Patient Capital and Authorised Funds

Discussion Paper
DP18/10

December 2018

How to respond

We are asking for comments on this Discussion Paper by 28 February 2019.

You can send them to us using the form on our website at: www.fca.org.uk/dp18-10-response-form.

Or in writing to:
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How to navigate this document onscreen

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1 Overview

Introduction

1.1 Asset managers provide an important economic function in bringing together those looking to make a return on savings with those who need capital to finance business growth. By directing investments, asset managers support businesses and drive economic growth.

1.2 In 2016, Her Majesty's Treasury (the Treasury) and the Department for Business, Energy and Industrial Strategy (BEIS) launched the Patient Capital Review (PCR). The PCR investigated whether the UK market for 'patient', or long-term capital is working well – successfully bringing together those looking to make long-term investment with those needing long-term financing. It found that investment in patient capital assets is below its potential. The report said this negatively impacts the UK economy, tax receipts and job creation.

1.3 As part of our response to the PCR, we are publishing this Discussion Paper (DP) to explore the impact of the regulatory regime on investment in patient capital assets through authorised funds. We have separately published a Consultation Paper (CP) on the 'permitted links' rules,[1] which proposes a package of changes to enable retail consumers to invest in a broader range of patient capital assets through unit-linked funds.

1.4 This DP provides an overview (in Chapter 2) of the existing regime to invest in patient capital through UK authorised funds and specialised funds. We want your views on whether the regime provides investors and fund managers with appropriate access to patient capital investments while maintaining the right level of consumer protection. We ask, in particular, whether the current limits on investments in patient capital for some types of fund are appropriate, and, for example, whether we should amend the rules to make it easier to make direct investments in infrastructure projects. We also ask whether there is demand for a new type of authorised retail fund which can invest all its capital directly into patient capital assets. These and further questions are set out in Chapters 3, 4 and 5.

What is patient capital?

1.5 'Patient capital' refers 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. These assets are typically illiquid and often require a committed investor willing and able to tie up their capital and forgo on-demand liquidity or an immediate return on investment.

1 The Consultation on proposed amendment of COBS 21.3 permitted links rules. Please see COBS 21 for the rules governing linked long-term insurance business.

What is an authorised fund?

1.6 An 'authorised fund' is a collective investment scheme[2] (CIS) that is authorised by the Financial Conduct Authority (FCA) and is allowed to be promoted to retail investors in the UK. To be authorised, a fund and its fund manager must meet prescribed standards set out in the legislation and our Handbook. These standards include, for example, investment limits and restrictions on investment in certain types of assets. Broadly, these rules exist to help us achieve our statutory consumer protection objective.

Who does this document affect?

1.7 This DP may be of interest to you if you are a stakeholder in authorised funds that invest directly or indirectly in patient capital or if you have an interest in investing in patient capital, or offering patient capital investments. This DP is relevant for:

- operators and investment managers of UK authorised funds and specialised funds (ELTIF, EuSEF and EuVECA), and their depositaries
- intermediaries, such as platform service providers, discretionary wealth managers and financial advisers
- pension plan operators (eg those offering self-invested personal pensions)
- life assurance companies with an interest in patient capital, either by direct investment or through holdings in investment funds
- retail, professional and institutional investors
- ancillary service providers

Is this of interest to consumers?

1.8 Consumers who invest in authorised funds, or who have an interest in authorised funds through their pension contributions or their long-term life assurance policies could be affected by the issues we discuss in this paper.

1.9 We welcome views from individual consumers and groups representing consumer interests. Your responses will help us to understand consumer demand to invest in patient capital and how best to secure an appropriate degree of consumer protection.

2 Collective investment scheme is defined in s235 FSMA. A summary is provided in the FCA Handbook glossary definition of the term https://www.handbook.fca.org.uk/handbook/glossary/?starts-with=C.

Wider context

1.10 In November 2016, the Prime Minister announced the PCR to strengthen the UK as a place where high-growth innovative firms can obtain long-term finance (eg venture capital). As part of the review, the Treasury published the consultation 'Financing growth in innovative firms' in August 2017. This paper concluded that levels of investment in patient capital in the UK are below the evident level of demand for long term finance. It also explained the economic consequences, explored the underlying reasons and sought views from stakeholders. The Treasury's consultation response was published in November 2017.

