Competition, proportionality, and better results for consumers

AIC submission to Review of the UK funds regime: call for input

Executive summary

A successful review of the UK funds regime should seek to:

- Maximise effective competition between products in the public interest;
- Balance high standards with proportionality;
- Create an outcome focussed, consumer orientated, regulatory culture; and,
- Recognise the international character of asset management.

Three priorities for early action, which will demonstrate a commitment to the goal of effective competition in the public interest, should be:

- Removing tax distortions affecting investment companies;
- Requiring firms to justify their product design choices for authorised open-ended investment funds; and,
- Enhancing Independent Financial Adviser (IFA) standards.

The questions raised by the Call for input highlight the risk of focussing too much on creating new structures (notably the Long-Term Asset Fund (LTAF)) instead of addressing other, more fundamental, issues. The UK funds market is potentially biased towards the commercial interests of product providers over the interests of consumers and the economy. For example, the open-ended sector relied on commission to support its distribution. This, alongside other commercial factors, has favoured these funds over others that might secure better investor outcomes and act as a more effective conduit of capital into UK businesses (see Fig 1 and Fig 2 for data).

Independent authorities have offered a similar perspective. The Bank of England's Financial Policy Committee (FPC), in a discussion on open-ended property funds, recently noted that "*other structures, such as closed-ended funds, may be more appropriate vehicles for investing in certain illiquid assets*".

A key question for the review should be 'why have open-ended structures been favoured when this may not be the best option for the investment strategy being considered?'

Investment companies are an important part of the UK's funds market. They can be a source of competition in the public interest, deliver better returns and help differentiate the UK's financial services industry. Yet too often the policy and commercial environment suggests a different, more negative, perspective (demonstrated, for example, by the tax treatment of investment companies and the identification of some of them, without justification, as being Non-Mainstream Pooled Investments (NMPIs)).

The decision to seek views on investment company launches is a welcome signal that policymakers' attitudes have the potential to change. Delivering the recommendations made in this submission would be an important step towards making such a change a reality.

Context

The Association of Investment Companies (AIC) is a trade body for the closed-ended investment company sector. We represent 360 investment companies, managing assets of some £240 billion. The AIC's members are predominantly listed on the Main Market of the London Stock Exchange. Some have shares admitted to trading on the Specialist Fund Segment; others are quoted on AIM. The AIC's members include investment trusts, Venture Capital Trusts (VCTs), UK Real Estate Investment Trusts (REITs) and non-EU companies. Our non-EU members are primarily incorporated in Guernsey and Jersey.

Investment companies offer access to a diversified portfolio and can hold assets including listed equity, unquoted shares, property, infrastructure, venture capital and debt (including business-to-business loans).

Investment companies offer attractive options to increase diversification, provide alternative sources of income and secure superior returns. They also create a significant source of potential competition in the market, notably with authorised open-ended funds. They are widely held by retail investors.

Objectives of the review

The AIC **recommends** that, in developing the funds regime, policymakers should have regard to the objectives set out below:

- **Maximise effective competition between products in the public interest:** Previous reviews of the asset management sector (notably the Financial Conduct Authority's (FCA) Asset Management Market Study) identified low levels of competition, particularly on pricing. Achieving a more competitive market will create incentives for keener pricing and higher standards. This will enhance the capacity of the asset management sector to deliver better outcomes for consumers and secure business internationally.
- **Balance high standards with proportionality:** Too frequently the debate over the UK's regulatory approach is focussed on calls for 'international competitiveness'. This commercial preference is too often shorthand for fewer regulatory obligations. It is raised without proper regard to achieving standards that will deliver consumer protection and financial stability. Instead of being led by rules applied in other jurisdictions, the goal should be achieving the right balance. Standards must be maintained to protect against regulatory risks. Regulatory requirements must be proportionate, so they do not act as an unnecessary drag on the asset management sector.
- **An 'outcome-focussed' consumer orientated regulatory culture:** Detailed rule making has not always delivered effective regulation. Too often specific obligations can be delivered without securing the regulatory intention. A better approach will involve regulating to identify required outcomes and creating a culture which prioritises effective compliance and the consumer interest alongside the business achieving its commercial objectives. This will avoid unnecessarily restrictive and granular rules while producing more effective outcomes which deliver required standards and attract consumer confidence.
- **Recognise the international character of asset management:** The review should recognise the value of the asset management sector having strong links with other financial centres. The investment company sector is significantly enhanced by its partnership between UK providers and the Channel Islands. Asset management firms work with companies and service providers based in Guernsey and Jersey to launch and manage

investment companies incorporated there. This has helped develop new investment propositions and offered new opportunities to investors. This is supported by a similar regulatory approach and common commitment to high regulatory standards. Partnerships such as these benefit all jurisdictions and add to the global impact of the UK's asset management sector. Preserving and enhancing these links should be a priority.

The AIC **recommends** that these objectives should inform HM Treasury's (HMT) approach. This will ensure the review delivers for both producers and consumers. Ultimately, it will support a more commercially sustainable and effective asset management sector.

The UK investment company sector

The investment company sector is a unique part the UK's funds offering. It is not replicated in the EU. Most EU member states have no investment companies available (quoted on their own public markets) or domiciled there. Those that do tend to have a handful of companies at most. As a result, the sector's interests have traditionally not been fully recognised in European policy making processes (despite welcome efforts by the UK authorities to support it). In contrast to the EU, the UK has some 400 investment companies. They hold a wide range of asset classes and are purchased by both retail and institutional investors. This experience provides a foundation to build the sector further and enhance the offer made by the UK asset managers to domestic and international investors.

Investment companies are supported by a variety of asset management firms and related service providers (lawyers, accountants, administrators, registrars etc.) They make up a substantial number of the companies quoted on UK stock markets.

Investment companies have the capacity to pioneer new asset classes. Traditionally, they have been some of the first investors in emerging geographic markets. In these situations, even where investments are quoted, liquidity in the shares can sometimes be thin. Investment companies are better suited than other structures, for example open-ended funds, to holding a portfolio of such assets. In the last thirty years, investment companies have also increasingly provided exposure to inherently illiquid asset classes in the UK, such as infrastructure, direct property, growth and venture capital, and private equity.

The structure is also well suited to other emerging asset classes, such as intellectual property rights and investment strategies seeking Environmental, Social and Governance (ESG) outcomes.

Investment companies are well suited to supporting the government's productive finance agenda, which is seeking to mobilise new sources of capital to invest directly in UK businesses to support further growth. The suitability of the structure for this type of investment is demonstrated by the experience of VCTs. VCTs were launched in 1991. They are supported by tax reliefs for retail investors to channel investment into SMEs with the potential for future growth. This investment helps bridge the structural 'finance gap' which makes it difficult for smaller, inherently risky, businesses to secure long-term investment.

With appropriate support from the UK's policy and regulatory authorities, including rules which promote greater competition in the public interest, investment companies have the potential to make an even greater contribution to the UK's funds and asset management sector by offering differentiation, reliable access to private markets, high standards and superior returns to investors over the long term.

Fair taxation of collective investment undertakings

UK policy traditionally ensures tax neutrality for the end investor, such that an individual or institution investing through a fund will be in a similar tax position as if they had invested in the underlying assets of the fund directly.

To deliver this policy objective, and support competition in the public interest, reforms are required to remove significant discrepancies in the tax treatment of investment companies so that they are not subject to more tax than their competitors. Investment trust companies, UK-REITs and unit trusts and Open Ended Investment Companies (OEICs) are all UK tax-favoured vehicles designed to encourage investment in a diversified portfolio of assets. Whilst their structure and legal characteristics may differ, they serve the same fundamental purpose. There should be a level playing field between the different types of collective investment undertakings as far as tax is concerned.

Reforms have helped secure greater tax neutrality for investment companies in recent years. This includes the abolition of VAT on management charges for investment trust companies, the introduction of the whitelist for investment trust companies as well as unit trusts and OEICs, the introduction of the investment trust streaming regulations and changes to the personal portfolio bond legislation which allowed these wrappers to hold non-UK investment companies. These measures have brought investment companies closer to the preferential position of open-ended funds.

Nonetheless, it remains a disappointment that investment companies have traditionally had to 'catch up' to the position allowed for their open-ended counterparts. An important outstanding area is Stamp Duty, where investment companies suffer from a significant, prejudicial tax position. The AIC **recommends** that, as a priority, this distortion between the vehicles should be removed (see our response to Q2 for details). This will create a fairer tax position for investors, support the commercial attractions of investment companies, and maximise competition in the public interest. It will also support UK public stock markets as UK investment companies make up such a significant proportion of total listings.

Distribution

As long as proper standards are maintained, there should be no regulatory preference in the type of fund structure that is distributed to the same class of investors. A distribution environment which is agnostic on fund structure will support more effective competition in the public interest. Consumers will benefit from an environment where different products (including investment companies) compete on their merits. They will have better opportunities to secure better returns in accordance with their appetite for risk, more competitive charges, and diversification of assets. The current structure of fund distribution, which for so long included commission payments to IFAs, has not secured this outcome.

Banning IFA commission, delivered by the Retail Distribution Review (RDR), was an important milestone. It removed a significant conflict of interest which had previously influenced the advice process. It resulted in an increase in investment company recommendations by IFAs, suggesting that some are considering a wider range of products. More needs to be done. The end of commission was an important first step towards achieving distribution that recognises the merits of different fund offers, but it was not the end of the journey.

Evidence suggests that the initial positive gains made by the RDR have stalled. The AIC estimates that fewer than 10% of IFAs ever recommend investment companies. It is difficult to believe that the remaining 90% have no clients for which investment companies could be suitable. This seems unlikely given the propensity of self-directed investors to purchase investment company shares. Along with many wealth managers, self-directed retail investors often buy investment company shares. Recent research, looking at the ownership of investment company shares, has shown that direct to consumer (D2C) investors are the most significant buyers of investment company shares, purchasing 35% compared with only 2% of investment company shares held via adviser platforms.

The lack of consideration of the sector by many IFAs does not seem to be compatible with their obligations to provide independent advice. Their disregard for the sector in turn reduces competition in the public interest in the investment product market. The AIC **recommends** that IFAs should be given clearer regulatory obligations to consider the full range of products when they are making client recommendations (see Q24 for further discussion).

