Protecting investors in authorised funds following the Russian invasion of Ukraine

Policy Statement
PS22/8

July 2022
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1 Summary

1.1 This Policy Statement sets out our response to the feedback we received to Consultation Paper CP22/08, proposing to allow authorised fund managers to take steps to protect investors in funds affected by the Russian invasion of Ukraine. It also details the final rules and guidance that we are introducing following the consultation.

1.2 The Russian invasion of Ukraine on 24 February affected financial markets in many ways. The United Kingdom and other jurisdictions have imposed financial sanctions, 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.

1.3 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, such as 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

1.4 We refer to all these affected assets as ‘affected investments’.

1.5 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.

1.6 So we consulted on rules to give AFMs of UK authorised investment funds a way to deal with this situation by allowing 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 these 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 investors’ best interests. 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.

Who this affects

1.9 This policy statement will primarily be of interest to:

- 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

1.10 This policy statement affects 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.

The wider context of this policy statement

How it links to our objectives

1.11 As set out in CP22/8, the final rules set out in this policy statement advance our operational objectives of consumer protection and market integrity by helping to ensure that all unitholders are treated equitably. Side pockets will give new investors confidence that they will not gain exposure to the affected investments.

1.12 Side pockets will 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 mean that existing investors in the suspended funds would be able to redeem units that do not relate to affected investments.

1.13 Side pockets should also help 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 regain value.
What we are changing

1.14 We are finalising Handbook rules in our Collective Investment Schemes sourcebook (COLL) 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, the rules allow these funds to use side pockets for their Russian, Belarusian and Ukrainian exposures.

1.15 Following consultation feedback, we are finalising the rules to facilitate the use of side pockets broadly as consulted on, with the following principal exceptions. We have:

- defined the Glossary term ‘sanctioned investment’ more broadly, to cover any asset or investment that is subject to a relevant sanctions regime and held in a retail authorised fund
- enhanced the risk warnings to be set out in the prospectus and in the information to be sent to existing investors when they receive units in the side pocket class
- added a rule and guidance about how voting rights for side pocket units may be exercised at a unitholder meeting
- added a rule and guidance clarifying our expectations of how AFMs should carry out the assessment of value required by COLL 6.6.20R, in relation to a fund with a side pocket class
- clarified some provisions around the ability of AFMs to effect redemptions and transfers of title to units in a side pocket class
- added guidance that AFMs should consider the operational needs of distributors before deciding to set up a side pocket class

Outcome we are seeking

1.16 Our rules introducing side pockets will help protect fund investors while empowering investment managers to isolate their holdings of Russian and Belarusian assets, avoid new investors in the fund acquiring affected investments, and facilitate winding down as opportunities arise.

Measuring success

1.17 If the new rules are successful, we will see:

- 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

1.18 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.
Summary of feedback and our response

1.19 We received 17 responses, mainly from industry stakeholders, as well as from the Financial Services Consumer Panel. Respondents broadly supported the proposal, though several said the proposed rules should be made permanent rather than just an emergency measure. There was also support for us to develop an alternative model involving a restructuring of the fund.

1.20 AFMs and their representatives generally supported the detailed proposals to give effect to the side pocket class structure, though some respondents wanted clarification or additional guidance on certain points.

1.21 Respondents representing distributors (such as unit-linked life assurance providers, SIPP providers and platform service providers) had more reservations. They were concerned that although they would not be the decision-makers for introducing side pockets, the operational complexity and burden would fall on them. They sought assurance that they would be given sufficient time to make necessary systems and procedural changes; that the rules would still enable them to discharge their own legal and regulatory responsibilities; and that AFMs would give them the information they need to pass on to their own customers.

1.22 The wider use of side pockets is not within scope of this policy statement. We will review the effectiveness of the use of side pockets in dealing with the current scenario before deciding a wider future policy position.

1.23 We have made several changes, as noted in paragraph 1.15 above, to clarify the proposed requirements. We have added rules and guidance to explain how AFMs should treat side pocket classes in certain situations, eg when votes are cast at a unitholder meeting and when the AFM is carrying out the annual assessment of value for the fund.

1.24 We have also added wording to emphasise the need for AFMs to consider the impact of creating a side pocket class on other firms offering products or services, through which investors have exposure to the fund. However, our rules and guidance cannot anticipate or address all the possible operational issues and concerns reported to us in feedback. Firms will need to work together to find solutions to operational difficulties.

Equality and diversity considerations

1.25 In putting together the final rules and guidance in this policy statement, we have had due regard to the need to eliminate unlawful discrimination, harassment, victimisation and other conduct prohibited under the Equality Act 2010; the need to advance equality of opportunity between those who share a protected characteristic and those who do not; and the need to foster good relations between persons who share a relevant protected characteristic and those who do not.

1.26 Overall, we do not consider that the rules and guidance in this policy statement adversely impact any of the groups with protected characteristics ie age, disability, sex, marriage or civil partnership, pregnancy and maternity, race, religion and belief, sexual orientation and gender reassignment. However, we recognise that investors with exposure to the side pockets will require certain types of investor, for example those close to retirement, to carefully consider when they might need to take out the proceeds of their investment.
We asked:

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. If so, please provide details.

Most respondents did not believe our proposals would adversely impact any groups with protected characteristics under the Equality Act. However, several respondents agreed with our assessment that older investors, specifically pensioners and those approaching pensionable age who are more likely to have SIPPs and ISAs, would need to plan further ahead as to when they will need the proceeds of their investments.

Next steps

We set out the final Handbook text in Appendix 1. The new Handbook rules and guidance will come into force on 11 July 2022. We encourage AFMs looking to implement side pockets to engage with us before submitting an application to modify scheme documents. This is so that we can tell you what specific information we will want you to provide as part of the application. Please initially confirm your intention to submit to ukcis@fca.org.uk. We will look to undertake our review of the authorisation application as quickly as possible.

We received feedback that retail funds should be allowed to use side pockets more broadly, as opposed to being limited to assets affected by the Russian invasion of Ukraine. The wider use of side pockets is not within the scope of this policy statement. We will review the effectiveness of the use of side pockets in dealing with the current scenario before deciding a wider future policy position.
2 Structure and governance of side pockets

2.1 This and the following chapters provide a summary of feedback we received and set out our response to the issues raised, including areas where we are making changes in response to feedback.

2.2 We explained in CP22/8 that our proposal to allow side pockets could interfere with the property rights of existing investors in certain ways and could have unintended consequences for some investors.

2.3 We asked:

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

Feedback and our response

2.4 Respondents generally supported our proposed side pocket unit class structure. However, some respondents also supported the alternative proposal (set out in paragraphs 3.24 to 3.30 of CP22/8) by means of a scheme of arrangement. Some respondents asked for flexibility to allow AFMs to choose the most appropriate side pocket structure for their funds’ investors.

2.5 Respondents asked us for guidance on the percentage exposure of the fund’s net asset value (NAV) to affected assets that would trigger the need for establishing a side pocket.

2.6 One respondent approved of the structure, but questioned the proportionality of the proposed new rules if only 10 to 15 funds were to utilise side pocket classes.

2.7 A few respondents were concerned about the asymmetry of information between a fund manager and its distributors. Distributors raised concerns that they would need information to inform the beneficial owners of units on how the side pocket would be managed, how frequently the AFM would review the side pocket, as well as the AFM’s policy for winding up the side pocket class.

2.8 There was also broad support for side pockets to be made available more generally as a liquidity management tool for undertakings for collective investment in transferable securities (UCITS) funds and for their use not to be restricted to the situation of the Russian invasion of Ukraine. Respondents generally considered that there could be other scenarios in which side pockets could help reduce consumer harm, by segregating affected assets so that only investors with exposure to the assets at the time the side pockets are created would retain that exposure.
Our response

We set out our response to the proposed side pocket and the alternative proposal in questions 3 and 5 below. We set out our response on the disclosure of the side pocket in questions 17 and 18 below.

The wider use of side pockets, as a liquidity management tool that should be made generally available for UCITS schemes and non-UCITS retail schemes (NURS), is not within scope of this policy statement. Given that the Russian invasion of Ukraine has caused exceptional circumstances outside of the control of an authorised fund manager, we think a side pocket is an appropriate response to deal with affected assets held in authorised retail funds. The current scenario is very different to one caused by a poor investment decision, or an idiosyncratic event that changes the liquidity profile of either an underlying asset or a fund. We would have concerns around a fundamental shift in policy to allow retail funds to implement side pockets in response to liquidity problems that could have been better managed by the AFM.

We are engaging internationally with the International Organisation of Securities Commissions (IOSCO) on liquidity management tools for open-ended funds and will consider side pockets more generally as part of this work. We will bear in mind the effectiveness of the use of side pockets in dealing with the current scenario before deciding a wider future policy position.

Proposed side pocket structure

2.9 Our proposal allows AFMs to establish a separate unit class (or range of classes) within a UCITS scheme or a NURS, which would be valued purely by reference to the sanctioned and untradeable assets and not the remaining tradeable 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 tradeable assets, but not the affected investments.

2.10 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 proposed 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 tradeable assets (the treatment of uninvested cash is considered in our feedback on question 13 in chapter 3).

2.11 We believe this arrangement benefits 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.
We asked:

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?*

**Feedback and our response**

2.13 There was broad agreement that the proposed side pocket class is a suitable way to create a side pocket in a retail fund. There was also broad support for the scheme of arrangement structure that was set out as an alternative proposal.

2.14 Respondents noted that side pockets will increase administrative burdens. Distributors said beneficial owners and policyholders will need to receive information on how the process of the establishment of a side pocket class will work. End investors will need to be informed of the fund manager’s policies regarding using unitholders’ assets to cover side pocket expenses, as well as the terms and conditions on which the fund manager could wind up a side pocket class.

2.15 Operationally, it was noted that IT systems development may be needed to implement side pockets, which will extend implementation timelines and increase costs.

2.16 One industry group sought confirmation that the scheme of arrangement option, although more burdensome administratively for a fund manager than the creation of side pocket classes, would still be available for authorised fund managers to use if they deemed it to be in the interests of unitholders. Some respondents asked us to consult on this alternative proposal.

2.17 Several respondents noted that the creation date of the side pocket is not retrospective. Fund managers and distributors expressed their view that backdating the creation of a side pocket class to, for example, the date of the invasion or the date of certain sanctions being imposed, would create a range of administratively burdensome hurdles. It would also be difficult to determine retrospectively the exposure that unitholders should have to the affected assets, especially if the fund remained open for dealing and investors have subscribed or redeemed since the affected date. Respondents thought the fairest policy outcome is for the fund manager to set the effective date for the side pocket to be created in the present or the near future.

