Closing the gaps: how the FCA proposes to strengthen shareholder protections for closed-ended investment funds

The UK Financial Conduct Authority (FCA) has published a consultation paper proposing changes to the UK Listing Rules (UKLRs) to clarify and strengthen investor protections around related party transactions and conflicts of interests for closed-ended investment funds (often referred to as investment companies).

These proposals come at a time of increased shareholder activism, which has brought about a growing perception from certain market participants that there are not sufficient protections against unwanted interference with the running of an investment company. This is partly because the percentage of the shareholder register that votes at a general meeting of an investment company can be very low, meaning an activist can hold a fairly small position but exert significant influence.

There is a delicate balance to be struck between allowing shareholders the ability to effect change and ensuring that backdoor channels cannot be used inappropriately. The investment company community has lobbied for these changes and the fact that the FCA is receptive to them is a sign that the market is currently not working as most stakeholders would like it to.

The question is whether the FCA's proposals solve the perceived problem in a proportionate manner or whether the reforms are effectively a sledgehammer to crack a nut.

Key current UKLR provisions for closed-ended investment companies

The UKLRs currently include the following protections for shareholders:

- The board must be able to act independently of any investment manager
- Companies entering into transactions with related parties where the percentage ratio is 5% or more (or which is uncapped) must obtain board approval (with any conflicted directors excluded from voting) and written confirmation from a sponsor that the terms are fair and reasonable as far as the shareholders are concerned
- Companies entering into transactions with related parties relating to fees payable to an investment manager or a member of its group where the percentage ratio is 0.25% or more must obtain board approval (with any conflicted directors excluded from voting) and written confirmation from a sponsor that the terms are fair and reasonable as far as the shareholders are concerned. In addition, if the ratio is 5% or more the company must publish a shareholder circular and obtain shareholder approval (with the related party being excluded from voting)

- Material changes to the investment policy must be approved by both the FCA and the shareholders.

Key proposals

Appointment of new investment managers

There are two proposed changes to tighten up shareholder protections where a new investment manager is being appointed:

- The related party regime will apply to the investment management agreement with the proposed investment manager
- Directors who are not independent of the proposed investment manager will not be able to participate in the board's consideration of the appointment

The FCA proposes that where a listed investment company seeks to appoint a new investment manager, that investment manager will be a related party and the class tests will apply to the fee arrangements.

This closes a perceived lacuna in the current rules where, unless the new investment manager was already a related party, it was not necessary to consider the new investment management agreement as a related party transaction. The current rules potentially expose shareholders to the risk that a proposed new investment manager could impose unfair management fees, leading some shareholders to prematurely exit their positions incurring losses and tax costs.

A potential problem with the reform is that it may be more difficult to dislodge a poorly performing manager by setting more obstacles in the way. The FCA's proposals acknowledge this and therefore if the new fees are comparable to the existing fees, it will only be necessary to class test the difference between the two. As such, where a new manager is willing to accept the same fee arrangements, the transfer to a new investment manager should remain straightforward.

The exclusion of directors that are not independent from board consideration of a proposed new investment manager is also understandable. A director nominated by the proposed investment manager or who is connected to the proposed investment manager as a director, employee or adviser of the investment manager or one of its group or its funds will not be independent under the proposed rules. This would already be the case if the director was associated with an investment manager in situ so it makes sense it equally applies where a new investment manager is being proposed.

Association between directors and substantial shareholders

It is proposed to expand the definition of an 'associate' for directors to include a substantial shareholder (a shareholder with 20% or more of the voting rights) and its associates where they were involved in the appointment of the director. This would mean any such directors would be associated for the purposes of related party rules, so that they would not be able to take part in decision making on related party transactions with the substantial shareholder or its associates.

In its questions, the FCA has asked for feedback on whether a director should no longer be considered a related party of a substantial shareholder after a set period of time, for example, two years. The FCA also queries whether in this scenario the substantial shareholder percentage should be reduced from 20% to a lesser figure.

The FCA is right to tread carefully here as this is potentially a significant fetter to a director in fulfilling their role. Simply because a director is put forward by a substantial shareholder should not necessarily mean that they are unable to act independently of that shareholder and they will already need to have regard to their duties to the company.

Shareholder voting on changes to the investment policy

It is proposed that where the investment manager is a substantial shareholder, or associated with a substantial shareholder, that shareholder would be restricted from voting on material changes to the investment policy.

The FCA acknowledges there are risks to this approach. From a first principles perspective, it is counterintuitive to disincentivise an investment manager from investing in the fund it manages to align directly with other shareholders. The FCA has therefore suggested some alternative approaches, including:

- limiting any vote to no more than 20% of the voting rights even where the substantial shareholder holds more shares
- only excluding the investment manager/substantial shareholder where a director or directors of the company are not independent of the investment manager/substantial shareholder
- applying a double majority approach meaning both approval from all shareholders (including the substantial shareholder/investment manager) and all other shareholders.

In our view, however, even with a potential softening of the proposal to restrict voting rights, it is difficult to justify the disenfranchisement of a shareholder on fundamental decisions for the strategy of the investment company.

What is not changing

The following rules will continue to apply:

- The requirement that the board must be able to act independently of any investment manager as set out above
- The chair and the majority of the board must be independent. The rule sets out certain categories of persons who are not independent such as directors and employees of the investment manager or other investment companies managed by the same investment manager. It has not been changed to refer to associates of substantial shareholders meaning that directors appointed by a substantial shareholder may be considered to be independent and can participate in board decisions in the ordinary course (i.e., those not involving related party transactions).

It is worth noting that listed investment companies which are incorporated in the UK are subject to the statutory framework set out in the Companies Act 2006 (Act). The Act sets out obligations on directors in relation to directors' duties including exercise of independent judgement and avoiding conflicts of interest which will continue to apply to the boards of investment companies. So, for example, in resolving to remove an existing investment manager and to appoint a new one, the directors must consider section 172 of the Act which requires a director to act to promote the success of the company for the benefit of the shareholders as a whole, including the need to act fairly between members of a company. The FCA's proposed changes do not affect the statutory framework.

Retail shareholders

The FCA has also published some guidance on good practice to support retail investors in exercising their voting rights at the same time as publication of the consultation. In a perfect world, increasing shareholder engagement would be the key to protecting investment companies from unwanted attack. Investment companies are targets to activist investors often because they have passive shareholders who do not vote.

The guidance encourages companies to provide investors with timely and clear information about issues they may want to vote on and intermediaries to enable investors to vote easily. It also makes it clear that it should be good practice for intermediaries to allow their customers to vote on all general meetings and corporate actions. The FCA notes that the dematerialisation of share certificates project is underway but in the meantime encourages firms to consider how they can continue to improve their arrangements for facilitating investors to exercise their rights.

What happens next

The consultation closes on 14 August 2026. The FCA will then finalise its proposals by the end of the year. The intention is that the new rules will come into force around four weeks after publication to allow sufficient time for any current transactions to go through.

The FCA states that it is also reviewing the eligibility criteria for listed investment vehicles, including the requirement for a closed-ended investment fund to manage its assets in a way that aligns with the objective of spreading investment risk and whether this requirement is proportionate. The timeline for this work stream will be published later this year.

Comment

We think this is a thoughtful paper from the FCA, tackling several tricky issues to seek to strike a balance between protecting shareholders and enabling them to legitimately register their opinions and effect change. We hope that market participants engage with the proposals in order that we land in a place that builds confidence in listed investment companies, a product that has been central to the success of the London market for more than 150 years.