JULY 2008

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 86 - "OPERATING" A COLLECTIVE INVESTMENT SCHEME

Legal assessment of problems associated with the definition of Collective Investment Scheme and related terms

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 86 WORKING GROUP[1]

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1 INTRODUCTION AND EXECUTIVE SUMMARY

a) Introduction

1.1 The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2 In February 2004, a number of uncertainties in the legal and regulatory framework relating to the operation of a collective investment scheme ("CIS") were brought to the Committee's attention by market contacts. In November 2005, the Court of Appeal in *FSA v. Fradley and Woodward*[2] delivered a judgment relevant to the operation of a CIS in the UK. Market contacts expressed their concern to the FMLC that the judgment had set an unexpectedly low threshold in determining when a manager is operating a CIS. In 2006, the FMLC investigated these concerns by consulting experts in the field. In the course of these enquiries it became apparent that not only did the criteria for establishing a CIS create legal uncertainty, but a number of other questions relating to CISs were raised, especially in view of the Treasury's proposal to amend paragraph 9 of the Schedule to the FSMA 2000 (Collective Investment Schemes) Order 2001 ("CIS Order"). Further consultation on the proposed amendment of paragraph 9 ensued, and the Treasury's amendments were implemented in final form by the FSMA 2000 (Collective Investment Schemes) (Amendment) Order 2008[3]. Nonetheless a number of problems remain unresolved. This paper now provides a comprehensive account of some of the key issues examined by the FMLC and sets out an analysis of those issues, providing a legal assessment of the problems arising.

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2 [2005] EWCA Civ 1183, [2006] 2 BCLC 616 ("*Fradley*")

3 SI 2008/1641

b) Executive summary

1.3 Section 235 of the Financial Services and Markets Act 2000 ("FSMA") sets out the elements of a CIS. There is uncertainty in the meaning and effect of those elements. The greatest problems lie with the wide concept of "arrangements" (including the problem of the management of property "as a whole") and the uncertainties in relation to "day to day control" and the meaning of "operator".

1.4 The market in the UK is aware of the issues highlighted in this paper and has come up with structures to counter the associated difficulties, but an improvement to the definition of a CIS would nonetheless be much welcomed. The ambit of the statute could easily be clarified without the concept of a CIS becoming undesirably restricted.

1.5 Amendment to the exclusions contained in the Schedule to the CIS Order may ameliorate the problems and is to be welcomed, especially in relation to paragraph 9. However, this is not in our view a substitute for the need to clarify the definitions in section 235 of FSMA.

2 OVERVIEW OF THE LEGAL UNCERTAINTY ISSUES ARISING IN CONNECTION WITH THE DEFINITION OF CIS

a) Implications of the definition

2.1 Because of the regulatory consequences stemming from a scheme qualifying as CIS, legal uncertainty arising in the context of such definition affects the efficient application of the regulatory regime and concomitantly the operation of the financial markets. The key regulatory aspects of CISs are summarised below:

a. The establishment, operation and winding up of a CIS are regulated activities under the FSMA 2000 (Regulated Activities) Order 2001 (S.I. 2001/544, the "RAO").[4] This means that any person carrying on the business of doing so needs to obtain permission from the FSA under Part IV of the FSMA. Failure to do so is a serious criminal offence, and the FSA has extensive powers of intervention to prevent the prohibition from being contravened.

b. Once authorised, there are significant regulatory restrictions on the ability of a CIS to invest and in particular to acquire certain assets, for example derivatives.[5]

c. Agreements entered into by a person in the course of carrying on a regulated activity without permission are unenforceable unless the court determines otherwise.[6] This will primarily affect agreements between the person operating the putative CIS and the CIS itself or its participants, but could arguably (and more significantly) also apply to agreements which are entered into by the operator on behalf of the scheme.

d. There are considerable restrictions on the promotion of CISs (s238(1) FSMA). Unless a CIS is of a kind authorised or recognised under FSMA, it cannot be marketed except to certain specific categories of people, even if the communication is made or approved by an authorised person.[7]

2.2 A separate issue is tax. The FSMA definition of CIS is used in a variety of tax legislation relating both to stamp taxes and to taxes on income and capital

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4 Article 51.

