Response to HM Treasury and Cabinet Office consultation on Charity pooled funds

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BACKGROUND AND INTRODUCTION

- The Charities Aid Foundation (CAF) is a registered charity that aims to help charities and social enterprises make the most of their money. CAF provides financial, investment and fundraising services and works directly with tens of thousands of charitable organisations across the UK and internationally.

- CAF has a strong history of campaigning for changes in policy and legislation in order to improve the giving environment and to secure supportive legal, fiscal and regulatory conditions for donors, charities and social enterprises. Our knowledge and understanding - gained through direct experience and research - makes us a trusted voice on giving and the effective use of charitable funds.

- CAF is also the principal shareholder in CAF Bank Limited (CAF Bank), a firm that is authorised and regulated by the Financial Services Authority (FSA). CAF Bank is an alternative to traditional high street banks, delivering quality banking products that provide enhanced net value to charities and social enterprises, as well as supporting industry and regulatory reforms capable of delivering better regulation and protection for its customers.

GENERAL COMMENTS

- CAF broadly welcomes the proposals outlined in the consultation document – the proposed creation of AIFs is likely to streamline regulation and provide greater access to market and fund management expertise. It also has the potential to improve the effective and appropriate investment of charitable funds.

- It is our understanding that CIFs were introduced to allow access to markets and professional fund management, in particular for smaller charities. They were designed to accommodate the principles of Charity Commission investment guidance, currently captured under CC14, with charity trustees seeking to pass the responsibility of compliance onto the manager.

It is clear to CAF through a number of investment and charitable relationships that the scope of CC14 can easily become blurred and we anticipate that the current review of that document will make the guidance more appropriate for modern markets and investment thinking. It is not, however, clear how this aspect will be regulated under the proposed rules or indeed who will be responsible for their formulation. How would the Charity Commission & FSA work together to ensure that funds comply with the appropriate investments rules? It is assumed that FSA would take this over but how would the sector continue to be appropriately represented in changes of policy?

On the other hand, it could be argued that moving CIFs into Charity AIFs creates the opportunity to remove the requirement for compliance with CC14, since the new entities would not be charities and therefore free from tax and other considerations specific to that form. This would allow more flexible investment strategies and create the opportunity for a much wider range of investment managers, who are not familiar with charity investment rules, to become involved to the benefit of the charity investments market in terms of competition, levels of service and performance.

- CAF is concerned that the general level of investment knowledge is low amongst the public and charity trustees. Access to training and information is largely restricted to higher value
there is a feeling in the sector that the Charity Commission ‘endorsement’ of CIFs validates the investment as suitable for them. It should be recognised, however, that this endorsement is something of a false comfort as it does nothing to reduce charity trustees’ fiduciary responsibility. There is a great opportunity with the proposed change to improve investor knowledge and understanding, and we hope the FSA will take on this role of seeking to educate the sector and ensure that any advice given is appropriate for funds held in trust for public benefit by charity Trustees.

- The consultation makes consistent references to ‘charities’. We would like to be reassured that this includes all currently eligible investors, such as exempt organisations under Sect 505 etc, as well as registered charities.

**THE CHARITY AIF PROPOSAL (CHAPTER 4)**

_The proposal is that existing CIFs and CDFs would become charity AIFs. Are there any adverse consequences of this proposal, and how might they best be mitigated? (4.1)_

CIFs allow for smoothing of income flows – AIF rules would appear to require that all income be paid out annually. This would remove the ability to have a Distribution Equalisation Reserve and potentially disadvantage charities that rely on their manager to generate regular cash flows from their investments. The onus of planning and anticipating future cash flows would fall on the charity, not fund management experts. However, there is an argument that charities choosing to invest should be sufficiently knowledgeable to anticipate and account for their own cash flows.

The increased complexity and nature of the AIF arrangements will inevitably lead to some increased costs and these are likely to be passed onto investors.

_Are there any funds for which the OEIC category would be more favourable than the AUT category, and if so, why? (4.2)_

The OEIC category will undoubtedly offer greater flexibility to managers and will be the preferred choice of many. However, the category of fund should not be specified as different structures will better suit different objectives.

It should be noted nevertheless, that the added levels of complexity are likely to have a bearing on the charity decision-making process.

_When church exempt funds cease to be exempt from registration as charities, should they be brought within the charity AIF regime, and if not, how best should they be regulated? (4.3)_

We are not directly involved with church exempt funds so will leave any technical response to those that are. However, if the aim of the consultation is to bring charitable funds under a common regime then it would seem logical to incorporate all funds within the AIF structure.
Charity AIFs would not be charities themselves. Would this have any adverse impacts, and if so, how might they be minimised? (4.4)

Charity pooled funds, as charities themselves, are currently governed by independent Trustees which is a valuable source of comfort to the sector. The intended governance structure for Charity AIFs is unclear in this regard. It is important, however, that small charities are given adequate protection and that the largest charity or most valuable unit holders do not dictate the aims and objectives of the broader fund.

It is also important that Charity AIF investors continue to receive comparable tax exemptions and there needs to be certainty about the responsibility for ensuring that dividends are used for charitable purposes. Charities are obliged to use all funds for the furtherance of their charitable objectives; therefore presumably the onus must rest with the Charity AIF rather than the investing charity itself.

