Charity Authorised Investment Fund (CAIF) - the new investment vehicle for the charity sector

Grania Baird and Julian Smith | January 2018 (this is an update to an earlier briefing)

Introduction

The charities investment market is a substantial one with the top 10 investment firms serving the market managing just over £32 billion of assets for nearly 1600 charities[1]. Having a pooled investment vehicle which is regulated directly by the Financial Conduct Authority (**FCA**) and tax efficient for charities and with features which are able reflect the particular needs of charity investors has been an aspiration for some years now. This is now available in the form of the Charity Authorised Investment Fund (**CAIF**), the first of which was registered with the Charity Commission on 12 December 2017.

In this briefing Grania Baird seeks to respond to key questions interested parties in the CAIF may have.

1. What is a CAIF?

A CAIF is both an investment fund authorised by the FCA and a registered charity. As a registered charity the CAIF must comply with applicable charity law. In addition, as an FCA authorised fund, the CAIF must comply with applicable financial services law and regulation including the relevant FCA rules. Subject to registration with HMRC, the CAIF will be treated as a registered charity for tax purposes and benefit from the direct tax exemptions available to charities.

2. Why was the CAIF introduced?

There are other fund structures which can be used as collective investment vehicles when targeting charity investors. These include traditional common investment funds (**CIF**s), FCA authorised funds, and unregulated structures such as offshore funds. However, for a variety of reasons generally none of these existing fund structures are considered ideal. If an unregulated fund structure is used (in most cases) the charities are vulnerable to suffering irrecoverable VAT on management fees. With the

If you require further information on anything covered in this briefing please contact Grania Baird (grania.baird@farrer.co.uk; +44(0)203 375 7443), Julian Smith (julian.smith@farrer.co.uk; +44(0)203 375 7432) or your usual contact at the firm on 020 3375 7000. Further information can also be found on the Commercial and Regulatory page on our website.

[1] This figure is based on the Charity Investment Spotlight report published by Wilmington Insight in June 2016 and is available here.

exception of CIFs these structures are also difficult to market to the wider charities market and are generally only considered appropriate for more sophisticated charity investors.

Traditional CIFs were specifically created for charity investors and benefit from certain bespoke features, such as the ability to operate income smoothing and/or to have an independent board representing the interests of unit holders. However the Charity Commission has in recent years been reluctant - absent a clear need - to authorise new CIFs. For these and other reasons there has been a desire and push for a new bespoke investment vehicle for charities that has led to the creation of the CAIF.

3. Who regulates the CAIF?

The CAIF is dual regulated by the FCA and the Charity Commission. The Charity Commission is responsible for registration of the CAIF as a charity and regulates the CAIF (and the charity trustees) in respect of compliance with charity law. The FCA is responsible for authorising the CAIF as an authorised fund and regulates the operation and administration of the CAIF and its compliance with the financial services law and regulation, including the FCA Rules. The FCA and the Charity Commission have made arrangements to ensure their respective roles are as clear as possible and that the regulation and supervision of CAIFs operates as intended.

4. Is a CAIF also a "common investment fund"?

Interestingly, yes. Whilst processing the first few CAIF applications late last year the Charity Commission introduced an additional aspect to the CAIF registration process. This change means that in connection with any registration of a proposed CAIF (which is approved in principle by the Commission and authorised by the FCA) the Commission will issue an order pursuant to section 96 of the Charities Act 2011. The effect of this is that CAIFs are brought within the definition of "common investment fund" for the purpose of sections 96 – 99 of the Charities Act 2011. In some respects this was rather a surprising turn of events but as a result the CAIF benefits from the deeming provision under section 99(3) of the Charities Act 2011 as regards its charitable status which is helpful, and puts its charitable status beyond doubt.

5. What are the differences between a traditional CIF and the CAIF?

Although both the CAIF and traditional CIF are registered charities and are considered common investment funds under the Charities Act 2011there are some key differences in terms of their structure and regulation.

- The CAIF must first be established as an authorised fund before the Charity Commission issues its section 96 order (although in practice we expect the FCA order and Charity Commission Order will be made on the same day).

- The CAIF (in comparison to the traditional CIF) is also subject to direct regulation and oversight by the FCA. In comparison, the FCA's role in relation to traditional CIFs is indirect, via regulation of the manager and trustee but not the CIF itself.