5 S. Gleeson, Retail Derivatives Made Simple, May 2003 *International Financial Law Review*, p 27-28.

6 Section 26 FSMA.

7 See the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001, and Section 4.12 of the FSA's New Conduct of Business Sourcebook (COBS). Authorised and recognised schemes have to conform to strict criteria designed to protect retail investors and are unlikely to be relevant in the present context.

gains. The tax treatment of a structure will often critically depend on whether it is or is not a CIS. In the tax area uncertainty in the definition is even more damaging than in the regulatory context. This is both because of the potentially unlimited financial consequences of a determination that a particular tax treatment is incorrect; and also because any pragmatic approach which may be adopted by the FSA in the regulatory context is strictly irrelevant to the construction of the tax legislation. For example, guidance issued by the FSA (e.g. in its Perimeter Guidance Manual) is not binding on the courts.[8]

b) Legal uncertainty in the definition of CIS

2.3 Section 235(1) of FSMA provides a very wide definition of a CIS, the main elements of which are discussed in section 3 below, starting with the wide concept of "arrangements", which is fully analysed in section 4 below. The provisions in FSMA, in the RAO and in the Schedule to the CIS Order have some, albeit limited, effect of limiting the wide scope of the definition set out in section 235(1).

2.4 Section 235(2) of FSMA refers to the notion of "day-to-day" control; this creates significant uncertainties in the interpretation and application of the CIS regime. The arrangement must be such that the participants do *not* have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions. Several comments need to be made with respect to this definition.

2.5 The notion of "day to day control" is vague and FSMA does not give any further guidance on how it should be interpreted. Furthermore, the phrase "whether or not they have the right to be consulted or to give directions", which purports to clarify the "day to day control of the property" notion, is also

[8] This at least is the FSA's own view: see section 1.3 of the Perimeter Guidance Manual.

obscure. There is not a clear picture as to which level of control the "right to be consulted or to give directions" encompasses.

2.6 Laddie J held in *The Russell –Cooke Trust Company v. Elliott*[9] that a scheme is a CIS even if not all the participants in it have transferred day-to-day control of the management of their monies to the operators of the scheme. Based on this argument, Lady Justice Arden continued in *Fradley* that, for the purposes of that case, it did "not matter that the scheme was not a CIS as regards any participant who retained day-to-day control of the management of his monies".[10]

2.7 Section 235(2) of FSMA raises a question with regard to which actions may be considered to be "day-to-day control" by the participants. Do those actions need to be joint, or generally undertaken by all or more than one participants? In *Fradley*, Lady Justice Arden reasoned with respect to the word "operator" in section 235 of FSMA that "the singular in a statute includes the plural".[11] But does the plural include the singular in respect of participants? The interplay between operator and participants is considered in sections 5 and 6 below.

2.8 Section 235(5) empowers the Treasury ("HMT") to provide by order that certain arrangements do not amount to CISs in two cases: (a) in specified circumstances or (b) if the arrangements fall within a specified category of arrangements. The wording of this provision allows HMT to exercise a certain degree of discretionary power, which may raise uncertainty, since the "specified circumstances" could encompass an unexpectedly wide range of conditions.

2.9 Article 3 and the Schedule of the CIS Order, as in force since 1 December 2001, set out the arrangements which do not amount to CISs. The list is

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9 [2001] NPC 69, [2001] All ER (D) 300 Mar, [2001] All ER (D) 197 ("*Elliot*").

10 *Fradley* paragraph 46.

11 *Fradley*, paragraph 37.

extensive and could pose problems for the market participants to know the state of the law. It has been suggested that some of the issues discussed below could be solved by extending the exclusions. However, it is arguable that the adding of further exclusions to a very wide basic definition of CIS could worsen the present state of play. The exclusions are considered in section 7 below.

2.10 The market in the UK is already aware of the issues highlighted above and has come up with structures to counter the associated difficulties, but an improvement to the definition of a CIS is nevertheless important, especially for those who need advice as to whether schemes which they propose qualify as CIS schemes or not.

3 THE DEFINITION OF A CIS

3.1 Section 235 FSMA defines a CIS as follows:

(1) In this Part "collective investment scheme" means any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

(2) The arrangements must be such that the persons who are to participate ("participants") do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.

(3) The arrangements must also have either or both of the following characteristics—

(a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;

(b) the property is managed as a whole by or on behalf of the operator of the scheme.

(4) If arrangements provide for such pooling as is mentioned in subsection (3)(a) in relation to separate parts of the property, the arrangements are not to be regarded as constituting a single collective investment scheme unless the participants are entitled to exchange rights in one part for rights in another.

(5) The Treasury may by order provide that arrangements do not amount to a collective investment scheme—

(a) in specified circumstances; or

(b) if the arrangements fall within a specified category of arrangement.

3.2 The definitions in section 235 FSMA comprise the following key elements:

(a) a general description of the type of "arrangements" which are capable of falling with the definition (section 235(1));

(b) additional criteria which must be satisfied by such arrangements:

(i) the test of "day to day control of management" (section 235(2));

(ii) the alternative tests of "pooling" and "management of the property as a whole" (section 235(3)).