Creating conditions that require IFAs to consider investment companies would also create incentives for parts of the distribution chain. While more platforms now offer investment companies, they are not always presented in an optimum way. For example, they may not be included in searches alongside open-ended funds which are invested in the same asset classes. Clearer requirements for IFAs to consider investment companies may help break down structural barriers of this nature.

Q1 This call for input on the UK funds regime is necessarily wide-ranging. As the government would not be able to take forward all proposals immediately, what do you think the top 3 priority proposals should be for government implementation and why?

Various important policy areas have been excluded from this call for input. These include the Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs), the Markets in Financial Instruments Directive (MiFID) and the Alternative Investment Fund Managers Directive (AIFMD). The AIC understands that these will be examined separately and would encourage HM Treasury to review these rules as soon as possible. There is an especially pressing need to create a common disclosure framework for Undertakings for the Collective Investment in Transferable Securities (UCITS) alongside PRIIPs. See Q38 for further comment on these issues.

Notwithstanding these matters, the priorities for action following the Call for input should be:

- **Removing tax distortions for investment companies (including discriminatory stamp duty charges):** Early action to remove tax distortions (discussed in Q2) will signal that HM Treasury is prioritising competition in the public interest and providing a secure foundation for the development of more competitive products. The principle that there should be no double taxation where an investor uses a collective investment vehicle is well established. There is therefore no fundamental policy issue to be addressed. This will support a swift policy response. Adopting the tax reforms recommended by the AIC will make the UK a more competitive jurisdiction and widen the range of investment strategies which can be offered by investment companies without them experiencing unnecessary compliance burdens. Adopting these reforms will give asset managers more options to develop attractive products better able to appeal to domestic and international investors.

- **Require fund managers to justify the product design choices for authorised investment funds:** Requiring asset managers to adopt a more consumer centric decision-making process should be a priority. Public trust in financial services has suffered in recent years. Building confidence by making the consumer interest a priority in product design decisions will underpin industry efforts to provide reliable products and services to UK consumers while also financing the economy. Asking firms to justify their product choices (discussed in response to Q25) would be an important early step. It is a straightforward measure to impose. It will help secure better outcomes for consumers as well as supporting the commercial desire of producers to have a range of fund options available to them. It is an outcome focussed measure which encourages a broader change in culture within the asset management sector.
- **Enhancing IFA standards:** Facilitating the supply of more consumer-friendly products is only one part of the challenge for UK asset management. Enhancing the influence of the demand side is also a priority. Retail consumers, an important part of the market, are not always well placed to provide competitive pressure. They may lack the expertise and insight that can allow products to secure market share in comparison with lower quality offerings. Achieving higher standards in the adviser sector (discussed in response to Q24) could support a structural change on the demand side of the market with the potential to drive long-term improvements for all consumers. This could be a significant mechanism to deliver greater competition in the public interest.

Q2 How effective were recent reforms to UK funds taxation in achieving their aims? Please explain your answer. Could anything have made these reforms more effective, particularly in terms of increasing the attractiveness of the UK as a location to set up funds?

The reforms to the investment trust regime in 2012 were very successful. They supported an increase in the number of investment trust IPOs and higher levels of secondary fund raising. Before these reforms, fundraising in the UK had been very low.

The revised rules reduced compliance burdens for investment trusts, making them easier and more cost-effective to operate. These reforms were achieved without a detrimental impact on the Exchequer. They supported economic activity within the UK by asset managers and other service providers and contributed to tax revenues.

The modernisation of the investment trust regime allowed them to diversify their asset allocation and offer wider choice to investors. That said, there are a number of areas where the tax treatment of UK listed funds (investment trusts and UK-REITS) is inferior in comparison with their authorised counterparts and reform is required to maximise effective competition.

Stamp duty/SDRT

Investment trusts, VCTs and UK REITs, unit trusts and OEICs are all UK collective investment undertakings. Whilst their structures may differ, they serve the same fundamental purpose. They compete directly with one another. Investors should be in the same position in relation to transfer taxes, but they are not.

Before 30 March 2014, dealings in units or shares of an OEIC were generally subject to a special Stamp Duty Reserve Tax (SDRT) regime contained in Schedule 19 to the Finance Act 1999. Under this Schedule, there was a charge to SDRT at the rate of 0.5% of the market value of the unit if the unit was a chargeable security and was surrendered. A unit was surrendered when a unit holder authorised or required the trustees or manager to treat them as no longer interested in the unit, or the unit was transferred to the managers of the scheme (for example, on redemption).

The regime had been extended to OEICs, so that all references to units were interchangeable with shares in an OEIC. Following the abolition of Part 2 of Schedule 19 by the Finance Act 2014, the general SDRT charge under section 87 of the Finance Act 1986 continues to apply to transfers of units in unit trusts and shares in OEICs to third party buyers because they are chargeable interests for SDRT purposes, unless all the unit trust or OEIC's investments are exempt investments. It is not common for transfers to third parties to occur as investors generally realise their investment by redeeming the units or shares. The trustees or manager are often required to provide consent to a transfer to a third party and the investor is often required to first offer the units or shares to existing investors.

Stamp duty and SDRT are payable on the transfer or agreement to transfer shares in investment trust companies, UK REITs and VCTs. Dealings in units in unit trusts and shares in OEICs, whereby the units or shares are surrendered to the fund manager, are no longer subject to SDRT in practice.

There is no policy rationale for distinguishing the stamp duty/SDRT treatment of shares in investment trust companies, VCTs and UK REITs from shares in unit trusts and OEICs when all these vehicles serve the same investor need. The abolition of Schedule 19 has placed investment trusts, UK REITs and VCTs at a competitive disadvantage.

Notably, non-UK companies also benefit in comparison with their UK counterparts as they are also not subject to stamp duty on share transfers. In addition, the Finance Act 2014 abolished stamp duty and SDRT on unlisted shares and securities traded on recognised growth markets such as AIM and the NEX Exchange.

As previously stated, in order to encourage saving, it is a public policy presumption that there should be no double taxation so that the investor in the collective investment vehicle is in the same position as if they had invested in the fund’s underlying assets directly. This is a recognised objective of the review of the UK funds regime. The current approach results in an element of double-taxation, which also undermines the competitive position of investment trusts.

For direct tax, unit trusts, OEICs, investment trusts and VCTs pay no corporation tax on their chargeable gains. Unit trusts and OEICs that are bond funds are liable to corporation tax on income received but are entitled to a deduction when that income is distributed to the investors. Similarly, investment trusts can avail themselves of the streaming regime to achieve the same result. This ensures that investors receiving interest distributions from unit trusts, OEICs and investment trust companies are taxed as if they had invested in interest-bearing securities directly. UK REITs and Property Authorised Investment Funds (PAIFs) pay no corporation tax on the income from their qualifying property rental business or ring-fenced property rental business, respectively. Investors are taxed on the property income distributions received as if they had received income from property directly.

Investment trust, VCT and UK REIT shareholders pay stamp duty or SDRT when they buy their shares. The investment trust, VCT and UK REIT also pays stamp duty or SDRT or Stamp Duty Land Tax (SDLT) when they purchase their underlying investments. This leads to double taxation for the investor owning shares in closed-ended collective investment vehicles.

HMT's UK Investment Management Strategy published in March 2013 stressed the importance of the investment management industry as a major source of funding for the economy, a significant provider of high value-added jobs and skills and providing liquidity to global markets and services to investors on every continent. The strategy stated that, despite its dominant position in AUM, over the last ten years the UK had lost ground to both Luxembourg and Ireland as the leading location for European fund domicile. It also stated that the UK was under competitive pressure from jurisdictions outside the EU.

The Investment Management Strategy aimed to enhance the UK's share of fund domicile. The abolition of Schedule 19 was part of that strategy. When the abolition of Schedule 19 was announced in the 2013 Budget, the intention was to support the government's objective of making the tax system more competitive by making the UK more attractive as a domicile for certain collective investment schemes. Schedule 19 had been identified as a major deterrent to domiciling funds in the UK, with a particularly damaging effect on the ability of UK funds to attract non-UK investors. That reasoning should hold true in relation to closed-ended investment companies. It provides the basis for a number of additional reforms.

The AIC **recommends** that the stamp duty/SDRT treatment of shares in investment trust companies, VCTs and UK REITs be equalised with the position applying to unit trusts and OEIC shares.

Note, the AIC **recommends** the treatment of UK REITs should be equalised only where those issuers are collective investment undertakings and which fall within the scope of relevant regulation (for example, where they are Alternative Investment Funds (AIFs) for the purposes of the AIFMD or where they are listed under Chapter 15 of the Listing Rules). This will ensure that the relevant tax treatment is extended only to those UK REITS which are collective investments, competing in the funds market. This will prevent trading companies with REIT status gaining an inappropriate benefit in comparison with other trading companies.

If the AIC's recommendation on the abolition of stamp duty/SDRT on transfers of shares in investment trust companies, VCTs and REITs is not accepted, the AIC **recommends** that, as a minimum, share buy-backs should not be subject to stamp duty on form SH03 filed with Companies House. This would support improved liquidity of the investment trust sector and enhance its attraction to a broader range of investors.

Also, if the primary stamp duty/SDRT recommendation is not adopted, the AIC **recommends** that, when a reconstruction of investment trusts, VCTs or REITs or indeed, open-ended funds (see below) occurs, whereby the underlying assets of the vehicle being reconstructed are transferred to the new vehicle in exchange for an issue of shares, that transfer is exempt from transfer taxes. This would include SDLT on the transfer of real property in the same way that the Stamp Duty Land Tax (Open-ended Investment Companies) Regulations 2008/710 provided for an exemption from SDLT on the conversion of an authorised unit trust to an OEIC or the amalgamation of an authorised unit trust with an OEIC. The SDLT charge on the reconstruction of closed-ended property vehicles is a particular disincentive. Clearance from HM Revenue and Customs (HMRC) could be required, if necessary, to exempt that transfer. Such a measure would support the rationalisation of the sector in circumstances where the market capitalisation of the vehicle does not justify the costs of running the vehicle concerned and a reconstruction is considered appropriate.

