

Amendment of COBS 21.3 permitted link rules – final rules and feedback to CP18/40

Policy Statement

PS20/4

March 2020

This relates to

Consultation Paper 18/40
which is available on our website at
www.fca.org.uk/publications

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1 Overview

Introduction

- 1.1** This Policy Statement (PS) sets out our response to the feedback received to our Consultation Paper CP 18/40 Consultation on proposed amendment of COBS 21.3 permitted links rules in our Conduct of Business (COBS) sourcebook. It also sets out the final rules and guidance we are publishing following the consultation.
- 1.2** The new rules seek to address any unjustified barriers to retail investors investing in a broader range of long-term assets in unit-linked funds, while maintaining an appropriate degree of investor protection.
- 1.3** They follow recommendations by the Law Commission and engagement with the Treasury's Pension Scheme Investments Taskforce regarding potential regulatory barriers to investment in some less liquid or illiquid assets. This includes, for example, investment in infrastructure, loans secured on infrastructure assets and some less liquid securities.

Who does this affect?

- 1.4** This PS will affect those who have an interest in investing in illiquid or higher risk assets via unit-linked funds. It will therefore be of interest to:
- pension scheme operators and trustees
 - operators and investment managers of unit-linked funds
 - life assurance companies with exposure to illiquid assets such as property, either by direct investment or through holdings in investment funds
 - intermediaries, such as platform service providers, wealth managers or financial advisers, whose retail clients invest in funds holding illiquid assets
 - firms communicating to retail clients financial promotions relating to unit-linked funds making significant investments in illiquid assets (these firms will be subject to the requirement in COBS to include a risk warning)
 - investors who have direct or indirect investments in these funds
 - managers of other types of fund such as undertakings for collective investment in transferable securities (UCITS), qualified investor schemes (QIS) or unauthorised schemes which may be affected by our proposals
 - insurance and investment trade bodies

Is this of interest to consumers?

- 1.5** Our new rules may affect retail consumers if they have direct or indirect exposure to these funds via unit-linked policies. They may therefore also be of interest to consumers and consumer groups.

Context

- 1.6** 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.
- 1.7** Our 2016 review of property funds and liquidity risks found that the proportion of illiquid assets held in unit-linked funds was very low in proportion to overall assets (£27 billion compared with £914 billion in total).
- 1.8** The Treasury carried out a review of long-term capital investment (the 'Patient Capital Review') and convened a Pension Scheme Investments Taskforce (the 'Patient Capital Taskforce') with representatives from the PRA, FCA, Department for Work and Pensions (DWP) and industry. The Treasury's initiative looked at removing barriers to this type of investment, to help grow private sector investment in these areas.
- 1.9** The taskforce discussed potential regulatory barriers to this investment arising from the 'permitted links' rules. The rules, set out in [COBS 21.3](#), specifying the types of investment (the permitted links) insurers can make when the investment risks of a contract lie with a natural person.
- 1.10** The June 2017 Law Commission report on Pension Funds and Social Investment ([PENSION FUNDS AND SOCIAL INVESTMENT \(LAW COMM NO 374\)](#)) recommended that the FCA should consider further guidance for unit-linked funds on the permitted links rules, including how defined contribution (DC) pension schemes can manage some element of illiquid investment within their funds. In our response, we said we would review our rules, engage with the Patient Capital Taskforce and continue our work following the Treasury's Patient Capital Review.
- 1.11** The existing rules are already permissive in some areas, for example allowing the unit-linked fund to be invested wholly in property or land, or unlisted securities. But are restrictive in other respects, such as not allowing investment in infrastructure (for example windfarms or transport infrastructure), and in the way they define permitted unlisted securities.
- 1.12** Our revisions will amend some of the restrictions where we have concluded that an absolute restriction is no longer necessary to ensure an appropriate degree of protection. Allowing a proportion of the unit-linked fund to be invested in these assets may benefit those consumers interested in choosing longer-term investment opportunities that match their needs. Our changes aim to strike an appropriate balance between facilitating long-term capital investment via unit-linked insurance contracts and maintaining an appropriate degree of consumer protection.
- 1.13** The suspension of the LF Woodford Equity Income Fund in June 2019, after closure of the consultation on CP 18/40, the subsequent winding-up of the fund which began in January 2020, and the suspension of the M&G Property Portfolio Fund in December 2019 have highlighted some of the risks of holding illiquid assets in certain fund structures. These risks are one of the reasons why our consultation proposals and our final rules do not remove all restrictions. Our consultation proposals include an overall

limit on use of the new categories of permitted links that will be introduced. They also attach a number of conditions to use of the links aimed at securing an appropriate degree of consumer protection. They are, however, designed for the specifics of insurers selling contracts with unit-linked funds rather than open-ended funds sold direct to retail investors.

