FCA FINANCIAL CONDUCT AUTHORITY

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Rt Hon Nicky Morgan MP
House of Commons
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18 June 2019

Dear Nicky,

Thank you for your letter in relation to the events surrounding the suspension of the LF Woodford Equity Income Fund (the 'WEIF'). I fully recognise the concerns that have been raised by the Committee and investors who have been impacted by the suspension.

Before I answer the specific questions you have raised, I thought it would be helpful to set out some background on funds; the work we've been doing in this area; and why funds are important to the UK economy.

What is a fund and what is the FCA's role?

There are two primary types of funds. Open-ended funds (such as UCITS[1] funds) are funds that issue new units to customers and redeem customers' existing units on demand. Closed-ended funds have a fixed number of units or shares and units may not be redeemed by the fund manager. The WEIF is an example of the former type.

The FCA authorises the fund manager and the fund itself. In the United Kingdom, currently there are just over 3,200 authorised UCITS funds managed by nearly 200 Authorised Fund Managers. The total assets under management (AUM) within all authorised UK funds is £1.5trn.

In the case of WEIF, which was first authorised by the FCA in 2014, the fund manager is Link Fund Solutions ('Link'). Subject to certain restrictions, our rules allow fund managers to delegate functions such as investment management to appropriate third parties. Link has appointed Woodford Investment Management ('WIM') to manage the assets within the fund in line with the investment mandate it has given to WIM (though we do not approve WIM's appointment by Link). As an FCA authorised investment manager, WIM can undertake the regulated activity of 'managing investments', by for example, making investment decisions and buying and selling securities in a fund. WIM is not, however, the authorised manager of the WEIF itself. The fund manager has the regulatory responsibilities in relation to operating the fund and therefore, for WEIF, Link is accountable to the FCA.

A depositary is an independent firm that holds the fund's assets. It has an important role to play in providing independent governance and oversight to certain decisions made by the fund manager, such as suspensions. In the case of WEIF, the depositary is Northern Trust Global Services SE.

The FCA oversees investment funds authorised in the UK and deals with issues that may raise regulatory concerns in relation to investment funds. This includes regular supervisory

[1] Undertakings for Collective Investment in Transferable Securities

activity in respect of fund managers, and where appropriate taking action against them where we discover concerns about, for example, excessive liquidity risks and potential rule breaches within funds or by fund managers or depositaries.

The FCA's rules governing UCITS schemes, such as the WEIF, derive from the EU UCITS Directive and are contained within the Collective Investment Schemes (COLL) sourcebook of the FCA Handbook. These rules set out, amongst other things, restrictions on the investments that a UCITS fund can make, for example a 10% limit on investments in unlisted securities (though, as noted later, the definition of unlisted is complex). These securities must satisfy certain criteria, including that their liquidity must not compromise the ability of the fund manager to meet redemption requests from unitholders. The EU UCITS Directive is generally minimum harmonising which means the FCA can impose additional requirements on UK UCITS funds that are stricter than the Directive text in certain circumstances, subject to the usual FSMA processes, such as formal consultation. However, the FCA could not unilaterally extend these measures to any EEA UCITS funds sold in the UK.

Non-UCITS Retail Schemes (NURSs), such as the open-ended property funds that suspended following the EU Referendum in June 2016, are subject to different investment restrictions. For example, NURSs can invest 100% of scheme property in commercial real estate and up to 20% in unlisted securities. NURSs are subject to FCA authorisation and can be marketed to retail investors in the UK. NURSs do not fall under the EU UCITS Directive, rather they are governed by rules which are set domestically in the UK and are contained within the FCA's COLL sourcebook.

The COLL rules apply to the authorised fund manager, which is Link in the case of the WEIF. A delegate portfolio manager, such as WIM in the case of the WEIF, is not subject to COLL. The authorised fund manager is responsible for overseeing the conduct of a delegate portfolio manager, including ensuring that it undertakes activities in a way which does not conflict with COLL rules.

Why are funds important?

As I said in a recent Financial Times article, funds play an essential part in fostering investment in the broader UK economy.