2.18 Some respondents thought that if the war in Ukraine continues for a prolonged period, then we should consider consulting on rules to close side pockets as costs accumulate. Respondents questioned what a fund manager’s strategy should be if the affected assets regain value in the future and start to perform. They asked whether the affected assets should be sold off or merged back into the original fund.

**Our response**

We have considered the feedback received and are proceeding with final rules allowing side pockets only by means of a unit class. We comment further on the possibility of using the alternative side pocket model in our response to feedback on question 5 below.
We understand that the creation of side pocket classes will lead to operational burdens, although they will be an optional tool. In response to the feedback received, AFMs should consider the operational changes that need to be implemented by other participants in the value chain. They should allow sufficient time, from announcing the creation of the side pocket to implementing it, for it to be created with minimum disruption to intermediate unitholders and end investors.

We understand that, given the exceptional circumstances and the operational changes that are required, the AFM may decide it is in unitholders’ best interests to suspend dealing in the fund for a short period of time when announcing the creation of a side pocket and to allow a reasonable amount of time for the operational changes to be made. If the AFM suspends the fund, in deciding the length of the suspension period it must balance unitholders’ need for access to their investments with the potential operational disruption to be overcome.

2.19 We asked:

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

**Feedback and our response**

2.20 The majority of respondents did not believe that operating side pockets would cause prejudice to other investors in the fund.

2.21 Several respondents commented that side pockets are the simplest and fairest way to deal with the affected assets for investors. Several respondents suggested reviewing periodically (e.g. annually) whether the side pocket should continue. A few respondents noted the risk of cross-class contagion if insufficient cash were made available to pay side pocket fees and expenses, although they considered this unlikely to happen in practice.

2.22 One respondent articulated very firmly that a side pocket class is the best solution to the challenges faced by fund managers holding affected investments because of the war. They noted that side pockets permit affected investments to be realised in an orderly way, while protecting existing investors against the behaviour of speculative investors and ensuring and providing any potential upside for those investors who took the losses because of the Russian invasion. Importantly, side pockets allow new investors to enter a fund without gaining exposure to the affected assets, reducing the need for the fund to suspend.

**Our response**

Given the feedback that we received, we are finalising the rules largely as consulted on. We believe that the rules we are putting in place will ensure that investors in a fund with side pockets are treated fairly, provided the AFM applies due skill, care and diligence when considering what would be in the best interests of all investors.
Issues relating to costs and charges payable from a side pocket class are addressed in our responses to subsequent questions.

An alternative side pocket model

2.23 CP22/8 described a possible alternative side pocket model, which would involve establishing a new authorised fund (or sub-fund of an umbrella) that would have the same investment objective and policy as the existing fund. The AFM would then carry out a scheme of arrangement to transfer the majority of the scheme property of the existing fund – all the tradeable assets and most of the uninvested cash – to become the first property of the newly-created fund.

2.24 The existing fund would retain the affected investments and the rest of the uninvested cash. It would immediately be put into winding-up. The winding-up would not be completed until the AFM could disinvest from the affected investments and pay out to the unitholders according to their stake in the fund.

2.25 We explained in CP22/8 that we were not consulting on specific proposals to allow this model, because the potential difficulties and costs would make it unattractive to most AFMs.

2.26 We asked:

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?

Feedback and our response

2.27 Several respondents strongly believed that the fund manager should have the choice to pursue a side pocket either by way of a unit class or a scheme of arrangement.

2.28 One fund management company noted that the Luxembourg securities regulator allows both the share class and the scheme of arrangement side pocket models.

2.29 Respondents who showed interest in the alternative model wanted it to be made generally available and not exclusively for the special circumstance of the Russian invasion of Ukraine.

2.30 No respondent suggested that the alternative model was the overall best option. However, respondents in general believed that fund managers would benefit from having both options to choose from, when providing a solution for their specific investors or assets.

2.31 One investor noted our comments about the time needed for regulatory approval of changes, and said that since side pockets would be an exceptional liquidity management tool, we should consider how to streamline our process where certain ‘trigger’ conditions arise.
Our response

Our pre-consultation engagement with a number of stakeholders indicated that the scheme of arrangement model presents significant and costly operational problems, which we detailed in CP22/8.

We still 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. However, as stated in CP22/8, we are willing to engage with any firms that think it might offer a preferable alternative for dealing with assets affected by the Russian invasion of Ukraine, even though operationally more onerous. We ask such firms to contact us directly.

Affected investments and scope

2.32 We explained in CP22/8 that these rules will apply only to certain financial instruments impacted by the consequences of the Russian invasion of Ukraine. We proposed criteria which between them define the range of assets that we think are most likely to be affected. The asset must either be a ‘sanctioned investment’ or fall within a category of investment which is impacted economically through its links to one of the ‘affected countries’ – Russia, Belarus or Ukraine.

2.33 We asked:

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?

Feedback and our response

2.34 There was broad support from respondents on the current definition of the scope of affected investments. This support from stakeholders was also generally accompanied by the observation that if the Ukrainian war continues or broadens, the scope may need to be broadened or narrowed depending on the course of the conflict.

2.35 One respondent noted that derivative hedges (such as negative basis credit default swaps or asset swaps) need to be included as well as cash holdings in Russian banks. Respondents concluded that if an underlying asset becomes untradeable, then all derivatives based on those assets should qualify for inclusion in a side pocket.

2.36 One respondent noted that a fund may hold units in another fund (the ‘target fund’) that has suspended dealing, in which case the units could be put in a side pocket of the investing fund. They queried whether the liquid portion of those holdings should be used to cover fees and expenses of the side pocket when the target fund reopens for trading or the end of sanctions occurs.
In line with feedback requesting the availability of side pockets for other situations at the discretion of a fund manager, respondents also called for us to broaden the scope of affected investments accordingly, giving the fund manager more flexibility to make the best possible choices for a given fund.

Our response

We have considered the feedback received and are proposing limited changes to the definition or scope of the affected investments in response. We have modified the definition of ‘sanctioned investment’ to extend it to any investment or asset that would contravene the financial sanctions laws and regulations of the UK and other specified jurisdictions, which should address some of the concerns expressed in feedback. We will keep the scope of affected investments under review while the conflict continues.

Governance issues for establishing a side pocket class

We proposed that the decision to create a side pocket class should be taken by the AFM’s governing body, including the independent directors, and after having consulted the fund’s depositary. We proposed rules setting out the conditions which must be satisfied before a side pocket class could be created, including an annex with a non-exhaustive list of matters which the AFM’s governing body must consider before taking a decision.

We asked:

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?

Feedback and our response

There was broad agreement with our proposed conditions for creating a side pocket class. There was also broad support for the creation of side pockets for other events. One respondent expressed the view that having the side pocket option in place would help fund managers to better deal with ‘black swan scenarios’.

One respondent proposed that there should be a mechanism for side pockets to be valued at crucial life event milestones, such as an investor’s retirement, or at their death.

One fund manager proposed a minimum trigger of 10% of pre-invasion assets by value for a fund manager to be allowed to set up a side pocket class.

As a general condition, respondents raised the point that fund managers should communicate clearly the conditions which need to be met in order for the side pocket to be wound up.
2.44 Several stakeholders noted that the fairest way to introduce side pockets would be for them not to be retrospective. Fund managers and platforms noted that it would be administratively cumbersome to backdate a new side pocket. It would also raise the issue of which date to use for the creation date – for example, the day of the invasion or the day sanctions were imposed.

2.45 However, one stakeholder opposed this view on the grounds that by allowing side pockets to be introduced months after the invasion, some funds have already received inflows from investors seeking the upside from a potential revaluation of the affected assets. Therefore, investors who did not suffer the losses of asset devaluation after the invasion would unfairly receive the upside of revaluation.

**Our response**

The rules that we consulted on did not allow the creation of a side pocket to be backdated, for reasons of fairness to investors. The responses to the consultation supported this approach. We have also taken into account the operational considerations, which reinforce our view that it would not be feasible for an AFM to backdate the creation of the side pocket. Therefore, we are finalising the rules as consulted on.

We are not setting any exposure threshold to affected assets to determine whether to use a side pocket, but leaving it to each AFM’s discretion. A blunt % threshold of pre-invasion exposure to the affected assets may not always be the best way to decide whether the fund should implement a side pocket or not. For example, the AFM of a large fund with a 2% exposure may consider it cost-effective to implement a side pocket, whereas for a smaller fund with a greater exposure it may not be.

The need to provide ad hoc valuations of illiquid assets, for example at the date of an investor’s death, may arise in other situations where the product is not valued and priced on a daily basis, so there are precedents that firms should be able to follow. We comment further on considerations when valuing unit-linked life policies with exposure to side pockets, in response to question 22.

2.46 We asked:

**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?

**Feedback and our response**

2.47 Respondents broadly agreed that a fund’s governing body should consider the matters that we set out ahead of creating a side pocket class.

2.48 Distributors who responded asked that fund managers be required to liaise with them to ensure there is sufficient lead time to implement a side pocket class.
2.49 There was strong support for the principle that the AFM’s governing body should make the decision whether or not to implement a side pocket and whether to set a trigger, or threshold of exposure to affected assets, for that decision.

2.50 One respondent questioned our statement, in paragraph 4.15 of CP22/8, about how the eligible assets rules apply in relation to side pockets. They asked for clarification that the eligibility and transferability of affected investments remains a separate question to be decided by the AFM, after having consulted with the depositary.

**Our response**

We intend to make the relevant rules as consulted on, subject to minor clarifications of the wording in COLL 7 Annex 1R setting out the matters to be considered by the AFM. We have modified the requirement about the AFM’s intention to invest in affected countries in future, so that it refers to any investment not just new investment. We note that the Government intends to legislate to prevent further new investment in Russia. We have also added more specific wording about which firms the AFM should assess for their readiness to implement and maintain arrangements for the side pocket class, to make it clear that SIPP providers and unit-linked life fund providers are among those that should be considered in this respect.

We discuss matters relating to the impact of the AFM’s decision on distributors in our response to feedback on questions 17 and 18 below.

We confirm that the question of whether affected investments are still eligible assets under the relevant rules in COLL 5.2 or 5.6 is a separate matter for the AFM to consider in conjunction with the depositary. We do not consider that it has to be addressed as a pre-requisite to any decision to set up a side pocket class.
3 Setting up a side pocket

Amendments to scheme documents

3.1 The ability to issue different classes of units in an authorised fund depends on the provisions set out in its constituting instrument and prospectus. We proposed rules to require the AFM to amend the instrument and prospectus before creating the side pocket, noting that these changes would require notification to and approval by our Fund Authorisations team. We offered to work with industry stakeholders to develop a process for a fast-track approval of the changes necessary to establish the side pocket.

3.2 We asked:

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?

Feedback and our response

3.3 There was broad agreement with our approach to amending the instrument constituting the fund and the prospectus to enable the creation of a side pocket class.