- 1.14** On 30 September 2019, we published PS 19/24 on illiquid assets held in open-ended non-UCITS retail schemes (NURs). Chapter 7 of PS 19/24 set out the scope for potential further work in this area including our work with the Bank of England Financial Policy Committee (FPC), as reflected in the July and December 2019 editions of the Bank's Financial Stability Report, to assess how funds' redemption terms might be better aligned with the liquidity of their assets to minimise financial stability risks without compromising the flow of productive finance. As well as enhancing financial stability, this should also improve outcomes for investors. The FPC work is ongoing and the implementation of our consultation proposals in this paper does not preclude our considering other interventions as that work reaches its conclusions.
- 1.15** The fundamental issue of how best to allow investors access to less liquid assets that may offer diversification or higher expected returns, while maintaining appropriate protections for investors is common to both unit-linked and authorised funds. However, there are also important differences.
- 1.16** 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 rather than short-term liquidity. We have calibrated the rules accordingly although they do contain some restrictions on investment in illiquid assets that we consider proportionate.
- 1.17** Moreover, in the case of unit-linked funds, the obligations of the insurer are backed by capital requirements on insurers imposed under PRA rules pursuant to 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, including those arising from the conditions attaching to use of the new linked funds.
- 1.18** This means that insurers should be able to meet their contractual and regulatory obligations to investors even if fund assets cannot be realised. Para. 3.16 of PRA Supervisory Statement SS5/19 'Liquidity risk management for insurers' clarifies that in some instances, for example where policy documentation provides for a specified time to payment, an insurer may be expected or required to provide supporting liquidity when liquidity buffers within funds are depleted. An insurer is also expected to consider the possible actions it can take to meet short-term liquidity needs and to take such circumstances into account in its liquidity risk management strategy. Our rules already impose obligations on insurers to ensure that valuations of the fund are done fairly so that, in part, liquidity problems do not unfairly affect the value of policyholder benefits. The conditions we are proposing clarify where insurers may not pass on liquidity risks in the new linked funds to policyholders. Regulatory requirements for the timely pay-out of policy obligations, backed by capital, help to align insurer and customer interests in ensuring that the liquidity of fund assets is appropriate given the fund's liabilities. At the same time, we recognise that it will sometimes be reasonable for the insurer to maintain options to defer redemptions or switches from the unit-linked funds holding illiquid assets in order to avoid disadvantaging investors by having to sell illiquid assets at discounted prices. Such options will have to be clearly and prominently disclosed.

- 1.19** The need and incentive for insurers to make sure the liquidity of fund assets is appropriately matched to the fund's liabilities is further reinforced by a conduct obligation for insurers using our new conditional permitted links to ensure in addition that investment risks, including liquidity risk, are suitable for the policyholder's circumstances. A proportion of illiquid investments may meet these suitability requirements, and match policyholders' needs, where the objective of most policy holders is long-term return rather than short-term liquidity.

Summary of feedback and our response

- 1.20** We received 29 responses to Consultation Paper CP18/40, largely from asset management firms, life companies and relevant trade bodies. We received no responses from consumers or from groups representing consumers.
- 1.21** We received broad stakeholder support for our proposals and in most areas intend to implement them as proposed.
- 1.22** However in a couple of areas (rules relating to investment in permitted land and property and the level of the overall threshold limit on illiquid assets held as permitted links) we have revised our proposals in the light of responses received.
- 1.23** Our final set of measures removes some of the restrictions on the type of illiquid assets in which investment may be made, but sets an overall limit of 35% on the proportion of the fund that may be invested in these assets. We also clarify that we will keep the limits in existing rules relating to investment in land and property. These investments will not be included in the overall 35% limit. Use of these extended permissions is conditional on the insurer satisfying new requirements in our rules, namely:
- ensuring, on a continuing basis, that the investments are suitable and appropriate for a policyholder's circumstances, and that the timing of benefits due to a policyholder under the contract are not negatively affected by liquidity issues
 - setting out clearly and prominently to a policyholder the additional risks and consequences involved.
- 1.24** The new rules apply only where insurers choose to use the new regime, ie where they choose to take advantage of the new 'conditional permitted links' described below. Insurers may continue to use the existing 'permitted links' rules if they choose.
- 1.25** We set out our approach in detail in the following chapter.

Equality and diversity considerations

- 1.26** We have considered the equality and diversity issues that may arise from the proposals in this Policy Statement. We do not consider that the proposals in this Policy Statement adversely impact any of the groups with protected characteristics i.e. age, disability, sex, marriage or civil partnership, pregnancy and maternity, race, religion and belief, sexual orientation and gender reassignment.

