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The FCA introduces side pockets for authorised funds: Protecting investors in authorised funds following the Russian invasion of Ukraine

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FCA policy statement PS22/8 "Protecting investors in authorised funds following the Russian invasion of Ukraine" sets out emergency measures to deal with the impact of the Russian invasion of Ukraine on authorised funds and retail investors. The rules came into force on 11 July 2022.

The policy statement follows on from the FCA consultation paper CP22/8 "Protecting investors in authorised funds following the Russian invasion of Ukraine".

See our 10 May 2022 client briefing "The use of side pockets by retail funds for assets affected by the invasion of Ukraine".

The FCA policy statement and consultation

The FCA recognises that the Russian invasion of Ukraine has had a significant impact on financial markets and on FCA-regulated authorised funds. To address this, the FCA is introducing an unprecedented liquidity management tool for authorised funds, known as side pocketing. Side pockets are commonly used in non-retail funds, such as hedge funds, either to deal with illiquid assets or in response to unforeseen circumstances. To date, side pockets have not been permitted for FCA authorised funds, on the basis most types of them are meant to hold liquid assets and offer redemption on demand.

The use of side pockets should be seen in the context of the current emergency situation. Side pockets will be permitted only if a fund's assets are genuinely affected by the Russian invasion of Ukraine and resulting sanctions. The FCA say that they will not allow authorised funds to use side pockets more widely.

The FCA truncated its usual consultation period to 18 days in light of the urgency of the situation.

Background to the policy statement

Numerous Russian, Belarusian and Ukrainian assets have been rendered illiquid or untradeable due to the Russian invasion, international sanctions imposed on Russia and Belarus and Russian and Belarussian countermeasures. Normal mechanisms for accurately valuing these assets are therefore currently unavailable. PS22/8 and the regulation refers to such assets as "affected investments", which include any asset or investment that is subject to a relevant sanctions regime and held in an authorised fund.

Affected investments include:

- equities and fixed-income securities issued by governments, public authorities and corporates in Russia, Belarus and Ukraine and securities listed, offered or placed in those countries
- assets listed and traded on other stock exchanges and backed by such securities, for example depositary receipts
- securities issued by companies whose operations are particularly severely affected by the current situation, or which are owned or controlled by individuals who are the subject of UK or international sanctions relating to Russia
- units in other collective investment schemes that have suspended dealings because of exposure to such assets

Some authorised funds with material exposure to affected investments have suspended dealing because of valuation uncertainty, in line with the FCA's usual rules on suspension. Investors in those funds are currently unable to exit and redeem their investments. It is unclear how long these funds will remain suspended and, with no alternative measures, investors could be locked in for long periods.

Many authorised funds with limited, but not material, exposure to affected investments remain open for dealing but face other issues. In many cases, as a prudent measure, authorised fund managers ("**AFMs**") have written down the value of affected investments to zero or near-zero in light of the current situation, risks and inability to deal in assets subject to sanctions.

The FCA believes that permitting side pockets will allow:

- new investors to enter funds without being exposed to affected investments
- existing investors to redeem that part of their investment which relates to liquid assets
- some suspended funds to recommence dealing

Overview of side pocketing

Side pocketing separates illiquid, hard to value and high risk assets from the other assets of a fund. The FCA's chosen side pocket model is to create one or more new unit classes in the existing fund to hold the affected investments.

AFMs will be allowed to establish a separate class, or a range of classes, within the fund which will be valued purely by reference to the affected investments. All other classes will be valued by reference to the liquid assets only. The number of side pocket unit classes and their features will be at the AFM's discretion. AFMs might consider it helpful to issue units by reference to the existing structure of unit classes in the fund. Alternatively, AFMs might decide to issue a single side pocket unit class for simplicity.

On creation of the side pocket, investors will receive units linked to the value attributable to the affected investments, proportionate to the exposure they had immediately before the creation of the side pocket. The side pocket unit class will not accept further subscriptions. The AFM will manage the side pocket with an eye to realising the value in the assets as and when this can be done in the best interests of its unitholders as part of an orderly wind down.

