

Consumer and Retail Policy  
Financial Conduct Authority  
12 Endeavour Square  
London  
E20 1JN

Submitted by email to [dp21-05@fca.org.uk](mailto:dp21-05@fca.org.uk)

4 March 2022

Dear sir/madam,

**RE: Discussion Paper DP 21/5: Compensation Framework Review**

The Investment Company Institute (ICI), including ICI Global,<sup>1</sup> welcomes the opportunity to provide input to the Financial Conduct Authority's (FCA) review of the Financial Services Compensation Scheme (FSCS) by submitting this response to Discussion Paper (DP) DP21/5.<sup>2</sup>

ICI members manage regulated funds in jurisdictions around the world, including the UK and EU, which may be the subject of protected claims under the FSCS in the event of certain losses. We have provided recommendations in this letter on the application of the Collective Investment Scheme (CIS) *look through* provisions of the FSCS in response to Question 11 in the DP.

We urge the FCA to limit the scope of the CIS look through to just United Kingdom (UK) domiciled investment funds. As we have set out below, the costs resulting from the application of the look through to funds domiciled outside the UK ("overseas funds") are not commensurate to investor protection benefits, particularly given other mitigating factors. Furthermore, the scope of the look through reduces the UK's competitiveness as both an investment fund domicile and an investment management centre.

**Background**

The FSCS<sup>3</sup> provides important protection for consumers by compensating them for loss when an authorised firm's financial circumstances prevents the firm from doing so. More precisely, the FSCS enables *eligible claimants* who have a *protected claim* against a *relevant person in default* to receive *compensation* for loss.<sup>4</sup> Levies imposed on *participant firms* and their *appointed representatives* cover the FSCS' management expenses and compensation costs.<sup>5</sup>

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<sup>1</sup> ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of \$41.6 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Brussels, Hong Kong, and Washington, DC.

<sup>2</sup> FCA Discussion Paper DP21/5: Compensation framework review, December 2021, available at <https://www.fca.org.uk/publication/discussion/dp21-5.pdf>

<sup>3</sup> Established in accordance with Part XV of the Financial Services and Markets Act 2000 (as amended)

<sup>4</sup> As defined in the FCA's COMP rules, an *eligible claimant* is a person (COMP 4) whom, in connection with protected business, is eligible to bring a *protected claim* (COMP 5.2) against a *relevant person in default* (COMP 6) for *compensation* (COMP 11).

<sup>5</sup> As set out in the FCA's FEES rules, *participant firms* (FEES 1) pay management expenses levies (FEES 6.4) and compensation costs levies (FEES 6.5)

Fund investors can seek compensation from the FSCS for loss resulting from the activities<sup>6</sup> of investment fund managers (IFMs)<sup>7</sup> and delegated investment managers (DIMs)<sup>8</sup> where the loss is not solely due to market movements. Claims for loss can either be brought directly by a fund investor against an IFM,<sup>9</sup> or on their behalf<sup>10</sup> against an IFM or a DIM<sup>11</sup> by the Collective Investment Scheme (CIS) or an intervening *operator* or *manager* of the CIS.

In 2016 and 2017, the FCA consulted on reforms<sup>12</sup> intended to bring greater consistency to fund investors' compensation claims by addressing instances where fund investors do not have a valid direct civil liability claim for loss against the IFM<sup>13</sup> and therefore may not have a protected claim under the FSCS. As is noted in the DP, the FCA introduced a CIS look through provision in April 2018 to enable *participants* in a CIS to be treated as having a claim rather than the CIS or any intervening operator or manager who may be the actual claimant.<sup>14</sup>

### **Application of the CIS look through should be narrowed to UK domiciled investment funds**

The scope of protected claims under the FSCS that can be brought against IFMs is narrower than for claims that can be brought against DIMs. Claims for loss against IFMs are limited to the management of UK domiciled funds<sup>15</sup> and cannot be brought against IFMs managing overseas funds,<sup>16</sup> even if those funds are marketed in the UK.<sup>17</sup> Claims for loss against DIMs are not, however, subject to a similar territorial scope limitation and may be brought by eligible claimants regardless of where the fund is domiciled, marketed, or managed.

The FCA has sought to justify the absence of a territorial scope limitation for claims against DIMs on the basis that non-UK investors might "expect" some degree of compensation.<sup>18</sup> We disagree and believe that non-UK investors in overseas funds would not seek to obtain compensation from the FSCS. Non-UK fund investors are far less likely to expect and/or be aware of the FSCS. Furthermore, even if non-UK investors are aware of the FSCS, they may not in all cases be able to ascertain if a UK DIM has been appointed and whether they are covered by the FSCS.

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<sup>6</sup> i.e., designated investment business as defined in COMP 5.5. and including activities such as *managing investments*, *managing a UK UCITS* and *managing an AIF*.