Next steps

- 1.27** We are publishing final rules with this Policy Statement. Firms wishing to make use of the new conditional permitted links will need to ensure compliance with these rules with effect from 4 March 2020.

2 Proposed amendments to COBS 21.3

- 2.1** The FCA Handbook specifies (in [COBS 21.3](#)) 12 categories of assets in which firms may invest to provide linked benefits in unit-linked life policies sold to retail customers.
- 2.2** The relevant rules are known as the 'permitted links' rules. They are designed to ensure that, where a natural person is holding the investment risk, the assets underlying unit-linked life policies are appropriate for retail investors. There are five existing categories of permitted links most relevant to long-term capital investment in illiquid assets:
- Category 1 - Permitted land and property (COBS 21.3.1R (2) (d))
 - Category 2 - Permitted unlisted securities (COBS 21.3.1R (2) (c))
 - Category 3 - Permitted scheme interests (COBS 21.3.1R (2) (g))
 - Category 4 - Permitted loans (COBS 21.3.1R (2) (e))
 - Category 5 – Approved securities (COBS 21.3.1R (2) (a))
- 2.3** In Consultation Paper CP18/40, we proposed:
- a. adding new 'conditional permitted links' which supplement the existing range of permitted links, but only for insurers able to meet conditions providing an enhanced degree of investor protection (for example, adequate risk warnings)
 - b. for firms choosing to invest in conditional permitted links and meeting the relevant conditions, a new amalgamated limit such that overall investments in illiquid assets in a linked fund should comprise no more than 50% of total assets. These firms could exceed the current limits for individual permitted links categories as long as they didn't exceed the overall threshold limit. For other firms (i.e. for firms whose unit-linked funds are linked only to the existing permitted links categories and not any conditional permitted links), there would be no change to current limits.
- 2.4** We set out our response to the feedback received on the proposals for new conditional permitted links in each relevant category below.

Category 1: Permitted land and property

- 2.5** The existing category of 'land and property' is defined in our Handbook Glossary as 'any interest in land (and any buildings on it)'. To allow for broader investment in the infrastructure elements of long-term capital via this category, we proposed:
- Allowing for investment in 'immovable' structures or installations on any property situated within the UK, by creating a new 'conditional permitted immovables' category. This allows for investment in assets like wind farms, bridges or railways to the extent that they are currently permitted investments under our funds rules in the Collective Investment Schemes sourcebook ('COLL') subject to meeting the investor protection conditions below.
 - Removing the limit on the proportion of fund assets held in permitted land and property for firms choosing to utilise the conditional permitted links and who meet the related investor protection conditions and

- Replacing the above limit with an overall amalgamated limit on the proportion of a fund's gross assets held in conditional permitted links.

2.6 We asked:

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

2.7 Respondents were generally in favour of the first proposal. But some did not want immovables geographically limited to the UK and felt the existing definition of immovables in COLL was not clear enough to encompass the structures listed in the Consultation Paper CP18/40.

2.8 Respondents were generally not in favour of the second proposal in this category. Stand-alone property funds are already in common use under the current rules. The 10% limit in the current rules is a gearing limit. It means firms are technically permitted under COBS 21.3.1R to invest up to 110% of the gross assets of a linked fund in 'permitted land and property'.

2.9 Many did not support the proposed inclusion of permitted land and property within the overall 50% limit on illiquid assets as they felt that this would significantly restrict existing levels of investment in permitted land and property. This was not our intention. Some respondents argued permitted land and property should be removed from the overall amalgamated limit for illiquid assets which should be focused on the new illiquid categories, and that the amalgamated percentage limit should also be reduced to reflect that.

2.10 Respondents were generally in agreement with our proposals to allow additional investments only if the conditions for conditional permitted links were satisfied.

Our response

For the first proposal, we intend to proceed with the proposed 'conditional permitted immovables' link aligned with the 'immovable' definition in COLL. This will remove a barrier to investment in assets such as rail track, bridges, roads, runways, wind turbines, hydroelectric schemes, solar farms, pylons, gas storage and sewerage plants. Such investments are subject to the condition that the insurer judges that the investments are suitable for the fund's retail investors. This may be the case where the objective of most policy holders is long-term return

rather than short-term liquidity and the type of investments envisaged are suitable to meet their objectives overall. The conditions for permitted immovables in COLL do not necessarily limit immovables geographically to the UK as some respondents envisaged.

For the second proposal, we note respondents' concerns and will make no change to the current limit on investment in land and property. We will not include permitted land and property in the overall amalgamated limit for other types of long-term capital under the conditional permitted links, but will therefore reduce that overall limit accordingly, as discussed further below.