1.11 The PCR's findings have prompted work across Government and public bodies to seek out and remove barriers to investment in patient capital. This has included commitments from:

- The Chancellor of the Exchequer, who announced in the Autumn Budget 2017, a 10-year action plan to unlock over £20 billion to finance growth in innovative firms
- The Pension Regulator (TPR), to clarify guidance on how the trustees of pension funds can invest in patient capital assets, and
- The FCA, to publish this DP and the permitted links CP referred to in paragraph 1.3

Our consultation on illiquid assets

1.12 We are currently consulting on proposals to reduce the potential harm for retail investors in funds that hold inherently illiquid assets. While that CP is not part of our work in response to the PCR, patient capital assets are typically illiquid, so the outcome of the consultation is likely to affect the discussions and any potential proposals that come out of this DP. Our CP on illiquid assets is available on the publications page of the FCA website. It includes proposed remedies to protect investors when funds hold significant amounts of illiquid assets, including patient capital.

The FCA's role and objectives

1.13 As the UK's financial regulator, we aim to make financial markets work well – for individuals, for businesses, large and small, and for the economy as a whole.

1.14 The FCA's strategic objective is to ensure that the relevant markets[3] function well and our operational objectives are to:

- protect consumers
- protect and enhance the integrity of the UK financial system
- promote effective competition in the interests of consumers

1.15 The authorised fund regime exists to protect consumers by ensuring that only appropriate investment products and services can be marketed to retail investors in the UK. While we welcome suggestions for change, only proposals that maintain appropriate consumer protections will be taken forward.

3 As defined in section 1F of the Financial Services and Markets Act 2000.

Equality and diversity considerations

1.16 Overall, we do not believe that this DP adversely affects any of the groups with protected characteristics ie age, disability, sex, marriage or civil partnership, pregnancy and maternity, race, religion and belief, sexual orientation and gender reassignment. We welcome any input to this DP on these matters and we will continue to consider the equality and diversity implications as part of the next steps outlined below.

Next steps

What do you need to do next?

1.17 We want to know what you think about the existing opportunities to invest in patient capital through authorised funds and what changes, if any, you would make to remove barriers to invest in patient capital. Please see Annex 1 for a full list of the DP questions and send us your comments by 28 February 2019. Please provide evidence to support your answers where possible.

How?

1.18 Use the online response form on our website or write to us at the address on page 2.

What will we do?

1.19 We will review your feedback and discuss this paper with various stakeholders, including industry and consumer groups. We will publish a Feedback Statement to set out the feedback received and next steps in 2019. Any proposals for change will be subject to further consultation in due course.

2 UK investment products

2.1 This chapter sets out the main investment products available to investors in the UK, through which they can invest in patient capital assets. It is provided as background information before we consider what changes, if any, are required to the authorised funds regime to remove barriers to investing in patient capital. More information on how certain types of fund can invest in patient capital is provided in Chapters 3 and 4 of this document.

Authorised funds

2.2 UK investment funds must be authorised by us to be marketed to retail investors. Certain funds exclusively marketed to professional and other sophisticated investors[4] may be, but are not required to be, authorised by us. Authorised funds are popular, with more than £1.2 trillion currently invested in them in the UK by retail, professional and institutional investors, including pension funds, the public sector, corporate investors and insurance companies.

2.3 Authorised funds, also known as schemes, provide investors with a wide variety of investment opportunities. However, to protect consumers from harm, different types of fund have different limits and restrictions on the kind of assets in which they can invest.

2.4 There are 3 categories of schemes that can be authorised:

- An undertaking for collective investment in transferable securities (UCITS), which is a fund that invests in transferable securities and other liquid financial instruments and can be marketed to all retail investors.
- A non-UCITS retail scheme (NURS) is a fund with greater investment flexibility than a UCITS, which can also be marketed to all retail investors. A NURS can also be a specialised property authorised investment fund (PAIF) which is designed to invest in immovables, such as commercial properties.
- A qualified investor scheme (QIS) which is a fund that can invest in a wider range of assets than a UCITS or a NURS. QISs can invest in most types of assets with few restrictions, but can only be marketed to professional and sophisticated retail investors.[5]

2.5 An important feature of authorised funds is that they are open-ended structures, which means investors can join and leave the fund on an ongoing basis, changing the overall size of the fund accordingly. When investors join they pay cash, which is invested on their behalf, and fund shares or units (called units for the purposes of this DP) are issued to them. The value of these units changes over time as the value of the fund fluctuates. When investors leave the fund, the manager sells assets and provides them with cash equivalent to the

4 In this paper when we refer to professional and other sophisticated investors please see COLL 8.1.3 R cf. COBS 4.12.4 R, for the full list of eligible investors.

5 As explained below in 3.20 retail investors can invest in QIS via pension schemes.

value of their units at that time. Their units are then cancelled or resold (investments are redeemed). This means there is no fixed number of units issued at any one time. Open-ended structures can be scaled up or down in-line with changing investor demand.

