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Liquidity and resilience issues for UK authorised open ended funds

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The FCA have made their new rules for "Funds investing in Illiquid Assets" or FIIAs which will come into force in September 2020 but further work obviously remains to be done. The FCA plan to look at liquidity issues more generally for UK authorised investment funds, notably in the light of the Woodford Fund issues which have arisen since the FCA's Consultation Paper 18/27 was published on Illiquid Assets and Open-Ended Funds.

To address the wider liquidity issues which are now being discussed though likely requires a much wider and more radical rethink of how best to ensure the overall resilience of funds to deliver what they were designed to do and, as only one aspect of this, how best to offer fit for purpose actively managed regulated funds investing in inherently illiquid assets.

New rules for FIIAs

On 30 September, the FCA issued their Policy Statement PS 19/24 finalising the FCA's amendments pursuant to their Consultation Paper 18/27 on "Illiquid assets and open-ended funds". We therefore now have a new category of a fund investing inherently illiquid assets, or "FIIA" in the COLL Handbook.

Consultation Paper 18/27 always had limited scope – the FCA has now finalised the rules having only tinkered with the draft rules which are to apply to currently available retail NURS open ended funds which invest in inherently illiquid assets.

- **NURS only**: For now, the proposals only apply to NURS funds. Investors in QISs are deemed to be sufficiently knowledgeable to look after themselves. We have recently seen some illiquidity issues now being considered in the UCITS environment but any action in respect of these would need to be the subject of a separate consultation.

- **FIIA definition**: The FCA have kept the threshold for determining if a Fund is an FIIA as:

  - a NURS which has disclosed to investors that it is aiming to invest at least 50% of its scheme property in inherently illiquid assets or

  - a NURS which has invested at least 50% of the value of its scheme property in inherently illiquid assets for at least three continuous months in the past twelve months, whether or not they have disclosed their intention to do so.

  There was some debate about whether this is the correct threshold. NURSs that apply limited redemption arrangements are still excluded from the definition of an FIIA despite lobbying to the contrary. The FCA maintain this is in line with IOSCO's February 2018 Recommendations on Liquidity Management and Open-ended Funds but we rather agree with commentators on the consultation that this may not be a helpful exclusion from the FIIA definition.

- **Inherently illiquid assets**: A key issue is what might be classed as an inherently illiquid asset and the FCA will be given further consideration to the definition.

  They will consider the most appropriate rules and guidance around those listed securities that are less liquid in practice because there is not also an active market in the securities. They intend to look at the definition of liquid and illiquid assets held in open-ended funds, including how this is accounted for in the UCITS Directive, as implemented in COLL as part of a further work stream.

  For the present though, in the rules made in September, they are keeping the definition essentially as originally drafted. As now defined in the Glossary, an inherently illiquid asset is an asset which is:

  - an immovable;

  - an investment in an infrastructure project;

  - a transferable security (within paragraph 2 of that definition) that is neither a government and public security denominated in the currency of the country of its issuer; a security which is listed or traded on an eligible market nor a newly issued security which can reasonably be expected to fall within the previous listed or traded category once it begins to be traded (one wonders if this should read "listed or traded");

  - any other investment which is not listed or traded on an eligible market and which satisfies one or more of certain conditions:

    - sale and purchase transactions typically being negotiated on a one off basis;

    - valuation for the purposes of agreeing a sale price being typically complex and may require the seller and/or buyer to obtain specialist advice;

- it may take significant time for one party in the proposed transaction to identify another party prior to sale and purchase negotiations commencing; and

- once negotiations have commenced, transactions typically taking significant time to complete;

- a unit in another FIIA;

- a unit in a qualified investor scheme where that qualified investor scheme would meet the first condition of the definition of an FIIA if it were a NURS; permits redemptions of units on timescales which do not reflect the time typically needed to sell assets in which it invests; and is not in the process of winding up or termination;

- a unit in an open-ended unregulated collective investment scheme where that unregulated collective investment scheme aims to invest at least 50% of the value of its property in assets falling in the above types of assets; permits redemptions of units on timescales which do not reflect the time needed to sell or close out those assets and which is not in the process of winding up or termination.

A NURS that falls into this new FIIA category will be subject to additional requirements including:

- **prescribed suspension requirements**

  There will be a requirement that a NURS must suspend dealing in fund units where the standing independent valuer expresses material uncertainty regarding the value of 20% of the scheme property.

