

# Introduction of protected cell regime - Consultation

August 2009

## Summary

HM Treasury and the FSA are jointly consulting on the introduction of a protected cell regime for umbrella open-ended investment companies ("OEICs"). The new regime will segregate liabilities within an umbrella OEIC so that liabilities of any one sub-fund can only be met out of the assets of that sub-fund, thereby reducing the risk of contagion between sub-funds.

## What is changing?

Currently there is no segregation of liabilities between sub-funds within an umbrella OEIC, which means there is a risk of 'contagion' whereby the assets of one sub-fund may be used to meet the liabilities of another sub-fund. Where sub-funds within an umbrella OEIC are structured with varying risk profiles, investors in a more cautious fund may be required to bear the risk of a riskier sub-fund.

The protected cell regime will be introduced into the UK through the Open Ended Investment Companies Regulations 2001 (as amended) (the "OEIC Regulations") and COLL. The key changes are:

- the assets of a sub-fund belong exclusively to that sub-fund and are therefore 'ring fenced' from the other sub-funds within the umbrella, and the umbrella itself;
- each sub-fund's liabilities may only be met out of its own assets;
- notwithstanding this, assets or liabilities incurred by the umbrella itself which are not directly attributable to a particular sub-fund may be allocated in a manner which is fair to shareholders;
- the prohibition on cross sub-fund investment will be removed, subject to certain conditions similar to those applicable to investment in group schemes;
- an ACD must take reasonable care that foreign law contracts entered into by the umbrella OEIC are consistent with the principle of segregated liability, and must promptly remedy any breach; and
- a sub-fund may be terminated in the same way as the winding up of a solvent OEIC.

The intention is to enhance investor protection and to make the UK authorised fund industry more competitive with those jurisdictions (such as Ireland, Jersey and Guernsey) which already operate a protected cell regime.

## Documentation changes

Both the prospectus and the instrument of incorporation of an umbrella OEIC must include a statement which discloses the protected cell status of its sub-funds.

As the enforceability of the protected cell regime in overseas jurisdictions cannot be guaranteed the prospectus must outline the potential limitations of the regime in respect of foreign law contracts. This will be particularly relevant where a sub-fund invests in assets which are situated in the jurisdiction of courts of a foreign territory and could be subject to local insolvency proceedings.

Similar disclosures will be required in the ACD's report.

An umbrella OEIC's agreements (such as ISDAs entered into in respect of OTC derivatives) must also reflect the segregated liability of the sub-funds. ACDs of existing umbrella OEICs will therefore need to review the agreements which are in place in respect of each OEIC, and assess what changes will be required once the new regime has been implemented.

Once in force, the new regime will be compulsory for new umbrella OEICs, existing umbrella OEICs will have a one year transition period during which to amend the instrument of incorporation and prospectus and notify the FSA of the changes. Any such notification must also include certification that all the OEIC's agreements are on a segregated liability basis.

## Notification to shareholders

The FSA has indicated that whilst it is for authorised fund managers to decide how changes will be treated, the adoption of the protected cell regime is likely to be regarded as a post-event notifiable change in accordance with COLL 4.3.

*Continued overleaf*

## Do the changes go far enough?

Whilst the introduction of the protected cell regime in the UK is widely welcomed, the regime will only apply to umbrella OEICs. Arguably HM Treasury have missed an opportunity to establish a cell company regime as part of UK company law which would have enabled other structures such as common investment or deposit funds or perhaps even captive insurance companies, to take advantage of the regime. This may also have helped to provide some certainty as to the enforceability of the structure in the context of foreign liquidations.

The deadline for submission of responses to the consultation is on 27 September 2009. Whilst there is no clear indication as to when the changes will be effective they are likely to come into force towards the end of the year.

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