Tax efficient reorganisations

For the most part, a tax efficient reconstruction of a closed-ended vehicle to another collective investment vehicle, including an open-ended vehicle, is possible. This can be achieved for shareholders or unitholders and for the vehicles themselves. The exception relates to transfer taxes on the underlying investments (see above).

On the reconstruction of a closed-ended investment company, it is common for investors to be offered a range of different rollover investment options on the winding up of the investment company, including other closed-ended investment companies as well as open-ended investment companies and a cash exit.

Under the current terms of the FCA Handbook (COLL 7.6.2), it is only possible for an authorised investment fund vehicle to reconstruct to another authorised fund or regulated collective investment scheme. This would not include a closed-ended investment company.

The FCA is currently considering longer notice periods for daily-traded open-ended property funds. An authorised fund investing in property could see a number of investors wanting to exit the fund on implementation of longer notice periods. It may be that some authorised property funds will no longer be sustainable.

Converting these funds to, say, a REIT could be a suitable option in some situations. The viability of this would depend on regulatory approval being facilitated and also a SDLT exemption being put in place. The AIC **recommends** that the FCA Handbook allows the reconstruction of authorised open-ended funds into closed-ended vehicles and that HM Treasury enacts an exemption from transfer taxes, including SDLT, on the transfer of underlying investments from an authorised open-ended fund to a closed-ended investment company.

The AIC also **recommends** that consideration is given to facilitating the reconstruction of other vehicles such as limited liability partnerships into other vehicles in a tax efficient manner.

Non-dividend income

Investment trusts are taxed on non-dividend income. Whilst the streaming regime for investment trusts investing in interest bearing securities enables them to invest in debt securities in a tax efficient way, it does not enable investment trusts to invest in other income generating assets (such as property or copyright) in a tax efficient way without further structuring.

Two investment companies have been launched recently investing in music royalties. Both were domiciled and tax resident outside the UK although one has since become UK tax resident and sought investment trust status. Had they been investment trusts, they would have been liable to corporation tax payable on the royalty income in the absence of further structuring involving complication and expense. The current tax position means that investment trusts may not be tax efficient for similar emerging asset classes.

Receiving income from such sources is not inherently offensive. This must be the case as it is possible to construct arrangements to facilitate investment in them. However, the UK's ambition should be to allow this investment in the most straightforward way possible, with reduced complexity and cost while also protecting tax revenues.

One solution would be to give investment trusts the option to become exempt from corporation tax on income as well as chargeable gains. However, this would not be a sufficient measure on its own, as this approach could give rise to increased withholding of taxes on payments received from overseas companies.

An alternative solution is to provide investment trusts with the ability to opt into an equivalent regime to the Tax-Elected Fund (TEF) regime for authorised funds. This was intended to overcome the issues raised for balanced funds, by requiring the TEF to make two distributions: a dividend distribution and a non-dividend distribution. The call for evidence acknowledges that the take up of TEFs has been low and suggests that, in part, this is because of the availability of platform access to stream different income sources to investors.

The AIC **recommends** that investment trusts be given the option to elect for a similar TEF regime. The AIC also **recommends** that, if any alternatives to the TEF regime are introduced for authorised open-ended funds as a result of this call for input, similar capacity to opt into the regime is given to investment trusts to maintain competition between the two structures.

Inheritance Tax

Section 186(1) Finance Act 2003 amended section 6 of the Inheritance Act 1984 to extend the list of excluded property to include a holding in an authorised unit trust and a share in an OEIC. This means that the estate of an individual domiciled outside the UK would not pay inheritance tax on unit trusts and OEIC investments but would pay inheritance tax on investment trust shares.

This issue is of increasing significance as pension freedoms, for some, has reduced annuity purchases and increased exposure to collective investments in the drawdown phase of retirement. Investment trusts have significant income advantages over open-ended funds, which should be an important consideration for retirement planning. Investors may be discouraged for inheritance tax planning purposes from choosing the optimum investment mix. This reduces effective competition in the market for collective investments. It may also mean that those in retirement have lower incomes (which attract income tax) than would otherwise be the case. This is a poor outcome for individuals and the Exchequer as well as a restraint on effective competition.

The AIC **recommends** that section 6 of the Inheritance Act 1984 should be extended to include shares in investment trusts, VCTs and UK REITs as well as investments in OEICs and unit trusts.

Minimum distribution

Some investment trusts seek capital returns and do not actively seek to secure income. They may, nonetheless, be in receipt of income in some situations. The current rules allow for a minimal amount to be retained (with no proportion distributed). This helps manage the consequences of small amounts of unexpected income. It removes the need to make potentially tiny distributions to investors, for whom the amount is not significant or the purpose of investment but may create a need to disclose tiny amounts on their tax returns. The administrative costs in making small distributions, including, for example, postage costs, could even outweigh the amounts received by some retail shareholders. The exemption is a sensible measure which reduces administrative complexity and costs. It achieves its objectives without any meaningful reduction in Exchequer revenues. It exemplifies proportionality in action.

The current level of income which can be received without distribution being required is £30,000. This amount has not been increased since the investment trust regime was modernised in 2012.

The AIC **recommends** that the level be increased to £100,000. To maintain the policy, and ensure it remains set at a sensible level, the AIC **recommends** that this amount be increased automatically on a regular basis: say, by 5% every 3 years or annually, say, by 2%.

Close company test

One of the requirements of investment trust status is that the company is not a close company, as defined by section 439 of the Corporation Tax Act 2010 (CTA 2020). A breach of this requirement is a serious breach which will give rise to loss of investment trust status.

It is also a requirement for REIT status that the REIT is not a close company. However, there is a modification to the definition of close company status for this purpose. The company must not be ‘close’, or it is ‘close’ only because it has a participator that is an institutional investor (section 528 CTA 2010). The list of institutional investors is given at S528(4A) CTA 2010 and includes:

- Trustees or managers of authorised unit trusts (or overseas equivalents);
- Pension schemes (as defined in the Finance Act 2004 S150(1));
- Insurance companies;
- Charities;
- Limited partnerships;
- Registered social landlords;
- OEICs; and
- UK REITs and overseas equivalents.

The amendments made by the Finance Act 2012 allow a company to be close for the first three years of being a REIT.

The non-resident capital gains tax (NRCGT) provisions relating to UK land for collective investment vehicles (CIVs) in Schedule 5AAA of the Taxation of Chargeable Gains Act provides an exemption for CIVs from NRCGT if they meet the relevant qualifying conditions. CIVs which are companies need to meet the recognised stock exchange condition and the non-close company condition. The non-close company condition is that at any time, it:

(a) is not a close company, or

(b) is a close company but only because it has a qualifying investor as a direct **or indirect** participator. (Emphasis added.)

A qualifying investor is defined to include entities within section 528(4A) of CTA 2010, with some modifications to ensure that such entities are widely held.

In the second asset holding company consultation, the government noted that there are several changes to the REIT rules that could be made alongside the introduction of the Asset Holding Company (AHC) rules. It was, therefore, seeking views on (among other things) other types of investors that can be added to the institutional investors list.

The AIC **recommends** that the close company test for investment trusts follows the close company test for REITs. A rationalisation of the test across different vehicles would provide clarity and promote consistency. It would enhance the attractions of the UK.

The AIC also **recommends** that some modifications are made to the close company test for investment trusts, REITs and CIVs opting for the exemption election from NRCGT to facilitate the holding of shares by overseas institutional investors, such as overseas pension schemes, without the vehicle being deemed a close company.

Wealth managers and platforms increasingly own large holdings in investment trusts, REITs and CIVs investing in property on behalf of numerous individuals. The AIC **recommends** that it should be possible to look through these wealth managers to the underlying beneficial owners to ascertain whether the close company test is met.

The consequences of failing the close company test for investment trusts should also be reconsidered to provide flexibility on launching an investment trust, in much the same way as flexibility is given to a new REIT. The AIC **recommends** that the close company test for investment trusts should not be a requirement for the first three years.

Further, the AIC **recommends** that consequences of a breach should also be reviewed so that breach of the close company test is not a serious breach. Whether an investment trust is a close company or not is outside the control of the investment trust. The sanctions for breach of the close company test should be more proportionate.

Listing condition

A significant feature of the investment trust rules are the breach provisions, which provide latitude to HMRC when a compliance error is made. Without compromising the effectiveness of the regime, these provisions support appropriate and proportionate compliance obligations. Consideration should be given to making a small, but helpful, extension to this mechanism.

One of the eligibility conditions for investment trust status is the listing condition which requires that the ordinary share capital of the company must be admitted to trading on a regulated market. The AIC supports this condition and does not consider that the substance of this requirement should be changed.

Ordinary share capital is defined as:

> "*all the company's issued share capital (however described), other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company's profits.*"

Investment trusts occasionally issue subscription or C shares which subsequently convert into ordinary shares. Sometimes they issue different classes of shares which convert from one class of share to another class of share. The conversion ratio whereby the shares convert into another class will depend on the underlying Net Asset Value (NAV) of the respective share class. The mechanism by which the shares convert will often involve the issue of deferred shares. Deferred shares are usually given very small, fixed rights and are eventually repurchased by the investment company. Therefore, they do not usually need to be listed.

There have been instances where, due to an oversight occurring during the conversion, deferred shares have been left in existence or count as ordinary share capital where they have not been listed. This amounts to an unfortunate but essentially administrative error.

The AIC understands that the breach regime has not been available in these circumstances as it relates to a condition. Often a solution has been found by closing-off the accounting period of the investment trust concerned. This is not inherently offensive to HMRC, but it is complicated to resolve and creates anomalies in the accounting approach. Rather than require these complex mechanics, the AIC **recommends** that HMRC should have greater powers of flexibility to deal with such a situation.

Change to investment policy

A change in investment policy of an investment trust requires notification to HMRC, even where the change is not significant and does not require shareholder approval in accordance with the Listing Rules. It has been the case that investment trusts have inadvertently failed to notify HMRC of an immaterial change to an investment policy which did not require shareholder approval. This is unfortunate but not inherently problematic from a tax perspective. The obligation itself is disproportionate and unnecessary. The AIC **recommends** that the notification of a change in investment policy should only apply where shareholder approval is required. This will remove an unnecessary compliance burden.

