



The Association of Investment Companies

Investment policies

AIC guidance on the requirements of the
Listing Rules

August 2008

To discuss the issues raised in this paper please contact:

Ian Sayers

Deputy Director General
E-mail: ian.sayers@theaic.co.uk
Tel: 020 7282 5612

Guy Rainbird

Public Affairs Director
E-mail: guy.rainbird@theaic.co.uk
Tel: 020 7282 5553

Legal status and disclaimer

The FSA has reviewed "*Investment policies – AIC guidance on the requirements of the Listing Rules*" ('this Guidance') and has confirmed that it will take it into account when exercising its regulatory functions. This Guidance is not mandatory and is not FSA Guidance. The FSA view cannot affect the rights of third parties.

This Guidance applies for the relevant Listing Rules as they stood when the paper was published in August 2008. Readers should ensure the edition of the Guidance they are relying upon has not been updated on the FSA website.

This Guidance is designed to help investment company directors and their advisers consider the issues involved in establishing an investment policy under the Listing Rules. It is not exhaustive and therefore is intended to be general guidance only. Readers should consider taking professional advice before relying on anything contained in this paper.

The AIC accepts no responsibility for any errors or omissions in this paper or for any loss occasioned to any person acting or refraining from action as a result of any material contained in this publication.

Introduction

All investment companies listed under Chapter 15 of the Listing Rules now have to publish an investment policy on application to list and annually thereafter.

The rules setting out these requirements have been prepared according to the FSA's new 'principles-based' approach. They represent a departure from the way in which the listing requirements have traditionally been constructed. Rather than relying on detailed – and potentially commercially-restrictive conditions – the rules now focus on the overall purpose of investment companies. For example, one of the critical conditions for listing an investment company is that it should seek to deliver a spread of investment risk. Under the principles-based approach the rules no longer define in detail how this objective is to be achieved. Instead this matter will now be left to the board of the company to decide (subject to shareholder agreement). This approach should allow a broader range of investment companies to list in the UK and enhance the ability of companies to deliver returns for shareholders. The publication of clear investment policies is critical in allowing the regime to function effectively as, in the absence of specific restrictions, they will explain to the market how the company will manage its portfolio on an ongoing basis.

Investment policies are also intended to deliver consumer protection by helping investors make better informed investment decisions and enhancing their understanding of how the company's approach to investment balances risk and reward. Helping shareholders in this way, particularly retail investors, will reduce the danger that they will make investments that do not suit their needs. As a consequence, those policies written in clear, jargon-free language are likely to be the most successful. Boards should also note the FSA's overall expectation that communication with investors should be precise and clear and not misleading.

The FSA's view is that investment policies will be:

“the key mechanism for ensuring that each listed investment fund is subject to appropriate flexible and transparent risk management which is subject to direct shareholder oversight. In other words, the mechanism offers a principles-based system of transparent self-imposed limits.” (List!, Issue 17, 2007, page 4)

This highlights another purpose of investment policies. They will allow shareholders, on an ongoing basis, to understand how the actual practice of the company matches up with its proposed policy. This will help them take decisions over any recommendations the board may have for policy changes and inform their views on other governance issues.

One of the crucial aspects of the principles-based approach is that compliance should be an integral part of the way a company does its business – not an add-on. The FSA expects senior managers of companies to be involved in ensuring compliance. This is something of a departure from traditional compliance systems and the AIC is keen to provide guidance which will help those unaccustomed with considerations of this nature to be fully and productively engaged in developing investment policies.

This guidance is designed to help investment company boards develop investment policies that both comply with the new rules and provide the best quality information for shareholders. We anticipate it will also be of help to company secretaries, professional advisers and other stakeholders with an interest in the construction of investment policies as required under the new rules.

Who do the rules apply to?

The rules requiring the publication of investment policies apply to all closed-ended investment companies which are listed under Chapter 15 of the Listing Rules (which now incorporates VCTs).