2.6 For open-ended structures to work, our rules require managers to maintain the following fund features:

- liquidity – each fund's portfolio of assets must be sufficiently liquid to meet investor redemption requests[6]
- diversification – there must be a prudent spread of risk, consistent with the fund's investment policy and objectives[7]
- valuation – the overall value of the portfolio must be fair and accurate[8]

2.7 When considering changes to the investment limits and restrictions for authorised funds, we will need to consider the impact of proposals on each on these 3 features. This is discussed further in Chapter 3.

Specialised funds

2.8 For the purposes of this paper, 'specialised funds' are the following investment schemes:

- European Long-Term Investment Funds (ELTIF) are funds designed to invest in various alternative asset classes such as infrastructure, small and medium sized enterprises and real assets.
- European Social Entrepreneurship Funds (EuSEF) are funds designed to invest in social enterprises. These are undertakings that are set up with the explicit aim to have a positive impact and address social objectives, rather than only maximising profit.
- European Venture Capital Funds (EuVECA) are funds designed to invest in start-ups and early stage companies.

2.9 ELTIFs can be authorised by the FCA if managed by a 'full-scope UK alternative investment fund manager'. Full-scope managers are firms authorised by the FCA, subject to the full requirements of the Alternative Investment Fund Managers Directive (AIFMD). They may also manage EuSEFs or EuVECAs following a registration of these funds with the FCA.

2.10 In addition, EuSEFs and EuVECAs can be managed by 'small UK alternative investment fund managers' (a subset of which are not authorised by the FCA) who have to comply with a limited number of requirements, mainly relating to reporting, as set out in Article 3 of the AIFMD.

6 For UCITS see COLL 5.2, for NURSs see the commission's delegated regulation (EU) no 231/2013 of 19 December 2012 section 4.
7 For UCITS see COLL 5.2.3 R(1), for NURSs see COLL 5.6.3 R(1).
8 For UCITS see COLL 6.3.3 R(1), for NURSs see the commission's delegated regulation (EU) no 231/2013 of 19 December 2012 section 7.

Other investment products

2.11 Other investment products are available to consumers seeking to invest in patient capital assets. These investment products are not themselves authorised by the FCA. When considering what changes, if any, are required to remove barriers to investing into patient capital through authorised funds, investors' current access to these products is relevant.

2.12 These products are often closed-ended structures, which means they have fixed number of shares issued, so investors can only invest into the product by buying a share from another investor. Unlike open-ended funds, investors in closed-ended funds can normally only exit their investment by selling their share to someone else (or on wind up of the fund). Therefore, each share is valued on the open market and is subject to the economic principles of supply and demand. This means that the shares can trade at a premium or discount on the net asset value (NAV) at that time.

2.13 Examples of closed-ended investment products include:

- Investment trusts – designed as a pooled investment vehicle in the form of a listed closed-ended investment company. While the product is not authorised it is operated by a fund manager authorised by the FCA.
- Venture capital trusts – a special type of investment trust designed to invest specifically into venture capital.
- Some types of crowdfunding – a relatively new practice which can fund a project or venture typically by raising small amounts of money from a large number of people, often intermediated via the internet.

2.14 As investors cannot redeem their investments directly from the fund, closed-ended funds are not subject to the same liquidity, valuation and diversification considerations as open-ended funds.

Open-ended vs closed-ended structures

2.15 Open-ended and closed-ended funds are both professionally managed with the aim of maximising investment returns for investors in accordance with an agreed level of risk. The pooling of cash from numerous sources enables fund managers to use economies of scale to diversify their portfolio and to lower investment and operating costs.

2.16 The key differences include:

	Open-ended, such as NURS	Closed-ended, such as investment trusts
Capital	Capital (units) is flexible, units are issued and redeemed on an ongoing basis.	Capital (shares) is fixed.
Access	Investors can enter and exit fund often at a value determined by the fund each business day.	Shares can be bought or sold to other investors on secondary markets.
Price	The price investors receive when leaving is based on assets of the fund.	The price investors receive when selling their shares is determined by supply and demand. This means shares can trade a premium or discount on the fund NAV.
Valuations	NAV typically published daily.	NAV typically published weekly.
Restrictions	Authorised fund regime prescribes investment limits and restrictions on certain types of asset.	Investment limits and restrictions are agreed between investors and fund managers.
Liquidity	Sufficient liquidity must be maintained to enable investors to redeem their investment.	Investments can be illiquid and long-term as investors have no right to redeem their investment.

3 Patient capital in authorised funds

3.1 Our authorised funds regime provides consumers with investment products designed to promote the following outcomes:

- Investors will be treated fairly by those entrusted to manage their assets.
- Investment risks will be managed in a professional and appropriate manner.
- Investors can redeem their investments on demand and in a timely fashion.

