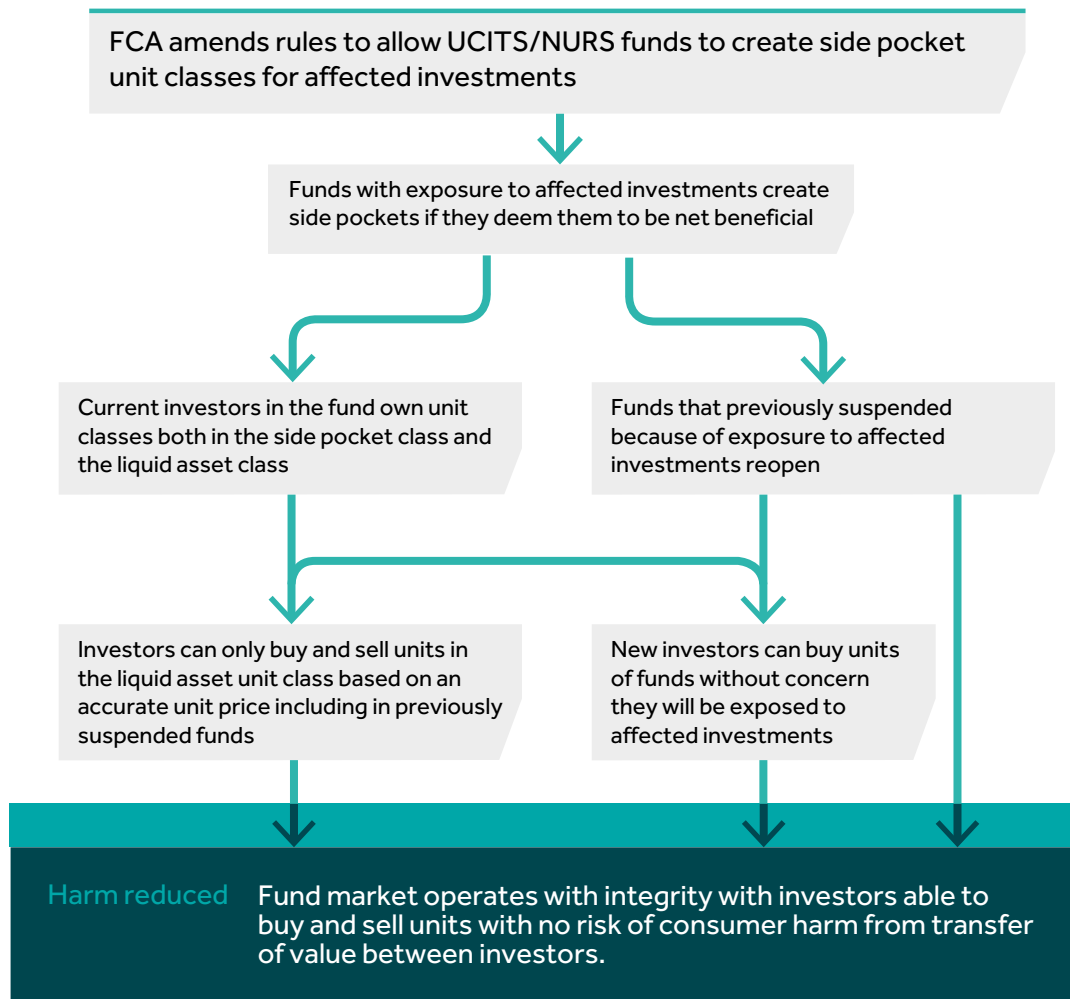
10. As a result of measures taken in response to Russia's invasion of Ukraine, authorised funds own assets which they are unable to value accurately or to deal in because some securities have become illiquid or untradeable. Normal mechanisms for determining accurate and reliable valuation for some securities have stopped operating. This includes Russian and Belarusian assets, and potentially Ukrainian assets. The full list of affected assets is detailed in paragraph 1.2 of the consultation paper. In this CBA we refer to all these affected assets as "affected investments".
11. Authorised fund managers (AFMs) who have these affected investments in their funds are faced with the challenge of how to value or sell them. In many cases the AFMs have written down the value of the affected investments to zero or near-zero as a prudent measure, to reflect the current situation and risks.

12. According to data from Morningstar, over 1,300 authorised funds, managed by around 94 AFMs, had some affected investments (equities or bonds) prior to the invasion, representing around £4.5 billion at pre-invasion valuation. Of these funds, around 100 funds had more than 2% of their net asset value in affected investments. Authorised funds with any exposure to affected investments were worth in total around £730bn which is around half of all assets in UK domiciled funds.
13. One driver of harm is that existing investors are not able to access their investments where a fund has suspended dealing because of its exposure to affected investments. As of 21 April, 4 UK authorised retail funds are in this situation. These funds might need to remain suspended for a significant period. The use of side pocket units would potentially allow these funds to reopen. Investors in these funds would then be able to access that portion of their assets which is not directly affected by the current situation, while the assets in the side pocket remain untradeable. Investors would retain an economic interest in the side pocket units and benefit from any future value from these units.
14. Other funds with exposure to affected investments have not suspended dealings and are valuing affected investments at zero or near-zero. Another driver of harm is that, when an open-ended fund creates or cancels units, it must do so at prices based on a fair and accurate valuation of the underlying assets. Because these assets currently cannot be traded or accurately valued, it may not be possible for funds to produce an accurate unit price.
15. If units are not priced accurately there is a transfer of value from one group of investors to another. If a fund's dealing price is lower than the true net asset value per unit, redeeming investors and ongoing investors lose out but subscribing investors gain. Without side pocket units, new investors could potentially buy into the fund at a unit price that reflects no value for the affected investments. There is a risk of unfairness if investors deal in units of the fund and the unit price is inaccurate. The proposed intervention will enable a fund to hold affected investments separately while continuing to be owned by the current unitholders.
16. Finally, side pockets could allow new investors to enter the fund without getting exposure to affected investments, which may be of benefit if they have ethical concerns about buying such assets or if sanctions make ownership of these assets more difficult.

Summary of our proposed intervention

17. We propose to allow AFMs to establish a separate class, or range of classes, within the fund which would be valued purely by reference to the affected investments and not the remaining liquid investments in the fund. We refer to this class as the 'side pocket class'. Conversely, all other classes would be valued by reference to the liquid assets, but not the affected investments.
18. Units in the side pocket class would be issued to all unitholders at the point when the class is created, but the expectation is that no further units in that class would be issued after that point. All further investments, whether by existing or new investors, would receive units in a class valued only by reference to the liquid assets. Chapter 3 sets out in further detail our proposed intervention.

Figure 1: The causal chain



Baseline

19. Without intervention, investors and potential investors in affected funds have uncertainty about the fair value of fund assets. If we do not intervene, investor transactions will continue to occur in funds open for dealing where the unit price may not be based on a fair and accurate valuation of underlying assets. This is likely to be an increasing issue over time, to the extent that the investor base of the fund changes materially.
20. If affected investments have been written down to zero or near-zero value, existing investors who wish to redeem will have to give up any potential for the future value of those assets, which will be transferred to remaining investors or new investors. If the assets are not being valued accurately, there is a risk that the valuation ascribed to them would be wrong and that unitholders would receive the wrong price (potentially at the expense of other unitholders) if they enter or exit the fund. Inaccurately priced funds could see very rapid unit price changes in some circumstances, if the amount of unaffected investments is small compared to affected investments.
21. Additionally, some funds have suspended dealings, so investors in these funds cannot access any of their investments. Suspended funds may not be able to reopen in

the near future without the possibility of creating side pockets, or may potentially wind down.

22. Finally, without side pockets, new investors will not be able to enter the fund without getting exposure to affected investments. This may conflict with investors' ethical concerns and lead to challenges if sanctions make ownership of affected investments more difficult.