3.3 These are analysed briefly in turn, so that the essential problems within the definition can be understood. The problem areas are analysed more fully in later chapters.

a) Arrangements

3.4 The "arrangements" within section 235(1) are:

> arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

3.5 The scope of this definition is clearly very wide. In particular:

a. "arrangements" is a very broad term, and arrangements may have no clear boundaries. So, for example, a series of separate trusts may be viewed as a single set of "arrangements" (as in *Elliott*); on the other hand it is quite possible that a single financial structure may be analysed as comprising a series of separate or overlapping sets of "arrangements";

b. the arrangements may apply to "property of any description" and are not restricted to "investments" within the meaning of the RAO. A CIS can relate to, for example, real estate, rights under betting contracts or even to ostriches;

c. there is no need for the participants to have any ownership or other interest in the property, or to receive directly the profits or income arising from its management. So, to take merely one example, an insurance company selling with profits policies would fall within the definition in the absence of exemption;

d. arrangements can be caught if their "purpose" is to enable those taking part to participate in the relevant profits or income, even if this is not achieved; and conversely where this is the "effect" of the arrangements, even if this is not their purpose, or primary purpose.

3.6 The breadth of the definition is clearly intentional: the aim is to cast the regulatory net wide and then cut back its scope with exclusions. The difficulty with this approach is that:

a. it leaves within the net harmless arrangements where the need for an exclusion has not been identified;

b. more insidiously, the generality of the definition may be expansively interpreted by reference to the exclusions.

3.7 More specific uncertainty relates to what is meant by "persons taking part in the arrangements". It is at least arguable that this phrase implies a degree of positive involvement (so that, for example a private trust, or a fund designed to compensate or make charitable payments to specified categories of beneficiaries, will not be caught). However, this is only one view. A related question is whether it is of the essence that the persons concerned make a financial contribution: this might be inferred from the reference to "the contributions of the participants" in section 235(3)(a) but this also is far from conclusive.

b) Day-to-day control over management

3.8 To qualify as a CIS the arrangements discussed above must have the additional characteristic that they are:

> such that the persons who are to participate ("participants") do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions." (Section 253(2)).

3.9 "Day-to-day control over the management of…" is not a wholly easy concept. "Control over the management of…" is presumably intended to be distinguished from "management of…" i.e. arrangements will not qualify simply because the participants do not manage the property themselves. On the other hand "day to day control" must clearly mean more than having the "right to be consulted or to give directions". In *Elliott*, Laddie J referred "in colloquial terms" to "minding the shop". In practice it is not always easy to apply the test, though it appears that as a minimum the participants should be in a position to tell the person who is actually managing the property what to do on a continuing day-to-day basis.

3.10 More specifically:

a. it is difficult to apply the test to property which requires only occasional "management" or no "management" at all, e.g. a portfolio of fixed term debt securities;

b. it is established that the test is whether all the participants have "day-to-day control". But it is unclear whether this means the participants collectively (in which case some participants could possibly have more control than others) or individually. If the latter is right, it is hard to see

how arrangements with more than a very small number of participants could ever satisfy the test.

c) Pooling

3.11 The test in section 253(3)(a) is that:

"the contributions of the participants and the profits or income out of which payments are to be made to them are pooled".

3.12 This does not seem to give to any particular problems, except to the extent that some or all of the participants do not make "contributions" at all. We therefore do not consider this point further in this paper.

d) Management of the property "as a whole"

3.13 Section 235(3)(b) requires that (if the pooling criterion is not met) the property concerned must be "must be managed as a whole by or on behalf of the operator of the scheme".

3.14 This criterion, and the contrast with the alternative of "pooling", makes it clear that arrangements can (in the absence of an exclusion) amount to a CIS even though each participant is entitled to distinct part of the property if all such property is "managed as a whole". Take the example of an asset manager which provides a "managed fund service", i.e. buys and sells units in investment funds for its clients on the basis of preset models depending on the client's risk appetite: all clients with the same risk appetite will hold investments of the same kind in the same proportions, even though these may be held in separate accounts beneficially owned by the individual clients. It is arguable that notwithstanding the distinct entitlements the "arrangements" under which they are managed may fall within the CIS definition. This view is

supported by the existence of a partial exclusion for "individual investment management assignments".

