FINANCIAL CONDUCT AUTHORITY

Liquidity mismatch in authorised open-ended property funds

Consultation Paper
CP20/15**

August 2020

How to respond

We are asking for comments on this Consultation Paper (CP) by **3 November 2020**.

You can send them to us using the form on our website at: www.fca.org.uk/cp20-15-response-form

Or in writing to:
Michael Collins
Financial Conduct Authority
12 Endeavour Square London E20 1JN

Email:
cp20-15@fca.org.uk

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1 Summary

Why we are consulting

1.1 The UK has a number of FCA-authorised 'daily dealing' funds which invest directly in property, for example commercial buildings. These are open-ended funds which offer investors the option to put money in and take it out on each working day (this is sometimes called 'offering daily liquidity').

1.2 Daily dealing can be attractive for investors because, assuming it can be maintained, it means they can invest in and move out of an asset class whenever they want.

1.3 But the underlying asset that they are investing in cannot be bought and sold in this way. So, fund managers often hold large cash balances to manage the risk that investors choose to redeem their investments at any time. Holding these cash balances is inefficient and reduces expected returns to investors. When outflows are too large, a fund manager may still have to suspend dealings in the fund. The structural mismatch between the liquidity that these funds offer their investors and the time it takes to buy or sell property assets means that there is an inherent risk of suspension that is not present to the same extent in funds that do not have such a mismatch.

1.4 Fund suspensions can protect investors from worse outcomes. But repeated suspensions suggest that the daily liquidity that these property funds offer cannot always be delivered and comes with a price. Investors in authorised open-ended funds need to have confidence that they will be treated fairly. Funds should not contain structural features that enable some investors to take advantage of them for their own benefit, against the interests of other investors. When an investor deals in a fund, it should be at a price that reflects an accurate and fair valuation of the underlying assets. It should also take into account the costs that their deal imposes on the fund.

1.5 The illiquid nature of property also means that a value is not always readily available, and in some market conditions the fund units cannot be priced with confidence on a daily basis. This valuation uncertainty can also lead to a need to suspend the fund. These factors and a lack of liquidity have resulted in these funds suspending on several occasions in recent years.

1.6 While it may be unavoidable that there will be times when an illiquid asset such as property cannot be valued reliably, structural liquidity mismatch is in general avoidable. So, in this paper, we set out a possible way of addressing this structural mismatch through a proposal to require investors to give notice before their investment is redeemed. We estimate that the introduction of notice periods could potentially deliver a material increase in returns to property fund investors. This is due to the funds operating in a more stable and sustainable way, with more assets invested in property and less in cash.

1.7 The approach we set out in this paper would not remove all risk of suspensions. There could still, for example, be times where uncertainty over the valuation of scheme assets could lead funds to suspend dealing.

1.8 But this approach would allow these funds to offer a structure more closely mirroring the economic reality of the underlying investments. This could go some way towards addressing the issues with these funds and better protecting their investors. In particular, it would reduce the incentive to exit the funds at a time when sale of the fund's assets might be most difficult and might disadvantage remaining investors. This would potentially reduce the pressure to sell fund assets quickly and at a discount, and help investors to understand that these funds cannot in practice offer frequent redemption opportunities across a full range of market conditions.

1.9 We recognise that our proposed approach would affect the rights that investors have under their existing investments, as they will no longer be able to redeem at short notice. But on balance we think investors as a whole will benefit from this amended structure within which to hold property investments.

1.10 We are also interested in hearing alternative proposals to address the problems arising from the mismatch between holding illiquid assets and offering daily redemptions. We are aware that there is a range of views in the market, from those who believe that no change is necessary to those who take the view that inherently illiquid assets such as property should not be held in open-ended structures.

1.11 The proposed approach in this consultation paper is only directly relevant to UK authorised property funds that are non-UCITS retail schemes (NURS). Other funds that invest in illiquid assets may face similar structural issues. We continue to work with the Bank of England (the Bank) on the issue of illiquid assets in open-ended funds, and will consult on any further remedies, if appropriate, after the conclusion of the current work being undertaken by the Financial Policy Committee (FPC).

1.12 Although it is not covered in detail in this paper, we are supportive of considering new initiatives within the regulatory framework that would facilitate investments in long-term assets. We are interested in hearing comments on this topic.

Who this applies to

1.13 This consultation primarily affects:

- managers of UK authorised property funds, constituted as NURS
- depositaries of these funds
- feeder funds that invest in these property funds
- master funds that invest in property, which these property funds invest in
- ancillary service providers
- providers of investment services offering access to these funds, including Self-Invested Personal Pension (SIPP) and Small Self-Administered Scheme (SSAS) providers, as well as Individual Savings Account (ISA) managers
- distributors of these funds
- investment intermediaries who advise on or invest in these funds
- unit-linked insurers who offer insurance contracts linked to these funds
- discretionary wealth managers, including those who offer model portfolios
- other professional or institutional investors

1.14 This consultation may also be of interest to:

- managers of other types of UK property funds
- managers of other UK authorised funds
- investment managers who manage investments on behalf of UK authorised funds

1.15 Interest to consumers

- Consumers who invest directly in UK authorised property funds, or who are exposed to these funds through their pension contributions or their long-term life assurance policies are affected by our proposals in this paper. We welcome input from individual consumers and groups representing their interests.

The wider context of this consultation

1.16 We launched a discussion paper (DP17/1) on illiquid assets in open-ended funds in 2017. As a result of the feedback that we received, we consulted on (CP18/27), and set out new rules (PS19/24) for open-ended funds investing in inherently illiquid assets. The new rules require:

- investors to be provided with clear and prominent information on liquidity risks, and the circumstances in which access to their funds may be restricted
- managers of funds investing in inherently illiquid assets to maintain plans to manage liquidity risk

1.17 In PS19/24, we said we would explore the use of notice periods and reduced dealing frequency as liquidity management tools for open-ended funds that invest in illiquid assets and are offered to retail investors.

1.18 Since 2019, we have been reviewing the liquidity of open-ended funds with the Bank. The December 2019 Financial Stability Report provided an update on this, setting out three principles underpinning this work, including one on notice periods.

1.19 We have published this paper now, while almost all relevant funds are suspended for dealing. We want a considered debate about the merits of the approach we have set out, at a time when there is less risk of there being a disorderly market caused by many investors demanding to sell units in these funds. We want an open discussion about these potential measures.