Costs and benefits

23. We set out the expected costs and benefits below. We note that our proposed rules are generally 'permissive' so firms will only incur the costs of introducing new unit classes to the extent that they take advantage of our rule changes. They will be likely to do this only if they perceive that the benefits of doing so exceed the costs. There may be some uncertainties in this respect as assets placed in the side pocket may not recover in value. Additionally, there are some uncertainties about the implications for side pockets in the longer term and whether for example, units could be sold on secondary markets. We are not making assumptions about how many funds might take up the proposals and set out illustrative costs for funds that choose to implement side pockets.
24. We consider that there are benefits in terms of greater efficiency of the management of funds that hold affected investments. We also consider there will be benefits from greater confidence in the valuation of fund assets. But if no value can be realised it is unlikely that there will be a financial net benefit to investors, and there could be a net cost, from side pockets being created. Additionally, there will be benefits for investors with ethical concerns who will be able to invest in the funds without gaining exposure to Russian and Belarusian assets.

Benefits of our proposals

Benefits to firms

25. We consider that our proposals will deliver an appropriate, stable and resilient structure for funds with exposure to affected investments. However, it is up to the AFM to determine whether a side pocket would be the best way to deal with its fund's exposure to affected investments.
26. If firms choose to create side pockets, benefits may include being able to manage the ongoing fund assets more efficiently. Firms may be able to make better investment decisions without having to consider the potential impact on portfolio construction of a highly uncertain exposure to affected investments. Managers of index tracking funds may be able to manage their funds more efficiently in line with their mandate to track the index. Side pockets may reduce the risk that firms would give one set of investors (e.g. subscribing investors) preferential treatment over another (existing investors). Side pockets could also provide investors with the confidence to continue investing into the funds, meaning that the authorised fund manager still receives a management fee from the wider fund.

27. As benefits will be highly dependent on the degree to which firms choose to use side pockets, we believe that it is not reasonably practicable to quantify these benefits.

Benefits to investors

28. We consider that there will be benefits to investors from allowing firms to use side pockets. However, the financial benefits are dependent upon firms' take up of side pockets and the extent that affected investments regain value.
29. For investors in funds that have suspended there will be benefits if those funds reopen for dealing earlier than they would otherwise have done. This would then mean that existing investors in the suspended funds would be able to redeem units which do not relate to affected investments.
30. There will be benefits to investors through side pockets avoiding the transfer of value from one group of investors to another. They would allow new investors to enter the fund without gaining exposure to the affected investments while they are marked down (at the expense of existing investors). There will also be benefits from greater confidence in the valuation of fund assets. Side pockets could therefore potentially further our consumer protection objective by helping to ensure that all unitholders are treated equitably, while also providing investors with confidence that they can invest into the funds without gaining exposure to the affected investments.
31. Benefits to investors are dependent on firms taking up side pockets. We do not know how many funds will use side pockets and as a result we don't think it is reasonably practicable to estimate the benefits to investors.
32. Whilst we consider that there will be benefits from allowing firms to use side pockets, it is likely that there will only be a direct financial benefit to investors if and to the extent that affected investments regain value in the future. If they do not, then there may be no financial benefit (and potentially a cost) relative to the baseline.
33. Investors will also have non-financial benefits from being able to buy funds that do not have exposure to affected investments. For example, this may be of benefit if investors have ethical concerns about buying funds with exposure to Russia or Belarusian assets. Our proposals also allow for the segregation of affected investments in a way that potentially supports compliance with sanctions regimes relating to Russia, imposed by the UK and certain other jurisdictions. The benefits of our proposals overall therefore may outweigh the costs overall even if the financial benefits do not.

Costs of our proposals

Costs to firms

34. As noted above, our proposed rules allow firms to change their practices, in this case creating side pockets, but don't oblige them to do so. As firms don't have to change their practices, we believe that familiarisation costs, that is reading and learning about the rules, will be the main direct costs to firms resulting from the proposals.
35. We expect firms affected by our intervention will read and familiarise themselves with the relevant changes proposed in this consultation paper. We estimate there

are currently around 94 AFMs with any investments in affected investments, and 7 depositaries who will also need to familiarise themselves with the rules.

- 36.** Based on assets under management (AUM), we assume there are 16 large, 37 medium and 41 small AFMs. Large AFMs are defined as those with over £10 billion in potentially affected funds, medium AFMs as those with between £1 billion and £10 billion, and small AFMs those with less than £1 billion. All the depositaries are large firms.
- 37.** We have estimated the costs of this to firms using assumptions on the time taken to read the document, which is 40 pages long. We assume that there are 300 words per page and reading speed is 100 words per minute. This means that the document would take 2 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.
- 38.** Table 1 sets out the total familiarisation costs by firm type, along with the assumptions to calculate these costs based on firm size. In total, we estimate that the one-off industry cost of familiarisation would be around £89k.

Table 1: familiarisation costs

Firm Size	Number of firms	Number of compliance staff needed to read the document	Total Familiarisation Cost (£,000)
AFMs			
Large	16	20	39.6
Medium	37	5	24.2
Small	41	2	7.8
Depositaries	7	20	17.3
Total Industry			88.8

Note: figures do not add up due to rounding

- 39.** For AFMs that choose to create side pockets, we would expect them to incur legal costs as they seek to understand and comply with the rules. We estimate using the standardised cost model these AFMs would have to review 20 pages of legal text, with approximate per firms costs of £160 for small, £1200 for medium and £3200 for large firms. The estimated large firm cost also applies to the depositaries.

Further potential costs if side pockets are created

- 40.** If AFMs choose to create side pockets, we consider further ongoing costs will be incurred by AFMs and depositaries of funds that invest in affected investments, as well as costs potentially by administrative service providers such as transfer agents and fund accountants, and by distributors including investment platforms, advisers and life assurers.
- 41.** AFMs who choose to take up the opportunity to use side pocket unit classes for their funds will incur costs of setting them up. We understand that the costs of setting up a new class are relatively small. Funds will not have to open new custody or bank accounts, or transfer their assets to a new structure. Firms will have to develop accounting policies and processes for the side pocket class, and potentially agree these with their auditor. We have had feedback from firms that one-off costs of setting up a side pocket as share class would be approximately £25,000 per fund.

This substantially lower than the £100,000 cost estimates received for the alternative 'scheme of arrangement' option considered in paragraph 3.24.

42. Transfer agents and other record keepers such as investment platforms will need to record the ownership of the new unit class and maintain this on an ongoing basis. This should be similar to other corporate actions in funds, and so should not incur costs from the development of new processes.
43. AFMs, advisers, investment platforms and life assurers will have to communicate to investors what is happening. As per the proposal, we are not planning to require AFMs to seek investor consent, but simply to notify them. There are also likely to be ongoing costs around providing information to consumers of the status of their fund. One AFM provided us with estimates of ongoing administrative and communication costs. These were indicative costs in the region of £50k – 100k per fund, per annum.
44. We do not believe that it is reasonably practicable for us to quantify and monetise further one-off and ongoing costs of creating side pockets for AFMs. Our rules do not oblige AFMs to make changes, and firms will only choose to incur the cost of setting up side pockets if they consider it beneficial.
45. To the extent that firms choose to create side pockets, there could also be cost implications for advisers with affected clients and life assurers. Advisers would have to communicate to clients about the side pocket units. Life assurers who invest in funds that set up side pocket units would have to consider whether and how these impact their insurance contracts. We do not think it is reasonably practicable to estimate these costs as the extent of the costs will depend on the number and type of investors in the fund.

Costs to investors

46. There are likely to be some additional costs to investors if side pockets are created. AFMs will have to decide how to charge for managing the side pocket unit class. If they charge in the usual '*ad valorem*' way, and the assets are valued at zero, there would be no cost to consumers from investment management fees. However, we assume that AFMs will estimate the potential costs and allocate some cash to the side pocket to pay the expenses of managing the unit class.
47. To the extent that distributors such as investment platforms, pension providers and advisers incur costs, for example administrative costs, they may be passed on to investors. Firms may charge absolute levels of fees to compensate for their costs. The fund rules prevent an investor in a fund being exposed to liabilities that are greater than their investment. But this would not prevent an investor in a fund being charged other fees outside the fund, which could be greater than their investment.
48. If investors obtain some benefit from a recovery in value of affected investments, there may be tax or other costs arising from the creation of a side pocket. We are currently engaging with the Treasury and HMRC to understand the interactions between our proposals and the ISA Regulations and will take this into account in our final decision.