They do not apply to companies admitted to the Official List under Chapter 14 or Chapter 6, AIM traded investment companies or those without a listing in the UK.

Is the term “investment policy” defined?

In keeping with a more principles-based approach, there is no formal definition of the term “investment policy”. This gives boards some flexibility over how they approach this matter. However, the rules do set out various requirements for the statement (see “*What issues does a policy have to cover?*”) which highlight the fact that an investment policy should provide an overview of what the company is likely to invest in, how the portfolio will be managed, and what risks the investor may be exposed to (particularly in relation to gearing).

The FSA has provided further insight into how policies should be presented by saying that an investment policy should:

“not be expressed in difficult-to-understand legalese or technical jargon that only asset management professionals understand ... the language should be firm so that it binds the company to its chosen course of action.” (List!, Issue 17, 2007, page 5)

We would also note that, as well as publishing the full text of an investment policy in the annual report (LR 15.6.2(5)), the Listing Rules also require companies to set out in their reports how they have invested their assets with a view to spreading investment risk in accordance with its published investment policy (LR 15.6.2(1)). It will be worthwhile keeping this obligation in mind when the investment policy itself is being constructed.

What issues does a policy have to cover?

All published investment policies need to meet the following rule:

LR 15.2.7R An applicant must have a published investment policy that contains information about the policies which the closed-ended investment fund will follow relating to asset allocation, risk diversification, and gearing, and that includes maximum exposures.

The following guidance also applies:

LR 15.2.8 G The information in the investment policy, including quantitative information concerning the exposures mentioned in LR 15.2.7R, should be sufficiently precise and clear as to enable an investor to:

- (1) assess the investment opportunity;*
- (2) identify how the objective of risk spreading is to be achieved; and*
- (3) assess the significance of any proposed change of investment policy.*

What must be disclosed in relation to asset allocation?

The asset allocation disclosure is likely to be heavily influenced by the objective of the company. It should seek to describe, in general, what assets the company will be exposed to.

Where an investment company has a relatively narrow objective, say UK smaller companies, the policy would not address international spread, but might wish to address market capitalisation (to clarify what is meant by smaller companies) or sector spread.

Where an investment objective is broader, say global remits, the policy is more likely to concentrate on higher level issues such as geographic or sector spread. Narrower criteria, such as limits on individual stocks, may be less relevant in terms of asset allocation, though they will still be important to demonstrate how risk spreading will be achieved.

The critical issue is that the policy should allow investors to understand the type of assets the company is likely to invest in.

What has to be disclosed in relation to risk diversification?

For many companies, the discussion of asset allocation may be sufficient to describe how risk has been diversified. Where broader criteria (such geographic or sector allocations) do not adequately describe the approach to risk diversification adopted by the company it will be more likely that the investment policy will have to 'drill down' into the details of the number of stocks held, or the percentage of the portfolio which would be invested in any one stock, to adequately describe its 'risk diversification'.

A board may choose to include other information on risk, for example, on its hedging strategy, which is not strictly related to risk diversification. This may be appropriate where these details are critical to investor understanding of the company's activities. If it is not germane to an overall understanding of the activity of the company, this information need not be disclosed.

In considering whether or not the information on risk diversification is suitable, boards may also wish to consider how it relates to the required disclosures on maximum exposures (see *"How should disclosure of 'maximum exposures' be approached?"*, *"Can disclosure of limits 'on acquisition' meet the requirement to publish maximum exposures?"* and *"What 'maximum exposures' must be included"*).

What information on gearing has to be disclosed?

Boards should seek to disclose their gearing policy as clearly as possible. The rules do not define specifically how this should be done – this is a matter for issuers.

The key gearing disclosure is likely to involve the amount of borrowing a company will take out for investment purposes (i.e. 'financial' gearing). The policy should include the maximum financial gearing a company is prepared to adopt. In considering this issue, the board may wish to take account of both the maximum allowed by the company's constitution/articles (if any has been set) and any other ongoing limitations established by the board before reaching a conclusion on setting a published maximum.

