

UKLA Technical Note

Application of related party rules to funds investing in highly illiquid asset classes

Ref: UKLA / TN / 406.1

LR 11.1.4R and
LR 15.5.4R

Background

LR 15 came into force as a result of the FSA's Investment Entities Listing Review.¹ It opened listing to a wide range of investment entities, including, for example, those investing in infrastructure assets.

In the context of infrastructure funds, it was suggested to us at the time that a pipeline of large-scale infrastructure assets is a key part of the investment proposition, and that access to such assets could only be ensured through a tie-up with key providers to source future investment opportunities and satisfy investor demand for exposure to this specific asset class. Such a provider may also be the investment manager. As an investment manager falls within the definition of related party (LR 15.5.4R and LR 11.1.4R), this means that any such transactions would prima facie be related party transactions and subject to the requirements in LR11.

As a result, it was suggested to us that, in light of the illiquid nature of certain asset classes, if a fund had stated its intention to make such purchases and had procedures in place to manage any conflicts arising from the purchase, then it should be able to successfully argue that such acquisitions are in the ordinary course of its business (and therefore in accordance with LR 11.1.5R, not subject to the related party rules in LR 11).

While we have accepted such arguments on a number of occasions, we have also rejected these arguments in some instances (e.g. where a fund proposes to invest in small-scale infrastructure assets that appear to be readily purchasable).

Current interpretation

We have reviewed our approach to make sure it is fit for purpose.

Closed-ended investment funds are exempt from LR 10 (Significant transactions) for transactions that are executed in line with the fund's published investment policy (LR 15.5.2R); such transactions are always deemed to be in the ordinary course of the fund's business.

No such wholesale exemption exists for LR 11 (related party transactions). When a fund acquires new investments, it would not typically be expected that these would be sourced from the balance sheet of the fund's investment manager, and so our presumption is that the requirements in LR 11 will apply.

However, in some limited cases, a fund may be able to argue that, due to the nature of the asset class it invests in, new investments can only be acquired from an entity with which the fund has a long-standing relationship (which may be the investment manager). In that context, what constitutes 'ordinary course' should be interpreted differently.

¹ CP 06/4, CP 06/27 and CP 07/12.

We would only accept this argument in the following circumstances:

- The fund can point to structural characteristics that make purchases from the related party the only viable option allowing the fund to provide investors with exposure to the asset class. A statement of intent to purchase from a related party – made by funds investing in sectors where fungible or near fungible investments can be sourced from other parties and are readily available – will not be sufficient grounds for such purchases to be considered ‘ordinary course’. In such cases, the requirements in LR 11 will apply. In assessing whether there are structural characteristics that would support an ‘ordinary course’ argument, we would seek to understand for example the nature of the asset, and the relationship between the manager and the asset (such as how it has been originated and whether value has been added). We will also consider the relationship between the issuer and the related party, as well as how the related party provides the issuer with preferential access.
- The fund is able to demonstrate that it has in place arrangements to effectively process such purchases and manage any conflicts of interest that may arise. Arrangements that we have previously found convincing include strong buy-side committees that are independent of the related party (or at least its sell-side), staffed by individuals who have credible experience.

We would expect sponsors advising on the application of LR 11 to such investments to discuss with us whether such transactions should be considered to be in the ordinary course.

We would also remind funds and sponsors that, as markets continue to develop, funds may not be able to successfully argue that such investments are in the ordinary course, even where other funds may have successfully argued this in the past in relation to that asset class.