EXPLANATORY MEMORANDUM TO

THE OPEN-ENDED INVESTMENT COMPANIES (AMENDMENT) REGULATIONS 2009

2009 No. 553

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

This Order allows transfers of title to shares in Open-Ended Investment Companies (OEICs) to be made by electronic communication. The law currently requires a paper instrument of transfer. Permitting electronic transfer should allow significant cost savings and reductions in error rates for asset managers.

3. Matters of special interest to the Joint Committee on Statutory Instruments

None

4. Legislative Context

The Law of Property Act 1925 in England and Wales requires transfers of title to shares in OEICs to be made with a paper instrument of transfer. In Scotland, the Requirements of Writing (Scotland) Act 1995 requires the giving of title to OEIC shares as a gift to be in writing. Transferring title by a paper process is often more costly and less reliable than using a fully electronic process. This Order permits electronic transfer of title to OEIC shares in England, Wales and Scotland.

There is a separate legal framework for the establishment and regulation of OEICs which have a head office in Northern Ireland set out in the Open Ended Investment Companies Act (Northern Ireland) 2002 and the Open Ended Investment Companies Regulations (Northern Ireland) 2004.

The Unit Trusts (Electronic Communications) Order 2009 makes the same amendment for transfer of title to units in authorised unit trusts (AUTs).

5. Territorial Extent and Application

This instrument applies to Great Britain.

6. European Convention on Human Rights

The Economic Secretary to the Treasury has made the following statement regarding Human Rights:

In my view the provisions of the Unit Trust (Electronic Communications) Order 2009 are compatible with the Convention rights.

7. Policy background

- ***What is being done and why***

AUTs and OEICs are the two vehicles used in the UK to create open-ended investment funds for sale to the public. Around £468 billion is currently held in such funds.[1] Allowing paperless transfer of ownership of units and shares in these funds is widely supported by the fund management industry.

- ***Consolidation***

HM Treasury does not intend to consolidate the OEIC regulations at this stage.

8. Consultation outcome

The proposals were subject to a 3-month open consultation. Feedback was generally positive. Based on feedback from respondents, the draft regulations were amended to separate the requirement for managers to take "reasonable steps" to verify the identity of the person submitting electronic instructions from the property law provisions providing that a transfer made by means of electronic communication could be effective. This was in order to increase certainty over the operation of the rules.

9. Guidance

The Investment Management Association, a trade body, has produced guidance for firms on meeting the requirement to take "reasonable steps" to ensure transfer instructions are genuine. The Investment Management Association has asked the Financial Services Authority (FSA) to approve this guidance, which the FSA is currently considering. The current draft of this guidance is attached. Minor changes are likely to be needed before the guidance is approved including to reflect rule changes made by the FSA consequential on these statutory amendments.

10. Impact

The proposals are expected to yield regulatory savings of between £70 million and £290 million. Since the use of the new provisions is optional, no new costs will be imposed except insofar as firms choose to spend money to allow them to access the potential cost savings. An Impact Assessment is attached to this memorandum.

11. Regulating small business

[1] Source: Asset Management in the UK 2007

The legislation applies to small business. It does not impose any additional burden.

12. Monitoring & review

The Financial Services Authority will oversee the operation of the new powers to ensure they are working as intended. The Treasury has not scheduled a future review but will consider whether any review is necessary as implementation progresses.

13. Contact

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Regulatory Impact Assessment for the Unit Trusts (Electronic Communications) Order 2009 and Open-Ended Investment Companies (Amendment) Regulations 2009

- **Summary**

Annual costs	£0
One-off costs	<£5m
Total costs	<£5m
Key non-monetised costs	None
Annual benefits	£70m - £290m
One-off benefits	£0
Key non-monetised benefits	Faster and more accurate processing of investor instructions
Net annual benefits	£70m - £290m
Net first year benefits	£65m - £290m

- **Key Assumptions and Sensitivities**

These estimates rely on the assumptions that:

- the overall EU estimates for the additional costs of manual fund processing are accurate;
- the UK industry suffers these costs in proportion to its share of total funds under management; and
- between one quarter and one half of those costs would be avoided if paperless transfer and settlement were permitted.

- **What is the problem under consideration? Why is Government intervention necessary?**

OEICs and authorised unit trusts (AUTs) are open-ended collective investment funds authorised by the FSA. Because they are open ended, investors can and generally do redeem their investments by selling their shares (in the OEIC) or units (in the AUT) back to the fund's management company. The Law of Property Act 1925 (LPA) only provides for these redemptions or transfers to be made in writing. Although the initial instruction can be made electronically, it must be confirmed by a written instruction from the investor.