REGULATORY ISSUES (CHAPTER 5)

How would the current governance structures of charity pooled funds need to change, given the possible AUT or OEIC structures? (5.1)

The corporate governance structure of old and new style CIFs is similar to AUTs and relatively little change would be required. On the other hand, the structure of OEICs is somewhat different to CIFs. The corporate governance principles are similar and, although more structural changes would be required, these should not be unduly onerous.

As in 4.4 above, the true independence of some CIF boards has a positive impact on the efficient and correct management of the fund, which offers good protection for many smaller investors. Whilst the responsibility for investment decisions correctly rests with the investor’s trustee board the presence of an expert overview provides added confidence, especially for trustees of smaller charities who can be less experienced in investment matters. The loss of this reassurance, allied to increased complexity, may act as a barrier to good investment decisions.

Given the beneficial nature of non-executive oversight boards, and the improvement to governance they bring to old and new style CIFs which have adopted this approach, we advocate that they become a requirement for Charity AIFs. The unique nature of charity funds, which are held in trust for public benefit, and the implications for their appropriate investment would be more effectively protected if all Charity AIFs are required to incorporate a non-executive oversight board. This would exercise a monitoring and scrutiny role over the FSA approved corporate trustees and investment managers, both of whom may have little understanding of charities, the nature of charity funds and the responsibilities of charity trustees.

Would it be preferable to specify that charity AIFS must take the format of NURS (rather than UCITS schemes or QISs)? (5.2)

The NURs format is attractive due to the relatively lower regulatory impact and fewer restrictions.
Particularly given the variations in charity law and related taxation around the EU, the benefit of UK Charity AIFs being established as UCITS would be very limited.

It is unlikely that small to medium sized charity investors would be considered to be qualified investors, either as defined by the FSA within the COLL sourcebook, or in practical terms, particularly given that charity trustees act as individual persons. Therefore, Charity AIFs do not need the option to be formatted as QISs.

Simplification of the marketplace for the less experienced charitable investor by providing for a single vehicle would be a significant advantage. We support the proposal to specify that charity AIFs must take the format of NURS rather than UCITS schemes or QISs.

Any move to the FSA regulation model will inevitably increase compliance costs due to the difference in regulatory approach between the FSA and Charity Commission. There is a danger of regulatory creep which may adversely affect Charity AIFs, regardless of format, and mechanisms to prevent this would be welcome.

**Which requirements of COLL would be unduly burdensome for charity AIFs? Please explain why and provide details of compliance costs, where possible. (5.3)**

We presume that charity AIFs would be deemed as packaged products under COLL. Converting funds would be required to re-issue literature, provide greater reporting and create new Key Features Documentation. If this move is allied to a re-classification of charities as retail customers then the long term benefits may outweigh the short term expenditure, especially if the introduction could be phased (see 5.5).

A further fundamental difference is that changes to the scheme would in future require unit holder approval rather than that of an experienced CIF trustee board. As with previous answers, this has the potential to disadvantage smaller investors. It is possible that their voice may be lost rather than championed by an independent board with charitable motivation.

**Which requirements of the FSA Handbook outside COLL would be unduly burdensome for charity AIFs? Please explain why and provide details of compliance costs, where possible. (5.4)**

We anticipate additional FOS / FSCS levies as a result of fund reclassification. The new regime could be more nimble for fund providers but the FSA and Charity Commission bring different expertise to the table from an end-user perspective. In the same way that the Charity Commission does not have the same financial regulatory skills of the FSA, the latter does not have charity expertise and we are concerned that a ‘catch all’ mentality could be applied to this specialist area.

**What, if any, transitional arrangements should be made for charity pooled funds converting to charity AIFs? Please explain why and provide details of compliance costs, where possible (5.5).**

Appropriate transition arrangements are vitally important. A smooth transition process based on the reorganisation of the existing funds is highly preferable to the costs and impacts of closing and opening of the fund under a new structure. We would advocate that the enabling
legislation should proscribe the principle of reorganising into a new structure, thereby avoiding a trigger event and preventing the need for the closing out of old units and the disadvantages that this implies.

It may also be advantageous to allow a single opportunity for the conversion of existing CIFs into standard non-charity AIFS without a trigger event, since in some cases the benefits to the charity investors of the restricted charity vehicle may have passed. Normal controls and regulations around the investment of charity funds in standard vehicles would then apply.

It is recommended that a significant transition period of approximately two years should be allowed to migrate funds into the new structure. This would enable CIF providers to spread the cost of complying with the new rules and absorb as many changes as possible into other pre-planned communications and notifications. A phased migration would ensure that changes are not left to the last minute and the cost merely delayed in implementation. This would also help to mitigate the effects of possible changes to the structure of the FSA following the 2010 general election.

**TAX ISSUES (CHAPTER 6)**

*Would the proposal to tax charity AIF income at 20 per cent if the income is not applied for charitable causes have any adverse consequences in practice, and if so, why? (6.1)*

Most charities have limited taxation expertise. Providing that it remains the responsibility of the fund to ensure that only eligible organisations were allowed to become unit holders we do not see any adverse consequences.

*Are there any circumstances where the requirement that the charity AIF does not withhold tax from distributions work to the detriment of the charity investors? (6.2)*

We cannot foresee any circumstances where this would be detrimental.

*Are there any other adverse tax consequences arising from the charity AIF proposal? (6.3)*

There are no other obvious adverse tax consequences to the proposal as outlined. The proposal to remove VAT from management charges corrects an anomaly and is particularly welcome.

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