3.15 However in such cases it may be possible to argue:

a. that the "arrangements" do not "enable" the participant to invest (as required by section 235(1)), since the manager could have provided the same result by managing each investor's portfolio entirely separately; or

b. more generally, on a purposive basis, that the arrangements have no "communal" basis: in *Elliott* Laddie J felt able to exclude from the scope of a putative CIS arrangements under which the clients chose their own investments, on the broad grounds that "the arrangements put in place and given effect to were not for the purpose of enabling communal investment nor did they have that effect".

3.16 It is hard to take this any further. It seems to us to be an unnecessary element of uncertainty which could be easily clarified.

e) Who is "the operator"?

3.17 Section 235(3)(b) also raises the issue of what is meant by the "operator" of a CIS. "Operator" and "operate" are not defined generally in FSMA. Section 237 states that in relation to a unit trust scheme with a separate trustee, “operator” means the manager and that in relation to an open ended investment company it means that company. It is not clear how far these stipulations assist in interpreting the wider meaning of "operator", since they are probably based on a policy desire to prescribe who the operator is in the particular cases, rather starting from the general meaning of the term.

3.18 In the absence of any clear definition the key area of dispute in practice is whether "operation":

a. extends to the overall "running" of the CIS, including the management of its assets (this is understood to be the view of the FSA); or

b. is limited to the "administrative" aspects of operation (including in particular the accounting and calculations involved in the "collective" nature of the structure) to the exclusion of asset management.

3.19 The distinction is particularly important in funding structures (particularly limited partnerships) where separate entities perform the asset management and administrative functions. If the view in (a) is correct, both entities may be regarded as "operating" and will need to be authorised under FSMA. On the view in (b), the asset manager will not need authorisation as an "operator" and may not need authorisation at all if the assets concerned are not themselves "investments" within the meaning of the RAO.

3.20 There is one final difficulty. Where a CIS takes the form of a corporate body, it is unclear whether the entity is to be treated as "operating" itself or whether one should look beyond the entity to its management. In the original legislation this issue did not arise in practice, since:

a. in the case of an open-ended investment company, the operator was defined as meaning the company (section 237);

b. no other body corporate could constitute a CIS.

3.21 However the legislation was amended in an anomalous way to reflect the introduction of limited liability partnerships: an LLP can constitute a CIS, but there is no prescription as to who the operator will be in such a case.

3.22 It seems that the greatest problems lie with the wide concept of "arrangements" (including the problem of the management of property "as a whole") and the uncertainties in relation to "day to day control" and "operator". Each of these is considered separately below.

4 ARRANGEMENTS

4.1 In *Fradley* Lady Justice Arden said this (at paragraph 33):

> The word "arrangements" has been considered in other statutory contexts. No formality is required. In some contexts communications may amount to "arrangements" even if they are not legally binding (see for example *Re Duckwari PLC* [1999] Ch 235 at 260). I need not decide whether that is the case in section 235. In my judgment, the judge was correct to say that "property of any description" in section 235(1) could include amounts paid to TBPS by persons joining in the scheme. There is no requirement for those monies to be invested in some investment….

4.2 She continued at paragraph 37 as follows:

> …it is convenient to refer to a single set of "arrangement" as a single scheme. There is no doubt that the expression "operator" in section 235 includes two or more operators acting as operators of a single scheme: the singular in a statute includes the plural. Likewise, there is no logical reason why, if there are two operators, they should have to be responsible for the entire operation of the scheme. It is enough that they are responsible for separate parts of the entire scheme. But, where two services are offered together, it does not necessarily follow that there was only one set of arrangements.

4.3 With respect we do not find this at all clear. It is very hard for anyone advising those setting up what might be a collective investment scheme to give a conclusive opinion as to whether a set of arrangements will be regarded as a

one “arrangement” or as several. We fully understand that it is the deliberate intention of the drafting of this legislation that it should cast as wide a net as possible, clawing back from that through a series of exemptions or exclusions. We also acknowledge that in many instances this may work reasonably satisfactorily, but sometimes this is not the case

4.4 As mentioned in section 3 above the *Elliott* decision supports the view that a series of separate trusts may be viewed as a single set of arrangements, whereas on the facts of *Fradley* it was regarded by the Court of Appeal as quite possible that a single financial structure could be analysed as comprising a series of separate and overlapping sets of arrangements. It is not very helpful to say that each case depends on its own individual facts

4.5 A further problem arises in connection with the reference in section 235(1) to “persons taking part in the arrangements”. It is by no means clear how far this reaches. Does it only include those who have a degree of positive involvement, or does it include passive beneficiaries? In particular, how is a private trust to be treated? The definition, being intended to be wide, may well include anyone who stands to benefit from the arrangements, or it may require that they should do something in order to be said to participate. The reference in section 253(3) (a) to the contributions of participants suggests that at least some form of financial contribution may be required, but the logic for this requirement in the overall context of the statute is doubtful.