Corporate Interest Restriction

Many investments trusts gear or borrow money to invest in additional assets in anticipation that the investment returns will exceed the costs of the borrowings. This is a feature of investment trusts that can make them attractive to investors. Many investment trusts will have an interest expense below the proposed de minimis threshold. However, some of the larger investment trusts will have a level of gearing which could result in a net interest expense above the de minimis threshold.

Whilst a restricted interest expense may not be material for investment trusts with predominantly tax-exempt income, such as dividend income, it may be material for investment trusts with significant levels of taxable income, such as property income or royalty income. In any event, even if it is not material, it is a significant administrative and compliance burden to assess the amount of interest which is restricted.

The AIC **recommends** that the corporate interest restriction rules should not apply to investment trusts that fall outside the de minimis thresholds.

Q3 Why has uptake of TEFs been limited? Please explain any operational or commercial factors that have influenced their uptake. How could these be addressed?

The AIC has no comment.

Q4 How would the proposals in paragraph 2.9 improve tax efficiency of multiasset authorised funds? Please explain how the proposals would work in practice and how a proportionate impact on HMRC could be ensured.

The AIC has no comment.

Q5 Are there are any additional changes the government could consider to reduce tax leakage in multi-asset/balanced authorised funds?

As described in the response to Q2, the AIC **recommends** creating an opt in for a TEF equivalent regime for investment trusts. If an alternative to the TEF regime is considered for authorised funds, then an equivalent regime should be available to investment trusts.

Q6 Where funds are already tax neutral, how would a tax-exempt status for funds influence decisions about how and where to set up funds?

Depending on how the regime is established, one consideration might be the ability to claim treaty relief.

Q7 How would tax-exempt funds affect the competitiveness and attractiveness of the UK funds regime? Please explain your answer providing evidence and international comparisons where possible.

The AIC has no comment.

Q8 What would be the likely impact if changes were made to the REIT regime in the areas discussed in paragraph 2.16? To what extent could investment in the UK be expected to increase, and what would be the drivers for this? Could such changes be expected to impact the extent to which funds with UK and foreign property assets are managed in the UK?

Changes would make the UK REIT regime more attractive. However, the AIC is not in a position to quantify this. We would expect that it would increase the proportion of non-UK property held within a REIT.

Q9 Are there any other reforms to the REIT regime that the government ought to consider, and why?

Certain reforms to the REIT regime have already been consulted on in the second Asset Holding Company consultation. The AIC has not referred to those reforms in this submission. The AIC's response can be found here.

Capital allowances

One of the attractions of the UK REIT regime is the capacity to provide an income stream. This is a priority for many investors in a low interest rate environment. The requirement to distribute 90% or more of the income from the property rental business means that a dividend has to be split between a property income distribution (PID) and non-PID distribution on a quarterly basis as many UK closed-ended property companies pay dividends quarterly. The capital allowance reporting invariably lags behind the actual expenditure on the capital assets.

Section 599(8) Corporation Tax Act 2010 requires that any capital allowances which would be claimed under section 3(1) Capital Allowances Act 2001 are made automatically and reflected in the calculation of the profits of the UK REIT. As pooling and claiming capital allowances is mandatory, it can result in the tax adjusted property income for a given accounting period (from which the 90% minimum PID is paid) changing after PID and non-PID distributions have already been paid. If the level of tax adjusted property income reduces (as a result of additional capital allowances being claimed), this can mean that the PID element of the distributions already paid in respect of an accounting period becomes more than 100%. This issue can also arise in relation to other costs. For example, break costs associated with early repayment of bank debt that relates to property rental business, particularly if the break fees become payable towards the end of the accounting period.

The AIC **recommends** a review of the operation of the capital allowances regime for UK REITS which should consider the following options:

- that the requirement to calculate capital allowances is optional rather than mandatory;
- any excess PID payment for one accounting period is treated as satisfying the minimum PID requirement for a later accounting period.

Q10 Regarding the proposals covered in this call for input, are there any specific considerations that the government ought to take account of in the context of the UK's double taxation treaty network? Please provide as much detail as possible.

The AIC has no comment.

Q11 What are the barriers to the use of UK-domiciled LP Funds and PFLPs, and how might tax changes help to address them? Please provide detailed proposals and explain your answers.

The AIC has no comment.

Q12 What benefit does fund authorisation bring to product providers beyond access to retail investors? Does this benefit vary depending on the specific investor base or investment strategy? What relevance does authorisation of a product have to its appeal to the UK market and to the international market?

The AIC has no comment on this question.

Q13 Do you have views on the current authorisation processes set out in legislation and how they could be improved?

The AIC has no comment.

Q14 How do the FCA's timescales for fund authorisation compare internationally? Is there value in providing greater certainty about these timescales? Other than by reducing the statutory time limit, how could this be achieved and what benefits would it bring?

The AIC has no comment.

Q15 What would you like the QIS structure to enable you to do that is not currently possible? What are the existing impediments to your suggested strategies, and why would the QIS be the preferred UK structure for those strategies?

The AIC has no comment.

Q16 Do you think that the range of QIS permitted investments should be expanded? If so, in what way should it be expanded, what impact would this have, and would it still be appropriate for sophisticated retail investors?

The AIC has no comment.

Q17 Do you think that the QIS borrowing cap should be raised or QIS constraints on derivatives exposure should be relaxed? If so, to what magnitude and why? Would this be appropriate for sophisticated retail investors?

The AIC has no comment.

Q18 Do you agree that the QIS sub-fund structure could be improved? If so, how? Would greater clarity for the segregation of assets between subfunds via legislation or rules be helpful? Please provide details.

The AIC has no comment.

Q19 Do you agree that reforms to enhance the attractiveness of the UK funds regime should focus on appealing to the creation of entirely new funds that have not yet been set up?

No. There is commercial interest in creating new structures (for example, the proposed LTAF). Given this demand, there is no inherent problem with creating new vehicles if this is done with appropriate regulatory protection.

However, there is a risk that attention is being focussed on creating new structures at the expense of considering other, more fundamental, issues. To take the LTAF as a good example, it is difficult to see that there are any fundamental problems with existing structures where investment in illiquid and/or productive assets are concerned. Investment trusts provide a closed-ended market traded option. Qualified Investor Schemes (QIS) provide an open-ended option suitable for institutional investors. Non UCITS Retail Schemes (NURS) provide a further opportunity to invest in certain asset classes. It is difficult to identify a material benefit of the LTAF (particularly as the AIC considers that it is not likely to be suitable for retail investors).

The primary aim of the LTAF seems to be to encourage DC pension scheme investment into different, more illiquid asset classes. Achieving this is not primarily a question of creating a suitable collective investment vehicle. Other barriers, including trustees' appetite for these assets, are more significant. Resolving these issues is more likely to change investment practice and create opportunities for the asset management sector than creating an LTAF. The focus on fund structures is arguably seeking to treat the symptom without looking at the cause, an approach which is ultimately unlikely to be successful.

The debate over the LTAF is also a distraction because it is being promoted as a solution to the challenge of securing 'productive finance' for UK business. That is providing capital directly to companies to increase their productive capacity. This is an important ambition. However, it will not be served by the creation of the LTAF. The commercial ambition for supporters of the LTAF is for an open-ended fund able to invest in illiquid assets. This goal is not problematic in itself, as long as it is achieved within a suitable regulatory framework which protects consumers and maintains financial stability.

Illiquid assets are not synonymous with productive finance. Most illiquid assets are 'secondary', that is, traded between investors. In this situation no capital is received by the business. Many illiquid assets are located outside the UK. A key ambition of supporters of the LTAF is to invest overseas. None of these ambitions are inherently offensive from a policy perspective, but this would not provide productive finance.

More important than creating new regulatory structures would be to have a clearer focus on promoting competition in the public interest. Sharpening competitive incentives is more likely to deliver better long-term outcomes for all stakeholders.

If the ambition is to provide capital in 'productive finance' then this should be considered separately from the creation of a new fund structure, as existing structures could already deliver this capital. After all, the key issue is not the structure used; it is the incentives to make such investment in the first place.

Q20 Why do firms choose to locate their funds in other jurisdictions in cases where the UK's funds regime has a comparable offering, for example ETFs? Are there steps which could help to address this following the potential reforms to the UK funds regime discussed in this call for input, and would the scope to address this vary depending on the type of fund or target investor market?

The investment company sector is predominantly located within the UK and the Channel Islands. All these vehicles have close links to the UK as they are traded on UK stock markets and often work with UK-based professional service providers.

The development of the Channel Islands as a domicile for investment companies has been an important source of support for the UK asset management sector. It has increased its capacity to offer different options for structuring investment companies according to specific investment needs. The relationship with the Channel Islands has been particularly helpful in supporting the development of novel and illiquid asset classes.

While the goal of supporting domestic providers is important, the review should also recognise the benefits of the UK's close association with other jurisdictions: particularly those offering high standards and similar commercial perspectives. These links bring important benefits to the UK's asset management sector. These links must be preserved as part of the UK's strategy to enhance the completeness of its asset management sector.

Q21 Do you agree that reforms to enhance the attractiveness of the UK funds regime should focus on appealing to AIFs targeting international markets? Which markets would be most valuable and what would be the key obstacles to overcome in each?

It depends on what this approach means in practice. A key market for funds offered by UK asset managers is domestic consumers. Making the funds regime work better for these consumers should be a primary goal. This should be achieved by enhancing competition in the public interest and delivering proportionate regulatory requirements. The policy approach should consider competition between structures and distribution mechanisms (platforms, advice etc.). Achieving these outcomes should be the bedrock to creating a funds (and asset management) sector able to compete in international markets. This will result in keenly priced products and services that are attractive to investors outside the UK.

Of course, it is also worthwhile reducing barriers to targeting international investors, but this should not be at the expense of domestic competition. The reality is that there are likely to be persistent barriers to overseas purchase of UK AIFs and most of these cannot be addressed by regulatory reform in the UK. Investment companies, for example, did not make significant inroads into the EU market while the UK was a member of the EU primarily because of cultural and national barriers rather than because of specific regulatory issues.

