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Illiquid Assets and Open Ended Investment Funds which are "FIIAs" - CP18/27

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Somewhat belatedly, we have the FCA's formal consultation proposing the invention of a new category of fund – funds investing in inherently illiquid assets'or FIIAs.' For these types of funds, there are proposals for mandatory suspension of dealings in certain situations, improvements of liquidity risk management policies and better disclosures.

Unfortunately this consultation first pursues some ideas of imposing rigid constraints of managers of NURS property funds. Secondly, it is limited in its scope. We await with interest progress on some of the more radical solutions which might be made available for offering appropriate illiquid investment fund solutions to retail investors.

The FCA's original discussion paper on inherently illiquid assets was i triggered by the events surrounding property fund suspensions following the Brexit Referendum in June 2016, on which the FCA published a number of recommendations in July 2017. The FCA's Discussion Paper DP 17/1 was considered in our briefing paper which can be found here.

The FCA's Consultation Paper 18/27 now sets out various proposals aimed at reducing the risks of poor outcomes to retail investors in open ended funds, specifically non-UCITS retail schemes (NURSs) that invest in illiquid assets. It takes into account IOSCO's revised Recommendations on Liquidity Risk Management for Collective Investment Schemes which were updated on 1st February 2018 (from the original publication of 2013).

This Consultation however fails to progress some 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. A further paper is yet to come on that topic.

FIIAs

To set the scope for the funds to which the new provisions will attach, there is a need for a new definition of an **"FIIA" – a fund investing in inherently illiquid assets**. This term is to cover a non-UCITS retail scheme which satisfies three conditions:

- first, either the investment objectives and policy published in the instrument constituting the fund and the prospectus aiming to invest at least 50% of the value of the scheme property in inherently illiquid assets or alternatively at least 50% of the value of the scheme property has been invested in inherently illiquid assets for at least 3 continuous months in the last 12 months;
- secondly, the instrument constituting the fund and the prospectus do not provide for limited redemption arrangements that reflect the typical time needed to sell, liquidate or close out the inherently illiquid assets in which the NURS invests; and
- thirdly, the scheme is not in the process of winding up or termination.

By **"inherently illiquid assets"** the FCA mean to include any of the following:

- an immovable;
- an investment in an infrastructure project;
- a transferable security that is not a readily realisable security;
- any other security or asset which is not listed or traded on an eligible market and has particular features that make the process of buying or selling difficult or time consuming. It satisfies one or more of the following conditions:
  - sale and purchase transactions are typically negotiated on a one-off basis;
  - valuation for the purposes of agreeing a sale price is typically complex and may require the seller and/or buyer to obtain specialist advice;
  - it may take significant time for one party in a proposed transaction to identify another prior to sale and purchase negotiations commencing; and
  - once negotiations have commenced, transactions typically take significant time to complete.
- a unit in another FIIA;
- a unit in a qualified investor scheme where that scheme would itself meet the first condition for a fund investing in inherently illiquid assets if it was a NURS; permits redemptions of units on time scales which do not reflect a typical time needed to sell, liquidate or close out the assets in which the scheme invests (those assets being ones which fall within other paragraphs in this list of inherently illiquid assets; and being a fund which is not in the process of winding up or in termination);
- a unit in an unregulated scheme where that scheme aims to invest at least 50% of the value of the property of the scheme in assets falling within the above types of inherently illiquid assets; permits redemptions of units on time scales which do not reflect a typical time needed to sell, liquidate or close out those assets; and is not in the process of winding up or in termination.

The FCA is to issue guidance on a non-exhaustive list of the types of asset that will be "inherently illiquid assets", including property and real estate, shares in a special purpose vehicle (SPV) investing in infrastructure projects, shares not officially listed on or admitted to a recognised investment exchange and units in a property authorised investment fund (PAIF).

NURSs only

As you would expect, all of the retail property funds that suspended dealing following the 2016 Referendum were NURSs and this package of FCA remedies focuses on such NURSs.

The FCA do not propose to extend these remedies to qualified investor schemes, which are inevitably intended only for professional clients and retail clients who are sophisticated investors. The FCA have taken the view that they do not think sufficient evidence of harm applies to the remedies to qualified investor schemes at the moment. QIS funds therefore are not going to be put in the similar straightjacket as NURS fund managers.