5 DAY TO DAY CONTROL

5.1 For a scheme to qualify as a CIS the “participants” must not have “day to day control over the management of the property, whether or not they have the right to be consulted or give directions”. These words were considered in both *Elliott* and *Fradley*.

5.2 In *Elliott* Mr. Justice Laddie said that it is not necessary for all the participants in a CIS to have handed over day-to-day control over management of the property in order for the scheme to remain a CIS. Thus, where some have transferred control and others have not, the scheme will be a CIS.

5.3 This was followed by the Court of Appeal in *Fradley*. At paragraph 46, Lady Justice Arden said:

> …As Laddie J, held in…Elliott… a scheme will be a CIS even if not all the participants in it have transferred day-to-day control of the management of their monies to the operators of the scheme. This is because the fact that some of them have relinquished day-to-day control to the operators of the scheme means that section 235(2) is satisfied as regards them.

5.4 Nonetheless, confusion remains as to whether the same scheme can be regarded as a single uniform CIS from the different perspectives of both the participants who have relinquished day to day control and those who have not. In *Elliott* the view of Mr Justice Laddie was that if an investor who retains managerial control participates in an arrangement in which the other participants have relinquished control, it is just as much a CIS for him as it is for the others.

5.5 However, in *Fradley* Lady Justice Arden apparently took a different view. Following the dictum above, she went on to say:

> That is sufficient for the purposes of this case; it does not matter that the scheme was not a CIS as regards any participant who retained day-to-day control of the management of his monies…

5.6 Thus, following *Fradley*, the position seems to be a curious one. A scheme can be a CIS and not a CIS at one and the same time, depending on which participant is under consideration. This can create difficulties of application of the requirements and benefits of being a CIS which are listed in paragraph 2.1

above. It also leads to the question whether the test is to be applied on a collective or an individual basis, a point not resolved by *Elliott* or *Fradley*. Perhaps either will suffice to take participants out of a CIS, even if others with neither form of control stay in. But if individual control is required to be outside the definition of a CIS, then there will rarely be a scheme which does not qualify as a CIS by virtue of section 235(2).

5.7 The word used in the sub-section is "participants". The use of the plural may indicate that an individual approach is not to be taken, but we are not convinced that this is correct. The plural could include the singular, and "participants" could mean "each participant, whether collectively or individually". One does not know the answer.

5.8 Nor is it clear what "day-to-day control" actually involves. Is this what the operator does or something else? Presumably control exercised on a weekly basis is not covered. The phrase "whether or not they have the right to be consulted or to give directions" does not assist. In particular, it is very unclear where the boundary lies between giving directions and having day to day control. To be in a position to give directions necessarily involves control, so the key is what is meant by "day-to-day". What of participants who give directions on a regular basis, perhaps daily or at least on many days? Is that giving directions or is that day-to-day control?

5.9 It may be that section 235(2) is drawing a distinction between the right to exercise control and the actual exercise of such rights. The mere right to give directions, even on a daily basis, does not constitute day-to-day control, but if the right is actually exercised on a regular basis it may do so. Once again, one cannot have any confidence in the correct answer to the question. The uncertainty is an inevitable consequence of the desire to caste the net as wide as possible. As with the other points considered in this paper, the ambit of the statute could easily be clarified without the definition of a CIS becoming undesirably restricted.

6 OPERATOR

6.1 The most important area of uncertainty in section 235 relates to the meaning of the expression "operator". Neither the word "operator" nor indeed "operate" are defined anywhere in FSMA.

6.2 Nonetheless, section 235(3) stipulates that a scheme can only be a CIS, where contributions and profits are not pooled if "the property is managed as a whole by or on behalf of the operator of the scheme". The question of what is management as a whole has been considered in section 3 above. But it is crucial to know whether such management is or is not "by or on behalf of the operator".

6.3 Section 237 does provide that in relation to a unit trust scheme with a separate trustee "operator" means the manager, and that in relation to an open-ended investment company it means that company. But these particular cases require that as a matter of policy it should be stipulated who the operator is; no clue at all is given as to the meaning of the expression in other situations.

6.4 There is a practical issue here as to which of the following is covered, or whether both are covered. Thus:

a. does the operation refer to the actual running of the investment scheme, including the management of the assets themselves, or

b. is operation a reference to administration of the scheme?

6.5 It is common for schemes to have an administrator, who deals with information and accounting, the valuation of interests, the calculation of payments due on exit from the scheme etc. Asset managers typically fulfil a different function. Section 235 (3) talks of management of the property by the operator, so that

one might think that management of the assets is what the "operator" is concerned with, and it is believed that the Financial Services Authority is of the view that paragraph 6.4 (a) above is the correct view. But this is itself not certain.