<sup>7</sup> e.g., in accordance with COMP 5.5.1 that are acting as the manager of an Authorised Unit Trust (AUT), the Authorised Corporate Director (ACD) of an ICVC, the authorised contractual scheme manager of an Authorised Contractual Scheme (ACS) or the manager of a Long Term Investment Fund.

<sup>8</sup> e.g., in accordance with COMP 12A.3.1(2)(a)(ii) that are *managing investments*.

<sup>9</sup> In their capacity as *holders of units* in an *authorised fund* or *other collective investment scheme (CIS)*

<sup>10</sup> As *participants* in the *CIS*.

<sup>11</sup> For instance, *managing investments* for the *CIS*

<sup>12</sup> CP16/42: Reviewing the funding of the Financial Services Compensation Scheme (FSCS), 1 May 2018, available from <https://www.fca.org.uk/publication/consultation/cp16-42.pdf>; CP17/36: Reviewing the funding of the Financial Services Compensation Scheme (FSCS), feedback from CP1642, final rules and new proposals for consultation, 30 October 2017, available from <https://www.fca.org.uk/publication/consultation/cp17-36.pdf>

<sup>13</sup> For instance, where investors do not have a direct contractual relationship with the IFM as may be the case for an externally managed Investment Company with Variable Capital

<sup>14</sup> Paragraph 9.23, CP 16/42

<sup>15</sup> COMP 5.5.2

<sup>16</sup> The FCA's Cross-Sectoral and Funds Policy Department has confirmed on several occasions that the territorial limitation in COMP 5.5.3 has the effect of excluding the management of offshore funds from being the subject of a protected claim.

<sup>17</sup> HM Treasury confirmed in its response to the Overseas Funds Regime (OFR) consultation that it intends to leave the scope of FSCS jurisdiction unchanged, so that it will not apply to overseas funds under the OFR, see paragraph 2.39, "Overseas funds regime, a summary of responses", available from [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/933879/FINAL\\_OFR\\_Consultation\\_Response.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933879/FINAL_OFR_Consultation_Response.pdf).

<sup>18</sup> Letter from Andrew Bailey, CEO, FCA to Chris Cummings, CEO, Investment Association, RE: FSCS Levies, dated 27 July 2018.

If a non-UK fund investor suffers loss, they are likely, in the first instance, to seek compensation directly from the overseas fund and/or the overseas primary fund manager. Moreover, a non-UK fund investor will likely only turn to the FSCS if the overseas primary fund manager is in default, or the claim is unsuccessful, and the UK DIM is in default.

The FCA acknowledges that claims against fund operators (as well as depositaries) have been low.<sup>19</sup> However, the FCA asserts that a low level of claims now is not a guarantee of low levels of claims in the future. The FSCS is, by its nature, a form of backstop – intended to be called upon when events occur which cause significant harm to investors. The FCA is required under statute<sup>20</sup> to consider the desirability of ensuring that FSCS levies imposed on a class of firms are commensurate with the value of claims made on that class. The absence of a territorial scope limitation for claims against DIMs of overseas funds does not, in our view, represent a reasonable application of this “polluter pays” principle.

The absence of a territorial scope limitation also penalises DIMs of overseas funds by imposing a disproportionate levy that neither IFMs of overseas funds nor DIMs located in other jurisdictions are subject (e.g., France and Germany.) Penalising DIMs of overseas funds in this manner may create an incentive to undertake delegated investment management outside the UK, with associated implications for the competitiveness of the UK. It is notable that the FCA may be required to take account of such competitiveness implications going forward considering the Government’s Future Regulatory Framework Review.<sup>21</sup>

The FCA asserts that the impact of the *failure* of a fund operator – for instance due to loss resulting from investments made outside its mandate – is significant enough to justify FSCS protection.<sup>22</sup> It is important to recognise that fund operators do not operate in isolation and are not absent oversight. For instance, the following aspects of the regulatory framework already provide important additional protections for investors:

- **Oversight** – the investing activities of fund operators, IFMs and DIMs may be overseen by an independent fund depositary. In the case of a UCITS, the depositary is obliged to check whether instructions it is asked to carry out by the fund operator conflict with national law, the fund rules, or instruments of incorporation (e.g., investments outside of mandate.)<sup>23</sup> This obligation creates an additional layer of oversight of the fund operator and, in turn, an appointed IFM or DIM.
- **Prudential tools** – fund operators, IFMs and DIMs are required to consider the financial implications of operational risks crystallising (e.g., mandate breaches) and implement prudential tools (e.g., capital, insurance etc.) to cover these operational risks with reasonable confidence (e.g., under the Investment Firms Prudential Regime.)