  The FCA noted the substantial resistance they received to the blanket suspension requirement at the 20% threshold. However, despite recognising that in some limited circumstances it could be in investors' interests for the fund to remain open despite material uncertainty about valuations, they have pursued their original proposal, subject to one significant amendment in the light of feedback.

  Where material uncertainty applies to the value of immovables that constitute more than 20% of a Fund's scheme property, the FCA's Rules will still require that the fund manager suspend dealing but the fund manager may continue to deal if they have a reasonable basis for determining that it is not in the best interests of investors to suspend. In those circumstances, the Depositary must give its agreement.

  The provision as finalised does therefore at least give some flexibility for the Manager to take actions it thinks best in all the circumstances. The FCA are clearly though cautious – for example they are including a rule on the use of this discretion that makes it clear that setting a fair value price alone does not constitute a reasonable basis for keeping a fund open because the adjustment does not address the uncertainty around the value of the assets which is where the potential for harm to consumer arises.

- **enhanced depositary oversight**

  The FCA have decided to be more explicit about expectations of Depositaries.

  There is a new oversight role given to the Depositary, under a new COLL 6.6.4B, requiring the Depositary of an FIIA regularly to make its own assessment of the liquidity profile of the FIIA and the liquidity risk presented by the scheme property of an FIIA – and to take reasonable care to oversee the AFM's liquidity management systems and procedures on an ongoing basis using its assessment to ensure that the FIIA is managed in accordance with the relevant COLL Rules.

- **standard risk warnings on financial promotions**

  For the new standard risk warning, the FCA have conceded that the text of their CP 18/29 draft could be improved so that it is not unduly alarming and does not highlight liquidity risk as necessarily being the most important risk an investor will face.

  The text now reads as follows (as recorded in COBS 4.5.16):

  "*[Name of fund] invests in assets that may at times be hard to sell. This means that there may be occasions when you experience a delay or receive less than you might otherwise expect when selling your investment. For more information on risks, see the Prospectus and Key Investor Information Document.*"

- **increased disclosure of liquidity management tools and liquidity risk contingency plans**

  The FCA proposed that contingency plans would be required for dealing with liquidity risks, and depositaries will have a specific duty to oversee processes used to manage the liquidity of funds. The FCA focus is on "better contingency planning". This follows on from IOSCO's Recommendation 16 stating that a fund manager "*should put in place and periodically test contingency plans with an aim to ensure that any applicable liquidity management tools can be used where necessary and, if being activated, can be exercised in a prompt and orderly manner.*".

  This reinforces the existing requirement to have liquidity management systems and procedures and so again is not entirely new. It is asking managers to improve their existing contingency planning tools.

- **expanded prospectus disclosures**

  Detailed information of liquidity risks will also be required to be included in the Prospectus. They must include an explanation of the risks associated with the scheme investing in inherently illiquid assets and how these might crystallise; a description of the tools and arrangements the fund manager proposes to use; and details of the circumstances in which these tools and arrangements would be deployed and the likely consequences for investors.

  This would supplement the existing required disclosures. The aim is to assist a retail investor's understanding of the position.

  This is viewed as consistent with Recommendation 7 of IOSCO's Recommendations that a fund manager should "*ensure that liquidity risk and its liquidity risk management process are effectively disclosed to investors and prospective investors.*"

The FCA have followed through on their proposals with the exception of two:

- They have decided not to proceed with the proposal to require the manager of an FIIA to add an identifier to the name of the Fund. This could have misinformed investor conclusions about relative risk as the FCA acknowledge.

and

- They have not proceeded with guidance about limiting the accumulation of large cash buffers within NURSs and UCITS funds.

  The FCA decided not to take that proposal forward because there was clear opposition and concerns about whether the guidance would be ineffective or even counterproductive. Often it is necessary to accumulate cash – it may be the prudent and cautious view to take.

The new rules for FIIAs come into force on 30 September 2020, which gives a twelve month timescale for these funds to be identified and the necessary changes to be put in place. Fund managers may do this earlier than the deadline if they wish to do so where this does not conflict with the rules applicable until that date.

Will the FIIA changes achieve the expected objectives?

One might question the outcomes of these rule limited amendments of limited application.

