Consultation on illiquid assets and open-ended funds and feedback to Discussion Paper DP17/1

Consultation Paper
CP18/27**

October 2018

How to respond

We are asking for comments on this Consultation Paper (CP) by 25 January 2019.

You can send them to us using the form on our website at: https://www.fca.org.uk/cp18-27-response-form

Or in writing to:
Mike Bolton
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

Email:
cp18-27@fca.org.uk

How to navigate this document onscreen

returns you to the contents list

takes you to helpful abbreviations

Contents

1 Summary

Why we are consulting

1.1 Following the result of the UK referendum on EU membership in June 2016, dealing in a number of property funds was temporarily suspended. This prevented investors from accessing their money, though dealing in all funds had resumed by the end of the year. This event raised a number of questions, including:

- How fund managers use different liquidity risk management tools
- How to strike a fair balance between the interests of investors wishing to redeem their holdings and those wishing to remain invested in the fund

1.2 We observed that the use of suspensions and other liquidity management tools generally worked as they were intended to and prevented the problems that property funds were facing from causing any wider market disruption. This did not suggest that a major overhaul of the regulatory framework in this area was needed. However, there were lessons that could be learned from what happened after the referendum to inform specific improvements in some areas, for example on the use of certain liquidity management tools, contingency planning, oversight arrangements and disclosure to retail clients.

1.3 While most holdings in a fund are invested in assets to generate returns for investors, funds generally hold a certain amount of cash. They do this for a variety of reasons, including the need to pay investors promptly when they wish to sell units in the fund. Under stressed market conditions, a large number of investors may sell their units at the same time. The cash held by the fund is then used to pay for units sold in the first instance. Funds will sell other assets, such as shares or other financial instruments, to raise more cash and pay investors leaving the fund.

1.4 However, the need to raise cash quickly in response to investors wishing to sell their units poses a challenge to open-ended funds that invest in illiquid assets, such as commercial property. The assets may be hard to sell quickly. Even if it is possible, the fund manager may have to accept a substantial discount to their previous, 'open market' value, to achieve a quick sale. This means that investors in funds holding significant amounts of illiquid assets may not be able to redeem their investments at short notice, or may be able to do so only at a substantial discount to the unit price.

1.5 In theory, all assets can become illiquid if market conditions fundamentally change and there are no willing buyers. However, in this CP, illiquid assets refer to assets which are illiquid even under normal market conditions. Examples of such illiquid assets are property or infrastructure investments. Our proposed approach to defining 'inherently illiquid assets' is set out in 3.13.

1.6 Our proposals aim to reduce the risk of poor outcomes to retail investors in open-ended funds, specifically non-UCITS retail schemes (NURSs), that invest in illiquid assets. An open-ended investment fund is a collective investment scheme (CIS) that can create or redeem shares, also known as units, at any time. This is different from a closed-ended fund, in which the number of shares is generally fixed. Most open-ended funds that are marketed to retail investors opt to deal daily. This means that, under normal market conditions, investors can redeem their holdings every business day, at a price based on an up-to-date valuation of the fund's assets and liabilities (the net asset value (NAV) of the fund).

1.7 We also aim to ensure that investors are better informed about the liquidity risks inherent in these funds and the potential consequences for them, particularly under stressed market conditions. There will be improved oversight of the process of liquidity management and greater clarity on the use of liquidity management tools.

1.8 Specifically, we are consulting on a package of measures that will:

- Reduce the risk that some investors may lose out because the units in a fund are wrongly priced. We will do this by requiring NURSs holding immovables[1] to suspend trading when the Standing Independent Valuer (SIV) expresses 'material uncertainty' about the value of immovables that account for a significant part of the scheme property.
- Improve liquidity management in NURSs investing mainly in illiquid assets. We are requiring fund managers to produce contingency plans in case of a liquidity crisis and enhancing depositaries' oversight of the liquidity management process. We are also clarifying how we expect firms to use some liquidity management tools.
- Improve disclosure. For NURSs investing mainly in illiquid assets, we will require more information to be disclosed about the liquidity risks, the liquidity management tools available to the fund manager, the circumstances in which they may be used and what impact they may have on investors. This should make it less likely that consumers invest in funds that are not suitable for their needs.

1.9 As well as better protecting consumers, these changes should help to promote our objective of protecting and enhancing the integrity of the UK financial system. They will increase retail investors' understanding of, and confidence in, fund managers' management of liquidity risk in open-ended funds holding illiquid assets. That should make it less likely that investors in these funds will seek to redeem their investments under stressed market conditions.

1.10 The greater clarity around the suspensions should also produce a fairer balance between the interests of investors wishing to remain invested and those wishing to sell their units. There will be less incentive for some investors to try to gain a 'first mover advantage' by redeeming their units quickly under stressed market conditions. This should reduce the likelihood of destabilising outflows under these conditions.

1 'Immovables' are not defined in our Handbook, but they include, for example, property and infrastructure.

Who this applies to

1.11 You should read this if you have an interest in open-ended investment funds that are likely to hold illiquid assets. This includes:

- operators and investment managers of these funds
- depositaries
- ancillary service providers
- intermediaries, such as platform service providers, or those, like wealth managers or financial advisers, whose retail clients invest in funds holding illiquid assets
- firms communicating financial promotions relating to funds investing mainly in illiquid assets to retail clients. These will be subject to the new requirement in our Conduct of Business sourcebook (COBS) to include a standard risk warning
- investors, whether institutional, professional or retail, who have direct or indirect exposure to these funds

1.12 Others may have a less direct interest in the issues raised in this consultation but may also find the CP relevant:

- pension plan operators, for example those offering Self-invested personal pensions (SIPPs) and Small self-administered schemes (SSASs)
- managers of other types of fund, such as undertakings for collective investment in transferable securities (UCITS), qualified investor schemes (QISs) or unauthorised funds, which may be affected to some extent by one or two of our proposals (UCITS by the new guidance on the use of cash and near cash; QISs by the categorisation of units in certain QISs as 'inherently illiquid assets', and by the updated references to the Royal Institution of Chartered Surveyors (RICS) Red Book)
- life assurance companies with exposure to illiquid assets such as property, either by direct investment or through holdings in investment funds

The wider context of this consultation

1.13 In February 2017, we published a Discussion Paper (DP) on open-ended funds holding illiquid assets. The DP posed a wide range of questions around the definition of an illiquid asset, the risks posed when such assets are held in open-ended fund structures and the effectiveness of different existing and potential approaches to mitigating those risks. We received 57 responses to that DP.

1.14 On 20 July 2017, we published the results of a supervision project that reviewed, across the value chain, the events surrounding the property fund suspensions that followed the referendum on UK membership of the EU in June 2016. The findings included a number of recommendations for new rules or guidance to meet shortcomings identified by the project.

1.15 In the international arena, on 1 February 2018, the International Organisation of Securities Commissions (IOSCO) published a revised version of its Recommendations on Liquidity Risk Management for Collective Investment Schemes (CISs) that were originally published in 2013. The revision of the Recommendations was in response to recommendations issued by the Financial Stability Board in January 2017.

1.16 In drafting our proposals, we have considered the responses to our DP, the results of our supervisory work and the updated IOSCO Recommendations.

What we want to change

1.17 We are proposing changes to our Handbook in 3 broad areas:

Suspension of dealings in units (Chapter 4)

1.18 Our proposals will require NURSs holding property and other immovables to suspend dealing when there is 'material uncertainty' about the valuation of at least 20% of the scheme property.

Improving the quality of liquidity risk management (Chapter 5)

1.19 We propose to require managers of funds investing mainly in illiquid assets to produce contingency plans for dealing with liquidity risks. We also propose to give depositaries a specific duty to oversee the processes used to manage the liquidity of the fund.

1.20 We will make further specific guidance to clarify:

- The circumstances in which it may be appropriate to suspend dealing. For a fund mainly investing in illiquid assets, the fund manager may suspend dealing before running down the liquidity in the fund, if this is in unitholders' best interests.
- How a fund manager should arrive at a fair and reasonable value for an immovable, where it needs to be sold quickly to ensure that the fund can continue to meet redemption requests as they fall due.

1.21 Finally, we propose guidance to clarify that managers of NURSs and UCITS should not build up or hold large cash buffers for a long period, merely to deal with the possibility of unanticipated high levels of requests from investors wishing to redeem their units at some point in the future.

Increased disclosure (Chapter 6)

1.22 We propose to require:

- Managers of funds that invest mainly in illiquid assets to add an 'identifier' to the name of any relevant fund – a label, that will draw attention to the nature of the fund.
- Disclosure in the fund prospectus of the details of their liquidity risk management strategies, including the tools they will use and the potential impact on investors.
- A standard risk warning to be given in financial promotions relating to such funds to retail clients. This will apply to all firms communicating a financial promotion, not just the fund manager.

1.23 A table providing an overview of our proposed remedies can be found in Annex 6.

Outcome we are seeking

1.24 We are seeking to reduce the potential for harm to investors in funds that hold illiquid assets, particularly under stressed market conditions. Our measures should:

- Help investors understand better any restrictions on access to their investments and the circumstances in which these restrictions will be placed on the funds.
- In the case of funds investing in immovables, reduce the potential for some investors to gain at the expense of others because units have been incorrectly priced, due to uncertainty about the value of assets held in the fund.
- Reduce the likelihood of a run, which could substantially reduce the value of investments for those left in the fund and possibly destabilise the market more widely.

Measuring success

1.25 If successful, we should see fewer runs on funds holding illiquid assets, and fewer complaints from retail investors about perceived unfair treatment when exiting these funds. The frequency with which funds investing in illiquid assets are suspended is not being used as a measure of success, as suspension may be in the interests of investors.

Next steps

How to respond to our consultation

1.26 You are invited to respond to this paper by 25 January 2019.

1.27 The ways in which you may submit your response are set out on page 2.

What we will do

1.28 We will consider feedback to this consultation and will publish a Policy Statement and make our final rules and guidance next year. We expect the changes to come into force one year later.

1.29 Later this year, we plan to publish a paper exploring approaches and issues relating to patient capital (where investors make long-term investments, such as in infrastructure projects, with longer term horizons for investment returns). This paper may also be of interest to readers of this CP.

2 The wider context

The potential harm we are trying to address

2.1 If successful, our proposals will better protect consumers by:

a. Increasing confidence and participation in the market by providing better protection for consumers seeking to invest in illiquid assets.

b. Preventing consumers from buying products that are unsuitable for their needs by making the impact of the illiquidity more transparent.

c. Ensuring that consumers get a fair price when selling their investments. The measures we are taking should also have a beneficial impact on market integrity and thus support the broader financial stability agenda by reducing the likelihood of runs on funds.

2.2 The proposals we are making were primarily informed by responses to our Discussion Paper on illiquid assets, findings from our review of property fund suspensions and recommendations from the International Organization of Securities Commissions (IOSCO). These are summarised below.

Discussion Paper (DP) on illiquid assets

2.3 Property fund managers' use of liquidity management tools in 2016 appears to have been effective in helping to avoid an escalation in market uncertainty following the referendum result. However, we cannot conclude, from the experience of one market event, that no changes are needed to the current policy framework. Therefore, we decided that it would be appropriate to review more broadly the current regulatory framework around open-ended funds investing in illiquid assets and published a wide-ranging DP in February 2017.

2.4 The paper, published as DP 17/1, raised questions on a series of topics, including:

- Scope, particularly how we could define what was meant by an illiquid asset in the context of fund management.
- The use of the range of available liquidity risk management tools within open-ended funds investing in illiquid assets.
- The potential for different treatment of professional and retail investors, including prevention of co-mingling or creation of different share classes for different investor types.

- Applying new rules on the portfolio structure of funds, for example by setting a cap on the proportion of illiquid assets or requiring them to hold a minimum liquidity buffer.
- Asset valuation and anti-dilution measures.
- The use of specific tools, such as deferred redemptions, reduced redemption frequency and notice periods.
- Direct intervention by the regulator during difficult market conditions.
- Requiring enhanced disclosure for funds investing in illiquid assets.
- The pros and cons of a secondary market in units of open-ended funds investing in illiquid assets, and whether we should do more to encourage the development of such a market.

Responses to the DP

2.5 We received 57 responses to the DP, mainly from the asset management sector.

2.6 Most respondents felt that retail investors should be able to invest in property funds, and that open-ended funds should not be barred from holding illiquid assets. Most also felt that fund managers should retain primary responsibility for the deployment of liquidity management tools in the interests of all investors, but there could be improvements in the governance and communication to clients of the use of these tools, as well as clarification of our expectations.

2.7 In terms of the individual liquidity management tools available to fund managers, the most substantive comments centred on liquidity buffers, redemption profiles/dealing arrangements and valuations. In summary, these were:

- There was no appreciable support for prescriptive limits/thresholds to be set for either liquidity buffers or portfolio structures.
- Most respondents supported the continuation of the ability to apply daily pricing and dealing, subject to appropriate liquidity management. A minority were critical of daily dealing, because of the perceived mismatch between the liquidity of the fund and that of the underlying assets. As a minimum, they wanted investors to have a greater choice of funds that dealt less frequently. Several raised the issue of operational challenges, in particular for platforms, of funds that dealt less than daily.
- Asset valuation and anti-dilution measures were one of the most complex areas, with a perceived lack of clarity on the differences between the tools available (for example, between dilution adjustments and levies) and when they should be deployed. There was disagreement over the status quo, with some believing it worked reasonably well but others concerned at the 'arbitrary' way in which some of the pricing adjustments could be applied.

2.8 There was strong support for improving transparency to investors on the risks involved in investing in funds dealing in illiquid assets, the circumstances in which those risks could crystallise, the broad approach to liquidity management and the specific tools that the manager would use, and the consequences for investors.

2.9 A fuller account of the feedback to DP 17/1 can be found at Annex 4.

Findings from our review of property fund suspensions

2.10 On 20 July 2017, we published the results of a supervision project that reviewed, across the value chain, the events surrounding the property fund suspensions, following the referendum on UK membership of the EU.

2.11 Overall, we found that:

- The use of suspensions, deferrals and other liquidity management tools was effective in preventing market uncertainty from escalating further.
- The quality of liquidity monitoring and management varies between different property funds.
- The valuation of real estate assets poses challenges under stressed market conditions and firms need to consider how best to deal with this issue.
- Firms could be clearer in their communications, including to end-investors, following significant market events.
- Depositaries' oversight of fund managers' liquidity management varied in practice because of the absence of any prescriptive rules in this area.

IOSCO recommendations

2.12 On 1 February 2018, IOSCO published a revised version of its Principles of Liquidity Risk Management for Collective Investment Schemes (CISs) that were originally published in 2013. The revision of the Principles was in response to recommendations issued by the FSB in January 2017. The amendments and additions emphasise, among other things:

- The need to consider the appropriate structure and dealing frequency of a fund during the design process, taking into account the target investor base, investment strategy and liquidity of the assets.
- The idea that CISs should be designed to 'give strong assurance that redemptions can be met in both normal and reasonably foreseeable market conditions', with a documented assessment of the liquidity risks forming part of the initial design process.
- The desirability of greater disclosure of a fund's liquidity risks and its liquidity risk management process and tools.

- The need for more stress testing and contingency planning to ensure that liquidity management tools can be used in a prompt and orderly manner.

2.13 Although the IOSCO recommendations are non-binding, national regulators are expected to have regard to them and consider whether national requirements need to be altered, to capture the intention of the recommendations.

Wider effects of this consultation

Longer-term impact on market for funds holding illiquid assets

2.14 The changes we are proposing should make more visible the consequences of having daily dealt NURSs holding illiquid assets. We are not proposing to require that the liquidity of the fund reflects that of the underlying assets. But we are proposing rules that should ensure that fund managers are able to deal effectively with liquidity issues that can arise during periods of market uncertainty. They will also have to make full disclosure of liquidity risks, and the tools to be used to mitigate them, to retail investors.

2.15 Over time, our proposed changes may increase the appetite of managers to design and create, and of investors to subscribe to, funds that have features that mitigate some of the liquidity risks, such as dealing arrangements that more closely reflect the time needed to sell the underlying assets which are inherently illiquid.