49. There could also be cost implications for life assurance firms operating unit-linked life funds and for policyholders whose returns are based on those funds, if side pockets are created. Insurance firms will need to decide how to process transactions into funds with side pockets. Additionally, there could be implications for self-invested personal pension schemes (SIPPs) providers and capital rules. We welcome views on the implications for these funds as part of this consultation.

FCA costs

50. The FCA will incur some costs in supervising side pocket unit classes. The costs will be relative to the number of side pockets that are set up, which we are unable to predict, and therefore we believe that it is not reasonably practicable to quantify these costs. Our expectation is that we will use existing FCA resources to supervise side pockets.

Q32: Do you have any comments on our cost benefit analysis?

Annex 3

Compatibility statement

Compliance with legal requirements

1. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation, including 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 which 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 the 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. Our assessment of the equality and diversity implications of our proposals is set out at paragraph 2.21 of this paper.
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 like making rules). This Annex sets out how we have complied with requirements under the LRRRA.

The FCA's objectives and regulatory principles: Compatibility statement

7. We consider these proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well. The relevant markets include the financial markets and the markets for regulated financial services. Unitholders in UK authorised retail funds buy and sell units in the funds through the financial markets by using the services of AFMs and depositaries who carry on regulated activities.
8. The proposals are compatible with our strategic objective because fund managers will be able to segregate "affected investments" so that if or when sanctions are unwound, investors may benefit from any increase in value of their investments held before the Russian invasion of Ukraine. Our proposals will allow any potential upside of the revaluation of "sanctioned assets" to be attributed only to those who had invested in the fund before the implementation of these proposals. Our proposals mean that fewer funds are likely to have to suspend dealing in units and some that have been suspended may be able to resume dealing for some classes of unit.
9. 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 advancing the FCA's market integrity objective.
10. In formulating our proposals for consumer protection, we have considered the risks that may arise when a UK authorised retail fund holds assets that are linked to a person under financial sanctions relating to Russia or that otherwise relate to Russia, Belarus or Ukraine. As set out in this paper, our proposed measures should secure an appropriate degree of protection for consumers. In particular, our proposals apply to UK authorised retail funds whose investors are likely to have less experience and expertise in investing in units than unitholders in funds designed for professional investors. The proposals should ensure that the UK financial system is not used for a purpose involving financial crime.
11. Also, we think that the proposals will advance our integrity objective to protect and enhance the integrity of the UK financial system. In particular, we consider that our proposals will aid the orderly operation of the financial markets and enhance the transparency of price formation in units of collective investment schemes, in accordance with s.1D(2) FSMA.
12. In preparing the proposals set out in this consultation, the FCA has had regard to the regulatory principles set out in s. 3B FSMA.
13. **The need to use our resources in the most efficient and economic way**
The Russian invasion of Ukraine has created a situation which needs to be addressed urgently for unitholders and UK authorised retail funds with exposure to affected investments. Given the current situation, we consider that our proposals are an efficient and economic use of our resources. The alternative model for segregating affected investments would involve establishing a new fund; this would be likely to be more resource-intensive over the short to medium term, as fund managers would need seek authorisation from the FCA for their new funds.

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

14. We have considered whether the rules enabling firms to create side pockets are proportionate for fund managers and depositaries. The proposed rules are designed to be flexible. Fund managers may make use of the ability to create side pockets but are not under any obligation to do so. If fund managers do decide to create side pockets, they will be subject to certain requirements which we consider to be proportionate given our objective to secure an appropriate degree of protection for consumers.
15. We have also considered the proportionality of our proposals to the extent that they involve potential interference with investors' existing property rights. Our assessment on this aspect is set out in Chapter 2.

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

16. The asset management industry is one of the most important providers of capital needed for economic growth. By introducing side pockets, our proposals will support the efficient operation of authorised funds as part of the asset management sector which contributes towards the sustainability of UK economic growth. Our proposals should enable existing investors in UK authorised retail funds to redeem units valued by reference to unaffected liquid investments.
17. Without our proposals, some funds might need to suspend dealings or unitholders would have to crystallise their losses in respect of the exposure to affected investments. Such actions would be likely to damage the perceived attractiveness of authorised funds as an investment vehicle for the general public.

The general principle that consumers should take responsibility for their decisions

18. The Russian invasion of Ukraine has had financial consequences for some UK authorised retail funds which most investors in such funds could not have predicted when they invested. Our proposals will allow investors who were exposed to affected investments to receive the benefit of any future revaluation of these assets as the situation unwinds, rather than allowing other investors to benefit at their expense.

The responsibilities of senior management

19. Our proposals would require the governing body of each fund manager to take the decision on whether to create a side pocket and require the governing body to consider various specified matters such as ensuring that the side pocket would be in the interests of unitholders and would comply with relevant sanctions legislation.

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation

20. Our rules will apply to all fund managers of UK authorised retail funds. They may also impact on other types of firm indirectly e.g. platform providers, unit-linked life assurance providers and SIPP providers, but do not (and are unlikely to) apply to mutual societies.

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

21. In formulating these proposals, the FCA sets out the detail of our concerns and assessment of the likely costs and benefits, and seeks feedback. This is consistent with the principle of exercising our functions transparently. Given the urgency of the situation, we think it is appropriate to have a shorter consultation period than we would typically allow respondents.
22. 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). The proposals allow for the segregation of affected investments in a way that supports compliance with sanctions regimes relating to Russia and Belarus imposed by the UK and certain other jurisdictions.

Expected effect on mutual societies

23. The FCA does not expect the proposals in this paper to have a significantly different impact on mutual societies. Mutual societies are not permitted to operate or manage authorised collective investment schemes, and do not normally distribute them or provide services to them in the course of business.

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

24. 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. Our policy proposals will allow UK firms to act in the interests of consumers and to mitigate the detriment of consumers adversely impacted by the imposition of sanctions and interruptions to the normal functioning of financial markets. Given the particular circumstances of our proposals, we consider it unlikely that firms would be seeking to compete in the interests of consumers but we note that our proposals are flexible and can be implemented at the discretion of individual AFMs.

Treasury recommendations about economic policy

25. We consider that our proposals are consistent with the aspects of the Government's economic policy to which the FCA should have regard.
26. In the remit letter from the Chancellor of the Exchequer to the FCA on 23 March 2021, the Chancellor affirms the FCA's role in protecting consumers, promoting competition in financial services and protecting and enhancing the integrity of the UK financial system.

- 27.** The FCA has had regard to this letter and its recommendations. As set out in this Annex, we consider that our proposals are proportionate and aim to secure an appropriate degree of consumer protection. Our proposals are of relevance to the government wanting to see financial services work in the best interests of the consumers and businesses they serve and, as explained in the CP, our proposals aim to secure better outcomes for consumers than would be the case without our proposed intervention.

Legislative and Regulatory Reform Act 2006 (LRR)

- 28.** We have had regard to the principles in the LRR for the parts consisting of general policies, principles or guidance. We consider 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 industry, or adversely affecting competition. We consider the process to be transparent, and the measures are targeted only at firms with affected investments.
- 29.** We have had regard to the Regulators' Code for the parts of the proposals that consist of general policies, principles or guidance and consider that the proposals are proportionate to the potential harm to consumers or risks to our statutory objectives that have been identified.

Annex 4

Abbreviations used in this paper

Abbreviation	Description
AFM	Authorised fund manager
CIS	Collective investment scheme
COLL	Collective investment schemes sourcebook
EU	European Union
FCA	Financial Conduct Authority
G7	Group of 7 countries
FSMA	Financial Services and Markets Act 2000
HMRC	Her Majesty's Revenue and Customs
ISA	Individual savings account
KII	Key investor information
NURS	Non-UCITS retail scheme
OEIC	Open-ended investment company
SIPP	Self-invested personal pension scheme
UCITS	Undertaking for collective investment in transferable securities

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.

