PUBLIC

14th August 2026

The Primary Markets Policy Team
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

Submitted by e-mail to: cp26-21@fca.org.uk

Dear Policy team,

CFA UK letter in response to FCA's CP 26/21: Proposed changes to the UK Listing Rules for closed-ended investment funds

CFA UK consistently advocates for investor protection while balancing this with innovation, growth and regulatory simplification. Closed ended investment funds (CEIF) or Investment Trusts (an innovation originally attributed the UK) **are an important component of the UK investment landscape**, being a material contributor to the capitalisation of the LSE and a vehicle for investor access to less liquid assets.

Our brief responses are at Appendix 1 in which **we have focussed on the principles for managing conflicts**, rather than legal aspects or recent cases from the sector. We support proposals that enhance board independence and minimise conflicts of interest, potentially increasing confidence in governance and trust in the sector.

We however have a concern that **codifying too many new rules under UKLR runs the risk of indirectly diluting overarching responsibility for conflicts management**. Directors already have a duty to disclose and manage conflicts and place the company's interest ahead of any other party or shareholder. There is also extensive principle based regulation in place such as FCA's SYSC and PRIN covering conflicts of interest, related party rules, disclosure under DTR, Companies Act and the corporate governance code.

Another concern is that a higher independence bar for directors may challenge the competency and expertise of independent voting directors. We recommend the FCA consider **a thematic review of the governance arrangements of closed ended investment companies** – we had similarly advocated a review of pensions trustee boards for competency and independence, and the FCA took concrete steps to improve these in the pensions sector, which sets a good precedent.

We hope our comments are useful and would be grateful for the opportunity to meet and discuss our feedback.

Yours sincerely,

CFA Society of the United Kingdom

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With thanks for their contributions to our volunteers: Natalie Schoon, CFA, and CFA UK's Ethics & Professionalism Steering Committee.

APPENDIX I
Responses to Questions

Question 1: Do you agree that we should not treat a director as independent of a proposed investment manager if they: • Were appointed as director after being proposed for appointment to the board of directors by the proposed investment manager or its associate; and/or • Meet any of the descriptions of persons not being independent, based on the criteria under UKLR 11.2.13R? If not, please explain why. Please also provide any other examples of non-independence that we should consider.

We agree with the criteria under which a director should not be independent from the proposed investment manager. This is **consistent with the conflict of interest with an incumbent investment manager**, and the proposing of a director by an investment manager creates room for a potential conflict in appointment of the manager.

We presume that broader provisions relating to non-independence, not necessarily codified in UKLR will continue to apply, **such as conflicts based on economic interest** e.g. a director or close family has an equity stake in, or receives remuneration from the proposed investment manager.

Question 2: Do you agree that only directors who are independent of the proposed investment manager should take part in the board's consideration of the transaction or arrangement appointing the investment manager? If not, please explain why.

We agree that this is the simplest and most apparent way in which to mitigate the potential conflict of interest. In addition, we recommend linking the requirements to the related party rules outlined in the Disclosure Guidance and Transaction Disclosure Rules (DTR) sourcebook and SYSC 10.

We also flag a concern that excluding directors who are not independent from the proposed investment manager may reduce the number of non-independent directors voting to such an extent that the overall quality of decision making in terms of expertise and experience is compromised. In practice a conflicted director is likely to be excluded from the entire selection process rather than just the final decision vote. **Boards should therefore be expected to enlist 3rd party experts or independent consultants in such scenarios** to support decision making.

Our broader concern is **ensuring the competency and expertise of independent voting directors** - we accordingly recommend that the FCA considers a thematic review of the governance arrangements of closed ended investment companies.

Question 3: Do you agree that any director appointed after being proposed for appointment by a substantial shareholder, or its associates should be considered as not independent of that substantial shareholder, or its associates? Do you agree

that the director should not participate in votes on a related party transaction or relevant related party transaction with that substantial shareholder, or its associates? If not, please explain why.
Question 4: Are there unintended consequences that we have not identified. For example, would it materially impede the appointment of directors? If so, could such a risk be mitigated by applying a time limit of, for example 2 years?