3.2 The authorised fund regime achieves this by providing a framework within which fund managers can launch a range of products, with varying investment limits and restrictions that are suited to the needs of different types of investor. As part of this discussion, we welcome your views on whether any of the investment limits and restrictions, or any other in-built consumer safeguards, are acting as inappropriate barriers to patient capital investment in the UK.

3.3 The extent to which authorised funds can invest in patient capital depends on which type of investor the fund can be marketed to. Broadly, funds authorised for marketing to all retail investors are subject to more investment limits and other safeguards than funds authorised to be marketed to professional and sophisticated retail investors.

3.4 A brief overview of authorised funds is provided in Chapter 2. The consumer safeguards that apply to authorised funds are set out below under the sub-headings:

- Liquidity
- Diversification
- Valuation

Liquidity – redeeming investments

3.5 For investments in authorised funds, the industry standard is to provide investors with a right to redeem their investments at a relatively short notice.

3.6 The regulatory regime safeguards retail investors' ability to redeem their investments by limiting how much of a fund's capital can be invested in certain investment categories. These category limits ensure funds predominantly hold liquid assets, as the maximum permitted allocation that a fund may make to each category is based on the liquidity of the category. Liquidity depends on the structure of the investment and whether it can be traded readily.

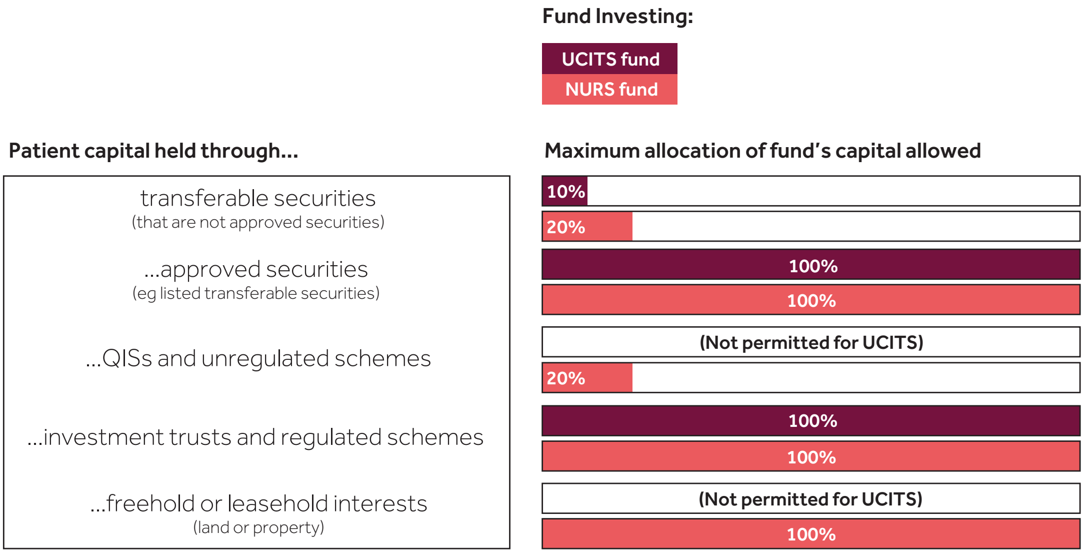
3.7 Fund managers can provide investors with access to patient capital either by investing directly into patient capital assets or indirectly by investing into other funds or structures which in turn hold patient capital assets. The latter can have the advantage of providing a more liquid way of holding patient capital, as well as increasing the funds diversification. However, indirect investment can also add an extra layer of investment complexity and cost. For example, a UCITS fund cannot hold a property directly (real estate) as this is illiquid,[9] but the fund may indirectly hold all of its capital in property by acquiring securities in listed real estate investment trusts (REITs), or index based derivatives,[10] as these are liquid assets.

3.8 Our rules have different category limits depending on whether the fund type is authorised for marketing to all retail investors or professional and sophisticated retail investors.

Retail investors access to patient capital assets

3.9 The following chart provides an overview of the extent to which authorised funds that can be marketed to all retail investors can hold different categories of patient capital directly (such as where a fund holds a freehold estate in land), or indirectly, such as where a fund holds a company, which in turn holds the freehold. A full explanation of these rules is available in Chapter 5 of COLL.

3.10 Chart: Indicative summary of patient capital funding through retail funds[11]



Note to chart:

'Transferable securities' are investments such as shares or bonds issued by limited liability companies. Transferable securities are defined in COLL5.2.7 R and UCITS and NURS funds may only invest into transferable securities subject to certain eligibility criteria.[12]

'Approved securities' are transferable securities, which are listed or traded on certain eligible markets subject to the rules of these markets.