What we are doing

2.16 In the following chapters, we set out in detail the proposed Handbook changes on which we are now consulting. These take into account the responses received to our DP 17/1, the outcomes of our analysis of the 2016 property fund suspensions and new IOSCO Recommendations. The delay between receiving responses to the DP and producing this CP partly reflect the need to wait for the publication of the IOSCO Recommendations, but also the fact that our proposals include detailed additions and amendments across a range of areas within our COBS and Collective Investment Schemes (COLL) sourcebooks.

2.17 We are keen to have respondents' views on whether:

- our proposals are a sufficient and proportionate response to the issues identified in open-ended funds holding illiquid assets
- there are any potential unintended negative consequences of any of the measures set out in this CP
- we should consider taking any further measures to improve the framework of rules and guidance applying to this area of the market

Equality and diversity considerations

2.18 We have considered the equality and diversity issues that may arise from the proposals in this CP. Overall, we do not consider that the proposals materially impact any of the groups with protected characteristics under the Equality Act 2010. But we will continue to consider the equality and diversity implications of the proposals during the consultation period and we welcome input to this consultation on this.

3 Our approach, scope and definitions

Approach

3.1 In line with our experience of the events following the EU referendum, including the conclusions of our supervision project, the responses to the DP suggested that a radical overhaul to our rules and guidance in this area was not necessary. We agree that retail investors appear to value the ability to diversify their portfolios by gaining exposure to open-ended funds that invest in illiquid assets. Significant changes to the current regulatory regime, such as requiring that such assets be held in close-ended funds only, or by substantially restricting redemptions from open-ended funds during normal market conditions, could make the funds less attractive to retail investors, create operational problems for funds, platforms and other service providers, and could generate the type of market uncertainty that we are seeking to avoid.

3.2 Instead, we are proposing a combination of changes to rules and guidance to address shortcomings that we have identified within the existing framework.

Which funds are we targeting?

3.3 The package of remedies will have cost implications which could ultimately be borne by investors. We have considered carefully which funds should be in scope and which level of protection is appropriate for different types of investors. We want to avoid imposing requirements which are not justified in terms of the improved outcomes they achieve for consumers, against the costs they impose.

3.4 There is a framework of EU legislation in place, in particular the Alternative Investment Fund Managers Directive (AIFMD) (Directive 2011/61/EU) and the AIFMD level 2 regulations (Commission delegated regulation (EU) No 231/2013), that place requirements on fund managers in areas covered by this CP, such as liquidity management and disclosure to investors.

3.5 Our proposals do not replace those requirements but add to them where we think it is necessary to address harm and proportionate to do so, and where the relevant EU legislation permits member states to make additional rules. We particularly rely on Article 43 of AIFMD which says that, where a member state allows fund managers to market alternative investment funds (AIFs) to retail investors, it may impose stricter requirements on the fund manager or AIF than those that apply to AIFs marketed to professional investors.

Funds investing in inherently illiquid assets – FIIAs

3.6 We propose to apply many of the remedies, including most of those aimed at improving disclosure and liquidity management, to a new category of 'funds investing in inherently illiquid assets' (FIIAs). A fund would be classed as FIIA in one of two circumstances:

a. NURSs which have disclosed to their investors that they are aiming to invest at least 50% of their scheme property in inherently illiquid assets.

b. NURSs which have invested at least 50% of the value of their scheme property in inherently illiquid assets for at least three continuous months in the last twelve months, whether or not they have disclosed their intention to do so.

3.7 We have chosen the 50% threshold because we think it offers a clear distinction between mixed funds that might hold some inherently illiquid assets, but not enough to give rise to the risks we have identified, and specialist funds that aim to invest substantially in inherently illiquid assets. Although it is possible that some funds will be close to the threshold, we think that, in the vast majority of cases, it will be clear to the fund manager whether a NURS meets the definition of a FIIA.

Q1: **Is 50% the right threshold to set for a NURS to be classified as a FIIA? If not, please explain where you would set the threshold, and why.**

3.8 We believe that the 3-month window referred to in paragraph 3.6(b) gives fund managers enough time to correct any temporary, unintended breach of the 50% threshold. It would allow them to exit positions or take other actions to reduce the fund's exposure to inherently illiquid assets should the fund manager wish, without having to classify a fund as a FIIA. If they do not reduce the exposure to illiquid assets within this timescale, we think it is reasonable that the fund should be classified as a FIIA. This would allow investors to benefit from the enhanced disclosure and oversight arrangements.

Q2: **Do you agree that NURSs which have invested at least 50% of their scheme property in illiquid assets for at least 3 continuous months in the last 12 months should be classified as FIIAs, even if this is not their stated investment aim?**

3.9 Our rules permit certain types of NURS, including those that invest substantially in immovables, to provide for limited redemption arrangements. This means that units will be redeemed less frequently than twice in a calendar month, although the scheme must provide for sales and redemptions at least once every six months. Where a NURS applies limited redemption arrangements that reflect the typical time needed to dispose of the assets in it, the fund will be less exposed to liquidity issues at times of market turbulence than is the case for funds that deal more frequently. We think it is appropriate, therefore, to exempt them from the new requirements that we propose to apply to FIIAs and propose to exclude such funds from the definition of a FIIA.

Q3: Do you agree that a NURS that applies limited redemption arrangements that reflect the typical time taken to liquidate assets should be excluded from the definition of a FIIA?

3.10 The proposed definition of an inherently illiquid asset includes units in other FIIAs and in any QISs or unregulated schemes that have substantially similar features to a FIIA. This means that some feeder funds, multi-asset funds or funds-of-funds will meet the proposed definition of a FIIA, due to their holdings in other funds.

Q4: Do you agree that feeder funds, multi-asset funds and funds-of-funds with at least 50% of their scheme property invested in FIIAs, other similar funds and/or other inherently illiquid assets, should also be classified as FIIAs?

3.11 Under our proposals, it would be the responsibility of the fund manager to identify which, if any, of its funds is a FIIA and to take the appropriate steps to comply with the new requirements.

3.12 The exposure of individual funds to inherently illiquid assets may change either as a result of investment decisions or, for example, because a particular asset class has become inherently illiquid due to market developments. We expect fund managers to monitor the proportion of inherently illiquid assets in their funds and to take any necessary action.

What do we mean by inherently illiquid assets?

3.13 The DP raised the question of how to describe the types of inherently illiquid assets that might be held in open-ended funds. There was strong agreement among respondents that it would not be helpful to try to produce an exhaustive list of illiquid assets for this purpose. Instead, we are proposing a definition of an inherently illiquid asset, which reflects the type of criteria that we listed in paragraph 3.2 of the DP. In summary, we are proposing that an asset is inherently illiquid if it is 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 that 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
- a unit in a FIIA or another fund with substantially similar features

3.14 This should capture the majority of types of illiquid asset that are currently held in open-ended funds. We include units in FIIAs and other similar funds because, although these are not themselves illiquid, they invest mainly in illiquid assets and so an investor buying units in a fund which, in turn, invests in a FIIA faces very similar liquidity risks to one who invests directly in a FIIA. If we were to exclude units in FIIAs from the definition, the result would be that many of our remedies would apply to FIIAs, but not to feeder funds of FIIAs, despite the liquidity risks being substantially the same in both.

3.15 We also propose to issue guidance on a non-exhaustive list of the type of asset that will be an inherently illiquid asset. These include

- 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
- units in a property authorised investment fund (PAIF)

3.16 As new types of asset class emerge in future or markets change, we will expect market participants, particularly fund managers, to decide whether such asset classes meet the definition and so are inherently illiquid assets.

> **Q5: Do the proposed new rule and guidance adequately define existing and potential future assets that are inherently illiquid?**

Types of fund to which our proposals apply

3.17 The UK authorised funds that are permitted to invest substantially in illiquid assets are NURSs and QISs. The investment powers of these fund types are set out in the COLL sourcebook of the FCA Handbook.

3.18 All of the property funds that suspended dealing following the referendum on the UK's membership of the EU in 2016 were NURSs. As they may be promoted to the general public, our package of remedies is focused on NURSs, particularly those which invest substantially in illiquid assets.

3.19 QISs are authorised funds which are intended only for professional clients and retail clients who are sophisticated investors. They cannot be promoted more widely to retail clients. Investors in QISs are generally prepared to accept a higher degree of risk in their investments and have greater knowledge and experience than retail investors. For this reason, we believe that QISs investing substantially in illiquid assets pose a lower risk of harm to investors than do NURSs, and we do not propose to extend our remedies to QISs.

3.20 We recognise that there are some arguments for extending some of the measures to QISs, in particular those that would improve the quality of disclosure in a way that could be helpful to clients of QISs. For example, we could require that relevant QISs include the indicator of FIIA in the name of the fund, and make fuller disclosure within the prospectus of the liquidity risks and the strategy and tools the fund manager will use to deal with them. However, we do not think there is sufficient evidence of harm to apply the remedies to QISs at this time, but welcome input on this issue.

3.21 COLL 5.2 allows UCITS to make limited investments in illiquid transferable securities, but not to invest directly in non-financial assets like property or infrastructure.[2] So, there are no material risks to investors in UCITS of the type dealt with in this CP and our proposals should not have a significant impact on UCITS.[3]

> **Q6:** **Do you agree that the potential harm we are trying to address lies mainly in NURSs and the remedies should be limited in scope to NURSs? Is there a case for extending some of our proposed remedies to QISs? If so, which measures do you think should also apply to QISs investing in inherently illiquid assets?**

2 There is one exception to this rule, allowing a fund that is an open-ended investment company to own property 'essential for the direct pursuit of [its] business' (COLL 5.2.6AR (6)).

3 Our proposed guidance on the use of cash and near cash, discussed in Chapter 5 does, however, also apply to UCITS.

4 Suspension

Mandatory suspensions due to material uncertainty

4.1 We propose to introduce a new rule that requires an authorised fund manager to temporarily suspend dealing in units of a NURS where the SIV has expressed material uncertainty about immovables that account for the value of at least 20% of the scheme property.

4.2 Open-ended funds must be priced correctly to ensure that investors are treated fairly and can have confidence in the product. If there is material uncertainty about the valuation of a significant proportion of the assets in an open-ended fund, that uncertainty will be reflected in the unit price of the fund. That creates the potential for investors to be treated unfairly. In essence, the uncertainty in the value of the underlying assets may mean an investor exiting the fund receives a unit price significantly lower or higher than its underlying value. Those investors who remain invested in the fund might then see the value of their investments go up or down once it became clearer to the market the underlying value of the assets in the fund, relative to the price paid to those who exited.

4.3 Under our current rules, a manager of a NURS that holds an investment in land or a building must have a report from an appropriate valuer about that immovable (COLL 5.6.18R). The SIV is required to carry out the valuation in accordance with the relevant part of the RICS[4] Valuation Standards (The Red Book) (COLL 5.6.20R).

4.4 Current FCA guidance (COLL 6.3.6G(1)(7A)) sets out that, where the authorised fund manager, the depositary or SIV have reasonable grounds to believe that the most recent valuation of an immovable does not reflect the asset's current value, the fund manager should agree with the SIV a fair and reasonable value for the immovable. This is part of the manager's duty to carry out a fair and accurate valuation of all scheme property to determine the overall price of units.

4.5 Several respondents to the DP made the point that this provision does not work effectively in all circumstances, particularly where there is material uncertainty about a SIV's valuation of an immovable. In such cases the fund manager was unlikely to be in a better position than the SIV to determine a fair and reasonable value for the asset with any greater degree of certainty.

4.6 When there is material uncertainty about the value of the immovables held by a NURS, we think there is a good case for requiring the fund to suspend dealing temporarily, rather than continuing to buy and sell units at a price that may not accurately reflect the fund's NAV. We have chosen the term 'material uncertainty'[5] as it is already a concept that is incorporated into The Red Book as part of the methodology.

4 Royal Institution of Chartered Surveyors

5 We rely on the commentary in the RICS Red Book on material uncertainty. It states that 'for this purpose, 'material' means where the degree of uncertainty in a valuation falls outside any parameters that might normally be expected and accepted.'

4.7 The concern that some investors may be treated unfairly, and may be better served by a suspension, needs to be balanced against investors' expectations that they will be able to redeem their holdings on a daily basis, as permitted by most property funds marketed to retail investors. If only a relatively small proportion of the scheme property is subject to a material uncertainty clause, fund managers should continue to be allowed to manage the impact on the fund's overall valuation, in discussion with the SIV.

4.8 Our current rules already permit suspensions where, due to exceptional circumstances, it is in the interests of all unitholders in the authorised fund (COLL 7.2.1R). We propose to require authorised fund managers to temporarily suspend dealing in units of the fund where the SIV has expressed material uncertainty about immovables that account for the value of at least 20% of the scheme property. We propose to apply other parts of the existing rules relating to suspensions to the new mandatory suspensions. Fund managers and depositaries would not have to wait until the 20% threshold is reached before temporarily suspending dealing, if the existing test in COLL 7.2.1R is met.

Q7: **Do you agree that mandating suspension in these circumstances would be in the best interest of investors?**

Q8: **Do you agree that 20% of the scheme property is the right level at which to set the threshold for mandatory suspension? If not, please explain why a higher or lower threshold would be preferable.**

Funds with indirect exposure to immovables

4.9 Some funds have significant indirect exposures to immovables. Examples of such funds are multi-asset funds holding units in property funds as part of their portfolio, or feeder funds which hold units in PAIFs.

4.10 In turbulent market conditions, it may be difficult to obtain an accurate valuation of these funds. We propose that the requirement to suspend dealing should also apply 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. This is covered in the proposed new rule at COLL 7.2.-1R(1)(b).

4.11 This provision addresses the risks discussed above to the fair pricing of units for those leaving and remaining in the fund. Additionally, as the fund manager will not be able to sell units in the suspended funds and can only sell the non-suspended assets to meet redemption requests, the investors who have not sold their units would be exposed to an increasingly illiquid portfolio. This favours first movers over investors who are 'loyal', or simply less informed about the advantage to be gained by redeeming early. It may not ensure fair treatment of all investors.

4.12 We have chosen 20% as the threshold, as it aligns with the rule requiring suspension in funds that invest directly in immovables. The proposed rule is straightforward and should be easy to implement quickly in difficult market conditions. We considered trying to apply the threshold on a 'look through' basis. Under that approach, a fund would have to calculate its indirect exposure to immovables by considering the current portfolio of each of the funds in which it invested. However, we feel this would be complex and difficult to put into operation at times when speed might be essential.

Q9: **Do you agree that 20% of the scheme property is the right level at which to set the threshold for mandatory suspension of funds investing indirectly in immovables? If not, please explain why a higher or lower threshold would be preferable.**

Q10: **Do you agree that the threshold for suspension for a fund investing indirectly in immovables should not be calculated on a look through basis? If not, please explain how a calculation on a look through basis would work in practice.**

Role of Depositary in Suspensions

4.13 Our current rules (COLL 7.2.1R(1)) require the fund manager to gain the prior agreement of the depositary before temporarily suspending dealing in a fund. During fast moving market events, it can be a challenge for the governance structures of NURSs to keep up with developments. We observed during our supervisory work in 2016 that fund committees, depositaries and platforms co-operated and worked quickly to respond as events unfolded. Mandating suspensions in the circumstances above would provide a faster response to uncertain market conditions. It would make it less likely that any particular group of investors would suffer harm in those circumstances. When suspending due to material uncertainty, we propose that fund managers should not need to gain the depositary's consent, but should simply notify the depositary before suspending.

4.14 We propose that fund managers should be required to resume dealing in units in 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.

Q11: **Do you agree that fund managers should not need to gain the depositary's consent, but should simply notify the depositary before suspending?**

Q12: **Do you agree that fund managers should be required to resume dealing in units in 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?**

Other Amendments

4.15 We propose to update the references to the Red Book in COLL 5.6.20R and COLL 8.4.13R to reflect the latest version published by RICS.