Gearing arising from the company's share structure need not be described, as it is unaffected by decisions that the board or manager might take in connection with the management of the portfolio and is not therefore part of the 'investment policy'.

If the company has a policy to invest in other investment funds, or instruments which are themselves geared, it may be necessary to make some disclosures on how the company manages this gearing risk. As calculating the precise level of gearing that the company is exposed to is likely to be impossible (as the gearing in the underlying investments is constantly changing), these disclosures (if included) may be more likely to focus on any policies the company has which limit the total investment into such funds or instruments (see *"What about policies on cross-holdings?"*).

What about policies on cross-holdings?

The rules do not explicitly require an investment policy to address the company's approach to investing in other closed-ended investment companies (cross-holdings). However, if the company does invest in other closed-ended funds, its exposure to these vehicles is likely to be relevant to describing its general approach to risk diversification.

In considering whether or not cross-holdings should be addressed in the investment policy, a board may wish to reflect on the requirements of LR 15.2.5 (which establishes limits on cross-holdings by an investment company depending on published investment policies of the closed-ended funds which it might hold in its portfolio).

To help investors understand the extent to which the company is cross-invested, and to maximise the scope for other investment companies to make purchases of its shares, a board may choose to

address the company's approach to cross-holdings in the published policy even where it is not strictly required.

How should disclosure of 'maximum exposures' be approached?

The investment policy must include various 'maximum exposures'. However, there are no rules prescribing how these maximum exposures should be formulated and what they need to be applied to, providing that these, in conjunction with the rest of the investment policy, meet the conditions set out in LR 15.2.8.

To reduce the risk of breaching the obligation in LR 15.4.2 (to ensure that the company invests and manages its assets in accordance with its published investment policy), boards may wish to consider setting high maximum exposures.

Where gearing is concerned, the company will need to take into account market volatility, and any other activities that affect the company's gearing, such as share buy-backs, when setting a maximum exposure which provides sufficient headroom to avoid breaching this maximum exposure.

Where asset allocation and risk diversification are concerned, the same general principle applies. (Except where an on-acquisition approach has been adopted) maximum exposures should be set with sufficient headroom such that they cannot be breached through market movements. In some cases (e.g. where the company is likely to have a significant exposure to certain asset classes) this may mean having to set the maximum exposure at 100%. Certainly, it is very likely that the total maximum exposures will exceed 100% of the portfolio (perhaps by a number of times). The potential need to set high limits reflects the reality of providing for a 'hard' maximum exposure in the context of volatile markets.

However, it is not appropriate to publish high maximums simply to meet the technical requirements of the rules if this disclosure conflicts with the overall obligation to provide consumers with a realistic view of how the objective of risk spreading will be achieved and allow them to assess the investment opportunity offered by the company (as required in LR 15.2.8). Boards will therefore need to consider the broader context within which maximum exposures are set, and what supplementary information needs to be included in their investment policies to meet the broader requirements of LR 15.2.8. As this supplementary information is not required to meet the 'maximum exposures' requirement, it can be set in 'softer', more conditional, terms.

One approach might be to include additional information explaining the anticipated asset allocation or gearing, or ranges in which the likely levels can fluctuate, or other parameters within which the manager is expected to operate in normal market conditions. Such explanations might usefully be caveated by saying that the actual holdings and/or asset allocation will depend on market conditions and the judgement of the board of what is in the best interests of shareholders.

The advantage of combining 'hard' and 'soft' information is that it may be possible to provide shareholders with a more useful guide as to how the portfolio will be invested in normal market conditions, but without any regulatory concerns if it is necessary, on occasion, to exceed any declared parameters. Similarly, it may be easier to alter these parameters to reflect changing market conditions without this amounting to a material change of investment policy requiring shareholder approval. This approach is likely to maximise the value of investment policies to consumers.