The outcome the FCA think they are seeking is reduce the potential for harm to investors in funds that hold illiquid assets particularly under stressed market conditions. They take the view that their measures should:

- help investors understand better any restrictions on access to their investments and the circumstances in which those restrictions will be placed on the funds;

- in the case of funds investing in immovables, reduce the potential for some investors to gain at the expense of others because units have been incorrectly priced due to uncertainty about the value of assets held in the fund; and

- reduce the likelihood of a run which could substantially reduce the value of investments for those left in the fund and possibly destabilise the market more widely.

Whilst additional risk warning requirements may explain better the risks of investing in such an FIIA, the disclosures will not change the potential consequences of any such investment.

Also, the risk with specific changes for those funds which do fall within the FIIA definition is that, in reacting to circumstances in future (whether for liquidity concerns or otherwise) following such specific regulatory steps may now put fund managers in a straightjacket which may constrain how they may ideally wish to react.

A fund that had uncertainty about its valuation would likely suspend dealing anyway: if you think about the reaction of property funds post the EU Referendum, this is what happened.

Managers of these funds should indeed need to work carefully on their liquidity contingency plans but then I think most managers for most funds will in any event now be looking carefully at this issue in the light of the Woodford Fund issues - for all of their funds not just those which might fall within the FIIA definition.

Liquidity management plans and procedures are not new – and indeed have gradually been improving over time.

Established liquidity management requirements

Before looking at what further initiatives are in the pipeline and what further changes might be advisable, first, it is important to note that the issues are not a new ones. Both of the key European Directives already impose obligations to look at the liquidity area:

- **UCITS liquidity provisions**

  First, "Liquidity risk" is defined in Article 3 of Commission Directive 2010/43/EU as "*the risk that a position in the UCITS portfolio cannot be sold, liquidated or closed at limited cost in an adequately short timeframe and that the ability of the UCITS to comply at any time with Article 84(1) of the UCITS Directive [the obligation to repurchase or redeem units at the request of any unitholder] is thereby compromised.*" This definition is used within the definition of "transferable securities" in Article 2 of the Eligible Assets Directive from 2007. To be classified as an eligible

transferable security, one of the required criteria is that their liquidity does not compromise the ability of the UCITS to comply with the redemption provision. This provision is recorded in the FCA's COLL Rules at COLL 5.2.7AR(1)(b).

Secondly, Article 51 of the UCITS Directive requires there to be a risk management process and the underlying provisions for these include the requirement for the risk management policy to cover market, liquidity and counterparty risks and exposure of the UCITS to all other risks including operational risks which may be material for each UCITS it manages. Liquidity is already therefore specifically mentioned.

Article 40(3) of the UCITS Level 2 Directive states specifically that Member States must ensure that "*management companies employ an appropriate liquidity risk management process in order to ensure that each UCITS they manage is able to comply at any time with Article 84(1) of the UCITS Directive [re redemptions]. Where appropriate, management companies shall conduct stress tests which enable assessment of liquidity risk of the UCITS under exceptional circumstances.*" Further, paragraph 4 indicates that the Member States shall require management companies to ensure that, for each UCITS they manage, "*the liquidity profile of the investments of the UCITS is appropriate to the redemption policy laid down in the Fund Rules or the Instruments of Incorporation or the Prospectus.*"

- **AIFMD liquidity provisions**

Clearly AIFMD covers a wide-range of types of AIFs which will vary in their structure, obligations regarding issue and redemption of interests and investments. One should not therefore expect the specific provisions as appear for UCITS funds.

Article 16 of AIFMD requires that, for each AIF that an AIFM manages that is not a unleveraged closed-ended AIF, it employs an appropriate liquidity management system and adopts procedures which enables them to monitor the liquidity risk of the AIF and to ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations. AIFMs must regularly conduct stress tests under normal and exceptional liquidity conditions which enable it to assess the liquidity risk of the AIF and to monitor the liquidity risk of the AIF accordingly. AIFMs must ensure that, for each AIF they manage, the investment strategy, liquidity profile and the redemption policy are consistent.

The AIFMD Level 2 Regulation expands upon these requirements for liquidity management systems and procedures, monitoring and managing liquidity risk and liquidity management limits and stress tests, and aligning of investment strategy, liquidity profile and redemption policy.