3.11 As the chart illustrates, our regime limits the extent of investment by a UCITS fund into transferable securities, that are not approved securities,[13] to 10% of its scheme property (the funds capital). For NURS funds this limit is 20%.

9 There is a limited exception to this rule in COLL 5.2.6A R whereby an open-ended investment company that is a UCITS may acquire movable property that is essential for the direct pursuit of its business.

10 Subject to eligibility rules and diversification limits.

11 This chart extracts information from the indicative overview of investment and borrowing powers for UCITS schemes and NURS in COLL 5.1.14 G for the purposes of this DP. This chart does not seek to alter the scope or meaning of COLL 5.1.14 G. To interpret the terms used in this chart, please refer to the FCA Handbook definitions of the same terms as referred to in COLL 5.1.14 G.

12 See COLL 5, including COLL 5.2.7A R and COLL 5.6.5A R.

13 Transferable securities, which are not approved securities, are assets which are not listed and can consist of company shares. However, they must adhere to certain criteria in COLL 5.2.7 R, such as the security being transferable without the consent of a third party (subject to exceptions). Please see COLL 5.2.7 R for more detail.

Q1: Do the category limits strike the right balance between enabling retail investments in patient capital while ensuring investors can redeem their investments in a timely fashion? If not, what changes should be made to existing structures?

Q2: Is there retail investor demand for a new type of authorised retail fund which can, for example, invest all its capital directly into patient capital assets?

Q3: If authorised funds marketed to retail investors were permitted to hold more patient capital, what safeguards do you think are needed to adequately protect investors?

NURS investment in immovables

3.12 NURSs can invest directly into immovables, such as infrastructure, and PAIFs, a specialist type of NURS fund, can do so without limit. However, they may only invest into immovables that meet the following requirements:

- In England, Wales and Northern Ireland an immovable must be a freehold or leasehold interest. In Scotland, the immovable must be an interest in or over land or a heritable right including a long lease.[14]
- If the immovable is located outside the UK the immovable must be an equivalent interest or, if no such equivalent interest is available in the jurisdiction, be an interest that grants beneficial ownership of the immovable to the scheme and provides as good a title as any of the interests in the UK.

3.13 Due to these requirements, it may be difficult for NURSs to finance infrastructure projects, because investment for the construction phase may not provide the fund with a freehold or leasehold interest.

3.14 However, our rules do provide scope for authorised funds to finance infrastructure projects by investing through other categories such as corporate loan issues within the transferable securities category.

3.15 We are keen to explore whether our current categories provide sufficient access for authorised retail funds to finance infrastructure, and whether our rules are acting as an inappropriate barrier to investment. Please note that PAIFs are subject to our current consultation on illiquid assets held in open-ended funds, as they invest in inherently illiquid assets.

Q4: Should NURSs have a broader ability to finance infrastructure projects than is currently possible under our regime? If so, what changes do you think are necessary to our handbook?

14 COLL 5.6.18 R.

Professional and sophisticated retail investors' access to patient capital assets

3.16 Patient capital funding can be provided by QISs. QISs are open-ended authorised funds intended for investors that can accept a higher degree of risk or have greater knowledge, experience, and expertise than most retail investors. Fund managers must take reasonable care to ensure that ownership is held only by eligible investors such as professional clients and sophisticated retail investors.[15]

3.17 QISs can invest in a similar range of investments as our other authorised funds, as set out in COLL 8.4.4 R, but, importantly, without limit or restriction by way of category limits and diversification rules.

3.18 However, QIS fund managers must take reasonable steps to ensure that the fund provides a spread of risk. They must take into account the investment objectives and policy of the scheme as stated in the fund prospectus, and in particular, any investment objective as regards return to the unitholders (cf. COLL 8.4.2 R).

3.19 This gives QISs a significantly broader remit to invest in patient capital assets than UCITS or NURSs.

3.20 All retail investors can invest in QISs via unit-linked funds, as our rules enable unit-linked policyholders to acquire exposure to authorised funds subject to compliance with our 'permitted links' rules.

3.21 Our concurrent CP on the permitted links rules addresses whether those rules give retail investors sufficient access to investment in patient capital via unit-linked pension schemes, see paragraph 1.3 above. In this DP, we are interested in discussing investors' opportunity to invest in patient capital directly through QIS funds.

Q5: **Do the current rules governing QISs provide professional and sophisticated retail investors with sufficient access to patient capital? If not, why not and what changes do you think are necessary to our handbook?**

If our rules do not provide sufficient access for QISs to fund patient capital please suggest which handbook changes could be changed to address this.