3.4 Several respondents expressed support for the confirmation that as no new investors are involved, a key investor information (KII) document will not be required for the new side pocket class.

3.5 Most respondents to this question requested a fast-track FCA process to approve the side pocket. Respondents requested us to explain how the fast-track approval process would work at the same time as the policy is announced.

Our response

We intend to make the rules as consulted on, subject to some clarifications of what details should be set out in the prospectus. As explained in our response to the feedback on question 27 in chapter 5, we will allow an AFM the option to specify in the prospectus that redemption will be available subject to an extended period for settlement to be paid to the unitholder. We have also adjusted the wording relating to redemptions and transfers of title to make that section clearer.

We have added a requirement to disclose in the prospectus if there could be a ‘contagion risk’ as a result of any costs and charges attributable to the side pocket class becoming a liability on the assets attributable to other classes. The prospectus must in such cases explain what steps the AFM will take to prevent unitholders in other classes from having to bear such a liability.
We note the broad support for the FCA to put in place a fast-track process to review and approve changes to fund documentation to enable a side pocket class to be created. Once the AFM has decided that it wishes to establish a side pocket class, it should contact our Fund Authorisations team at ukcis@fca.org.uk to obtain further information on the approval process. We will require the AFM to provide certain specific information as part of the process.

AFMs will need to complete the relevant fund approval form (forms 251/21/261Q) and submit it to ukcis@fca.org.uk. On receipt of a complete application, we will aim to expedite the review of the application and give a decision as soon as we can.

### Unitholder consent

3.6 Empowering an AFM to create a side pocket class could be regarded as a fundamental change, by changing the nature of the fund or altering its risk profile. Such changes normally require prior approval by unitholders passing a resolution at a general meeting.

3.7 Having considered the benefits and costs of requiring the AFM to seek unitholder approval before creating a side pocket unit class, we proposed that the AFM need not treat this course of action as a fundamental change, provided the AFM is satisfied on reasonable grounds that the foreseeable costs are not disproportionate to the benefits.

3.8 If the AFM determines that implementing side pocket unit classes should be treated as a significant change, we also proposed that 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.

3.9 We asked:

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?*

### Feedback and our response

3.10 Nine respondents answered question 10 and were broadly supportive of the policy proposal to dispense with holding a unitholder meeting. One respondent also agreed with removing normal notice requirements, if the AFM determines the implementation of a side pocket unit class to be a significant change. All the respondents agreed it was important that investors were appropriately notified of the side pocket in a timely manner. One respondent queried if the decision to allow a vote or not would depend on the size of the assets, the percentage amount of assets affected, or a combination of both.
3.11 Twelve respondents answered question 11, with eleven of them broadly supportive of our proposal to notify investors about the creation of the side pocket. Many of these respondents noted that AFMs may need to work with intermediaries and distributors and give thought to their communication requirements. As such, one respondent also suggested AFMs may need to work to an ideally standardised notice period to accommodate the needs of distributors.

3.12 Respondents highlighted the importance of information being clear and understandable with due consideration for retail investors. Various examples of information were mentioned, including the treatment of fees and costs and how contagion risk will be managed, as well as other tools to enhance investor understanding. Such tools might include risk warnings, regular web updates, and potentially two levels of documentation to ensure sufficient information is provided to retail unitholders.

3.13 One respondent disagreed with our proposal to remove the requirement to give prior notice to unitholders before the deemed significant change to implement side pocket classes, saying this would create significant operational issues for unit-linked providers.

### Our response

We intend to make the rules on removing the requirement to hold a unitholder meeting, as proposed. Fund-specific factors, such as the overall size of assets and the percentage of affected investments, should be considered by the AFM as part of its decision whether to set up a side pocket. Once the decision has been taken, we do not think these factors would have a bearing on whether or not to hold a unitholder meeting.

We also intend to make the rules and guidance on providing information to unitholders, with minor amendments. We have clarified that the disclosure should include any risks associated with the side pocket that are identified in the fund prospectus, such as the possibility of costs and charges attributable to the side pocket class creating a contagion risk for other classes.

We address issues relating to the timing of the announcement and communication of information, including the implications for unit-linked providers, in our responses to feedback on question 18 below and question 22 in chapter 4.

### Issue of units in new classes

3.14 We proposed that 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, though the simplest solution would be for a unitholder to receive one new unit in the side pocket class in addition to each unit currently held. The combined value of the total units that unitholders will hold immediately after the side pocket is created must exactly equal the value of their holding immediately prior to it being created.
We asked:

**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?

**Feedback and our response**

3.16 Ten respondents answered this question, with six broadly supporting our proposal that AFMs should decide the best way of issuing units in new classes so that holdings are proportionate to the existing classes.

3.17 Several respondents considered the importance of the information needs of other parties including intermediaries and distributors. In this capacity, four respondents broadly disagreed with our proposal and suggested prescribing a ‘pari passu’ approach to ensure consistency. One respondent suggested AFMs be directed by the COLL rules to use one of a few limited methods. One respondent agreed that the method decided upon should be at the discretion of the AFM, but noted it should be easily understood by unitholders and those responsible for carrying out corporate actions.

3.18 One respondent queried how voting rights at unitholder meetings would apply for new investors versus existing investors, noting this could create problems if the value of assets recovered in the future. In certain situations where a resolution is put to the vote at a meeting of unitholders, it would be unfair if unitholders who have received units in the side pocket class in addition to their existing units were able to have greater voting power than new investors outside the side pocket class.

**Our response**

We note the concerns that the decision of the AFM on how to issue units may impact on intermediaries and in any case should be easily understandable by investors. Although we agree that a ‘pari passu’ approach of issuing one new unit for each existing one is likely to meet everyone’s needs, AFMs are capable of judging what approach is in their unitholders’ best interests. We do not think it is necessary to be prescriptive in rules on this point and will make the rule broadly as consulted on.

Regarding the point made about voting rights we think that, since the weight each vote represents should normally be proportionate to its value, unitholders with units in both a standard class and a side pocket class should not receive any undue advantage from the arrangement. However, to give certainty on this point we have added a rule (COLL 7.8.19R) to ensure that when a resolution is voted on at a meeting, votes in relation to units in a side pocket class may only be cast if the resolution relates to or affects the side pocket.
Chapter 3

Financial Conduct Authority

Protecting investors in authorised funds following the Russian invasion of Ukraine

Allocation of scheme property

3.19 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.

3.20 We proposed guidance to clarify how the AFM should allocate capital 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.

3.21 We asked:

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?*

Feedback and our response

3.22 Eight respondents answered this question. Respondents broadly agreed with the proposals on income property and capital property, and that income arising from the affected investment should be allocated to the side pocket class. One respondent noted a proportionate amount of the capital property should be allocated to the side pocket, based on the expected timeline.

3.23 Respondents broadly agreed that the AFM and its governing body would be best placed to decide whether a proportion of uninvested cash should be allocated to the side pocket class as a provision against costs and charges attributable in the future, and whether to undertake derivative transactions attributable only to the side pocket class, to hedge foreign currency exposures to the fund’s base currency.

3.24 One respondent noted that such hedging may result in losses from forwards (hedges), and those losses would need to be covered via the sale of assets, thus preventing the side pocket from realising the full value of its assets. Some respondents noted this would require appropriate segregation and a separate bank account, as well as notes at accounting level. One respondent also noted managers will need to carefully assess how to seed the side pocket.

3.25 Respondents generally noted that the amount of cash required to cover expected future costs would be hard to calculate with any certainty. One respondent suggested scenario analysis, with consideration of expected fees from various parties and length of the lifetime of the side pocket. Another noted the estimate should be performed in a fair and equitable manner, with the intention that the side pocket would not go overdrawn, as it would be difficult to obtain approval for a bank account if it would be deemed a credit risk.
One respondent said that cash levels should be kept at a minimum in the side pocket. They said that in the event of under-provision, the management firm should meet any shortfall, and that this could be on an accrual basis pending liquidation but would ultimately be for the board to decide.

**Our response**

We intend to make rules and guidance on this matter as consulted on. Feedback from respondents confirms our view that the question of how much capital cash to allocate to the side pocket requires careful consideration by the AFM. Our rules on the matters to be considered by the AFM before setting up a side pocket include risk modelling of scenarios and we agree that thought needs to be given in advance as to how to prevent the cash position attributable to the side pocket class from becoming overdrawn. We have added guidance indicating that if a side pocket class does become overdrawn, the position should not be netted off against positive cash balances attributable to other classes of the fund.

The concerns raised by respondents in relation to the use of derivative positions to hedge currency exposure are legitimate and we have some doubt whether their likely benefit could justify the risk of losses being incurred through poor management of those positions. We have to weigh this against the possibility that such hedging, if carried out carefully, could at some future point protect investors from more significant losses of value.

On balance we think it is better to let AFMs exercise their judgment as to the best course of action in investors’ interests, although we will expect any AFM wishing to hedge an exposure in a side pocket class to ensure that its risk management process is appropriately calibrated to address the potential impact of loss-making transactions on the overall cash position of the class.

**Costs and charges**

We proposed guidance on the treatment of costs and charges in a side pocket class (COLL 7.8.9G). We accept that the new class should bear a proportionate share of costs which arise, to be recovered out of available income or capital attributable to the side pocket class. Unitholders in other classes without any interest in the affected investments should not be cross-subsidising the costs of managing that class.

We said the AFM’s governing body should consider how to account for such income and for expenses attributable to the new class, when evaluating whether to proceed with side pocket arrangements.
3.29 The governing body should also consider whether or not it is appropriate for the AFM to be remunerated for managing a side pocket class. We consider that any fee should not exceed what is reasonable to cover the necessary costs of the AFM. We also proposed that the AFM should not be able to make any preliminary or exit charges in relation to the side pocket class, nor be able to charge a performance-related fee.

3.30 We asked:

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?

Feedback and our response

3.31 Ten respondents answered question 14 and broadly agreed with the proposed guidance on how costs and charges should be allocated.

3.32 Respondents generally agreed that investment management fees should not be charged on the assets held within the side pocket class in these circumstances. Respondents also said that AFMs would need to allocate enough cash to the side pocket class to meet fees and expenses, whilst also recognising the difficulty in estimating the correct amount of cash, and with due consideration to prevent a significant debt cost accrual. One respondent noted the need for full transparency on the fees and costs charged, and that the value assessment statement would be one place where these disclosures could be made.

3.33 One respondent asked us to clarify that arrangements involving a single ‘all-in’ management fee, where operated on a clear and transparent basis, would not give rise to any supervisory considerations regarding the fair treatment of all unitholders in the fund.

3.34 One respondent requested our views on an appropriate means of assessing the value of cash to a portion of the side pocket, and the appropriate fees to be charged and waived in the side pocket.