Financial markets should support investment in companies that will contribute to economic growth and create jobs. That will foster innovation and help to tackle critical issues such as climate change. Securities issued by start-ups and other firms with innovative strategies will often be unlisted and illiquid, particularly before they begin bringing in revenue, and not all of them will succeed. That is the nature of innovation.

I believe there should be clearer and binding limits on the share of such investments held in collective investment schemes whose shares are typically bought and sold freely and frequently, and that it is crucial that investors understand what they are investing in. We should not, however, discourage investment in unlisted and illiquid assets.

What has the FCA done to date and what work will the FCA do in the future in this area?

The FCA has undertaken three significant pieces of work in the area of funds looking at competition in the fund and investment platforms sectors.

We undertook a competition market study into the asset management market. We identified a number of areas where we had concerns that competition was not acting effectively in the interests of consumers. In response to this, among other remedies we have made new rules strengthening the duty of fund managers to act in the best interests of investors by requiring them:

- To appoint a minimum of two independent directors to their boards (by October 2019)

- To conduct an annual assessment of value, using a number of specific criteria, and to report publicly on the outcome of that assessment (beginning October 2019)
- To disclose clearly why or how they are using benchmarks[2], or if they do not, to explain how investors might assess the performance of the fund (beginning August 2019 for most funds)

The second piece of work concerns investment platforms are intermediaries which are increasingly used by consumers and financial advisers to access investments. Our Investment Platforms Market Study looked at how platforms compete to win new and retain existing customers. We are currently consulting on introducing new rules as well as working with industry to introduce needs.

There are a range of tools available to retail investors on platforms – including best buy lists – which can guide their investment choices. As part of our work on the asset management and platforms sectors, we looked at whether platforms' best buy lists add value to investors. We found (over 2006-2015) that the funds on best buy lists (though not those of platforms' in-house funds) on average outperformed the funds not on the best buy lists before charges. We also compared platforms' in-house funds on best buy lists with funds not on best buy lists. The in-house funds did not, on average, outperform these other funds. In our final report, we noted there has been a decline in platforms promoting in-house funds through Best Buy lists and highlighted our requirements for vertically-integrated firms to manage conflicts of interest.

We also published a consultation paper (CP18/27) on illiquid assets and open-ended funds in October 2018. This followed an earlier discussion paper on the same subject, and drew on the experience of property fund suspensions following the EU referendum in 2016, Broadly, we took the view that retail investors should continue to be able to invest in illiquid assets through open-ended funds, and that there we should not pursue a radical overhaul of the rules applying to funds investing in illiquid assets. At the same time, we recognised that there were specific measures that we should take to clarify the use of suspensions in these funds, to strengthen liquidity management processes and improve disclosure to investors of the liquidity risk inherent in these funds.

It is worth stressing, in this context, that these measures are focused on NURSs, as these are the type of fund through which ordinary retail clients may invest in illiquid assets such as commercial property. As such, there is no direct read-across between the Woodford fund suspension and our proposed new rules for open-ended funds investing in illiquid assets, although we shall take account of any lessons learned from the Woodford fund when finalising the new rules.

I will now turn to this specific issue and respond to your questions.

The Purpose of a Suspension

Open-ended funds (such as UCITS funds) are funds that issue new units to customers and redeem customers' existing units on demand. Closed-ended funds have a fixed number of units or shares and units may not be redeemed by the fund manager. The WEIF is an example of the former type.

There can be a structural liquidity mismatch in certain open-ended investment funds. Open-ended funds offer to redeem units at certain frequencies, often daily. However, the fund manager may not be able to liquidate the assets of the fund at that same frequency, particularly where the volume or scale of redemption requests is especially large. This means there can be a mismatch in the liquidity of the units of the fund and the liquidity of the underlying assets in which the fund invests, which take longer to liquidate. This mismatch is more acute for less liquid assets, for example, high yield bonds.

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[2] Benchmarks are references that fund managers use as a constraint, target or comparator for a fund, such as market indices like the FTSE 100.