Maintaining adequate standards and offering better products will support the sales of funds overseas. This would include ensuring that open-ended funds (including the proposed LTAF) meet internationally recognised standards such as the International Organization of Securities Commissions (IOSCO) Recommendations for Liquidity Risk Management for Collective Investment Schemes.

Q22 Do you agree that new UK fund administration jobs associated with new UK funds would be likely to locate outside London? How could the government encourage fund administration providers to locate jobs in specific UK regions?

The AIC has no comment.

Q23 How can the government ensure the UK offers the right expertise for fund administration activity?

The AIC has no comment.

Q24 Are there specific barriers to the use of ITCs, either from the perspective of firms creating fund products or from the perspective of investors seeking to access them? Are there specific steps which could address these?

Yes. Over the last 40 years the fund market grew in an environment where the commercial incentives were concentrated on manufacturing and distributing open-ended structures. These incentives had a number of sources. The creation of UCITS, which reflected European fund preference, boosted the open-ended funds market. Offering UCITS gave UK asset managers access to an internationally recognised brand and opportunities to gain access to significant markets in other EU member states.

Open-ended structures offer a convenient way of increasing assets under management, particularly alongside significant marketing efforts. This undoubtably had, and has, commercial attractions.

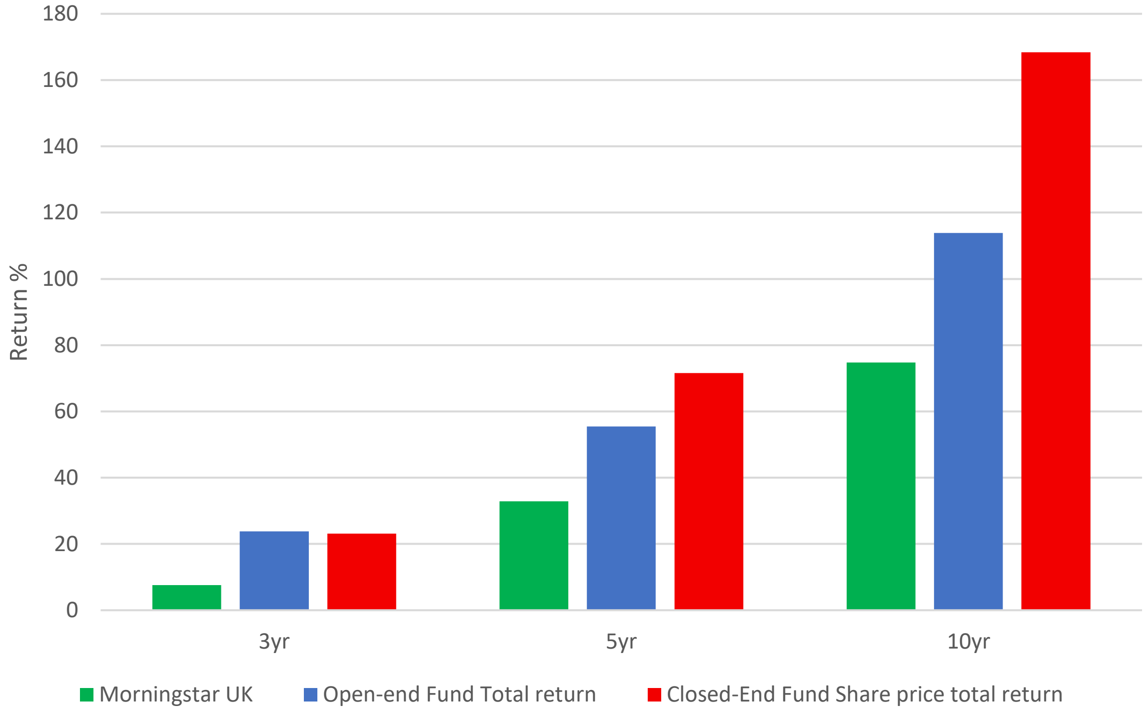
Commission paid to financial advisers (which could not be paid by investment companies) further favoured the distribution of open-ended funds.

At the same time, distribution has evolved to support the sale and marketing of open-ended funds. This has included the development of platforms and other online services which have often favoured access to, and distribution of, open-ended funds as the (now) dominant structure in the UK.

Open-ended funds are clearly an important part of the market. They have specific qualities which make them attractive to a broad range of investors. This discussion does not deny these attractions. However, it is also clear that these prevailing incentives have produced a funds ecosystem with inbuilt cultural, practical, and regulatory perspectives which have made it more difficult to launch and subsequently grow investment companies. These trends have been mutually reinforcing, making it more difficult for investment companies to secure a greater share of the market. This is despite their evident advantages in certain areas.

Investment companies have often been able to deliver superior investment performance over the long-term (see Fig 1).

Fig 1: Investment company vs. open-ended funds vs. index



Investment companies have also been strong and reliable sources of income, particularly valuable for investors in the decumulation phase of their retirement planning. Arguably more important than absolute levels of income is reliability. The AIC analysed the performance of income-paying investment companies and open-ended funds in 2020. Headline findings included that:

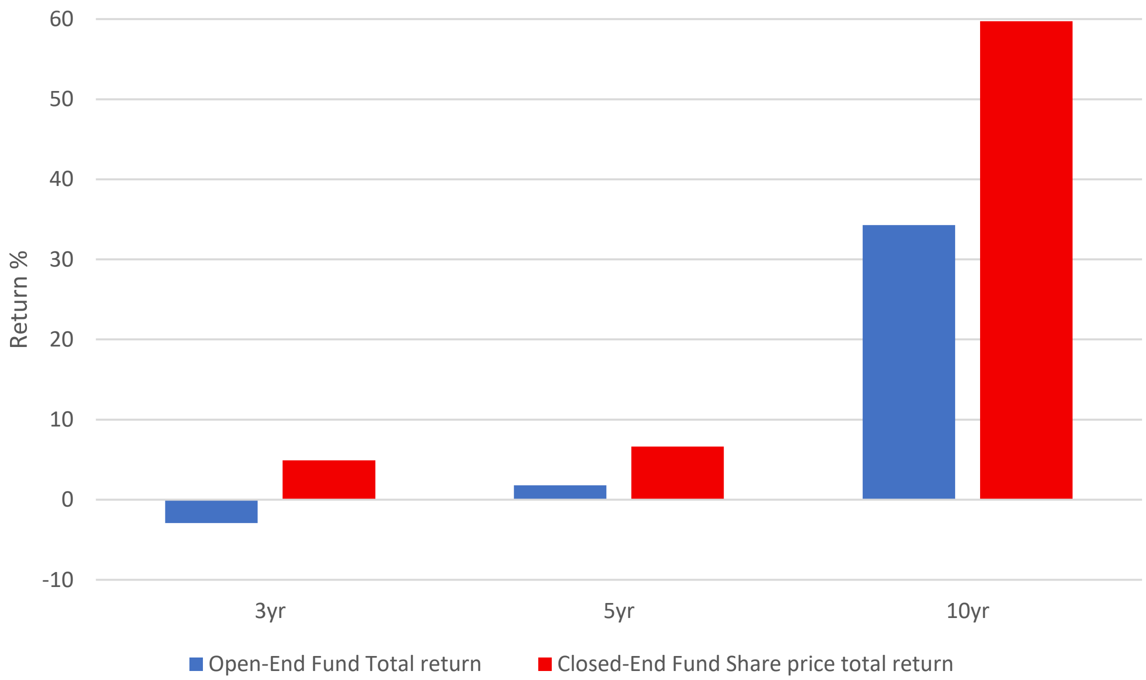
- 85% of equity income-paying investment companies increased or maintained their dividends in 2020 despite the pandemic.
- Out of 129 equity investment companies yielding more than 1%, 64% increased their dividends. A further 28 (22%) maintained their pay out in comparison with 2019.
- Out of 700 open-ended funds yielding over 1%, only 159 (23%) increased their dividends and none held their dividends at 2019 levels.

This record suggests that managers and advisers seeking to offer the best income producing funds for clients might often favour investment companies. This tends not to be the case.

Another instance of open-ended funds not necessarily serving investor requirements as well as investment companies has been seen in the property sector. Commercial preferences of fund operators led to open-ended property funds offering daily redemption. This offer has not been sustainable, and many property funds have been forced to suspend trading on more than one occasion in recent years, sometimes for sustained periods.

Aside from these redemption failures, the performance of open-ended property funds has been poor in comparison with their closed-ended counterparts.

Fig 2: Investment company vs open-ended funds (property direct)



One reason that open-ended property funds have lagged their investment company counterparts has been because, to make daily traded funds work commercially, they have held significant amounts in cash (often over 20% of the portfolio). There is a strong argument that this has been to the detriment of investors, who have received less exposure to the target asset class than they would have expected.

Independent authorities agree that offering illiquid assets via open-ended funds may not be the best approach. The Bank of England's Financial Policy Committee, in a discussion on open-ended property funds, said that "*other structures, such as closed-ended funds, may be more appropriate vehicles for investing in certain illiquid assets*" (Financial Stability Report, August 2020, page 42). It added "*Relative to open-ended funds, closed-ended funds face a lower risk of having to liquidate asset holdings earlier than planned to meet redemptions – potentially making them a more suitable vehicle for certain illiquid investments*". Despite this, asset managers have tended to prefer the open-ended option.

The evolution of the current market architecture has been driven by entrenched commercial and regulatory preferences. These have reinforced each other over time. A key policy question is whether these factors have reduced incentives to create and distribute collective investment products most likely to deliver the best outcome for consumers.

To focus the market more clearly on consumer outcomes, the AIC **recommends** asset managers should be required to consider consumer needs more prominently when making product design decisions (see our response to Q25 for more detail). This would provide the basis for securing a more competitive market better able to support the public interest. It might also create a more diverse market, with greater opportunities for the UK to compete internationally.

Other reforms would also reduce barriers to the launch and take up of investment companies.

Tax reform

The AIC has **recommended** tax reforms to remove competitive distortions (see Q2). These include removal of stamp duty for investment trusts, VCTs and certain UK-REITs. Tax reform could also enhance the investment trust structure by allowing them to opt to become TEFs to allow them to hold a wider range of income producing assets (other than shares and securities) in a tax efficient manner.