Existing investors will continue to hold regular units in the fund linked to the value of the liquid assets, which they will be able to realise on the usual basis. Existing investors' overall exposure to assets (both affected investments and liquid assets) and their ownership rights will not change as a result of creating a side pocket unit class.

The alternative model to the side pocket

There is an alternative model to the side pocket which can achieve a similar result in substance, but through a separate route. This involves setting up a new fund with a similar investment objective and policy and then using a scheme of arrangement under COLL to transfer the liquid assets to it, leaving the affected investments behind in the original fund that is then wound up. The FCA rejected facilitating this approach under the new rules on the basis of cost and complexity. However, this model is we believe from experience still feasible without any regulatory amendments, although it does (unlike the new side pocket route) require an extraordinary resolution by investors at an EGM, which has time, cost and project planning implications. In the Policy Statement, the FCA invites those firms who would prefer to use the new fund model to contact them directly.

Overview of the rules

Changes between the Policy Statement final rules and Consultation Paper proposed rules

The FCA has:

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

Scope

The side pockets rules are set out in COLL 7. They apply to transferable securities including depositary receipts, money market instruments, units in collective investment schemes and shares in AIFs which are:

- sanctioned by one or more of Canada, the EU, France, Germany, Italy, Japan, the United Kingdom or the United States
- issued or guaranteed by the government, central authority, regional authority, local authority or central bank of Russia, Belarus or Ukraine
- issued or guaranteed by an issuer which has its principal place of business in or has significant economic ties to Russia, Belarus or Ukraine, such that fair valuation of the investment is no longer possible

To fall within the scope of the side pockets rules a fund must meet a three step test:

- it must hold an affected investment within the categories set out above
- the affected investment must be connected with one or more of the three affected countries
- the affected investment must either be sanctioned or impacted economically through its connection to the affected countries

The side pocket rules apply to UK UCITS and NURS, but do not apply to regulated money market funds. The FCA has explained that it sees no need to introduce the new rules for Qualified Investor Schemes (QIS) on the basis, in short, that side pockets should be available to them already.

Initial considerations

The AFM must understand the legal requirements and obligations under the applicable sanctions regimes and be satisfied that the creation of the side pocket and associated operational arrangements will comply.

New guidance in COLL 7.8.3G notes that contravention of the UK sanctions regime constitutes a criminal offence. Further guidance on issues to be considered by AFMs is set out in COLL 7.8.7G.

A new rule under COLL 7.8.4R provides that a side pocket unit class can be created if:

- an AFM determines that:
    - the affected investments meet the three step test
    - creating the side pocket unit class will protect the interests of unitholders
    - the rights of side pocket units will not be unfairly prejudicial to the interests of unitholders generally
    - the issue of units in the side pocket unit class will be in the best interests of unitholders, the fund and the integrity of the market
    - all unitholders in the fund will be treated fairly
- the fund's prospectus and instrument provide for the issue of units in a side pocket unit class and set out the terms on which that class will operate

In order to reach a final decision, the AFM must also:

- consult with the depositary
- consider a list of non-exhaustive matters and guidance in COLL 7 Annex 1
- consider whether to suspend dealing in the fund as an alternative to creating a side pocket
- have regard to the reasonable operational needs of distributors and intermediate unitholders, taking into the account the context, urgency and exceptional nature of the situation and the necessity to protect investors' interests in a timely manner

The decision to create a side pocket unit class must be taken by the AFM's governing body. If, after setting up a side pocket, further affected investments need to be segregated from the fund's liquid assets, a second side pocket must be created, as it will not possible to add further affected investments to an existing side pocket.

The rules suggest an AFM should seek legal advice on certain initial considerations, including whether the side pocket and the rest of the fund should together constitute a single collective investment scheme under FSMA. This uncertainty was noted in the FCA's consultation and it has unfortunately not been able to resolve it for the final rules.

Limited issue

Side pocket unit classes are limited issue under COLL 6.2.18R, so no further units in that class can be issued after the initial pro rata issue to existing shareholders.

Any further investments in the fund, whether made by existing or new investors, can only receive units in classes valued by reference to liquid assets.