5 Improving the quality of liquidity risk management

Better contingency planning

5.1 We propose to introduce a new rule to require managers of FIIAs to draw up and maintain contingency plans for exceptional circumstances.

5.2 In its final report in January 2018 on liquidity risk management, IOSCO included a new measure (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.' Our supervision work on property fund suspensions found that fund managers did not adequately plan, or have clear policies, for valuing their portfolios in stressed market environments.

5.3 Fund managers are already required to have liquidity management systems and procedures and identify when these tools and arrangements may be used in both normal and exceptional circumstances.[6]

5.4 This proposal will address the shortcomings that we observed in some fund managers' contingency planning. It may also help fund managers to satisfy their obligations under AIFMD in relation to FIIAs. The contingency plans must in summary:

- Describe how the fund manager will respond to a liquidity risk crystallising
- Set out the range of liquidity tools and arrangements which they may deploy in such exceptional circumstances, any operational challenges associated with the use of such tools and the consequences for investors
- Include communication arrangements for internal and external concerned parties and explain how the fund manager will work with the depositary, intermediate unitholders, third party administrators and others as necessary to implement the contingency plan

Q13: Do you agree with our proposal to require contingency plans?

Q14: Are there other elements of FIIA managers' approach to managing liquidity risk that need to be included in the contingency plan?

5.5 Our supervision work also found that where fund managers relied on third parties to implement certain liquidity management tools, those third parties were not always able

6 See Article 16(1) AIFMD transposed at FUND 3.6.3R and Articles 46 and 47, in particular 47(1)(e), Commission delegated regulation (EU) No 231/2013 ('the AIFMD level 2 regulation')

to do so in a timely manner. It is important, particularly in difficult and rapidly changing market conditions, that managers of FIIAs can rely on third parties to fulfil their role in implementing their contingency plan.

5.6 We propose to introduce a specific requirement on FIIA managers to obtain written confirmation from any third party, on which they rely on to deliver the contingency plan, that they are able to place this reliance on them.

Q15: Do you agree that the written agreement that we propose to require FIIA managers to obtain is the best way to ensure that fund managers can be confident that third parties will be able to play their part in implementing the contingency plan? If not, how do you think that we can gain this confidence?

Clarifying the use of different liquidity management tools

5.7 Fund managers in the UK have a broad range of potential tools that they may use to manage liquidity. In this respect, our regulatory framework already accommodates IOSCO's recommendation that 'as many of the liquidity management tools are available for use by [fund managers] as possible'. However, during the 2016 property fund suspensions, practice varied substantially between fund managers in how they used these tools.

5.8 The responses to DP 17/1 revealed little appetite for imposing mandatory approaches to liquidity management, such as minimum liquidity buffers, liquidity buckets or caps on the proportion of fund investments that should be made in illiquid assets. However, there was support for greater clarity from the FCA on the appropriate use of different types of liquidity management tool, for example when fair value pricing adjustments and dilution adjustments or levies could be applied.

5.9 We set out below a number of guidance provisions, clarifying how liquidity management tools can or should be used in different situations.

Rapid sales of immovables

5.10 A situation could arise where the market itself is not experiencing turbulence, but a particular fund investing in immovables is coming under pressure for idiosyncratic reasons and facing exceptionally high levels of redemption demand from investors. The fund manager and the SIV may be confident about the open market value of the immovables, but the assets may need to be offered at a discount, in order to sell quickly to meet the demand for redemption.

5.11 In this case, we believe that the fund manager should consult and agree with the SIV a fair and reasonable value for the immovable to reflect a rapid sale and have clarified this in proposed guidance.

5.12 Given the impact that this type of adjustment could have on investors, in order to value the immovable at a value that reflects a rapid sale, the intention to do so must be disclosed in the prospectus.

5.13 Fund managers who are contemplating the possible use of price reductions for rapid sales should consider carefully how this mechanism will work in practice. They may wish to agree with the SIV in advance a methodology for determining the value of the immovables, depending on how quickly they need to sell the assets. This is reflected in our proposed guidance.

Q16: Do you think that the proposed new guidance, clarifying the mechanism for reducing the price of an immovable to allow it to be sold more quickly to meet redemption demand, is helpful?

Q17: Do you agree that fund managers wanting to use this tool should be required to disclose their intention in the fund prospectus?

The use of anti-dilution measures

5.14 Fund managers commonly apply anti-dilution measures (dilution levies or adjustments) at times when funds are experiencing strong inflows or outflows. Although these may have the effect of slowing the flow of investments into or out of a fund, their primary function is not to manage liquidity. They are intended to help ensure that the transaction costs of investors dealing in the fund's units are met largely by those entering or exiting the fund and not other investors. This intention is set out clearly in COLL 6.3.8R(2) which states that 'a fund manager operating either a dilution levy or a dilution adjustment must operate that measure in a fair manner to reduce dilution **and solely for that purpose**' [our emphasis]. We remind fund managers that they should ensure that other liquidity management measures are not misclassified as anti-dilution measures.

5.15 A further measure that may be used to prevent dilution is the single swing pricing mechanism. Under this regime, when a fund experiences net redemptions or subscriptions, the price may swing to negate the impact of the expected transaction costs incurred. In practice, net outflows mean the price swings down to 'bid', while net inflows mean it swings up to 'offer'. In the case of property funds, reflecting the transaction costs, the bid-offer spread can be in the region of 6%. Our findings from the analysis of the 2016 suspensions showed that retail investors did not understand this mechanism. They tended to mistake the swing from offer to bid as poor performance, encouraging further redemptions while the funds remained open.

5.16 We do not believe that any further rules or guidance are needed to clarify the use of the anti-dilution mechanisms. However, given the capacity for retail investors to misunderstand their nature and scale, we remind fund managers of the existing obligation to disclose the details of what is meant by dilution, including any policies the fund manager is adopting to deal with it, in the fund prospectus (COLL 4.2.5R(18)). Some fund managers have also explained these mechanisms via homepages or through platforms. We consider this to be good practice, in line with Principle 7 of our Principles for Businesses (PRIN 2.1.1R(7)) that firms must pay due regard to the information needs of clients and communicate in a way which is clear, fair and not misleading. We discuss measures to improve disclosure in more detail in Chapter 6.

Liquidity buffers and first mover advantage

5.17 UCITS and NURSs, including FIIAs, may retain cash and near cash in the scheme property for the purposes outlined in COLL 5.5.3R. This may include for the pursuit of the scheme's investment objectives, the redemption of units and the efficient management of the fund in accordance with its investment objectives.

5.18 In the run-up to the EU referendum in 2016, we observed property funds increasing their liquidity ratios. They continued to maintain historically high levels of liquidity until the end of 2017. Those levels have since fallen again and are close to those observed in early 2016.

5.19 We are concerned that, unless it is done for a specific purpose which meets the requirements in COLL 5.5.3R, the accumulation of large liquidity buffers may increase the first mover advantage that exists in funds that invest in illiquid assets. An example of where it may be appropriate could be in anticipation of a large redemption order that the fund manager knows will be submitted at a future date. But, if a fund holds '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.

5.20 Fund managers also need to bear in mind the importance of meeting investors' expectations. Large cash positions create a drag on yield, diminishing the fund's performance and potentially disappointing investors who expected to be more fully exposed to the risks and rewards associated with a particular asset class. This is true even if the prospectus formally permits the fund manager to hold significant amounts of cash and near cash.

5.21 To underline the intention of COLL 5.5.3R, we propose to introduce a guidance provision that applies to UCITS and NURSs.[7] It sets out that these 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.

> **Q18:** **Do you agree the proposed guidance would discourage the speculative accumulation of large liquidity buffers and help to reduce first mover advantage in funds investing in inherently illiquid assets? If not, is there a more appropriate way to achieve this?**

Guidance on the use of suspensions

5.22 We noted in the conclusions of our supervision project in 2016 that the liquidity management tools that fund managers used, including suspensions, were effective in preventing a further escalation of market uncertainty. A number of respondents to our DP called on the FCA to take steps to remove the perceived stigma from fund suspensions.

5.23 As discussed in Chapter 4, we plan to require that a NURS suspends if the SIV has expressed material uncertainty about the value of immovables accounting for at least 20% of the scheme property. We considered whether the guidance at COLL 7.2.2G on the use of suspensions is appropriate for open-ended funds that invest in illiquid assets. We concluded that the guidance remains appropriate for other funds to which it applies. But, in the case of FIIAs, there may be circumstances where suspension is in the best interests of unitholders, for example, where redemption demand cannot be met without significantly depleting the fund's liquidity and/or without selling off scheme property at a substantial discount.

7 The application to NURSs will be achieved by an appropriate amendment to COLL 5.6.22AG

5.24 We are proposing new guidance to this effect at COLL 7.2.2G(1A) This may help to ensure that priority is always given to protecting investors' interests. It may also have the effect of further reducing first mover advantage in FIIAs, because fund managers should feel more able to suspend rather than using all the available liquidity to meet redemption requests.

Q19: Do you agree with the proposed guidance on the use of suspensions for funds investing in inherently illiquid assets? If not, how, if at all, do you think the existing guidance at COLL 7.2.2G should be amended in respect of FIIAs?

Depositary oversight of liquidity risk management processes

5.25 All authorised funds have an independent depositary whose role is to provide investor protection by safeguarding the fund's assets, monitoring the fund's cash flows and providing oversight of the fund manager. This includes taking reasonable care to ensure that the scheme is managed by the authorised fund manager in accordance with our rules. Depositaries must give prior agreement when a fund manager wants to suspend dealing in a fund. They can also require funds to suspend on their own initiative.

5.26 Our work on the property funds suspensions in 2016 found that, generally, depositaries are effective in checking that fund managers are meeting their responsibilities under the Investment Funds sourcebook of the FCA Handbook (FUND) and COLL in these matters. However, the current rules do not prescribe depositaries' responsibilities with respect to ensuring that fund managers have robust systems in place to manage liquidity risk or monitor the liquidity profile of funds.

5.27 As outlined above, we intend to require managers of FIIAs to draw up detailed contingency plans, setting out how they would react if a liquidity risk crystallised. We consider it would be appropriate to specify that depositaries' duties in respect of FIIAs also include oversight of the fund manager's liquidity management systems and processes.

5.28 We recognise that this will impose some additional costs on FIIAs. Depositaries will likely seek to be paid for carrying out their new oversight duties. But we believe that depositary oversight of the liquidity management function will help to ensure that fund managers more consistently manage liquidity risk in FIIAs. They will also provide an independent evaluation of the adequacy of the liquidity management arrangements the fund manager has in place. Our supervisory work revealed that some depositaries are already providing a degree of oversight in this area. For those that are not, we believe that the proposed new task is a natural extension of their existing remit and they should have, or be able to gain, the necessary expertise to carry it out.

5.29 Our proposed new rule requires the depositary of a FIIA to assess regularly the liquidity profile and liquidity risks presented by the FIIA's scheme property and to devise procedures for overseeing the fund manager's liquidity management. This is comparable to the general requirements around depositaries' oversight duties, as set out in Article 92 of the AIFMD level 2 regulation.

5.30 The second part of the provision then sets out the parts of COLL, FUND and the AIFMD level 2 regulation over which the depositary of a FIIA will be required to take reasonable care to oversee the AFM's compliance. This requirement closely parallels the existing general duties of the depositary, as set out in COLL 6.6.4R(1). In relation to these new functions, we propose that depositaries should be able to delegate only administrative or technical tasks to third parties.

Q20: Do you agree that it is appropriate to extend depositaries' duties to include oversight of FIIAs' liquidity management processes?

Q21: Do the proposed requirements cover all the aspects of liquidity management prescribed by the current framework of rules, that depositaries should oversee?

6 Increased disclosure

6.1 Open-ended funds that invest in illiquid assets, but offer the opportunity to redeem frequently, often on daily basis, represent a risk to retail investors under extreme market conditions that other funds, investing in more liquid assets, do not. Although the occasions when these liquidity risks may crystallise are rare and unpredictable, we believe it is important that investors are aware of these risks.

6.2 As a way of decreasing the likelihood that retail clients invest in funds unsuitable for their individual financial circumstances, we believe that:

- it is necessary to signpost the liquidity risks in FIIAs, which have a significantly higher probability of suspending than other funds
- a prescriptive risk warning is needed in financial promotions provided to retail clients about those products
- fund managers should outline in the prospectus the nature of the liquidity risks in funds that invest in inherently illiquid assets, and the tools and arrangements they propose to use to mitigate them

6.3 We believe that these proposals are consistent with Recommendation 7 of IOSCO's report on liquidity risk management[8] and the responses that we received to our DP on the question of improved disclosure. Many respondents recognised the need for greater transparency on:

- the risks involved in investing in a fund holding illiquid assets
- the circumstances in which those risks to the fund could crystallise
- the range of liquidity management tools that the fund manager had at their disposal
- the scenarios in which these might be used
- the consequences for investors

Signposting liquidity risks

6.4 Being able to exit investments is a core feature of funds. Both open-ended and closed-ended funds which are widely distributed via platforms have mechanisms allowing investors to exit their investments in an easy and timely manner. Retail investors may suffer harm if they are unable to access invested capital as expected, or only able to do so at a significant cost.

6.5 We propose to signpost that a fund invests in inherently illiquid assets by requiring managers of FIIAs to add '– a fund investing in inherently illiquid assets' to the final part of

8 Recommendation 7 states that a fund manager 'should ensure that liquidity risk and its liquidity risk management process are effectively disclosed to investors and prospective investors.' They added further guidance to the recommendation, including on the disclosure of the use of 'additional' liquidity management tools and what this would mean for investors.

the name of FIIAs. For example, a fund currently presented by the fund manager as 'The Blue Fund' would be labelled 'The Blue Fund – a fund investing in inherently illiquid assets'.

6.6 The proposed requirement would apply to written communications that relate to a FIIA and are provided to or seen by retail clients. It would require fund managers to include the new identifier where its appearance would best meet the purpose of highlighting the illiquidity of the fund's underlying investments. But the identifier would not have to be used every time the name of the fund was mentioned – provided it was displayed in the best way of bringing the matter to the attention of the retail investor. The label would be included in a key information document.

> **Q22: Do you agree that using an identifier would effectively highlight that FIIAs are fundamentally different in regard to liquidity than other authorised funds?**

Risk Warning

6.7 There are already requirements for relevant liquidity risks to be disclosed to investors under the Packaged retail and insurance-based investment products (PRIIPs) Regulation (Regulation (EU) No 1286/2014)[9] or in the Key Investor Information Document (KIID) equivalent document for NURSs[10] and as a result of the Markets in Financial Instruments Directive (MiFID).[11]

6.8 To emphasise further the liquidity risks inherent in FIIAs, we are also proposing new rules requiring the following risk warning to be given in financial promotions provided to retail clients: '[Name of fund] invests 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.' By key information document, we are referring to either the PRIIPs Key Information Document or the KIID equivalent document for a NURS, as both types of disclosure are currently permitted. These documents and the prospectus will contain further detailed information on liquidity risks.

6.9 This requirement will apply to all firms communicating financial promotions relating to FIIAs, whether in relation to their MiFID or non-MiFID business. It will also apply to relevant firms when approving financial promotions in relation to FIIAs. It will not only apply in relation to financial promotions produced by a FIIA's manager. Other firms in the value chain, such as intermediaries and platforms, who may be promoting FIIAs to retail investors, will also be required to provide this risk warning. The requirement will not affect the content of key investor documents or the prospectus, as these are already subject to their own requirements about risk warnings that need to be included.

6.10 Labelling a FIIA by using an identifier highlights the illiquid nature of the fund to retail clients, including those who acquire units on an execution-only basis. This, together with the risk warning, should give investors early notice that FIIAs have special characteristics, which they need to understand and consider carefully before investing.

9 and Article 3(2)(b) Commission Delegated Regulation (EU) 2017/653/EU supplementing PRIIPs Regulation by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents.