6.6 The issue is of real practical importance in those cases where asset management and administration are separated. Do both asset manager and administrator have to manage the property as a whole? Is it enough if one or the other does so? If only (a) or (b) is covered, but not both, these questions can be answered, but which is it, (a) or (b)? And what of the custodian of the assets under a scheme, often a different party again from the administrator and the asset manager? Is he also an operator?

6.7 As with the observation in relation to "arrangements" and "day-to-day control", there is no obvious reason why these doubts could not be clarified without jeopardising the desire to cast the net wide. This would bring clarity where it is much needed for those operating in the financial markets.

6.8 One further point should be mentioned. Where a CIS is itself a corporate body, is that body to be regarded as "operating " itself, or need one look to who is managing within that body? The asset management and administration functions may all be functions of the company, but conducted by different individuals or groups of individuals. Again, who is the "operator"? This was foreseen in FSMA in relation to open-ended investment companies (see section 237), and no other body corporate could qualify as a CIS by virtue of paragraph 21 of the Schedule to the CIS Order. However, that paragraph also provides that a limited liability partnership can constitute a CIS, without stipulating who the operator would be in such a case. Is the position the same as for an open-ended investment company? Again, this can readily be clarified.

7 EXCLUSIONS

7.1 As mentioned above, the statute, namely FSMA, defines a CIS very widely and then cuts it down by exclusions. We now turn to consider, without prejudice to our view that the statutory scope should be clarified as set out in sections 3 to 6 above, (a) what those exclusions are and any particular difficulties which arise with them and (b) whether or not those exclusions should be amended or extended.

a) The existing exclusions

7.2 The Schedule to the FSMA 2000 (Collective Investment Schemes) Order 2001 (S.I. 2001/1062, "the CIS Order") specifies arrangements not amounting to a collective investment scheme. These are:

1) Individual investment management arrangements, being

   a. investments of a kind specified in articles 76 to 81 of the FSMA 2000 Regulated Activities Order 2001 ("the RAO") or contracts of long-term insurance, provided that

   b. each participant is entitled to a part of that property and to withdraw that part at any time; and

   c. the arrangements do not have the characteristics mentioned in section 253(3) (a) of the statute and have those mentioned by section 253(3)(b) only because the parts of the property to which different participants are entitled are not bought and sold separately except where a person becomes or ceases to become a participant;

2) Enterprise initiative schemes;

3) Pure deposit based schemes;

4) Schemes not operated by way of business;

5) Debt issues, as defined in articles 76 to 79 of the RAO;

6) Common accounts;

7) Certain funds relating to leasehold property;

8) Certain employee share schemes;

9) Schemes entered into for commercial purposes related to existing business;

10) Group schemes, i.e. schemes where participants are companies in the same group;

11) Franchise arrangements;

12) Trading schemes;

13) Timeshare schemes;

14) Other schemes relating to use or enjoyment of property;

15) Schemes involving the issue of certificates representing investments;

16) Clearing services;

17) Contracts of insurance;

18) Funeral plan contracts;

19) Individual pension accounts;

20) Occupational and personal pension schemes;

21) Bodies corporate etc. This exempts all companies other than open-ended investment companies, but the exclusion does not apply to any body incorporated as a limited liability partnership.

7.3 This list is set out in order to show the extent of the exclusions which are recognised. It is not desirable in principle and from a legal certainty perspective that regulatory definitions are vague and subject to many exclusions. Some of those exclusions, especially paragraphs 1, 2 and 5, are complex in themselves, and a scheme could fail to qualify for exclusion, and thus fall for consideration within the uncertain definitions of section 235.

b) Amendment or extension of the exclusions

7.4 Moving on from the consideration of the existing exclusions contained in the Schedule to the CIS Order, the next question is whether or not those exclusions should be amended or supplemented. Clearly, if the basic definition of a

collective investment scheme is narrowed or more clearly defined, as considered in sections 3 to 6 above, then that will have a knock-on effect on the necessary scope of the exclusions. This section proceeds on the assumption that the basic definition is maintained.

c) Paragraph 9 of the Schedule

7.5 The principal focus of discussion to date has been on the redrafting of paragraph 9 of the Schedule. That paragraph excludes certain arrangements entered into for commercial purposes relating to an existing business. HM Treasury accepted that the scope of the current paragraph 9 is or could be perceived to be too narrow, and published two consultation papers, in January and August 2007, on the topic. Between these two papers a meeting took place at the Bank of England between representatives of the Treasury and of the FMLC Working Group, and we welcome and appreciate the extent to which our views expressed at that meeting were taken into account in the further consultation paper and in the amendments as finally adopted (the "Amended Provisions").[12]

7.6 It was common ground between the Group and the Treasury that the way forward was to redraft paragraph 9 rather than to exempt particular bodies carrying out property or commercial transactions. It was also common ground that amendment of paragraph 9 was preferable to the status quo. The Amended Provisions go a long way to meeting our concerns about the desirable scope and the drafting of an amended paragraph 9.