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Appendix 1

Draft Handbook text

**COLLECTIVE INVESTMENT SCHEMES SOURCEBOOK (SIDE POCKETS)
(RUSSIA) INSTRUMENT 2022**

Powers exercised

- A. The Financial Conduct Authority (“the FCA”) makes this instrument in the exercise of the following powers and related provisions in or under:
- (1) the following sections of the Financial Services and Markets Act 2000 (“the Act”):
 - (a) section 137A (The FCA’s general rules);
 - (b) section 137T (General supplementary powers);
 - (c) section 139A (Power of the FCA to give guidance);
 - (d) section 247 (Trust scheme rules);
 - (e) section 248 (Scheme particulars rules);
 - (f) section 261I (Contractual scheme rules); and
 - (g) section 261J (Contractual scheme particulars rules);
 - (2) regulation 6(1) of the Open-Ended Investment Companies Regulations 2001 (SI 2001/1228); and
 - (3) the other rule and guidance making powers listed in Schedule 4 (Powers exercised) to the General Provisions of the FCA’s Handbook.
- 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 Glossary of definitions is amended in accordance with Annex A to this instrument.
- E. The Collective Investment Schemes sourcebook (COLL) is amended in accordance with Annex B to this instrument.

Notes

- F. In this instrument, notes shown as “Note:” are intended for the convenience of the reader but do not form part of the legislative text.

Citation

- G. This instrument may be cited as the Collective Investment Schemes Sourcebook (Side Pockets) (Russia) Instrument 2022.

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

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

- affected country* Any of the following:
- (1) the Republic of Belarus;
 - (2) the Russian Federation;
 - (3) Ukraine.
- affected investment*
- (1) a *sanctioned investment*; or
 - (2) an *investment* in (a) which falls within any of the limbs in (b).
 - (a) (i) A *transferable security* within limb (2) of that definition.
 - (ii) A money-market instrument.
 - (iii) A *unit* in a *collective investment scheme*.
 - (iv) A *share* in an *AIF*.
 - (b) (i) The *investment* is issued or guaranteed by:
 - (A) the Government of, or a central authority in, an *affected country*;
 - (B) a regional or local authority of an *affected country*; or
 - (C) the central bank of an *affected country*.
 - (ii) The *investment* is issued or guaranteed by an *issuer* which:
 - (A) has its principal place of business in an *affected country*; or
 - (B) has such significant economic ties to an *affected country* that fair valuation of the *investment* is no longer possible, regardless of where the *investment* is *listed* or traded.

- (iii) The *investment* is a right or interest in another *affected investment* issued by an *issuer* in (ii).
- (iv) The *investment* is denominated in the currency of an *affected country*.
- (v) On 24 February 2022, the *investment* was *listed* or traded on a market or *MTF* in an *affected country*.
- (vi) Prior to 24 February 2022, the *investment* was offered, or was offered for private placement, in an *affected country*.
- (vii) The *investment* is a *unit* in a *collective investment scheme* or a *share* in an *AIF* which has suspended *redemptions* as a result of investing substantially in one or more:
 - (A) *sanctioned investments*; or
 - (B) *investments* in (2)(a) which fall within any of (i) to (vi) above.

sanctioned investment

an *investment* which is:

- (1) a *transferable security* within limb (2) of that definition;
- (2) a money-market instrument;
- (3) a *unit* in a *collective investment scheme*; or
- (4) a *share* in an *AIF*,

where dealing with the *investment* (whether directly or indirectly) would contravene the financial sanctions regimes of any one or more of Canada, the *EU*, France, Germany, Italy, Japan, the *United Kingdom* or the United States of America, as those sanctions regimes relate to Russia.

[**Note:** The *UK*'s financial sanctions regime relating to Russia is set out in the Russia (Sanctions) (EU Exit) Regulations 2019.]

side pocket class

has the meaning given in *COLL* 7.8.5R(3) (Side pocket classes).

side pocket property

the *scheme property* which is allocated to a *side pocket class* in accordance with *COLL* 7.8.5R(2)(a) (Side pocket classes) and *COLL* 7.8.27R(3) (Modified application of *COLL* 6.2 (Dealing)).

[**Note:** See also *COLL* 7.8.8G (Allocation of scheme property to a side pocket class).]

Annex B

Amendments to the Collective Investment Schemes sourcebook (COLL)

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

7 Suspension of dealings, ~~and~~ termination of authorised funds and side pockets

7.1 Introduction

...

Table of application

7.1.2 R This table belongs to *COLL 7.1.1R*.

<i>Rule</i>	<i>ICVC</i>	<i>ACD</i>	<i>Any other directors of an ICVC</i>	<i>Depository of an ICVC</i>	<i>Authorised fund manager of an AUT or ACS</i>	<i>Depository of an AUT or ACS</i>
...						
<u>7.8</u>	<u>x</u>	<u>x</u>	<u>x</u>	<u>x</u>	<u>x</u>	x
Notes	...					
	(5)	<u><i>COLL 7.8 (Side pockets) applies only to UCITS schemes and non-UCITS retail schemes in which the authorised fund manager intends to establish (or has established) a side pocket class. The rules in COLL 7.8 do not apply to a regulated money market fund.</i></u>				

Purpose

7.1.3 G ...

(3) *This chapter also helps to achieve the statutory objectives of protecting consumers and protecting and enhancing the integrity of the UK financial system, by enabling unitholders or potential unitholders in a UCITS scheme or non-UCITS retail scheme with affected investments to continue to deal in units representing assets held in the scheme property that are not affected investments.*

...

After COLL 7.7 (UCITS mergers), insert the following section. The text is new and is not underlined.

7.8 Side pockets

Application

- 7.8.1 R (1) Subject to (2), this section applies to:
- (a) the *authorised fund manager* of an *AUT*, *ACS* or an *ICVC*;
 - (b) any other *director* of an *ICVC*;
 - (c) the *depository* of an *AUT*, *ACS* or an *ICVC*; and
 - (d) an *ICVC*,
- which is a *UCITS scheme* or a *non-UCITS retail scheme*.
- (2) This section does not apply to a *scheme* which is a *regulated money market fund*.
- 7.8.2 G (1) This section sets out the terms on which the *authorised fund manager* of a *scheme* holding *affected investments* can segregate those *affected investments* from the other assets held in the *scheme property* by establishing a *side pocket class*.
- (2) The purpose of the *rules* in this section is to advance the *FCA's* consumer protection and integrity objectives (see s1B(3) of the *Act*) by helping *authorised fund managers* deal with the consequences of the Russian invasion of Ukraine.
- (3) The *rules* in this section apply other *rules* in *COLL*, where necessary, with appropriate modifications, as well as imposing certain additional requirements.

Financial sanctions regimes relating to Russia

- 7.8.3 G (1) The definition for a 'sanctioned investment' in the *Glossary* (which is incorporated in the definition for 'affected investment') relates to the financial sanctions regimes of the Group of 7 (G7) countries comprising Canada, France, Germany, Italy, Japan, the *United Kingdom* and the United States of America, plus the *EU*, as those sanctions regimes relate to Russia.

- (2) Before deciding whether to create a *side pocket class* and determining the arrangements under which the *class* is to operate, the *authorised fund manager* will need to understand the legal requirements and obligations that apply under the relevant financial sanctions regimes. The *authorised fund manager* will need to be satisfied that creation of the *side pocket class* and the operational arrangements for the *class* will comply with those regimes.
- (3) The *UK's* financial sanctions regime is set out in the Russia (Sanctions) (EU Exit) Regulations 2019. The Regulations are available at <https://www.legislation.gov.uk/ukxi/2019/855/contents>. The *UK* regime prohibits certain types of activity and conduct, including dealing with funds and economic resources, and dealing with transferable securities and money-market instruments, subject to certain exceptions. Contravention of these prohibitions constitutes a criminal offence.
- (4) The Office of Financial Sanctions Implementation (OFSI) (part of HM Treasury) helps to ensure that the *UK* financial sanctions regime is properly understood, implemented and enforced in the *United Kingdom*.