Where the volume of redemptions is in line with the fund manager's expectations, redemption requests can normally be managed in an orderly manner. The fund manager invests the fund's assets, in line with our COLL rules (discussed above) and the fund's constitutional documents and prospectus, to optimise returns. At the same time, the fund manager balances this imperative with the need to ensure sufficient liquidity to meet reasonably foreseeable redemption demand. Sometimes liquidity may be held in cash or cash-like instruments within the fund, but holding excessive cash limits returns and may be contrary to the fund manager's obligations under the fund's constitutional documents and prospectus. Sometimes liquidity may need to be generated by liquidating assets, such as selling shares.

In exceptional circumstances where, for example, redemption requests are extremely high or much higher than foreseen, it may not be possible for the fund manager to meet those requests in line with the fund's normal redemption frequency. This may be because there is insufficient liquidity currently held in the fund. It may also be because the fund manager cannot liquidate assets quickly enough to meet the redemption demand without risking sales of those assets at a lower value than might be the case in a more orderly sale or distorting the portfolio away from the constitutional documents and prospectus. Even where there is sufficient liquidity to meet immediate demands, if the manager knows that it will not be possible to meet future redemptions as they arise, it would be unfair to remaining investors to allow the current sellers to deplete all the available liquidity. Were it to do so, this could result in outcomes which might harm the interests of remaining investors.

Another reason for suspension may be that the value of the assets is uncertain and therefore the Net Asset Value (NAV) itself, which is the total value of the fund's assets, cannot be known with sufficient certainty. Where the NAV cannot be known, the value of a unit cannot be known either. This was one of the reasons certain property funds were suspended following the 2016 EU referendum (though this is not the case for the WEIF suspension).

Where redemption pressure is high, or the NAV cannot be known with certainty, the fund manager may decide it is necessary to suspend the fund, with the agreement of its depositary.

In summary, a suspension enables fund managers, in such exceptional circumstances, temporarily to cease the sale or redemption of units in an open-ended authorised fund. Suspensions are not unique to the UK. They are an internationally recognised tool available to fund managers and the International Organization of Securities Commissions (IOSCO), which is an international group of securities regulators, has published various documents on them including Principles on their proper use[3].

What factors should dictate how long a suspension should be, and is there a maximum length? At what point would the FCA intervene in a suspension?

We do not specify a time limit for a suspension and to do so may run contrary to the interests of investors if, for example, it was lifted before the fund could operate in an orderly fashion without disorderly sales. In this scenario, value for investors would be reduced or even destroyed.

Nonetheless, a suspension imposed due to liquidity issues should last no longer than necessary to generate sufficient liquidity to meet actual and expected redemptions demand again. It must be formally reviewed by the fund manager at least every 28 days and the FCA must be informed of the results of that review. In receiving this information, we would, for example, review the plan for getting the portfolio into a more liquid state, how it is being implemented and the progress achieved.

[3] See for example: www.iosco.org/library/pubdocs/pdf/IOSCOPD349.pdf

At all times, the best interests of all investors, those remaining invested and those seeking to exit, must be upheld. All investors in an authorised fund (which includes UCITS) should be treated equitably and therefore it would be inappropriate to favour one set of investors over another, or to inform one set of investors of the imposition, or lifting, of a suspension ahead of another. If we believe that the interests of investors are not being upheld we would take action.

The FCA has the power to direct an authorised fund to suspend but only under specific circumstances (such as where the fund manager has contravened, or is likely to contravene, relevant provisions of FSMA or our rules). The FCA would not act in such a way unless there was clear evidence to justify such an intervention. We do however engage with the fund manager to ensure the actions necessary to allow a suspension to be lifted are undertaken in an orderly and timely manner.

The FCA's Principles for Businesses require all firms, including fund managers, to exercise due skill, care and diligence and our rules require fund managers to uphold the best interests of investors at all times. Where we suspect this has not been the case in practice, we may choose to open an investigation.

Whether the FCA has a view on the fees that funds charge during a suspension?

There is no requirement on fund managers to reduce or waive entirely their investment management fees during suspensions. However, a firm can choose to do so. The investment management element of the fees that investors in a fund bear relates broadly to the activities that the fund manager undertakes to manage the assets of the fund, for example by buying and selling securities in line with the fund's constitutional documents and prospectus.