Use of the new permitted links will only be allowed if the additional conditions are satisfied. We set out our approach to the conditions in detail under the amalgamated overall threshold limit and consumer risk mitigation sections below.

Category 2: Permitted unlisted securities

2.11 The current permitted links rules allow unlimited investment in unlisted securities, but only when these securities are 'readily realisable in the short term'. As many illiquid securities may not be readily realisable in the short term, this restricts investment in unlisted securities which are often illiquid. We proposed:

- Creating a new category of conditional permitted unlisted securities, allowing investment by firms in permitted unlisted securities which are not 'realisable in the short term':
 - providing liquidity requirements at the level of the investment fund can be met;
 - subject to the overall limit on illiquid assets in the new conditional permitted links; and
 - subject to the insurer satisfying the additional consumer protection conditions referred to above.

This would enable the liquidity of individual investments to be viewed in the context of the whole portfolio of the fund and its liquidity requirements.

2.12 We asked:

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

2.13 Nearly all respondents were in favour of the proposed liquidity test at fund level.

Our response

We intend to implement the proposal as planned. Following the consultation, we have been asked whether specific provision for venture capital will be made within this conditional permitted link. Venture capital would only be permissible under permitted links or the new conditional permitted links if it met the criteria specified in paragraph 2.11. How venture capital may be held via authorised funds (as opposed to unit-linked funds) remains a matter for further consideration as part of our ongoing work on long-term capital in authorised funds ([FS20/2: Patient Capital and Authorised Funds](#)).

Category 3: Permitted scheme interests

- 2.14** The rules for 'permitted scheme interests' (ie investments in other funds, including, for example, authorised funds, such as UCITS and Qualified Investor Scheme (QIS), non-UCITS retail scheme (NURS) and Unregulated Collective Investment Scheme (UCIS)) require the underlying funds to publish their prices regularly. It appears that there has been an industry perception that daily pricing was required. To remove this perceived 'regulatory barrier', we clarified in Consultation Paper CP18/40 that regular publication of pricing does not mean daily pricing either in the existing or the new conditional permitted links.
- 2.15** There is also a limit of 20% in the existing permitted links on the proportion of a unit-linked fund which can be invested in QIS and UCIS assets. In the latter case, the UCIS must also invest only in permitted links and must publish its prices regularly. This was put in place because there are fewer investor protection requirements applied to these schemes compared with UCITS or NURS. QIS are by definition, for 'qualified investors' not retail investors. We proposed:
- Removing the current 20% limit on holdings of assets through QIS/UCIS for firms meeting the investor protection conditions. Investments in this category would instead be limited by the overall amalgamated percentage limit across all illiquid assets (see para 2.21 below). The existing 20% limit would remain for firms using the existing permitted links.
- 2.16** We asked:
- Q5:** *Do you agree with our proposal to remove, for firms meeting the investor protection conditions, the current 20% limit on holdings of assets through QIS/UCIS and instead rely on the overall limit of 50%? If not, how could we change it?*
- 2.17** Nearly all respondents were in favour of our proposal, although views on the level of the overall amalgamated percentage limit varied (see para 2.28 below).

Our response

We intend to implement the proposal as planned. The aggregated limit also applies to permitted scheme interests above the existing limit of 20% but within the overall limit, so long as all the conditions and requirements applying to conditional permitted links are met in respect of the entire holding (see amended definition of *permitted scheme interests* in the final instrument attached to this Policy Statement).

Category 4: Permitted loans

- 2.18** Under the existing permitted link for this category, firms may include loans that, among other conditions, are fully secured by a mortgage or charge on permitted land or property. In Consultation Paper CP 18/40, we proposed creating a new category of conditional permitted loans for firms, to include loans secured on immovables within the new conditional permitted immovables category. This increased scope will also be subject to the overall amalgamated limit on illiquid assets and the additional conditions to mitigate risk to consumers as discussed below.
- 2.19** No objections were made to this proposal, although views on the level of the overall amalgamated percentage limit varied (see para 2.28 below).

Our response

We intend to implement the proposal as planned.

Category 5: Approved securities

- 2.20** In Consultation Paper CP18/40 we clarified that the existing permitted link in COBS 21.3.1R (2) (a) includes securities or loans guaranteed by any government, public or local authority. Any long-term capital security which comprises a security or loan with a government guarantee would be an approved security and, therefore, could be held.

Amalgamated overall threshold limit

- 2.21** Rather than the current combination of limits to holdings under some of the permitted links categories, but no limits on other categories, in Consultation Paper CP18/40 we proposed introducing an overall limit of 50% on illiquid assets held as permitted links or conditional permitted links for firms meeting the investor protection conditions.

2.22 We proposed that it would be defined as the total of categories of:

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

2.23 We proposed that one of the conditions which must be met in order to access this more flexible limit is a requirement on the product provider to ensure that a sufficient amount of the assets held can at all times be realised to satisfy the reasonable needs of investors, including:

- allowing them to switch funds,
- take benefits or
- to withdraw or transfer their unit-linked investments in a timeframe specified in their contract or, in any event, within a reasonable timeframe, taking into account the needs of the linked policyholder

2.24 Our aim was to achieve an appropriate balance between meeting investors' liquidity needs and allowing flexibility to choose investments which could earn long term returns for investors, so that the fund can meet liquidity demands with a high degree of confidence. This balance should in our view be set in the context of assets in the fund portfolio overall and the requirement for additional protection provided by the insurer to meet pay-out obligations to policyholders even if the fund's liquidity buffers are depleted.

2.25 We asked:

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

2.26 Opinions among the respondents to Consultation Paper CP18/40 regarding the establishment of an overall limit were mixed, with the majority not in favour of the proposal – in some cases because of an assumption that it amounted to a tightening of the current 110% limits on investment in property.

2.27 Respondents accordingly argued that permitted land and property should be excluded from any overall limit on 'patient capital' assets. They argued that management of liquidity risks in unit-linked funds invested solely in property, and investors' familiarity with the concept of property investments being less liquid meant it was not proportionate to restrict investment in land and property to the same extent as other categories of illiquid assets.

2.28 Several respondents disagreed with the proposed level of 50% for the overall limit, but for varying reasons.

2.29 At one end of the scale, respondents questioned the need for any limit, on the grounds it would be arbitrary and would dilute the benefit of investing in illiquid assets, and could lead to forced sales of assets to avoid breaching it. At the other end of the scale, several respondents suggested that the 50% limit was too high, particularly

when considering liquidity to meet the needs of investors to switch funds, transfer or take benefits. They thought that, particularly if permitted land and property were not included, a lower limit would seem more prudent until industry experience developed. Suggestions for a lower percentage ranged from 20% to 35%. Respondents also warned against the potential concentration risk of 50% in one asset class and suggested that no more than 35% to 40% should be invested in one asset class within the 50% overall limit.

Our response

As discussed under Category 2 above, we will not include permitted land and property in the amalgamated overall limit for long-term capital. We will not restrict existing investment levels in permitted land and property. The overall limit will therefore apply only to the other permitted link and conditional permitted link categories above. The only limit relating to investment in land and property remains the 10% gearing limit on permitted land and property under existing COBS 21.3 permitted links rules.

Given that we are not including permitted land and property in the overall limit, we have also looked again at whether the proposed 50% level is higher than justified when considering the need to maintain a level of liquidity to meet the reasonable needs of investors, eg switching funds, transferring or taking benefits. In normal market conditions, these needs could be met by the liquid component of the fund but if the fund was experiencing higher than normal withdrawal requests (or was contracting) this could result in the fund becoming unbalanced towards illiquid investments. On balance, we think it appropriate to reduce the limit to 35%. This should facilitate a broader range of illiquid investments but in a way which will mitigate the risks.

Consumer risk mitigation

2.30

We proposed new obligations on firms using the new conditional permitted links to avoid passing on unsuitable risks to retail investors. We proposed:

- Where we extend current permitted links categories, limits or requirements, firms must continually ensure that any investment in these new conditional permitted link categories does not stop a policyholder exercising rights under the unit-linked contract. In our guidance, we said these rights would include switching funds, taking benefits and withdrawing or transferring their unit-linked investments. Policyholders must be able to exercise these rights within the timeframe envisaged in that contract and, in any event, within a reasonable timeframe taking into account the policyholder's needs, regardless of any contractual terms. Insurers would also need to ensure a policyholder could exercise these rights and take benefits, as specified in the contract, and in any event, within a reasonable period given the policyholder's needs.
- Firms can only use the expanded categories with the pre-condition that the insurer continually ensures that the investment risks are suitable and appropriate for a policyholder in the circumstances, including the policyholders' investment needs. This includes consideration of the expected period to maturity of the investment and what the policyholder is using it for. Lower liquidity investments could also create investment risks by reducing the value of benefits when the policyholder wants to take them. Our new rules require insurers to ensure that these

investment risks are suitable and appropriate for a policyholder. If they are not, and policyholders suffer loss as a result, the insurer will have an obligation to make good those losses.

- Firms must also give consumers adequate risk warnings about the additional risks and consequences of liquidity and investment risk. They should do this in relevant disclosures at an appropriate point in the investor's decision-making process.

Insurers will need to monitor the first 2 of these regulatory obligations on a continuing basis. They will also need to consider them in the context of valuation of assets and liabilities and capital requirements.

2.31 We asked:

Q7: *Do you agree that the obligation on firms to provide adequate risk warnings about liquidity and investment risk would contribute to better understanding of those risks by investors in unit-linked funds?*

2.32 Nearly all respondents agreed with firms providing risk warnings on liquidity and investment risk at appropriate points in the investor's decision-making process. However, some were concerned that some customers would not read and understand them.

Our response

We intend to implement the proposal so that firms give risk warnings in relation to conditional permitted links at all appropriate times, taking into account a policyholder's needs.

We note the concerns expressed about whether customers will read and understand risk warnings. We require the risk warnings to be suitably clear and prominent. While all customers may not read these warnings, we think they are useful to more engaged non-advised consumers. They are also useful to financial advisors when making decisions about which funds to select within a unit-linked product.

The main consumer protection these rules give is not disclosure. The new conditions include obligations on the insurer which aim to ensure the timing of benefits due are not negatively affected by liquidity. They also require the timing of these benefits to be based on policyholder needs, and that investment risks - including those from liquidity risks - are suitable and appropriate for a policyholder.

2.33 We asked:

Q8: *Do you agree with our proposal to require provider firms to ensure that any unit-linked investment does not interfere with retail investors' rights to switch funds, take benefits or to withdraw or transfer funds? And our proposal that links to the new categories of investment are only offered/ taken up in suitable and appropriate investment contexts? If not, how would you change it?*

- 2.34** On our proposals for the provider to ensure that any unit-linked investment does not interfere with investors' rights, while respondents understood the motivation for this, some expressed concern. They felt that this may hamper the overarching objective of bringing more investment into long-term capital. They said firms would probably have to update their policyholder terms and conditions (where possible) for existing policies, as well as introducing similarly revised terms and conditions for new policies, to reflect the management of the credit and liquidity risks of these new investment types.

Our response

We appreciate that firms will need to consider how the new conditional permitted links work with contractual rights if they want to use them. So our policy will allow firms using these new links to include contractual provisions that allow them to defer policyholder requests to exercise rights other than the right to receive their benefits falling due, where that is reasonably necessary for the prudent management of the fund and in the best interests of the relevant policyholders. This approach is consistent with the view that notice periods can help protect investors where funds hold less liquid assets. This is because the price at which these assets could be sold would probably be heavily discounted if they had to be sold quickly. So there will also be a requirement that firms make the risks and consequences of any such deferral provisions clear to policyholders at appropriate times, taking into account policyholder needs. However, we will keep the requirement that insurers must ensure that the policyholder's rights to take benefits due under the contract are not deferred (which we think is in line with current industry practice). Insurers will not be allowed to include in their contracts any deferral provisions in relation to policyholder rights to take benefits due. This is because, in any event, we require that benefits due must be paid in a reasonable time based on policyholder needs).

- 2.35** The majority of respondents supported the pre-condition for the insurer to ensure that the investments are suitable and appropriate for the policyholder's purposes and expected period to maturity, in the investment context in which they are being used.

Our response

We intend to implement the proposal as planned. This additional protection will help to maintain an appropriate degree of protection for investors in long-term capital via the new conditional permitted links.

Annex 1

List of non-confidential respondents

ABI

AEW UK

AREF

Aviva plc

Aviva Investors

Big Society Capital

BioIndustry Association (BIA)

BlackRock

British Business Bank

British Private Equity & Venture Capital Association (BVCA)

HD Legal & Compliance

Mr. J Hoskin

IDAD Limited

ILAG

Institute and Faculty of Actuaries

Investment Association

Legal & General Investment Management

Mills & Reeve LLP

NEST

New Model Venture Capital

Pensions Infrastructure Platform

Phoenix Life Limited

RBS Investment Executive Limited

Redington

Schroders

Social Impact Investing Implementation Taskforce

Standard Life Assurance Limited

Vanguard Asset Management Ltd

Willis Towers Watson

Annex 2

Abbreviations used in this paper

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

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



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Appendix 1

Made rules (legal instrument)

**CONDUCT OF BUSINESS SOURCEBOOK (CONDITIONAL PERMITTED LINKS)
INSTRUMENT 2020**

Powers exercised

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

Commencement

- C. This instrument comes into force on 4 March 2020.

Amendments to the Handbook

- D. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- E. The Conduct of Business sourcebook (COBS) is amended in accordance with Annex B to this instrument.

Citation

- F. This instrument may be cited as the Conduct of Business Sourcebook (Conditional Permitted Links) Instrument 2020.

By order of the Board
27 February 2020

Annex A

Amendments to the Glossary of definitions

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

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

- | | |
|---|--|
| <i>conditional permitted immovables</i> | <p>in relation to <i>conditional permitted links</i>, any <i>permitted immovable</i> which is:</p> <ul style="list-style-type: none"> (a) not <i>permitted land and property</i>; and (b) either: <ul style="list-style-type: none"> (i) owned directly by the <i>firm</i>; or (ii) held in a structure, or a series of structures, that do not pose a materially greater risk to <i>linked policyholders</i> than a direct holding. |
| <i>conditional permitted links</i> | <p>where the conditions in <i>COBS 21.3.16R</i> are met, the property in <i>COBS 21.3.15R</i> that an <i>insurer</i> may use for the purposes of determining <i>property-linked benefits</i> or <i>index-linked benefits</i> under <i>linked long-term contracts of insurance</i>.</p> |
| <i>conditional permitted loan</i> | <p>in relation to <i>conditional permitted links</i>, a loan with any person, provided that the loan:</p> <ul style="list-style-type: none"> (a) is documented in a written agreement setting out the rate of interest and the amount of, and due dates for, repayments; and (b) is fully secured by a mortgage or charge on <i>conditional permitted immovables</i> that, if made to someone other than a body corporate, is not used wholly or mainly for domestic purposes. |
| <i>conditional permitted scheme interests</i> | <p>in relation to <i>conditional permitted links</i>, and in respect of a <i>firm's</i> business with <i>linked policyholders</i>, a <i>qualified investor scheme</i> or its <i>EEA</i> equivalent, or any <i>unregulated collective investment scheme</i> that:</p> <ul style="list-style-type: none"> (a) is not a <i>permitted scheme interest</i>; (b) invests in <i>conditional permitted links</i>, either exclusively or in combination with <i>permitted links</i>; and (c) publishes its prices regularly. |
| <i>conditional permitted</i> | <p>in relation to <i>conditional permitted links</i>, any investment (including a share, debt security, Treasury Bill, Tax Reserve Certificate or Certificate</p> |

unlisted securities of Tax Deposit) that is not a *permitted unlisted security* or *listed security*, but provided always that the *insurer* is able to demonstrate, on a continuing basis, that the investment is realisable in a timeframe necessary to meet the liquidity requirements of the *linked fund* in which it is held.

Amend the following definitions as shown.

index-linked assets in relation to *permitted links* and *conditional permitted links*, the assets held by an *insurer* for the purposes of matching *index-linked liabilities*.

linked fund a real or notional account to which an *insurer* appropriates *linked assets* for the purposes of their being *permitted links* or *conditional permitted links*, and which may be subdivided into units, the value of each of which is determined by the *insurer* by reference to the value of those *linked assets*.

permitted links the property in COBS 21.3.1R(1) and (2)(a) to (l) that an *insurer* may use for the purposes of determining *property-linked benefits* or *index-linked benefits* under *linked long-term* contracts of insurance.

permitted scheme interests (a) [deleted]

(b) in respect of a firm's business with *linked policyholders*, any of the following:

...

(v) a *qualified investor scheme* or its *EEA* equivalent or any *unregulated collective investment scheme* that invests only in *permitted links* and publishes its prices regularly, provided that either:

(A) no more than 20% of the gross assets of the *linked fund* are so invested; or

(B) provided that the *firm* treats it as a *conditional permitted link* and meets the conditions in COBS 21.3.16R and the requirements in COBS 21.3.20R and COBS 21.2.4R(3), it complies with the aggregated limit in COBS 21.3.19R.

Annex B

Amendments to the Conduct of Business sourcebook (COBS)

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

21 Permitted Links and conditional permitted links

...

21.2 Rules for firms engaged in linked long-term insurance business

21.2.1 R For the purposes of determining *policyholder* benefits, a *firm* must ensure that the values of its *permitted links* and conditional permitted links are determined fairly and accurately.

...

21.2.4 R A *firm* must notify its *linked policyholders* of the risk profile and investment strategy for the *linked fund*:

(1) at *inception*; ~~and~~

(2) before making any material changes; and

(3) (in relation to *conditional permitted links*) at other appropriate times, taking into account a *policyholder*'s needs.

...

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

...

Permitted links and conditional permitted links

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

...

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

...

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

(l) *permitted derivatives contracts*; and

(m) *conditional permitted links*.

- 21.3.1A R A *firm* must classify the types of property listed in *COBS* 21.3.1R(2)(a) to (2)(~~h~~m) according to their economic behaviour ahead of their legal form.
- 21.3.2 G (1) Nothing in these rules prevents a *firm* making allowance in the value of any *permitted link* or *conditional permitted link* for any notional tax loss associated with the relevant *linked assets* for the purposes of fair pricing.