7.7 The first point made at the meeting and accepted in the second consultation paper is that the paragraph should define “permitted participants” falling outside the CIS regime rather than, as sub-paragraph (4) of the first draft of the amendment provided, saying that certain bodies are not participants at all.

[12] See the FSMA 2000 (Collective Investment Schemes)(Amendment) Order 2008 (SI 2008/1641).

Thus, in respect of new arrangements there is exclusion where all participants are permitted participants (as defined), absent agreement to the contrary in writing at the time the arrangement is entered into.

7.8 The second point reflected in the Amended Provisions is that the exclusion should not only be for participants who have a pre-existing business (other than or in addition to any business comprising specified regulated activities - "specified business"), but should extend at least to Special Purpose Vehicles set up for the purpose of the transaction itself. In the event the Treasury has extended the range of permitted participants to cover *all* entities which do not carry on specified business and whose participants would themselves qualify as permitted participants if they participated directly in the scheme.

7.9 The third point which the Treasury has taken on board is the need to include non-legal persons. This is achieved in the following way. Of the two types of "permitted participant" the first, covering participants with existing businesses, makes no mention of extension beyond legal persons. The second, however, namely that considered in paragraph 7.8 above, expressly extends not only to corporate bodies, but also to an "unincorporated association, partnership or trustee (unless that trustee is an individual)". Limited liability partnerships are not mentioned, presumably because they qualify as "bodies corporate". The principal issue here is whether or not there is any need to extend the first type of "permitted participant" to include these non-legal persons.

7.10 The fourth point taken on board by the Treasury is the need to observe the requirements of Article 7 of the ECHR with regard to retrospectivity. Under the Amended Provisions that there be three categories.[13] Existing CIS-exempt arrangements are to be preserved. Existing arrangements which do qualify as CIS should only be able to take advantage of the wider exclusion for the future where all participants irrevocably so agree and where they are "permitted

[13] Subject to a minor textual correction which the Treasury is to make to the Amended Provisions.

participants". New arrangements can take advantage of the wider exclusion, unless all participants agree irrevocably not to benefit from it. This seems to solve any retrospectivity problems.

7.11 The effect of these improvements to the amended paragraph 9 may be thought satisfactorily to address the concerns previously outlined. However, there is some room for argument about the words "wholly or mainly" which appear in the Amended Provisions. The idea is that a company which has a specified business should be able to benefit form the exclusion where it enters into an arrangement for commercial purposes "wholly or mainly" related to another existing business. There is some uncertainty here as to how this will operate, but it is probably acceptable, given the need to be able to protect those with specified businesses but also other businesses and yet to stay within the spirit of the proposed amendments.

7.12 It is worth noting that:

a. In applying the paragraph in its present form the general view appears to be that "commercial purposes" is essentially a synonym for "business", or "money-making" purposes. In practice the FMLC understands that the exclusion is used in cases where at least some of the participants participate for what would naturally be characterised as investment purposes. It has to be assumed that the legislation does not intend to distinguish in this context between "commercial" and "investment" purposes as is the case, for example, in Articles 83 and 84 of the RAO (on options and futures, respectively). This view is convenient but not self-evidently correct;

b. It will not always be easy to justify the participation of parties acting as trustee or nominee, since:

(i) It is at least arguable that trustees do not per se "carry on a business" at all, in which case they will not qualify as permitted participants except in the specific circumstances described in paragraph 7.8;

(ii) A nominee may be engaged in the regulated activity of safeguarding and administering investments (article 40 of the RAO); and

(iii) To qualify as in "indirect" participant a beneficiary of a trust will have to be involved in the overall arrangements for commercial purposes relating to the beneficiary's business

7.13 These points reflect a remaining uncertainty about whether the exclusion is meant only to cover "commercial transactions between businesses" (in the Treasury's words) or a wider range of joint transactions/investments involving financial and investment institutions.

d) Other exclusions

7.14 Other commonly-used exclusions either create their own uncertainty or exacerbate the practical difficulties of the general definition by being unduly narrow in scope. These are addressed below.

i) Individual investment management arrangements (paragraph 1)

7.15 This exclusion is designed to provide a partial answer to the problem of “parallel management” (see paragraph 3.14 above). An investment manager who manages a series of portfolios for individual clients in accordance with a standardised model will make acquisitions and disposals for each portfolio in accordance with the model and may thus be said to "manage [the property

concerned] as a whole". The result may be that the overall arrangements constituting the manager's business in this area amount to a CIS, even though there is in substance no "collective" element.