NMPI regime

The Non-Mainstream Pooled Investment (NMPI) rules seek to protect retail investors from speculative unregulated investment schemes. NMPIs cannot be promoted to retail investors (except in very specific, limited circumstances). This is a reasonable regulatory intervention for speculative investments. The AIC supports the NMPI approach overall. It is, nonetheless, a concern that any investment company, including those with a Premium Listing on the London Stock Exchange, could be considered to be NMPIs.

The NMPI rules identify investment companies as NMPIs but then exclude most from them the consequences of being an NMPI. The fact that investment companies fall into scope of this regime at all indicates a troubling regulatory perspective. Investment companies are not speculative or insufficiently regulated. It is not reasonable that their shares have been deemed by the FCA to fall within the scope of the NMPI regime.

When these rules were introduced (to replace the Unregulated Collective Investment Schemes (UCIS) regime) the FCA concluded that investment company shares are securities issued by a ‘special purpose vehicle’ (SPVs) and that they may be NMPIs where the underlying assets are illiquid. This analysis is highly problematic.

Investment companies are not SPVs on a reasonable interpretation of the FCA’s definition of these structures. The FCA’s conclusion arguably stems from a latent suspicion of the investment company structure. It also betrays a view that retail investors should be wary of investing in illiquid assets, even though investment company shares are located within a robust framework of market transparency, accounting, company law and other rules which provide regulatory protection.

Investment companies are more correctly seen as mainstream Retail Investment Products, suitable for widespread retail distribution. Linking investment companies in any way with the

NMPI regime adversely affects perceptions of the structure, including the views of IFAs and other intermediaries. It potentially raises a flag that they should be treated with wariness when this is not justified in any way.

Investment companies are an important part of the UK's listed company offering and a valuable component of the funds market. They can be a source of competition in the public interest and help differentiate the UK financial services industry. Yet the FCA's rules suggest a different, more negative, and unjustified perspective. The AIC **recommends** that all closed-ended publicly traded investment companies be removed from the NMPI regime as part of a wider project to remove unnecessary impediments to their distribution (see below).

Categorisation of investment companies under MiFID II

MiFID II's product governance provisions require that, where a client is not advised, there must be an 'appropriateness assessment' prior to a possible sale of a 'complex' product. This assessment requires retail investors to answer a series of questions before being eligible to purchase that category of product.

MiFID II does not set out what constitutes a 'complex' product. It instead sets out the criteria for a 'non-complex' product. It requires product providers to make an assessment, based on these criteria, about whether a product is 'complex' or 'non-complex'. The criteria are set out in Article 57 of the MiFID II delegated regulation. They include having opportunities to trade, no exit charges, no trigger that could change the character of the investment, no liability amounting to more than the cost of the instrument and sufficient information on the nature of the investment. The ordinary shares of investment companies should all be considered to meet these criteria. Despite this, there has been an unhelpful degree of uncertainty because they have not been designated automatically as not being 'complex' and because of unhelpful statements from EU regulators.

The regulatory value of the 'complex' designation and appropriateness assessments are debatable. Even if they were worthwhile, designating the ordinary shares of listed investment companies as complex is inappropriate. It potentially creates a barrier to retail investors buying these shares in comparison with other trading company shares when there is no substantive reason for doing so.

More significantly some distributors have a commercial preference not to sell 'complex' products or any investment which might conceivably fall within this definition. This leads some not to offer investment company shares. This is not because of specific regulatory requirements. Instead, it reflects more general, sometimes unspecified, concerns that distributing investment company shares represents a regulatory risk.

The AIC **recommends** that the FCA confirms that it considers that the ordinary shares of investment companies are automatically 'non-complex'. This would reduce the administrative cost and compliance burdens on product providers having to assess whether shares in investment companies are 'complex' or 'non-complex'. Investors can purchase the shares of commercial companies which are traded on public markets without the need for an appropriateness assessment. Investment companies invest in a diversified portfolio of assets. Therefore, arguably, the risk to investors is less than investing in other shares. Automatically designating investment company shares as non-complex would put them alongside their trading company equivalents, a far more appropriate treatment.

While this issue (and the question of NMPI status) may not seem huge considerations, they are indicative of a broader perspective on the regulatory (and tax) position of investment companies which raises barriers to purchasing investment company shares. Collectively, these factors are a drag on the sector and reduce its commercial attractions.

Removing constraints on investment company growth

Larger investment companies have greater liquidity (and are thus able to attract a greater range of potential investors). They can achieve economies of scale – a critical issue given the current focus on costs. A policy priority should be to help investment companies grow by issuing new shares. This can help improve their liquidity and cost effectiveness.

Current requirements for a prospectus where shares in an existing share class are issued create an unnecessary and expensive compliance burden. The case for removing this requirement was set out in the AIC's submission to Lord Hill's review of the UK Listing regime.

With this in mind, the AIC welcomed the UK Listing Review, published on 3 March 2021, which recommended that a "*fundamental review*" of the prospectus regime be undertaken. It stated that "*further issuances by companies that are listed or quoted, should either be completely exempt from requiring a prospectus, or be subject to much slimmed down requirements, for example, confirmation of no significant change*."

The AIC **recommends** that this review be taken forward as early as practicable. Our view remains that the outcome should be to remove the prospectus requirement for secondary issuance.

Enabling investment companies to grow in this way could support other important policy agendas. In August 2020, the FPC stated it would "*examine why pension funds allocate only a small proportion of assets to illiquid investments*". It also stated that it would seek "*to address distortions that discourage the use of funds with longer redemption notice periods or closed ended funds. These may be a more appropriate vehicle for investing in certain illiquid assets*".

The investment company structure is well suited to providing access to illiquid investments. One constraint on their use by pension funds is that they may not be large enough to provide sufficient liquidity for large DC investors. Reform of the rules for share issuance would help to address this issue.

The removal of the prospectus requirement for secondary issuance will not undermine market integrity or investor protection. It maintains key mechanisms to protect consumers and maintain shareholder control. Shareholder approval would still be required to allow the company to issue additional shares. Issuers would still need to communicate and engage with shareholders on why a further issue of shares is appropriate. The Transparency Directive rules would maintain the integrity of these communications and the Premium Listing Principles would continue to apply. These require that companies act with integrity towards the holders and potential holders of their securities and companies must communicate information to holders and potential holders of their securities in such a way as to avoid the creation or continuation of a false market in those securities.

Launching new investment companies

A report by TheCity UK explored the use of different fund structures to support the UK economy's recovery from COVID. It set out a very positive policy case for using investment trusts. The one area where investment trusts received a negative conclusion (a 'cross in the box') related to the process of setting up and launching these companies. The report said that it "*Can be relatively expensive to set up and getting FCA/LSE approvals for the Prospectus can extend timetable Expected timeframe of 4-5 months*."

There must be proper standards where a company is brought forward for an IPO, but this should not prevent the process from being as straightforward as possible. One way to achieve this is to reconsider the liability regime applied to prospectuses. In particular, as set out in our submission to the Listing rules review, the AIC **recommended** that prospectuses be prepared under the liability regime applicable under the Transparency Directive. Applying one standard (to the prospectus and ongoing market disclosures made under the Disclosure Guidance and Transparency Rules (DTRs)) would simplify the overall structure of liability in capital markets without lowering standards.

Role of IFAs

Independent Financial Advisers (IFAs) should have the knowledge, expertise, and resources to consider all retail investment products when making recommendations. Without this they will not be able to identify which investment products can offer their clients the best value and investment outcomes. These intermediaries direct substantial investment flows and therefore have the potential to influence what products are made generally available.

Improved standards within the IFA sector would increase competition in the public interest: incentivising manufacturers to develop better quality, better value products that serve the needs of all customers. This could result in better products being brought to market and poorer ones being withdrawn. All retail consumers would benefit, including self-directed consumers.

In many respects the rules for IFAs are in good order. It is more debatable whether they are being properly observed and enforced. AIC research indicates that many IFAs do not consider investment companies for their clients. This does not seem to be compatible with their obligations to provide independent advice. In turn, this reduces competition in the public interest in the investment product market.

The AIC estimates that fewer than 10% of IFAs ever recommend investment companies. As stated above, it is difficult to believe that IFAs that do not consider the sector have no clients for which investment companies could be suitable. Recent research, looking at the ownership of investment company shares, has shown that direct to consumer (D2C) investors are the most significant buyers of investment company shares, purchasing 35% compared with only 2% of investment company shares held via adviser platforms.

This suggests considerations unrelated to client needs inappropriately affect IFAs' product recommendations. The AIC **recommends** that steps be taken to enhance the role of IFAs in supporting effective competition in the public interest. This should include the FCA:

- reviewing whether the requirement for IFAs to consider a 'sufficient range' of products is being met and, if not, take active steps to ensure that it is;

- providing clear guidance on what a considering a 'sufficient range' of products involves. This would address when a whole class of Retail Investment Products can be excluded and the importance of considering individual client needs;
- examining whether IFAs' reasons for excluding product types is driven by the client need. For example, the AIC understands that some advisers may exclude investment company shares where the client (for example, those acting as the officers of a charity) would need a legal entity identifier (LEI). Obtaining an LEI is a simple administrative exercise. The requirement to obtain one should not prevent an adviser recommending an investment company where this might better suit the investment needs of the client.
- increasing its scrutiny of whether IFAs are complying with all the requirements which allow them to hold themselves out as being independent. For example, if they have sufficient knowledge of products;
- adjusting the supervisory approach taken in relation to IFAs to actively review whether IFAs are providing advice on an independent basis;
- requiring IFAs to set out how the client interest is best served by using open-ended funds holding illiquid or hard to sell assets (including in relation to the level of cash holdings within the portfolio and the reliability of the redemption offer); and
- reviewing the training and syllabus requirements for financial advisers and increasing the coverage of investment companies and other types of investment product. Research commissioned by AIC found IFAs cite lack of knowledge as a reason for not recommending investment companies. It is difficult to understand how these advisers are meeting the requirements to maintain their skills and knowledge, including undertaking continuing professional development (FCA Handbook Training and Competence 2.1.15R) which should "*address any identified gaps in the adviser's technical knowledge*" (TC 2.1.22G (4)).