10 COLL 4.7.3AR and Section 2, Article 8 COLL Appendix 2

11 Article 24(4)(b) MIFID and Article 48 of the MiFID Org Regulation

> **Q23: Do you agree that that the risk warning would contribute to better understanding of the risks by investors in FIIAs?**

Disclosure in prospectus

6.11 Investors and intermediaries should have an opportunity to understand thoroughly in advance how a fund manager will manage a FIIA where liquidity issues arise. We are proposing that a FIIA's prospectus should include the following:

- **i.** an explanation of the risks associated with the scheme investing in inherently illiquid assets and how these might crystallise
- **ii.** a description of the tools and arrangements the authorised fund manager would propose to use, including those FCA rules require them to use to mitigate the risks referred to at (i)
- **iii.** details of the circumstances in which these tools and arrangements would typically be deployed and the likely consequences for investors.

These measures supplement existing prospectus disclosure requirements under AIFMD as transposed in FUND 3.2.2R(8).

6.12 We propose to provide guidance on the types of liquidity management tools and arrangement that should typically be described, as part of this enhanced disclosure.

6.13 Our aim is that, by explaining in advance the liquidity risks and how fund managers propose to mitigate them, retail investors will be better placed to choose the right product. This should help to avoid a situation where the fund is managed differently to how investors had expected. It should also help market participants and investors understand why similar funds may be managed differently in response to the same market events.

> **Q24: Do you think that our proposals relating to the prospectus are sufficient to provide investors and professionals who act on their behalf with sufficient information about liquidity risk management in FIIAs? If not, what additional information should be disclosed? And where and how would disclosure be most efficient?**

Next Steps

6.14 We envisage that our proposals should come into force a year after we make our final rules. That should minimise any extra cost for fund managers and others, in particular in relation to disclosure, as relevant material can be amended to bring it into line with our new requirements when it is reviewed in the normal course of business.

> **Q25: Do you agree that our new requirements should come into force a year after we make our final rules? Are there any parts of the instrument that should take effect earlier?**

Annex 1
Questions in this paper

Q1: **Is 50% the right threshold to set for a NURS to be classified as a FIIA? If not, please explain where you would set the threshold, and why.**

Q2: **Do you agree that NURSs which have invested at least 50% of their scheme property in illiquid assets for at least 3 consecutive months in the last 12 months should be classified as FIIAs, even if this is not their stated investment aim?**

Q3: **Do you agree that a NURS that applies limited redemption arrangements that reflect the typical time taken to liquidate assets should be excluded from the definition of a FIIA?**

Q4: **Do you agree that feeder funds, multi-asset funds and funds-of-funds with at least 50% of their scheme property invested in FIIAs, other similar funds and/or other inherently illiquid assets, should also be classified as FIIAs?**

Q5: **Do the proposed new rule and guidance adequately define existing and potential future assets that are inherently illiquid?**

Q6: **Do you agree that the potential harm we are trying to address lies mainly in NURSs and the remedies should be limited in scope to NURSs? Is there a case for extending some of our proposed remedies to QISs? If so, which measures do you think should also apply to QISs investing in inherently illiquid assets?**

Q7: **Do you agree that mandating suspension in these circumstances would be in the best interest of investors?**

Q8: **Do you agree that 20% of the scheme property is the right level at which to set the threshold for mandatory suspension? If not, please explain why a higher or lower threshold would be preferable.**

Q9: **Do you agree that 20% of the scheme property is the right level at which to set the threshold for mandatory suspension of funds investing indirectly in immovables? If not, please explain why a higher or lower threshold would be preferable.**

Q10: **Do you agree that the threshold for suspension for a fund investing indirectly in immovables should not be calculated on a look through basis? If not, please explain how a calculation on a look through basis would work in practice.**

Q11: **Do you agree that fund managers should not need to gain the depositary's consent, but should simply notify the depositary before suspending?**

Q12: **Do you agree that fund managers should be required to resume dealing in units in 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?**

Q13: **Do you agree with our proposal to require contingency plans?**

Q14: **Are there other elements of FIIA managers' approach to managing liquidity risk that need to be included in the contingency plan?**

Q15: **Do you agree that the written agreement that we propose to require FIIA managers to obtain is the best way to ensure that fund managers can be confident that third parties will be able to play their part in implementing the contingency plan? If not, how do you think that we can gain this confidence?**

Q16: **Do you think that the proposed new guidance, clarifying the mechanism for reducing the price of an immovable to allow it to be sold more quickly to meet redemption demand, is helpful?**

Q17: **Do you agree that fund managers wanting to use this tool should be required to disclose their intention in the fund prospectus?**

Q18: **Do you agree the proposed guidance would discourage the speculative accumulation of large liquidity buffers and help to reduce first mover advantage in funds investing in inherently illiquid assets? If not, is there a more appropriate way to achieve this?**

Q19: **Do you agree with the proposed guidance on the use of suspensions for funds investing in inherently illiquid assets? If not, how, if at all, do you think the existing guidance at COLL 7.2.2G should be amended in respect of FIIAs?**

Q20: Do you agree that it is appropriate to extend depositaries' duties to include oversight of FIIAs' liquidity management processes?

Q21: Do the proposed requirements cover all the aspects of liquidity management prescribed by the current framework of rules, that depositaries should oversee?

Q22: Do you agree that using an identifier would effectively highlight that FIIAs are fundamentally different in regard to liquidity than other authorised funds?

Q23: Do you agree that that the risk warning would contribute to better understanding of the risks by investors in FIIAs?

Q24: Do you think that our proposals relating to the prospectus are sufficient to provide investors and professionals who act on their behalf with sufficient information about liquidity risk management in FIIAs? If not, what additional information should be disclosed? And where and how would disclosure be most efficient?

Q25: Do you agree that our new requirements should come into force a year after we make our final rules? Are there any parts of the instrument that should take effect earlier?

Annex 2
Cost benefit analysis

1. The Financial Services and Markets Act 2000 (FSMA), as amended by the Financial Services Act 2012, requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish 'an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made'.

2. This analysis presents estimates of the significant impacts of our proposal. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide estimates of outcomes in other dimensions. Our proposals are based on carefully weighing up these multiple dimensions and reaching a judgement about the appropriate level of consumer protection, taking into account all the other impacts we foresee.

Market failure analysis and the proposed remedies

3. Open-ended funds investing in illiquid assets have a potential structural liquidity mismatch which, under stress, can create a first mover advantage that may lead to runs and sales at reduced prices. For example, following the EU referendum, open-ended property funds experienced a surge in redemptions; some fund managers had to suspend dealing and adjust asset valuations; a few sold properties at a discount to their open market value, to rebuild cash positions; and investors may have lost money as a result.

4. The remedies in this CP aim to reduce harm to retail investors and mitigate potential systemic risks, threatening market integrity. We set out a definition of funds investing in inherently illiquid assets (FIIAs) in paragraph 3.6. Subject to an exception with regards to funds with limited redemption periods, NURSs will be in scope if their investment objectives and policy published in the instrument constituting the fund and the prospectus aims to invest at least 50% of the value of the scheme property in inherently illiquid assets; or 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. We propose to apply most of our new requirements to FIIAs. Our guidance to clarify that fund managers should not accumulate or hold cash and near cash for a significant duration in anticipation of unusually high and unpredictable volumes of redemption requests will apply to NURSs and UCITS.

5. Additionally, firms involved in the distribution of funds, such as intermediaries and platforms, promoting FIIAs to retail investors should take note of the proposed provisions in COBS 4.5.16R and COBS 4.5A.17R on giving a risk warning in financial promotions of FIIA's.

6. Our proposed remedies aim to:

- **Reduce the risk of harm to investors** by
  1. requiring NURSs holding immovables to suspend dealing when there is material uncertainty about at least 20% of the value of the fund's scheme property
  2. requiring NURSs to suspend dealing when at least 20% of the value of the scheme property is invested into other funds which have suspended due to material uncertainty
- **Improve liquidity management** by
  1. requiring depositaries to provide oversight of fund managers' liquidity management
  2. issuing guidance on the use of (i) liquidity buffers and (ii) suspensions to reduce first-mover advantages
  3. improving contingency planning
- **Reduce the likelihood of unsuitable outcomes** by
  1. adding the identifier '– a fund investing in inherently illiquid assets' in the final part of a fund's name in written communications to retail investors
  2. providing a risk warning in financial promotions for FIIA funds
  3. improving prospectus disclosures

7. We now assess costs and expected benefits due to the proposals.

Cost decomposition

Compliance costs

8. Our proposed rules require fund managers to assess whether each NURS they manage is within scope of our proposed definition of a FIIA. The majority of NURSs invest most of their assets into liquid assets, so the assessment should be straightforward for most firms and within their BAU running costs. For firms managing funds holding illiquid assets near the threshold, we estimate an average one-off cost of £9,800 per fund. The estimate is based on 5 'person days' of compliance staff work and 2 working days of external legal advice.[12] We do not expect feeder funds to incur any material costs as their assessment would follow the master-funds in which they invest.

9. Based on the available data, we expect approximately 24 NURSs to be near or above the threshold in addition to PAIFs. Due to the definition of inherently illiquid assets, the assessment must be done on a fund-by-fund basis which in practice only the

12 An average annual staff cost to the AFM £80,000 per person, dividing by 220 working days, we obtain the daily cost per person, £363.64. The external legal advice is estimated by multiplying two working days (16 hours) by the estimated average cost per hour (£500). See also 'Consultation on implementing asset management market study remedies and changes to Handbook', CP17/18: https://www.fca.org.uk/publication/consultation/cp17-18.pdf

fund manager can do with a high degree of certainty. This is because the assessment presumes access to a range of data and analysis (such as each fund's current and recent portfolio breakdown compared to market liquidity of different asset types which each fund holds), which for some funds only the fund manager will have. However, we do not expect PAIFs to incur any significant costs in assessing whether they fall within the definition of FIIA's.[13] On the basis that 24 NURSs are near or above the threshold the overall one-off compliance cost adds up to approximately £235,000.

10. Firms also need to ensure that they monitor whether funds they manage cross the 50% threshold for 3 continuous months, as the value of individual assets in portfolios changes, assets are replaced and changes in circumstances lead certain assets to become inherently illiquid. We do not expect this additional monitoring to substantially change the already ongoing monitoring costs as firms are already subject to liquidity monitoring requirements and the threshold would be wrapped up in the overall reporting.

Costs for reducing the risk of harm to costumers

11. Our proposals do not require investors to switch funds. We assume that investors will not choose to switch investments if this would be net costly to them. So, we do not include any transaction or tax liability costs for investors in our estimates.

12. Funds may suspend more frequently because of our proposals. Investors who want to redeem their units may not be able to do so when the fund is suspended. However, our fund suspension proposal reduces the risk of investors redeeming at a unit price which has been significantly reduced due to liquidity issues during uncertain market conditions. We have estimated that, after the EU referendum, suspended funds sold properties on average at a 2% discount. This is likely to be higher than most investors' opportunity costs of not being able to redeem their units/shares immediately.

13. Additionally, since our remedies aim to improve suitability, we assume that investors requiring constant access to their assets will be less likely to invest in open-ended funds holding inherently illiquid assets. However, they would still be able to invest in listed products holding the same type of assets.

Costs for improving liquidity management

14. We propose that depositaries provide ongoing oversight of fund managers' liquidity management. Depositaries already have to provide daily cash reconciliations and should already have access to data and necessary understanding needed to provide this oversight for FIIAs. However, we expect the proposal to increase depositaries' operational costs, and so funds' annual on-going costs by £5.6m.[14]

15. We do not expect any significant incremental cost from the guidance that it may genuinely be in the best interests of unitholders for FIIAs to suspend before significantly depleting the fund's liquidity and/or without selling off scheme property at a substantial discount to its open market value.

13 This is due to tax legislation which requires PAIF's to mainly invest directly into property [insert relevant tax legislation] and the assessment of feeder PAIFs will follow that of master PAIFs. A few PAIFs may fall within our proposed deferred redemptions exception.

14 This is based on a depositary cost of 0.2% of NAV. We expect the proposal to increase the ongoing costs of depositaries by 10%, so in this case this would amount to 0.02% of NAV. Total NAV in PAIFs adds up to £17.6b, implying £3.5m of extra costs for these funds. PAIFs are 62.5% of the estimated in-scope funds (40 out of 64). We assume the rest of the funds face analogous costs, so we expect total on-going costs of £5.6m per year.

16. For FIIAs, fund managers need to implement and maintain adequate liquidity management contingency plans. This includes setting out how they will work with relevant third parties and obtain written agreement from third parties that they rely on to deliver their contingency plans. Our rules aim to improve upon already existing requirements to have contingency plans. We also estimate an average one-off cost of £9,800 per fund to negotiate and set up the updated contingency plans.

17. We expect most PAIFs (approximately 40 out of 55) will incur these costs. Only a few of them have limited redemptions and sufficiently long arrangements reflecting the time to sell, liquidate or close out the inherently illiquid assets, to not fall in scope of the definition of a FIIA. If we add the estimated 24 NURSs meeting the FIIAs definition, the total number of funds which we expect will incur the costs of revising contingency plans is approximately 64.

18. The overall one-off liquidity management cost adds up to £627,000 for in-scope funds. But, as fund managers must obtain written agreement from third parties, then third parties will also need to negotiate and possibly change their procedures. Following a reasoning similar to the one for funds, we expect an overall one-off cost up to £627,000 also for third parties having to negotiate with FIIAs. This assumes that the third party or parties from which a fund manager is seeking written agreement incur the same aggregate one-off costs as the fund manager. The total one-off liquidity management cost should be approximately £1.25m.

19. Fund managers also need to review contingency plans periodically and ensure they can adhere to them. We expect firms to have these reviews according to the Alternative Investment Fund Managers Directive (AIFMD) requirements, and within existing BAU running costs.

Costs for reducing the likelihood of unsuitable outcomes

20. Our proposed rules will require authorised fund managers of FIIAs to include the identifier '– a fund investing inherently illiquid assets' in the fund's name and improve prospectus disclosures about FIIAs. This will trigger a review of FIIAs' documentation involving compliance, legal and internal sales departments. We expect 2 'person days' of work to identify, draft and review and approve for each affected fund.

21. As we are considering approximately 64 FIIAs and expecting an average £364 daily rate per person, the overall one-off costs to add the identifier and improve the prospectus disclosure add up to approximately £47,000.

22. Prospectus disclosures needs to be reviewed occasionally. But firms already review and update their documentation on annual basis. So, on-going costs for reducing the likelihood of unsuitable outcomes are within ongoing BAU costs.

23. We do not expect any significant incremental costs from communicating a risk warning in financial promotions of FIIAs for firms involved in the distribution of funds. Our proposal is not retrospective and we suggest that the requirement should come into force twelve months after the rule is made. We therefore believe that firms involved in the distribution of funds can update the relevant material during the normal course of their business.

Overall costs

24. Overall, we estimate the total one-off costs of our proposal to amount to £1.53m and ongoing costs to amount to £5.6m a year.

Benefits we expect to see

25. We believe the remedies will reduce the first-mover advantage and the risk of a run on funds. The remedies should also decrease the risk of funds having to sell at prices which do not reflect the properties open-market value. Consequently, our remedies should reduce systemic risks, which may threaten market integrity.

26. Reducing the risk of a run on funds will benefit those investors who, in case of a run, remain in a fund valued at a price which has been reduced due to liquidity issues. As a run can undermine confidence in other funds and potentially spread, the remedies will also benefit investors in funds which are not in scope.

27. As a result of our disclosure remedies, we also expect investors, intermediaries such as financial advisors and wealth managers, to better understand funds' investment objectives and the risk of not being able to redeem on demand. Investors should be better able to identify products that best suits their needs.

Conclusions

28. We believe the positive benefits that may arise from a reduction of risks to market integrity and an increase of investors' welfare justify the overall one-off cost of £1.53m and ongoing costs of £5.6m a year.

Annex 3
Compatibility statement

Compliance with legal requirements

1. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation, including an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under the Financial Services and Markets Act 2000 (FSMA).

2. When consulting on new rules, the FCA is required by section 138I(2)(d) FSMA to include an explanation of why it believes making the proposed rules is (a) compatible with its general duty, under s. 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, and (b) its general duty under s. 1B(5)(a) FSMA to have regard to the regulatory principles in s. 3B FSMA. The FCA is also required by s. 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.