7.16 To qualify for the exclusion the arrangements must (in summary) satisfy the following criteria:

a. The property concerned must comprise:

(i) shares, debt instruments, warrants, or certificates representing securities, i.e. instruments falling within Articles 76 to 80 of the RAO;

(ii) units in a regulated investment fund;

(iii) a contract of long term insurance; or

(iv) cash awaiting investment.

b. Each participant must be "entitled to a part of the property and to withdraw it at any time".[14]

7.17 There are various problems with these criteria:

a. there seems no reason why the range of permitted investments should be so limited. If this ever made sense, it does not do so in an investment

[14] Under an additional subparagraph (c) the arrangements must not involve poooing as mentioned in section 235(3)(a) of the Act and must involve management as a whole as mentioned in section 235(3)(b) only because the parts of the property to which different participants are entitled are not bought and sold separately except where a person becomes or ceases to be a participant.

environment where, for example, structured investment products (which are likely to fall within Articles 83 to 85 of the RAO) and unregulated hedge funds are widely used. If consumers need protection in dealing with those investments, this can be (and is) achieved in other parts of the regulatory system;

b. it is common for the assets managed under such a structure to be held by a custodian appointed by the manager. It is also common for assets in these circumstances to be held in a single account in the name of the manager, designated as held for the manager's clients. It is at least arguable that on the true legal analysis of such an account the clients concerned have an undivided share in the entire property. There is therefore some doubt about whether each of them is "entitled to a part of the property";

c. it is not wholly clear whether an "entitlement to withdraw" must comprise a right to withdraw the assets in specie, or whether a right to realise their cash value is sufficient. To the extent that the client is not "entitled" to identifiable assets (see above) it is arguable that the reference to "withdrawal" of a part of the assets cannot be construed narrowly, but this is not clear.

7.18 Some liberalisation and clarification of the exclusion would remove uncertainty in this area.

ii) Pure deposit-based schemes (paragraph 3)

7.19 This exclusion appears primarily designed to ensure that a bank or other deposit-taker is not a collective investment scheme. It applies where the whole of each participant's contribution is:

a. a deposit (presumably as defined in the RAO, though this is not stated);

b. which is accepted by an authorised person with permission to accept deposits or an exempt person.

7.20 The oddity here is the restriction in (b). This implies that a non-UK bank may be a CIS. More generally there seems no good reason why a person who accepts deposits in circumstances which, presumably for good policy reasons, fall outside the scope of the regulated activity in article 5 of the RAO should then be made subject to the CIS regime.

iii) "Schemes not operated by way of business" (paragraph 4)

7.21 The problem here is that there may be different views about what is intended by the phrase "by way of business". On a narrow view the exclusion will not apply if the operator is paid for its services. On a wider view the exclusion will apply if the scheme itself is not run as "a paying proposition". The distinction is important as arrangements where assets are commingled for purely administrative purposes, e.g. as a fund to make charitable payments, may be excluded on the wider view, but not on the narrower view if a professional nominee or administrator is used. [15]

iv) Further exclusions

7.22 We are not convinced that there is a pressing case for the addition of any new categories, subject to one exception. That relates to closed-ended collective investment undertakings which are now covered by the Prospectus Directive. Given that these arrangements are fully provided for under that Directive, there seems no need for them to be regulated twice, i.e. under the FSMA CIS regime as well. Not only is this duplicative, but also there is a danger of inconsistency. Given that the opportunity is being taken to review the scope of the exclusions,

[15] The exclusion of LLPs from the exemption for bodies corporates has had the unfortunate consequence, from the perspective of legal certainty, that it is unclear whether any given LLP is likely to constitute a CIS or not. See also paragraph 3.21 above.

it would seem that this is an ideal opportunity to promote legal certainty by preventing an anomalous and inconsistent result.

7.23 This leads to a broader point. The point taken in the earlier paragraph about the Prospectus Directive could be replicated in future as a result of further changes in European law, where schemes of one sort or another are brought within some form of regulatory control, creating duplication with the FSMA CIS regime. It would be useful to provide a streamlined mechanism so as to enable such anomalies to be dealt with without the need for the introduction of a fresh statutory instrument.

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