- As the CAIF is an FCA authorised fund it is considered a special investment fund and management fees will be exempt from VAT. This is not the case for the traditional CIF.

- The principal governing document for the CAIF will, in the case of an authorised unit trust, be the Trust Deed rather than, as is the case for the traditional CIF, a Charity Commission Scheme.

- Changes to the CAIF structure and documentation will be subject to the standard change process for authorised funds including, as required, FCA approval of such changes, notification to investors and in some cases investor approval. Certain changes may also require Charity Commission approval, for example, increases to the remuneration of the Manager or the Trustee where the CAIF does not have an advisory committee.

6. Which legislation applies to the CAIF?

The CAIF is subject to the relevant FCA rules and requirements applicable to FCA authorised funds. The specific FCA rules applicable to CAIFs are set out in chapter 14 of the Collective Investment Schemes Sourcebook (**COLL**). Other sections of COLL will also apply and, where applicable, parts of the Investment Funds Sourcebook (**FUND**).

The CAIF as a registered charity is subject to charity law and the manager and trustee, must, as charity trustees comply with their obligations under charity law.

A CAIF (as is the case of the traditional CIF) is also subject to the provisions of sections 96-99 of the Charities Act 2011, including the section 98 limitations. The key limitation which we understand section 98 introduces is a requirement that any borrowing must be on a temporary basis only. We understand that the Charity Commission is considering issuing further guidance on their views as to the scope and impact of section 98 in the context of CAIFs. This would be helpful, not least as the constitutional documents of the CAIF will need to incorporate certain limitations on the powers of the manager and trustee to ensure consistency with section 98, and provisions applicable to common investment funds generally.

7. Which FCA fund structures can be used?

The FCA has confirmed that a CAIF can be established as a non-UCITS Retail Scheme (**NURS**), UCITS or Qualified Investor Scheme (**QIS**) type of authorised fund. The type of scheme used will depend on the target investors and the investment objective and policy of the proposed scheme.

In terms of structure, the Charity Commission's current position is that it is comfortable a CAIF can be established as an authorised unit trust. An umbrella authorised unit trust CAIF can be established.

If the alternative FCA structures of an OEIC, or using one of the authorised contractual scheme (**ACS**) structures, is proposed this would involve further dialogue with the Charity Commission and any applicant would have to be able to satisfy the Commission that this vehicle is capable of being a charity.

8. What are the novel features of the CAIF?

In addition to the unique nature of the CAIF (being both an FCA authorised fund and a registered charity), there are a number of optional features available to use within a CAIF which are novel in the authorised funds context. These optional features are:

- ***Advisory committee*** – the idea behind the advisory committee is to seek to replicate the role of the advisory board in a CIF, but without the committee having executive powers. An advisory committee which only has a consultative function is provided for in COLL. Members of the advisory committee must be independent of the manager of the CAIF (**Manager**) and trustee of the CAIF (**Trustee**) and their role will be to represent the interests of unit holders, and to be consulted on various matters regarding the operation of the CAIF. The advisory committee will have the power to convene a meeting of unit holders, and may be required to prepare an annual report. If the CAIF has an advisory committee this must be included in the trust deed and prospectus. Although the advisory committee is not mandatory, without such a committee any increases in the rate of remuneration of the Manager or Trustee, or other increases in charges, must be pre-approved by the Charity Commission.

- ***Income reserve account*** – the ability to hold back income from one accounting period to another and pay out previously held back income is one of the unique features of traditional CIFs and allows such funds to maintain a regular level of distributions which can be appealing to charity investors. The FCA rules allow a CAIF to operate an income reserve account provided this is used solely for the purpose of avoiding fluctuations in income for allocation/distribution and is subject to certain conditions, including a limit of 15%

of income being transferred to the income reserve account in any one accounting period. If an income reserve account is to be established this must be included in the trust deed and prospectus.

- ***Total return approach*** – the ability to return capital as well as income in distributions is a concept increasingly familiar to the charities market, particularly to those charities which have permanent endowment funds. Under the FCA Rules, the CAIF will be able to operate a total return approach where this is for the purpose of meeting a pre-determined target return, which is consistent with the investment objective and policy of the CAIF. Again, if such an approach is to be adopted this must be included in the trust deed and prospectus.