As we have both said, there are good arguments for waiving fees during a suspension as a gesture of support to investors. That said, management activities continue during suspension. Clearly, the fund manager continues to accrue operational costs during this period, including the need to pay staff and rent for premises and so forth.

However, decisions around fee structures are for the fund manager to take.

Please could you provide a timeline of the FCA's supervisory contact with the Fund, or those related to its management?

For the reasons I set out above, the FCA has had most engagement with Link Fund Solutions, which is the 'authorised fund manager'.

The FCA has been in contact with Link since February 2018 regarding issues related to liquidity risks. In February and March 2018, the FCA engaged with Link in connection with two breaches of the 10% limit on the maximum proportion of unlisted securities held within WEIF. Following our engagement, these breaches were each notified to us as resolved within a timeframe we had agreed with Link.

From April to December 2018, we held monthly monitoring discussions with Link in relation to the deteriorating liquidity position within WEIF. Following this engagement, Link revised its liquidity risk management measures to seek to ensure it could meet redemptions on demand. No further breaches of the 10% limit were notified.

To put how the fund managed its liquidity into more context, I set out details of the fund's liquidity process and certain metrics below. Fund liquidity risk management measures often include setting certain thresholds of liquidity risk, which, if met, would trigger contingency plans. Link allocated the portfolio into four 'buckets', each with a certain liquidity profile.

Link broke down the portfolio of the WEIF into four liquidity 'buckets'. Each bucket contains a proportion of the fund's asset that are expected to be able to be sold within a specified

time period (in normal market conditions). As at the 30 June 2018, the liquidity profiles of these buckets for the WEIF was as follows.
The expected length of time to liquidate securities in each 'bucket' is indicated in brackets; the percentages refer to proportions of the NAV:

- Bucket 1 (1 – 7 days): 21%
- Bucket 2 (8 – 30 days): 24%
- Bucket 3 (31 – 180 days): 30%
- Bucket 4 (181 – 365+ days): 25%

As at 30 April 2019, the liquidity profile of the fund was:

- Bucket 1 (1 – 7 days): 8%
- Bucket 2 (8 – 30 days): 29%
- Bucket 3 (31 – 180 days): 32%
- Bucket 4 (181 – 365+ days): 33%

The figures indicate the fund became less liquid between June 2018 and April 2019. However, the fund did not breach any internal thresholds during this period and was able to meet redemptions throughout.

Link had set the following restrictions when assessing fund liquidity:

Trigger: Launch an 'event' to investigate the cause and update contingency plan if any of the following thresholds are met:

- Bucket 4 increases above 30% of NAV
- Bucket 3 and 4 combined increases above 65% of NAV
- Bucket 1 decreases below 8% of NAV

Limit: Invoke contingency plans if any of the following thresholds are met:

- Bucket 4 increases above 35% of NAV
- Bucket 3 and 4 combined increases above 70% of NAV
- Bucket 1 decreases below 5% of NAV

On 28th February 2019, Link notified the FCA that a transaction was due to be effected that same day involving the purchase of certain unquoted assets by the Patient Capital Trust ('PCT'), an investment trust for which WIM is the portfolio manager, from WEIF, in return for shares in the PCT. We sought and reviewed further information on the rationale for the transaction and the decision-making and governance processes around it.

During this assessment and towards the end of March 2019, we became aware of press articles discussing certain securities listed on The International Stock Exchange (TISE) in Guernsey, which were reported to be held by the WEIF. The UCITS rules do not require fund managers to notify their regulator that securities held within their funds are due to be or have been listed, or suspended from listing on an approved exchange.

Following these reports, we met Link to discuss its management of the WEIF, which particularly focused on issues related to the fund's exposure to illiquid assets, including those reported to be listed on TISE.

During this meeting, Link informed us that three stocks listed on TISE and held by WEIF had been suspended from dealing by the TISE Authority (the 'Authority'). We sought further information from Link in relation to its risk management strategy, stress testing and plans to reduce the fund's exposure to unquoted securities. From 24th April, Link began to send us daily reports of all flows into and out of (i.e. subscriptions and redemptions) WEIF.