The requirement for paper settlement and transfer of title costs fund managers, stockbrokers, financial advisers and other intermediaries money. The Government believes that provision could be made to facilitate purely electronic settlement of trades in OEIC shares and AUT units without compromising investor protection.

- **What are the policy objectives and the intended effects?**

The policy objective is to facilitate purely electronic settlement of trades in OEIC shares and AUT units in order to remove the need for a manual, paper-based, settlement process for authorised investment funds. This is intended to allow fund managers, stockbrokers, financial and other intermediaries to realise cost savings which can be passed on to investors.

- **What policy options have been considered? Please justify any preferred option.**

The Government could:

  - do nothing; or
  - allow for electronic transfer and settlement of AUT units and OEIC shares by the assignor or his duly authorised agent.

The Government's preferred option is the second one above due to the significant potential cost savings and reduced administrative burden.

- **Estimated Costs**

This change would not directly bring any additional costs. While the option of paperless transfer and settlement would be introduced, there would be no requirement on firms to allow it. Although it seems unlikely in practice, if the costs of handling electronic instructions outweighed the benefits for a particular firm it would have the option of maintaining existing paper-based systems.

However, it is necessary to subtract from the estimated savings any additional costs that would be involved in the set up of new electronic systems to benefit from the removal of the requirement for paper transfer and settlement. It is necessary to consider these costs across the range of potentially affected stakeholders. For custodians the systems implications should be minimal. Many are using a workaround for settlement known as a coverall to allow largely paperless processes already. These could be replaced with standard settlement instructions which under the proposals would have the advantage of giving greater legal certainty than coveralls currently do. Other than that, the systems used should be essentially the same. It would be possible to provide these standard settlement instructions in electronic form, but this is unlikely to have a significant impact on cost.

Brokers who already deal on clients' behalf over CREST are likely already to have in place mechanisms to identify and authenticate their clients' instructions. There should therefore be no significant systems implications for them. Small financial advisers would be likely to rely on infrastructure provided by fund managers or fund supermarkets.

Fund managers may not always have the same electronic mechanisms. However, it is unlikely that electronic settlement would be used in transactions where there was not already some method for secure electronic communication established between the client and the fund manager. It therefore seems unlikely that entirely new electronic systems would be set up purely in order to allow electronic transfer and settlement.

In all, the costs to the industry of allowing electronic settlement are not likely to be material and are estimated at less than £5 million one-off cost. The day-to-day running costs of electronic settlement systems are taken into account in the estimates of cost savings from electronic straight through processing.

- **Estimated benefits**

The direct additional costs of manual fund processing compared to straight through electronic processing have been estimated at €1 billion per year across the EU.[2] However, the higher error rates generally associated with manual processing are thought to bring additional costs through loss and correction. Taking this into account, the total cost has been estimated at between €5 and €10 billion[3]. Assuming the UK share in these additional costs is equal to its share of the EU UCITS market of around 7 per cent, this puts the total costs of manual processing for UK UCITS funds between €350 million and €700 million. Around 20 per cent of UK retail funds are non-UCITS[4.] Assuming a constant ratio of additional costs from manual processing to assets under management this increases the total cost to between €420 million and €840 million. In Sterling, this range is approximately £290m to £580m.

It is difficult to estimate what percentage of these costs are directly applicable to the requirement for paper transfer and settlement. There is still a significant amount of manual processing even in EU Member States where there is no requirement for paper transfer and settlement so it would not be reasonable to assume all of the cost would disappear as a result of the proposal. However, there is a general trend towards implementing electronic straight through processing. If allowing paperless transfer and settlement were helpful in encouraging this trend it could bring additional indirect savings. A reasonable range seems to be between one quarter and one half the total additional costs of manual processing related to the requirement for paper transfer and settlement. This yields a range of £70m to £290m for gross annual cost savings. This range is consistent with research carried out by the Investment Management Association with various individual stakeholders in the UK.

In sum, this yields an annual cost saving of £70 million to £290 million with an initial one off cost of less than £5 million.

An additional non-monetary benefit would be the potential for faster settlement and lower error rates with electronic (rather than manual) systems. This would benefit investors who would see their instructions executed more quickly and accurately.

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[2] Source: SWIFT. Available at http://www.swift.com/index.cfm?item_id=42770

[3] Source: Siebel, Rudolph (2006), *How to eat an elephant: exploring the future of investment fund processing in Europe,* available at http://ec.europa.eu/internal_market/financial-markets/docs/cesame/users/20060612-efama-background_en.pdf

[4] Source: EFAMA