Allocation of scheme property

The FCA expects AFMs will need to consider how to apply a fair accounting treatment when the side pocket unit class is established, in addition to the obligations imposed by COLL 7.8.4R. No rules have been drafted, but new guidance at COLL 7.8.8G clarifies how the AFM should allocate capital property and income property to the side pocket unit class.

The AFM will need to decide whether to allocate a portion of uninvested cash to cover costs and charges of the side pocket. The side pocket may also need to undertake derivative transactions to hedge its foreign currency exposures back to the fund's base currency.

Costs and charges

The FCA accepts that a side pocket unit class should bear a proportionate share of costs which are incurred for the benefit of all unitholders, such as depositary fees, audit fees, regulatory charges and expenses incurred by the AFM managing and administering the fund. AFMs will have some discretion to determine how to allocate such costs and charges, including recovering these from any income or capital attributable to the side pocket unit class. The AFM may decide to accrue such costs and charges indefinitely until sufficient cash is available to cover them, or to waive some charges or pay them from its own resources.

The FCA also accepts that AFMs should not be prevented from charging for managing the side pocket, but it warns that any such management fee should fairly reflect the AFM's activities. In the circumstances, the FCA believes that it might be more appropriate for the AFM to charge a reduced or nil fee for managing side pocketed affected investments. Under COLL 7.8.30R, AFMs will be prevented from charging preliminary, exit or performance fees to side pocket unit classes.

If an AFM's approach to costs and charges deviates from FCA guidance, we anticipate that the FCA will scrutinise and question that deviation, particularly as part of assessment of value reporting.

Updating scheme documents

The FCA takes the view that, notwithstanding the usual rules on the ability to issue unit classes permitted under the instrument, instruments and prospectuses of authorised funds do not currently allow for side pocket unit classes. AFMs will need to amend fund documents before creating side pockets. Those amendments must include the terms on which such classes will operate under COLL 7.8.4R(2)(c).

Amending fund instruments requires prior approval by the FCA's Fund Authorisations team, a process which normally takes a month. The FCA aims to expedite the review of the application and approval process for amendments which are limited to those necessary to permit a fund to create side pockets.

Notifying investors

The FCA will treat implementing side pocket unit classes as a significant change (rather than a fundamental change) provided the foreseeable costs of the side pocket are not disproportionate to its benefits.

Despite being classified as a significant change, the FCA will use COLL 7.8.16R to disapply the usual requirement under COLL 4.3.6R(3) to give prior notice. Instead, the AFM must inform unitholders in a timely way, either by announcing its decision in advance, or after the change has been implemented.

The key points to be covered by this notification are set out in FCA guidance under COLL 7.8.20G. The notification must:

- explain what a side pocket is
- avoid excessive use of legalistic language
- summarise the key features and enhance the risk warnings in the prospectus relating to the side pocket unit class
  including the possibility of 'contagion risk' (when costs and charges attributable to the side pocket class become a liability on the assets attributable to other classes) and how the AFM will protect unitholders in other classes from this risk
- say where further detail may be found

Voting rights

The rules dispense with the requirement to hold a unitholder meeting to approve a side pocket, and explain how voting rights attaching to side pocket units may be exercised at a meeting of unitholders. Respondents to the consultation asked whether the absolute value of the affected assets in the fund or the percentage of the fund comprising of affected assets should determine whether a unitholder meeting should be held. The FCA has stated, however, that the fund specific factors to be considered when deciding whether to create a side pocket do not affect whether or not a unitholder meeting should be held.

FCA website content relating to side pockets

The FCA are considering publishing material on the consumer section of their website explaining the key features of the side pocket regime in order to help demystify the concept.

No requirement for UCITS KIIDs or NURS KIIs

There will be no requirement to produce UCITS KIIDs and NURS KIIs for side pocket unit classes as they will not be offered to potential investors in exchange for new subscriptions.

Managing the side pocket

The FCA proposals include guidance on the long term management of side pockets.

COLL 7.8.33R explicitly recognises that AFMs will not be managing side pocket unit classes in line with fund's investment objectives and policies, but with a view to closing down the side pocket class as and when this can be done in the best interests of unitholders.

AFMs should implement regular review processes to assess the impact of costs and charges on side pocket unit classes and whether they are offering good value for investors.