Q25 Should asset managers be required to justify their use of either closed ended or open-ended structures? How effective might this requirement be, and what are the advantages or disadvantages of this approach?

Yes. Too often, product design decisions seem to have focussed on asset mangers' commercial preferences at the expense of securing the best consumer outcomes. Where this is the case, the consequences are borne by consumers rather than the fund operator.

Open-ended funds have invested in highly illiquid assets such as property whilst offering daily redemption. Serious problems can arise when they cannot raise sufficient cash to meet their redemption promises. This creates the potential for fire sales of assets and suspensions. This potential creates 'first mover' incentives for investors to sell out of a fund when levels of liquidity start to fall. This dynamic can lead to fund collapses. There is also a contagion risk where the failure of one fund has spill-over effects for others. Property is not the only asset class where these risks arise. Illiquid shares can also cause issues, as demonstrated by the collapse of Woodford Equity Income Fund.

The worst effects of poor fund design tend to fall on investors. The value of their investment can suffer, sometimes dramatically. They can be trapped in funds that they had expected to be able to leave at a time of their choosing. Unfortunately, retail investors are also least able to weather losses or react quickly to the deteriorating position of the fund.

This raises questions as to why the original decision was to offer daily redemption and whether the consumer interest was given sufficient weight – particularly if the target investors include the retail market.

Where assets are inherently illiquid, it is debateable whether an open-ended structure is appropriate at all. Stock market traded, closed-ended funds – investment companies – arguably provide a better structure. They do not have to maintain the same liquidity buffers as open-ended funds to manage redemptions. It is not uncommon for open-ended property funds to hold well over 20% in cash. This will mean that investors who seek property exposure may not have more than 70% - 80% of their investment exposed to property assets. This can have significant implications for returns (see Fig 2). The 'cash drag' from liquidity buffers is one reason why closed-ended funds investing in property typically outperform open-ended alternatives.

Product manufacturers are supposed to observe various rules to secure good customer outcomes when designing investment products. These are not currently working as intended. A recent FCA review found failings in relation to product design requirements, product testing (including scenario and stress testing) and governance and oversight. The FCA concluded *"Nearly all firms carried out a formal product assessment or review every year. However, different firms showed varying levels of oversight and challenge across these governance channels."*

The FCA said that "*We expect firms to ensure their activities prioritise good customer outcomes and that they comply with the relevant regulatory rules and requirements*." Unfortunately, it seems clear that these expectations are not always achieved.

The FCA also stated "*Our review suggests that some asset managers are not undertaking activities in line with MiFID II's PROD regime. This increases the risk of investor harm, particularly where investors buy products that may not be appropriate. As a result, we believe there is significant scope for asset managers to improve their product governance arrangements*."

The risks to consumers of poor product governance in open-ended funds will increase. Policymakers and regulators are currently fast tracking the development of the proposed LTAF. The current intention of industry is for it to be distributed to retail investors and institutions, such as DC pension schemes. The LTAF is (like open-ended property funds) intended to invest in inherently illiquid assets. It will be essential for the LTAF to properly manage liquidity and redemptions to prevent mismatches. If this is not effectively done the negative effects on investors (including fire sales and suspensions) could be substantial. The best means to address this problem are notice periods of sufficient length. The commercial incentives will be for fund operators to minimise these periods. This seems likely given the track record in offering daily dealing open-ended property funds.

The desire to minimise notice periods wherever possible is also indicated by the industry response to the FCA's consultation on notice periods for open-ended property funds. The submission by the Association of Real Estate Property Funds and the Investment Association recommended notice periods of 90 days for all property funds. On the evidence included in the submission, it is difficult to conclude that a 90 day notice period would be suitable for most property funds. Many commercial properties will take far longer to transact. Instead, the 90 day proposal seems more likely to reflect the operational and commercial preferences of asset managers. The AIC's own analysis is that a 12 month notice period would be required to remove liquidity mismatches across the open-ended property fund sector, assuming a one-size-fits all approach is adopted. This conclusion was based on available public analysis of how long it takes to sell commercial property (see *Don't let the tail wag the dog* for the full analysis).

Whatever conclusions are drawn on notice periods for property funds, it is evident that there are strong commercial incentives to minimise their length. Also, the current rules have not resolved current shortcomings in the product governance and product design processes of authorised fund managers.

To address these, the AIC **recommends** that senior management within authorised fund managers should be required to undertake greater oversight of product design and to ensure that more attention is paid to consumer needs. This should be achieved by requiring them to make a statement that the fund structure chosen is appropriate for the intended assets and investment strategy. The statement should be made before the fund is launched, with an annual restatement that the structure remains suitable. The annual statement should be made alongside the annual value for money assessment the FCA imposed on asset managers as a result of its Asset Management Market Study. This obligation to assess value for money has started to show results where costs are concerned. The proposed statement on fund structure could have a similar impact in relation to product standards. The analysis underpinning the statement should consider issues such as:

- Whether the structure has potential liquidity mismatches;
- Whether the redemption policy is appropriate for the fund's assets and/if it mitigates liquidity mismatches; and
- Whether the fund structure will deliver an appropriate outcome for consumers given the investment objectives of the fund. This analysis would consider, for example:
    - if required cash buffers create an unacceptable drag on performance or value for money;
    - if mechanisms (such as vertical slicing) used by the operator can successfully prevent new liquidity mismatches arising;
    - if stress testing is based on reasonable assumptions and supported by sufficient data;
    - whether notice periods (or other liquidity management tools) are sufficient to prevent liquidity mismatches crystallising.

The AIC **recommends** that the conclusions of this analysis should be published in the fund prospectus (or similar public disclosure) and reviewed annually thereafter and published in a prominent position on the fund's website.

The AIC **recommends** that a link to these disclosures should be included in the Key Investor Information Document (KIID) or Key Information Document (KID) and in factsheets.

To be clear, the AIC **recommends** that the obligation for senior management to consider the product design choices made should apply irrespective of the authorised open-ended fund structure (UCITS, NURS, QIS or LTAF) being utilised. It should apply irrespective of the target assets of the open-ended fund.

Problems with liquidity mismatches, stress testing and potential concerns about levels of cash holdings are not limited to property or other inherently illiquid assets. Woodford Equity Income Fund – a UCITS – collapsed with liquidity mismatches being a central cause of its demise. This is despite rules limiting it to a 10% holding in illiquid assets. Property funds – customarily NURS - have suspended on a number of occasions. Their redemption arrangements have self-evidently been unreliable. The Bank of England/FCA report into *Liquidity management in UK open-ended funds* raised questions about asset managers' assessments of liquidity and their use of liquidity management tools. These issues arose in both corporate bond funds and some small cap equity funds. A 2019 speech by then Governor of the Bank of England, Mark Carney, cited estimates that over half of all open-ended funds globally have structural liquidity mismatches.

Research by the European Securities and Markets Authority (ESMA) simulated the impact of a possible 'redemption shock'. This is where an open-ended fund receives redemption requests of between 5% and 10% of its NAV in one week. ESMA described this as a "*large but plausible*" event. It looked at 6,000 UCITS bond funds and found that 40% were vulnerable to redemption shocks. They could be forced into asset sales which, in turn, could depress asset values in the market. ESMA's April 2021 statistical report on alternative investment funds again raises concerns about increasing liquidity risks. IOSCO is undertaking a thematic review of liquidity risks in collective investment schemes, expected to report in autumn 2022.

Problems with the design of open-ended funds, notably their potential to incorporate liquidity mismatches, have arisen in relation to various structures and underlying assets. Growing international awareness of these issues will surely lead to further action to address these issues.

Adopting the proposal for managers of authorised open-ended funds to justify the structure used, including the liquidity and redemption arrangements, would position the UK as setting a precedent of establishing proportionate, outcome focussed rules which are targeted on an identified issue. It would reaffirm its position as a responsible rule maker, with an important role in leading the international regulatory debate. It would also protect consumers and financial stability without imposing overly detailed, technical rules which may not achieve the desired regulatory outcomes.

Q26 Should the distribution out of capital be permitted? What types of products would this facilitate and what investment or financial planning objectives would they meet for investors? What are the possible advantages, disadvantages, and risks for investors?

This issue should be approached with some caution for open-ended funds. Any flexibility to allow distribution out of capital should be constructed so that it does not affect the ability of the fund to meet its redemption offer. Problems with redemptions are most likely to arise where assets have liquidity constraints.

If liquid assets are sold, rather than making a distribution it may be necessary for the asset manager to reinvest the proceeds in similarly liquid assets to prevent the overall liquidity profile of the fund declining. The risk of liquidity concentration may be particularly material if redemption demands arise after a capital distribution has been made.

It is most likely that capital distributions might cause increased liquidity/redemption risks for less liquid assets. This does not reduce the potential for problems to arise for more liquid asset classes.

One mechanism to manage the additional liquidity risks arising where capital is distributed could be to mandate longer notice periods whenever a fund has powers to make capital distributions (although notice periods should, in any event, not be shorter than the time taken to sell a representative slice of the assets, including some from the least liquid portion of the portfolio). The AIC **recommends** that explicit vertical slicing requirements should be a prerequisite for capital distributions if this is allowed at all.

The AIC **recommends** that, in the event that capital distributions for open-ended funds is allowed, the fund operator should make a statement when making such a distribution to confirm that it will not result in liquidity concentration or otherwise affect the reliability of the redemption offer.

Q27 How do you consider that such a change might be delivered? Please explain your answer, providing specific examples of rules, how they could be changed, and the effect of the changes.

It is unclear that this can be achieved without creating liquidity issues within the fund (see the discussion above). The AIC is not supportive of allowing this without a full consultation on the issues arising and setting out suitable regulatory measures to protect consumers and the integrity of open-ended funds making such distributions.

Q28 Do you foresee any issues with the LTAF adopting the current tax rules for authorised investment funds? Would the nature of an LTAF's investments, and the tax treatment of the income it receives in respect of those investments, mean that the current rules for authorised funds lead to tax inefficient outcomes?

It is difficult to provide a substantive response to this question given significant uncertainties about the LTAF, including its structure, redemption arrangements and investment powers. We are, however, keen to engage in this debate and are pleased to be able to offer input via the Productive Finance Working Group.