Q6: **If QISs are permitted to hold more patient capital, what safeguards do you think are needed to adequately protect investors?**

Diversification – managing risks appropriately

3.22 The authorised fund regime contains safeguards by way of diversification rules. These rules require that authorised funds hold an adequate spread of assets to avoid a disproportionate loss if a single investment fails.

15 For a full list of eligible investors please see COLL 8.1.3 R cf. COBS 4.12.4 R.

3.23 Category limits for different types of assets, explained above, prescribe a maximum level for how much of a fund's capital can be invested in a particular category and also require a prudent diversification of risk within the categories. For example, an authorised fund can invest all its capital into listed equities.[16] However, diversification rules mean the fund cannot invest all its capital in shares in a single company. A fund investing all of its capital in equities will need to hold a relatively diverse portfolio of equities. COLL gives further information on these rules.[17]

3.24 The diversification rules can lead to complications for funds investing in illiquid assets like patient capital. Firms investing in patient capital may choose to hold a level well below the actual threshold set out in our rules because of the risk of breaching the threshold, for example if these assets perform well. Ordinarily, breaches of the diversification rules are often resolved swiftly by selling the asset to which the fund has become over-exposed. Rules require fund managers to do this as soon as reasonably practicable having regard to the interests of the unitholders and, in any event within 6 months for most breaches.[18] However, this may be difficult for funds directly holding patient capital as these investments are illiquid and not easily transferable, or can only be transferred at significant cost. Rather than risk a long-term rule breach, managers may instead choose to keep patient capital investments far below the permitted thresholds.

3.25 The difficulty in managing diversification limits potentially presents a barrier to investing in patient capital. We would like to understand if this is an issue for fund managers, and if so, your suggestions on how it can be resolved. We would like to explore whether a more nuanced approach to threshold limits could remove barriers to investing into patient capital.

Q7: **Do the current diversification rules strike the right balance between investor protection, by requiring a prudent spread of risk, and sufficient access to patient capital? If not, do we need a different or more flexible approach to diversification rules?**

Please provide an explanation of your answer.

16 The equities would have to fulfil the eligibility requirements as 'approved securities' for the fund to invest all its capital in them, see COLL chapter 5.2 and 5.6.

17 Please see COLL 5.2.11 R for UCITS funds, COLL 5.6.7 R and 5.7.5 R for NURS funds and PAIF NURSs, and COLL 8.4.2 R for QIS funds.

18 See COLL 6.6.14 R(1) and (5).

Valuation – treating investors fairly

3.26 The authorised funds regime provides safeguards to ensure investors are treated fairly and that some investors do not receive inappropriate preferential treatment at the expense of others. One prerequisite of open-ended structures is that fund managers must be able to value the fund's assets fairly, accurately and on an ongoing-basis.

3.27 While we do not believe our current valuation rules present a barrier to investment in patient capital, the way in which patient capital is valued may require further consideration if some of our funds are permitted to hold more patient capital.

3.28 When a fund is incorrectly priced, some investors will inevitably be short-changed when there are redemptions at an incorrect price. This is because an incorrect price leads to transfers of value between particular groups of investors. For example, if investors leaving the fund receive too much cash for their units this will cause remaining investors to lose money because the excessive price is paid by the fund. If the price is set too low, departing investors are short-changed.

3.29 Funds commonly hold listed securities together with an amount of cash. When investors subscribe or redeem units they pay or receive money based on the fund's NAV per unit. This price is calculated by taking the current market value of the fund's assets, for example, if the fund's assets are all listed securities, the price published on an exchange, plus the cash held, less any liabilities, divided by the number of units in circulation.

3.30 As a patient capital asset is not typically listed, fund managers may not have a readily obtainable market value for these investments. However, patient capital funds' valuation can be based on an appropriate valuation methodology, as set out in the applicable EU regulation.[19] A methodology can be developed by the fund manager providing it is fair, appropriate and transparent. If a model is used for valuing assets, the model must be validated by a suitably qualified individual who was not involved in the process of building the model, such as an external auditor.

3.31 Fund managers may add patient capital to a fund to improve the potential return from the portfolio without significantly increasing its overall risk.[20]

3.32 However, circumstances can arise where investors believe that the valuation methodology has led to assets being priced significantly above their market value. This increases the risk of a run on the fund which might result in an unfair treatment of remaining investors.

3.33 This is what happened following the UK referendum on EU membership in June 2016. Increased market uncertainty around the pricing of commercial property led to fears of significant falls in value. The valuations of authorised funds provided by Standing Independent Valuers (SIVs) were subject to uncertainty clauses,[21] while REITs, which are closed-ended entities, were trading at a substantial discount. This caused substantial outflows from authorised open-ended property funds. When redemption

19 The commission delegated regulation (EU) No 231/2013 of 19 December 2012. For UCITS see COLL 6.3.

20 This would be as part of creating an optimal portfolio which gives the highest expected return for a given level of volatility or the lowest volatility for a given level of expected return, cf. the efficient frontier theory based on Harry Markowitz's work in 1952.