3. This Annex also sets out the FCA's view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (s. 1B(4) FSMA). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.

4. In addition, this Annex explains how we have considered the recommendations made by the Treasury under s. 1JA FSMA about aspects of the economic policy of Her Majesty's Government to which we should have regard, in connection with our general duties.

5. This Annex includes our assessment of the equality and diversity implications of these proposals.

6. Under the Legislative and Regulatory Reform Act 2006 (LRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRA.

The FCA's objectives and regulatory principles: Compatibility statement

7. The proposals set out in this consultation are primarily intended to advance the FCA's operational objective of protecting consumers. They are also relevant to the FCA's market integrity objective.

8. In formulating our proposals for consumer protection, we have considered the particular risks that may arise when open-ended funds invest in illiquid assets. We have sought to identify ways in which these may be mitigated in a proportionate way, while still allowing retail investors access to products that can help to diversify their investment portfolios. Our remedies are focused on products that are available to mainstream investors. So, we have largely excluded funds that are open only to institutional or sophisticated retail investors, who generally require a lower level of protection. Ensuring that consumers have the information they need to understand fully the risks involved in funds that invest in inherently illiquid assets is a key element of the package of remedies that we are proposing.

9. We consider these proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well because they require funds to suspend dealing if the value of immovables which account for at least 20% of the scheme property is subject to material uncertainty. We believe that this is preferable to the current position where the fund may continue to deal in these circumstances, with the unit price based on a 'fair and reasonable' value for the immovables that the fund manager has agreed with the SIV. We also believe that providing retail investors with greater information about the liquidity risks inherent in such products will enable them to make better investment choices. For the purposes of the FCA's strategic objective, 'relevant markets' are defined by s. 1F FSMA.

10. In preparing the proposals set out in this consultation, the FCA has had regard to the regulatory principles set out in s. 3B FSMA. We cover the most relevant of these below.

The principle that a burden or restriction should be proportionate to the benefits

11. We have undertaken a cost-benefit analysis of our proposals which is outlined in Annex 2 of this CP, and believe that the costs of our proposals are proportionate to the benefits.

12. Our proposals amend the current framework of rules that apply to funds investing in inherently illiquid assets, to tighten up the disclosure requirements and improve liquidity risk management. They complement existing requirements under FCA rules in COBS and COLL, as well as EU legislation such as AIFMD. We consider that this is a proportionate response to issues that have arisen in such funds, particularly during periods of market uncertainty. Our remedies are focused on NURSs that are marketed to the general public, who are in greatest need of protection. As noted earlier, we have decided against a more radical intervention in the design of funds investing in inherently illiquid assets. We believe this would be disproportionate to the risks that these products present to consumers or to the integrity of markets.

The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term

13. The asset management industry is a vital source of economic growth and one of the most important providers of liquidity needed for the smooth functioning of markets. Currently, funds investing in inherently illiquid assets mainly invest in commercial property. However, the Government is seeking to promote sustainable long-term growth by encouraging greater private investment in 'patient capital', for example through infrastructure and venture capital funds. By maintaining the ability of retail clients to invest in such funds, within a more robust regulatory framework, our proposals permit investments that could contribute towards the sustainability of UK economic growth.

The general principle that consumers should take responsibility for their decisions

14. Our proposals do not remove investors' responsibility for their financial decisions. They improve the information to be disclosed to investors and advisors on the risks of investing in a fund that invests in inherently illiquid assets and what the consequences may be for investors. We expect the proposals to enable consumers to take better-informed investment decisions, and make it more likely that they will invest in products which are suitable for their individual needs. However, the final responsibility for their decisions will remain with them.

The principle that we should exercise of our functions as transparently as possible

15. We engaged with a broad range of stakeholders by issuing a DP last year. We have reflected the views expressed in the responses to the DP in this CP. We will continue to engage with stakeholders throughout the consultation process, before making any rules.

Expected effect on mutual societies

16. We do not expect the proposals in this paper to have a direct impact on mutual societies, as they are not within the scope of this CP.

Compatibility with the duty to promote effective competition in the interests of consumers

17. In preparing the proposals as set out in this consultation, we have had regard to the FCA's duty to promote effective competition in the interests of consumers.

18. In other jurisdictions, open-ended funds may not invest in illiquid assets or, if they do, there are significant mandatory restrictions on redemptions for investors wishing to sell their units. By allowing open-ended funds to continue to invest in illiquid assets, but introducing new rules on the use of liquidity management tools and enhanced oversight and disclosure requirements, we are providing retail investors with an appropriate level of protection, without substantially affecting the level of competition within the market. Indeed, to the extent that the enhanced disclosure of the risks associated with investing in FIIAs enables retail investors to take better-informed investment decisions, our measures will promote more effective competition and improve outcomes for consumers.

Equality and diversity

19. We are required under the Equality Act 2010 in exercising our functions to 'have due regard' to the need to eliminate discrimination, harassment, victimisation and any other conduct prohibited by or under the Act, advance equality of opportunity between persons who share a relevant protected characteristic and those who do not, and to foster good relations between people who share a protected characteristic and those who do not.

20. We do not believe the policy proposals in this CP raise equality or diversity questions or other conduct issues covered by the Equality Act 2010 but we welcome comments on any issues you believe may arise.

Legislative and Regulatory Reform Act 2006 (LRRA)

21. We have had regard to the principles in the LRRA for the parts of the proposals that consist of general policies, principles or guidance. We consider that they are proportionate and promote our statutory objectives of consumer protection and market appropriately, without creating undue burdens on the asset management industry, nor adversely impacting competition.

22. We have had regard to the Regulators' Code for the parts of the proposals that consist of general policies, principles or guidance and consider that the proposals are proportionate to the potential harm to consumers or risks to our market integrity objective identified.

Annex 4
Summary of responses to DP 17/01

1. We published a DP in February 2017 on illiquid assets and open-ended funds. This Annex summarises the main points that respondents made on each of the questions that we asked in that DP and sets out briefly our policy response.

Q1: Do you have any comments on our description of the types of inherently illiquid assets that might be held in open-ended funds? Are there others you would consider inherently illiquid?

2. Respondents generally agreed with the examples outlined in paragraphs 3.4-3.12 of the DP. A few explicitly welcomed the fact that the paper considered liquidity of assets more broadly, rather than focusing solely on property, although one cautioned that including infrastructure was confusing, as infrastructure funds behaved differently to property funds under stressed market conditions.

3. Some respondents suggested additional assets that could be considered illiquid, including:

- thinly-traded Alternative Investment Market (AIM)-listed stocks
- small and microcap equities
- private debt securities
- secured loans
- limited partnership funds
- insurance-linked securities
- catastrophe bonds

4. By contrast, several firms challenged whether all of those assets identified as illiquid in the DP (eg unlisted securities, structured products and securitisations) were uniformly illiquid. For example, SPVs could hold highly liquid asset-backed securities traded on a recognised market. One firm pointed out the need to consider indirect holdings of illiquid assets (eg model portfolios, funds of funds).

5. A number of respondents agreed that liquidity was a fluid concept and that some assets now considered liquid could become illiquid, depending on developments in the market environment. There was general agreement that the correct approach was to describe common features of illiquid assets (eg a shallow market with few potential buyers/sellers; sale of asset not generally possible in less than X days; difficulty in timely valuation), rather than attempt to produce an exhaustive list of illiquid asset types.

Our response

There was no support for a prescriptive approach involving compiling lists of illiquid asset types, especially given that the degree of liquidity can vary within any set asset class, and that asset classes themselves can become more or less liquid, depending on wider market developments.

We have, therefore, broadly carried forward into our proposals the approach set out in the DP, by creating a mixed definition, which prescribes some inherently illiquid assets, while listing the characteristics of others. In our definition, we have drawn on the term 'readily realisable securities', which is already defined in the Handbook.

Q2: Do you have any observations on our analysis of liquidity management tools? Are there other factors affecting the liquidity management of open-ended funds investing in illiquid assets that we should take into account?

General

6. A few respondents stressed that retail investors should continue to be able to invest in property funds, and that open-ended funds should not be barred from holding illiquid assets. One suggested that the FCA permit long-term savers to invest in institutional open-ended funds eg QISs with monthly or quarterly redemption periods, subject to a limit on the overall exposure to less liquid assets.

7. There was strong support among respondents that fund managers should remain responsible for managing liquidity risk and should continue to have access to a broad variety of tools to do this. Several mentioned the need to deter first-mover advantage and to protect the interests of long-term investors. Most thought that fund managers should remain in control of the deployment of liquidity management tools. A number commented that the FCA should provide more clarity on its expectations over the application of liquidity management tools and should promote good practice.

8. Respondents also underlined the need for better disclosure to investors of liquidity risks, the tools that fund managers had to deal with them, the circumstances in which they would be deployed and any associated fees and charges. One respondent thought it would be useful to have more guidance on communications to investors in this area.

Portfolio structure and liquidity buffer

9. Several respondents noted that cash holdings did not fully address the underlying challenge of holding illiquid assets in daily-dealt funds.

10. Many respondents noted the trade-off between liquidity and yield as holding substantial liquidity buffers acted as a drag on returns and could encourage first-mover activity during periods of market stress. A few suggested that retail investors should not expect to have easy access to property fund investments, noting that these generally formed only a small proportion of their overall wealth and investors should not be reliant on these holdings to meet short-term liquidity needs.

11. There was no support for the imposition of prescriptive approaches such as mandatory minimum cash holdings or a maximum on individual portfolio holdings as these could be a barrier to innovation. Respondents noted that limits on portfolio investments could impede investment strategies and be difficult to adhere to, for example if redemptions were running at a high level.

12. A few respondents supported greater use of real estate investment trusts (REITs) or property shares instead of cash. However, a number of others cautioned that REITs (as well as property shares) were not necessarily a good proxy for direct property holdings. Respondents raised potential concerns, including that:

- their apparent liquidity could be illusory, given the illiquidity of the underlying assets.
- there was a potential for price volatility, with REITs trading at a substantial premium or discount to the NAV of the underlying assets; and
- they could change the risk profile of the fund and correlate it more closely to equity-based investments.

Our response

We agree with the reservations that some respondents expressed about the effectiveness of cash buffers to deal with liquidity issues that funds investing in illiquid assets may face. We discuss this in more detail below, in our response to comments received on Q4 in the DP.

REITs (and property shares and derivatives) might appear to offer a means for fund investors to gain exposure to property as an asset class, without some of the liquidity issues around direct property holdings. But – even if these benefits materialised – this could be at the expense of greater volatility and higher correlation with other asset classes. We think it is appropriate to monitor the use of such instruments, but that there is not a clear case for the FCA actively to encourage their use.

Understanding investors' behaviour

13. There was general support for the idea that fund managers should seek to understand better their investors' behaviour. At the same time, a number of respondents argued that there were limitations on the usefulness of any analysis as investor behaviour can be irrational and unpredictable.

14. Some respondents pointed to the role they felt that intermediaries – in particular discretionary investment managers operating model portfolios – had played in increasing redemptions in property funds in the run-up to the EU referendum. In response to falling returns from property investment, as well as uncertainty about the outcome of the referendum, discretionary managers had already started to reduce the proportion of property in their clients' portfolios in the months leading up to the referendum.

15. A few respondents said that fund managers' ability to have oversight of their end-clients was limited by the unwillingness or inability of intermediaries or platforms to provide sufficient information.

Redemption profile/dealing arrangements

16. Most respondents supported daily pricing and dealing, saying that they were needed to meet investors' (and distributors') requirements and ensure continuing access to property as an asset class. The system worked well under most market conditions and should be allowed to continue, provided funds managed their liquidity appropriately.

17. A number of respondents pointed to operational issues around platforms in particular, which generally required daily dealing. One respondent suggested that platforms needed to adapt to be able to deal with less frequently dealing funds.

18. A minority of respondents was critical of daily dealing for illiquid property funds. One suggested that funds containing direct investments in property should move to a quarterly dealing basis. Another respondent doubted whether there would be retail demand for products offering restricted access to liquidity.

Our response

While we are not proposing to require funds investing in illiquid assets to move away from daily dealing, which still enjoys broad support, we think it is right that, where the dealing arrangements create the potential for liquidity risk, the rules should be amended to enhance consumer protection and promote market integrity. Many of our proposed new requirements, for example those requiring greater oversight, contingency planning and disclosure, are focused on funds marketed to retail investors that mainly invest in inherently illiquid assets but offer frequent (often daily) dealing.

The impact of these changes may be, over time, to encourage the development of funds that have more restricted dealing arrangements, such as less frequent dealing periods.

Asset valuation and anti-dilution measures

19. Many respondents pointed out that Fair Value Pricing adjustments and anti-dilution adjustments and levies should be seen primarily as a mechanism for ensuring fair and balanced treatment of all investors, whether redeeming or remaining in the fund, and not as a liquidity management tool. At the same time, some respondents recognised that, during periods of market stress, these adjustments did help to manage liquidity.

20. A number of respondents stated that it was difficult to determine the appropriate level of adjustments, especially in the absence of a reliable daily price discovery mechanism. A few suggested that they would have welcomed clearer guidance on the use of the various tools in the period following the referendum. They noted that there was great diversity in how managers interpreted COLL rules in this area. They suggested that the FCA should review the rules to remove ambiguity and ensure managers were aware of how to use the adjustments/levies in times of market stress. They pointed to the relationship between depositary, fund manager and independent valuer as an area which needed focus. One respondent felt that the different adjustments had worked well in the post-referendum period, particularly where investors were given the opportunity to withdraw from trades if they did not want to redeem at the lower (adjusted) price.

21. One respondent called for greater disclosure to investors on how anti-dilution mechanisms worked and interacted with dual/single pricing approaches.

Our response

We are proposing to make a number of changes that will clarify the use of some liquidity management tools in certain circumstances. In particular, we will require dealing in a fund to be suspended when more than 20% of scheme property is subject to material uncertainty. We are also clarifying the use of pricing adjustments where a fund manager wishes to sell immovables quickly in response to high levels of redemption demand.

22. We have reviewed our rules in respect of anti-dilution adjustments but consider that they are sufficiently clear and that no further guidance is needed on their use.

Deferred and limited redemption

23. There was general agreement among respondents that current COLL provisions governing deferred redemptions limited their usefulness as a liquidity management tool for daily dealt funds, given that they allowed for only 1 day's deferral (ie until the next valuation point). Respondents noted that the same applied to notice periods and suggested it would be helpful if these could be longer, especially since the idea of having to give notice to redeem was familiar to retail investors (from savings accounts with fixed notice periods).

Suspension of dealing

24. There was little comment on the use of suspensions. Fund managers responded that, while suspension should remain a tool of last resort, it had worked well in protecting investors' interests following the EU referendum and should not be stigmatised. They felt that the FCA could help to change attitudes on this.

Our response

As noted, we propose to mandate suspension of dealing in certain circumstances. We also propose to amend our guidance on the use of suspensions for funds that invest mainly in inherently illiquid assets to clarify that there may be circumstances where suspension is genuinely in the best interests of unitholders.

Liquidity management and distribution

25. There were few comments on this section of the DP. Those who responded recognised the key role that platforms played in allowing retail investors to access investments in property funds, and that we needed to consider the impact of the distribution chain on the applicability of different potential liquidity tools. One respondent noted that most platforms preferred daily dealing funds, and that we would need to consider the impact on the Individual Savings Account (ISA) rules, which at present require that eligible funds deal at least fortnightly, if we wanted to introduce alternative liquidity management arrangements.

Q3: What are your views on these, or other, possible approaches to the treatment of professional investors? Would these approaches be fair to retail investors in the same fund?

Prevention of co-mingling of professional and retail investors

26. The substantial majority of respondents opposed the mandatory separation of retail and professional investors. They noted that, in co-mingled funds, retail investors benefited from the economies of scale that the participation of institutional investors generated and the enhanced ability of professional investors to engage with AFMs to improve the management of the fund. Respondents argued that mixed funds generated desirable diversification of funds' investor bases, facilitating liquidity risk management and segregation would make a number of funds unviable, reducing retail investors' choice and possibly leading to poorer performance. The difficulty of seeding new real estate funds for retail investors was also flagged.