Q29 Are there any other tax considerations, outside of those that follow from the adoption of the current tax rules for authorised funds, that will be important to the success of the LTAF? Please explain your answer.

Currently, there are no plans to target the LTAF on productive finance. The current expectation is that the LTAF will be able to purchase secondary assets. If capital is invested into UK businesses, then there is no intention to target its use (to support the creation of manufacturing capacity, building infrastructure, R&D, for example).

Without specific arrangements, it is unlikely that the LTAF will provide any meaningful amount of productive finance. This suggests that incentives (potentially via the tax regime) may have to be provided. Of course, if such incentives are envisaged, they should be available to any fund, including investment companies, which deliver productive finance investments.

Q30 How would each of the proposed unauthorised fund structures add value alongside existing authorised and unauthorised UK fund structures, including the QIS? Would they bring value alongside each other? Would they bring unnecessary complexity? What would each structure allow fund managers and investors to do that they are unable to do currently in the UK regime? Please address each proposed unauthorised structure separately and indicate which of the proposed unauthorised structures you consider most important.

The LTAF should be based on the current QIS. This would have various benefits, including preventing its distribution to the mainstream retail market.

Retail distribution should only be considered once the LTAF has become established and greater understanding of its redemption arrangements and performance characteristics has been gained.

The LTAF is a complicated, novel product. Most likely it will only be suitable for institutional investors. Wider distribution at an earlier stage creates significant regulatory and reputational risks.

Q31 Would these unauthorised structures support the government's work on facilitating investment in long-term and productive assets, as outlined in Chapter 1?

Long-term and productive assets can already be invested in through stock market traded, closed-ended investment companies. Such companies are already invested in these assets.

The suitability of closed-ended, stock market traded funds has previously been recognised by government policy. This structure has been utilised for VCTs, an early example of a government initiative seeking to provide permanent, growth capital finance.

In many respects, closed-ended investment companies, with their shares admitted to trading on public stock markets, are a more suitable structure for this investment than the proposed LTAF. Critically, they can provide access to an underlying portfolio of inherently illiquid assets while offering liquidity for investors who are able to trade their shares on the stock market. They also have high standards of governance and established regulatory mechanisms in respect of valuations, disclosures etc.

Q32 How do you think the government could best achieve consistent branding for UK fund structures which target only professional investors?

Using the existing QIS structure for open-ended funds holding illiquid assets would provide the basis for such branding.

Q33 Do you think that these unauthorised structures should be unregulated collective investment schemes? If you consider any 'light-touch' authorisation necessary or desirable, what do you understand this term to mean and what form could it take? Why would it be beneficial for investors, and how could it be explained to them in a way that avoids confusion with the regulatory assurances of fully-authorised structures?

The implications of the proposal for 'light-touch' authorisation are unclear. Any moves in this direction should not undermine the development of an effective regulatory regime, with sufficient commercial flexibility and consumer protection, to provide a product which meets investor needs and which can attract investor confidence.

The ambition to achieve a 'light-touch' authorisation regime is misconceived. The objective should be to be proportionate while delivering suitable regulatory standards.

Q34 Do you think these structures should have flexibility on whether they are open-ended or closed-ended? Should they have flexibility on whether they are listed or non-listed? How important is this?

The essential issue is to avoid liquidity mismatches in open-ended funds. This means the fund operator must establish a redemption policy which can operate effectively over the lifetime of the product in both normal and foreseeably stressed market conditions (the basic standard identified by IOSCO).

Achieving this outcome will require adequate stress testing and rules on liquidity management, including vertical slicing requirements, to prevent the fund from experiencing liquidity mismatches as a result of inadequate redemption arrangements, including insufficient notice periods.

Q35 Do you think these vehicles should or could be implemented as part of existing structures set out in legislation? Please provide details. If not, please explain why not.

This will depend on the basic structure chosen. The AIC **recommends** the QIS as a starting point, which may facilitate the creation of the LTAF without primary legislation.

Q36 Are there any specific tax treatments that would be either necessary or desirable to support the successful introduction of new unauthorised fund vehicles in the UK? Please provide detail of how and where this is the case.

The AIC has no comment on this question.

Q37 Are there any interactions with wider tax policy that the introduction of new unauthorised vehicles would need to navigate, in order to avoid unintended consequences?

Any innovations in tax policy to support the introduction of new unauthorised vehicles should be structure neutral. That is to say, innovations should be available to collective investment vehicles, such as stock market traded closed-ended funds, as well as open-ended alternatives. This will maximise effective competition in the public interest and better deliver the government's policy ambitions.

Q38 Are there other things government should consider as part of this review of the UK funds regime, or proposals for enhancements to the UK funds regime which the government has not included in this call for input? If so, how important are they and how would you like to see them prioritised in relation to the proposals explored in this call for input?

PRIIPs

The AIC has long campaigned for fundamental reform of KIDs. These disclosures have been consistently misleading. Too often KIDs overstate potential performance and understate risks: a toxic message for unwary investors relying on the KID. Our view on these disclosures was summed up in the title of our report, *Burn Before Reading*.

The AIC **recommends** that the KID regime should be suspended, as KIDs are misleading and harmful to consumers. Consumers would still be able to use other, more helpful, disclosures already provided. The AIC recognises that there could be a benefit in a properly designed regulated consumer disclosure. This should be developed independently of the KID requirements.

The AIC remains disappointed that policymakers have not adopted this proposal. This is despite their clear misgivings of the current KID requirements, indicated by the decision to exempt UCITS from publishing these documents for, potentially, as much as five years. HMT has also said that it will review the broader question of consumer disclosures at a non-specified date in the future.

Legislation is currently before Parliament to give powers to the FCA to amend the KID requirements. The AIC remains concerned that this will result in small adjustments that do not resolve the fundamental problems with KIDs nor create a comparable disclosure with UCITS. The FCA should:

- use its powers to amend the scope of KIDs to exclude targeted sectors, such as investment companies;
- allow PRIIPs' issuers a choice as to whether they offer a PRIIPs KID or a UCITS KIID;
- remove the requirement for performance scenarios and replace it with a past performance disclosure;
- change the PRIIPs costs methodology, including removing the reduction in yield disclosure and abolishing the 'slippage' methodology for calculating transaction costs;
- make fundamental changes to the presentation of risk, removing the requirement to publish a risk indicator and instead allow issuers to provide a general, freeform, risk disclosure. The AIC considers that the Summary Risk Indicator (SRI) (which shows risk on a scale of 1-7) is fundamentally flawed. The SRI is not a clear statement of the risks of the product. It is not a summary, neither is it an indicator of the risk associated with the product. It only gives an indication of historical volatility and it can be misleading.

AIFMD

The call for input is not inviting views on the onshored AIFMD legislation at this time but the potential to reform these rules to secure effective and proportionate regulation of the UK funds regime should not be overlooked.

The stock market traded closed-ended investment company industry is, broadly speaking, a UK-focussed sector. The UK is unique in Europe in having a well-established, broadly-based sector with a sophisticated infrastructure of advisers and service providers behind it. This includes its active partnership with the Channel Islands, which has made an important contribution to the development of this industry.

The UK did not push for the introduction of the AIFMD. Its negotiating positioning reflected its view that the benefits of this legislation were unclear, particularly given the wide variety of policy objectives and the application of the regime to such a broad range of structures. The Directive purports to guard against systemic risk but nevertheless applies to very small funds with no possible systemic relevance. It includes private equity provisions with no relevance to the objectives of managing systemic risk, delivering investor protection, or delivering effective prudential regulation. The provisions on private equity owe more to political preferences of certain EU member states and MEPs than a conventional regulatory agenda.

The UK authorities were highly cautious about the proposed Directive and rightly sought to significantly amend a substantial number of its provisions. The initial UK position supported the AIC's proposal that investment companies whose shares are traded on regulated markets (and are therefore governed by various EU rules including the Transparency Directive and Prospectus Directive) should be excluded from scope. This was a welcome commitment to proportionality which, while ultimately unsuccessful, did focus attention on the need to make the rules work for publicly traded, closed-ended structures.

Now that the UK has left the EU, the AIC **recommends** a fundamental review of the AIFMD rules. This should include an assessment of whether the requirements should be abolished in whole or in part. Notwithstanding this, the AIC **recommends** the review consider whether closed-ended investment companies listed on public markets (particularly those subject to Chapter 15 of the Listing Rules) should be excluded from the scope of the AIFMD.

If the AIC's recommendation to exclude publicly traded investment companies is not accepted, the AIC **recommends** that they are excluded from the provisions of the AIFMD relating to depositaries and private equity investments.

The AIC also **recommends** that the thresholds for 'small' Alternative Investment Fund Manager's (AIFM) be increased and that the definition of non-leveraged AIFMs is relaxed. Reforms in this area, for example setting the small AIFM threshold at, say, £10 billion (which ensures that they do not represent a systemic risk) could be instrumental in supporting new entrants to the asset management market, including the development of investment companies operating as self-managed AIFMs.

Regulation of proxy advisers

Proxy advisers are an increasingly important part of the investment chain, yet they remain unregulated. They are not required to report against an independently written code of best practice, such as the Stewardship Code. They are encouraged to report against the Stewardship Code, but this is voluntary. The AIC **recommends** that proxy advisers be required to report against the Stewardship Code. If implemented, this would bring proxy advisers into line with other significant participants in the investment chain.

The AIC **recommends** the Stewardship Code, as it applies to proxy advisers, is enhanced.

The AIC **recommends** proxy advisors be required to:

- Explain their policy on engagement with companies that are the object of their research, advice or voting recommendations. This should include:
  - Describing how they engage with companies throughout the year;
  - Setting and disclosing minimum time deadlines for engagement with companies to allow companies to respond appropriately to any issues raised; and
  - Describing the extent to which they engage with companies in circumstances where they make a negative research finding or voting recommendation.
- Describe whether, and if so how, they consider explanations provided by companies which are the object of their research, advice or voting recommendations and describe how they communicate these explanations to their clients;
- Establish and explain their procedures to prevent and detect factual inaccuracies in research, advice or voting recommendations; and
- Confirm that they train their staff to ensure they have the expertise required to understand the companies which are the object of their research, advice or voting recommendations. This is particularly important for companies with unusual or different market characteristics.

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