Conditions for creating a side pocket class

- 7.8.4 R
- (1) If all the conditions in (2) are satisfied, the *authorised fund manager* of a *scheme* holding *affected investments* may, after consulting with the *depository*, create a *side pocket class*.
 - (2) The conditions are:
 - (a) The *authorised fund manager* has determined that the *affected investment* held in the *scheme property* is:
 - (i) a *sanctioned investment*;
 - (ii) a *unit* in a *collective investment scheme* or a *share* in an *AIF* within the meaning of paragraph (2)(b)(vii) of the definition of ‘affected investment’; or
 - (iii) to the extent not in (i) or (ii), an *affected investment* for which there are no accurate, reliable and regular prices.
 - (b) The *authorised fund manager* has determined that:
 - (i) creating the *side pocket class* will protect the interests of *unitholders*;
 - (ii) the rights of any *unit* in a *side pocket class* will not be unfairly prejudicial to the interests of *unitholders* generally or to the *unitholders* of any other *class* of *units* in the *scheme*;

- (iii) the *issue* of *units* in the *side pocket class* will be in the best interests of *unitholders*, the *authorised fund* and the integrity of the market; and
 - (iv) all the *unitholders* in the *authorised fund* will be treated fairly.
- (c) The *instrument constituting the fund* and the *prospectus*:
- (i) provide for the *issue* of *units* in a *side pocket class*; and
 - (ii) set out the terms on which that *class* will operate,
- in accordance with the *rules* in, and applied by, this section (see in particular *COLL 7.8.13R* (Modified application of *COLL 4.2* (Pre-sale notifications))).
- (3) Before making the determination in (2)(b), the *authorised fund manager* must consider:
- (a) at least each of the matters specified in *COLL 7 Annex 1* (Matters to be considered by the authorised fund manager before creating a side pocket class); and
 - (b) whether it would be in the interest of all the *unitholders* in the *authorised fund* to suspend *dealings* in *units* in accordance with *COLL 7.2.1R* (Requirement) instead of creating a *side pocket class*.
- (4) (a) The decision to create a *side pocket class* pursuant to (1) must be taken by the *authorised fund manager's governing body*.
- (b) The *authorised fund manager* must make a record of the *governing body's* decision and the reasons for it.

Side pocket classes

- 7.8.5 R (1) The *authorised fund manager* may:
- (a) *issue units* in a new *class* to *unitholders* in the *authorised fund*;
or
 - (b) convert a *unit* in an existing *class* into *units* in one or more new *classes*.
- (2) Where the *authorised fund manager* has taken an action pursuant to (1)(a) or (1)(b), it must determine the *price* of *units* of each existing and new *class* by reference to a valuation of the portions of *capital property* and *income property* represented by either:

- (a) one or more *affected investments* held in the *scheme property*;
or
- (b) the *scheme property* excluding some or any such *affected investments*,

as provided for in the *instrument constituting the fund* and the *prospectus*.

- (3) A new *class* within (2)(a) is referred to as a ‘side pocket class’.
- (4) The *authorised fund manager* must determine the date and time on which the *units* in the new *class* are to be *issued*.
- (5) On the date and time specified in (4):
 - (a) the combined net asset value of all *units* of the new *class* and all *units* of the existing *class*; or
 - (b) the combined net asset value of any new *classes* of *unit issued* by conversion from an existing *class* of *unit*,

must equal the net asset value of all *units* of the *class* or *classes* that existed immediately before the specified date and time.

- (6) On the date and time specified in (4), the number of *units* held by a *unitholder* in a new *class* must be proportionate to the number of *units* held by them in an existing *class* immediately before such date and time.

7.8.6 R The *prospectus* of the *authorised fund* must limit the *issue* of *units* in a *side pocket class* after the date and time specified in COLL 7.8.5R(4) (see COLL 7.8.27R(5) (Modified application of COLL 6.2 (Dealing))).

7.8.7 G (1) An *authorised fund manager* intending to *issue units* in a new *class* will need to consider the effect of section 235(4) of the *Act*. In broad terms, this provides that if the contributions of the *participants* and the profits or income out of which payments are to be made to them are pooled in relation to separate parts of the *scheme property*, the arrangements are not to be regarded as constituting a single *collective investment scheme* unless the participants are entitled to exchange rights in one part for rights in another (see section 235(4) of the *Act* (Collective investment schemes)).

- (2) The *authorised fund manager* of an *ICVC* will also need to consider the effect of section 236(3) (Open-ended investment companies) of the *Act*. PERG 9.6 (The investment condition (section 236(3) of the Act): general) sets out the *FCA’s* view of this provision. In particular, PERG 9.6.3G and PERG 9.6.4G provide *guidance* on situations where an *ICVC* issues shares or securities that may not satisfy the investment condition.

Allocation of scheme property to a side pocket class

- 7.8.8 G (1) The *authorised fund manager* will need to consider carefully how to apply a fair accounting treatment when a *side pocket class* is created.
- (2) Where the *unit price* is determined only by reference to *affected investments* that are themselves valued at or close to zero, then a *unit* in the *side pocket class* will have minimal value. Where a portion of the *income property* of the *scheme* is attributable to *affected investments*, it is likely to be fair that the *unit price* of the *side pocket class* should include that element of income.
- (3) The *authorised fund manager* may determine that a proportion of uninvested cash held in the *capital property* of the *scheme* should be attributed to the *side pocket class*, as a provision against costs and charges attributable to the *class* in the future. This will depend on the *authorised fund manager's* policy for the treatment of costs and charges (see also *COLL 7.8.31R* (Modified application of *COLL 6.7* (Payments))).
- (4) Some *authorised fund managers* may wish to use *derivatives* and forward transactions within the *side pocket class* to hedge exposure to currency fluctuations affecting asset valuations, especially if the *affected investments* acquire value at a later point. *Authorised fund managers* may also wish to replicate currency *class* hedging arrangements where these already exist. Such activities will require an allocation of *capital property* to cover transaction costs and margin requirements.
- (5) Decisions whether to undertake the activities in (4) should be taken by the *authorised fund manager* based on its judgment of *unitholders'* reasonable expectations and future best interests. The *authorised fund manager* should take particular care to ensure its risk management process is properly applied to analyse the possible harm that could arise from such transactions. See also *COLL 7.8.23R* (Side pockets: modified application of *COLL 5* (Investment and borrowing powers)) and the related *guidance* in *COLL 7.8.24G*.

Costs and charges for a side pocket class

- 7.8.9 G (1) The *FCA* accepts that a *side pocket class* should bear a proportionate share of the costs which arise and are incurred for the benefit of all *unitholders*, such as depositary expenses and fees, audit fees, and regulatory charges. The *authorised fund manager*, in managing and administering the *authorised fund*, will also incur necessary expenses which it may recover from the *scheme property*. The *FCA* would not expect *unitholders* in *classes* without any interest in the *affected investments* to cross-subsidise the costs of managing the *side pocket class*. Such costs may be recovered in the first instance out of available income or capital attributable to the *side pocket class*, depending on the normal charging policy set out in the *prospectus*.
- (2) Since it is not possible to know whether any income from *affected investments* will be receivable on an ongoing basis in future, the *authorised fund manager* will have to determine how to account for such income and for expenses attributable to the *side pocket class*. The *authorised fund manager* may decide to accrue such charges indefinitely until sufficient cash is available to cover them, or to waive some charges or pay them from its own resources. The *governing body* of the *authorised fund manager* should consider this when evaluating whether to proceed with creating a *side pocket class*.
- (3) The *governing body* should also consider whether the *authorised fund manager* should be remunerated for managing a *class* that is valued largely or solely by reference to *affected investments*. To ensure fair treatment of all *unitholders* in the *fund*, it may be more appropriate for the *authorised fund manager* to forego some or all remuneration from the *side pocket class*.
- (4) An *authorised fund manager* may be able to charge a fee for managing the *side pocket class*, but the fee should fairly reflect the services provided and activities carried on by the *authorised fund manager* for *unitholders* in that *class*. The fee should not exceed what is reasonable to cover the necessary costs of the *authorised fund manager* (including any *firm* which has been given the mandate to *manage investments* for the *scheme* under *COLL* 6.6.15AR (Committees and delegation)) and to reward the amount of work entailed in seeking opportunities over time to dispose of the *affected investments* in an orderly way. The *FCA* would expect such a fee to be less than the *authorised fund manager's* charges for managing the rest of the *scheme property*.

