Policy Statement

Financial Services Authority

Investment companies (including investment trusts)

Changes to the Listing Rules and the Conduct of Business Rules; Changes to the Model Code

Feedback on CP164 and made text

October 2003

Contents

1	Executive summary	3
2	Introduction	5
3	Responses to CP164	8
4	Cost benefit analysis and compatibility statement	32

Appendix 1: Investment Entities (Listing Rules and Conduct of Business) Instrument 2003

Appendix 2: Listing Rules (Model Code) Instrument 2003

Appendix 3: List of non-confidential respondents to CP164

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This Policy Statement reports on the main issues arising from Consultation Paper 164. It also contains the Listing Rules text as made by the Board on 18 September 2003.

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

1 Executive summary

1.1 This Policy Statement (PS) introduces changes to the Listing Rules and the Conduct of Business Sourcebook (COBS). We published our proposals in Consultation Paper 164 *Investment Companies (including Investment trusts): Proposed changes to the Listing Rules and the Conduct of Business Rules; Changes to the Model Code* (CP164), in January 2003.

1.2 CP164 resulted from a commitment made to the Treasury Select Committee on 14 November 2002 to consult on several changes to the Listing Rules and COBS relating to investment companies. This followed concern expressed over:

- the suspension of the securities of a number of investment companies and investment trusts following uncertainty as to their financial position; and
- potentially significant losses to investors from investments that had generally been marketed as being relatively low risk.

1.3 The poor performance of equity markets in recent years led inevitably to falls in the value of investment companies. But the UK listed split capital investment trust (Splits) sector suffered disproportionately from the poor stock market conditions; some Splits lost their whole value. We concluded in CP164 that a combination of borrowing (gearing) to buy further assets and an investment policy enabling them to hold shares in other trusts, caused more extreme losses for investors in Splits in the falling markets.

1.4 Whilst it was the Splits sector that suffered disproportionately from the falling markets, we maintained in CP164 that the problems associated with gearing and cross-holdings were relevant to the investment company sector as a whole. So, we proposed that we extend the scope of CP164 beyond Splits. In CP164 we proposed changes to the Listing Rules that would apply to all existing listed issuers and new applicants listed and to be listed under chapter 21 of the Listing Rules. We proposed additional COBS requirements for investment trust companies listed in the UK or in other EEA states.

The consultation responses

1.5 The responses to CP164 largely supported the measures we were proposing to introduce. We have changed several proposals as a result of the responses that we received, the most significant of which were those regarding:

- cross-holdings;
- portfolio disclosure; and
- independence of the board

The modified rules are summarised in paragraphs 2.6 – 2.12 of the Introduction to this PS. There is a more detailed explanation in Chapter 3.

Next steps

1.6 In CP164 we explained that the new listing rules would become effective shortly after publication of this PS. The new rules will become effective on 1 November 2003.

1.7 We also stated that there would be a period of implementation for those listing rules on the composition of the board. The implementation period for those rules will be 18 months and they will be implemented on 1 April 2005.

1.8 Further, we explained in CP164 that there would be a delayed implementation period of three months for the proposed changes to the COBS. This will allow firms to make the required changes to systems and literature. The rules will be implemented on 1 January 2004.

1.9 There will also be a transitional period of 9 months from when the rule comes into force for discretionary managers subject to COBS 5.5.4E(6). The transitional period will extend until 1 October 2004.

1.10 Changes to the Model Code resulting from CP164 will be implemented on 1 December 2003

CONSUMERS

Investment in investment companies totals many billions of pounds. Our rule changes are designed to make it less likely that consumers will buy shares in an investment company without understanding the main risks of that investment

So, this PS will be of interest to consumers. Other interested parties will include listed companies, their directors, their advisors and those regulated by the COBS including those firms promoting, advising on, or buying such investments on a discretionary basis.

2 Introduction

2.1 In January 2003, we published Consultation Paper 164 *Investment Companies (including Investment trusts): Proposed changes to the Listing Rules and the Conduct of Business Rules; Changes to the Model Code (CP164).*

2.2 In CP 164 we proposed changes to the Listing Rules that would apply to all existing listed issuers and new applicants listed and to be listed under chapter 21 of the Listing Rules. We proposed additional COBS requirements for investment trust companies listed in the UK or in other EEA states.

CP164 Proposals

2.3 CP164 proposed the following changes.

- **Limit on cross-holdings –** a limit of 10% on the amount of a listed investment company's gross assets that can be invested in other investment companies whose investment policies allow cross-investing.
- **Risk factors in all listing documents –**a prominent "Risk factors" section in all listing documents setting out the risk factors specific to the company (including details of gearing), its industry, its investment policy and the securities it proposes to issue.
- **Increased portfolio disclosure –** monthly disclosure of any investment that exceeds 0.5% of the value of the portfolio of an investment company, together with 100% disclosure of all funds invested in other investment entities.
- **New COBS risk warnings –** enhancements to the COBS risk warnings given to those investors proposing to acquire holdings in geared investment companies or investment companies that propose to invest in geared investment companies themselves.

- **Increased independence of boards –** changes to the relationship between the investment company and its manager. These should enhance the independence of the company from its manager and provide better information to shareholders, from which they would be better placed to protect their interests.
- **Changes to investment policy –** a requirement for all material changes to the company's investment policy to receive prior shareholder approval.

2.4 Separately, CP164 also proposed a change to the Listing Rules to ensure that the controls on directors' dealings in shares keep up with market developments. Specifically, the proposed change would extend the provisions of the present Model Code on directors' dealings (which is attached to the Listing Rules) to synthetic instruments such as contracts for differences and spread betting.

CP164 responses

2.5 The responses to CP164 largely supported the measures we were proposing. However, we have modified several of the proposals as a result of the responses that we received. The most significant modifications are summarised below.

Cross-holdings

2.6 There was considerable support for the intention behind the limit on cross-holdings. However, many respondents were concerned that the provision was too widely drawn and would have an impact more far-reaching than we had intended.

2.7 We have modified this rule. The Listing Rules will now require that:

- a UK listed investment company may not invest, in aggregate, more than 10% of its gross assets (when the investment is made) in other UK listed investment companies that do not have a stated investment policy to invest no more than 15% of their assets in other UK listed investment companies.

Portfolio disclosure

2.8 As regards portfolio disclosure, a majority of respondents was in favour of increased disclosure of some kind but did not necessarily agree with the proposal in CP164.

2.9 Respondents argued that our proposal would benefit arbitrageurs, market makers, analysts, hedge funds and professional investors rather than retail investors. They said that the rule would mean that private investors would be overloaded with confusing and insignificant data that would be of little value to them. They also argued that compliance with the rule would be too onerous

and impractical and, for some issuers, might result in the disclosure of commercially sensitive information.

2.10 Based on these views we have amended our proposals and will now require all investment companies to provide:

- within 2 business days of the end of each calendar month, a list of all investments in other UK listed investment companies which do not have a stated investment policy to invest no more than 15% of their assets in other UK listed investment companies as at the last business day of the month; and
- within 2 business days of the end of each quarter, a list of all investments with a value greater than 5% of the company's investment portfolio and at least the top 10 investments as at the last business day of that quarter.

Independence of the board

2.11 There was considerable opposition to our proposal to increase the independence of the board of the investment company. We proposed that representatives of the investment manager not be allowed onto the board. The respondents who opposed this measure argued that there are significant benefits in having a representative of the investment manager on the board. They said that it strengthens the accountability of the investment manager, ensures continuity of involvement in the investment company, provides valuable links to the management company, and provides expertise regarding investment.

2.12 We now intend to modify our original proposal. The Listing Rules will now state that a maximum of one director or employee of, or professional advisor to, the investment manager may be appointed to the board, on which the majority of directors are independent. The Listing Rules will require that this director be subject to annual shareholder election.

Structure of Policy Statement

2.13 The rest of this PS is structured as follows:

- Chapter 3 summarises comments on the issues raised in CP164 and gives our responses to them;
- Chapter 4 contains the Cost Benefit Analysis and Compatibility Statement;
- Appendix 1 sets out the text of the proposed changes to the Listing Rules and Conduct of Business Rules;
- Appendix 2 sets out the text of the proposed changes to Model Code; and
- Appendix 3 contains a list of the non-confidential respondents to CP164.

3 Responses to CP164

3.1 General

3.1.1 We published CP164 in January 2003. We received over 200 responses for which we are very grateful. About half of the responses came from investment companies and investment trusts with the other half coming from investment managers, investors, trade bodies, directors and ex-directors and various professional advisors. Appendix 3 lists the non-confidential respondents to CP164.

3.1.2 This chapter summarises the responses that we received and sets out our subsequent comments on the main issues that have been raised. In CP164 we identified two main areas where we believed that new safeguards needed to be introduced. We said that we were proposing to introduce:

- measures that relate directly to the product and that govern the information that is provided to shareholders as well as the sales and promotional material provided to consumers; and
- measures that deal with the relationship between the board of an investment company and the investment manager.

The questions we asked in the consultation focused around those two areas and we have structured this PS accordingly.

Measures that relate to the product itself

3.2 A limit on cross holdings

3.2.1 In CP164 we explained that the tendency for Splits to invest in other Splits created a structural weakness. As this "cross-investing" increased, the percentage of the assets of those investment companies represented by real underlying securities fell, leaving the Splits sector extremely unstable and vulnerable to falling markets. The effect was exaggerated where the investment company had adopted high gearing policies.