This requirement is recorded in the UK's FUND Sourcebook at FUND 3.6.3R.

So overarching requirements in this area are not new. Rather the question is how one best complies with the evolving expectations on this topic.

Current European initiatives

One recent paper to review carefully is ESMA's Final Report: Guidelines on liquidity stress testing in UCITS and AIFs issued on 2 September 2019. The Guidelines are supplementary to the existing requirements on liquidity stress testing both in AIFMD and UCITS Directives and so should be treated as incremental to the existing provisions. They will apply from 30 September 2020.

The Guidelines include that a liquidity stress testing policy must be included in a UCITS and/or an AIF risk management process. Depositaries will be required to verify that a fund has documented procedures for its liquidity stress testing programme (but the Depositary would not need to replicate or challenge the liquidity stress testing performed by a Manager). Regulators may request submission of the Fund Manager's Liquidity Stress Testing Policy in order to demonstrate that the Fund is likely to apply with the applicable rules, including those regarding the ability to meet redemption requests in normal and stressed conditions.

For stress testing, you should also refer to the details set out in ESMA's Economic Report "Stress simulation for investment funds 2019" issued on 5 September 2019.

ESMA has developed a stress simulation framework for the investment funds sector which it sees as a key element of ESMA's strategy in this area. ESMA's Chair, Steven Maijoor has commented "*The resilience of the fund sector is of growing importance as it accounts for an increasing part of the EU financial system.*"

Clearly one is now expected to look at the overall resilience of funds to deliver what they were designed to do, offering structures which can deliver what was promised with regard to issuing and redemption of units to investors at fair pricing. Resilience concerns may apply to a much wider range of funds than those for which managers will expect to address the challenges for open-ended funds investing in illiquid assets .

Further actions required ?

Given these key Directive and European initiatives which will lead to tightening up of the position within 2020, plus the UK's Woodford funds issues, UK fund managers should take action now to consider their position.
For their part, the FCA have indicated that the FIIA provisions will not be the end of the story. Chapter 7 of PS 19/24 indicates the FCA's initial views on the further issues it intends to explore around the liquidity topic and related issues. It sets out some initial views on wider liquidity challenges but it is a list of items to explore rather than actual proposals.

It is likely that there will be further proposals which will result from consideration of the Woodford Fund issues. (And note the FCA's recent update on the Woodford Equity Income Fund issues issued on 15 October 2019 after the Fund's ACD's announcement that the Fund would not reopen but would move to an orderly winding up.)

It would be as well for fund managers to review now their own funds and look for the potential issues which could arise in a worst case scenario, so that they can try and develop their existing risk management policies accordingly.

The topic of liquidity management procedures should be considered in conjunction with a number of interlinking characteristics and features for open-ended funds which may, in combination, cause concern, including the following:

- ability to cope with net inflows and outflows;
- appropriate identification of eligible markets;
- how one maintains and complies with the thresholds for relevant investment limits; and
- ensuring there is a clear communication of the objectives and nature of a fund to investors so they understand the fund's dynamics.

You may perhaps have your own longer list of issues.

In the following paragraph, we offer some preliminary comments and suggestions on wider issues which are now coming to light.

Should we look for more radical solutions?

It may well be that we should now embark upon a fundamental review of fundamental questions. Review of existing risk management policies, including liquidity management policies, is likely to be insufficient.

To select just three key questions for discussion:

- **Access to illiquid assets**

  As mentioned at the beginning of this Briefing Paper, a key concern is that Consultation 18/27 failed to make progress on some of the more radical solutions which are probably needed in relation to how fund managers should best offer funds investing in inherently illiquid assets. The consideration of FIIAs by the FCA has failed to progress any of the more radical solutions which might be available, and in particular some of the more creative approaches which might in fact deliver better options for investors (retail and professional) for offering exposure through investment funds to illiquid assets.

  The FCA did publish a Discussion Paper (DP 18/10) in December 2018 entitled "Patient Capital and Authorised Funds". This Paper's role though was much more to acknowledge that Patient Capital can refer to a broad range of alternative investment assets intended to deliver long term returns, for example infrastructure, real estate, private equity/debt and venture capital, all of which assets are typically illiquid and often require a committed investor willing and able to tie up their capital and forego on demand liquidity or an immediate return on investments.