Within UKLR, the concept of **independence is relatively limited to the existing investment manager**. Extending this concept to a substantial shareholder and including a prohibition on voting in related party transactions is a reasonable measure to reduce conflicts of interest. This is aligned with standard governance expectations on related party transactions.

However, director nomination by shareholders is common, and in the normal course such conflicts are expected to be addressed by the disclosure responsibility of the director and the specific vote circumstances that may in any case result in a director being declared conflicted by the rest of the board. The proposal also goes beyond what applies to other listed companies. We therefore **recommend a balance between closing this gap and the stringency of the proposal** – for example limiting it to the 20% shareholding threshold and strictly in the context of related party transactions.

With respect to consequences, we consider the proposal proportionate as it does not per se impede the nomination of directors by substantial shareholders, which may add value to the makeup of the board.

Question 5: Do you agree that this requirement should focus on substantial shareholders, rather than shareholders with stakes of less than 20%? If not, please explain why similar protections would be required in this scenario?

We are in favour of avoiding inconsistency and complexity in the regulatory framework and therefore **suggest the FCA use the precedented thresholds under UKLR** e.g. 20% rather than have a bespoke rule for investment trusts.

For lower shareholding levels, conflicts disclosure and related party principles under UKLR and other regulatory frameworks can be relied on to discourage conflicted actions by shareholders and/or directors.

Question 6: If you agree to Q3, do you also agree that the proposed amendment to the definition of 'associate' in the Glossary helps to achieve this? If not, please explain why or provide an alternative suggestion.

Given the potential conflict of interest between a nominated director and the nominating substantial shareholder, we agree a proposing shareholder should require the same standards to apply, and be included as an associate.

Question 7: Do you agree that a proposed investment manager should be treated as a related party to ensure protections arounds its fees are consistent before and after the appointment? If not please explain why.

We agree that **the same yardstick should be applied to "proposed" investment managers** as is applied to appointed ones. The potential conflict is equally applicable in the process of appointment as it is in the ongoing retention or ongoing appraisal bias decision.

However, we feel that the proposals around the threshold require more clarity. The current rules use the thresholds of 5% and 0.25%, the latter pertaining to fees. Under the CBA it is implied that the 5% threshold could bring only 2 additional relevant related party transactions per year in scope due to fees being much lower. However, the fee threshold is 0.25%, not 5%, and this should capture a greater number of instances.

Question 8: Are there unintended consequences that we have not identified that we should take into account? If so, please explain what they are.

Multiple regulation could increase ambiguity around the application of principle based management of conflicts of interest. Care needs to be taken to ensure the amended rules fit do not duplicate or contradict existing application of principle based management of conflicts of interest. This is given the extensive conflict of interest provisions that already exist under FCA's PRIN8, SYSC10, COBS, DTR, the corporate governance code, the Companies Act etc. Where possible **we recommend the FCA references these where relevant, and reinforces these frameworks** when updating specific UKLR provisions

We note that the threshold of 0.25% for class test for fees allows for this to be applied only to the variation in fees where "the new fee structure is comparable between the two (i.e., the proposed and incumbent investment manager)" – Para 3.28. This proposal could have **practical challenges of determining comparability**, and runs the risk of gaming to avoid the threshold. It may be more practical to class test the entire fee structure when a new manager is appointed and remove this loosely defined window. It should also be stressed that in practice the process of a change in investment manager is typically lengthy and complex and such class tests can be infrequent and **should also apply to changes in incumbent manager fees.**

Question 9: Do you agree that it would be beneficial to address the potential conflicts of interest where a substantial shareholder, or one of its associates, is also a closed ended investment fund's appointed investment manager? If not, please explain why.

We agree that this is a material conflict of interest but question why the substantial shareholder being the appointed investment manager would not be covered by the related party voting restrictions. If the provisions are not considered adequate, related party transactions can be **clarified to include investment policy, manager fees and other material terms of appointment of the manager**.

Question 10: Do you agree with our proposal to exclude:
a. A substantial shareholder that is also a closed-ended investment fund's appointed investment manager, and any of its associates, from participating in a shareholder vote on a material change to the fund's published investment policy?
b. A substantial shareholder whose associate is a closed ended investment fund's appointed investment manager, from participating in a shareholder vote on a material change to the fund's published investment policy?
c. If not, please explain why or suggest alternative approaches.
Question 11: Do you consider if it would also be beneficial to extend this proposal to address the scenario where a material change is being made to the investment policy at the same time that a new investment manager is being appointed? If so, please explain why.

We agree with the proposal - if decisions on material changes to policy are to remain independent of the investment manager, it makes sense for the rules to cover participation by a substantial shareholder that is an associate. **Investment policy can be influenced in favour of certain asset classes, regions, stocks etc. that may be in the interest of the investment manager** (for example through fee margins, expertise, market support etc.) and present a conflict. Noting however, that seeking the advice of the investment manager remains valid, and can provide useful input in the process.

The timing of policy change and manager appointment is a logical addendum to the proposal if the appointment of the new manager has already been confirmed and is in process. To retain simplicity in the regulation, **we suggest more clarity is provided on "is being appointed"** for example whether it applies even a formal contract has not been signed, at what stage of the manager selection process, whether it applies when negotiations are underway etc.

Question 12: Are there any risks or unintended consequences with this proposal that you think we have not identified? If so, please explain what they are.

A potential **consequence could be discouraging large investment management firms from taking substantial stakes in the sector** as they may seek to integrate the investment company with their investment suite. It could also discourage the launch of new investment trusts by fund management companies interested in both deploying their own capital and managing the investments.

Question 13: What are your views on the alternative options also discussed? If you consider one of these to be a more effective approach, please explain why.

We favour alignment with existing provisions to the extent possible and feel that the current rules relating to substantial shareholders (e.g. 20%) voting on related party transactions should suffice and provide a consistent and simple control over shareholder conflicts of interest. Both the other options e.g. a double majority vote, could be unnecessarily complex.

Question 14: Do you agree with our proposed approach to implementation? For example, does a 4-week gap between the rules being finalised and coming into force allow enough time to complete any transactions or arrangements under the current rules?
Question 15: If not, what are the practical issues that may justify a different approach to implementing any final rules?

Our preference in relation to changes in regulation is to **allow a comfortable period of time for implementation.**

This is driven by both:
- Practical considerations, for example a process for manager selection, due diligence and negotiation could be underway and the process is potentially required to be redone.
- Positioning regulatory change as a smooth transition without the pressure of short timelines, cost/resource consequences, and aligned with the principles of regulatory stability and predictability.

Therefore, we **disagree with a short 4 week period and suggest a minimum of 3 months**.

We also note that any change in the timeline carries the risk of avoidance activity taken place in the period before implementation and we suggest that Boards are alerted that the FCA may scrutinise any apparently hasty completions of new manager appointments during the pre-implementation window.

Question 16: Do you agree with our proposed clarification to make it clearer that UKLR 8.1.11R(4), regarding 'associates' of related parties, also applies to the extended definition of related parties under UKLR 11.5.3R, regarding a closed ended investment fund's appointed investment manager? If not please explain why.

We agree that associates of an investment manager should be included in relation to related party transactions, so that conflict management provisions relating to investment managers are not easily circumvented.

Question 17: Do you have any comments on our Cost Benefit Analysis?

No comments other than to support attention to the closed ended investment company sector, as part of a wider range of initiatives to revive UK investment culture.

APPENDIX II
About CFA UK and CFA Institute

CFA UK serves nearly 12,000 members of the UK investment profession. Many of our members analyse securities, manage investment portfolios, advise on investments, or are in roles responsible for investment operations or oversight.

Our role is to help investment professionals build and maintain their skills and competencies so that they are technically and ethically competent to meet their obligations to clients. We advocate for high standards of ethical and professional behaviour and our work with regulators, policymakers and standard setters is focused on skills, knowledge, and behaviour.

We are not a lobby group or a trade body. We are an independent, professional association whose mission is to 'educate, connect and inspire the investment community to build a sustainable future.'

Founded in 1955, CFA UK is one of the largest member societies of CFA Institute. Most of our members have earned the Chartered Financial Analyst® (CFA®) designation. All our members are required to 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 institute is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Its aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.

It 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.