We subsequently spoke to TISE (see below) who informed us that the stocks had been suspended due to the press reporting and queries about whether the listings had led to a breach of any FCA regulations.

During May 2019, net outflows (meaning redemptions were larger than subscriptions) averaged one per cent of NAV per week. However, the redemption requests on 31st May and the 3rd June amounted to £296m, representing 8.2% of NAV, with the fund holding no cash at the time, having previously drawn down some of an overdraft facility. Funds are permitted to have access to overdraft facilities, to provide liquidity where necessary, but the value of the overdraft is restricted relative to the size of the fund. The redemptions on 31st May and 3rd June were very high and coincided with the repayment of the overdraft. See chart 1 (data source: Morningstar).

Note that the size of the WEIF had generally been falling from around May 2017 until it suspension in June 2019. Its assets under management (AUM) peaked in May 2017 and incurred redemptions totally around £4.3bn since then. The performance of the fund was also negative, further reducing AUM. It returned -16.5% in 2018 and -7% in 2019. Chart 2 (data source: Morningstar) shows these trends.

On 3rd June, Link determined that the fund was not able to meet the redemption requests and therefore, with the agreement of the WEIF depositary, Northern Trust Global Services SE, decided to suspend the fund. The FCA was notified that same day.

Link deemed the suspension necessary due to the risk that, in the event the fund did not suspend, assets would have to be sold at prices below current values and that the resulting composition of the fund's assets would be more illiquid. Neither outcome was deemed to be in best the interests of remaining investors.

Our preliminary supervisory inquiries suggest that the exposure to unlisted securities within the fund was around 20% of the NAV in February 2019 prior to the TISE listing. To maintain the reposted level below 10%, the WEIF appeared to make use of rules that derive from the EU UCITS Directive, including one that allows a security to be excluded from the 10% limit, i.e. to be deemed eligible, if its issuer plans to list that security within 12 months. There is no requirement for the fund manager to disclose this to the regulator.

Please could you provide a timeline of the FCA's supervisory contact with the authorities in Guernsey, in relation to activities related to the Fund?

Our contact with the authorities in Guernsey in relation to these matters has been as follows. On 11th April 2019, TISE suspended dealings in securities listed by the following issuers:

- Ombu Group Limited (admitted to TISE: 15th June 2018)
- IH Holdings International Limited (admitted to TISE: 5th October 2018)
- BenevolentAI Limited (admitted to TISE: 21st March 2019)

The FCA did not receive, nor would we have expected to receive, prior notification that securities held by the WEIF were to due be listed on TISE or had been suspended. The fund manager is not obliged to inform its regulator that securities within a fund are to be listed. Moreover, the Guernsey authorities were not under an obligation to inform the FCA ahead of any suspension.

UCITS funds can invest 100% of scheme property in transferable securities that are listed on an eligible market. The UCITS Directive permits an authorised fund manager, after consultation with and notification to the fund's depositary, to decide that a non-EEA market is eligible on the basis of various factors such as regular operation, openness, liquidity and has adequate arrangements for the unimpeded transmission of income and capital to investors. Link had designated the TISE an 'eligible market'.

However, the events surrounding the WEIF have underlined that just because securities are listed on an eligible market does not automatically mean that those specific securities are liquid. A case can be made for reviewing the UCITS eligibility rules to take greater account of the depth of the market for the individual securities listed.

Nevertheless, it should be noted that the rules currently make it clear that 'the liquidity of a transferable security – listed or unlisted] should not compromise the ability of the authorised fund manager to comply with its obligation to redeem units at the request of any qualifying unitholder.' (COLL 5.2.7AR(b)).

On 15th April, TISE contacted us by email requesting a call to discuss the above suspensions. Unfortunately, TISE did not make contact with the areas of the FCA that processes and considers these sorts of requests.

On 26th April, we responded immediately to TISE suggesting a call. On 1st May, TISE replied suggesting a call take place that week or the following week. On 8th May, we spoke with TISE regarding issues surrounding the listings. TISE subsequently followed up with further information in writing.