21 An uncertainty clause is when the funds SIV expresses uncertainty about the value of a property. If the uncertainty is material this means a degree of uncertainty exists in a valuation which falls outside any parameters that might normally be expected and accepted, for example, due to events causing market disruption.

requests were received at a faster rate than the managers could realise assets to raise cash, this led to suspensions. This is the subject of our current CP on illiquid assets in open-ended funds.

3.34 In our illiquid assets CP, we have proposed a mandatory suspension for NURSs holding property and other immovables in circumstances where there is material uncertainty about the valuation of these assets. This is to reduce the risk of investors being treated unfairly due to the fund being incorrectly priced.

3.35 The remedy proposed in our CP would only apply to immovables which are valued by a SIV in accordance with the terms of the Red Book published by the Royal Institution of Chartered Surveyors.

Q8: If authorised funds' scope to invest directly into patient capital assets other than immovables is increased do we need a remedy similar to the proposed mandatory suspension to avoid investors being treated unfairly?

If you agree that suspension rules would be appropriate, please set out your suggestions as to what such a remedy would look like. If you do not think suspension rules would be appropriate, please explain why not.

4 Patient capital in specialised funds

4.1 The EU framework provides for 3 types of specialist fund, which are specifically designed to invest in patient capital:

- European long-term investment funds (ELTIF)
- European social entrepreneurship funds (EuSEF)
- European venture capital funds (EuVECA)

4.2 As set out in Chapter 2, these specialised fund regimes have been created by EU Regulations.

ELTIFs

4.3 An ELTIF can be marketed to retail and professional investors. The concept was launched by Regulation (EU) 2015/760 (the ELTIF Regulation) in December 2015 and is designed to increase finance available to small and medium enterprises (SMEs) and social infrastructure projects across Europe.

4.4 The ELTIF Regulation requires that an ELTIF must invest at least 70% of its capital in the following qualifying assets:

- non-listed companies, or listed companies with a market capitalisation not exceeding €500 million
- real assets, with an individual value of more than €10 million, that generate an economic and social benefit, such as schools, hospitals and prisons etc

4.5 ELTIF qualifying assets are highly illiquid and must be held as a very high proportion of total investments. Ordinarily, this would pose a significant challenge for open-ended fund managers, who are required to manage sufficient liquidity to meet expected investor redemption requests (see Chapter 3). To overcome this challenge, the ELTIF Regulation requires ELTIFs to run for a fixed-term period much like a closed-ended fund. This requirement is also designed to help the companies and projects receiving investment from the fund. It provides them with the certainty they need that their finance will not suddenly be withdrawn to meet investor redemption requests.

4.6 However, some investors are unwilling or unable to tie up their capital for long periods of time. To help ELTIFs attract such investors, the ELTIF Regulation also grants the fund managers discretion to offer limited redemption rights. Redemption is limited to an amount equal to the non-qualifying assets held by the fund (ie up to 30% of the fund's investable capital) and is only allowed after half the ELTIFs fixed-term has passed. For example, the fund manager of a 10 year ELTIF can choose to accept limited redemption requests after the fifth year.

4.7 While ELTIFs can be marketed to retail investors, the ELTIF Regulation requires the manager, or any distributor, of an ELTIF to conduct a suitability test for all retail investors whose total investment portfolio does not exceed €500,000. Additionally, there is an obligation to ensure that such retail investors are prevented from investing more than 10% of their total financial instrument portfolio in ELTIFs, and they need to invest an initial minimum amount of €10,000 in ELTIFs.

EuSEFs and EuVECAs

4.8 EuSEFs and EuVECAs were launched in July 2013 to facilitate cross-border fundraising for funds investing in social enterprise and venture capital respectively.

4.9 An EuSEF is a fund that intends to invest at least 70% of its capital in European social businesses. Social businesses are those who have explicit aims to have a positive social impact and address social objectives.

4.10 An EuVECA is a fund that intends to invest at least 70% of its capital in innovative SMEs. For the purposes of EuVECAs, SMEs are non-listed companies with fewer than 500 employees and SMEs listed on SME growth markets.

4.11 Unlike ELTIFs, EuSEFs and EuVECAs are designed specifically for professional investors and both require a minimum investment of €100,000. Investors must be professional clients in accordance with Sections I or II of Annex II to MiFID. In addition to minimum investment rules, investors are required to confirm in writing that they are aware of the risks associated with their investments.