3.2.2 We explained that it was important to break this chain of cross-investing to address the unknown levels of risk to which shareholders may be subjected and to restore market confidence.

3.2.3 CP 164 proposed a 10% limit on the amount of gross assets of an investment company that can be invested in shares of other investment companies whose investment policies allow investment in other such companies or funds. CP164 explained that the limit would be introduced as a condition for listing and also as a continuing obligation.

3.2.4 We asked:

> Q1: Do you believe that a limit should be placed on the amount of an investment company's gross assets that can be invested in the shares of other investment companies whose investment policies allow cross-investing? If so, do you believe that a 10% limit is appropriate?
>
> Q2: What will be the cost, if any, of introducing a limit of this kind?

Consultation feedback – introduction

3.2.5 There was considerable support for the intention behind this proposal. However, many respondents were concerned that the provision was too widely drawn and would have an impact more far-reaching than we had intended. The three main concerns with the rule were:

- the investment policy requirement;
- the scope of the rule; and
- the amount of the limit.

Consultation feedback – the investment policy requirement

3.2.6 Many of the respondents were concerned with the use of the word “allow”, explaining that they were not aware of any investment trusts whose investment policies disallowed investment in other investment trusts. Some issuers explained that they did not invest in other investment companies but did not want to change their investment policies to prevent them from doing so, should they identify an investment opportunity.

3.2.7 Some respondents explained that if a listed fund of funds changed its investment policy so as not to allow investment in other investment companies, it would result in a radical change to its investment mandate and possibly lead to reconstruction or even liquidation. If the issuer did not change its investment policy, it would reduce the amount of listed investment companies that could invest in its securities and this in turn could affect its share price.

3.2.8 There were various alternatives offered to the original proposal.

- Some respondents suggested that we should take the approach adopted by the Irish Stock Exchange, which limits the amounts that investment companies can invest in other investment companies whose primary purpose or primary investment objective is also investing in funds.
- Others supported the proposal put forward by the Association of Investment Trust Companies (AITC) that the limit should be directed at investment companies which do not have a stated policy of investing less than a certain percentage of their assets in other investment companies.
- Others suggested that investment companies should be prevented from holding more than a given percentage in companies that themselves have holdings above a certain percentage in other investment companies.

Our response:

3.2.9 We accept that the rule proposed in CP164 may have been drafted too widely. We also accept that investment companies may not want to change their investment policy to remove completely the possibility of investing in other investment companies.

3.2.10 Also, we do not wish to create a rule that may damage the fund of funds sector. As we explained in CP164, we recognise the principle that investments in other investment companies are an efficient and effective method of spreading risk. However, we do want to create a rule that prevents the funds invested by investment companies from being invested back in themselves ('circularity'); and limits the number of times that investment companies can invest in other investment companies ('layering'). We consider that the only way to achieve this is by limiting the amounts investment companies can invest in other investment companies.

3.2.11 We intend to modify our original proposal by adopting wording similar to that proposed by the AITC. This modification does not remove the need for an investment company to take a decision about, and perhaps change, its investment policy. But the modification will allow funds of funds to continue to diversify and spread risk through investment in other investment funds. A fund of funds, that chooses not to limit its investment policy, may continue to invest in investment companies so long as the investment companies in which it invests have adopted the investment policy limitation. The modification of the rule allows other investment companies to invest up to 10% of their gross assets in a fund of funds like this which has not adopted the investment policy limitation. This would not have been possible under the original proposal.

Consultation feedback – the scope of the rule

3.2.12 Many respondents were concerned that funds of unlisted funds would be unable to exert sufficient influence to require their investee companies to change their investment policies in line with the requirements of CP164.

Some argued that this would impact, in particular, on funds of hedge funds and funds of private equity funds. This is because the investment by these funds in the unlisted funds is comparatively small, meaning that they would be unable to influence the investee companies to change their investment policies. The impact on funds of unlisted funds, we were told, could be very damaging.

3.2.13 Some respondents suggested the exclusion of certain types of investment funds from the definition of "investment fund" as an alternative to our proposal. Other respondents agreed with the AITC's suggested approach that the limit should be restricted to UK listed companies only. Under this proposal, the UK listed investment companies would be restricted as to the amount they could invest in other listed investments companies unless those investment companies themselves limited the amount that they could invest in other UK listed investment companies.

Our response – the scope of the rule

3.2.14 We are sympathetic to the arguments raised in support of funds of unlisted funds. We recognise that these innovative funds offer retail investors in the UK the only realistic access to these specialist markets. We have no intention of undermining these legitimate funds with the implementation of this rule.

3.2.15 We explained in CP164 that the tendency for Splits to invest in other Splits resulted in a significant structural weakness leaving the sector unstable and vulnerable to falling markets. Our proposed rule is aimed at protecting not just Splits but the UK listed investment company sector, and to do that we need to deal with the issues of circularity and layering in the UK listed investment company sector.

3.2.16 We have considered the various options suggested in response to CP164 and agree in principle with the AITC's suggested approach. We believe we can achieve our aims by adopting the AITC's suggestion of restricting the limit to UK listed companies only.

3.2.17 The Listing Rules will be amended. They will require that a UK listed investment company may not invest, in aggregate, more than 10% of its gross assets (at the time the investment is made) in other UK listed investment companies that do not have a stated investment policy to invest no more than 15% of their assets in other UK listed investment companies.

Consultation feedback – the limits

3.2.18 Some respondents suggested that the 10% limit on investment was too low. Other respondents suggested that 15%, 20% or 25% would be preferable. There were also suggestions regarding the investment policy limit if we redrafted this rule.

Our response - the limits

3.2.19 Our modified rule contains two limits: the first is a listing rule limiting the amount that a company is allowed to invest in UK listed investment companies whose investment policies do not contain certain restrictions. The second is a limit relating to those policy restrictions; the first limit is 10% and the second is 15%

3.2.20 This second limit has been introduced by the modifications to our proposal. It is important to note that companies are not required to introduce this restriction into their investment policies and we are not proposing to make this a listing rule.

3.2.21 The effect of the first limit is that UK listed investment companies will only be permitted to invest up to 10% of their assets in companies which do not restrict investment in other listed investment companies to 15%. Companies which do not restrict investment in other listed investment companies to 15% may be less likely to attract funds from other UK listed investment companies.

3.2.22 However, an investment company that exceeds the 10% limit when this rule is implemented will not be required to sell down its investments. But, it will not be allowed to invest further in investment companies that do not have the stated investment policy limit.

3.2.23 If an investment company does restrict its investment policy, in line with the new listing rule it would be expected to establish monitoring procedures to ensure compliance with its investment policy, as would be the case with any investment company. We understand, however, that in certain circumstances fluctuations in the market could result in an investment company exceeding the limit in its investment policy, and that at times it may be difficult to adhere strictly with the investment policy limit.

Consultation feedback – additional concerns

3.2.24 Some respondents were concerned that the proposal would prohibit legitimate merger and take-over transactions. There was also concern that the proposal would prevent the rescue of an investment company having temporary liquidity difficulties if the resultant holding was more than 10% of assets.

Our response – additional concerns

3.2.25 We note the concerns about merger and take-over activity and rescues. In our experience, mergers and take-overs in this sector are infrequent and would be unlikely to result from stakebuilding. We would deal with mergers, take-overs and rescues of investment companies on a case by case basis.

Consultation feedback – cost implications

3.2.26 A number of respondents commented that if the drafting issues were resolved then there should not be any significant cost implications. If we proceeded with the rule changes proposed in CP164, respondents raised the following as direct and indirect cost implications:

- funds of funds would no longer be able to operate as they presently do, which would require them either to liquidate or change their investment policy and sell down their existing portfolio;
- there would be a cost of establishing new databases of funds compliant with the new Listing Rules in which to invest;
- the cost of missed opportunity;
- a higher risk to investors if diversification options are restricted; and
- a number of investment trusts may decide to move their listing or domicile overseas.

Our response – cost implications

3.2.27 We believe that our modifications of the rule should overcome most of the various cost implications raised by respondents (which, in most cases, had been flagged in the original Cost Benefit Analysis (CBA)). However, please note that under the original proposal, as remains the case under the revised proposal, we still do not require investment companies to sell down holdings where they exceed the 10% limit and we made this clear in CP164. The continuing obligation that this rule creates only applies at the time of acquisition. So, while an investment company exceeding the 10% limit when this rule is implemented will not be required to sell down its investments, it will not be allowed to invest further in investment companies that do not have the stated investment policy limit.

3.3 Risk Factors

3.3.1 CP164 set out our proposal to introduce a specific requirement for listing documents to include a "Risk factors" section in a prominent position. We proposed that this should set out the risk factors specific to the issuer, its industry, its investment policy and the securities it proposes to issue.

3.3.2 We proposed that investment companies disclose in listing documents:

- a statement on the extent to which the company proposes to borrow money to achieve its objectives;
- an explanation of the risks to the value of the company's securities associated with any such borrowing; and
- an explanation of the risks associated with investing in geared companies.

3.3.3 We asked:

> Q3: What are your views on the proposal to require an explanation of the risks associated with investing in investment companies to be included in listing documents?
>
> Q4: What are you views on the proposal to include an explanation of the specific risks associated with gearing?
>
> Q5: Are there other issues that should be considered in the risk factors section of a listing document?

Consultation feedback

3.3.4 There was strong support for these proposals. There was support for the requirement that the risk factors should be clear and easy to understand. There was also support for risk factors being specific to the policy of the investment trust and not to investment trusts in general.

3.3.5 There were some additional suggestions for ways to make the risk factors more meaningful.

- Many respondents suggested that the risk factors section should be separate from the investment policy section, and that each section should have equal prominence within the listing document.
- Other respondents said the listing document should discuss both the benefits and the drawbacks in terms of risk to the investor.
- There was a comment that foreseeable risks should be disclosed and that any risk warnings must include a statement that there is a limit to the risks that can be identified in advance.
- It was suggested that factors described in the listing document should be carried through the life of an investment trust into other documents such as the Annual Report and Accounts. Some suggested that these are more likely to be read by private investors.

Our response

3.3.6 We intend to proceed with the changes to the Listing Rules on risk factors as detailed in CP164. We appreciate the helpful suggestions aimed at making the risk factors section more meaningful. We do not, however, wish to be overly prescriptive in making these rule changes. We do not want to set out a list of specific risks that need to be identified because we are concerned that this could lead to a "box ticking" approach to compliance with this new rule. Our aim is for the risk factors to be considered by the issuer when each listing document is prepared and for full consideration to be given to them at that time.

3.4 The investment company's own gearing

3.4.1 CP164 stated that the FSA's current view is that directors and their advisors are best placed to determine the capital structure most appropriate for a listed investment company. We explained that we recognise that high levels of bank borrowings increase the risks to the holders of a company's securities. However, we did not think that the regulator should intervene directly to set limits on the proportion of a company's capital that can be represented by debt finance.

3.4.2 We asked:

Q6: Do you agree that limits should not be imposed on the amount of money that investment companies can borrow?

Q7: What would be the consequences of introducing a limit on the amount of money investment companies can borrow? Would such a proposal have significant cost implications and, if so, what are they?

Consultation feedback

3.4.3 All of the respondents to these questions agreed that there should be no intervention by the regulator in setting a limit on gearing. It was suggested that, because gearing is a distinguishing feature of investment companies, a limit on gearing would undermine one of the features that differentiates investment trusts from other forms of collective investment.

3.4.4 The other implications of a limit on gearing that were suggested by respondents were that it could:

- result in early repayment of borrowing, which could attract significant penalties, perhaps forcing the sale of stock;

- constrain the potential for investment and the potential amount of investment returns to investors, particularly in the event of upturns in the market;
- give a false sense of comfort on the underlying risk of a product;
- stifle innovation and reduce investment flexibility;
- force investment companies to find alternative means of financing, which may lead to the further proliferation and use of unregulated hedge funds and derivatives; and
- result in shareholders who suffered with the downturn of the market not benefiting fully from a market recovery.

3.4.5 Many of the respondents said that whilst gearing should not be limited there should be increased disclosure.

Our response

3.4.6 We note the overwhelming support for our intention not to introduce a limit on the amount that investment companies can borrow. We still do not intend to introduce a limit on gearing.

3.4.7 We agree that the appropriate protective measure in the case of gearing is disclosure. We would expect to see any relevant disclosure of the risks of gearing to be detailed in the risk factors section of listing documents.

3.4.8 We maintain that it is the directors and their advisors who are best placed to determine the capital structure most appropriate for a listed investment company. Accordingly, we do not propose to introduce a requirement that investment companies obtain shareholder approval before increasing the gearing limit.

3.5 Limit on investment in other geared instruments

3.5.1 CP164 explained that we wanted to explore the practical implications of introducing a limit on the amount of an investment company's investment portfolio that may be invested in other geared investments. We said that a way of introducing such a requirement might be to create a new listing rule that would prevent an investment company from investing more than 10% of its gross assets (at the time an investment is made) in any other investment company whose debt to equity ratio could exceed, say, 25%.

3.5.2 We asked:

> Q8: What are you views on the introduction of a limit on the amount of an investment company's investment portfolio that may be invested in other geared investments?

Q9: If you are in favour of introducing limits either on the amount of money companies can borrow, or on the amount of an investment company's investment portfolio that may be invested in other geared investments, how should borrowings be determined and what should the limit be? Should borrowings include amounts due under stock lending and repurchase agreements?

Consultation feedback

3.5.3 There was very little support for a limit on the amount an investment company might invest in other geared investments. Many of the respondents were of the view that disclosure was sufficient to reduce the risks associated with gearing. Quite a few of the respondents said that such a limit on gearing would be too complex to regulate, and many suggested that monitoring would be time consuming and costly.

3.5.4 Given the overwhelming opposition to limits on gearing, there were only a handful of responses to question 9, with a majority concluding that amounts due under stocklending and repurchase agreements should not be included in total borrowings.

Our response

3.5.5 We note the opposition to any limit on gearing. We do not intend to introduce a limit on the amount of an investment company's investment portfolio that may be invested in other geared investments.

3.5.6 We agree that the appropriate protective measure in the case of gearing is disclosure. We would expect to see any relevant disclosure relating to the risks of gearing to be detailed in the risk factors section of listing documents.

3.6 Enhanced information disclosure

3.6.1 CP164 proposed to increase the extent and frequency of the disclosure of an investment company's underlying investments. It proposed a new listing rule that would require all investment companies to disclose details of their portfolio of investments to the market every month, through a regulatory information service. CP 164 suggested that the following monthly disclosure should be made:

- each holding that exceeds, say, 0.5% of the value of the portfolio; and
- all investments in other investment companies that allow investment in other investment companies.

3.6.2 We asked:

> Q10: Do you believe that it is appropriate for investment companies to disclose each holding that exceeds a certain percentage of the value of the portfolio at least once a month? If yes is 0.5% a reasonable threshold? If not what should be the threshold?

Consultation feedback

3.6.3 The responses to this section were extremely diverse. However, the majority of respondents were in favour of increased disclosure but did not necessarily agree with the frequency and threshold that were proposed in CP164.

3.6.4 The main arguments put forward were that the proposal would:

- benefit arbitrageurs, market makers, analysts, hedge funds and professional investors rather than retail investors (particularly in respect of illiquid stocks) and would encourage "front running";
- overload private investors with confusing and insignificant data that would be of little value to them;
- be onerous and it would be impractical to compile the data on a monthly basis;
- disadvantage private equity funds and smaller or specialist company funds because of the difficulty of valuing holdings in listed companies; and
- cause difficulties because some of the information would be likely to be commercially sensitive.

Our response

3.6.5 We accept a number of the arguments raised against this proposal. We intended to provide investors with additional but meaningful information about their investments. We have concluded, after considering the disadvantages raised by the respondents, that the disclosure threshold should be modified.

3.6.6 We derived the original threshold figure of 0.5% from the AITC's "Disclosure Project" which encouraged members to disclose on the AITC website holdings in investment entities greater than 0.5%. We now propose that the percentage should be changed to 5%. We also believe that quarterly disclosure of this information would be sufficient. These changes to the original proposal should overcome the problems raised by respondents. The changes should at the same time meet our original objective of providing more frequent and meaningful information to shareholders.

3.6.7 We also propose to modify the second part of our proposal to mirror the changes we have made to the limit on cross-holdings.

3.6.8 Accordingly, we intend to amend the Listing Rules to require all investment companies to provide both of the following disclosures:

- as at last business day of each calendar month, a list of all investments in other investment companies that do not have a stated investment policy to invest no more than 15% of their assets in other UK listed investment companies; and
- as at last business day of each quarter, a list of all investments with a value greater than 5% of the company's investment portfolio and at least the top 10 investments.

3.6.9 We propose that this information should be published within 2 business days from the end of the month, or quarter, as appropriate.

3.7 Changes to COBS

3.7.1 In addition to changes to the Listing Rules, CP 164 also proposed changes to the COBS. These changes would provide further guidance on the risk warnings that should be provided to investors proposing to acquire shares in investment companies that significantly geared their investment portfolio or investment companies that proposed to invest in other investment companies that had that ability.

3.7.2 We proposed that firms should warn investors that:

- movements in the price of such investment companies might be more volatile than movements in the price of the underlying securities;
- the investment might be subject to sudden and large falls in value; and
- that the customer might get back nothing at all.

3.7.3 We also proposed a new definition of gearing. We defined this as an investment strategy involving the use of borrowing or derivatives that was likely to result in movements in the price of the relevant security being amplified significantly.

3.7.4 We asked:

Q11: Is the scope of the changes to our risk warnings adequate or should it be drawn more widely to cover other geared investment products or services?

Consultation feedback

3.7.4 The majority of the responses to the consultation paper either made no reference to the COBS proposals or agreed that the scope of the proposed changes was adequate. Where responses did comment on the COBS proposals in more detail, the points made could be divided into four main categories:

- failure of the proposals to differentiate between high and low levels of gearing;
- creating an unlevel playing field compared to other investment products;
- the definition of gearing; and
- inadequate implementation period.

Consultation feedback – COBS - Failure to differentiate between high and low levels of gearing

3.7.5 A number of respondents were concerned that the proposed risk warnings did not distinguish between two types of company. These are highly geared investment companies where risk of significant fluctuations in price and total loss of investment was high and those that used modest amounts of gearing where the risk of total loss was highly improbable. The result, it was claimed, was that firms would be required to provide the risk warning for all investment companies regardless of the real level of risk they posed.

Our response – COBS - Failure to differentiate between high and low levels of gearing

3.7.6 COB 3.8.8R contains the requirement for specific non-real financial promotions to fairly and adequately describe the nature of the investment, the commitment required and the risks involved. Our policy intention here is to give further guidance on how firms can comply with this rule when 'gearing' risk is involved. So we are proposing that the proposed risk warning should be given where the level of borrowing or use of financial products such as warrants or derivatives is likely to give rise to significantly amplified price movements. Therefore if, after proper assessment, the level of gearing employed is not judged to be likely to give rise to significant price movements then the warning need not be provided.

3.7.7 The guidance we proposed in our consultation paper did not, however, differentiate in the provision of the risk warning between companies with different levels of investment. So, a company that invested 0.5% of its portfolio in another highly geared investment company and a company that invested a much higher proportion of its portfolio in highly geared investment companies were treated the same. Although, in the case of the first company, even if the entire investment in the geared company was lost, the investor could not lose the whole of his investment.

We have therefore changed the structure of our proposed guidance so that the risk warning need only be provided where the level of cross holding is likely to give rise to significant fluctuations in value.

3.7.8 We believe that firms should assess whether the gearing or cross holding undertaken by an investment company is likely to give rise to significant fluctuations. They should base this on their understanding of the investment trust, its investment strategies and its structure.

3.7.9 We have also amended the risk warning itself so that customers are warned that they may get back nothing at all if the fall in the value of the investment is sufficiently large.

Consultation feedback – COBS - The creation of an unlevel playing field

3.7.10 A number of respondents stated that many other investment products also used gearing. They said that by singling out investment trusts for the risk warning we would deter investors from using investment companies and provide a competitive advantage to open-ended funds.

Respondents stated that the risk warnings proposed would apply to an investment company that invested in a portfolio of other geared investment companies but would not apply to a unit trust that invested in exactly the same underlying portfolio.

Our response – COBS - the creation of the unlevel playing field

3.7.11 We carefully considered the scope of the proposed risk warnings when drafting the CP and took a policy decision to limit the scope of our changes to investment companies. We also flagged the issue referred to here as the 'unlevel playing field' in the original CBA. We believe that this approach is justified as the rapid and material decline in investment values was primarily a feature of investment companies and not other investment products.

3.7.12 We realise that open-ended funds (such as unit trusts) will not fall within the COB 3.8.9G(6) conditions, which are drafted with investment companies in mind. However, if other products invest in portfolios that involve significant gearing, this will be a risk factor, which would need to comply with COB 3.8.8R. Therefore, although not directly relevant, firms may find the guidance in COB 3.8.9G(6) helpful when considering how they ensure compliance with COB 3.8.8R and fairly and adequately describe the risks involved.

3.7.13 Many responses made the point that gearing was a feature of many trading companies and was not restricted to investment companies. Given this, the responses argued that it was inappropriate to single out investment companies for the proposed COBS warnings.

3.7.14 Again, we had considered this issue carefully when drafting the CP. We believe that it is appropriate to draw a distinction between the risk presented by gearing within individual trading companies and the additional level of gearing within investment companies that are specifically designed to be used as an investment vehicle to spread risk.

3.7.15 We do not propose to increase the scope of the proposed risk warnings at this point to include other investment products.

Consultation feedback – COBS definition of gearing

3.7.16 Several respondents pointed out that our proposed Glossary definition did not catch all forms of gearing. In particular, respondents pointed out that structural gearing could be created from the different rights attaching to different share classes without the use of borrowings or derivative products. One trade body also noted that financial products other than warrants and derivatives could give rise to a gearing effect and suggested that we introduce a wider definition of gearing.

Our response – COBS definition of gearing

3.7.17 The same trade body also suggested that it would be more appropriate if the significance test currently within the proposed definition of gearing was brought within the rule itself.

3.7.18 On consideration, we agree that it is appropriate that the definition of gearing should be neutral in respect of the extent to which the activity is undertaken. We have therefore removed the test of significance from the definition and brought it within the guidance at COBS 3.8.9G(6).

3.7.19 We have also amended the glossary definition of gearing to include the gearing that arises from investment in financial products other than warrants and derivatives and the creation of structural gearing.

Consultation feedback – COBS implementation period

3.7.20 A number of respondents claimed that the three-month implementation period we proposed in the CP would not be sufficient to enable firms to prepare for the new COBS changes. In particular, one trade body noted that the changes we proposed would require their members to review all managed portfolios to identify those that contained geared investments and also to revise their terms of business. They proposed alternative implementation periods of up to 12 months.

Our response – COBS implementation period

3.7.21 We do not agree with the view that the proposed risk warnings would require firms to revise their terms of business. While firms may satisfy their obligations under COBS

5.4.3R within their terms of business, this is not compulsory. Firms have the option to provide the additional risk warning we propose in a separate letter rather than requiring all customers to sign revised terms of business.

3.7.22 We do, however, have sympathy with respondents' concerns about the time required to review discretionary portfolios for geared investment companies. So, we propose a transitional provision that will give firms acting as discretionary managers up to 12 months from the making of the new guidance to send their customers the relevant risk warning.

THE RELATIONSHIP BETWEEN THE INVESTMENT MANAGER AND THE COMPANY

3.8 The independence of directors of investment companies

3.8.1 In CP164 we said that we needed to deal with the perception that the relationships between directors of investment companies and their investment managers may have become too close. We said that some additional practical safeguards were needed to clarify the meaning of independence in the context of the Listing Rules. We wanted to respond to the fall in market confidence caused partly by fears that directors may not always feel they are able to make objective decisions, especially where those decisions might conflict with the interests of the investment manager.

3.8.2 In CP164, we proposed the following changes to the Listing Rules:

- any director of an investment company who is also a director of another investment company managed by the same investment manager, will not be regarded as independent for the purposes of the eligibility criteria in listing rule 21.9(d);
- no director or employee of, or professional advisor to, the investment manager may be appointed to the board; and
- the Chairman of the board must be independent.

3.8.3 We asked;

Q12: Do you believe the measures are appropriate?

Q13: Are there any other measures that you would like to see adopted?

Q14: Is twelve months a reasonable period to enable listed companies to implement these proposals?

Consultation feedback – The revised definition of independent

3.8.4 The responses to our first proposed measure were equally divided. The most common argument in opposition to the measure was that the experience of a director serving on more than one board managed by the same investment manager was beneficial to the investment trusts and to their shareholders. Respondents claimed that any restriction would reduce the pool of independent directors available to investment companies. These respondents suggested that a director could be a director of a limited number of other investment companies managed by the same investment manager and remain independent. Others suggested that the board should judge the director's independence; some suggesting that there should be full disclosure in this regard.

Our response – The revised definition of independent

3.8.5 We maintain that for a director to be independent, he or she cannot be a director of more than one company with the same investment manager. This does not preclude them from serving as a director of more than one such company. It simply does not allow them to be counted as one of the independent directors.

3.8.6 We accept that these directors may have increased experience, and this is one of the reasons why we are not proposing to exclude them from the board, but we are identifying them as non-independent. We do not accept that a potential dilution of the pool of expertise might result from our proposed rule change.

3.8.7 We intend, as proposed in CP164, to amend the Listing Rules. They will now state that any director of an investment company who is also a director of another investment company managed by the same investment manager will not be regarded as independent for the purposes of the eligibility criteria in Listing Rule 21.9(d).

Consultation feedback - Representatives of the investment manager on the board of the investment company

3.8.8 About one third of the respondents who commented on this measure were in favour of introducing a requirement that would prevent representatives of the investment manager serving on the board of the investment company. The responses opposing this measure came from a number of sources including, but not limited to, investment managers. Of those respondents, many argued that there are significant benefits in having a representative of the investment manager on the board. They argued that it strengthens the accountability of the investment manager; ensures continuity of involvement in the investment company; provides valuable links to the management company and investment expertise.

3.8.9 Some respondents argued that it was not for us to determine who could be appointed to the board of a company, especially if the shareholders wanted a particular person to act on their behalf.

3.8.10 Most respondents suggested that there should be a limit of only one manager representative allowed on the board, and that this would be on the basis that the majority of the board would be independent. Some suggested that the rules should require annual shareholder election of the representative.

Our response - Representatives of the investment manager on the board of the investment company

3.8.11 We accept that there is some merit in the argument that having a representative of the investment manager on the board increases their responsibilities. These responsibilities include the fiduciary duties of a director required by the Companies Act and the duties and responsibilities in the Listing Rules. We are concerned, however, that there is a conflict for this director between his responsibilities as a director of the company and his responsibilities as an employee of the investment manager.

3.8.12 We accept that we should not regulate against the rights of shareholders and that we would not normally interfere with board structures. However, we believe that the inherent conflict of interests means that we need to take some action to change the present position to protect investors and retain market confidence.

3.8.13 We welcome the suggestion that investment manager representation be limited to one director on a board with a majority of independent directors.

3.8.14 We intend to amend the Listing Rules so that a maximum of one director or employee of, or professional advisor to, the investment manager may be appointed to the board of which the majority of directors are independent. The Listing Rules will require the director's appointment to be subject to annual shareholder election. We think that our modified rule deals with the opposition to the proposal while taking the action necessary to protect investors and retain market confidence.

Consultation feedback - Independent Chairman

3.8.15 The proposal that the Chairman should be independent received considerable support, although some respondents were of the view that it should be for the board to determine independence or that an alternative to our definition of independence should be adopted.

Our response – Independent Chairman

3.8.16 We intend, as proposed in CP164, to change the Listing Rules to require the Chairman of the board of an investment company to be independent.

Transition period

3.8.17 In CP164 we asked whether 12 months was a reasonable period to enable listed companies to implement these proposals on directors' independence.

Consultation feedback – Transitional period

3.8.18 Half of the respondents to this question agreed that a 12 month transition period was reasonable. Of the other half, some suggested the next AGM as being the logical time to appoint new directors. Others suggested 18 months and some said 2 years as a reasonable transition period. Many raised recruitment difficulties and the cost implications of terminating directors' contracts as the main reasons for needing more than 12 months.

Our response – Transition period

3.8.19 We agree with the suggestion of some respondents that the next AGM is the logical time to appoint new directors. The intention behind our proposed transition period of 12 months was to ensure all investment companies would be able to change directors at their next AGM, where appropriate. Given the responses we have received, we intend to extend the period to 18 months. This will ensure that those investment companies which have a period longer than 12 months between AGMs will not be disadvantaged by the transition period.

3.9 The appointment of the investment manager

3.9.1 In CP 164 we explained that one of the key roles of the board of an investment company is to continually review the performance of the investment manager. This assessment includes assessing the performance of the investment manager and deciding whether its performance warrants its removal.

3.9.2 We went on to explain that concerns have been raised in the past that a lack of independence of the board may interfere with its judgement when deciding whether or not to remove the investment manager.

3.9.3 Although we had considered changing the Listing Rules to require shareholder approval before the appointment of an investment manager, we decided against such a measure. Instead, we proposed a change to the Listing Rules requiring the board of directors to report to the shareholders once a year on the performance of the investment manager. The proposal required the directors to explain to the shareholders, in a prominent place in the Annual Report and Accounts, whether the continuing appointment of the investment manager on the terms agreed continues to be in the best interests of shareholders. The proposal required the statement to include the reasons for the decision.

3.9.4 We asked:

> Q15: Do you agree that the decision to appoint the investment manager should be one that is taken by an independent board without reference to shareholders?

Q16: Do you agree that the measures proposed in paragraph 3.90 above, together with those that currently exist in law, listing rules or other regulatory guidance are such that the board is deemed to be independent when making decisions that affect the interest of the investment manager?

Q17: Do you agree that the directors should be required to explain to shareholders in the Annual Report and Accounts, whether the continuing appointment o the investment manager on the terms agreed continues to be in the best interests of shareholders, together with a statement of the reasons for this decision?

Consultation feedback – shareholder approval

3.9.5 Nearly all of the respondents agreed that shareholder approval should not be obtained before appointing an investment manager. However, some respondents said that the board should stay abreast of the views of the shareholders.

Our response – shareholder approval

3.9.6 We note and agree with the respondents to this question. We do not propose to introduce a requirement for shareholder approval to be obtained before appointment of an investment manager.

Consultation feedback – Board deemed independent

3.9.7 About half of the respondents to question 16 agreed that the measures proposed would be sufficient to deem a board independent. Only a very small number said that the rules needed to be stricter. The remaining respondents expressed either their opposition to the new measures, or felt that the current position is sufficient for a board to be independent.

Our response – Board deemed independent

3.9.8 We maintain that our proposals for the composition of a board of an investment company will be supported by Company Law, the Listing Rules, the Combined Code and the Handbook. Together these will help to deal with the perception that inherent conflicts of interest exist between the board and the investment manager of an investment company.

Consultation feedback – statement of directors

3.9.9 Most of the respondents to question 17 supported the proposed rule change, or at least they supported the intention of the proposal but had reservations about the rule as drafted.

3.9.10 There were specific drafting concerns:

- that the statement should be expressed as an opinion of the board rather than a statement of the issuer, and
- the use of the word "best", which some respondents said resulted in the statement being a statement of fact rather than an expression of opinion.

3.9.11 Several of the respondents were concerned that the statement did not reflect the "long term" interests of the investment company and that a longer interval, say 3 years, was needed between the statements to avoid "short termism". Some respondents suggested that the statement should refer to the continuing appointment of the manager as a whole, with some explanation of the reasoning for this (based on criteria the manager is measured by and whether those criteria have been met).

3.9.11 Some respondents commented that this proposal, and those relating specifically to the independence of directors, were inappropriate for self-managed trusts.

Our response – statement of directors

3.9.12 We intend, as proposed in CP164, to amend the Listing Rules to require the board of directors of an investment company to report to the shareholders once a year on the performance of the investment manager. We have taken into account the drafting comments raised, and have redrafted the proposed new rule. It should be noted that to maintain consistency within the Listing Rules, we have specified that the statement should be expressed as an opinion of the directors.

3.9.13 We do not agree with the concerns of some respondents that this proposal will introduce "short termism". We maintain that this is a measure that will be used by investors as a way to monitor and compare the performance of an investment manager on an ongoing basis.

3.9.14 We agree that all the rule changes relating to investment managers are not appropriate for self managed trusts.

3.10 The terms of the investment management agreement

3.10.1 CP164 explained that one of the reasons why it may be difficult for the board to replace an investment manager is that early termination of the investment management agreement may expose the company to significant liabilities.

It had been suggested that investment managers may have used their position to negotiate terms that would make it difficult for them to be removed. CP164 proposed, in the interests of transparency, that the terms on which the company employs the investment manager should be disclosed to shareholders in the Annual Report and Accounts.

3.10.2 We made it clear that we do not intend to intervene in any other way in the terms of the investment management agreement.

3.10.3 We asked:

> Q18: Do you agree that, taking into account the other measures that are proposed, direct regulatory intervention in the terms of the investment management agreement, including severance arrangements is not warranted?

Consultation feedback

3.10.4 Virtually all respondents agreed that, taking into account the other measures that are proposed, direct regulatory intervention in the terms of the investment management agreement, including severance arrangements, is not warranted.

Our response

3.10.5 We intend, as proposed in CP164, to amend the Listing Rules to require investment companies to disclose a summary of the principal contents of any agreement between the investment manager and the company in their Annual Reports and Accounts.

3.11 Changes to stated investment policy

3.11.1 CP164 explained that, whilst in normal circumstances we are reluctant to regulate the relationship between the company and the investment manager, we believe regulatory intervention does have a role to play where directors propose to make material changes to the stated investment policy. CP 164 proposed a change to the Listing Rules that will require any material change to the stated investment policy at any time in the life of an investment company to be made only after shareholder approval. Currently shareholder approval is only required where changes are proposed within three years of admission.

3.11.2 We asked:

> Q19: Do you agree that material changes to an investment policy should not be made without prior shareholder approval?

Consultation feedback

3.11.3 There was strong support for the proposed rule change, although half of those respondents who were in favour had reservations or concerns with the use of the term "material change".

3.11.4 Several respondents agreed in principle to the proposals but asked for a definition of "material change", saying that without it, investment policies could end up being very widely drawn. Other respondents agreed in principle to the change, but only on the basis that "material change" meant "substantial change", while others asked for the wording to be changed from "material change" to "substantial change".

3.11.5 Some respondents asked for guidance on what would constitute "material change" with some asking us to devise specific examples.

Our response

3.11.6 We intend to amend the Listing Rules, as proposed in CP164, to require prior shareholder approval of a material change to the stated investment policy of an investment company at any time during the life of the investment company.

3.11.7 We note the requests for either a definition of "material change" or guidance. The question of materiality will depend on the circumstances of each case, so it is not practical to devise a definition that can be applied generally. We are able to discuss and consider individual cases when they arise, and we would encourage companies to come to us at an early stage. Ultimately it is an exercise of judgement for each investment company.

3.12 Changes to the Model Code

3.12.1 Of the two hundred or so respondents to this consultation paper, fifty-five responded to the questions on the proposed changes to the Model Code. The proposals suggest extending the scope of the Model Code to include spreadbets and other contracts for differences (CFDs)or any other contract the purpose of which is to secure a profit or avoid a loss by reference to the price fluctuations of that company's securities.

3.12.2 We asked:

> Q20: Do you see any reason why the Model Code should not be amended to cover contracts for differences and spreadbets? Are there any other instruments not covered by the proposed amendments that should be included?

Consultation Feedback

3.12.3 All the respondents to the first question were in favour of amending the scope of the Model Code.

3.12.4 A couple of respondents to the second question noted that the drafting of the amendment appears sufficiently wide to capture novel forms of instruments. Several others suggested that the drafting should include all instruments whose valuation is in any way linked to the valuation of the company in question. It was also suggested that, with new derivative instruments being created all the time, the provision should be kept under review. Another respondent noted that the Model Code should be amended to require any director or a member of a director's family to disclose dealings in CFDs to the company, which would then disclose them to the market.

Our response

3.12.5 Based on the unanimous support for including spreadbets and other CFDs, we will proceed to make these amendments to the Model Code with effect from 1 December 2003. In our view the new draft wording captures a broad range of instruments including contracts for differences, options or any right or obligation or interest to acquire or dispose of securities. We will keep under review the need to expand the scope of what is covered and may consider during the listing review whether the language needs to go further in capturing any instrument whose valuation is linked to the valuation of the company in question.

3.12.6 In response to the comment about requiring disclosure, the Model Code itself sets out restrictions on dealings in shares when a director or a company employee is in possession of price sensitive information. The Model Code does not address the issue of disclosure. Disclosure requirements are set out by the Listing Rules themselves and the Companies Act.

3.12.7 It is worth noting that the European Directive on Market Abuse, which is due to be implemented by October 2004, will extend current Companies Act disclosure requirements and associated listing rules to address disclosure of dealings by a group which is wider than directors and connected persons.

4 Cost benefit analysis and compatibility statement

4.1 In CP164 we presented a cost benefit analysis (CBA) for the changes to the Listing Rules and a separate one for the COBS changes. Both of the CBAs included discussions about the potential costs and benefits that would arise if our proposals in CP164 were implemented.

4.2 Compatibility statements (CSs) were also made for the Listing Rules and COBS changes. The compatibility statement for the Listing Rules analysed how our proposals in CP164 were compatible with our general duties under section 73 of the Financial Services and Markets Act 2000 (FSMA). The compatibility statement for COBS analysed how our proposals in CP164 were compatible with our general duties under section 2 of FSMA.

4.3 There was little comment from respondents. This chapter of the PS revisits the CBA as we are proposing some modifications to the CP164 proposals and are of the opinion that some of the final rules differ from the proposed rules. This section should be read with the original CBA which can be found at www.fsa.gov.uk/pubs/cp/164/index.html

4.4 We do not think that our modifications have made any significant differences to those we published in CP164. We believe that our modified proposals are the most appropriate way of meeting our objectives.

Listing Rules

4.5 We believe that the following changes that have been made to the Listing Rules proposals are significant for cost benefit purposes.

Limit on cross-holdings

4.6 In CP164 we proposed a 10% limit on the amount of a listed investment company's gross assets that could be invested in other investment companies whose policies allowed investment in other investment companies.

4.7 We have modified the limit on cross-holdings. The Listing Rules will now require that a UK listed investment company may not invest more than 10%, in aggregate, of its gross assets (when the investment is made) in other UK listed investment companies. That is unless that other company has a stated investment policy to invest no more than 15% of their assets in other UK listed investment companies.

4.8 We consider that the modified rule will significantly reduce the indirect costs of the original proposal. Our modified rule is drawn more narrowly so will not impact on funds of funds in the way we had detailed in the CBA. This is of particular significance to funds of unlisted funds (especially funds of private equity funds) which would have found compliance with our original proposal extremely difficult due to the nature of their investments.

4.9 More generally, the scope for investment companies to invest in other investment companies will not be reduced by as much as was anticipated in the original CBA.

4.10 The restriction of the modified rule to UK listed companies still achieves what we had set out to achieve in CP164. We explained that the tendency for Splits to invest in other Splits resulted in a significant structural weakness leaving the sector unstable and vulnerable to falling markets. This rule was originally aimed at protecting not just the Splits sector but the whole of the UK listed investment company sector from such instability and weakness. As it is unlikely that the problems associated with cross-holdings will arise where UK listed investment companies invest in unlisted investment companies, extending this restriction beyond UK listed investment companies would bring little benefit.

4.11 While there is no evidence to suggest that investment companies have to date made gearing less transparent by investing in unlisted investment companies, it is possible (although we believe unlikely) that by restricting the 10% limit to UK listed investment companies, this could occur. If it does occur, the benefits in the original CBA could be undermined.

Portfolio disclosure

4.12 In CP164 we proposed monthly disclosure of any investment that exceeds 0.5% of the value of the portfolio of an investment company, together with 100% disclosure of all funds invested in other investment entities.

4.13 We have modified this proposal so that we will now require that all investment companies provide:

- as at last business day of each calendar month, a list of all investments in other investment companies which do not have a stated investment policy to invest no more than 15% of their assets in other UK listed investment companies to be provided within 2 business days of the end of that month; and

- as at last business day of each quarter, a list of all investments with a value greater than 5% of the company's investment portfolio and at least the top 10 investments to be provided within 2 business days of the end of that quarter

4.14 Respondents said that compliance with the original proposal would be onerous. The amended rules are intended to go some way to addressing this concern.

4.15 Respondents also said that the proposal would provide little benefit to private investors who would be overloaded with meaningless information. The change to this rule addresses that concern by reducing this potential data overload, which could have been confusing to private investors. On the other hand it is possible that agents of private investors (and some private investors themselves) may have been able to deal with fuller disclosure. So the modified rule may reduce the benefits in CP164.

Independence of the board

4.16 In CP164 we proposed changes to the relationship between the investment company and its manager. One of the proposals was that no representative or employee of the investment manager could be a member of the investment company's board.

4.17 This proposal has been amended so that a maximum of one director or employee of, or professional advisor to, the investment manager may be appointed to the board of which the majority of directors are independent. The Listing Rules will require that the director be subject to annual shareholder election (which we anticipate could take place at AGMs, avoiding significant compliance costs). We have also changed the implementation period from 12 to 18 months.

4.18 Compliance costs may be reduced because the extended implementation period will be more likely to allow the replacement of directors to take place at AGMs, and issuers will have a longer period in which to find replacements, which may reduce recruitment costs. The amended rules will also mean that fewer directors will have to be replaced than under the original proposals, which will reduce the compliance costs in the original CBA.

4.19 We consider that this modification will not detract significantly from the benefit of this proposal to help to restore investor confidence in the relationship between the investment manager and the board. We consider that the majority of the benefits of this proposal set out in CP164 will be kept because of:

- the requirement for a majority of independent directors on the board;
- an independent Chairman;

- our new definition of independence;
- the annual re-election of the investment management director; and
- the limit of one such director on the board.

COBS

4.20 We believe that the following changes that have been made to the COBS proposals are of significance for cost benefit purposes.

Definition of gearing

4.20 We have amended the glossary definition of gearing to include the gearing that arises from investment in financial products other than warrants and derivatives and the creation of structural gearing. The amendment was prompted by consultation responses that noted that we had drawn our definition of gearing too narrowly. We believe that the changes will help us to secure the benefits outlined in CP164.

Level of cross-holding

4.21 We have amended COBS 3.8.9G (6) to clarify that a risk warning need only be provided where the level of investment in other geared investment companies is likely to give rise to price fluctuations being amplified, compared with the fluctuations in value of the underlying investments.

4.22 This amendment was made in response to consultation responses that noted that our rule did not differentiate in the risk presented by high and low levels of investment. By amending the rule in this manner we believe that we achieve our original policy objective whilst ensuring that the burden imposed is proportionate to the benefits that will be achieved. It will also help us to ensure that our risk warnings do not become devalued from the point of view of investors by being attached to products that do not warrant them. The revised rule is also in keeping with the principle concerning the responsibilities of those who manage the affairs of authorised persons.

Investment Entities (Listing Rules and Conduct of Business) Instrument 2003

Annex A – Amendments to Listing rules

Annex B – Amendments to the Conduct of Business Miscellaneous Traditional rules

Annex C – Amendments to the Conduct of Business sourcebook

Annex D – Amendments to the Glossary

INVESTMENT ENTITIES (LISTING RULES AND CONDUCT OF BUSINESS) INSTRUMENT 2003

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (the "Act"):

(1) section 74 (The official list);
(2) section 75 (Applications for listing);
(3) section 79 (Listing particulars and other documents);
(4) section 80 (General duty of disclosure in listing particulars);
(5) section 84 (Prospectuses)
(6) section 96 (Obligations of issuers of listed securities);
(7) section 138 (General rule-making power);
(8) section 145 (Financial promotion rules);
(9) section 147(1) (Control of information rules); and
(10) section 149 (Evidential provisions).

B. The rule-making powers listed above are specified for the purpose of section 153(2) of the Act (Rule-making instruments).

Commencement

C. This instrument comes into force as follows:

(1) the Listing Rules in Annex A, Part 1 come into force on 1 April 2005;

(2) the Conduct of Business Miscellaneous Transitional Rule in Annex B and the amendments to the Conduct of Business sourcebook in Annex C come into force on 1 January 2004;

(3) the remainder of this instrument comes into force on 1 November 2003.

Amendments to the Listing Rules

D. The Listing Rules are amended in accordance with Annex A, Parts 1 and 2 to this instrument.

Amendments to the Conduct of Business sourcebook

E. The Conduct of Business Transitional Rules are amended in accordance with Annex B to this instrument.

F. The Conduct of Business sourcebook is amended in accordance with Annex C to this instrument.

Amendments to the Glossary

G. The Glossary is amended in accordance with Annex D to this instrument.

Citation

H. This instrument may be cited as the Investment Entities (Listing Rules and Conduct of Business) Instrument 2003.

By order of the Board
18 September 2003

Annex A

Amendments to Listing Rules

In this Annex, underlining indicates new text and striking through indicates deleted text.

Part 1
Amendments coming into force on 1 April 2005

CHAPTER 21
INVESTMENT ENTITIES

…

Investment companies and investment trusts

Conditions for listing - investment companies other than investment trusts

21.9 An investment company (other than an investment trust) must comply with the conditions for listing, as set out in chapter 3, with the following modifications and additional conditions:

…

(d) the board of directors (or equivalent body) of the investment company must be able to demonstrate that it will act independently of any investment managers of the investment company; in any event a majority must not be directors ~~or employees of or professional advisers to the~~ of other investment companies managed by any such investment manager~~s~~ or by any other company in the same group as any such ~~the~~ investment manager~~s~~ or be directors, employees, partners or other officers of or professional advisers to any such investment manager or any other company in the same group as any such investment manager;

(e) ~~*Paragraph deleted - August 1995*~~ in any event, no more than one director, partner, other officer or employee of or professional adviser to each such investment manager or any other company in the same group as any such investment manager may be a director of the investment company; any such director shall be subject to annual re election by shareholders;

(ee) the Chairman of the Board of the investment company must be free of conflicts of interest and independent of any investment managers of the investment company and any other company in the same group as any such investment manager and, in any event, he must not be a director of any other investment company managed by any of the same investment managers or any other company in the same group as any such investment manager or a director, employee, partner or other officer of or professional adviser to any such investment manager or any other company in the same group as any such investment manager;

…

Part 2
Amendments coming into force on 1 November 2003

CHAPTER 21
INVESTMENT ENTITIES

…

Investment companies and investment trusts

Conditions for listing - investment companies other than investment trusts

21.9 An investment company (other than an investment trust) must comply with the conditions for listing, as set out in chapter 3, with the following modifications and additional conditions:

…

(j) except to the extent that the UK Listing Authority agrees, the distribution as dividend of surpluses arising from the realisation of investments must be prohibited and a provision to this effect must be contained in the issuer's memorandum or articles of association; ~~and~~

(k) paragraphs 3.18 to 3.21 (shares in public hands) do not apply to open-ended investment companies~~.~~; and

(l) not more than 10%, in aggregate, of the value of the gross assets of the issuer at the time of admission may be invested in other listed investment companies (including listed investment trusts) except that this restriction shall not apply to investments in investment companies or trusts which themselves have stated investment policies to invest no more than 15% of their gross assets in other listed investment companies (including listed investment trusts).

Conditions for listing - investment trusts

21.10 An investment trust must comply with the conditions for listing set out in chapter 3 as amended by paragraph 21.9(a) to (ee ~~d~~) and (l). In addition, an investment trust must comply with the requirements laid down for investment trusts in section 842 of the Income and Corporation Taxes Act 1988.

…

Listing particulars or equivalent offering document

21.13 An investment company (including an investment trust) must comply with the requirements relating to listing particulars or equivalent offering documents set out in chapter 5 as modified by this chapter and in the case of overseas companies by chapter 17. Listing particulars or equivalent offering documents must contain:

(a) a detailed description of the investment policiesy to be followed;

(aa) in a prominent position and in clear language:

(i) a description of the risks involved in investing in investment companies;

(ii) a description of risks that are specific to those securities to be listed, the company or its investment policy;

(iii) without prejudice to the generality of the foregoing, a statement of the extent to which the company proposes to borrow money to achieve its investment objectives, together with an explanation of the risks to the value of the company's securities associated with any such borrowing; and

(iv) in so far as the company proposes to invest in other companies or funds which themselves invest in a portfolio of investments and those companies or funds borrow or propose to borrow money to achieve their investment objectives, a description of the risks to the value of the company's securities associated with any such borrowing;

…

…

21.14 A newly formed investment company (including an investment trust) must include in its listing particulars or equivalent offering document:

~~(a)~~ in the absence of an accountants' report, a statement by the directors of the date upon which the company was incorporated and registered and that the company has not traded and no accounts have been made up~~; and~~.

~~(b) a statement that its principal investment policies there set out will, in the absence of unforeseen circumstances, be adhered to for at least three years following listing,. and that any material change in the policies within that period may only be made with shareholder approval.~~

…

Continuing obligations

21.20 An investment company (other than an investment trust) must continue to comply with paragraph 21.9(g) and (h). An investment company (including an investment trust) must continue to comply with paragraph 21.9(d), (e), (ee) and (l) and must comply with the applicable continuing obligations set out in the listing rules, modified by paragraphs 21.22 to 21.25 and, in the case of overseas companies, by chapter 17, save that:

…

(d) in the case of an open-ended investment company which is an unrecognised scheme, any provision of this paragraph 21.20 requiring

such a company to publish information or a document to the public will be modified to require the sending of such information or document only to the UK Listing Authority and to other recipients permitted under the Act;

(dd) in addition to the requirements of Chapter 12 (financial information) the issuer (including an investment trust) must include in its annual report and accounts;

(i) a statement in a prominent position, as to whether in the opinion of the the Directors the continuing appointment of the investment manager on the terms agreed is in the interests of shareholders as a whole, together with a statement of the reasons for this view; and

(ii) a summary of the principal contents of any agreements between the investment company and each of the investment managers, including but not limited to any provisions relating to compensation payable in the event of termination of the agreement;

…

(i) in the case of an investment company (including an investment trust) with no executive directors:

(i) paragraph 12.43A(a) does not apply in respect of Combined Code principles B.1 to B.3;

(ii) paragraph 12.43A(b) does not apply in respect of Combined Code provisions B.1.1 to B.1.10, B.2.1 to B.2.6 and B.3.1 to B.3.5; and

(iii) paragraph 12.43A(c) does not apply; ~~and~~

(j) for an investment company (including an investment trust), dealings by directors and purchases by the company of its own securities during a close period which would otherwise be prohibited under the provisions of the Model Code, may be permitted if the UK Listing Authority is satisfied that all price sensitive information which the directors and the company may have in periods leading up to an announcement of results has previously been notified to a Regulatory Information Service. The UK Listing Authority must be consulted at an early stage~~.~~;

(k) any material change to the investment policies of an investment company (including an investment trust) may only be made with shareholders' approval; and

(l) an investment company (including an investment trust) must notify to a Regulatory Information Service:

(i) within two business days of the end of each calendar month, a list of all investments in other listed investment companies (including listed investment trusts), as at the last business day of that month, which themselves do not have stated investment policies to invest no more than 15% of their gross assets in other listed investment companies (including listed investment trusts): and

(ii) within two business days of the end of each quarter, a list of all investments with a value greater than 5% of the companies gross assets and at least the 10 largest investments as at the last business day of that quarter.

Annex B

Amendments to the Conduct of Business Miscellaneous Transitional Rules

After Miscellaneous Transitional Rule 10, insert the following new Transitional Rule.

Risk warnings for listed securities involving gearing					
11	*COB* 5.4.4E (6)	R	A *firm*, which acts as a discretionary *investment manager* for a *private customer* on 1 January 2004 will not contravene this *evidential provision* if it provides the relevant risk warning to those *customers* no later than when it provides a statement in accordance with *COB* 8.2.4R provided that this is done no later than 9 months after this *rule* comes into force.	1 January 2004	30 September 2004

Annex C

Amendments to the Conduct of Business sourcebook

In this Annex, underlining indicates new text and striking through indicates deleted text.

3.8.9 G …

(6) If the *financial promotion* relates to *securities*, or to an *investment trust savings scheme* for *dealing* in *securities*, in respect of which the conditions in (a), (b) and (c) are satisfied, then the *firm* should ensure that the risks associated with the relevant investment approaches in (b) are properly explained. The conditions are that:

(a) The *securities* are

(i) listed in the *United Kingdom* under chapter 21 of the *listing rules* (Investment entities); or

(ii) issued by an *investment trust* and *listed* in an *EEA State* other than the *United Kingdom*;

(b) the *issuer* of the *securities* in (a):

(i) uses or proposes to use *gearing* as an investment strategy; or

(ii) invests or proposes to invest in *securities* that satisfy the conditions in (a) and the *issuer* of such *securities* uses or proposes to use *gearing* as an investment strategy; and

(c) the *securities* are likely to be subject to fluctuations in value which are significant compared with the likely fluctuations in value of the underlying investments.

…

Examples of applications which could meet COB 3.9.15R

3.9.17 G …

(14) … .;

(15) (for a *security* or an *investment trust savings scheme* which satisfies the conditions specified in *COB* 3.8.9G(6)): 'This investment may be subject to sudden and large falls in value and you could get back nothing at all'.

…

4.2.15 E Table Content of terms of business provided to a customer: general requirements

…

(16) …

(f) a *security* or an *investment trust savings scheme* which satisfies the conditions specified in *COB* 3.8.9G(6);

…

5.4.4 E … *COB*5.4.6E to *COB*5.4.~~10~~11E as appropriate

(5) .;

(6) a *security* or an *investment trust savings scheme* which satisfies the conditions specified in *COB* 3.8.9G(6) (see *COB* 5.4.11E).

…

Risk warnings in respect of listed securities where gearing is involved

5.4.11 E In relation to a transaction in a *security* or an *investment trust savings scheme* for dealing in *securities* which satisfies the conditions specified in *COB* 3.8.9G(6) a *firm* should provide to the *private customer* a notice to warn the *private customer* that the strategy which the *issuer* of *securities* uses or proposes to use may result in:

(1) movements in the price of the *securities* being more volatile than the movements in the price of underlying *investments*;

(2) the *investment* being subject to sudden and large falls in value; and

(3) the *private customer* getting back nothing at all if there is a sufficiently large fall in value in the *investment*.

…

6.5.14 G …

(15) .;

(16) for a *security* or an *investment trust savings scheme* which satisfies the conditions specified in *COB* 3.8.9G(6), the fact that the *investment* may be subject to sudden and large falls in value and that the *private customer* may get back nothing at all if the fall in value is sufficiently large;

…

Annex D

Amendments to the Glossary

Insert the following new definitions in the appropriate alphabetical position:

gearing	(in *COB*) a strategy, with a view to enhancing the return for, or the value of, a *security* without increasing the amount invested by the holders of the *security*, involving one or more of the following: (a) borrowing money; (b) investing in one or more instruments, such as (but not limited to) *warrants* or *derivatives*, for which a relatively small movement in the value or price of the underlying rights or assets to which the instrument relates, whether favourable or adverse, results in a larger movement in the value or price of the instrument; and (c) structuring the rights of holders of a *security* so that a relatively small movement in the price or value of the underlying rights or assets, whether favourable or adverse, results in a larger movement in the price or value of the *security*.

.

Listing Rules (Model Code) Instrument 2003

LISTING RULES (MODEL CODE) INSTRUMENT 2003

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (the "Act"):

(1) section 74 (The official list);

(2) section 75 (Applications for listing);

(3) section 79 (Listing particulars and other documents);

(4) section 80 (General duty of disclosure in listing particulars);

(5) section 84 (Prospectuses); and

(6) section 96 (Obligations of issuers of listed securities).

B. The rule-making powers listed above are specified for the purpose of section 153 (2) of the Act (Rule-making instruments).

Commencement

C. This instrument comes into force on 1 December 2003.

Amendments to the Listing Rules

D. The Listing Rules are amended in accordance with the Annex to this instrument.

Citation

E. This instrument may be cited as the Listing Rules (Model Code) Instrument 2003.

By order of the Board
18 September 2003

Annex

Amendments to the Listing Rules

In this Annex, underlining indicates new text.

APPENDIX TO CHAPTER 16

THE MODEL CODE

Definitions

In this code the following definitions, in addition to those contained in the listing rules, apply unless the context otherwise requires:

…

(b) "dealing" includes any acquisition or disposal of, or agreement to acquire or dispose of, any securities of the company, entering into of any contract for differences or any other contract the purpose of which is to secure a profit or avoid a loss by reference to fluctuations in price of any securities of the company and the grant, acceptance, acquisition, disposal, exercise or discharge of any option (whether for the call, or put, or both) or other right or obligation, present or future, conditional or unconditional, to acquire or dispose of securities, or any interest in securities, of the company and "deal" shall be construed accordingly;

…

List of non-confidential respondents to CP164

3i European Technology Trust plc

3i Group plc

3i Smaller Quoted Companies Trust plc

A B Parker

A Bain

A Gallo

Aberdeen Asset Management PLC

Actuarial Profession

Advance Developing Markets Trust PLC

Advance UK Trust Plc

Alliance Trust PLC

Allianz Desdner Asset Management (UK) Ltd

Alternative Investment Strategies Limited

Anglo & Overseas Trust PLC

Anson Fund Managers Limited

APCIMS (Association for the European Securities Industry)

Association of British Insurers

Association of Investment Trust Companies (AITC)

Aurora Investment Trust plc (the independent non-executive directors)

Baillie Gifford & Co

Baillie Gifford Japan Trust PLC

Bankers Investment Trust PLC

Barclays PLC

BFS Absolute Return Trust Limited

BFS Asian Assets Trust Limited

BFS Income and Growth Trust PLC

BFS Investments plc

BFS US Special Opportunities Trust PLC

Blue Planet Investment Management

British Empire Securities and General Trust p.l.c

British Venture Capital Association

C A Sheridan

C A TWilson

C Edgecombe

C I Phillips

C R Coid

Cazenove & Co Ltd

Centre for Financial Markets Research (University of Edinburgh)

City of London Investment Management Company Ltd

City of London Investment Trust PLC

Clifford Chance

Close Brothers Securities

Close Fund Management Ltd

Collins Stewart Ltd

D Cowie

D Gardiner

Dickson Minto W.S.

Dr A B Lamb

Dr A Rushworth

Dr A W Henfrey

Dr P Kelen

Dunedin Smaller Companies Investment Trust plc

E Duckett

E M A Towers

E. H Mauldon

Eaglet Investment Trust plc

Edinburgh Fund Managers PLC

Edinburgh Income and Value Trust

Edinburgh Investment Trust PLC

Establishment Trust plc

Exeter Investment Group plc

F & C Emerging Markets Investment Trust PLC

F C Tanan

F&C Emerging Markets Investment Trust PLC

F&C Management Limited

F&C Pacific Investment Trust PLC

Fidelity Investment Limited

Fidelity Japanese Values PLC

Fidelity Special Values PLC

Financial Services Consumer Panel

Fleming Continental European Investment Trust

Foreign & Colonial Investment Trust PLC

Framlington Group Limited

Framlington Income & Capital Trust PLC

Framlington Second Dual Trust PLC

Franklin Resources Inc.

G Laursen-Jones

G MacLennan

G N. Morgan and W.J Ratchford

G Weaver

Gartmore Investment Limited

H N Buchan

Hansa Trust PLC

Hargreaves Lansdown Asset Management Limited

Henderson European Micro Trust PLC

Henderson Global Investors

Henderson TR Pacific Investment Trust PLC

Herald Investment Management Limited/Herald Investment trust plc

Herbert Smith

Hermes Investment Management Limited

Howard Flight MP

International Biotechnology Trust plc

INVESCO Asset Management Limited

Invesco Japan Discovery Trust plc

Investment Management Association

Investment Trust of Investment Trusts PLC

ISIS Asset Management plc

J Birkett

J D Poland

J Davies

J Lloyd

J Mainhood

J.A. Burdon-Cooper

J.G. Larkin

J.W Mauldon

JPMorgan Fleming American Investment Trust plc

JPMorgan Fleming Asset Management

JPMorgan Fleming Chinese Investment Trust plc

JPMorgan Fleming Income & Capital Investment Trust plc

JPMorgan Fleming Managed Growth plc

JPMorgan Fleming Managed Income plc

JPMorgan Fleming Mid Cap Investment Trust plc

JPMorgan Fleming Overseas Investment Trust plc

Jupiter Asset Management Limited

Jupiter Dividend & Growth Trust Plc

Jupiter Enhanced Income Investment Trust PLC

Jupiter European Opportunities Trust plc

Jupiter Primadona Growth Trust PLC

JZ Equity Partners PLC

L A F Durant

L Callahan

Law Debenture Corporation p.l.c.

Law Society's Company Law Committee

Legal & General Investment Management Limited

Lindsell Train Investment Trust PLC

Local Authority Pension Fund Forum

London & Lawrence Investment Company P.L.C.

M&G Equity Investment Trust P.L.C

M&G High Income Investment Trust P.L.C

M&G Income Investment Company Limited

M&G Investment Management Limited

M&G Recovery Investment Company Limited

Majedie Investments PLC

Martin Currie Capital Return Trust plc

Martin Currie European Investment Trust plc

Martin Currie Investment Management Limited

Martin Currie Japan Investment Trust plc

Martin Currie Pacific Trust plc

Martin Currie Portfolio Investment Trust PLC

Merrill Lynch New Energy Technology plc

Merrill Lynch World Mining Trust plc

Mid Wynd International Investment Trust PLC

MJ & RC Caley

Monks Investment Trust PLC

Murray Emerging Growth and Income Trust PLC

N H Lewis

N Hewitt

N Sidebottom

New Star Asset Management Limited

Nicholson Graham & Jones

Northern Investors Company PLC

Old Mutual South Africa Trust plc

P D Dudly

P Durden

P J Milton

P.J.Farmer

Pantheon Private Equity Specialists

Polar Capital Technology Trust PLC

PricewaterhouseCoopers

Progressive Asset Management Limited

Progressive Geared Income Trust plc

R A and J Smith

R A Plummer

R Davis

R P Swaine

R Rankine

Real Estate Opportunities Limited

Rights and Issues Investment Trust PLC

RIT Capital Partners plc

Royal London Asset Management Limited

Royal London Growth & Income Trust plc

Royal London UK Equity & Income Trust plc

S J Walker

S M Hutton

S R Davis

S.J. Green

Schroder AsiaPacific Fund plc

Schroder Japan Growth Fund plc

Schroder UK Growth Fund plc

Schroder Ventures International Investment Trust plc

Schroders Investment Management Limited

Scottish American Investments Co PLC

Scottish Investment Trust PLC

Shepherd & Wedderburn

Shires Income plc

Sir Brian Williamson

Spiers & Jeffrey Ltd

Standard Life Investments Limited

T.M.Bull

Teather & Greenwood Limited

Templeton Emerging Markets Investment Trust PLC

Throgmorton Trust plc

Tribune Trust plc

Trust Associates Limited

Unicorn Asset Management Limited

W D Hickman

W Soloman

W T J Griffin

Witan Investment Trust PLC

Zero Preference Growth Trust

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