Application of *COLL* 3 (Constitution)

- 7.8.10 R The *rules* and *guidance* in *COLL* 3 (Constitution) apply to a *side pocket class* subject to the modifications specified in *COLL* 7.8.11R.
- 7.8.11 R In *COLL* 3.3.5R (Rights of unit classes), paragraphs (2) and (3) do not prohibit the *issue* of *units* in a *side pocket class*.

Application of COLL 4 (Investor relations): General

- 7.8.12 R The *rules and guidance* in COLL 4 (Investor relations) apply to a *side pocket class*, subject to:
- (1) the modifications in COLL 7.8.13R to COLL 7.8.18R; and
 - (2) the additional requirements in COLL 7.8.19R and COLL 7.8.21R.

Modified application of COLL 4.2 (Pre-sale notifications)

- 7.8.13 R In relation to a *side pocket class*, the information required to be included in the *prospectus* under COLL 4.2.5R (Table: contents of prospectus) must cover at least the additional matters set out in (1) to (4).
- (1) In COLL 4.2.5R(5) (Characteristics of units):
 - (a) a general description of the *affected investments* to be allocated to the *side pocket class* (or *side pocket classes*);
 - (b) an explanation of how the *scheme property* (both *capital property* and *income property*) will be allocated between the *side pocket class* (or *side pocket classes*) and other *classes* at the outset and on an ongoing basis;
 - (c) information which explains:
 - (i) that the *authorised fund manager* will seek to dispose of all the *affected investments* over time, on terms that it judges to be in the best interests of *unitholders*; and
 - (ii) that the *units* in the *side pocket class* (or *side pocket classes*) will be *cancelled* when this has been done, indicating where possible what options may be offered to *unitholders* for exiting the *side pocket class* (or *side pocket classes*) under the process.
 - (2) In COLL 4.2.5R(16) (Valuation and pricing of scheme property), the frequency at which:
 - (a) *affected investments* allocated to the *side pocket class* will be valued; and
 - (b) the *prices* of *units* in the *side pocket class* will be calculated, where these differ from other *classes* of the *scheme*.
 - (3) In COLL 4.2.5R(17) (Dealing):
 - (a) that the *issue* of *units* in the *side pocket class* is limited, and the circumstances and conditions for *issuing* them;
 - (b) a statement of when the *dealing days* for the *side pocket class* will be;

- (c) details of any cut-off point for the receipt of *dealing* instructions prior to the *valuation point* for the relevant *dealing day*;
 - (d) if applicable, details of any special arrangements put in place for *redemptions* of *units* in the *side pocket class*, including:
 - (i) whether *unitholders* can choose not to receive the payment of proceeds of *redemption* and, if so, what alternative is offered (e.g. payment to a charity);
 - (ii) whether proceeds can be reinvested in other *classes* of the *scheme* or in *units* of other *schemes*;
 - (iii) if there is any facility to transfer *units* to another *person*, as a donation or for financial consideration.
- (4) In *COLL 4.2.5R(27)(b)* (Additional information):
- (a) an explanation that there is no certainty that any *affected investment* will ever recover its value to a significant extent, or at all, and that the *authorised fund manager* may be unable to realise any material value for *unitholders* in respect of *units* held in the *side pocket class*;
 - (b) if applicable, that the costs and charges for operating the *side pocket class* may significantly erode the returns from any realisable value from the *affected investments* over time.

Modified application of *COLL 4.3* (Approvals and notifications)

- 7.8.14 R The *authorised fund manager* need not treat the creation of a *side pocket class* as a fundamental change for the purposes of *COLL 4.3.4R* (Fundamental change requiring prior approval by meeting) provided the *authorised fund manager* is satisfied on reasonable grounds that the foreseeable costs of this course of action are not disproportionate to the benefits.
- 7.8.15 G The *guidance* in *COLL 4.3.5G* (Guidance on fundamental change) should be read in accordance with the modification in *COLL 7.8.14R*.
- 7.8.16 R If the *authorised fund manager* considers that the creation of a *side pocket class* constitutes a significant change, the *authorised fund manager*:
- (1) may, but need not, give prior written notice to *unitholders* under *COLL 4.3.6R(1)* (Significant change requiring pre-event notification); and
 - (2) is not required to comply with *COLL 4.3.6R(3)*.
- 7.8.17 G The *guidance* in *COLL 4.3.7G* (Guidance on significant changes) should be read in accordance with the modification in *COLL 7.8.16R*.

Modified application of COLL 4.7 (Key investor information and marketing communications)

- 7.8.18 R The *rules* in COLL 4.7.2R (Key investor information) do not require an *authorised fund manager* to draw up a *key investor information document* or a *NURS-KII document* in relation to a *side pocket class*.

Additional information for unitholders on the creation of a side pocket class

- 7.8.19 R The *authorised fund manager* must provide a written notification to *unitholders* which meets the requirements of (1) to (3).
- (1) The notification must be provided to *unitholders* in a timely way, either shortly before the *side pocket class* is created or as soon as practicable afterwards.
 - (2) The notification must explain in a comprehensive manner:
 - (a) the reasons for the *authorised fund manager's* decision to create a *side pocket class*, including the expected benefits and costs;
 - (b) the effect on *unitholders'* ability to exercise their rights;
 - (c) if applicable, the basis on which the *authorised fund manager* has satisfied itself as to the cost impact of its decision under COLL 7.8.14R;
 - (d) a description of the main features of the *side pocket class*;
 - (e) practical information that *unitholders* will need to understand about the changes to their investment in the *authorised fund*.
 - (3) The notification must:
 - (a) be written in clear and plain language;
 - (b) be provided in a *durable medium*; and
 - (c) be accessible by existing and prospective *unitholders* (e.g. by publishing a copy in a prominent location on the *authorised fund manager's* website).
- 7.8.20 G (1) In relation to COLL 7.8.19R(2)(a), the information in the notification should include:
- (a) a description of the *scheme's* exposure to *affected investments* and the *authorised fund manager's* approach to valuing them;
 - (b) an explanation of the risks such *affected investments* pose to the *scheme* and its *unitholders*, and the *authorised fund manager's* policies for mitigating those risks;

- (c) a description of what measures the *authorised fund manager* is taking as a result of those risks, and in relation to which *affected investments*; and
 - (d) either a detailed list of the *affected investments* or a link to a place where they are (or will be) set out, making clear (if applicable) which *affected investments* are not subject to any of the measures referred to in (c).
- (2) In relation to *COLL 7.8.19R(2)(d)*, the information in the notification should include:
- (a) the name of each *side pocket class* and a description of how the rights of a *unitholder* differ from the rights attached to existing *classes* and any other new *classes*;
 - (b) any alteration in the rights attached to an existing *class* (e.g. that it will be valued without reference to *affected investments*);
 - (c) the terms on which new *units* are *issued* to existing *unitholders*, i.e. whether *units* in a new *class* are *issued* in addition to *units* in an existing *class*, or by way of conversion into *units* in one or more new *classes*;
 - (d) the terms on which *units* are *issued* to both existing and new *unitholders*;
 - (e) the date on which the changes take effect.
- (3) In relation to *COLL 7.8.19R(2)(e)*, the information in the notification should include:
- (a) an explanation of the *dealing* arrangements for *redemptions*, including the *dealing days*;
 - (b) if applicable, that *dealing* in *units* in the *side pocket class* has been suspended (see also *COLL 7.2.1R(2A)*, (2B) and (2C) (Requirement));
 - (c) when and how *redemption* proceeds will be paid, including any alternative arrangements for payment;
 - (d) in what circumstances *unitholders* may convert their *units* in a *side pocket class* to *units* of another *class* of the *scheme*;
 - (e) in what circumstances *unitholders* may transfer title to their *units* in the *class* to another *person*;

- (f) an explanation of the charges to be borne by *unitholders* in the new *classes* and of any resulting change in the charges borne by existing *classes*.