9. Who can invest in a CAIF?

The CAIF is for investment by charity investors. These are defined as charities within the meaning of Section 1 of the Charities Act 2011 and Schedule 6 to the Finance Act 2010 (thereby including charities in Scotland and Northern Ireland that also qualify for UK charity tax reliefs). As a CAIF itself will be a registered charity it can invest in other CAIFs. In addition, it is accepted by the Charity Commission that nominee companies can hold units in a CAIF provided the underlying investors are charities.

The Manager will also be permitted to hold units in the CAIF for box management purposes, provided that any profits from this activity are paid into the CAIF.

10. What is the CAIF's charitable object?

All charities must have an exclusively charitable object. The charitable object for the CAIF was subject to discussion and debate during the consultation stages. Although the Charity Commission has not prescribed what the charitable object of the CAIF must be, it has agreed that a wide objects clause which expresses the purpose of the CAIF as being to further the charitable purposes of the CAIF's investors would be acceptable. Model wording for this form of object is included in the model trust deed (see ***What industry guidance is available?*** section below).

11. Who will be the charity trustees?

The charity trustees will be the Manager and the Trustee and will be subject to the obligations of charity trustees under charity law. Members of the advisory committee will not be considered charity trustees, nor will delegates of the Manager or Trustee.

12. How is a CAIF created?

As regards the Charity Commission – a special procedure has been developed for CAIFs in respect of the registration process. At the pre-application stage a draft application form and the draft documents for the CAIF will need to be prepared (including the trust deed and prospectus) and submitted to the Charity Commission (the pre-application stage). In addition the Commission is likely to ask for evidence that a joint statement from the manager and trustee regarding the management of conflicts of interest will be available at final registration. The support of two charities (which could include traditional CIFs) will need to be referenced in relation to the application but formal evidence of support by the two charities is only needed at final registration. Once a "minded to approve" letter is received from the Charity Commission, the FCA application for authorisation process can commence.

As regards the FCA – the normal fund application for approval process will need to be followed but only once the "minded to approve" letter has been received from the Charity Commission. For an authorised unit trust the FCA process involves the normal Form 242 and supporting documents, including draft trust deed and prospectus. The Manager will need to have the necessary FCA permission to manage the particular type of CAIF envisaged (e.g.

permission to manage a UCITS or an alternative investment fund (**AIF**) as applicable). The FCA normal guidelines on naming of authorised funds will apply[2].

Once FCA approval has been given, the CAIF application will then be returned to the Charity Commission for final registration. This will involve submission of the executed trust deed (with at least £5,000 in an account for the CAIF or pledged to charity), together with evidence of support from two charities for the CAIF. The Charity Commission should then complete the process by issuing an order under section 96 of the Charities Act 2011 confirming the charity registered number for the CAIF.

The normal FCA fees for fund applications will apply. Currently there is no fee applicable for the registration with the Charity Commission.

Clearly this remains a relatively new process for the Charity Commission and a new vehicle for both regulators and we believe it may take a few more applications before the process operates completely smoothly. However, the process has been designed to try to ensure that applicants are given sufficient feedback at a relatively early stage from the Charity Commission.

13. What industry guidance is available?

The Investment Association has produced a model trust deed based on its existing model authorised unit trust deed in conjunction with members of the CAIF working group. This has been shared with the FCA and Charity Commission, both of which have reviewed and provided comments on it, although they have not "approved" the model deed as a binding precedent.

In addition, the CAIF working party has provided guidance which can be accessed from the Investment Association website at http://www.theinvestmentassociation.org/investment-industry-information/policy-and-consultations/industry-guidance.html.

14. Conclusion

It has taken a number of years, but the CAIF represents a positive change for the charities investment market. The CAIF opens the door for new charity pooled investment funds to be established, as well as the conversion of existing traditional CIFs to the new model. The CAIF will be regulated by the FCA and the Charity Commission in a manner which is appropriate to the competencies and statutory roles of each regulator, as well as having a tax efficient structure and bespoke features that address the needs of the relevant target charity investors.

With the first CAIF now registered, it will be interesting to see how many existing traditional CIFs look to use the new CAIF structure. It is certainly something we expect Managers to be actively considering.

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This publication is a general summary of the law. It should not replace legal advice tailored to your specific circumstances.

[2] This is helpful as the position of the Charity Commission has been that a Manager's name could not be included in the name of a traditional CIF (this practice will not be followed for the CAIF).