3.35 One respondent queried how the costs that an AFM incurs in creating, managing, and administering a side pocket will be reflected in the product cost element of ex-post cost disclosures made by platform providers and other intermediaries. They suggested that some form of regulatory forbearance should apply in recognition of the emergency nature of side pockets, with the result that product costs are not assigned to them on a regular basis – consistent with the suggestion in paragraph 4.39 of CP22/8 that “the AFM may decide to accrue such charges indefinitely until sufficient cash is available to cover them”. The respondent noted that if platforms are required to account for the product cost element of side pocket classes in their own ex-post disclosures, this information would have to be provided by AFMs.

3.36 One respondent said that the list of costs and charges should include transaction-related costs from disposing of the affected investments.
3.37 One respondent noted a potential risk of contagion to other classes, if there are costs and charges relating to the assets held or the operation of the side pocket which cannot be met by the side pocket class, and that new investors in the fund would need to be given an appropriate warning of this potential contagion risk.

3.38 Eight respondents answered question 15 and were broadly supportive of the proposal that an AFM should not charge preliminary or exit fees, or a performance fee, when managing a side pocket class. One respondent agreed but also considered the potential benefit from a performance fee if it didn’t exceed what would otherwise have been payable in the original fund, noting this may need ‘fair’ restructuring in relation to features such as high watermarks. They suggested this may incentivise the fund manager to sell the assets judiciously as markets recover and not necessarily at the first sight of a bid.

Our response

We intend to finalise the guidance on costs and charges as consulted on. We do not think it is practical to develop further general guidance at this stage, since we would first need to understand the models that AFMs intend to use when setting up side pocket classes. Likewise, regarding an ‘all-in fee’ model, it is for any AFM using one to consider whether and how a side pocket class could be operated in a way that is fair to all unitholders. We would suggest such firms develop their own thinking, then approach their usual supervisory contacts if they still have concerns.

We agree that contagion risk should be disclosed to new investors so we have added a requirement to disclose it in the fund prospectus. AFMs will also need to consider whether it is a material risk that should be mentioned in the KII document. The costs of transacting in affected investments, as and when they arise, should be reflected in the price of units, eg by applying a dilution adjustment to a single-priced fund if the cost impact is material.

To the extent that the costs of operating a side pocket class affect any disclosure of costs to be made by platform providers and other distributors, we agree that the intermediary may rely on information passed on by the AFM. In principle, we think the process should be no different to how fund costs and charges are currently disclosed.

We are not persuaded by the possible argument in favour of allowing a performance fee to be charged to a side pocket class, and intend to make the rule as consulted on, which the majority of responses to the question supported.
Communications to unitholders

3.39 We proposed that the AFM will need to prepare a written notification to unitholders that explains fully the reasons for its decision to set up a side pocket. We proposed issuing guidance with further detail on the key points the notification should cover.

3.40 We also proposed that 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.

3.41 We noted that platform providers and other intermediaries will need to be able to pass on the information to their customers, and to handle and respond to enquiries from them.

3.42 We proposed to modify COLL rules to make it clear that we do not consider the issue of units in a side pocket class to fall within the requirement to make a UCITS KII document, or a NURS-KII document, available to investors.

3.43 We asked:

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?

Feedback and our response

3.44 Eleven respondents answered question 16 and broadly agreed that the proposals and guidance would ensure unitholders receive adequate and timely information about the side pocket class structure. Respondents emphasised the need for communications to be clear, detailing how the investment is affected and how the AFM will continue to meet investor expectations and act in their best interest over the life of the side pocket.

3.45 Many of the respondents considered the importance of the role of intermediaries and distributors who would need to notify shareholders and manage ongoing communications and customer queries relating to the side pockets. One respondent suggested that information should be communicated before the side pocket has been set up and not after, to accommodate these parties. Another respondent suggested AFMs should provide a version of information to distributors which may be passed on to unitholders, as well as publishing a further ‘questions and answers’ document on their website and for provision to distributors.

3.46 Some respondents suggested that communications should be tested with consumers prior to wider communication, as well as ‘frequently asked questions’ specifically from consumer research (as opposed to what a firm thinks investors may ask).

3.47 One respondent asked if there will there be a cooling-off period to allow unitholders to exit a fund before side pockets are introduced.
Ten respondents answered question 17 and agreed we should publish consumer-facing material to explain the use of side pockets. Most respondents said we should publish high-level material, as AFMs of affected funds would provide more detailed information. One respondent noted it would be prudent not to carry out a mass campaign, to not worry all retail unitholders.

Many respondents included a detailed list of recommendations on the information our material could cover.

**Our response**

We intend to make the rules and guidance largely as consulted on, subject to minor editorial changes. We have added a requirement for the new disclosures in the fund prospectus, about the risks associated with creating a side pocket, to be included in this information so that the same warnings are disclosed to existing and new investors. We think we have made it sufficiently clear that we expect AFMs, when preparing this material, to take care to ensure it is capable of being understood by investors. This includes situations where the end investor is not a direct client of the AFM.

Although we acknowledge the potential benefits of carrying out consumer testing when designing investor communications, such a process would add considerably to the time needed to introduce a side pocket class. If AFMs judge it is in the best interests of unitholders to set up a side pocket class for affected investments as soon as possible, we would not recommend a delay purely in order to test prospective investor communications.

The ability of intermediaries to prepare and issue communications to investors, in a timely way, is an essential element in setting up a side pocket class and AFMs will need to plan the project accordingly. We have clarified that the obligation to provide generic information may be satisfied by issuing it to a client’s financial adviser rather than directly to the client. However, the statement of units issued to the unitholder must be sent to the unitholder’s registered address.

We have not proposed any rule or guidance on how an intermediate unitholder should treat the statement of units issued, since we understand that such unitholders would treat it as a form of corporate action and update the records of their individual clients accordingly. We would expect AFMs to ensure that they provide sufficient information to enable intermediate unitholders to carry out this process quickly and efficiently.

We shall not prescribe a ‘cooling-off period’ ahead of the introduction of a side pocket class. As noted in CP22/8, the AFM may judge that it would be in the best interests of unitholders to suspend dealing prior to the side pocket being created. We recognise that there is a fine balance between competing interests, taking account of the lead-in time that intermediate unitholders may ask for, and AFMs will need to plan this stage of the process carefully before committing to create a side pocket.
We shall take forward the idea of a consumer page on our website to explain side pockets, noting the many helpful suggestions as to what it should contain. The page will not be available immediately, but we shall aim to have something ready within a reasonably short timeframe.

Managing the transition to a side pocket

3.50 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.

3.51 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.

3.52 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.

3.53 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.

3.54 We asked:

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?

Feedback and our response

3.55 Ten respondents answered this question and broadly agreed that AFMs should be allowed to decide how to manage the transition process. However, views on the ideal transition process varied:

- one respondent noted that suspending funds earlier (instead of making no announcement until the point at which the class is launched) risks causing more problems for investment platforms, such as a greater likelihood of coinciding with regular savings and drawdown routines
one respondent noted it was important to ensure that all investors receive prompt notification around the same time, as not to hand an advantage to those with early warning

one respondent said the cleanest route would be to suspend trading in units until the side pocket is legally established; noting that where fund managers have concerns around the consequences of a lengthy suspension, they could make an announcement containing clear and relevant warnings about the affected assets being potentially undervalued before the transformation was completed, together with any other relevant price-sensitive information relating to the transformation, such as potential timescales, and so allow trading to continue

the same respondent said it was important for investors to trust in the transformation process and so there should be no value leakage (between unit values before the transformation and the sum of the values of existing and new units after transformation), which might be best achieved by the AFM writing down affected assets to zero before the transformation

some respondents considered the role of distributors, and the importance of advance communication between AFMs and fund distributors to ensure the issuing of side pocket units is managed in an orderly and timely way; therefore, some respondents suggested a period of suspension may be needed to ensure investor entitlements to the side pocket units are properly allocated and reconciled

another respondent said that AFMs will ideally need to operate to a standardised notice period to give distributors time to update and align their systems, so that customers' assets are adequately protected and recorded accurately

one respondent noted that the FCA's assumption that this process "should be similar to other corporate actions in funds" would depend upon whether a platform's technology can recognise and accommodate a fund unit class that is fundamentally unlike other existing classes

Furthermore, a respondent explained that if the AFM chooses the option set out in para 4.51 of CP22/8 (no announcement until the point at which the AFM is ready to launch the new class) then we need to acknowledge and accept that unitholding distributors will not be able to record or report their end customers' holdings in the new side-pocket class.

This respondent also said that if the valuation of the side pocket units is anything other than zero, it will also lead to significant knock-on issues and potential customer detriment, with the customer experiencing an apparent devaluation of their holdings in their accounts. They noted this could be particularly challenging for SIPP customers who may be undergoing specific crystallised events (for example, switching) while this process is taking place.

Our response

The diversity of possible approaches noted in the feedback indicates that it will be particularly challenging for AFMs intending to create a side pocket class to manage the process fairly for all parties. The AFM should avoid creating opportunities for new investors to enter the fund ahead of the side pocket being created, purely in order to exploit any potential upside if affected investments recover in value. It also needs to manage the risk of some unitholders seeking to exit the fund because they do not wish to take on units in a side pocket.
It is clear that AFMs will need to consider carefully the impact on intermediate unitholders, and to work with them to get the best results. This may mean that the AFM will need to share information about its plans with certain distributor firms before making it known more widely, in order to ascertain whether those firms have the technical capacity to support the desired model of side pocket class. We expect that any information will be shared on a confidential basis and used by distributors for the limited purpose of making operational arrangements. Platforms and other intermediaries may be able to help this process by considering their capacity pro-actively and being transparent with AFMs about what models they can or cannot support.

We have added guidance that AFMs should have regard to the reasonable operational needs of intermediate unitholders, such as platform providers, before announcing an intention to create a side pocket class. The AFM should have regard to any reasonable period of time such intermediaries will need to establish processes and procedures and communicate information to end investors. What could be considered ‘reasonable’ in this context should take account of the urgent and exceptional nature of the situation and the need to protect investors’ interests in a timely way.

Since the rules already require the AFM to ensure that the sum values of new and existing units are equal to the value of units before the side pocket is created, there should be no detriment to investors – although a clear explanation to investors of what has been done will be vital. This will be particularly important where it falls on an intermediate unitholder to notify end investors that they have received additional units in the side pocket class.
4 How side pockets affect other firms

4.1 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 identified, sets out the feedback we received and explains our proposed approach.

Stocks and shares ISAs

4.2 Our proposals to allow AFMs the option to introduce side pockets to deal with affected investments within their funds, potentially changes a fund’s dealing structure and therefore whether it can remain eligible to be held in an ISA.

4.3 We asked:

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?

Feedback and our response

4.4 Seven respondents answered this question and welcomed confirmation that the funds and side pocket classes would remain ISA-eligible. Two respondents stated that the fund’s ISA eligibility would impact the uptake of side pockets.

4.5 One respondent preferred the alternative scheme of arrangement model, as the existing side pocket fund (containing the distressed assets) could continue to be held in an ISA (or a SIPP) as a qualifying investment in termination / winding-up.

4.6 A few respondents raised a need for an industry consensus for all ISA managers to receive and accept units of funds with side pockets. They explained that one ISA manager would not want to be in a position of allowing the transfer-in and transfer-out of units of funds with side pockets if other ISA managers would be reluctant to do so.

4.7 Two respondents suggested that ISA managers may insert a clause into their terms and conditions stating that they would not accept assets held in a side pocket. They would welcome further discussion on this issue as, at the very minimum, it would add complexity to an ISA transfer and, at worst, could prevent a transfer taking place. One of these respondents said the FCA and HM Revenue & Customs (HMRC) should work to prevent such denial of service, as it is imperative that ISA transfers continue not only in the first instance, but with as close to a ‘business as usual’ operational impact for ISA platforms and their investors as possible.
Our response

The FCA has worked closely with HM Treasury and HMRC to assess whether a side pocket class created under these rules will remain ISA-eligible. The Treasury and HMRC are of the view that the ISA Regulations look to the qualifying status of a UCITS or NURS at the level of the FCA’s recognition or permission, not the unit class or the underlying assets. The creation of a side pocket class will therefore not impact the ISA eligibility of either the fund as a whole or the side pocket class, but there may be implications where an investor wishes to transfer the fund.

Transfer Requirements

The Treasury and HMRC have confirmed that ISA Regulation (21(3)) requires current year subscriptions to be transferred as a whole. There is no provision for a partial transfer of a current year subscription in an ISA. This would present an issue where an ISA investor holds a fund purchased with a current year (CY) ISA subscription which includes a suspended side pocket investment and wishes to transfer their ISA but either must, or wishes to, leave the side pocket element with the original ISA manager – as this would result in two stocks and shares ISAs with CY subscriptions. Although this would not affect the underlying ISA eligibility of either the side pocket or the wider fund, it would not be possible for an investor to transfer their CY subscriptions in this scenario.

The following options appear to be available where a CY transfer is requested:

a. transfer the side pocket and main body investment to the receiving ISA manager (if this is permitted by the AFM and acceptable to the receiving ISA manager)

b. remove the ISA wrapper from the side pocket investment and transfer the main body of the fund – any subsequent gain would be taxable in the usual manner

c. postpone the transfer until the following tax year

We expect there are likely to be a limited number of investors falling into this category and would note this is a time-limited issue, as it is only relevant in the year of ISA subscription in which the investment was purchased, and the side pocket was created (that is, after 5 April 2022).

Investment intermediaries

4.8 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.

4.9 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.

**4.10 We asked:**

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

**Feedback and our response**

4.11 Three respondents answered this question, saying that advisers would need to be able to provide their affected clients with a suitable level of information on the side pocket class structure, and keep their clients informed of developments. One respondent noted potential issues around how advisers could keep clients updated with events from third-party funds.

**Our response**

We agree that 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.

Investment advisers will also need to ensure that they have considered the effect of the side pocket before advising existing and new investors into the fund, including any regular subscriptions from existing investors.

The AFM will be required to communicate the creation of the side pocket to unitholders. Where the AFM knows that the fund was sold to a unitholder on an advised basis and details of the adviser are held, it may meet the requirement by providing the information to the adviser instead. We expect the AFM (and firms in the intermediation chain between the AFM and the end investor) to communicate the creation of the side pocket similarly to how they would communicate other one-off events such as proposed fund mergers, including making a public announcement where appropriate.

**Distributors and platforms**

4.12 Distributors and other service providers, such as investment platforms, would also need to consider the operational impacts of introducing side pocket classes and communicate the changes to their clients. They may need to amend systems to ensure that deals are recorded and processed correctly under the new terms.

4.13 Distributors 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. Investors may need additional information to help them understand the side pocket.
We asked:

**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?

**Feedback and our response**

Seven respondents answered this question and made various comments on the implications of creating a side pocket for platform service providers and other distributors, including that:

- we should consider making it mandatory for sub-register operators acting on behalf of institutions and retail investors to operationally support side pockets
- there are potential operational issues, e.g. dealing with transfers that cannot proceed due to complexity or legal issues if needing to deal with a third party in Russia; some platforms charge for investors to re-register their assets, so investors might be charged separately for both parts of the fund
- creating and launching the side pocket while dealing in the fund is suspended may require system development by platform service providers, which may take time and incur costs
- any required system updates would be easier if a side pocket is established as a new unit class with its own international securities identification number (ISIN), and the split / ratio between the main class and the side pocket class is determined well in advance
- backdating the effective date of the side pocket would create operational difficulties for the platforms; for example, they would need to track down investors who have subscribed or redeemed from the effective date
- inconsistent approaches to the creation of side pockets will also create operational challenges for investment platforms

**Our response**

We acknowledge the operational challenges that platform service providers will face if an AFM implements side pocket classes. We are confident that these challenges can be addressed if firms work co-operatively to find solutions. Platforms should look to continue to facilitate transfers of funds with side pocket classes, in line with their business-as-usual processes, as much as possible.

**Unit-linked insurance**

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 pocket classes, which could include treating the side pocket as they would any other suspended fund or share.
4.17 We asked:

**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?

**Feedback and our response**

4.18 Six respondents answered this question, four of which noted no material issues for unit-linked providers. However, two respondents said creating side pocket classes would create significant operational issues for unit-linked providers, although they did not provide evidence or additional detail.

4.19 Respondents made some additional points, including that:

- it is important for unit-linked funds to have the ability to use side pockets, for the same reason as authorised funds
- our rules should prevent platforms altering their terms and conditions to deny the re-registration of funds with side pockets, and ensure transfers between platforms continue as close to ‘business as usual’ as possible
- a policy provider may want to explain to policyholders that in the event of a claim under a life policy being triggered, any value attached to the side pocket will not be realised until such time as the side pocket can begin to be liquidated

**Our response**

We agree that unit-linked funds will also benefit from the facilitation of side pockets within authorised funds with affected assets. Side pockets should not be a reason to change the wider terms and conditions of a unit-linked fund, or for platform providers to stop offering them. Platforms should look to continue to facilitate transfers of funds with side pocket classes, in line with their business-as-usual processes, as much as possible.

We are leaving it to policy providers, dependent on the terms and conditions of their policies, to determine whether policyholders would:

- as part of any contractual payments, be paid the value of the side pocket from the policy provider’s balance sheet as long as the side pocket continues, or
- receive the value attached to the side pocket only when the side pocket is able to be liquidated

The insurer would need to balance the policyholder’s need for the immediate payment of the proceeds from the side pocket with the ability to ascertain the appropriate value of the side pocket assets.
SIPP provider capital rules

4.20 Many investors invest in these funds through their self-invested personal pension schemes (SIPPs). Our rules require a SIPP provider 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.

4.21 The amount of capital that we require SIPP providers to hold is determined by a combination of the amount and the nature of the assets that they administer. The capital adequacy rules for SIPP providers therefore distinguish between standard assets and non-standard assets. To be treated as a standard asset, any investment held in a SIPP must 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.

4.22 The SIPP rules do not look through to the unit class level of authorised funds, but do consider whether an asset (eg a unit or share in a fund) is capable of being readily realisable within 30 days. CP22/8 therefore set out that the presence of a side pocket unit class alone does not result in the fund (or side pocket class) becoming a non-standard asset.

4.23 We asked:

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?

Feedback and our response

4.24 Five respondents answered this question, some of them requesting clarity on whether the side pocket unit class would be treated as a non-standard asset.

4.25 One respondent noted a concern about unitholders in the process of crystallising their pensions at the time the side pocket is created, and their inability to use the funds held in the side pocket.

4.26 Other points that respondents mentioned included various operational issues that might impact either SIPP providers or platforms and other intermediaries involved in maintaining customer records. They mentioned transfers of a SIPP between providers, including the issue mentioned above of what happens if not all platforms accept transfers of the side pocket units, and the requirement for SIPP managers to support the ‘business as usual’ re-registration of funds.

4.27 They also said there might be a need for either systems development or manual intervention where clients invest in SIPPs directly from their payroll. Over time, there could be a growing number of residual side pockets creating record-keeping problems, and causing difficulty in closing accounts of deceased customers. They also flagged concern that some customers would find it difficult to understand the implications of having a side pocket in their SIPP and how to deal with it.
Our response

Taking account of the exceptional situation caused by the Russian invasion of Ukraine, we confirm that the implementation of side pocket classes for the categories of affected investments specified in these rules will not cause a fund that is a standard asset to be treated as a non-standard asset when calculating the capital requirements of the SIPP provider. Nor will the side pocket class itself be considered as having a different capital treatment to the fund of which it is part.

We acknowledge that creating side pocket classes will pose a number of new operational challenges for SIPP providers, and our response to platform providers under question 21 above is also relevant here.
5 Managing side pockets over the long term

5.1 A side pocket class is intended to be temporary, but it might be in existence for some time. We proposed measures for some of the issues that an AFM might have to address during the life-cycle of a side pocket class.

Aims and investor value

5.2 The AFM will have an ongoing responsibility to manage the side pocket class in the best interests of unitholders, having regard to its special purpose. We proposed that the AFM will need to implement a regular review process, linked to the annual value assessment conducted under COLL 6.6.21R. The governing body should periodically review the impact of costs and charges on the class and whether it is offering good value for investors.

5.3 We asked:

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

Feedback and our response

5.4 Nine respondents answered this question, with eight supporting our proposal that the AFMs should continue to apply the assessment of value (AoV) to side pocket classes. Whilst in agreement, many respondents considered that not all the AoV criteria would be appropriate or relevant. Some respondents sought clarity on our expectations regarding the provision of information within the AoV report, and clarification that AFMs have the flexibility to carry out the assessment separately from the rest of the fund.

5.5 One respondent disagreed with our proposal, noting that a value assessment for investors with assets in the side pocket could prompt client confusion by virtue of publishing two live assessments for the same fund, especially where investors are not able to disinvest their proceeds from the side pocket which will have zero value. Instead, they said upfront and ongoing client communications would be the appropriate medium for firms to update clients.

Our response

We intend to proceed with our proposal to require the AFM to review the side pocket class as part of the annual assessment of value process. However, we have taken account of feedback requesting greater clarity over our expectations, by adding a new rule and guidance. The rule (COLL 7.8.34R) states that the AFM of a fund with a side pocket class should consider the whole fund, including the side pocket class, as part of the AoV process but should adopt a proportionate approach to the specific assessment of the side pocket class.
The accompanying guidance explains that a proportionate approach is appropriate where a side pocket class, because of its special purpose, might in isolation represent poor value according to the standard criteria for assessment. However, where payments are being taken out of the side pocket property, the assessment of overall value delivered to unitholders should give due weight to the impact of those payments.