FCA proposals

The FCA's Consultation Paper focusses on three areas which will apply to FIIAs:

- **mandatory suspension of dealings**

  The FCA propose that there must be suspension of dealing where there is a "material uncertainty" about the valuation at least 20% of the scheme property.

  The FCA asserts that open ended funds must be priced correctly to ensure that investors are treated fairly and can have confidence in the product. Material uncertainty about valuation of a significant proportion of the assets will mean that uncertainty will be reflected in the unit price.

  To reiterate a key point, pricing is not an exact science, so nothing one can write down is going to improve that position. There is still going to be a value judgement on fair value pricing adjustments for unlisted and non-financial assets. What is in issue here is the degree of uncertainty rather than correct or incorrect pricing.

  The level of uncertainty selected for the FCA for mandatory suspensions is where the standing independent valuer has expressed material uncertainty about immovables that account for the value of at least 20% of the scheme property. Of course fund managers and depositaries can choose to suspend before this 20% threshold is reached.

  This mandatory suspension requirement will apply to those funds which invest directly into property but also to all NURSs that have at least 20% of the value of their scheme property invested in one or more funds which have suspended trading due to material uncertainty – and so addressing significant indirect exposure to immovables. There will be a new rule COLL 7.2.1R(1)(b) to address this.

  Fund managers will be required to resume dealing in units of a fund, with the approval of the depositary, as soon as reasonably practicable after the material uncertainty assessment applies to less than 20% of the scheme property – although this would seemingly remove the discretion on suspension before the 20% threshold is reached?

  Given that property funds did suspend in June 2016, this proposal is more likely to result in making mandatory what managers chose to do in the past rather than making a specific change in the position. Nonetheless this will force managers to declare a suspension, which limits fund managers' discretion as to when they might choose to suspend having regard to all the circumstances.

- **Improving liquidity risk management policies**

  The FCA propose that contingency plans will 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.

  The FCA propose to introduce a number of guidance provisions clarifying how liquidity management tools can or should be used in different situations covering:

  - **rapid sales of immovables**

    This concerns a situation where the fund manager and a standing independent valuer would be confident about the open market value of immovable but the assets may need to be offered at a discount if assets are to be sold quickly to meet the demand for redemptions. In this case, the FCA assert that the fund manager should consult with and agree with the standing independent valuer a fair and reasonable value for the immovable to reflect a rapid sale, and this is clarified in proposed FCA guidance. The intention to do so must be disclosed in the prospectus. Fund managers contemplating the use of price reductions for rapid sales should consider how this will work in practice and may wish to agree with a standing independent valuer in advance a methodology for determining the value of immovables depending on how quickly they need to sell assets – how this can be usefully

ascertained in advance of some circumstances is a moot point though.

- **use of anti-dilution measures**

  Obviously dilution levies or adjustments may be relevant when there are strong in-flows or out-flows. The FCA remind fund managers that they should ensure that other liquidity management measures are not misclassified as anti -dilution measures. Dilution levies or adjustments are intended where they are used to reduce dilution and solely for that purpose. Likewise swinging pricing mechanisms.

  Although no new rules or guidance are proposed, it will be worth revisiting prospectus explanations of what is meant by dilution to see if the wording can be improved to aid investors' understanding of the position. For example, the FCA assert that some investors mistook a swing from offer to bid as poor performance and so this encouraged further redemptions while funds remained opened in 2016. This topic links with improved disclosures discussed below.

- **liquidity buffers and first mover advantage**

  The FCA were concerned to note property funds' increasing liquidity ratios in the run-up to the Referendum in 2016. The FCA seemed concerned that, if there is "excess" liquidity, well informed investors may be tempted to redeem their holdings early in the event of market turbulence before the fund manager is likely to consider suspension. The FCA propose to introduce a guidance provision in COLL 5.5.3R for both UCITS and NURSs setting out that funds should not accumulate or hold cash and near cash for a significant duration in anticipation of unusually high and unpredictable volumes of redemption requests.