...

...

Requirements for Permitted derivative derivatives contracts

- 21.3.13 R ...

Insert the following new provisions after *COBS* 21.3.14G. The text is not underlined.

Conditional permitted links

- 21.3.15 R A *conditional permitted link* is any of the following property where the conditions in *COBS* 21.3.16R are met:
- (1) *conditional permitted unlisted securities*;
 - (2) *conditional permitted immovables*;
 - (3) *conditional permitted loans*; and
 - (4) *conditional permitted scheme interests*.
- 21.3.16 R The conditions for the property in *COBS* 21.3.15R to be a *conditional permitted link* are that an *insurer* must ensure, on a continuing basis, that:
- (1) a *linked policyholder* is not prevented by the nature of any *conditional permitted link* from exercising any right under the *linked long-term contract of insurance* within the timeframe specified in that contract and, in any event;
 - (a) (in relation to rights to take benefits due under the contract) within a reasonable timeframe based on the needs of the *linked policyholder*; and
 - (b) (in relation to other rights under the contract) within a timeframe that may be reasonably necessary to allow the *firm* to manage the *linked fund* prudently and in the best interests of all relevant *policyholders* linked to the fund.
 - (2) the investment risks of any *conditional permitted links*, both individually and in combination with other investments within a linked

fund, are suitable and appropriate for:

- (a) circumstances where investment risk is borne by a *linked policyholder*;
- (b) the expected period to maturity of the *linked long-term contract of insurance*; and
- (c) the purpose for which the *linked policyholder* holds the *linked long-term contract of insurance*.

- 21.3.17 G (1) Rights under a *linked long-term contract of insurance* which may be relevant for the purposes of COBS 21.3.16R(1) would include a *linked policyholder's* right to:
- (a) change the property to which the benefits of the *linked long-term contract of insurance* are linked;
 - (b) take benefits due under the *linked long-term contract of insurance*. Benefits due are those which the contract envisages will be paid at a particular date or on the occurrence of a particular event; or
 - (c) withdraw early or transfer the proceeds of, or benefits under, the *linked long-term contract of insurance*. Early withdrawal refers to withdrawals prior to the time or event for paying benefits due that is specifically envisaged in the contract.
- (2) A *firm* will have to pay benefits due under a *linked long-term contract of insurance* (for example on death or maturity) as specified in the contract. A *firm* is not permitted to specify in the contract that it can defer the payment of any such benefits as, in any event, benefit payments have to be made within a reasonable period based on the needs of the *policyholder*.
- (3) A *linked long-term contract of insurance* may provide that the *policyholder's* right to exercise rights under (1)(a) or (1)(c) is deferred for as long as may be reasonably necessary to allow the *firm* to ensure that a *linked fund* can be managed in a manner that is prudent and in the best interests of all relevant *policyholders* linked to the fund. The *firm* will need to ensure that it explains clearly to a *policyholder* the impact of any such provision on the *policyholder's* rights to withdraw early, switch or transfer.

- 21.3.18 G The assessment in COBS 21.3.16R(2), in relation to a *linked fund* which is included in a default or similar arrangement for a pension scheme, would include ongoing consideration of whether the investment risks of any *conditional permitted links* remain suitable and appropriate for a particular cohort of *linked policyholders*, including as that cohort moves toward retirement.

Conditional permitted links: requirements

- 21.3.19 R Where a *linked fund* is invested in any *conditional permitted link*, no more than 35% of the gross assets of the *linked fund*, when aggregated together, can be invested in:
- (1) *permitted scheme interests* in (b)(v) of the *Glossary* definition of that term; and
 - (2) *conditional permitted links*.
- 21.3.20 R Where a *linked fund* is invested in any *conditional permitted link*, the information that a *firm* must give a *linked policyholder* under COBS 21.2.4R must also prominently include, clearly and in language capable of being understood by a *linked policyholder*:
- (1) an explanation of the risks associated with any *conditional permitted links* and/or gross assets in *permitted scheme interests* exceeding 20%, how these might crystallise and how they might impact on a *linked policyholder*;
 - (2) a description of the tools and arrangements which the *insurer* would propose using, including those required by *FCA rules*, to mitigate the risks in (1);
 - (3) an explanation of the circumstances in which these tools and arrangements would typically be deployed and the likely consequences for *linked policyholders*; and
 - (4) an explanation of the possible impact on the *policyholder* of any provision in a *linked long-term contract of insurance* permitted under this section which allows for the deferral of the exercise of any rights under the contract.