The AFM need not consider matters set out in the table in COLL 6.6.21R that are not relevant to the side pocket class. However, where payments are being accrued or debited from the scheme property allocated to the side pocket class to cover its costs and charges, the AFM will need to consider whether those payments are justified in terms of the value delivered to unitholders.

Guidance on the rule states the AFM should consider the costs against the value it reasonably expects could be received when disposing of affected investments in future, taking account of current market conditions. The AFM must also consider whether payments are prejudicial to the interests of unitholders in other classes, for example because they result in some costs and charges that relate to the side pocket class being borne by unitholders in other classes of the fund.

Finally, the AFM must consider under the new rule whether it remains in unitholders’ best interests for the side pocket to continue in operation. The annual statement to unitholders concerning the AoV that is required by COLL 4.5.7R (8) will therefore need to cover these matters, in relation to any side pocket class.

### Investment and borrowing powers

5.6 We proposed that AFMs must comply with as much of the investment and borrowing powers rules in COLL 5 as is practicable, having regard to the limited purpose of the side pocket class. We explained that this is a limited modification and cannot be used to increase the fund’s overall risk profile.

5.7 We asked:

**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?*

### Feedback and our response

5.8 Nine respondents answered this question and were broadly supportive of our proposals on how investment and borrowing powers should apply to a fund with a side pocket class.

5.9 Many of the respondents requested additional clarity and guidance on objectives and investment policies for funds with significant exposure to affected assets. One respondent suggested it would be prudent for there to be two versions of the policy. Another noted...
that two versions may be unclear for investors, but fund documentation should explain what are effectively two sets of policies which should apply to investors, depending on whether they came into the fund before or after the effective date of the side pocket.

5.10 Another recommended solution was for the FCA to enable AFMs to recognise that affected investments held within the side pocket class may not align with the investment objectives for the impacted fund in perpetuity, without breaching other fund rules and/or guidance.

5.11 One respondent asked for clarity on how rules on investment and borrowing powers would apply to funds, should they not adopt side pockets but continue to hold Russian assets.

Our response

We intend to make the rules and guidance on the application of investment and borrowing powers to side pocket classes as consulted on.

There can be only one version of a fund’s investment objective and policy, applicable to all classes. It is for the AFM of each fund holding affected investments to consider whether the objective and policy are broad enough to encompass a modified strategy of not investing in affected investments in future. If they are, then continuing to hold the affected investments should be in line with the published policy provided the AFM makes it clear to investors that no further such investments will be made. This could be done for instance by updating the statements about investment strategy in the key investor information document and notifying existing unitholders accordingly.

If a fund’s investment policy is worded in such a way as to create a reasonable expectation that the fund will continue to invest in affected countries, then the AFM will need to consider whether to propose an amendment to it. This would require approval by a resolution of a meeting of unitholders. An amendment could make clear the position of legacy assets in affected countries.

If an AFM does not consider creating a side pocket class to be in unitholders’ interests, it should continue to comply with the relevant rules in COLL 5 in the usual way. Firms should approach their usual supervisory contacts if they are experiencing difficulty in complying with particular rules in relation to affected investments.

Valuation and pricing of units

5.12 We proposed to modify the valuation rules in COLL 6.3 so that the price of a unit in a side pocket class relates only to the net value of the affected investments and uninvested cash allocated to the class. We noted that 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.
5.13 We asked:

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

Feedback and our response

5.14 Eight respondents answered this question and were broadly supportive of proposals on the process for valuing and pricing a fund with a side pocket class. One respondent considered potential discrepancies in the market between assets priced at zero (where side pockets are in use), and those same assets when kept within a fund and fair-valued (based on proxies, historical data, unlisted alternatives, etc.). One respondent considered that a fund’s prospectus should detail the method and frequency of valuation, whereas another proposed communicating NAV frequency to investors at the time of creating the side pocket as being more appropriate.

5.15 Some respondents noted other points or queries, including:

- a request for guidance on the value of assets to be allocated to cover the expenses of running the class, given the open-ended timeline for resolution
- accounting challenges with having specific assets being segregated to a single class that would require technology development at third-party administrators and their fund accounting software providers
- the possibility of valuations of side pockets being negative, meaning that affected assets are likely to be valued at zero but costs and charges may still apply, which could give rise to contagion risks.

Our response

We intend to make the rules as consulted on, subject to some minor editorial changes. It is essential for the fund’s prospectus to set out the method and frequency of valuation, as required by existing rules which are unchanged in this regard. We would also expect the communication to investors to be clear about this (while having regard where relevant to the possibility that dealing in the side pocket class may be suspended).

We do not propose to issue further guidance on detailed operational and accounting issues at this point, as it is for AFMs to consider how these might be addressed and propose solutions. We are willing to engage with firms that intend to proceed with setting up a side pocket class, although we cannot undertake to check procedures and processes for managing the side pocket.
Dealing in the side pocket class

5.16 We proposed that the AFM could allow unitholders in the side pocket class to sell their units if it is satisfied that the unit price represents a correct asset valuation. This might appeal to some investors who would like to divest themselves of any exposure to Russian or Belarusian assets. The AFM could offer to write off amounts of minimal value, or donate the proceeds to charity.

5.17 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. We proposed rules allowing dealing to be suspended at class level, so AFMs could adopt either of these models according to their own judgment of what is in investors' best interests.

5.18 We asked:

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?

Feedback and our response

5.19 Nine respondents commented on this question, expressing mixed views. Some agreed that it should be left to the discretion of the AFM to decide which options were suitable for investors. Others thought that allowing redemption, before a market consensus has been reached on the maximum likely value of the affected investments, would appear to be contrary to the purpose of the side pocket. They were also concerned that investors who are allowed to sell units in the side pocket class at zero or minimal value might subsequently complain that the AFM had not acted in their best interests. These respondents favoured allowing dealing in the side pocket class to be suspended until the assets recover some value.

Our response

AFMs can use suspension as a tool for managing the liquidity of the side pocket class. They should consider carefully whether it would be in all investors’ interests to do so while there is continuing uncertainty over the realisable value of affected investments.

However, it may be appropriate in some cases to allow investors who insist on disposing of their units at zero or minimal value an opportunity to do so, provided they have first been alerted to the consequences of their decision if the affected investments should ever recover some or all of their value. We have modified the proposed rule to allow the AFM at its discretion to specify special non-standard dealing terms for the side pocket class in the prospectus, including the possibility of an extended time period for the proceeds to be paid to the unitholder.
An AFM that relies on third parties such as transfer agents and platform providers to carry out transactions for investors should work with those firms to assess what dealing arrangements could be supported, before finalising the design of a side pocket class. Options such as allowing redeeming investors to donate any proceeds to charity are entirely discretionary, there is no expectation that firms must put procedures in place to enable this to happen.

### Alternatives to redemption

5.20 We noted that as an alternative to redemption, unitholders could transfer title to the units in the side pocket class to a third party, for a price to be agreed between them. Some third parties have a commercial interest in buying up ‘distressed assets’ and we have concerns about consumers being exploited in these situations, especially if there is an asymmetry of information between buyer and seller about the prospect of affected investments recovering in value.

5.21 However, we proposed letting each AFM decide what steps it should take to allow or prevent transfers to third parties, working within relevant legislation and rules.

5.22 We asked:

**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?

### Feedback and our response:

5.23 Ten respondents commented on this question. There was broad agreement that the ability to transfer title to units in a side pocket needs to be available for certain situations, such as the death or bankruptcy of an investor, or so that the investor may transfer a personal pension, ISA or other product wrapper from one provider / platform to another. One respondent noted this may be a better alternative than redemption, for investors wishing to dispose of their units as soon as possible.

5.24 Regarding transfers between platforms, some respondents were concerned whether side pocket classes would be transferable alongside the main holding in the fund. One respondent said it should be a commercial decision for each platform provider whether to accept transfers of side pocket units but, even though this would limit consumer choice, it would be better than allowing AFMs to decide whether such transfers could happen at all.

5.25 Some respondents agreed that retail investors should be able to transfer their holding to a third party wanting to acquire it in the hope of gaining any future value. One suggested it would be better for the AFM to work with such a firm to ensure all investors are treated fairly, but another respondent thought that AFMs should not take on such a responsibility as they wouldn’t have enough information about investors and couldn’t give advice. The Consumer Panel noted the possible reputational risk to the FCA if hedge funds, for example, were to buy up side pocket units and then make a significant profit from them later on.
Our response

We agree that there are a number of situations, such as probate and bankruptcy administration, pension transfers, ISA transfers and switches between platforms, where re-registration of title to units is a business-as-usual activity.

As noted in CP22/8, we also think unit transfers for an agreed price would be possible in any situation where a unitholder is willing to sell to a third party, although we recognise that this might not always be in the investor’s best interests. A buyer of side pocket units that takes on a genuine risk of the assets never recovering value is more likely to be acting fairly than one which is exploiting superior knowledge of the market in the belief it will quickly be able to realise a profit.

On balance, we continue to think it should be left to AFMs, working where necessary with intermediaries such as platform service providers, to decide what facilities could be made available to unitholders wishing to effect a transfer of title while the side pocket units are suspended or marked down to minimal value.

Termination options for the side pocket class

5.26 The AFM would need to make a specific proposal at some point about how best to terminate the side pocket class in the interests of all investors. It may wish to offer options to allow unitholders to make individual choices at the point when affected investments can be traded at a reliable price. However, 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.

5.27 We proposed that the AFM should consider these issues from the outset and explain, in its initial investor communications about setting up a side pocket, how it might address them, without being committed to a firm plan.

5.28 We asked:

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?

Feedback and our response

5.29 Nine respondents commented on this question. A majority agreed that the AFM should have flexibility to decide how to provide unitholders with an exit from the side pocket, including the redemption and transfer mechanisms discussed in the preceding questions.

5.30 At the same time, several respondents thought that the fairest way would be for the AFM to make partial distributions of capital to unitholders as and when it becomes possible to realise affected investments, leading to an eventual winding-up of the class.
They noted that opening the class for optional redemptions, once some assets have become liquid, could lead to first-mover advantage with remaining investors left holding the illiquid assets. Conversely, the redeeming investors might end up worse off than if they had not sold.

5.31 Other respondents suggested that the AFM should have flexibility to develop responses as events unfold, without regulatory constraint other than the need to comply with sanctions requirements.

5.32 One respondent said that if the side pocket continues to exist until markets reopen, the AFM will need to decide whether to reopen the side pocket for trading, or wind it up if the costs look to outweigh any potential value. Respondents noted that any action taken by product providers must take account of the operational capabilities of platform providers and other intermediaries to support various redemption mechanisms, and must also consider how any option could be explained to investors. One respondent thought we should provide more detail on how capital distributions would work, including the tax implications.