Different share classes for retail and professional investors, with different terms and conditions

27. We received a large number of comments on this topic and a large majority were critical of the idea of giving particular advantages to retail investors, calling instead for equality of treatment of all investors. Among the arguments advanced were:

- Giving retail investors an inherent first mover advantage through a shorter dealing cycle than professional investors in the same fund would incentivise early redemption, when we should be trying to encourage all investors to accept longer dealing cycles, together with appropriate disclosure. At the very least, the FCA should do more analysis prior to finalising mandatory new rules in this area.

- It would disadvantage professional investors who might then withdraw from mixed funds. This would effectively segregate investments with the negative impacts on retail investors noted earlier. Experience had shown that professional investors were not interested in funds with longer redemption periods – they valued daily liquidity even if the fund management charges were higher than for daily dealt than for less frequently dealt funds.

- It would pose substantial conflicts for AFMs trying to balance the interests of different types of investor, particularly during stressed market conditions.

- It would involve disruption and costs for existing funds.

- Clients and their agents would find ways of circumventing the regime.

- There would be arbitrarily different treatment of retail investors, depending on whether they dealt direct with the fund, for example via a platform or through a life company.

- There was limited differentiation between retail and professional investors in other areas of risk and it is unclear what would justify it in the case of liquidity risk.

- There would be operational challenges for platforms coping with different redemption periods could potentially require a new an 'industry standard' for the sake of simplicity.

28. One respondent suggested that, rather than different share classes, it would be 'cleaner' to adopt a master feeder scheme that would provide retail clients access to the master fund on different terms.

Active management of the diversity of the investor base

29. Respondents generally recognised the need for fund managers to be aware of their investor base and to anticipate the pattern of redemptions that they might expect (also having regard to intermediaries' investment strategies, where relevant), but did not generally support fixed limits on exposure to individual investors. Among the arguments against were:

- Limits could be breached inadvertently through normal trading and in extreme cases, it might lead to a fund having to be liquidated following a large redemption.
- It could make it difficult to set up new funds.
- Most property funds that suspended were already PAIFs and subject to limits on exposures to individual investors. If lower limits were applied, it could reduce choice for large investors.
- Investors could be forced to redeem part of their holdings which could disadvantage them.
- There could be operational challenges for platforms in implementing such a regime (as there were currently in relation to PAIFs).
- It would be difficult to determine how to treat investments through pension and life fund which is made on behalf of underlying retail investors, for example should the threshold for diversification be set at the level of the underlying investor.
- The measure would not mitigate the risk of 'herd' behaviour by particular groups of investors.

30. A few respondents thought, however, the case for limiting exposure to individual investors should be explored further. There was an additional suggestion that consideration be given to putting a limit on the percentage of a fund's assets that could be redeemed at any time.

Our response

Respondents were substantially opposed to 2 of the main possibilities put forward to addressing any imbalance in the treatment of retail and professional investors – first, imposing strict segregation of retail and professional investors' funds, or, second, giving retail investors 'first mover advantage' by allowing them more frequent dealing and/or shorter notice periods than professional investors. Many confirmed the potential downsides of these approaches. We have not taken these ideas forward.

Most respondents were also against imposing mandatory limits on holdings in funds by a single individual investor. We can see a number of practical problems in introducing such limits, and the potential benefit is uncertain. Fund managers are already able to engage with large investors and so can better anticipate future investment flows, such as likely redemption demands. We do not see a strong case for new rules in this area.

Q4: What are your views on these, or other, possible approaches to the portfolio structure of funds?

31. An overwhelming majority of respondents were opposed to the (re-)introduction of a mandatory cap on the proportion of illiquid assets in a fund or a minimum cash requirement. The objections raised included that:

- it would be difficult to determine limits that were appropriate for all funds – decisions needed to be taken flexibly by individual fund managers
- caps/limits would create a drag on the performance of funds, preventing investors from getting the exposure they were looking for to a particular asset class
- mandatory limits would cause practical difficulties, as funds could breach the limits inadvertently
- retail investors were already protected through restrictions on the types of fund they could invest in
- the imposition of limits would be a disproportionate response to an issue that arose only rarely
- most retail investors had a broad and well diversified portfolio and very seldom relied on their investments in property funds to provide liquidity
- the existence of a liquidity buffer could encourage first-mover behaviour by investors during a crisis
- Unless set at a very high level, limits it would not prevent the need for fund suspensions if there were a run
- it was difficult to define liquid and illiquid assets as liquidity could change over time, depending on market conditions

32. A number of respondents proposed that property funds that needed to provide daily liquidity to their investors should invest in other instruments, including Property Derivative Index Linked Futures, derivatives, REITs, 'Exchange Traded Properties' and synthetic exposure instruments.

33. A substantial number of respondents called for greater disclosure to be made to investors, as an alternative to introducing mandatory caps or limits on fund investments. These respondents suggested that managers should spell out more clearly the inherent liquidity risks in the fund, their policy for managing them and what tools they would deploy in doing so.

34. Most respondents opposed the suggestion that funds should establish liquidity buckets, largely on the basis that these would be impractical for funds investing in illiquid assets. One respondent, while stating that the approach would probably not improve investor outcomes, thought that it might be encouraged as a worthwhile discipline on fund managers in discharging their risk management responsibilities. Another felt that it would ensure the regular review of the property portfolio as part of the liquidity management process.

35. There were a handful of responses on the question of whether restrictions might be placed on funds investing in funds that were in turn invested in illiquid assets. Two respondents thought that existing rules on investments by funds of funds were sufficient and opposed any new rules. One thought there could be benefits but conceded that it would dilute returns on property investment through unit-linked funds, while another suggested that funds investing into property funds should be subject to controls over investment periods and redemption volumes.

36. There was no appetite among respondents to impose formal requirements on diversifying the range of assets funds should hold, whether this was interpreted as meaning diversification within the asset class or including different, non-correlated asset classes within the same fund. Several respondents felt this was unlikely to help with liquidity management. One noted that fund managers were already subject to requirements on the prudent spread of risks. Several respondents warned against imposing different requirements on larger and smaller funds, saying that this would encourage market fragmentation.

Our response

The responses were close to unanimous in rejecting the idea of imposing either minimum cash buffer requirements or caps on the proportion of investments that a fund could make in illiquid assets, for reasons mentioned in the DP. Formal limits would be difficult to define and police, reduce the potential return to investors wanting to invest in illiquid asset classes and would not necessarily be effective in preventing the need for funds to suspend in the aftermath of a market event. We agree with this position and are not including minimum cash holdings or caps on the proportion of illiquid assets in our proposed new rules.

On the contrary, we believe that excessive liquidity holdings worsen first mover advantage in funds investing in illiquid assets. We propose to issue guidance, setting out our expectations that fund managers should not accumulate and hold cash or near cash in anticipation of unusually high and unpredictable volumes of redemption requests.

Similarly, there was only minimal support for a number of other detailed measures mentioned in the DP, including issuing guidance on asset sales, requiring funds to establish liquidity buckets, imposing eligibility requirements for assets to be held in funds or for diversifying the range of assets funds should hold, or placing restrictions on holdings by funds of funds and unit-linked funds of funds investing in illiquid assets. We have not taken forward proposals in these areas.

Q5: What are your views on these, or other, possible approaches to the valuation of illiquid assets?

37. The responses to the DP revealed widespread consensus on the need for greater clarity on valuations and the respective roles of fund managers and standing independent valuers (SIVs). This was particularly the case in stressed markets where valuers might cease to produce valuations or produce valuations that were uncertain or qualified. A need was identified for more definitive guidance on how and when fair value pricing and anti-dilution measures may be applied. Several respondents noted that SIVs were constrained by the requirements of the RICS Red Book, which did not align sufficiently with COLL. They called for the FCA to work with RICS on alternative approaches, for example through engagement with the current Red Book review.

38. In contrast, there was substantial disagreement over the current system for valuing scheme assets. There was inconsistency among respondents in the use of terms like fair value pricing and anti-dilution levies, suggesting that there is some confusion about the purpose of particular measures and when it is appropriate to apply them.

39. Some respondents defended the status quo, one describing it as a 'reasonable, even if imperfect' system for investing in illiquid assets. One noted that, while anti-dilution measures were there primarily to ensure fair treatment of investors, the fact that they deterred investors from redeeming was a beneficial side-effect.

40. A similar number of respondents expressed unease at the perceived arbitrary way in which fair value pricing adjustments and anti-dilution levies were applied. They stressed that these should not be a means of deterring redemptions through punitive haircuts. One respondent stated that across-the-board re-pricing created winners and losers among different groups of investors. Some suggested that managers should more readily contemplate suspending a fund, where it had become impossible to value the assets in it, as this was more likely to produce fair outcomes for all investors. A number of respondents noted that, without the daily pricing requirement, there would be less need for the various types of price adjustment.

41. There were a number of specific suggestions for improving the system for valuing illiquid assets. Several respondents called for two types of valuation to be made available at all times – open market (as now) and 'distressed', assuming that the sale of the assets must take place with a particular timescale. The distressed value could be applied when the fund received a high level of redemption orders. This would draw valuers more closely into the process of valuing assets under stressed market conditions.

42. A small number of respondents criticised the requirement, in COLL 6.3.6 1(7A), for the manager to consult and agree with the SIV on what was a 'fair and reasonable' value for an immovable, where he wished to apply an adjustment to the most recent open market valuation. They suggested that this did not make sense in circumstances where the SIV was no longer able to provide reliable valuations.

43. A few respondents suggested that there should be greater disclosure to investors and advisors of the different price adjustment tools and how and when these would be applied.

Our response

Valuations, including the adjustments that can be made to them under different circumstances to protect the interests of investors are one of the most complex issues that we face in respect of open-ended funds holding illiquid assets. Both the DP and our supervision work on property fund suspensions revealed a substantial demand for more guidance and clarity on how and when different price adjustment measures may be used. There is no clear agreement, however, about the desirability and adequacy of the options currently open to managers under circumstances where either the assets cannot accurately be valued, or an adjustment to the open market value is deemed necessary to ensure fair treatment of all investors.

We believe that our rules are sufficiently clear on the use of anti-dilution measures, in particular dilution levies and adjustments, that are used to ensure that the cost of dealing in the underlying assets is not unfairly passed on to existing investors in the case of large volumes of redemptions. These mechanisms are needed to ensure that all investors can be treated fairly under difficult market conditions, and we are not proposing to change them. We have, however, noted that some retail investors were unpleasantly surprised by the deployment of these tools, and their impact on the unit price, during the events following the EU referendum in 2016. Fund managers should be complying with existing obligation in COLL 4.2.5R (18) and should ensure that there is sufficient disclosure in the prospectus to allow investors to understand when and how anti-dilution measures will be used.

We are therefore proposing several measures to address these points:

- a rule requiring a fund to suspend if there is material uncertainty about the value of immovables that account for at least 20% of the scheme property;
- guidance clarifying that fund managers may, in consultation with the SIV, reduce the price of an immovable to enable it to be sold quickly, if this is necessary to meet high levels of redemption demand and avoid suspension. Fund managers may not use this liquidity management tool unless they disclose it beforehand in the fund prospectus.

Q6: What are your views on these, or other, possible approaches to the fund manager's use of specific liquidity management tools?

44. A few respondents were in favour of reducing the dealing frequency of funds holding illiquid assets, suggesting that this would allow funds to be managed more equitably and would avoid misleading investors about the availability of their capital. However, a larger number supported the continuation of daily dealing, saying that reducing the frequency of dealing would simply lead to the bunching of trades without having a significant impact on fund liquidity. One respondent noted that in 2008, quarterly dealing funds were no more successful in managing liquidity than were daily dealing ones. Respondents also pointed to operational problems that platforms and other players in the value chain would have with less frequent dealing. However, several suggested that the authorities should put pressure on platforms to be able to accommodate less frequently traded funds alongside daily dealt ones, so that investors could have a choice between the two. A few respondents involved in the property derivatives market proposed that funds wishing to continue to offer daily dealing should hold property futures or other near-cash real estate instruments as part of their liquidity buffer.

45. Respondents generally welcomed the availability of a broad range of liquidity management tools and thought that managers should continue to be able to use their discretion in applying these.

46. In terms of specific new liquidity management tools, several respondents asked for managers to be given the power to defer redemptions for up to 185 days, without formally suspending trading. There were various suggestions concerning the treatment of orders submitted during that time, with some proposing that they be pooled, rather than queued, to try to eliminate first mover advantage. Opinion was divided on the merits of queuing orders, with some stating that it would reduce the waiting time for investors to get their money back or help managers to plan liquidity and reduce the need for 'fire sales', while others pointed to the operational challenges for platforms and the possible lack of understanding by retail investors.

47. There was a range of views on the desirability of introducing notice periods for redemptions. One respondent thought that a 90-day notice period should be introduced on a mandatory or discretionary basis.

48. Several other respondents were more sceptical about the effectiveness of notice periods in managing liquidity risks, with one suggesting that they were not needed to deal with retail redemption requests, which were smaller than institutional ones and presented fewer challenges. It was noted that because of the operational difficulties, platforms might choose not to offer funds where the manager could impose a notice period, thus reducing investor choice. Respondents flagged that if platforms had to invest in system changes, investors would ultimately bear the costs.

49. There was an appetite among respondents for more FCA guidance on the use of different liquidity management tools, including on the decision-making process for using extraordinary tools (suspensions, gating) and on disclosure to investors. However, those commenting on this point were against the regulator prescribing rigidly when and how each tool could be used.

Our response

There was little support in the responses either for a mandatory move away from daily dealing, or for imposing minimum notice periods for redemptions from funds investing in illiquid assets. Although we believe that fund managers should consider carefully, what the appropriate structure and dealing arrangements should be when designing a new fund, we do not intend to mandate those in our rules.

Q7: Do you think our analysis of the possible benefits and risks of direct intervention by the regulator is correct? Do you think the FCA should be more proactive about directing the actions of fund managers in a stressed situation, and if so how?

50. There was widespread agreement with the analysis in the DP of the benefits and risks of direct intervention by the regulator. A few respondents were in favour of the FCA playing a more active role. Several respondents noted that the very different responses to the post-referendum issues in 2016, particularly the variety of approaches to applying pricing adjustments, reflected badly on the sector as a whole.

51. However, a substantial majority of the respondents cautioned against greater regulatory intervention at individual fund level, preferring to leave decisions about suspensions to managers, given the wide diversity of funds and their investors. Respondents argued that provided there was sufficient clarity about the appropriate use of liquidity management tools, direct regulatory intervention should be reserved for exceptional circumstances. Examples of exceptional circumstances cited included if the FCA was in possession of information about an asset class or the wider sector that was not available to fund managers, a firm was not exercising proper stewardship over a fund (for example, not suspending, where this was clearly in investors' interests), or managers collectively were unable to maintain an orderly market.

52. Respondents raised a range of concerns around possible (unintended) negative impacts of more direct regulatory intervention during periods of market stress including:

- it would send a negative signal to the market about the sector's ability to manage itself, further damaging confidence and possibly exacerbating any existing run on funds and deepening the overall market impact;
- it could have a significant distorting effect on market behaviour, for example by creating an expectation of further intervention;
- the FCA might not have sufficient expertise to make the right judgement calls, particularly about the appropriate point at which to lift a suspension;
- it could undermine fund governance and would go against the current policy of placing greater accountability on firms' senior management;
- a blanket regulatory approach to suspensions on a 'one-size-fits-all' basis would be damaging as it would not take account of individual funds' circumstances and would lead to funds being suspended that did not need to be.