Whether the FCA has initiated any formal investigation related to the events that led to the suspension?

We have opened an investigation but cannot comment any further.

Yours sincerely,

Andrew Bailey
Chief Executive

Chart 1: Displays the daily fund flows since May 2018 and highlights how significant the daily redemption was (on suspension day) relative to preceding daily flows over the previous 12 months.

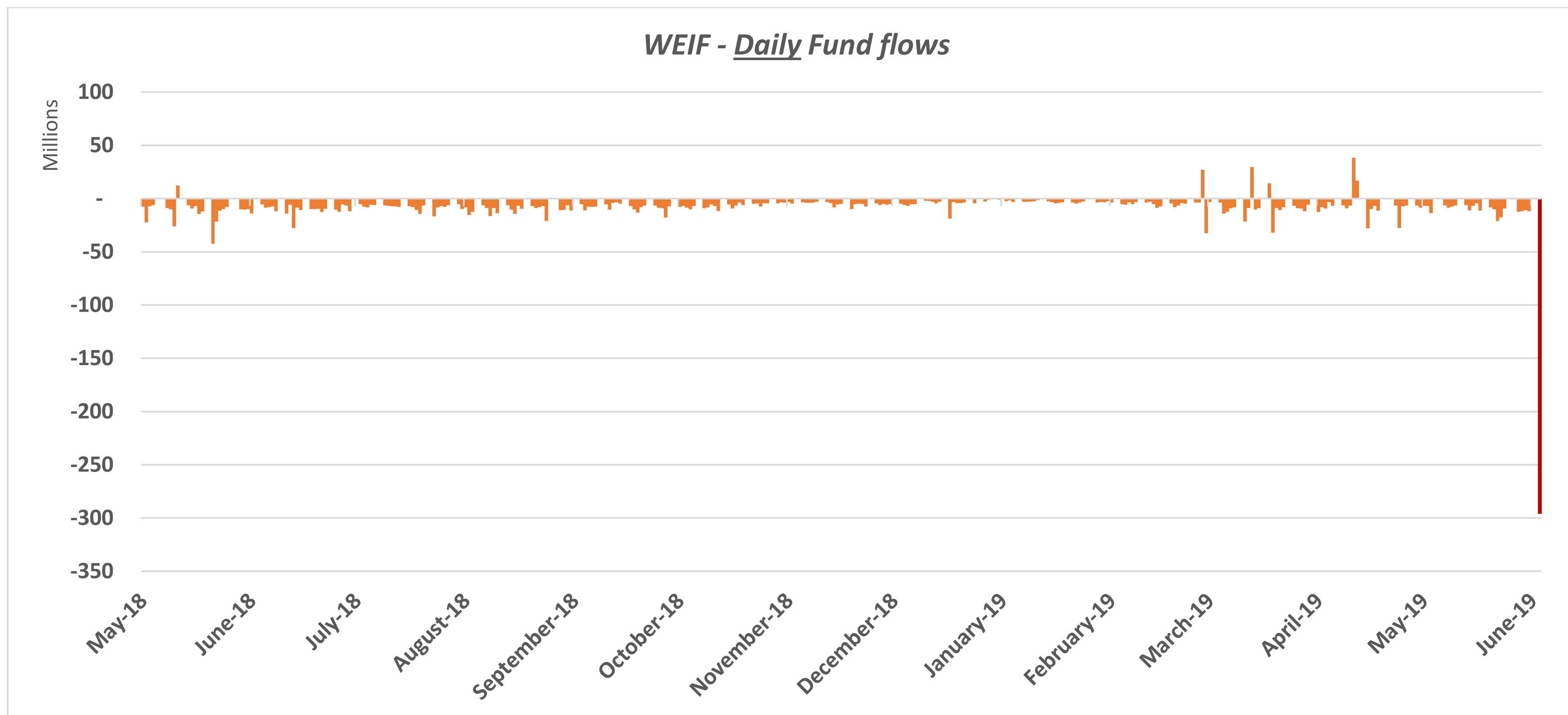

Chart 2: monthly outflows versus AUM, except for the final outflow, which is one day.