Our response

We note the broad support for partial distributions of capital, as and when possible, and the view that this way is most likely to ensure a fair outcome for all investors in the side pocket. At the same time, the unprecedented nature of events in Ukraine means that no one can predict to what extent affected investments will ever regain their former value, so it would make sense to keep options open as far as possible.

As noted elsewhere, we recommend that AFMs wishing to set up a side pocket class should include in their investor communications a clear indication of what the options for terminating the side pocket might be, and what factors the AFM would need to take into consideration before making a decision. It would not be for us to advise on the tax implications of any option proposed by an AFM.

Ongoing investor communications

5.33 We said in CP22/8 that AFMs will need to ensure 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.

5.34 The periodic managers’ reports and accounts are the principal means of keeping investors informed, but 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.
5.35 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.

5.36 We asked:

**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?*

**Feedback and our response**

5.37 Nine respondents answered this question and broadly agreed that the information needs of investors over the life of the side pocket class were adequately met by existing rules and guidance. Most agreed that AFMs should consider the best way to provide sufficient communications to side pocket unitholders.

5.38 Respondents noted the importance of the role of intermediaries and distributors in disseminating communications and answering queries. One respondent suggested the FCA should offer formal guidance to standardise the information that platforms are required to make available to their underlying customers. Another suggested additional guidance on communications for intermediate unitholders to clarify when updates should be provided, such as providing ad hoc updates where significant news is to be shared, alongside updates to the fund website at least quarterly or annually.

5.39 One respondent noted that financial reports were prepared at fund level across a common set of assets and asked us how a segregated value could be rolled up and explained in a fund’s financial reports.

**Our response**

As set out in CP22/8, we are not proposing further rules and guidance on ongoing investor communications. We will see how many AFMs take up the option to create side pocket classes before doing any further work on this matter. We may decide to assess the quality and thoroughness of the initial investor communications as a first step to seeing what interventions might be helpful to investors.

AFMs should discuss with the fund’s auditor in the first instance how the position of a side pocket class could best be presented in the fund’s financial statements. We are open to having further discussions with firms and auditors once they have developed their own thinking on this matter.
Other matters

5.40 We asked:

**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?

Feedback and our response

5.41 Four respondents raised several additional matters between them, which they asked the FCA to clarify or address by making rules and guidance. Some of these points overlap with issues raised under previous consultation questions, which we have covered in ‘our response’ sections above, but additional questions include:

- what happens to a fund of funds that owns assets in affected funds?
- how could a ‘corporate action event’ that does not affect the side pocket of distressed assets be managed whilst the side pocket forms part of the overall fund?
- how should an AFM record the historic performance of those funds in which it decides to set up side pockets?
- are qualifying investor schemes (QIS) allowed (under existing rules in COLL 8) to use side pockets?

**Our response**

Where a fund of funds holds units of another fund (the ‘target fund’) in which a side pocket class is created, the fund of funds will then have holdings in two different classes of the target fund, one of them effectively an illiquid asset. The fund of funds might in due course sell its holding in the main unit class of the target fund, but it would presumably need to continue holding the units in the side pocket class until the AFM of the target fund can offer a means of exiting the position. The AFM of the fund of funds will need to consider whether the holding of side pocket units has any material impact on its own ability to manage liquidity risk and react accordingly.

Regarding ‘corporate action events’ that do not affect the side pocket, the potential situations that might arise are probably too diverse to address through general guidance or commentary before any side pocket classes have actually been established. However, stakeholders with concerns over this matter are welcome to approach us to discuss any scenarios that they think are particularly likely to arise in practice.

Regarding past performance, we consider it to be a general principle that the reported performance of a fund should include any side pocket class. Not to do so could misrepresent the historical record, even if investors who enter the fund after the side pocket has been created do not have a share of the returns from those assets. We believe this position is in line with the Global Investment Performance Standards published by the CFA Institute.
However, there may be situations where it would be appropriate to consider two versions of a fund’s past performance:

- the first based on the historical record, combining the returns of the main portfolio and the affected assets; and
- the second using a model that excludes the affected assets from the historical record and, for the period after a side pocket is created, represents only the returns from the main portfolio.

The first model is likely to be more useful for investors who have a stake in the side pocket class, whereas the second model would be relevant for investors who join the fund after the side pocket is created. Making both versions available should enable all investors to understand the effect of the side pocket class.

This issue is likely to require further consideration if and when side pockets are actually set up, and we are willing to discuss the matter further with relevant stakeholders to help define what could be considered as good practice.

A QIS is permitted by COLL 8.2.2R to establish any unit class structure that is set out in the instrument constituting the fund and that is not prejudicial to the interests of unitholders in any other class of the fund. Therefore, it would appear that the AFM of a QIS could use the rules in this PS as a model for designing a side pocket class, provided the AFM is satisfied that (amongst other things) it complies with relevant provisions of Part 17 of the Financial Services and Markets Act 2000; it would be in unitholders’ best interests to do so; and the constituting instrument is amended to that effect.
6 Cost benefit analysis

6.1 We published a cost benefit analysis (CBA) of our proposals in Annex 2 of CP22/8.

6.2 We asked:

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

Feedback and our response

6.3 Most respondents who commented on our CBA broadly agreed with it. Whilst some respondents recognised that a higher proportion of costs may fall on platform providers and other distributors, rather than AFMs themselves, no one commented on the level of costs or provided evidence. Further to this, one respondent requested clarity on the type of communication needing to be passed on by platforms and other fund distributors, and the associated costs with each. This respondent noted that regular mailings (rather than web-based communications) could add significant cost if required over a long period of time.

6.4 Furthermore, one respondent noted that the CBA did not include the cost of trading out of assets if and when it should become possible to do so. Additionally, one firm asked for further guidance on the ongoing costs of maintaining a side pocket, in the context of determining if these costs are reasonable.

6.5 Another respondent also considered that making the proposed regime permanent would maximise ‘sunk costs’ and improve the overall cost-benefit analysis.

Our response

The rules are not prescriptive about the medium that firms should use when communicating with their clients, or the frequency of communications (other than in annual and half-yearly manager’s reports). Ongoing information about the status of a side pocket could be provided via a website, if the client wishes to receive communications from the firm in that way.

Overall, we do not believe it is reasonably practicable for us to quantify and monetise further costs to firms, including platform providers and distributors as well as AFMs. We acknowledged in our CBA that platforms and distributors will face costs to implement side pockets. However, as discussed above, firms did not comment on the level of costs or provide evidence for this population of firms, and we cannot reasonably predict the uptake of side pocket classes.

As stated previously, the wider use of side pockets is not within scope of this policy statement. This includes any possible extension in the scope of assets to which the policy applies, the potential for the arrangements to be made permanent, the duration of side pockets, and firms’ assessment of value and management of costs within this context.
We do not consider it reasonably practicable to quantify and monetise the costs of trading out of assets, which is an activity AFMs will carry out whether or not they make use of side pockets and so is unaffected by the policy proposals.

Additionally, 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. The changes we are making to the policy following the consultation do not impact the costs and benefits that we described in the consultation. We therefore think the CBA as consulted on remains appropriate, and the financial benefits could outweigh the costs if some value for the affected assets can be realised in the future.

We will review the effectiveness of the use of side pockets in dealing with the current scenario, before deciding a wider future policy position.
Annex 1
List of non-confidential respondents

abrdn
Association of British Insurers
Aviva UK Life
BlackRock
CFA UK/CFA Institute
Depositary and Trustee Association
Mr David Dixon
Eversheds Sutherland
Financial Services Consumer Panel
Hargreaves Lansdown
Invesco
Investment Association
Schroders
SS&C
UK Platform Group
## Annex 2
### Abbreviations used in this paper

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AFM</td>
<td>Authorised fund manager</td>
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<tr>
<td>AoV</td>
<td>Assessment of value</td>
</tr>
<tr>
<td>CBA</td>
<td>Cost benefit analysis</td>
</tr>
<tr>
<td>COLL</td>
<td>Collective Investment Schemes sourcebook</td>
</tr>
<tr>
<td>CP</td>
<td>Consultation paper</td>
</tr>
<tr>
<td>CY</td>
<td>Current year</td>
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<tr>
<td>FCA</td>
<td>Financial Conduct Authority</td>
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<td>HMRC</td>
<td>HM Revenue &amp; Customs</td>
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<td>HMT</td>
<td>HM Treasury</td>
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<tr>
<td>ISA</td>
<td>Individual savings account</td>
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<tr>
<td>ISIN</td>
<td>International securities identification number</td>
</tr>
<tr>
<td>KII</td>
<td>Key investor information</td>
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<tr>
<td>NAV</td>
<td>Net asset value</td>
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<tr>
<td>NURS</td>
<td>Non-UCITS retail scheme</td>
</tr>
<tr>
<td>QIS</td>
<td>Qualified investor scheme</td>
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<tr>
<td>SIPP</td>
<td>Self-invested personal pension</td>
</tr>
<tr>
<td>UCITS</td>
<td>Undertaking for collective investment in transferable securities</td>
</tr>
</tbody>
</table>
Protecting investors in authorised funds following the Russian invasion of Ukraine
Appendix 1
Made rules (legal instrument)
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 11 July 2022.

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
23 June 2022
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 asset or investment any dealing in which (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 7.8.30R(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.

6 Operating duties and responsibilities

... 

6.6 Powers and duties of the scheme, the authorised fund manager, and the depositary

... 

Assessment of value

... 

6.6.20A The authorised fund manager of a scheme with a side pocket class should note the modified application of the assessment of value rules in COLL 7.8.34R (Modified application of the assessment of value rules) and the related guidance in COLL 7.8.35G.

... 

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

7.1 Introduction

... 

Table of application

7.1.2 This table belongs to COLL 7.1.1R.

<table>
<thead>
<tr>
<th>Rule</th>
<th>ICVC</th>
<th>ACD</th>
<th>Any other directors of an ICVC</th>
<th>Depositary of an ICVC</th>
<th>Authorised fund manager of an AUT or ACS</th>
<th>Depositary of an AUT or ACS</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.8</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
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Notes

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<tbody>
<tr>
<td>(5)</td>
<td>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.</td>
</tr>
</tbody>
</table>

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 depositary 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.
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.

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/uksi/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 in the scheme property may, after consulting with the depositary, create a side pocket class.

(2) The conditions are:

(a) The authorised fund manager has determined that the affected investment in (1) 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 7.8.30R(5) (Modified application of COLL 6.2 (Dealing)).
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)).

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

The authorised fund manager will need to consider carefully how to apply a fair accounting treatment when a side pocket class is created.