Can disclosure of limits 'on acquisition' meet the requirement to publish maximum exposures?

Any maximum exposure expressed in the policy can be disclosed on an 'on acquisition' basis. That is, the limit can be set as a percentage of the total portfolio when the assets in question are purchased or when the gearing is taken out. The FSA has stated:

"Maximum exposures' can be either "at acquisition" limits or limits which apply at all times depending on what the board deems is appropriate, taking into [account] a fund's investment strategy and objectives. The policy should be clear either way." (List!, Issue 17, 2007, page 4)

However, if an 'on acquisition' approach is adopted, it is likely that further information will be required on how risk spreading will be achieved in practice, as actual holdings could diverge significantly from the percentage limits disclosed. This will be important to ensure that investors are given a sufficiently precise and clear view of the company's approach.

What 'maximum exposures' must be included?

The requirement to include maximum exposures applies to asset allocation, risk diversification and gearing.

All investment policies should include a gearing maximum exposure.

All investment policies should also, at the least, include a maximum exposure for asset allocation or risk diversification. In many circumstances a policy should incorporate maximums on both asset allocation and risk diversification to be compliant.

One maximum exposure in these areas might be permissible where it, in conjunction with the other disclosures included in the policy, provides sufficient information to fulfil the objectives of LR 15.2.8 G, i.e. the policy as a whole is sufficiently precise and clear to enable an investor to "assess the investment opportunity" etc.

Other than in very exceptional cases, a maximum exposure on individual holdings (used to describe risk diversification) will be required to ensure an investment policy is compliant.

Where a maximum exposure on individual holdings is disclosed it may be possible for a compliant policy not to include a maximum exposure on asset allocation. If this approach is taken, the board must be confident that the rest of the policy includes sufficient information to allow investors to assess the company's approach to asset allocation.

The exceptional circumstances where a maximum exposure for asset allocation would be sufficient on its own for a policy to be compliant (and therefore mean that a maximum exposure on individual holdings is not needed) would arise where the asset allocation figure, in itself, indicates a maximum exposure for individual holdings which is sufficiently detailed to explain the company's approach to risk diversification. This would be most likely where the figure for asset exposure is low.

So, for example, a policy might state that the company intended to invest in 25 European countries and have a maximum exposure of 5% in each country. (This, in effect, sets a maximum holding at 5% although it is expressed in terms of asset allocation.)

How long should a policy be?

It is a matter for boards as to how much detail they wish to provide in their investment policy. However, the AIC believes that, if policies are expressed in a simple and clear way, the essential information could be conveyed, in most cases, by relatively short investment policies (e.g. no more than a page in length).

Should I include information on the current position of the investment company in terms of asset allocation, diversification, gearing etc in the investment policy?

The investment policy is designed to show how a company intends to invest its assets. It is not supposed to be a 'snapshot' of the current portfolio.

Therefore, while this type of information is useful for shareholders to have (and indeed the company is required, under LR 15.6.2(1), to explain how it has invested its assets with a view to spreading investment risk in accordance with its published investment policy), boards should not include this information in the company's investment policy.

The Listing Rules require the company to set out the "full text" of the investment policy in the annual financial report. They also impose obligations on a company to seek shareholder approval for a material change to the policy. Therefore, including information that relates to the current composition of the portfolio might create confusion as to what is part of the company's formal investment policy and what is not. It could also confuse understanding over when shareholder approval will be required to change a policy.

It may therefore be more appropriate, if the board wants to draw attention to the current position of the company, for the investment policy to be followed by a note explaining where information on current investments can be found elsewhere in the annual report.

Can investment policies simply be published on the company's website?

The full text of the investment policy must be published in the annual financial report. Cross-references to other sources (say, to a website) cannot be used in lieu of including the full text. Of course, as long as this material is included in the annual report, it may also be useful to publish policies on a website, particularly as investors are increasingly using the internet as a means of researching investment companies.