Assessment of Value

COLL 7.8.34R, introduced in the Policy Statement, states that when making an assessment of value ("**AoV**"), an AFM of a fund with a side pocket should consider the whole fund, including the side pocket, but should adopt a proportionate approach to the specific assessment of the side pocket class. If payments are being accrued or debited from the scheme property allocated to the side pocket class to cover its costs and charges, the AFM must weigh up whether those accruals or payments are justified in terms of the value delivered to unitholders. The AFM must consider whether payments are prejudicial to the interests of unitholders in other classes and whether it remains in unitholders' best interests for the side pocket to continue in operation.

Investment and borrowing powers

The investment and borrowing powers under COLL 5 continue to apply, however they will be relaxed by COLL 7.8.26R and AFMs will only have to comply with the relevant sections of COLL 5 to the extent practicable.

The rules in the Policy Statement provide that a fund may have only one investment objective and policy applicable to all unit classes. The AFM of funds holding affected investments must decide if the objective and policy are broad enough to encompass a modified strategy of not investing in affected investments in the future. If the investment and objective and policy are broad enough, the AFM must hold the affected investments in line with the policy and inform investors that no further investments in affected assets will be made.

If a fund's investment policy is worded so as to permit continued investment in the affected countries, the AFM must consider whether to amend it, which will require the approval of a meeting of unitholders.

Redemption and exit

The FCA recognises that there are a number of possible redemption scenarios depending on developments impacting the liquidity and valuation of the affected investments. If the AFM is satisfied that valuations are accurate, it could allow unitholders in the side pocket to sell their units at that value should they wish to do so. If the value is negligible, it could be written off by cancelling the units without debiting the scheme property of the fund. If it is not, but the unitholder does not wish to receive proceeds from the fund's exposure to Russian or Belarusian assets, the AFM could donate the proceeds to charity. However, if the affected investments in the side pocket are insufficiently liquid to support redemption, the AFM should consider suspending all dealing in the side pocket unit class under an exception in COLL 7.8.37R permitting dealing to be suspended at class level.

AFMs will be allowed to use their discretion to specify special non-standard dealing terms for the side pocket class, including the option of an extended time period for settlement.

The hope is that side pocket unitholders will be offered a choice regarding exit, if future circumstances allow. The FCA expects AFMs to provide timely information to investors and to ensure that information can be easily passed on to investors with whom they do not have a direct relationship.

In due course, AFMs will need to make specific proposals for termination of side pockets.

Duration

There is no requirement in the draft rules for AFMs to make any explicit commitments to maintain the class for a minimum or a maximum period. The FCA expects AFMs to keep this under review and to respond to developments. AFMs should develop an appropriate risk management plan and determine how ongoing costs and charges will be met.

The FCA will consult in due course on the timing of the withdrawal of the emergency measures. Any withdrawal of the power to create side pockets will not compromise those side pockets already in existence.

ISA eligibility

HM Treasury and HMRC are of the view that under the ISA Regulations whether or not a UCITS or NURS is eligible for inclusion in an ISA should be determined at the level of the FCA's recognition or permission for the fund, not at the level of the fund's unit classes or the underlying assets. Therefore the creation of a side pocket class will not impact the ISA eligibility of either the fund as a whole or the side pocket class, however there may be implications if an investor wishes to transfer the fund.

Making side pockets permanent

In response to requests to make side pockets available permanently and more widely for authorised funds, the FCA notes that wider use of side pockets is not within scope of the policy statement. The FCA states that the scope does not include any possible extension in the scope of assets to which the policy applies, the potential for the arrangements to be made permanent, the duration of side pockets, and firms' assessment of value and management of costs within the context of side pockets.

The FCA will review the effectiveness of the use of side pockets in dealing with the current scenario, before deciding a wider future policy position.

How can Eversheds Sutherland help?

Eversheds Sutherland is widely recognised as one of the leading advisers to the investment funds industry, with one of the leading fund, asset management and regulatory teams. We have over 40 years' experience of investment funds work and, in particular, authorised funds.

If you would like further information on the side pocket rules of both the FCA and the Luxembourg CSSF (please see our previous May client briefing), get in touch with your usual Eversheds Sutherland contact or the authors below:

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