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, the unit price of the side pocket class should include that element of income.

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 7.8.36R (Modified application of COLL 6.7 (Payments))). If the side pocket class has an overdrawn cash position, it should not be netted off against a positive cash position attributable to other classes.

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 7.8.26R (Side pockets: modified application of COLL 5 (Investment and borrowing powers)) and the related *guidance* in COLL 7.8.27G.

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 and charges 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 and charges of managing the *side pocket class*. Such costs and charges 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 costs and 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*. 

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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 and charges 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 an authorised fund with 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 an authorised fund with a side pocket class, subject to:

(1) the modifications in COLL 7.8.13R to COLL 7.8.21R; and

(2) the additional requirements in COLL 7.8.22R and COLL 7.8.24R.

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; and

(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; and

(d) if applicable, details of:

(i) any special arrangements put in place for redemptions of units in the side pocket class, including any extended time period for settlement and any facility to pay the proceeds of redemption to a person other than the unitholder;

(ii) whether redemption proceeds can be reinvested in units of other classes of the scheme or in units of other schemes; and

(iii) any facility for a unitholder to dispose of an interest in units by transferring title to them to another person (other than by operation of law), 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; and

(c) whether the *authorised fund manager* has undertaken to bear all the costs and charges associated with operating the *side pocket class* from its own resources and, if not, a statement explaining:

(i) the risk that costs and charges might cause the cash position of the *side pocket class* to become overdrawn;

(ii) that a liability arising as a result of (i) would be accounted for against the *scheme property* allocated to the other *classes* in the *scheme*; and

(ii) the steps the *authorised fund manager* would take to ensure *unitholders* in other *classes* do not bear such a liability.

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.

7.8.18  G  Before announcing its intention to create a *side pocket class*, the *authorised fund manager* should have regard to the reasonable operational needs of *intermediate unitholders* and any reasonable periods of time they will need to establish processes and procedures and communicate information to those *clients* for whom the *intermediate unitholder* acts as a nominee in relation to *units* in the *scheme*.
Modified application of COLL 4.4 (Meetings of unitholders and service of notices)

7.8.19  R  (1)  COLL 4.4.8R (Voting rights) applies to an authorised fund with a side pocket class with the modifications set out in (2) and (3) below.

(2) Before a resolution is put to a vote at a unitholder meeting, it must be made clear whether the resolution relates to or affects:

(a) all the classes of unit in the authorised fund;

(b) those classes of unit in the authorised fund excluding the side pocket class; or

(c) only the side pocket class.

(3) On a poll, the votes of a unitholder may only be counted to the extent that the unitholder’s voting rights are attached to units in the class or classes to which the resolution relates or which the resolution affects in accordance with (2).

7.8.20  G  (1) The authorised fund manager will need to ensure that the instrument constituting the fund and the prospectus reflect the modified application of COLL 4.4.8R as set out in COLL 7.8.19R.

(2) COLL 7.8.19R modifies the application of COLL 4.4.8R but does not affect the other matters dealt with in COLL 4.4, such as COLL 4.4.6R (Quorum).

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

7.8.21  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

7.8.22  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) If the unitholder has a financial adviser, the requirement to provide the notification in (1) may be satisfied by sending it to the financial adviser.

(3) 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 the costs and charges;

(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*; and

(f) each of the matters specified in *COLL 7.8.13R(4)* (Modified application of COLL 4.2 (Pre-sale notifications)).

(4) 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).

7.8.23 G (1) In relation to *COLL 7.8.22R(3)(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*;

(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); and

(e) an explanation of the costs and charges to be borne by *unitholders* in the new *classes*, and of any resulting change in the costs and charges borne by existing *classes*.
(2) In relation to COLL 7.8.22R(3)(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; and

(e) the date on which the changes take effect.

(3) In relation to COLL 7.8.22R(3)(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) the circumstances in which unitholders may convert their units in a side pocket class to units of another class of the scheme; and

(e) the circumstances in which unitholders may transfer title to their units in the class to another person.

7.8.24 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.
The notification required by COLL 7.8.22R and the written statement of holdings required by COLL 7.8.24R may be issued to existing unitholders in a single combined communication. However, it will not be possible to use a single combined communication where the notification required by COLL 7.8.22R is provided to a unitholder’s financial adviser instead of the unitholder (see COLL 7.8.22R(2)).

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

(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 7.8.33R(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

7.8.27  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 7.8.26R(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

7.8.28  R (1)  This rule applies to the authorised fund manager and depositary 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 depositary 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

7.8.29  R  The rules and guidance in COLL 6 (Operating duties and responsibilities) apply in relation to an authorised fund with a side pocket class subject to the modifications specified in COLL 7.8.30R (Modified application of COLL 6.2 (Dealing)) to COLL 7.8.36R (Modified application of COLL 6.7 (Payments)).

Modified application of COLL 6.2 (Dealing)

7.8.30  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 depositary 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 depositary and take its views into account.

(c) After being consulted under (b), the depositary 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 the prospectus makes alternative provision for how unitholders may be paid; 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)

7.8.31 R (1) COLL 6.3 (Valuation and pricing) applies in relation to a side pocket class subject to the modifications specified in this rule (see also COLL 7.8.32G).
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.

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 the side pocket class 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.

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)

COLL 6.6 (Operating duties and responsibilities) applies to the authorised fund manager and depositary of an authorised fund with a side pocket class, subject to the modifications specified in this rule and COLL 7.8.34R (Modified application of the assessment of value rules).

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.

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.

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 the assessment of value rules

7.8.34 R When conducting an assessment of value for the purposes of COLL 6.6.20R (Assessment of value) in relation to a scheme that has a side pocket class, the authorised fund manager:

(1) must consider each of the matters included in COLL 6.6.21R (Table: minimum considerations – assessment of value) in relation to the scheme as a whole, including the side pocket class, but may adopt a proportionate approach to the assessment as it applies specifically to the side pocket class;

(2) in relation to the side pocket class, need not consider a matter included in COLL 6.6.21R if, in all the circumstances, it is not relevant to that class;

(3) must consider whether, to the extent that payments are being made out of the scheme property attributable to the side pocket class or are being accrued for that purpose, those payments:

(a) are justified in terms of the value delivered to unitholders in the side pocket class; and

(b) are not prejudicial to the interests of unitholders of other classes; and

(4) must consider whether it remains in unitholders’ best interests for the side pocket class to continue in operation.

7.8.35 G (1) In relation to COLL 7.8.34R(1), the authorised fund manager should consider the side pocket class when carrying out an assessment of value for a scheme. A side pocket class, because of its special purpose, might in isolation represent poor value according to the standard criteria for assessment, so the authorised fund manager should take account of that purpose in order to reach a proportionate assessment. However, where payments are being taken out of the side pocket property, the assessment of overall value delivered to unitholders in the scheme should give due weight to the impact of those payments.
(2) In relation to COLL 7.8.34R(3)(a), the **authorised fund manager** should consider whether the payments out of **scheme property** can be justified when compared with the value it reasonably expects that **unitholders** might receive from any eventual disposal of the **affected investments**, taking into account current market conditions and relevant political and economic developments.

(3) In relation to COLL 7.8.34R(3)(b), it is likely to be unfair or prejudicial to **unitholders’** best interests for costs and charges borne by the side pocket class to be attributable to **unitholders in other classes**.

**Modified application of COLL 6.7 (Payments)**

7.8.36  R  
(1) **COLL 6.7 (Payments)** applies in relation to an **authorised fund** with 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)**

7.8.37  R  
(1) **COLL 7.2 (Suspension and restart of dealings)** applies in relation 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 Annex 1R

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

This Annex belongs to **COLL 7.8.4R(3)(a) (Conditions for creating side pocket classes)**.

<table>
<thead>
<tr>
<th>1. Investment risk considerations</th>
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<tbody>
<tr>
<td><strong>(1)</strong> Whether there is agreement on which <em>affected investments</em> should be allocated to a <em>side pocket class</em>.</td>
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<td><strong>(2)</strong> The possible impact of relevant sanctions regimes.</td>
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<td><strong>(3)</strong> The <em>authorised fund manager’s</em> estimate of the likelihood of the <em>affected investments</em> achieving a realisable value within a range of timeframes.</td>
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<td><strong>(4)</strong> Whether the <em>authorised fund manager</em> intends to invest in <em>affected countries</em> if the economic situation stabilises and relevant sanctions regimes allow it and, if so, how that might affect <em>unitholders</em> in the <em>side pocket class</em>.</td>
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<td><strong>(5)</strong> Whether the <em>authorised fund manager’s</em> risk management function (see <strong>COLL 6.11 (Risk control and internal reporting)</strong>) has assessed the likely consequences for the <em>authorised fund manager</em>, the <em>authorised fund</em> and its <em>unitholders</em> if the <em>authorised fund manager</em> were to take no action to set up a <em>side pocket class</em>.</td>
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<td><strong>(6)</strong> That there is a risk management plan which considers different scenarios for what might happen to the <em>affected investments</em> allocated to the <em>side pocket class</em> and how such scenarios would be dealt with.</td>
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<th>2. Costs</th>
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<tr>
<td><strong>(1)</strong> The <em>authorised fund manager’s</em> estimated one-off costs of establishing the <em>side pocket class</em> and whether these costs will be met by the <em>authorised fund manager</em>, or paid from the <em>scheme property</em> of the <em>authorised fund</em>, or apportioned between both.</td>
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<td><strong>(2)</strong> The <em>authorised fund manager’s</em> estimated ongoing annual costs of operating the <em>side pocket class</em>, and the provision being made to pay these costs:</td>
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5. **Overall assessment**

Whether the *governing body* of the *authorised fund manager* is satisfied that:

1. the potential benefits to *unitholders* of *units* in any *side pocket class* are proportionate to the estimated costs of establishing and running the *class*, including over the long term;

2. proceeding to set up the *side pocket class* will be in the best interests of the *authorised fund* and its *unitholders*; and

3. the *depositary* 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**

<table>
<thead>
<tr>
<th>Handbook reference</th>
<th>Subject of record</th>
<th>Contents of record</th>
<th>When record must be made</th>
<th>Retention period</th>
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<td><strong>COLL 6.13.4R</strong></td>
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<td><strong>COLL 7.8.4R(4)</strong></td>
<td>The decision of the <em>governing body</em> of the <em>authorised fund manager</em></td>
<td>The decision to create a <em>side pocket class</em> and the reasons for it</td>
<td>As implicit from the rules in <strong>COLL</strong></td>
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### Schedule 2  Notification requirements

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**Sch 2.2  G  1  Notification requirements**

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<thead>
<tr>
<th>Handbook reference</th>
<th>Matter to be notified</th>
<th>Contents of notification</th>
<th>Trigger event</th>
<th>Time allowed</th>
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<td>COLL 7.8.37R</td>
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