Where should I locate the investment policy in the annual report?

As the investment policy will be a very important piece of shareholder information, boards may want to put it near the front of the report and accounts. However, there are no formal requirements and it can be located anywhere.

Are there restrictions on altering a published policy?

Under LR 15.4.8 material changes cannot be made to investment policies without shareholder permission. This is not a new requirement, and the old rules imposed a similar obligation. The Listing Rules do not define 'material', and it is for the board to determine this in the context of the company's existing investment policy. Changes to an investment policy are more likely to be material when they are intended, or will allow, the portfolio to be managed in a way that shareholders would consider was materially different to prior practice.

Boards should be aware that LR 15.4.9 states that, in considering what is material, they should have regard to the cumulative effect of changes since shareholders last had the opportunity to vote on the investment policy or, if they have never voted, any changes in approach since its admission to listing.

Must shareholders approve the new-look investment policy on publication?

Only in certain circumstances. The FSA has said that where:

"the new style investment policy simply describes the existing position with greater clarity (or adopts more conservative limits) [this does not represent a change of policy]. So for example, merely importing the

diversification limits the company has always observed under VCT legislation would not be considered a material change to the previous policy.” (List!, Issue 17, 2007, page 4)

So, for example, if before the introduction of the current rules the company had no maximum exposure for asset allocation (i.e. its maximum exposure was effectively 100%), and only a small allocation to the relevant asset class (e.g. 10%) but then decides (to meet the requirement of the Listing Rules) to introduce a high maximum exposure (e.g. 50%), this is unlikely to amount to a material change requiring shareholder approval. However, where a company (with 10% gearing in place) wants to increase its potential maximum gearing from 20% to 50% (albeit that it had no plans to change its actual level of gearing for the foreseeable future), this might amount to a material change, as the capacity to gear up would have been significantly changed.

So, if previous disclosures were set out in general terms and the new policy includes more specific information which simply clarifies the existing approach, publishing the new-look policy is unlikely to be material and will therefore not need shareholder approval.

What regulatory risks do these rules create?

There are three main ways in which a company might risk breaching the rules relating to new-look investment policies:

- by failing to publish a compliant policy (e.g. where the policy fails to include any maximum exposures or is not sufficiently clear and precise)
- by failing to comply with the terms of its investment policy (e.g. by allowing a ‘hard’ maximum exposure to be exceeded)
- by failing to seek shareholders’ approval for a material change to its policy

To help manage these risks, boards should create a clearly labelled policy. The policy should be focussed on investment issues and not include extraneous, irrelevant material. They should also ensure that any ‘hard’ maximum exposures are set with suitable headroom. However, they must still comply with the overall requirements of the rules, namely giving consumers sufficient information to assess the investment opportunity etc.

Boards should bear in mind that the overall purpose of the disclosure is to provide shareholders with a clear view about how the assets of the fund will be invested and other relevant information, for example, on gearing.

Can the board ask the FSA to 'sign-off' the company's policy?

The FSA will not 'approve' investment policies of currently listed investment companies in advance of publication. However, it has stated:

"The UKLA's helpdesk will be available as usual to help issuers who, due to unusual circumstances, have problems formulating their investment policies. However, we will not expect advisers to seek approval of their investment policies with the UKLA if issues and their advisers are confident they have satisfied the new rules." (List!, Issue 17, 2007, page 5)

Boards will have to take their own view on whether or not their policies are compliant, although the FSA will be able to provide some assistance in certain circumstances.



Association of Investment Companies

24 Chiswell Street
London EC1Y 4YY

Telephone 020 7282 5555

Fax 020 7282 5556

enquiries@theaic.co.uk

www.theaic.co.uk

August 2008

Issued by the Association of Investment Companies.

Registered in England No. 1910539. Vat Registration No. 397 2771 04.