  This seems curious given that a cautious cash policy, which is probably the one real policy which can preclude the need to suspend, is criticised. We are not convinced this is the right way to go. Subject to following the investment objectives of the fund (and so the fund not being un-invested), it should preferably be left for fund managers to determine the level of liquidity ratios, subject to depositary input. After some pressure on funds to remain fully invested some years ago, in practical terms there has been some caution exercised by fund managers and depositaries about liquidity levels, and again leaving discretion on such to those managing a particular fund might be preferable?

- **guidance on the use of suspensions**

  New guidance is to be introduced in COLL 7.7.2G(1A) to ensure that priority is always given to protecting investors' interests. For funds investing in inherently illiquid assets, there may be circumstances where a suspension is in the best interests of unitholders such as where redemption demands cannot be met without significantly depleting the fund's liquidity and/or without selling scheme property at a substantial discount.

- **depositary oversight of liquidity management processes**

  The depositary already needs to monitor a fund's cash flows and provide oversight of the fund manager, taking reasonable care to ensure that the scheme is managed in accordance with the FCA's rules. Depositaries have to give prior agreement to a fund dealing suspension and can also require funds to suspend on their own initiative. A depositary therefore has a number of powers already. The FCA is now to specify that depositary's duties in respect of funds investing in illiquid assets will include oversight of the fund manager's liquidity systems and processes. Whilst comparable to Article 92 of AIFMD Level 2 Regulation around depositary's oversight duties, one suspects the UK version will probably go further, given the specificity of the UK provisions now proposed for funds investing in illiquid assets. Note that, in relation to new functions, the FCA propose that depositaries should be able to delegate only administrative or technical tasks to third parties.

The FCA observe that practice varied substantially between fund managers in how the tools were utilised in 2016. They seem to want to introduce some standardisation. Again the upshot is that this proposal, if implemented, will limit fund managers' discretion.

- **better disclosures**

As we commented in our Briefing Paper on the Discussion Paper back in February 2017, it seems that so many things come back now to improving information flows, and to some extent this is right. If investors are aware of the position, the fact that they are better informed of itself improves matters.

In the October Consultation Paper the FCA is making various proposals to increase disclosure. 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*.", including on the disclosure of use of additional liquidity management tools and what this would mean for investors.

- **a label drawing attention to the nature of the fund**

  For a fund investing in illiquid assets, it must add a signpost - the label will therefore be the "***[name of fund] – a fund investing in inherently illiquid assets***".

  This will apply to written communications provided to or seen by retail clients. It would not however be used every time the name of the fund was mentioned. The label would though be used in a key information document.

- **a new required risk warning**

  There is to be a new risk warning in prescribed terms as

follows:

"*the ["name of fund"] investing in inherently illiquid assets. This means that at certain times you may experience a significant delay and/or need to accept a discount when selling your investments. See the Key Information Document and Fund Prospectus for more information*".

Any firm communicating financial promotions relating to funds investing in inherently illiquid assets, whether in relation to their MiFID or non-MiFID business, and relevant firms when approving financial promotions in relation to such funds will need to comply. It will not just apply to financial promotions produced by the fund manager. All firms in the value chain including intermediaries and platforms will be required to provide the new risk warning.

- **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 typically 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.

Timing

The aim is that these proposals should come into force one year after the final rules are made. Any responses to the consultation are requested by 25 January 2019, with the aim that a policy statement and final rules and guidance will be issued during 2019.

The FCA envisage that the proposals should come into force one year after it makes its final rules. (The FCA's intention is to allow fund managers and others to update relevant materials to meet the new requirements when they are otherwise reviewed in the normal course of business.)

Long term horizon funds?

Consultation Paper 18/27 has limited scope – it is tinkering with the rules which apply to currently available retail open ended funds which invest in inherently illiquid assets.

As mentioned at the beginning of this Briefing Paper, our key concern is that this Consultation fails 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.

Later in 2018, the FCA do plan to publish a paper exploring approaches and issues relevant to patient capital, where investors make long term investments such as in infrastructure projects, with longer term horizons for investment returns. We await that further paper with keen interest.

One hopes that in that paper they will take the opportunity to expand the range of funds which can be offered to retail investors – and professional investors - including those in the authorised fund space - which suit long term investments and probably are not fully open ended. It is increasingly important that a wider range of UK authorised funds is made available with longer term horizons.

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