7.8.21 R The *authorised fund manager* must, as soon as reasonably practicable after the date on which the *side pocket class* is created, send a written statement to each *unitholder* confirming the number and type of *units* of each *class* the *unitholder* holds in the *authorised fund* as a result of the creation of the *side pocket class*.

7.8.22 G The notification required by *COLL 7.8.19R* and the written statement of holdings required by *COLL 7.8.21R* may be issued to existing *unitholders* in a single combined communication.

Side pockets: modified application of *COLL 5* (Investment and borrowing powers)

7.8.23 R (1) *COLL 5* (Investment and borrowing powers) applies to the *side pocket property*, subject to the modifications in this *rule*.

(2) Subject to (4) to (6), in the case of a *UCITS scheme*, the *authorised fund manager* must comply with as much of *COLL 5.1* (Introduction), *COLL 5.2* (General investment powers and limits for UCITS schemes) and *COLL 5.3* (Derivative exposure) as is practicable having regard to the limited purpose for which the *side pocket class* was created.

(3) Subject to (4) to (6), in the case of a *non-UCITS retail scheme*, the *authorised fund manager* must comply with as much of *COLL 5.1* (Introduction) and *COLL 5.6* (Investment powers and borrowing limits for non-UCITS retail schemes) as is practicable having regard to the limited purpose for which the *side pocket class* was created.

(4) The *authorised fund manager* may only enter into a *derivative* or a forward transaction which:

(a) is a ‘class hedging transaction’ within the meaning of *COLL 3.3.5R(4)(d)*; and

(b) falls within *COLL 3.3.5AR* (Hedging of unit classes) (see also *COLL 3.3.5BG* (Guidance on hedging of unit classes)),

and all provisions of *COLL 5* relevant to such transactions apply.

(5) *COLL 5.5.3R* (Cash and near cash) applies, except that references to the ‘investment objectives’ of the *scheme* should be read as references to the objective in *COLL 7.8.30R(2)(b)* (Modified application of *COLL 6.6* (Operating duties and responsibilities)).

(6) The following *rules* apply:

(a) *COLL 5.5.4R* (General power to borrow);

- (b) COLL 5.5.5R (Borrowing limits);
- (c) COLL 5.5.6R (Restrictions on lending of money);
- (d) COLL 5.5.7R (Restrictions on lending of property other than money);
- (e) COLL 5.5.8R (General power to accept or underwrite placings); and
- (f) COLL 5.5.9R (Guarantees and indemnities).

Side pockets: guidance on modified application of COLL 5

- 7.8.24 G (1) The nature of a *side pocket class* means that the *authorised fund manager* cannot apply the same risk controls to *affected investments* that would apply to the rest of the *scheme property*. In the *FCA's* view, it would not be practicable for the *authorised fund manager* to apply a prudent spread of risk to the *affected investments* or to comply in full with the specific eligibility and risk-spreading limits set out in *COLL 5* for *transferable securities*, money-market instruments and *units* in *collective investment schemes*.
- (2) However, the modification of the *rules* provided in *COLL 7.8.23R(2)* and (3) is to be interpreted narrowly and only to the extent necessary to allow the *authorised fund manager* to manage the risks of the *affected investments* allocated to the *side pocket class* and to *deal* efficiently with them. In particular, the modifications in those *rules* do not permit an *authorised fund manager* to take any action that increases the risk profile of the *scheme* as a whole, such as acquiring property or entering into transactions that would not be permitted by the unmodified *rules* of *COLL 5*.

COLL 5 references to “scheme property” in relation to other parts of the scheme

- 7.8.25 R (1) This *rule* applies to the *authorised fund manager* and *depository* of an *authorised fund* with a *side pocket class*.
- (2) For the purpose of interpreting references to the ‘scheme property’ in *COLL 5* in relation to the part of the *scheme* which is not a ‘side pocket’, the *authorised fund manager* and *depository* may disregard the *side pocket property*.
- (3) The reference to a ‘side pocket’ in (2) is a reference to a part of the *scheme* which is represented by *units* in a *side pocket class*.

Application of COLL 6 (Operating duties and responsibilities): General

- 7.8.26 R The *rules and guidance* in COLL 6 (Operating duties and responsibilities) apply to a *side pocket class* subject to the modifications specified in COLL 7.8.27R (Modified application of COLL 6.2 (Dealing)) to COLL 7.8.31R (Modified application of COLL 6.7 (Payments)).

Modified application of COLL 6.2 (Dealing)

- 7.8.27 R (1) COLL 6.2 (Dealing) applies to a *side pocket class* subject to the modifications specified in this *rule*.
- (2) For the purposes of COLL 6.2.8R (Issue and cancellation of units through an authorised fund manager), if the *authorised fund manager redeems* a unit in a *side pocket class* from a *unitholder*, the *authorised fund manager* must immediately *cancel* the unit or, in relation to an *AUT* or *ACS*, instruct the *depository* to do so.
- (3) (a) Subject to (b) and (c), the requirement in COLL 6.2.13R (Payment for units issued) may be satisfied by the *authorised fund manager* allocating such proportion of the *scheme property* to that *class* as the *authorised fund manager* may determine.
- (b) Before making the allocation of *scheme property* in (a), the *authorised fund manager* must consult the *depository* and take its views into account.
- (c) After being consulted under (b), the *depository* must consider the proposed allocation of the *scheme property* and inform the *authorised fund manager* if it considers that the allocation is not appropriate, having regard to the purpose of the *side pocket class*.
- (4) In COLL 6.2.16R (Sale and redemption), in relation to the *redemption of units* in a *side pocket class*:
- (a) paragraphs (4) and (5) apply unless:
- (i) the *prospectus* provides for the proceeds of *redemption* to be paid to a *person* other than the *unitholder*; or
- (ii) the *unitholder* has given instructions for the proceeds to be paid to another *person*; and
- (b) paragraphs (5A), (6) and (7) do not apply.
- (5) The *authorised fund manager* must apply COLL 6.2.18R (Limited issue) as follows:

- (a) *COLL 6.2.18R(1)* applies to the *issue* of *units* in a *side pocket class*;
- (b) *COLL 6.2.18R(2)* does not apply to a *side pocket class*, and the *authorised fund manager* must not provide for the further *issue* of *units* in the same *class*; and
- (c) *COLL 6.2.18R(3)* applies where a *scheme* has a *side pocket class*.

Modified application of *COLL 6.3* (Valuation and pricing)

- 7.8.28 R (1) *COLL 6.3* (Valuation and pricing) applies to a *side pocket class* subject to the modifications specified in this *rule* (see also *COLL 7.8.29G*).
- (2) For the purpose of *COLL 6.3.5R* (Price of a unit), the *authorised fund manager* must ensure that the *price* of a *unit* in a *side pocket class* is calculated:
- (a) by reference to the net value of the *side pocket property*; and
 - (b) in accordance with the provisions of both the *instrument constituting the fund* and the *prospectus*.
- (3) Notwithstanding *COLL 6.3.11R* (Publication of prices), the *authorised fund manager* must make public in an appropriate manner the *price* of a *unit* in any *class* which is valued by reference to an *affected investment* after every *valuation point* (see *COLL 6.3.4R* (Valuation points)), even if the *authorised fund manager* is not holding itself out to *deal* in such *units* at that *valuation point*.
- 7.8.29 G The guidance in *COLL 6.3.12G(1)(a)* to (c) is unlikely to be relevant to an *authorised fund manager* when publishing the *price* of a *unit* in a *side pocket class* in accordance with the *rules* in this section.