53. Respondents put forward a variety of suggestions for actions they thought it would be helpful for the FCA to take, as an alternative to more direct intervention at individual fund level:

- provide enhanced guidance on the different mechanisms for dealing with stressed markets, including the expected level of disclosure in scheme documents on the use of different post-event tools;

- set expectations of managers at an earlier stage, ensuring at the authorisation stage that funds have considered liquidity issues and the application of available mechanisms;
- use existing powers to monitor and challenge managers' use of liquidity management tools, ensuring that it is proportionate, consistent and in the interests of all investors;
- engage in a dialogue with the industry prior to, as well as following, any known event and during stressed market conditions;
- facilitate 'safe harbour' discussions (or enable trade bodies to do so) where managers could meet to exchange information and views on market issues without breaching competition law;
- during stressed market conditions, provide timely public information on the actions the FCA is taking, provide reassurance to investors and stabilise the market;
- work with property fund managers to explain liquidity risks to investors and encourage them to consider their own liquidity needs.

Our response

Responses to the DP largely confirm the FCA's own analysis of the pros and cons of the regulator adopting a more intrusive role in supervising funds investing in illiquid assets. The potential drawbacks to such an approach set out by respondents reinforce those outlined in the DP. We are not, therefore, proposing a fundamental change to our supervisory approach, but will draw on the lessons learned from the 2016 suspensions in determining how and when we engage with the industry before and after an event that leads to a potential liquidity crisis. We shall obviously need to supervise firms against their compliance with our new rules, in due course.

Q8: What are your views on these, or other, possible approaches to requiring enhanced disclosure for funds investing in illiquid assets?

54. A few respondents argued there wasn't a strong case for greater disclosure. Arguments included that the current requirements (such as mandatory disclosure documents) were appropriate, disclosure would be ineffective in influencing investor behaviour and the potential harms open-ended funds investing in illiquid assets could not be mitigated through greater disclosure.

55. However, most recognised a need for greater transparency on the risks involved in investing in illiquid assets and when they could crystallise, the range of liquidity management tools that the manager had at his disposal when these might be deployed and the consequences for investors. Respondents agreed it would be beneficial for investors to be better educated on these issues, without overloading them with information or inappropriately dissuading them from investing in illiquid assets. One respondent referred to the recommendation in Principle 7 of the IOSCO report for greater disclosure of liquidity risks and another pointed to good practice on the institutional side, where managers had increased the frequency of communications and provided updates on the fund's liquidity position.

56. Several respondents noted the importance of communicating proactively with clients under stressed market conditions.

Our response

Enhanced disclosure is not a panacea and cannot, on its own, adequately deal with the challenges raised by holding illiquid assets in open-ended funds. However, we agree that there is benefit in improving the information that investors (and the advisers on whom many of them rely) receive about liquidity risks and the strategy and tools the fund manager will use in mitigating them. Better disclosure also aligns with the new IOSCO Recommendations published in February 2018.

We are therefore consulting on a set of proposals to improve disclosure as one part of the package of measures included in this CP. These apply in respect of funds investing in inherently illiquid assets and include a mandatory identifier included in the name of the fund, a standard risk warning in financial promotions and fuller disclosure of liquidity risk and its management in the prospectus.

Q9: What is your view of the benefits and risks of a secondary market in the units of open-ended funds investing in illiquid assets? Should the FCA do more to encourage the development of such a market?

57. A minority of respondents supported the proposition that the FCA should actively encourage the development of a secondary market. They said it would be useful to have an alternative means by which investors could dispose of illiquid holdings, and that it was preferable for the market to establish the 'fire sale' price in a transparent manner than for managers to do so subjectively by imposing fair value pricing adjustments.

58. A small group of respondents supported the development of a secondary market in principle, but pointed to a range of practical/operational factors that could prevent significant progress. A few respondents suggested that any movement in this direction should be led by market demand (which some doubted existed), and that the FCA's role should be confined to ensuring that no unnecessary restrictions stood in the way of a secondary market developing.

59. A majority of respondents were negative about the development of a secondary market, seeing it as unnecessary and undesirable for a number of reasons including:

- A secondary listing would involve greater cost and complexity, including additional governance and disclosure requirements, and require funds to abide by several potentially conflicting regulatory regimes.
- There would be no meaningful secondary market under normal conditions, at least for daily dealt funds. Under stressed conditions, including where trading was

suspended, liquidity would likely be available only at a substantial discount to the NAV, if at all. Retail investors might find it difficult to judge whether the price set in the secondary market was reasonable.

- It could create arbitrage opportunities that institutional/professional investors would seek to exploit, to the detriment of retail investors.
- It would raise difficult questions about the basis for valuing the underlying assets within funds – e.g. should this be done on the basis of independent valuers' assessments, or on the implied value observed from trading in the secondary market?
- By making fund units more equity-like, it could increase volatility, blur the distinction between open- and closed-ended funds and weaken the link between the unit price of open-ended funds and the underlying NAV, which could confuse retail investors.
- Potential investors on the secondary market might have to pre-qualify as fund holders, otherwise there would be a risk that funds subject to investor restrictions (Funds of Alternative Investment Funds (FAIFs), QISs) could become available to inappropriate investors.
- Secondary market trading would raise issues in relation to funds held in personal tax wrappers (ISAs, SIPPs) that would need to be clarified in discussion with Her Majesty's Treasury (HMT)/Her Majesty's Revenue and Customs (HMRC) etc.
- As fiduciary principles wouldn't apply in the secondary market, that could raise investor protection issues.

60. A few respondents pointed out that secondary markets already existed for units in both open- and closed-ended property funds. However, the examples cited were relatively small scale and informal (typically, brokers identifying willing buyers and sellers, as opposed to a formal exchange), geared to larger institutional investors and focused on funds which offered less frequent dealing. It was not clear whether any of these offered a template that could be readily expanded to cover a more significant proportion of the market.

Our response

There was limited support for the FCA actively to promote the development of a secondary market in open-ended funds investing in illiquid assets. Even if a broader secondary market could be achieved, it is not clear whether this would be of benefit to retail investors or produce a better outcome for investors than application of the tools currently available to fund managers, such as suspension or reducing the price of the units to reflect the need to sell the underlying assets rapidly.

We therefore plan to continue to allow market participants to respond to any demand that there is to generate a secondary market in holdings in open-ended funds, and to have an open ear to any concerns they might raise about unnecessarily regulatory obstacles to making progress in that direction. We do not, however, propose to take any steps to promote the development of a secondary market at this time.

Q10: Are there any other issues related to the subject matter of this paper that we should consider?

61. Several recommendations were made around the subject of liquidity management. Two respondents suggested that the manager should be able immediately to restrict the issue of shares when he believed that this would be in the interests of investors (pointing out that this also assisted with meeting Markets in Financial Instruments Directive (MiFID) II product governance requirements). Another expressed support for the dual pricing model for funds holding illiquid assets, claiming this was clear, fair and encouraged long-term investment.

62. Another group of respondents made operational points, the first of which was to note that there were operational challenges that might limit managers' ability to implement certain liquidity tools. Another suggested that the regulator should review platforms that were unable to offer non-daily dealing. One said that it would be helpful if managers could give platforms advanced notice (in confidence) 24 hours ahead of any suspension, to allow them to prepare properly and implement smoothly.

Our response

We welcome the additional comments provided by respondents to this section but do not believe they give rise to new areas for policy intervention not already addressed elsewhere in the feedback to the DP.

Annex 5
Abbreviations used in this paper

AIF	Alternative Investment Fund
AIFMD	Alternative Investment Fund Managers Directive
AIM	Alternative Investments Market
CBA	Cost-benefit analysis
CIS	Collective Investment Scheme
COLL	Collective Investment Schemes sourcebook of the FCA Handbook
CP	Consultation Paper
CRE	Commercial real estate
DP	Discussion Paper
EU	European Union
FCA	Financial Conduct Authority
FIIA	Fund investing in inherently illiquid assets
FSB	Financial Stability Board
FSMA	Financial Services and Markets Act 2012
FUND	Investment Funds sourcebook of the FCA Handbook
FVP	Fair value pricing
IHV	Intermediate holding vehicle
IOSCO	International Organisation of Securities Commissions
ISA	Individual savings account
KIID	Key investor information document
MiFID	Markets in Financial Instruments Directive

NAV	Net asset value
NURS	Non-UCITS retail scheme
PAIF	Property authorised investment fund
PRIIPs	Packaged retail and insurance-based investment products
QIS	Qualified investor scheme
REIT	Real estate investment trust
RICS	Royal Institution of Chartered Surveyors
SIPP	Self-invested personal pension
SIV	Standing independent valuer
SPV	Special purpose vehicle
SSA	Small self-administered scheme
UCITS	Undertakings for collective investment in transferable securities
UK	United Kingdom

We have developed the policy in this Consultation 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.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

All our publications are available to download from www.fca.org.uk. If you would like to receive this paper in an alternative format, please call 020 7066 9644 or email: publications_graphics@fca.org.uk or write to: Editorial and Digital team, Financial Conduct Authority, 12 Endeavour Square, London E20 1JN

Annex 6
Overview of remedies

	Purpose	Remedy	Applies to	Proposed provision
1	Reducing risk of harm to retail investors (Reducing the risk of harm to certain groups of investors when fund managers apply pricing adjustments)	Requiring funds holding immovables to suspend dealing when there is material uncertainty about at least 20% of the value of the scheme property.	NURSs	COLL 7.2.-1R(1)(a)
2		Requiring funds to suspend dealing when at least 20% of the value of the scheme property is invested into other funds which have suspended due to material uncertainty.	NURSs	COLL 7.2.-1R(1)(b)
3	Improving liquidity management (External oversight and cash requirements)	New rules and guidance on setting a fair and reasonable value for an immovable to achieve a rapid sale.	NURSs[15]	COLL 6.3.6G(1)(7B) COLL 6.3.7AR
4		Requiring depositaries to provide oversight of fund managers' liquidity management.	Depositaries of FIIAs	COLL 6.6.4BR COLL 6.6.4CR COLL 6.6.11G
5		New guidance on the use of (i) liquidity buffers and (ii) suspensions.	(i) UCITS and NURSs (ii) FIIAs	COLL 5.5.3AG COLL 5.6.22AG COLL 7.2.2G(1) COLL 7.2.2G(1A)
6		Improving contingency planning.	FIIAs	COLL 6.6.3CR COLL 6.6.3DG COLL 6.6.3ER
7	Reducing the likelihood of unsuitable outcomes (Improving disclosure to make it less likely that consumers invest in funds which are not suitable for their needs)	Adding the identifier '– a fund investing in inherently illiquid assets' in the final part of a fund's name in written communications to retail investors.	FIIAs	COLL 6.9.8CR
7		Giving a risk warning in financial promotions in regard to FIIAs.	Firms	COBS 4.5.16R COBS 4.5A.17R
8		Improving prospectus disclosures.	FIIAs	COLL 4.2.5R(3)(pa)

15 In theory, these provisions could also apply to UCITS. However, because of the restrictions on UCITS' investment powers, we do not consider that they would have any impact on UCITS in practice.

Appendix 1
Draft Handbook text

FUNDS INVESTING IN ILLIQUID ASSETS INSTRUMENT 2019

Powers exercised

A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in or under:

(1) the following sections of the Financial Services and Markets Act 2000 ("the Act"):

(a) section 137A (The FCA's general rules);
(b) section 137T (General supplementary powers);
(c) section 139A (Power of the FCA to give guidance);
(d) section 214 (General);
(e) section 247 (Trust scheme rules);
(f) section 248 (Scheme particulars rules);
(g) section 261I (Contractual scheme rules);
(h) section 261J (Contractual scheme particulars rules);
(i) section 137D (FCA general rules: product intervention);
(j) section 137R (Financial promotion rules);

(2) regulation 6(1) of the Open-Ended Investment Companies Regulations 2001 (SI 2001/1228); and

(3) the other rule and guidance making powers listed in Schedule 4 (Powers exercised) to the General Provisions of the FCA's Handbook.

B. The rule-making provisions listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Amendments to the Handbook

D. The modules of the Financial Conduct Authority's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2) below.

(1)	(2)
Glossary of definitions	Annex A
Conduct of Business sourcebook (COBS)	Annex B
Collective Investment Schemes sourcebook (COLL)	Annex C

Citation

E. This instrument may be cited as the Funds Investing in Illiquid Assets Instrument 2019.

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text, unless indicated otherwise.

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

FIIA — a *fund investing in inherently illiquid assets*.

fund investing in inherently illiquid assets — a *non-UCITS retail scheme* which satisfies the conditions in (1), (2) and (3):

(1) either:

(a) the investment objectives and policy published in the *instrument constituting the fund* and the *prospectus* aim to invest at least 50% of the value of the *scheme property* in *inherently illiquid assets*; or

(b) at least 50% of the value of the *scheme property* has been invested in *inherently illiquid assets* for at least three continuous *months* in the last twelve *months*; and

(2) 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 *non-UCITS retail scheme* invests; and

(3) the *scheme* is not in the process of winding up or termination.

inherently illiquid asset — an asset which is:

(1) an immovable;

(2) an *investment* in an infrastructure project;

(3) a *transferable security* (within paragraph (2) of that definition) that is not a *readily realisable security*;

(4) any other *security* or asset which is not listed or traded on an *eligible* market and satisfies one or more of the following conditions:

(a) sale and purchase transactions are typically negotiated on a one-off basis;

(b) valuation for the purposes of agreeing a sale price is typically complex and may require the seller and/or buyer to obtain specialist advice;

(c) it may take significant time for one party in a proposed transaction to identify another prior to sale and purchase negotiations commencing;

(d) once negotiations have commenced, transactions typically take significant time to complete;

(5) a *unit* in another *FIIA*;

(6) a *unit* in a *qualified investor scheme* where that *scheme*:

(a) would itself meet condition (1) of the definition of a *FIIA* if it was a *non-UCITS retail scheme*;

(b) permits redemptions of *units* on timescales which do not reflect the typical time needed to sell, liquidate or close out the assets in which the *scheme* invests, those assets being ones which fall within paragraphs (1) to (5) above or (7) below; and

(c) is not in the process of winding up or termination;

(7) a *unit* in an unregulated *scheme* where that *scheme*:

(a) aims to invest at least 50% of the value of the property of the *scheme* in assets falling within paragraphs (1) to (6) above;

(b) permits redemptions of *units* on timescales which do not reflect the typical time needed to sell, liquidate or close out those assets; and

(c) is not in the process of winding up or termination.

Amend the following definition as shown.

eligible	(in *COLL* <u>and in the definition of *inherently illiquid asset*</u>) (in relation to a *securities* or a *derivatives* market) a market that satisfies the requirements in *COLL* 5.2.10R (Eligible markets: requirements) in relation to schemes falling under *COLL* 5.

[*Editor's note*: the text in this Annex takes account of the changes proposed in the instrument included in CP18/9 'Consultation on further remedies – Asset Management Market Study' (April 2018) as if they were made.]

Annex B

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text.

4 Communicating with clients, including financial promotions

…

4.5 Communicating with retail clients (non-MiFID provisions)

…

Funds investing in inherently illiquid assets (FIIAs)

4.5.16 R (1) This *rule* applies to a *financial promotion* relating to a *FIIA* unless it is:

(a) a *FIIA's prospectus*; or

(b) a *FIIA's NURS-KII document*.

(2) A *firm* must ensure that the following risk warning is given:

"[Name of fund] invests in inherently illiquid assets. This means at certain times you may experience a significant delay and/or need to accept a discount when selling your investments. See the fund prospectus and key information document for more information."

(3) If the *financial promotion* is a *non-real time financial promotion*, a *firm* must ensure that the risk warning is prominently placed in the *financial promotion* in a font size that is at least equal to the predominant font size used throughout the communication.

4.5.17 G An *authorised fund manager* of a *FIIA* is also reminded of *COLL* 6.9.8CR, which applies a naming requirement to a *fund investing in inherently illiquid assets*.

4.5A Communicating with clients (including past, simulated past and future performance) (MiFID provisions)

…

Funds investing in inherently illiquid assets (FIIAs)

4.5A.17 R (1) This *rule* applies to a *financial promotion* relating to a *FIIA* that is addressed to or disseminated in such a way that it is likely to be received by a *retail client*, unless it is:

(a) a *FIIA's prospectus*; or

(b) a *FIIA's NURS-KII document*.