  The FCA, in December 2018, sought views from consumer interests who invest in authorised funds, or perhaps do so via long term assurance policies, asking whether any changes should be made to remove barriers to investment in patient capital. For authorised funds, it was acknowledged that these are all at the moment open-ended structures designed to maintain the features of liquidity, diversification and fair and accurate valuation. They included a chart with an indicative summary of patient capital funding through retail funds, acknowledging the limits but asking the question as to whether there was retail investor demand for a new type of authorised retail fund which could, for example, invest its capital directly into patient capital assets and, if so, what safeguards would be required to adequately protect investors.

  The feedback statement resulting from this Discussion Paper and, if they decide to take matters forward, a consultation paper, are yet to be published.

- **New types of fund?**

  In PS 19/24, the FCA do refer to the Investment Association's proposals for "long term asset funds" in the IA's Final Report to HM Treasury Asset Management Taskforce of 6 June 2019. The IA's Committee decided that an entirely new fund structure is not required but instead proposed the NURS Rules be adapted to accommodate a new sub-set for the long term asset fund, operating much like the existing sub-set of the NURS for funds of alternative investment funds (FAIFs) but with additional flexibility around the rules and investment and borrowing powers, dealing frequency, liquidity management tools and valuation of investments. The question is whether such a proposal is radical enough.

  Perhaps we now have an ideal opportunity to consider whether it continues to be right that only open-ended investment funds are thought appropriate for the retail market.

  With individual investors increasingly responsible for their own long term savings, encouraging them to take a long term horizon: not offering the reality, or possibly the illusion, of liquidity for their investments might be the prudent course?

At no point can an investment fund structure entirely cure the liquidity profile of its underlying assets. If there are illiquid assets held by a fund, one cannot magically create liquidity at the fund level.

Arguably, therefore there should be an acceptance that, for some illiquid asset funds, it might be more appropriate to offer a closed or semi-closed ended vehicle and still make this available to retail investors. Funds which suit long term investments are probably not fully open ended.

One hopes that the FCA will take the opportunity at least to review matters from the starting point of a blank sheet of paper in deciding what range of funds is now suitable to be offered to retail investors – and professional investors - including those in the authorised fund space. It is increasingly important that a wider range of UK authorised funds is made available with longer term horizons.

- **Managing investors' expectations**

Building investor trust and confidence is important. To do so, there has to be a match of the expectations of investors and the ability of a product to meet those expectations.

Whatever the type of fund product, it is essential that asset managers seek to ensure that each product's proposition is clearly defined. There is a need to look at:

- the basics of what a product is delivering;
- review of what investors should expect from it; and
- clarity on the basis on which investors can disinvest,

and clear explanations of those matters to investors at all stages: before they invest; and while they hold their investment.

Also one needs to consider investors' priorities. Are investors expecting liquidity in all instances? In some instances, might they be more concerned with being able to achieve a fair value for their investment in the longer term?

Such issues cannot be addressed on a checklist basis, nor as a matter of compliance with particular restrictions, such as UCITS provisions, but review of such issues should perhaps form an important part of prudent management of a retail fund. Review of a fund's overall proposition is an additional issue which is not really a compliance issue. One could comply with all applicable rules and still not offer a product which meets basic expectations.

Senior managers - including CIOs and CEOs - could perhaps look at their products and see if there is more to be done in respect of each fund's proposition, with a view to ensuring clarity on; clear explanation of; and constructive compliance with, the fund's proposition.
Review not only of a fund's investment objective statement but the way in which the fund's entire proposition is explained in promotions and prospectus documents is recommended. Whilst there are some constraints on what managers can do at the moment, given the prescribed nature for example of key information documents, there may still be much that could be done to improve customer communications and so management of investor expectations.

The value for money assessments which are currently being devised are an ideal opportunity to start this exercise. However ensuring there is clear communication to, and understanding by, investors will likely be a larger task than can be achieved by generating value for money statements.

Proactive contributions to the debate from asset managers in the coming months on these – and no doubt other ideas – should hopefully inform the FCA's further regulatory initiatives. There is an opportunity for the industry to influence how those initiatives should best be formulated.

For further information or assistance on any of the matters discussed in this Briefing Paper, please contact Kirstene Baillie or your usual contact at Fieldfisher.

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