Modified application of *COLL 6.6* (Operating duties and responsibilities)

- 7.8.30 R (1) *COLL 6.6* (Operating duties and responsibilities) applies to the *authorised fund manager* and *depository* in relation to a *side pocket class*, subject to the modifications specified in this *rule*.
- (2) For the purposes of *COLL 6.6.3R(3)(a)* (Functions of the authorised fund manager), the *authorised fund manager* must make decisions as to the constituents of the *scheme property*:
- (a) in accordance with the investment objectives and policy of the *scheme*, but may disregard any *affected investment* in the *side pocket property*; and

- (b) with a view to disposing of those *affected investments* over time as and when the *authorised fund manager* considers this can be done in the best interests of *unitholders*.
- (3) For the purposes of COLL 6.6.4R(1) (General duties of the depositary), the *depositary* must take reasonable care to ensure that the *scheme* is managed by the *authorised fund manager* in accordance with the matters specified in COLL 6.6.4R(1)(a) to (e) as modified by the *rules* in this section, and COLL 6.6.4R(2) is to be read accordingly.
 - (4) (a) The duty in COLL 6.6.14R(2) (Duties of the depositary and the authorised fund manager: investment and borrowing powers) requiring the *authorised fund manager* to rectify at its own expense a breach of COLL 5 (Investment and borrowing powers), or any provision of the *instrument constituting the fund* or the *prospectus*, does not apply to the extent that:
 - (i) the breach relates to *affected investments* in the *side pocket property*; and
 - (ii) the *depositary* is satisfied that it is not practicable for the *authorised fund manager* to comply with the relevant *rule* in COLL 5, the provision of the *instrument constituting the fund* or the *prospectus*.
 - (b) COLL 6.6.14R(4), (5) and (6) do not apply to the extent that the breach falls within (a) above.

Modified application of COLL 6.7 (Payments)

- 7.8.31 R (1) COLL 6.7 (Payments) applies to a *side pocket class* subject to the modifications and additional requirements specified in this *rule*.
- (2) The *authorised fund manager* must not impose any of the following charges or levies on *unitholders* of the *side pocket class*:
- (a) a preliminary charge or levy when the *units* in the *side pocket class* are *issued*;
 - (b) a charge or levy on the *redemption* or *cancellation* of *units*;
 - (c) a performance-related management fee.
- (3) The *authorised fund manager* must prevent undue costs being charged to the *scheme* and its *unitholders*.

[**Note:** In relation to (3), see also COLL 6.6A.2R(5) (Duties of AFMs of UCITS schemes to act in the best interests of the scheme and its unitholders) and article 17 of the *AIFMD level 2 regulation* (Duty to act in the best interests of the AIF or the investors in the AIF and the integrity of the market).]

Application of COLL 7.2 (Suspension and restart of dealings)

- 7.8.32 R (1) *COLL 7.2* (Suspension and restart of dealings) applies to a *side pocket class* subject to the modifications specified in this *rule*.
- (2) The *authorised fund manager* may suspend *dealings* in *units* of a *side pocket class*, while continuing to *deal* in other *classes* of the *scheme*.
- (3) If the *authorised fund manager* suspends *dealings* in accordance with (1), it is not required to carry out any request by a *unitholder* to convert *units* in the suspended *side pocket class* into *units* of another *class* in which *dealing* continues.
- (4) *COLL 7.2.1R* applies to the suspension of *dealings* in *units* of a *side pocket class* under (2).

7 **Matters to be considered by the authorised fund manager before creating a**
Annex **side pocket class**
1R

	This Annex belongs to <i>COLL 7.8.4R(3)(a)</i> (Conditions for creating side pocket classes).	
1.	Investment risk considerations	
	(1)	Whether there is agreement on which <i>affected investments</i> should be allocated to a <i>side pocket class</i> .
	(2)	The possible impact of relevant sanctions regimes.
	(3)	The <i>authorised fund manager's</i> estimate of the likelihood of the <i>affected investments</i> achieving a realisable value within a range of timeframes.
	(4)	Whether the <i>authorised fund manager</i> intends to make new <i>investments</i> in <i>affected countries</i> if the economic situation stabilises and relevant sanctions regimes allow it and, if so, how might that affect <i>unitholders</i> in the <i>side pocket class</i> .
	(5)	Whether the <i>authorised fund manager's</i> risk management function (see <i>COLL 6.11</i> (Risk control and internal reporting)) has assessed the likely consequences for the <i>authorised fund manager</i> , the <i>authorised fund</i> and its <i>unitholders</i> if the <i>authorised fund manager</i> were to take no action to set up a <i>side pocket class</i> .

	(6)	That there is a risk management plan which considers different scenarios for what might happen to the <i>affected investments</i> allocated to the <i>side pocket class</i> and how such scenarios would be dealt with.
2.	Costs	
	(1)	The <i>authorised fund manager's</i> estimated one-off costs of establishing the <i>side pocket class</i> and whether these costs will be met by the <i>authorised fund manager</i> , or paid from the <i>scheme property</i> of the <i>authorised fund</i> , or apportioned between both.
	(2)	The <i>authorised fund manager's</i> estimated ongoing annual costs of operating the <i>side pocket class</i> , and the provision being made to pay these costs:
	(a)	over various scenarios as to the duration of the <i>class</i> ; and
	(b)	(to the extent they differ) in relation to the scenarios considered by the risk management plan in paragraph 1(6) above.
	(3)	Whether the <i>authorised fund manager</i> will take a fee for managing the <i>side pocket class</i> and, if so, what factors have been considered to determine whether it is set at a fair level and to prevent <i>unitholders</i> from being charged undue costs.
	(4)	How the total costs, borne by a <i>unitholder</i> holding <i>units</i> in both the <i>side pocket class</i> and a <i>class</i> relating to unaffected <i>investments</i> , will compare to the total cost that the <i>unitholder</i> currently bears.
	(5)	If the future total cost for <i>unitholders</i> is expected to be higher than the current cost, how this will be justified to <i>unitholders</i> against the uncertain benefit of a future realisation of value in the <i>side pocket class</i> .
3.	Legal and operational considerations	
	(1)	The <i>authorised fund manager's</i> legal advice on the implications of setting up a <i>side pocket class</i> , having regard to s235(4) and, in the case of an <i>ICVC</i> , s236(3) of the <i>Act</i> (see the guidance in <i>COLL 7.8.7G</i>).
	(2)	Whether the <i>authorised fund's</i> auditor has been consulted and its view taken into account.

	(3)	Whether the <i>authorised fund manager</i> is satisfied that all operational functions for which it is responsible, including fund accounting and transfer agency functions, are able to fully support the <i>side pocket class</i> .
	(4)	The <i>authorised fund manager's</i> assessment of the readiness of third parties in the distribution chain to implement and maintain arrangements for the <i>side pocket class</i> to operate effectively.
4.	Longer-term investor considerations	
	(1)	The <i>authorised fund manager's</i> policy for allowing <i>unitholders</i> to exit the <i>class</i> during its lifetime.
	(2)	The <i>authorised fund manager's</i> view of the likely future options for enabling the <i>side pocket class</i> to be terminated.
5.	Overall assessment	
	Whether the <i>governing body</i> of the <i>authorised fund manager</i> is satisfied that:	
	(1)	the potential benefits to <i>unitholders</i> of <i>units</i> in any <i>side pocket class</i> are proportionate to the estimated costs of establishing and running the <i>class</i> , including over the long term;
	(2)	proceeding to set up the <i>side pocket class</i> will be in the best interests of the <i>authorised fund</i> and its <i>unitholders</i> ; and
	(3)	the <i>depository</i> has been properly consulted and its view taken into account.

Amend the following text as shown.

Schedule 1 Record keeping requirements

Sch 1.1 G 1 Record keeping requirements

Handbook reference	Subject of record	Contents of record	When record must be made	Retention period
...				
COLL 6.13.4R	...			

<u>COLL 7.8.4R(4)</u>	<u>The decision of the governing body of the authorised fund manager</u>	<u>The decision to create a side pocket class and the reasons for it</u>	<u>As implicit from the rules in COLL</u>	<u>5 years</u>
...				

Schedule 2 Notification requirements

...

Sch 2.2 G 1 Notification requirements

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
...				
<u>COLL 7.7.22R</u>	...			
<u>COLL 7.8.32R</u>	<u>Suspension or resumption of dealing</u>	<u>Details including reason for suspension</u>	<u>Occurrence</u>	<u>Immediate</u>
...				