4.12 To date, these specialised funds have not been widely distributed and the FCA has received relatively few applications for registration of EuVECAs and EuSEFs, and no applications for authorisation of ELTIFs. We welcome your views as to why these schemes have not been more popular and used to invest in patient capital in the UK.

Q9: **Why do you think the specialised funds have not being used in significant volumes?**

Q10: **Are there specific features of these funds which prevent fund managers or investors from using them to invest in UK patient capital?**

5 Concluding remarks

5.1 This paper has explained the extent to which authorised funds can currently invest in patient capital assets. It has also set out the requirements on fund managers to ensure investors are treated fairly when investing, that investment risks are managed in an appropriate manner and that investors are able to redeem their investments in a timely fashion when they wish to withdraw their investments.

5.2 We have set out the opportunities within the current regulations to invest in patient capital assets through authorised funds, and specialised funds, and explained the safeguards in place to protect consumers from harm.

5.3 We are inviting a discussion on whether our regime should be changed to remove or reduce barriers to investing in patient capital and provide consumers with greater opportunity to invest in such assets, while maintaining an appropriate level of protection. We have set out some of the potential barriers and we are keen to hear your views on these and whether the current regulatory framework contains any inappropriate barriers which are hindering patient capital investments.

5.4 Following your input, we will publish a Feedback Statement and, if we decide to take a proposal forward, a Consultation Paper will be published in 2019 to set out the feedback we received and our next steps. We will also take on board recommendations and commentary arising from any other industry or Government-led work, considering these issues before making any future proposals.

Q11: Are there other areas where the current regulatory framework creates unnecessary barriers, either directly or indirectly, to investing into patient capital?

Annex 1
List of questions

Q1: Do the category limits strike the right balance between enabling retail investments in patient capital while ensuring investors can redeem their investments in a timely fashion? If not, what changes should be made to existing structures?

Q2: Is there retail investor demand for a new type of authorised retail fund which can, for example, invest all its capital directly into patient capital assets?

Q3: If authorised funds marketed to retail investors were permitted to hold more patient capital, what safeguards do you think are needed to adequately protect investors?

Q4: Should NURSs have a broader ability to finance infrastructure projects than is currently possible under our regime? If so, what changes do you think are necessary to our handbook?

Q5: Do the current rules governing QIS's provide professional and sophisticated retail investors with sufficient access to patient capital? If not, why not and what changes do you think are necessary to our handbook?

If our rules do not provide sufficient access for QIS's to fund patient capital please suggest which handbook changes could be changed to address this.

Q6: If QISs are permitted to hold more patient capital, what safeguards do you think are needed to adequately protect investors?

Q7: Do the current diversification rules strike the right balance between investor protection, by requiring a prudent spread of risk, and sufficient access to patient capital? If not, do we need a different or more flexible approach to diversification rules?

Please provide an explanation of your answer.

Q8: If authorised funds' scope to invest directly into patient capital assets other than immovables is increased do we need a remedy similar to the proposed mandatory suspension to avoid investors being treated unfairly?

If you agree that suspension rules would be appropriate, please set out your suggestions as to what such a remedy would look like. If you do not think suspension rules would be appropriate, please explain why not.

Q9: **Why do you think the specialised funds have not being used in significant volumes?**

Q10: **Are there specific features of these funds which prevent fund managers or investors from using them to invest in UK patient capital?**

Q11: **Are there other areas where the current regulatory framework creates unnecessary barriers, either directly or indirectly, to investing into patient capital?**

Annex 2
Abbreviations used in this document

AIFMD	Alternative Investment Fund Managers Directive
BEIS	The Department for Business, Energy and Industrial Strategy
COBS	Conduct of business sourcebook
COLL	The Collective Investment Schemes sourcebook
CP	Consultation Paper
CIS	Collective investment schemes
DP	Discussion Paper
ELTIFs	European long-term investment funds
EU	The European Union
EuSEFs	European social entrepreneurship funds
EuVECAs	European venture capital funds
FCA	The Financial Conduct Authority
Illiquid assets CP	CP18/27: Consultation on illiquid assets and open-ended funds and feedback to Discussion Paper 17/1 illiquid assets
NAV	Net asset value
NURS	Non-UCITS retail scheme
PAIF	Property authorised investment fund
Permitted links CP	Consultation on proposed amendment of COBS 21.3 permitted links rules
PRC	The Patient Capital Review
QIS	Qualified investor scheme
REIT	Real estate investment trust
SIV	Standing Independent Valuer
SME	Small and Medium Enterprises

TPR	The Pension Regulator
UCITS	An undertaking for collective investment in transferable securities
UK	United Kingdom of Great Britain and Northern Ireland

We have developed this Discussion Paper in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

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