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<sup>19</sup> DP at 4.16

<sup>20</sup> Section 213(5), Financial Services and Markets Act 2000

<sup>21</sup> Financial Services Future Regulatory Framework Review: Proposals for Reform, HM Treasury, November 2021, available at [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1032075/FRF\\_Review\\_Consultation\\_2021\\_-\\_Final\\_.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1032075/FRF_Review_Consultation_2021_-_Final_.pdf)

<sup>22</sup> DP at 4.16

<sup>23</sup> For instance, Article 22(3)(c) of the UCITS Directive requires a depositary to carry out the instructions of the management company or an investment company, unless they conflict with the applicable national law, or with the fund rules or the instruments of incorporation, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A02009L0065-20140917>

The tenuous circumstances in which a claim against a DIM could possibly be brought, given the oversight of fund operators, IFM and/or DIM, and the prudential tools used to cover operational risks, does not appear to justify FSCS coverage of these situations. In fact, in the Overseas Funds Regime, HM Treasury rightly determined that FSCS coverage should not be extended to overseas funds that are marketed into the UK because of their highly regulated nature (e.g., EU UCITS).<sup>24</sup> HM Treasury also did not identify examples of loss or harm to UK investors in overseas funds resulting from a lack of access to the FSCS.

### **Implications for FSCS levies from the absence of a territorial scope limitation for DIM claims**

In the absence of a territorial scope limitation for claims against DIMs, it is necessary for DIMs to identify, on a worldwide basis, whether the underlying investors in the overseas funds under their management<sup>25</sup> are eligible claimants for the purpose of calculating their FSCS levy.<sup>26</sup> As acknowledged by the FCA, this is a significant undertaking as it may involve identifying the ultimate source of investor subscriptions<sup>27</sup> and may be resulting in some DIMs unnecessarily overreporting income for the FSCS levy.<sup>28</sup>

### **Enhancing disclosure of FSCS coverage for the marketing of funds to UK investors**

The FCA suggests that it is not reasonable to expect investors to know whether a claim for compensation against a UK authorised firm may or may not be covered by the FSCS, including under the CIS look through. We see merits in clarifying for UK investors – who are most likely to be aware of the FSCS – whether they are covered by the FSCS or another compensation scheme. We recommend that the FCA takes up HM Treasury’s recommendation that the absence or existence of compensation scheme coverage, including overseas schemes, should be disclosed to UK investors at the point of subscription.<sup>29</sup> Limiting the scope of the CIS look through, as we have suggested in this letter, would also make it simpler for UK investors to understand the scope of FSCS coverage made through such disclosures.

Fund investors who value the benefit of FSCS coverage may actively subscribe to a UK domiciled investment fund rather than an overseas funds which does not benefit from the same protection. Limiting the scope of the CIS look through to just UK domiciled funds and clearly disclosing the benefit of FSCS coverage to investors therefore has the potential to enhance the UK’s competitiveness as an investment fund domicile.

### **Conclusion**

The tenuous circumstances in which a claim against a DIM could possibly be brought, coupled with the existing oversight of fund operators, IFM and/or DIM and the prudential tools they use to cover operational risks, does not appear to justify FSCS coverage of DIMs of overseas funds. The absence of a territorial scope limitation for such claims does not, in

<sup>24</sup> Paragraph 2.39, Overseas Funds Regime: A summary of responses

<sup>25</sup> i.e., “beneficiaries”.

<sup>26</sup> i.e. to determine eligible income.

<sup>27</sup> These subscriptions may be from many different investor types (e.g., individual vs institutional investors), multiple investment vehicles (e.g., funds, separately managed accounts) and multiple jurisdictions (e.g., if a fund is distributed across the world), and may have been made via third party intermediaries with whom the DIM may not have a contractual relationship.

<sup>28</sup> FCA News Publication: Options for reporting income for FSCS levy calculations, 18 November 2020, available from <https://www.fca.org.uk/firms/reporting-income-fscs-levy-calculations>

<sup>29</sup> Paragraph 2.38, Overseas Funds Regime: A summary of responses

our view, represent a reasonable application of this “polluter pays” principle. Furthermore, it penalises DIMs of overseas funds by imposing a disproportionate levy that neither IFMs of overseas funds nor DIMs located in other jurisdictions are subject. The resulting costs of the current CIS look through are not commensurate to investor protection benefits and create an incentive to undertake delegated investment management outside the UK.

We urge the FCA to introduce a territorial scope limitation for claims against DIMs similar to that for IFMs managing overseas funds,<sup>30</sup> thereby limiting the scope of FSCS’ look through provision to just UK domiciled investment funds. We recommend that the FCA introduces a requirement for the absence or existence of compensation scheme coverage, including overseas schemes, to be disclosed to UK investors at the point of subscription.

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If you would like to discuss any matter covered in this letter in further detail please do not hesitate to contact me at [giles.swan@ici.org](mailto:giles.swan@ici.org) or on +44 7810 654951.

Yours sincerely

/s/

Giles Swan

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<sup>30</sup> COMP 5.5.3