(2) A *firm* must ensure that the following risk warning is given:

"[Name of fund] invests in inherently illiquid assets. This means at certain times you may experience a significant delay and/or need to accept a discount when selling your investments. See the fund prospectus and key information document for more information."

(3) If the *financial promotion* is a *non-real time financial promotion*, the risk warning must be prominently placed in the *financial promotion* in a font size that is at least equal to the predominant font size used throughout the communication.

Annex C

Amendments to the Collective Investment Schemes sourcebook (COLL)

In this Annex, underlining indicates new text and striking through indicates deleted text.

4 Investor Relations

…

4.2 Pre-sale notifications

…

Table: contents of the prospectus

4.2.5 R This table belongs to *COLL* 4.2.2R (Publishing the prospectus).

…			
Investment objectives and policy			
3	The following particulars of the investment objectives and policy of the *authorised fund*:		
	…		
	(pa)	for a *fund investing in inherently illiquid assets* at least the following (see *FUND* 3.2.2R(8) (Prior disclosure of information to investors):	
		(i)	an explanation of the risks associated with the *scheme* investing in *inherently illiquid assets* and how these might crystallise;
		(ii)	a description of the tools and arrangements the *authorised fund manager* would propose using, including those required by *FCA rules*, to mitigate the risks referred to in (i); and
		(iii)	an explanation of the circumstances in which these tools and arrangements would typically be deployed and the likely consequences for investors;
	…		
…			

…

Guidance on contents of the prospectus

4.2.6 G (1) …

(4A) In relation to *COLL* 4.2.5R(3)(pa), the types of liquidity management tools and arrangements that should typically be described under *COLL* 4.2.5R(3)(pa) (ii) and (iii), include:

(a) suspension of dealing under *COLL* 7.2.1R and *COLL* 7.2.-1R;

(b) fair value pricing adjustment (see *COLL* 6.3.6G(1)(5) to *COLL* 6.3.6G(1)(7));

(c) fair and reasonable valuation of an immovable (see *COLL* 6.3.6G(1)(7A) and *COLL* 6.3.6G(1)(7B)); and

(d) anti-dilution measures such as applying a dilution levy under *COLL* 6.3.8R.

…

…

5 Investment and borrowing powers

…

5.5 Cash, borrowing, lending and other provisions

…

Cash and near cash

…

5.5.3A G Cash and *near cash* retained in the *scheme property* for the purposes specified in *COLL* 5.5.3R(1) should not be accumulated or held for a significant duration in anticipation of unusually high and unpredictable volumes of *redemption* requests.

…

5.6 Investment powers and borrowing limits for non-UCITS retail schemes

…

Funds investing in inherently illiquid assets (FIIA)

5.6.5E G (1) Within the *Glossary* definition of a *fund investing in inherently illiquid assets* (or *FIIA*) are conditions relating to, amongst other things, the investment objectives of such *non-UCITS retail schemes* and the proportion of *scheme property* which is invested in *inherently illiquid assets*.

(2) Examples of such assets include:

(a) property and real estate;

(b) *shares* in a *special purpose vehicle* investing in infrastructure projects;

(c) *shares* issued by a company that has not applied for them to be officially listed or admitted to a *recognised investment exchange*; and

(d) *units* in a *property authorised investment fund*.

…

Standing independent valuer and valuation

5.6.20 R …

(3) The following requirements apply in relation to the functions of the *standing independent valuer*:

…

(f) any valuation by the *standing independent valuer* must be undertaken in accordance with ~~UKPS 2.3 of the RICS Valuation Standards (The Red Book) (9th edition published November 2013)~~ UKVS 2.3 and paragraph 2.1 of UK Appendix 9 of the RICS Valuation – Professional Standards UK January 2014 (revised April 2015) (the RICS Red Book) or, in the case of overseas immovables, on an appropriate basis but subject to *COLL* 6.3 (Valuation and pricing).

…

…

Cash, borrowing, lending and other provisions

…

5.6.22A G The *guidance* in *COLL* 5.5.3AG (Cash and near cash) also applies to a *non-UCITS retail scheme*.

…

6 Operating duties and responsibilities

…

6.3 Valuation and pricing

…

Valuation and pricing guidance

6.3.6 G Table: this table belongs to *COLL* 6.3.2G(2)(a) and *COLL* 6.3.3R (Valuation).

Valuation and pricing			
1	**The valuation of scheme property**		
	…		
	(7A)	Where the *authorised fund manager*, the *depositary* or the *standing independent valuer* have reasonable grounds to believe that the most recent valuation of an immovable does not reflect the current value of that immovable, then, unless *COLL* 6.3.6G(1)(7B) or *COLL* 7.2.-1R applies, the *authorised fund manager* should consult and agree with the *standing independent valuer* a fair and reasonable value for the immovable.	
	(7B)	(a)	Where the *authorised fund manager* decides that an immovable must be sold quickly to meet *redemption* requests as they fall due, it should consult and agree with the *standing independent valuer* a fair and reasonable value for the immovable to reflect a rapid sale, unless *COLL* 7.2.-1R applies.
		(b)	The *authorised fund manager* may devise a methodology with the *standing independent valuer* that sets out agreed guidelines for a rapid sale valuation under (a), such as applying a sliding scale of discounts that reflects the speed at which an immovable must be sold.
	…		
…			

…

Valuation of an immovable

6.3.7A R An *authorised fund manager* may only agree a fair and reasonable value for an immovable to reflect a rapid sale if it has included the proposal to use such a tool in the *prospectus* in accordance with *COLL* 4.2.5(R)(3)(pa)(ii).

…

6.6 Powers and duties of the scheme, the authorised fund manager, and the depositary

…

Table of application

6.6.2 R This table belongs to *COLL* 6.6.1R.

Rule	*ICVC*	*ACD*	Any other directors of an *ICVC*	Depositary of an *ICVC*	Authorised fund manager of an *AUT* or *ACS*	Depositary of an *AUT* or *ACS*
…						
6.6.3CR*		x			x	
6.6.3DG*		x			x	
6.6.3ER*		x			x	
6.6.3FR*		x			x	
…						
6.6.4BR*				x		x
6.6.4CR*				x		x
…						
Notes:	…					
	(5)	**COLL* 6.6.3CR, *COLL* 6.6.3DG, *COLL* 6.6.3ER and *COLL* 6.6.3FR only apply to the *authorised fund manager* of a *FIIA*.				
	(6)	**COLL* 6.6.4BR and *COLL* 6.6.4CR only apply to the *depositary* of a *FIIA*.				

…

Additional functions of an authorised fund manager of a FIIA

6.6.3C R The *authorised fund manager* of a *FIIA* must establish, implement and maintain an adequate liquidity management contingency plan for exceptional circumstances which sets out:

(1) how the *authorised fund manager* will respond to a liquidity risk crystallising;

(2) the range of liquidity tools and arrangements which they may deploy in such exceptional circumstances, any operational challenges associated with the use of such tools and the consequences for investors;

(3) the procedures for working with the *depositary* in the event the *authorised fund manager* must implement these liquidity management tools and arrangements;

(4) how the *authorised fund manager* will work with relevant third parties including *intermediate Unitholders*, third-party administrators and delegates to:

(a) deploy any liquidity management tools and arrangements;

(b) communicate the use of any liquidity management tools and arrangements with *Unitholders*; and

(c) implement any other part of this contingency plan;

(5) any operational challenges arising from working with relevant third parties identified at (4); and

(6) communication arrangements for internal and external concerned parties (including the *FCA*, investors and the press where necessary).

6.6.3D G Compliance with *COLL* 6.6.3CR may enable an *authorised fund manager* of a *FIIA* to meet some of its obligations under article 47(1)(e) of the *AIFMD level 2 regulation*.

6.6.3E R (1) The *authorised fund manager* of a *FIIA* must obtain written confirmation from any relevant third parties identified in their contingency plan in accordance with *COLL* 6.6.3CR(4) that they are able to undertake the matters specified in (2) as soon as is reasonably practicable.

(2) The matters specified for the purposes of (1) are that the relevant third party is, where necessary, able to:

(a) deploy any liquidity management tools on which *the authorised fund manager* plans to rely as part of their contingency plan;

(b) communicate the *authorised fund manager's* use of any liquidity management tools and arrangements with *Unitholders*; and

(c) implement any other part of the contingency plan which the *authorised fund manager* has identified as requiring input from that third party.

6.6.3F R The *authorised fund manager* of a *FIIA* must provide the *depositary* on an ongoing basis with all relevant information it needs to comply with its obligations under *COLL* 6.6.4BR.

…

Specific duties of a depositary: oversight of the liquidity management of a FIIA

6.6.4B R The *depositary* of a *FIIA* must:

(1) regularly make its own assessment of the liquidity profile of the *FIIA* and the liquidity risks presented by the *scheme property* held by a *FIIA* in order to devise procedures for overseeing the *authorised fund manager's* liquidity management in accordance with *COLL* 6.6.4BR(2);

(2) take reasonable care to oversee the *authorised fund manager's* liquidity management systems and procedures on an ongoing basis, to ensure the *FIIA* is managed in accordance with the following *FCA rules* and provisions in the *AIFMD level 2 regulation*:

(a) *COLL* 4.2.5R(3)(pa);

(b) *COLL* 6.6.3CR and *COLL* 6.6.3ER;

(c) *FUND* 3.2.2R(8) (article 23(1)(h) of the *AIFMD*);

(d) *FUND* 3.2.5R (article 23(4) of the *AIFMD*);

(e) *FUND* 3.6.3R (article 16 of the *AIFMD*);

(f) article 44(1) and (2)(c) of the *AIFMD level 2 regulation*;

(g) articles 46 to 49 of the *AIFMD level 2 regulation*; and

(h) article 108 of the *AIFMD level 2 regulation*; and

(3) establish a clear escalation procedure when instances of potential non-compliance with the *rules* and provisions set out in paragraph (2) are identified, the details of which must be made available to the *FCA* upon request.

6.6.4C R The *depositary* must not delegate its functions under *COLL* 6.6.4BR to one or more third parties except in relation to supporting administrative or technical tasks that are linked to these functions.

…

Duty to inform the FCA

6.6.11 G *SUP* 15.3 (General notification requirements) contains *rules* and *guidance* on matters that should be notified to the *FCA*. Such matters include, but are not limited to, any circumstance that the *depositary* becomes aware of whilst undertaking its functions or duties in *COLL* 6.6.4R(1) (General duties of the depositary) and (where applicable) *COLL* 6.6.4BR (Specific duties of a depositary: oversight of the liquidity management of a FIIA), that the *FCA* would reasonably view as significant.

…

6.9 Independence, names and UCITS business restrictions

…

Naming requirement for a fund investing in inherently illiquid assets

6.9.8C R (1) Subject to (2), an *authorised fund manager* of a *FIIA* must include the identifier "- a fund investing in inherently illiquid assets" in the final part of the *scheme's* name in any written communication which relates to a *FIIA* that is provided to or seen by *retail clients*.

(2) The identifier must not be included within the risk warning provided in accordance with *COBS* 4.5.16R and *COBS* 4.5A.17R.

(3) The identifier must appear at least once in the communication and its location and appearance must serve to clearly bring the matter to the attention of the *retail client*.

…

7 Suspension of dealings and termination of authorised funds

7.1 Introduction

…

Table of application

7.1.2 R This table belongs to *COLL* 7.1.1R.

Rule	*ICVC*	*ACD*	Any other *directors* of an *ICVC*	*Depositary* of an *ICVC*	*Authorised fund manager* of an *AUT* or *ACS*	*Depositary* of an *AUT* or *ACS*

…						
7.2.-1*		x			x	
…						
Notes	…					
	(4)	*COLL* 7.2.-1R only applies to the *authorised fund manager* of a *non-UCITS retail scheme*.				

Purpose

7.1.3 G (1) This chapter helps to achieve the *statutory objective* of protecting investors by ensuring they do not buy or *redeem units* at a *price* that cannot be calculated accurately. For instance, due to unforeseen circumstances, it may be impossible to value, or to dispose of and obtain payment for, all or some of the *scheme property* of an *authorised fund* or *sub-fund*. *COLL* 7.2.-1R and *COLL* 7.2.1R (Requirement) ~~sets~~ set out the circumstances in which an *authorised fund manager* must or may suspend dealings in units and the manner in which a suspension takes effect.

(2) …

7.2 Suspension and restart of dealings

Requirement

7.2.-1 R (1) An *authorised fund manager* of a *non-UCITS retail scheme* must temporarily suspend *dealings* in *units* if:

(a) a *standing independent valuer* has expressed material uncertainty in accordance with VPS 3 paragraph 2.2(o) and the guidance at VPGA10, RICS Valuation Global Standards 2017 (The Red Book) (effective from 1 July 2017), about the value of one or more immovables under management and that material uncertainty applies to at least 20% of the value of the *scheme property*; or

(b) the *scheme* invests at least 20% of the value of the *scheme property* in one or more other *authorised funds* for which *dealings* in *units* have been temporarily suspended under (a).

(2) Prior to temporarily suspending *dealings* in *units* in a *fund* under (1) the *authorised fund manager* must notify the *fund's depositary* of the suspension.

(3) During the suspension, the *authorised fund manager* must also comply with the following *rules* where applicable:

(a) *COLL* 7.2.1R(2);

(b) *COLL* 7.2.1R(2A);

(c) *COLL* 7.2.1R(2B);

(d) *COLL* 7.2.1R(2C);

(e) *COLL* 7.2.1R(3);

(f) *COLL* 7.2.1R(4A);

(g) *COLL* 7.2.1R(5); and

(h) *COLL* 7.2.1R(6).

(4) The suspension of *dealings* in *units* must cease as soon as reasonably practicable after:

(a) the *standing independent valuer's* material uncertainty assessment applies to less than 20% of the value of the *scheme property*; and

(b) the *scheme's depositary* gives its approval for the temporary suspension to be removed.

(5) If a *non-UCITS retail scheme* operates *limited redemption arrangements* and the suspension has affected a *valuation point*, the *authorised fund manager* must declare an additional *valuation point* as soon as possible after the restart of *dealings* in *units*.

(6) This *rule* applies to a *sub-fund* as it applies to an *authorised fund*, and:

(a) references to the *units* of the *class* or *classes* relate to that sub-fund and to the *scheme property* attributable to the *sub-fund*; and

(b) this *rule* can only apply to one or more *classes* of *units* without being applied to other *classes*, if it is in the interest of all the *unitholders*.

…

…

Guidance

7.2.2 G (1) Suspension should be allowed only in exceptional cases where circumstances so require and suspension is justified having regard to the interests of the *unitholders*. Except in the case of *FIIAs*, ~~Difficulties~~ difficulties in realising scheme assets or temporary shortfalls in liquidity may not on their own be sufficient justification for suspension. In such circumstances the *authorised fund manager* and *depositary* would need to be confident that suspension could be demonstrated genuinely to be in the best interests of the *unitholders*. Before an *authorised fund manager* and *depositary* determines that it is in the best interests of *unitholders* to suspend *dealing*, it should ensure that any alternative courses of action have been discounted.

(1A) In the case of *FIIAs*, there may be circumstances where suspension is genuinely in the best interests of *unitholders*, where, for example redemption demand cannot be met without significantly depleting the *scheme's* liquidity, and/or without selling off *scheme property* at a substantial discount to its open market value.

…

8 Qualified investor schemes

…

8.4 Investment and borrowing powers

…

Standing independent valuer and valuation

8.4.13 R (1) …

(2) …

(f) any valuation by the *standing independent valuer* must be undertaken in accordance with ~~UKPS 2.3 of the RICS Valuation Standards (The Red Book) (9th edition published November 2013)~~ UKVS 2.3 and paragraph 2.1 of UK Appendix 9 of the RICS Valuation – Professional Standards UK January 2014 (revised April 2015) (the RICS Red Book) or, in the case of overseas immovables, on an appropriate basis but subject to any provisions of the *instrument constituting the fund*.

…

…

Pub ref: 005734

FINANCIAL
CONDUCT
AUTHORITY

12 Endeavour Square London E20 1JN
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk