16 May, 2022

Mhairi Jackson & Mark Glibbery
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

Submitted by e-mail to: amfpolicy@fca.org.uk

Dear Ms Jackson & Mr Glibbery,

CFA UK response to the FCA regarding CP22/08: Protecting investors in authorised funds following the Russian invasion of Ukraine

The CFA Society of the UK (CFA UK) and CFA Institute1 are pleased to respond jointly on this topic of immediate and widespread relevance to many UK institutional and retail investors. Whilst ‘only’ £4.5 billion of affected assets were held by UK domiciled funds pre-invasion, we note the wide distribution of these assets means that as many as half of the authorised retail funds domiciled in the UK are currently impacted.

We are pleased to provide our responses to the consultation questions in Appendix II. However, we summarise our main points below:

• **Voluntary decision**: We agree it is of fundamental importance that the decision to set-up a side-pocket rests with the fund managers and directors exercising their fiduciary duty to look after the best interests of their clients. We believe this to be entirely appropriate since the position of each and every fund will be unique in terms of the relative proportion of their assets which are ‘affected assets’ and their nature (sanctioned, economically impacted, unquoted or illiquid).

• **Sanctions**: Whilst the prime objective of this side-pocket proposal is to ensure the ongoing full liquidity of the main part of funds invested in unaffected assets we are conscious that it also leaves a rump of affected assets, most of which will be sanctioned. As such, we do not believe that the majority of side-pockets should be tradeable or transferable currently and we believe the FCA should make this expectation clear. These proposals should not become a mechanism by which sanctioned assets can become tradeable or transferable.

• **Future-proofing**: We think the FCA should give consideration to allow future fund documentation to be drafted, and existing fund documentation to be amended, to provide for the ability to establish side pockets so that, in the event of repeat set of circumstances and under specific FCA direction, a new side-pocket could be set up almost immediately in response, free of consultation delay.

• **Bank deposits & derivatives**: we see no reason why ‘affected’ bank deposits and derivatives should not be eligible for inclusion in the side-pocket.

• **Investor communications**: we agree that the FCA and the fund manager will both need to carefully consider the precise communications to investors concerning the

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1 CFA UK’s mission is to help build a better investor profession for the ultimate benefit of society. We refer you to Appendix 1 for a brief overview of both CFA UK and our umbrella organisation, CFA Institute.
transformation process and the rationale for it. These communications will need to cater for all investor types and the different chains and channels of ownership.

- **Performance Fees**: we would have no issue with a performance fee provided it was not allowed to exceed the fee that would have been payable in relation to the assets had they still been in the main fund. We do see a benefit of incentivising the fund manager to sell the assets judiciously as markets recover and not necessarily at the first sight of a bid. However, any fee should not exceed that which would otherwise have been payable.

- **Transformation process**: we believe it is vitally important that the affected assets are written down to an appropriate valuation in good time ahead of the transformation date so that no apparent value leakage is seen to occur on the transformation date. A failure to do this would risk undermining investor trust and confidence in what would clearly be viewed as an FCA-led process. Index providers may be a useful valuation source on some assets; fund managers should document the source and justification for affected asset valuations on transfer.

- **Performance Evaluation**: we believe it would be helpful if the FCA could give some thought and guidance to how they would expect funds to record the historic performance of those funds which do decide to set-up side-pockets. If affected assets are written down to zero before transfer to the side-pocket, thereby negatively impacting fund performance, but then the side-pocket is subsequently sold for a positive sum, should that recovered value be included in fund’s historic recorded performance data? It would seem wrong to exclude that value recovery in the historic performance data for investors that owned the fund up until the date of the transfer of affected assets to the side-pocket; equally it would seem wrong to include it in the historic performance data for those investors investing in the fund for periods of time after the date of the transfer of assets to the side-pocket.

Should you have any questions or points of clarification regarding this letter or our responses to the questions, do not hesitate to contact us.

Yours sincerely,

Will Goodhart
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CFA Society of the UK

Olivier Fines, CFA
Head of Advocacy and Policy Research, EMEA
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Andrew Burton
Professionalism Adviser
CFA Society of the UK

With thanks for the oversight of the CFA UK Professionalism Steering Committee
APPENDIX I: About CFA UK and CFA Institute

CFA UK serves nearly twelve thousand leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments, or as in-house employees responsible for pension investment oversight.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society’s best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation or are candidates registered in CFA Institute’s CFA Program. Both members and candidates attest to adhere to CFA Institute’s Code of Ethics and Standards of Professional Conduct.
- For more information, visit www.cfauk.org or follow us on Twitter @cfauk and on LinkedIn.com/company/cfa-uk/.

CFA Institute is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organisation is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors’ interests come first, markets function at their best, and economies grow.
- CFA Institute awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations worldwide, publishes research, conducts professional development programs, and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.
- CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.

For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAIInstitute and on Facebook.com/CFA Institute.
APPENDIX II: Responses to questions

Q1. Do you have any comments on our assessment of the effects of our proposals on existing unitholders? If so, please provide details.

We believe the FCA’s reasoning behind the proposals is sound. Asset illiquidity in certain markets does naturally occur from time to time due to extraneous events and it is not normal practice for regulators to intervene in this manner. However, given that the sanctions on Russian assets were imposed by the UK as well as other governments it is perhaps right that a regulatory solution should be sought in this instance.

The problem is widespread with half of UK domiciled funds owning affected assets. As a result of the sanctions, these funds may (i) be no longer investable for many investors (even though the affected assets constitute in most cases a very small part of the fund) and (ii) unsellable for existing investors.

We believe it could make sense for the FCA or the government to think of regulatory provisions allowing AFMs to structure such side pocket structures as a regular standing provision of fund prospectuses, so that, in the event of repeat set of circumstances and under specific FCA direction, a new specific side-pocket could be set up almost immediately in response.

Q2: Do you consider our proposals adversely impact any groups with protected characteristics under the Equality Act 2010? Do you consider there are any issues which may be relevant to our obligations under the Equality Act (see paragraph 2.24)? If so, please provide details.

No.

Q3: Do you agree that the proposed unit class structure is a suitable way to create a side pocket in a retail fund? Are there any improvements that could be made to it?

Yes. We see no obvious improvements that could be made.

We think consideration should be given to allow future fund documentation to be drafted, and existing fund documentation to be amended, to provide for the establishment of side pockets so that, in the event of repeat set of circumstances and under specific FCA direction, a new specific side-pocket could be set up almost immediately in response.

Q4: Do you agree that the proposed side pocket class could operate without causing prejudice to the interests of other investors in the fund?

Yes.

We agree that the main objective of the side pocket, to restore market liquidity in an affected fund, will be welcomed by most investors in it. There are potential downside consequences, but these can be managed along the lines that the FCA describes. Lastly, we note the establishment of the side pocket is voluntary so should only be employed by fund directors in the exercise of their fiduciary duty to protect investors in the fund.
Fund performance and reporting is designed to operate on a unit-by-unit basis, so investors who are not invested in the side pocket unit should not be impacted beyond normal cost sharing allocations.

Q5: Do you have any comments on the side pocket model set out above? Should the FCA take steps to enable AFMs of funds holding affected investments to use this alternative model?

We have no further comment. The unit-share structure looks preferable to the more costly alternative of full legal separation. The latter looks more cumbersome and is likely to involve heavier administrative steps between the AFM, the directors and the shareholders.

Q6: Do you agree with our proposals to define the scope of affected investments? If not, which other assets would you allow to be included in a side pocket (or require to be excluded) and why?

The overall scope outlined is reasonable and rational. Namely, affected assets are defined as those which are, as a result of the crisis, either (i) sanctioned, (ii) incapable of fair valuation, (iii) denominated in an affected currency or (iv) traded on an affected exchange.

As for derivatives, we believe any derivative hedges (for example negative basis CDS or asset swaps) need to be allowed to follow the underlying affected assets into the side-pocket.

Though the amounts concerned are likely to be relatively small, we are unclear why the FCA concludes in paragraph 4.4 to exclude affected cash and investment derivative assets. Cash deposits or derivative positions with Russian banks, for example, would seem to be just as impacted as affected tradeable securities being potentially frozen, illiquid, non-cancellable and designated as ‘sanctioned assets’?

Q7: Do you agree with our proposed conditions for creating a side pocket class? If not, what conditions do you think should apply to the creation of a side pocket class and why?

Yes. We agree with the listed conditions.

Importantly the fund directors make the decision to create a side pocket class only if it is in the interest of unit holders generally. In the event of a swift recovery to the markets in the affected assets, there is a risk of costs being incurred for no real benefit but we consider this eventualty unlikely at present.

Q8: Do you agree that the AFM’s governing body should be required to consider the matters set out above before deciding whether to approve the creation of a side pocket unit class? Are there any other matters the governing body should consider?

Yes. No further comment.

Q9: Do you agree with our approach to amending the instrument constituting the fund and the prospectus? If not, what alternative approach would you recommend?
Yes. The proposed approach sounds practical and reasonable given the urgency of the situation in some cases. Proposing to work with industry stakeholders for example on template legal wording seems eminently sensible and should minimise cost.

As mentioned earlier in question 3, we think consideration should be given to allow future fund documentation to be drafted, and existing fund documentation to be amended, to provide for the establishment of side pockets so that, in the event of repeat set of circumstances and under specific FCA direction, a new specific side-pocket could be set up almost immediately in response.

**Q10: Do you agree with our proposal to dispense with holding a unitholder meeting to approve the side pocket? If not, what benefit do you think holding a meeting would provide for unitholders in the current situation?**

Yes. Holders should have the right to request a meeting if they deem it in their interests, subject to the usual thresholds, but we cannot foresee any material, general reason why an investor would wish to take this up.

**Q11: Do you agree with our proposals for AFMs to notify investors about the creation of the side pocket? If not, what steps should the AFM be required to take?**

Yes.

It will be of particular importance that sufficient information is provided so that retail unit holders understand the restructuring process. Potentially two levels of documentation could be made available: (i) a fairly simple fact-sheet for retail investors, with key aspects, risks, limitations, and (ii) a more detailed disclosure with full legal technicalities for professional investors and lawyers.

**Q12: Do you agree that AFMs should decide the best way of issuing units in new classes so that holdings are proportionate to the existing classes? If not, what alternative approach would you suggest?**

Yes. No further comment.

**Q13: Do you have any comments on how income property and capital property should be allocated to a side pocket class? What are your views on the allocation of uninvested capital cash and its use to carry out hedging transactions?**

We believe cash levels should be kept at a minimum in the side pocket. If the assets are written down to zero we assume no capital is actually needed.

Since (i) the length of time the side pocket will be needed cannot be determined at the outset and (ii) given the probable uncertainty of income from affected assets, sizing a sufficient cash buffer in the side pocket to meet ongoing fees and expenses would appear to be prone to error. In the event of under provision we would expect the management firm to meet any shortfall, perhaps on an accrual basis pending liquidation though that will be an interesting matter for the fund board, together with I-NEDs to decide.
Clearly, we would not expect any asset transfers or asset sales back to the main fund from the side-pocket.

**Q14: Do you agree with the proposed guidance on how costs and charges should be allocated where a side pocket class is created?**

Yes. We agree with the FCA’s comments. The likelihood is that the affected assets will be written down to zero and as a consequence should incur no *ad valorem* fee so long as they remain at that value. Otherwise, fees and costs should be kept at a minimum, though we do not necessarily agree that these assets will be ‘low maintenance’ just because there is no market for them. In the event of a cash shortfall emerging in the side pocket due to costs and expenses this will need to be met/absorbed by the fund manager either directly on an ongoing or an accrual basis (which may prove ultimately unrecoverable).

Fund managers should ensure that there is full transparency on the fees and costs charged and we agree that the Value Assessment statement is one place where we would expect to see disclosures.

We would have no issue with a performance fee provided it was not allowed to exceed the fee that would have been payable in relation to the assets had they still been in the main fund. We do see a benefit of incentivising the fund manager to sell the assets judiciously as markets recover and not necessarily at the first sight of a bid. However, any fee should not exceed that which would otherwise have been payable.

**Q15: Do you agree that an AFM should not charge preliminary or exit fees, or a performance fee, when managing a side pocket class?**

We fully agree that there should be no preliminary, entry or exit fees.

As stated above in our response to question 14, we can see a benefit in the alignment of interests from a performance fee provided that it did not exceed that which would otherwise have been payable. If the original fund did have a performance fee, then it would seem fair in principle to retain this on the side pocket though it may need ‘fair’ restructuring in relation to features such as high watermarks etc. (e.g. a situation where assets valued at 0 were suddenly sold at 90, a participation of 30% above a pre-existing hurdle and/or high watermark would be clearly inappropriate).

**Q16: Do you agree that our proposed rules and guidance will ensure unitholders receive adequate and timely information about the side pocket class structure? If not, what further steps should firms take to meet investors’ information needs?**

Yes. We note the FCA’s proposals regarding valuations and refer you to our response to question 26.

**Q17: Do you agree that the FCA should publish consumer-facing material to explain the use of side pockets? If so, what matters should it cover?**

Since the FCA is determining that investor meetings need not be held, we believe it should be incumbent on the FCA to provide investors with the information that would otherwise have been within the notices to investors had meetings been held. This
should include an explanation for the need for the side-pocket and relevant information pertaining to its operation and eventual wind-up.

As well as explaining the rationale for and the benefits of the side-pockets, the FCA would ideally outline to investors other issues that will be important for investors to be aware of such as:

- Factors that might affect when the assets in the side-pocket could be sold-down and/or liquidated and generally how investors might expect to recoup some of the value lost;
- The circumstances under which the side-pockets themselves could be traded. For example, we assume that it will not be possible to trade in the side-pocket so long as any of the affected assets within it are subject to sanctions. However, we could see that trading in the side-pocket might be possible if it contained only Ukrainian assets which were not under sanction but whose value had been impaired;
- How regularly investors might reasonably expect to receive a valuation of the side-pocket and under what circumstances that might differ;
- How the transition period between the announcement and the establishment of the side pocket would be expected to run;
- The options available to fund managers in terms of charging fees and costs on the side-pocket.

**Q18: Do you agree that AFMs should be allowed to decide how to manage the transition process? Are there any other investor protection issues arising from the process of setting up a side pocket class, that we should address in rules or guidance?**

We concur that the cleanest transition process would involve an initial announcement as soon as practicable after the fund board had taken the decision to set up the side-pocket. The cleanest route would be to then suspend trading in the unit-shares until the side-pocket had been legally established.

However, we also acknowledge this loss of liquidity could be a problem if the transition period was likely to be protracted. As circumstances might differ from fund to fund, we therefore agree it is probably best to leave the AFMs to make these decisions.

Where the fund manager had concerns around the consequences of a lengthy suspension of trading in the unit-shares they could potentially make an announcement which contained clear and relevant warnings about the affected assets being potentially undervalued before the transformation was completed together with any other relevant price-sensitive information relating to the transformation, such as the potential timescales, and so allow trading to continue?

We think it is important for investor trust in the process that both the published NAV and the closing price of the unit-share before the transformation are no higher than the sum of the published NAV and the opening price of the unit-share after the transformation plus the NAV and opening price of the side-pocket respectively. In other words, it is important that there is no apparent value leakage as a result of the process. This is probably best achieved by the fund manager writing down the affected assets to zero before the transformation if they have not indeed done so already.
Q19: Do you have any comments on the implications of creating a side pocket for ISA managers and for investors holding units in an ISA?

We presume the assets in the side-pocket are still permitted to benefit from the ISA wrap and will not become taxable.

Q20: Do you have any comments on the implications of creating a side pocket for firms giving financial advice?

No further comment. Advisers will need to continue to keep their clients abreast of developments and ensure that all future investment decisions are based on the latest information.

Q21: Do you have any comments on the implications of creating a side pocket for platform service providers and other firms involved in fund distribution?

It will be of particular importance that appropriate retail-oriented documentation be highlighted on websites in plain sight, in much the same way as would be expected of a corporate action notice, so that any prospective customer is made aware of the transformation early on and in clear language.

Where the affected fund was held in a self-select trading ISA we assume that the newly created side-pocket would also be set up as a ‘new security’ within the same ISA fund.

Q22: Do you have any comments on the implications of creating a side pocket for providers of unit-linked life funds and for policyholders of those funds?

It may be appropriate for the policy provider to explain to its policyholders plainly that in the event of a claim under a life policy being triggered any value attached to the side pocket will not be realised until such time as the side pocket can begin to be liquidated. Insofar as these assets have already been written down to zero this is obviously a moot point.

Q23: Do you have any comments on the implications of creating a side pocket for SIPP providers and for consumers holding fund investments in a SIPP?

We are mindful that the SIPPs attract a 1% capital charge for Standard Assets and a 2.5% capital charge for Non-Standard Assets. Given that in almost all cases the affected funds would have been classified as a Standard Asset before the creation of the side-pocket, we are wondering whether the assets in the side-pocket will continue to attract that capital charge or whether, because of the nature of the assets held, the higher capital charge would apply.

Q24: Do you agree that the AFM should continue to apply the assessment of value rules to side pocket classes?

Yes. How the fund directors decide to treat investors in the side pocket could become a determining feature and competitive advantage for funds and we would expect the topic to be prominently covered in the Quality of Service aspect of the report.
Q25: Do you agree with our proposed rules and guidance on how investment and borrowing powers should apply to a fund with a side pocket class?

Yes.

Q26: Do you have any comments on the process for valuing and pricing a fund with a side pocket class?

This is important and may have to be re-evaluated over time as the political situation and market conditions evolve.

We agree that this decision should be left to the fund manager under scrutiny from the fund directors. Situations will indeed differ from fund to fund and valuation choices should reflect the specific circumstances of each underlying asset. Equally, fund managers should document and be able to justify the transfer price (referring to an index value, perhaps).

We would underline our view expressed earlier in response to question 17 and our response to question 28 below that the provision of a daily or indeed any other valuation should not imply that a side-pocket is tradeable if it contains sanctioned assets. Perhaps the non-sanctioned assets within it can be sold down or realised for cash in some other way, but the unit should not be tradeable or transferable if it contains sanctioned assets.

Q27: Do you agree with our proposal to allow AFMs to choose whether to offer redemptions at zero / minimal value or to suspend dealing in units of the side pocket class? If not, what approach to redemption would you suggest?

Yes, we support the proposal to leave this to the discretion of the fund manager although as said previously our view would be that side-pockets of sanctioned assets should not be tradeable at all either internally to the fund manager or externally to the market.

Q28: Do you agree that AFMs should decide the extent to which transfers of side pocket units to third parties may be allowed? If not, what approach would you recommend and why?

Essentially, we view the side-pockets as wind-down vehicles from which affected assets can be sold and realised for cash as and when sanctions and market conditions allow.

We do not believe fund managers should decide the extent to which transfers of the whole side-pocket should be allowed. Where the side-pocket contains sanctioned assets, this would open the door to widespread evasion of sanctions which cannot be the aim of this exercise. We suggest that in exceptional circumstances where the side-pocket needs to be liquidated (for example, in the case of a fund with a maturity date) the fund manager may consult with the FCA proactively about possible solutions on a case-by-case basis.

Q29: Do you agree that AFMs should be able to offer unitholders a choice of ways of exiting the class if future circumstances allow? Are the options described above appropriate and are there other options that could be offered?
Yes.

Subject to applicable sanctions law, fund managers should be in a position to decide an exit route in the best interests of the unit holders offers, whether this be via partial realisation of assets and a gradual wind-down of the side-pocket or via a wholesale disposal to a consolidator or some such other alternative.

Q30: Are the information needs of investors over the life of the side pocket class adequately met by existing rules and guidance? Are there any other steps that AFMs or other firms should take to keep investors informed?

We agree with the FCA’s suggestion that in certain circumstances the fund manager may wish to communicate directly and proactively with all unitholders via email or some such similar mechanism over the life of the side-pocket, especially once a market is beginning to open up again in the underlying affected assets. We would consider relying on passive web-site posts or mail-outs on typical time-lags after the relevant year-end to be insufficient.

Q31: Are there any other matters not covered in this consultation, that the FCA should consider in making rules and guidance to allow side pocket unit classes?

We raise a question regarding the impact of the creation of the side-pocket on the funds’ historic performance data. We are considering this now within our GIPS team and we believe it would be helpful if the FCA could give some thought and guidance to how they would expect funds to record the historic performance of those funds which do decide to set up side-pockets.

If affected assets are written down to zero before transfer to the side-pocket, thereby negatively impacting fund performance, but then the side-pocket is subsequently sold for a positive sum, should that value be included in fund’s historic recorded performance data?

It would seem wrong to exclude that value recovery in the historic performance data for investors that owned the fund up until the date of the transfer of affected assets to the side-pocket; equally it would seem wrong to include it in the historic performance data for those investors investing in the fund for periods of time after the date of the transfer of assets to the side-pocket.

Q32: Do you have any comments on our cost benefit analysis?

We note that the cost-benefit analysis does not include cost of trading out of assets if / when it becomes possible to do so. These costs are likely to be high initially because of lingering market illiquidity and the possible need to obtain a valuation to avoid future lawsuits over the executed sale price when market prices are opaque. That said we note that arguably these costs would occur and would likely be very similar for each fund whether the side-pocket were created or not.