1.20 The authorised fund managers and the depositaries of suspended property funds must continue formally to review suspensions that are in force at least every 28 days (COLL 7.2.1R (4A)) during the suspension period, and we ask that they continue to inform the FCA of the results of this review and ahead of restarting dealings.

1.21 The introduction of the proposed notice period could mean that relevant funds might no longer be qualifying investments for Stocks and Shares ISAs. We are liaising with Her Majesty's Treasury (the Treasury) and Her Majesty's Revenue and Customs (HMRC) to confirm whether these funds would remain eligible for ISAs following a change in our rules for property funds as we recognise that for retail investors this could offset other benefits of the rule change. We will take this into account in our final decision.

What we want to change

1.22 We are consulting on how to address the potential harm caused by the liquidity mismatch of UK NURS that invest directly in property. So that these funds can operate fairly and efficiently in the interests of all investors, we propose introducing a notice period of up to 180 days for these funds (see section 3 for further details). This could eliminate the potential for some investors to gain at the expense of others, and reduce the likelihood of liquidity runs on funds leading to 'rapid sales' of assets which may disadvantage remaining fund investors. We refer to this as the 'first mover advantage'.

Other proposals

1.23 We propose a transitional rule for the capital rules for SIPP providers, so that the introduction of notice periods for existing client holdings in these funds within SIPPs would not automatically lead to a potential step increase in the amount of capital that SIPP operator firms are required to hold.

Outcome we are seeking

1.24 We are considering how to reduce the potential for investor harm created by the liquidity mismatch between the redemption terms of the fund, and the liquidity of the underlying property investments within the fund. We also estimate that the introduction of notice periods could potentially deliver a material increase in returns to property fund investors. This is due to the funds operating in a more stable and sustainable way, with more assets invested in property and less held in cash.

1.25 We want the funds to be resilient during periods of stress, and to operate in a way in which all investors are treated equitably.

Measuring success

1.26 If we implement this proposed approach, we will seek to measure success through evidence of fewer incidents of liquidity-related stress in open-ended property funds in the long term once funds and their investors have adjusted to the notice-period model.

Next steps

1.27 We welcome feedback on our proposals by 3 November 2020.

1.28 We will consider all feedback, and subject to the responses received, we will seek to publish a final policy statement and final handbook rules as soon as possible in 2021.

2 The wider context

2.1 This chapter describes the UK market for open-ended property funds, our concerns about the actual and potential harms to investors created by the liquidity mismatch within some of these funds and our current initiatives to address them.

Background

2.2 Open-ended funds let investors pool their contributions so they can invest efficiently, share in the profits or income made by the assets held by the fund, and have access to investment expertise. They issue new units to investors and redeem investors' existing units on demand. Open-ended funds operate within legal structures designed to protect investors. UK authorised funds are also subject to detailed regulatory requirements.

2.3 Authorised property funds let investors access the income and capital growth from commercial and other investment property through a diversified and risk-controlled portfolio of investments. Without pooling assets, this would be impossible to do for all but the wealthiest individuals. There are other ways to do this, for example by investing in shares in real estate investment trusts (REITs) or in insurance units linked to property assets.

2.4 Authorised property funds offer investors an option to invest in commercial property and to take their money out on a regular basis at the current net asset value of the fund, adjusted for any dealing costs. Transaction costs associated with direct investments in property, such as taxes, agent fees and legal fees, are typically high. This means that property funds are unlikely to be appropriate as a short-term investment.

2.5 Some of these funds are targeted at institutional investors, such as pension funds. This type of fund typically lets investors put money in and take it out from time to time (eg once a quarter). But there are also around 20 funds constituted as NURS which offer investors the option to put money in and take it out on each working day. This is what we term daily dealing. If funds offer daily redemptions, they must process redemptions on demand (unless suspended) and cannot currently impose any kind of notice period on investors.

2.6 But there is a structural mismatch between the dealing frequency of units in these daily-dealing open-ended property funds and the underlying property assets in which they invest. This liquidity mismatch made it harder for funds to meet the increased levels of redemption requests, and led to the temporary suspension of dealings in several property funds during the financial crisis in 2008, and following the EU referendum in 2016. One property fund also suspended in 2019. These suspensions were the result of fund managers' inability to realise sufficient levels of cash to meet the redemption requests they were receiving. More recently, almost all UK authorised funds that invest in property have suspended dealings because of valuation uncertainty in the light of the uncertain economic impact of the current coronavirus pandemic.

2.7 Our previous work on illiquid assets and open-ended funds has observed that suspensions and other liquidity management tools have generally worked as intended. That said, we consider that the increasingly frequent nature of property fund suspensions might sharpen incentives for some investors to redeem ahead of others. This may be either to attempt to achieve a better price or to avoid becoming temporarily trapped in a suspended fund (first mover advantage).

2.8 This situation creates issues of fairness. If a fund has to dispose of underlying assets to meet an unusually high volume of redemption requests, the manager must ensure these disposals are carried out in a way that does not disadvantage investors who remain in the fund or are newly investing in it. However, there is a risk that the manager may choose to sell the fund's highest quality, most liquid assets to meet redemptions. Although our rules aim to prevent this, there is a risk that remaining investors may be left with a less liquid, riskier and less attractive portfolio of investments. A notice period allows assets to be sold through an orderly sales process, reducing this risk.

2.9 The work on liquidity mismatch within funds which we have conducted jointly with the Bank at the request of the FPC, also highlighted first mover advantage, particularly during periods of stress, as a potential systemic risk.

2.10 Daily dealing property funds structured as NURS have held high average cash levels over recent years as fund managers seek to avoid suspensions due to large redemption requests. Higher cash levels result in lower property exposure, which can cause a drag on the level of performance consumers see on their investments.

2.11 The December 2019 Financial Stability Report (pp.75) noted the FPC's preference for greater consistency between the liquidity of a fund's assets and its redemption terms. It set out 3 principles to achieve greater consistency between asset liquidity, pricing of redemptions and the length of notice period:

- The liquidity of funds' assets should be assessed either as the price discount needed for a quick sale of a representative sample of those assets or the time needed for a sale to avoid a material price discount.
- Redeeming investors should receive a price for their units in the fund that reflects the discount needed to sell the required portion of a fund's assets in the specified redemption notice period.
- Redemption notice periods should reflect the time needed to sell the required portion of a fund's assets without discounts beyond those captured in the price received by redeeming investors.

2.12 Aligning the redemption profile of a property fund with the liquidity profile of the assets in which it invests should reduce the potential for first mover advantage. There would be less need for large cash holdings within funds, which would increase the proportion of the fund that could be invested in property assets. There would also be sufficient time for a manager to arrange property sales in an orderly way, removing the potential need to sell assets at a discount.

2.13 Since the publication of the December Financial Stability Report, we have engaged with managers of property funds and trade associations, as well as distributors of these funds, on possible options to address the risks associated with liquidity mismatch.

2.14 We set out a proposed approach in this paper to reduce this liquidity mismatch by requiring UK authorised property funds to introduce notice periods. As noted in Chapter 1, we are consulting on this now because we want a considered debate on the merits of this proposal to begin while almost all relevant funds are suspended. We would like an open discussion on the proposed approach, to deliver the right outcome, both for consumers and in the interests of market integrity and financial stability. We have also considered other possible approaches to addressing this issue. We set these out in Chapter 5, and ask for feedback on these.

The potential harm we are trying to address

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

- Reducing the likelihood of a property fund suspension due to a lack of liquidity, which will in turn reduce the likelihood of significant levels of withdrawals from a fund. Significant levels of withdrawals can have a negative impact on those investors who are slower to react, and therefore are temporarily unable to redeem their holding.
- Reducing the risk that consumers buy products that are unsuitable for their needs by making the impact of the illiquidity more transparent.
- Reducing inefficiencies and increasing the potential for higher investment returns by enabling property funds to hold less cash, and have greater exposure to property assets.

2.16 We anticipate that our proposals will benefit the integrity of financial markets and will help to reduce the FPC's broader financial stability concerns.

How it links to our objectives

Consumer protection

2.17 We consider that our proposals will help further our consumer protection objective by reducing the number of fund suspensions, preventing unsuitable purchases of these funds, and by increasing product efficiency by reducing inefficiencies created by large cash buffers.

2.18 Although suspension may be the best way of protecting fund investors in certain circumstances, repeat suspensions due to a lack of liquidity could be a sign of an inappropriate fund structure and can impact market confidence.

2.19 Our proposals will not remove the possibility of property funds suspending due to material uncertainty over the value of the underlying assets, and thus the price of units in the fund. We also recognise that in times of severe market stress the notice period will not completely remove the risk that a fund manager does not have sufficient time to sell properties to raise liquidity to meet redemption requests.

Market integrity

2.20 We consider that our proposals will deliver a more appropriate, stable and resilient structure for property funds. This will further our statutory objective of protecting and enhancing the integrity of the UK financial system.

Unintended consequences of our intervention

2.21 If we introduce notice periods, many property funds may no longer be qualifying investments for a Stocks and Shares ISA. Therefore, the tax treatment for those consumers who hold their fund within an ISA could change. We are in discussions with the Treasury and HMRC to confirm whether the funds would remain eligible for ISAs following a change in our rules and will take this into account in our final decision.

2.22 Some investors may value the ability to deal frequently in a property fund, and decide that they do not wish to remain invested if they have to give notice. Such investors are taking advantage of the structural mismatch between the redemption profile of the fund, and the underlying assets the funds hold. These investors might reduce their exposure to open-ended property funds as a result of our proposals.

2.23 As part of this consultation we are keen to hear other examples of potential unintended consequences as a result of the proposed changes, for example the emergence of secondary markets for units in property funds.

Equality and diversity considerations

2.24 We have considered the equality and diversity issues that may arise from the proposals in this Consultation Paper. 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, to 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.

2.25 According to HMRC data, consumers over 45 are more likely to invest in Stocks and Shares ISAs, and are therefore more likely to invest in open-ended daily dealing property funds, than consumers who are under 45. We recognise that notice periods might result in consumers needing to plan further ahead when they will need the proceeds of their investments.

2.26 However, overall, we do not consider that the proposals materially impact any of the groups with protected characteristics under the Equality Act 2010. However, we welcome any feedback on any diversity implications from our proposals in response to this CP.

Q1: **Do you consider our proposals impact any groups with protected characteristics under the Equality Act 2010? Do you consider there are any issues which may be relevant to our obligations under the Equality Act (see paragraph 2.24)? If so, please provide details.**

3 Notice periods for property funds

3.1 This chapter sets out proposed new rules for open-ended UK authorised funds that invest in property, which are constituted as NURS and offer investors daily, monthly and quarterly opportunities ('valuation points') to buy and redeem units. In this chapter, we refer to these funds as 'property funds'. We propose that, when such a fund receives a redemption request, the manager should wait for a period, in other words a notice period, after which they will process the redemption request. Redemption requests however could still be submitted as frequently as daily.

Why we are proposing this

3.2 Investors in authorised open-ended funds need to have confidence that they will be treated fairly. Funds should not contain structural features which some investors can take advantage of at the expense of other investors. When an investor deals in a fund, it should be at a price that reflects an accurate and fair valuation of the underlying assets. The price should also take into account the costs that the investment or redemption imposes on the fund.

3.3 As noted in the previous chapter, with property funds that offer frequent redemptions (eg daily) there is a structural mismatch between the liquidity that they offer their investors and the time it takes to buy or sell the property assets in which they invest. This can create an incentive for an investor to sell units in the fund while there is still sufficient liquidity to meet their redemption request, that is a first mover advantage.

What is the problem

3.4 Fund managers are required under FCA rules to manage the liquidity risk of their funds. Specifically, managers of alternative investment funds (AIFs), of which property funds are a subset, are required to 'ensure that the investment strategy, liquidity profile and redemption policy of each AIF... are consistent' (FUND 3.6.2R).

3.5 Periodic suspensions of property funds may demonstrate a tension between the redemption policies and the liquidity profiles of the investments. A typical commercial property transaction may take between 2 and 4 months to complete under normal market conditions. So, property funds hold cash balances to meet redemption requests.

3.6 This means that it is hard to manage property funds efficiently. If a fund receives unexpectedly large redemption requests, it might be unable to meet those immediately from the assets that it holds. So, to reduce this risk, the fund may hold a significant proportion of its assets in cash or other liquid assets (for example, REITs).

3.7 When a fund is unable to meet redemption requests in a way that is fair to all investors, the manager may need to suspend dealings. In this situation investors are unable to make further contributions to or access their investments, and there might not be clarity about when they will be able to access them.

3.8 Some investors are more aware of the liquidity position of such property funds, and may seek to take advantage of this to the detriment of other investors. They may perceive that, by moving first, they can exit a fund ahead of others and not incur the transaction costs that the fund may subsequently be forced to pay to sell its investments. Or they may perceive that a fund will run out of liquid assets before it is able to meet redemption requests, and seek to redeem ahead of others, before the fund suspends dealings.

3.9 As noted in Chapter 2, the FPC is also concerned that the structural mismatch of liquidity in these funds in some circumstances could create risks to financial stability.

Our plan to address this

3.10 In PS19/24, we announced new rules designed to improve the operation of funds investing in inherently illiquid assets, as well as to enhance the disclosures around such funds. But we have also been considering whether other remedies may be necessary to address the specific risks posed by property funds.

3.11 On balance, we consider that notice periods for redemptions from these funds would go some way to addressing the structural risks they pose.

3.12 The notice period would need to be of sufficient length that the manager could plan sales of property assets so that it could meet redemptions as they fall due. This would mean that the manager is better able to plan when to invest or to make asset sales without needing immediately to meet any unexpected requests. We think it would also mean that property funds could tolerate holding less cash than they do currently, enabling this money to be invested into property or other permitted assets, as permitted under our rules and by the instrument constituting the fund and its prospectus.

3.13 It would also send a clear signal to investors in these property funds that they are intended for medium-term to long-term investment. Future investors would better understand that these funds do not truly offer daily, monthly or even quarterly liquidity.

3.14 We do not consider that notice periods would necessarily solve all the liquidity issues in property funds, or mean that such funds would never suspend dealings. In times of severe market stress, the notice period may still not be sufficient to give fund managers time to sell the necessary property, and funds could still suspend in exceptional circumstances. The rules in PS19/24, that come into effect from 30 September 2020, also require an authorised property fund to suspend when there is material uncertainty over the valuation of more than 20% of its assets.

Proposed dealing structure

3.15 We propose that relevant funds would operate the following dealing structure:

- Each investor's redemption request would be received and recorded, then processed at the end of a notice period.
- The investor would receive the value of their investment, based on the unit price of the fund at the first valuation point following the end of their notice period.
- Redemption requests would be irrevocable, so that investors cannot place orders and withdraw them before the end of the notice period if market conditions change. Not doing this could lead to the fund manager selling property to meet redemption requests that are subsequently cancelled.

3.16 We do not propose changing the way that funds can accept subscriptions. In this way, a daily dealing fund for example would operate somewhat similarly to a deposit account with a notice period. Specifically, money can be deposited in these accounts on any working day, but when investors wish to obtain their money back they must wait for a set period. The main difference in property funds would be that the investor would have to wait a period of time until they knew the price at which they would redeem.

3.17 The price at which the redemption takes place would be based on the first valuation of the fund at the end of the notice period. This is how fund redemptions currently occur – the investor does not know the precise value they will get until the next valuation point. But with a notice period the gap between redemption request and determination of redemption value would be much longer.

3.18 This means that redeeming investors would be subject to greater 'market risk' than they are now. But we consider that this is a fair way to balance the interests of all investors in such funds.

3.19 If the price was instead determined at the point when notice was given, the value of the redemptions would be an obligation to be met out of the fund's assets regardless of how it might change in value during the notice period. The other, ongoing, investors in the fund would then be exposed to a higher level of market risk during the notice period which would not be fair to them. An obligation to meet these redemptions at the price when notice was given would effectively cause a leveraging of the fund, which might not be obvious to retail investors.

3.20 We are aware that these changes would pose additional risks to investors in property funds if they are not well understood. As such, the rules we are proposing will require fund managers to ensure that warnings are given to retail investors covering the market risk they would be exposed to during the notice period, the length of the notice period associated with their investment, and the irrevocable nature of the redemption requests.

Length of notice period

3.21 We have considered the appropriate minimum length of notice period from the perspective of:

- the time taken to sell commercial property

- the time horizon that a consumer may look ahead to when planning their financial affairs
- the level of market risk that a consumer would be taking on

3.22 Academic research on the length of time that commercial property assets take to sell is now quite dated, and it is not clear to us how far it reflects modern systems or working practices. One paper notes that 60-90 days is the most common period for a property to be sold from the time it is first marketed. It observes that this is the time that property professionals estimate it would take to sell a property. But it also notes that there is a positive skew to the distribution of time taken, and that in many cases it can take significantly longer.

3.23 We are also aware that there are sometimes periods when the property market does not operate in its 'normal' way, for example at the current time when commercial property markets are significantly impacted by measures taken to contain coronavirus. We would welcome any evidence that respondents have about the length of time to sell properties in both normal and exceptional market conditions.

3.24 For the consumer, we consider that 90 days is likely to be an acceptable timeframe in which to plan financial affairs. For example, many deposit-takers offer term deposits which require 90 days' notice. A longer notice period, for example 180 days, might provide more time to sell property at the best price which can be obtained, but might increase the complexity of decision-making for consumers. We would welcome views on both options.

3.25 The risk associated with the time taken to sell property is another relevant factor. One paper analyses the additional risk that an investor in property takes on, depending on how long it would take to sell their property assets, and the time-horizon that the investor has for their investment in property. The paper models that a 3-month sale period increases the risk of property investment by 10% for a 7-year time horizon, and 7% for a 10-year time horizon. A 6-month sale period increases the risk by 38% for a 7-year time horizon and 27% for a 10-year time horizon. This research can be found in 'Liquidity Risk and Real Estate: A quantitative approach to assessing risk', Bond & Hwang (2004).

3.26 Based on returns over the past 20 years, the average return on a daily dealing property fund over 3 months was around 1.2%. Funds fell in value around a quarter of the time. Around 6% of the time, the fall was greater than 5%. The worst falls occurred during periods of suspension, so investors were unable to access their money over most of the worst performance periods. Investors would have been exposed to this market risk if they had owned property directly, but the introduction of a notice period eliminates their ability to try and cut their losses by selling immediately (leaving the losses with remaining investors).

3.27 On balance, taking into account the different factors above, we are consulting on a notice period of between 90 and 180 days. The instrument proposes two alternatives (see draft COLL 6.2.22AR(2)(e)). But we are open to others. For example, depending on the construction of the underlying portfolio, a fund manager may feel that their fund warrants a longer notice period. We would also welcome feedback on whether there are other issues or practical factors we should consider here. For example, there may be practical benefits in having a notice period of 91 or 182 days, as these are multiples of 7 which would mean that redemptions would be processed after a set number of weeks. We would note that NURS are required to redeem investors at least once every 185 days and therefore notice periods could not exceed this length of time.

Other considerations

Scope

3.28 Similar to our definition of a fund investing in inherently illiquid assets (FIIA), we plan to include in scope of these rules any NURS that invests 50% or more of its assets in immovables (or in other schemes that invest in immovables to the same extent), and that if a fund operates limited redemption arrangements, any fund where those arrangements provide for dealing in units more frequently than the length of the notice period (see paragraph 3.29 below). By way of explanation, on the assumption that we decide that a notice period of 180 days is necessary, the definition brings into scope any property funds offering quarterly or more frequent dealing opportunities. If it is determined that 90 days, as opposed to 180 days, is the appropriate length of notice period for property funds then quarterly dealing funds would not be within scope of the proposed rules as there would be no perceived liquidity mismatch. This means the definition will only capture funds that do not operate redemption arrangements that reflect the typical time needed to sell these assets. Funds falling within scope of this definition would be referred to in our Handbook as 'funds predominantly investing in property' (FPIP). This would not be a consumer-facing term and would merely be used for Handbook navigation purposes.

3.29 Under our current rules, NURS employing limited redemption arrangements, such as those that deal monthly and quarterly, can have notice periods. These funds have typically not suffered the same history of suspension due to liquidity concerns, and are usually not marketed to retail investors. As such, we are proposing that the existing population of funds offering limited redemption which deal no more frequently than once a month will not fall under the new rules and would not be classed as FPIPs. However we propose that, after our rules enter into force, any new NURS property funds, including those that deal monthly (or potentially quarterly), per 3.28 above, would be classed as FPIPs and would need to have notice periods.

Need to change instruments and prospectuses to account for the new dealing structure

3.30 The dealing terms of funds are set out in the instrument constituting the fund and the prospectus. Any change to the dealing terms will require the fund manager (or where relevant, the fund) to amend the instrument and prospectus. Written notice will need to be given to the FCA of the proposed changes under sections 251 or 261Q of the Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012 (FSMA), or regulation 21 of the Open-Ended Investment Companies Regulations 2001. Changes like this to the instrument and prospectus, if initiated by the fund manager, would normally be treated as a fundamental change and be subject to the requirements in COLL 4.3.4R for fundamental changes.

3.31 However, if we proceed as proposed, the change would be driven by a new regulatory requirement, and we do not consider that the change of terms would mean that funds have to go through the fundamental change process and require unit holders to vote for the purposes of meeting our rules. Instead, we consider this would be a significant change, under COLL 4.3. We would expect fund managers to notify investors before any change comes into effect.

3.32 Fund managers will still have to obtain FCA approval for any changes to the instrument and prospectus. They will also need to consider any fund-specific requirements that arise as a result of any changes to the instrument constituting the fund or its prospectus which would be triggered by our proposals.

Significant changes

3.33 Once a notice period is applied, it will have an impact on any future changes to the fund that the fund manager decides to make. When a fund manager makes a significant change to the fund, unitholders must be given reasonable notice so they can consider the change and sell their units if they disagree with it. COLL 4.3.6R (3) requires notice of the change to be not less than 60 days in advance of it taking effect. For a property fund, we think the notice period for redemptions should also be allowed for in this procedure. So, if a fund is operating a dealing notice period of 90 days, we propose that significant changes would need to be communicated to unitholders at least 150 days in advance.

Feeder funds

3.34 Many of the daily dealing funds which invest in property have UK authorised feeder funds. These funds offer exposure to the underlying funds, and the economic experience of investing in a feeder fund should be consistent with that of investing directly into the property fund. We propose that investors in feeder funds should also have to give notice, and that the feeder fund must then immediately give notice to the underlying fund. Our proposed changes would mean that the experience for investors in UK authorised feeder funds will be the same as for investors in underlying funds.

Interaction with suspension rules

3.35 As previously stated, we do not think that our proposals will prevent property funds from suspending in future, where this is in the interest of investors. For example, where there is material uncertainty about the value of at least 20% of a funds' assets, suspension will be required under our existing rules.

3.36 Under the proposals, fund managers would not be able to cancel redemption requests that were placed prior to a fund suspending. We also propose that investors would be permitted to place redemption requests during a fund suspension, although they would not be able to purchase units.

3.37 Importantly, the period during which a fund is suspended would count towards the notice period. For example, if a fund operates a 180-day notice period and an investor placed a redemption request 120 days prior to a fund suspension, and if the fund was suspended for 50 days, the manager would need to redeem the investor's holding 10 days after the fund suspension ended. If the fund was still suspended at the end of the notice period for the investor's redemption request, the manager would need to redeem the investor at the first valuation point following the end of the suspension. We think this is a fair way to manage demand for redemptions during any period of suspension. It would also provide the fund manager with visibility around redemptions at reopening.

Interaction with incoming FIIA rules

3.38 NURS that fall into the category of FIIA are subject to additional requirements including enhanced depositary oversight, standard risk warnings on financial promotions, increased disclosure of liquidity management tools and liquidity risk contingency tools. We also require NURS to suspend dealing in fund units where the standing independent valuer (SIV) expresses material uncertainty regarding 20% of the scheme property.

3.39 Introducing notice periods for property funds may go further in addressing some of the risks that the FIIA rules are designed to tackle. There may be a reduced need for some aspects of the rules, for example around liquidity risk contingency planning. On balance, we consider that notice periods for property funds would complement the FIIA rules.

3.40 Under our proposals, property funds which meet the conditions for being both FIIAs and FPIPs will be considered FPIPs. However, FPIPs would be subject to all the FIIA rules except for the prescribed risk warning for retail investors (COBS 4.5.16R and 4.5A.17R). This risk warning does not appear to be appropriate for property funds with notice periods, so we are requiring these funds to include different warnings to retail investors. As set out above, these warnings would need to cover the market risk investors will be exposed to during the notice period, the length of the notice period associated with their investment, and the irrevocable nature of redemption requests. We do not propose to prescribe the exact wording to be used in these warnings.

Q2: **Do you agree with our proposal to introduce notice periods for UK authorised property funds? If not, what alternative proposal would you have to address the structural liquidity mismatch?**

Q3: **Do you agree that notice periods should be structured as described in this chapter? If not, why not and what alternative proposal would you suggest?**

Q4: **The instrument sets out two alternative notice periods with lengths of 90 days or 180 days in COLL 6.2.22AR(2)(e). Which of these is the best? If neither, what alternative length would you propose and for what reason?**

Q5: **Do you agree with our proposal regarding the interaction of notice periods and suspensions? If not, what alternative approach would you propose and why?**

Q6: **Do you agree that it is appropriate for FIIA rules to continue to apply to authorised property funds that operate notice periods?**

Q7: **Do you agree that property fund NURS currently dealing no more frequently than monthly should not be classed as FPIPs, and so would not need to operate notice periods? Do you agree that all other property fund NURS dealing at monthly or quarterly intervals (whether existing funds moving to such dealing arrangements or newly authorised funds) should be classed as FPIPs and be required to operate notice periods?**

4 Consequences of making this change

4.1 Introducing the proposed notice period may cause these property funds to be treated differently under some other regulations and will impact other market participants, as well as investors in these funds. This chapter sets out those consequences we have identified and explains our proposed approach to them, where they are in our control, and what we are doing where they are outside our control.

Effect of our proposals on existing investors

4.2 Our proposals involve making rules requiring property funds to introduce notice periods. Existing investors will have invested in these property funds on the basis that they can redeem their units on a daily basis, or at such other times as are specified in the instrument constituting the fund and its prospectus. One effect of the proposed rules would be to change the basis on which existing investors can redeem their units. Another effect of the proposals is potentially to change the eligibility of units in daily dealing property funds under the ISA Regulations 1998, which we explore further below.

4.3 As explained in Chapters 2 and 3 of this CP, we consider that the objectives of our proposed intervention are sufficiently important to justify such an intervention.

4.4 Requiring property funds to introduce notice periods for redemptions will help to achieve the objectives identified in paragraph 2.15. It will give fund managers information about redemption requests in good time, enabling them to manage the liquidity of their fund accordingly. This should in turn enable them to hold less cash as they would no longer need to hold such a large buffer against unexpected redemptions. The presence of a notice period should be a strong signal to consumers that they are investing in a product over a medium- to long-term time horizon.

4.5 We have considered whether there could be less intrusive ways of achieving our objectives. We set out in Chapter 5 some of the alternatives which we have considered. We also explain in Chapter 3 why we are proposing a notice period of between 90 and 180 days, and why we consider, on balance, that this would be an appropriate intervention. We also explain in Chapter 2 that we are working with the Treasury and HMRC to confirm whether the funds would remain eligible for ISAs following a change in our rules.

4.6 So far as our proposed intervention affects investors' existing rights, we consider that we have struck a fair balance between the rights of individual investors, the fund's overall investor community and other market participants, and with the potential threat posed to financial stability.

4.7 In paragraph 3.33, we explained how future significant changes to FPIPs should be notified far enough in advance to allow investors to sell units before the change takes effect. A fundamental change, such as an alteration to the fund's aims, requires a vote of approval by a general meeting of unitholders before it can take effect. Investors in a property fund who dislike the outcome of such a vote and wish to sell their units as a result, would not be able to do straight away because of the notice period. We think it is nevertheless fair to allow the change to proceed promptly if the majority of unitholder votes cast at the meeting support it, but we recognise that this may disadvantage some investors for a period of time. We would like to know if stakeholders have views on other ways to treat all investors fairly in these circumstances.

Impacts on other areas

Stocks and shares ISAs

4.8 Under current tax legislation, NURS only qualify to be ISA eligible under certain conditions. Because of this, these funds may no longer be qualifying investments for a Stocks and Shares ISA. We are currently engaging with the Treasury and HMRC on whether our proposals would mean that the units or shares in property funds would no longer be 'qualifying units in or share of a non-UCITS retail scheme' for the purposes of the stocks and shares component of an ISA.

4.9 The effect of our proposals could be that the units in or shares of property funds no longer qualify for the stocks and shares component of an ISA under the ISA Regulations 1998 (as amended). We will take this into account in our final decision, noting that retail investors currently benefit from these funds being eligible for ISAs.

Investment intermediaries

4.10 We are aware that investment intermediaries may have previously given advice to clients to invest in such funds. Where there is an ongoing advice relationship, they will need to consider the ongoing suitability of investments in such funds. Property funds are typically viewed as long-term investments, and the economic exposure of a fund will remain essentially the same. We think that these proposals would make these property funds better quality investments in the long term by reducing some risks and opening a possibility of higher expected returns. But there may be some situations where a client may have requirements that mean that a notice period to access money could change the assessment of whether the investment is suitable for them. Investment advisers will need to consider whether this is an issue for any of their clients, and, if so, raise it with them.

Distributors

4.11 Distributors, such as investment platforms, who make these products available on a non-advised basis would also need to consider the appropriateness of making such funds available, and how they are described. These funds will still be regulated, and we think that these proposals would reduce some of their risk and open a possibility of higher expected returns. But there may be a subset of investors for whom a longer notice period would mean they are not appropriate. Investors may also need additional information to help them understand the longer notice period.

4.12 Distributors and other service providers would also need to consider the operational impacts of changes to dealing terms. They may need to amend systems to ensure that deals are recorded and processed under the new terms.

Unit-linked insurance

4.13 We have also considered the potential impact on unit-linked insurers who offer pooled property investments. Unit-linked products are sold by life insurance companies which have underlying pooled investments (fund-type structures) linked to an insurance policy. In unit-linked funds the investor is allotted nominal units in the fund according to the premium paid and the unit price on date of purchase, and receives returns based on the performance of the fund's investments. Unit-linked funds must be purchased within an insurance wrapper, unlike authorised funds which can be purchased directly. The wrapper is in most cases an insurance-based pension, but can also be self-standing life insurance.

4.14 The fundamental issue of how best to allow investors access to less liquid assets that may offer diversification or higher expected returns, while maintaining appropriate protections for investors, is common to both unit-linked and authorised funds. However, there are also important differences.

4.15 Unit-linked funds are in general explicitly long-term investments (pensions, life insurance cover), in which most investors, for most of the investment period, are focused on long-term returns rather than short-term liquidity.

4.16 Moreover, in the case of unit-linked funds, the obligations of the insurer are backed by capital requirements on insurers imposed under PRA rules which reflect the Solvency II Directive. The obligations of the insurer include contractual obligations to pay out under the policy (on death or maturity, for example), as well as regulatory obligations imposed on insurers by our rules.

4.17 Many unit-linked insurance contracts offer investment into daily dealing authorised property funds. For these specific contracts, insurance firms would need to decide how to process transactions. The insurer would need to decide whether to continue to permit investors to deal on the current terms, which would involve them taking the risk that the price would change during the notice period. Alternatively, they might decide to change the terms and conditions of their insurance contracts.

4.18 There are also unit-linked insurance contracts that offer investment into property in other ways. We do not consider that our proposals will have a direct impact on such insurance contracts, as there would be no requirement for them to amend their terms. We set out rules in a Policy Statement (PS20/4: Amendment of COBS 21.3 permitted link rules) to address any unjustified barriers to retail investors investing in a broader range of long-term assets in unit-linked funds, while maintaining an appropriate degree of investor protection. We do not propose to change the permitted link rules as a result of the proposal to introduce notice periods for open-ended property funds.

Other investors

4.19 All investors in these funds will need to provide notice to redeem their investments. As a result, some investors will not be able to use them in precisely the same way as previously. For example, discretionary investment managers who trade in and out of these funds to rebalance portfolios would need to adjust to the situation that redemptions from this type of fund would only occur at the end of the notice period. We do not think this will create any material cost, as these funds are long-term investments, and prices do not vary significantly from day to day. A vehicle which owns direct property investments cannot buy and sell them from day to day, and this change more closely reflects the reality of dealing in property assets.

SIPP provider capital rules

4.20 Many investors invest in these funds through their self-invested personal pensions (SIPPs). A SIPP provider is required to hold adequate capital, in the event that it seeks to close to new business and run off, or transfer its book of pension schemes to another administrator. The risk that an operator may not have sufficient financial resources is not immediately apparent to consumers when they set up a SIPP plan, nor is the ongoing risk that the operator may fail in the future, at a time when the consumer has less time to rebuild their pension assets. This undermines market confidence and can cause significant consumer harm. If SIPP providers do not hold adequate capital there is a significant risk that investors can end up funding an administration out of their own pension assets.

4.21 The amount of capital that they are required to hold is determined by the nature of the assets that they administer. Some SIPP providers administer schemes that allow clients to invest in less easily realisable asset classes, and that can be difficult or costly to transfer to another provider or to wind-up. A SIPP provider that administers such schemes is required to hold more capital than a SIPP provider administering 'standard assets'.

4.22 The capital adequacy rules for SIPP providers therefore distinguish between standard assets and non-standard assets. To be treated as a standard asset, the rules require that any investment held in a SIPP must be capable of being readily realisable within 30 days. Where a SIPP provider administers client plans that contain non-standard assets it must hold additional capital (a capital surcharge) to provide additional client protection in the event of the firm exiting the market.

4.23 The proposals set out in Chapter 3 to introduce minimum notice periods for daily dealing property funds could mean that such funds were no longer strictly capable of being readily realisable within 30 days. So, if our proposals were made as rules then existing client property fund assets within a SIPP plan could move from being a standard asset to a non-standard asset. Where relevant client plans do not already contain non-standard assets this may lead to a step increase in capital requirements as the capital surcharge would apply.

4.24 To avoid a capital surcharge for existing SIPP providers that are managing existing client plans that contain property funds and where all assets within those plans are currently eligible as standard assets, a transitional rule is proposed.

4.25 The proposed transitional rule would make clear that where a SIPP provider administers client plans that are invested in property funds before the date on which the new provisions for minimum notice periods enter into force, the requirement in note 1 to IPRU-INV 5.9.1R, for the relevant units within the funds already held, should be considered on the basis of the notice provisions applicable to that fund immediately before the date on which those rules commence.

4.26 This approach would mean that the changes to notice provisions make no difference to the existing capital requirements for SIPP providers, for units in property funds already within their clients' SIPPs, where those funds currently qualify for treatment as a standard asset. It would also mean that firms would not need to seek to recoup the costs of increased capital requirements, potentially by raising fees on clients' existing property fund holdings within a SIPP.

4.27 However, where the SIPP provider has reason to believe that those existing property fund investments would take more than 30 days to realise due to factors other than the change in notice period, those assets should continue to be treated as non-standard in the usual way.

4.28 Consistent with the existing policy (PS14/12) on capital adequacy rules, it is difficult to see why, as a matter of prudence and mitigation of potential harm to investors, a new client investment (including any additional units purchased within existing fund holdings) put within a SIPP of a property fund that cannot be realised for at least 90 days should be treated in the same way as an investment in a fund that must be realisable within 30 days. We are therefore not proposing new rules for units purchased in the property fund from the date of commencement of the notice provisions. Continuing with the existing rule treatment (whereby the requirement to be readily realisable within 30 days still applies) provides transparency for all new client investments in property funds, while maintaining the desired client protection.

> **Q8:** **Do you agree that we should introduce a transitional rule to avoid the potential of a step increase in the capital requirements of SIPP providers? If not, what alternative proposal would you make?**

Transitional arrangements

4.29 We recognise that these proposals will present operational challenges for a number of different stakeholders, who will need time to prepare to implement them fully and effectively. It will also be important for authorised fund managers and others to explain the changes to existing and potential investors, before they come into effect.

4.30 Other than in relation to SIPP provider capital rules, and the specific arrangements for existing funds with limited redemption arrangements that deal no more frequently than monthly, we are not proposing specific transitional arrangements for the new rules at this stage. This is because we think it is important to get feedback from stakeholders on what they will need to do and how quickly they can do it.

4.31 We will look to engage actively with trade associations and other key stakeholders during the consultation period to gather information on these points. We will also need to take account of the position of property funds that are currently suspended, and for how long they are likely to remain in that situation.

> **Q9:** **Do you agree that we have identified the other products and services that the change to notice periods would materially impact? If not, what other impacts should we consider?**

> **Q10:** **What transitional arrangements do you think will be needed to implement the proposals in this paper? How quickly can they be brought into effect?**

5 Further points for discussion

5.1 Alongside these proposals, there are some other matters that we have been considering. The FPC may make recommendations to the FCA to change fund rules to reduce the risk that open-ended funds will impact financial stability. Such recommendations may relate to the duration of notice periods. This work has been delayed by the current pandemic, but we expect to consult on further changes to the fund rules to address these recommendations, once the FPC has reached its conclusions.

Alternative approaches to addressing liquidity mismatch

5.2 We have considered alternative approaches to address the liquidity mismatch, including requiring all such funds either to wind up, or to convert into an alternative structure that does not offer daily dealing. As set out in paragraph 3.4, fund managers are already under a duty to ensure that their funds' investment strategies, liquidity profiles and redemption policies are consistent. But there are limited incentives, and significant barriers, to change. This seems to have meant that, in practice, many property funds have continued to offer daily redemptions.

5.3 As an alternative, we could reduce the harm to retail consumers by preventing any property fund that did not have a notice period from being marketed, sold and distributed to retail investors in future. Subject to consultation responses, we consider this alternative to be less attractive than the proposal in this CP. This is because it would not prevent a property fund from offering daily dealing, but it would restrict the type of consumers who could invest in them.

5.4 We recognise that there would be significant practical consequences associated with such an intervention. While it would prevent new retail investors from the risk of misunderstanding the true liquidity properties of the fund, it would not address any investor protection, market integrity or financial stability risks associated with the liquidity mismatch of existing investments, at least until these were redeemed. On balance, we do not feel that this is as effective in addressing the issues set out in Chapter 3. But we would welcome feedback from respondents as to whether there are alternative ways to address the liquidity mismatch which do not involve notice periods.

Pricing

5.5 We have also considered whether to mandate the mechanism that these funds use to price units. Some firms have suggested that funds which operate a dual price are less attractive for investors who wish to move money in and out of a fund, compared with funds that operate a single price.

5.6 Units in single-priced open-ended funds are bought or sold at the same price, which is directly linked to the value of the fund's underlying investments. There is no bid-offer spread. Funds can apply a dilution adjustment (swinging price) or a dilution levy to protect existing shareholders from the costs of buying and selling underlying investments that are incurred as other investors join or leave the fund. The dilution adjustment will effectively swing the price from the mid-price to a single bid or offer price for investors joining or leaving the fund. This is usually applied when there are large inflows or outflows, as the associated transaction costs can dilute the value of the fund for existing investors. Single-priced property funds may automatically implement a dilution adjustment when net subscriptions or redemptions are above a certain percentage of the assets of the fund.

5.7 Dual-priced open-ended funds on the other hand, have an offer (or buying) price and a bid (or selling) price and the difference between these is known as the bid-offer spread. This spread will depend on estimates of transaction costs for dealing in the underlying investments of the fund. Dual-priced property funds typically have a wide spread, reflecting the relatively high transaction costs of dealing in property.

5.8 It has been suggested that it would be beneficial for all property funds to operate dual pricing, as this this might discourage short-term investment in property funds, and prevent investors from attempting to take advantage of the price swings created by single swinging pricing.

5.9 Under our rules, funds may choose whether to operate a single or dual price. If the manager considers that this would address some of the risks around liquidity management, they could choose to use a dual price rather than a single price structure. We do not propose to make dual pricing mandatory for UK authorised property funds, but we would be interested in feedback on this point.

Notice periods for other funds

5.10 Our current rules only permit some UK authorised funds to use limited redemption arrangements which may involve notice periods. There may be other types of funds that are not currently able to use notice periods where the manager might consider it appropriate to operate a notice period. We are interested in feedback on amending our rules to permit other types of fund to put in place notice periods.

Other illiquid assets

5.11 The Investment Association (IA) has published a proposal for a new type of authorised fund designed to invest in long-term assets – the Long-term Asset Fund (LTAF) as part of the UK Funds Regime Working Group's Final Report to the Asset Management Taskforce. In February 2020, we published FS20/2, which addressed various topics relating to Patient Capital and Authorised Funds, including our initial response to the LTAF proposal.

5.12 In the paper, we welcomed the IA's work given the importance of long-term capital to support economic growth and innovation. But we identified areas where we encouraged further work on the balance between expanding the types of assets that funds invest in and investor protection. We understand the IA is currently developing the proposal further, including the need to balance any expansion in the types of assets that authorised funds can invest in with appropriate levels of investor protection.

5.13 While we are not making specific proposals at this time, we welcome views on whether there are further steps the FCA should take to accommodate such structures within the regulatory framework.

Secondary markets

5.14 In some markets where there are open-ended property funds with dealing restrictions, there is a secondary market in units. Investors can agree to sell their holding in a fund to another investor at a price negotiated between them. We recognise that there might be some barriers to firms doing this in practice with UK authorised funds. If a firm acted in such a way as to bring potential buyers and sellers together, this would potentially constitute the regulated activity of arranging deals in investments, and any firm doing so would need to be authorised to do this and to comply with the relevant requirements. We are also aware that this might disadvantage retail investors were they to receive an inappropriately low price for their units.

5.15 We welcome feedback on whether any changes to the fund and/or other rules would be required to facilitate the development of an efficient secondary market.

Q11: **Do you agree that the proposals in this paper for notice periods are preferable to placing other types of restrictions on funds that offer frequent dealing while investing in property assets (for example preventing them from future marketing to retail clients)? If not, what do you suggest?**

Q12: **Do you think that other types of fund should be permitted to operate notice periods? If so, please explain which other funds and why.**

Q13: **Do you have any views on what further steps the FCA should take to accommodate long-term capital structures?**

Q14: **Do you consider that there are any amendments to the fund rules (or other rules) which we should make to facilitate the development of a secondary market in units in property funds?**

Annex 1
Questions in this paper

Q1: **Do you consider our proposals impact any groups with protected characteristics under the Equality Act 2010? Do you consider there are any issues which may be relevant to our obligations under the Equality Act (see paragraph 2.24)? If so, please provide details.**

Q2: **Do you agree with our proposal to introduce notice periods for UK authorised property funds? If not, what alternative proposal would you have to address the structural liquidity mismatch?**

Q3: **Do you agree that notice periods should be structured as described in this chapter? If not, why not and what alternative proposal would you suggest?**

Q4: **The instrument sets out two alternative notice periods with lengths of 90 days or 180 days in COLL 6.2.22AR(2)(e). Which of these is the best? If neither, what alternative length would you propose and for what reason?**

Q5: **Do you agree with our proposal regarding the interaction of notice periods and suspensions? If not, what alternative approach would you propose and why?**

Q6: **Do you agree that it is appropriate for FIIA rules to continue to apply to authorised property funds that operate notice periods?**

Q7: **Do you agree that property fund NURS currently dealing no more frequently than monthly should not be classed as FPIPs, and so would not need to operate notice periods? Do you agree that all other property fund NURS dealing at monthly or quarterly intervals (whether existing funds moving to such dealing arrangements or newly authorised funds) should be classed as FPIPs and be required to operate notice periods?**

Q8: **Do you agree that we should introduce a transitional rule to avoid the potential of a step increase in the capital requirements of SIPP providers? If not, what alternative proposal would you make?**

Q9: **Do you agree that we have identified the other products and services that the change to notice periods would materially impact? If not, what other impacts should we consider?**

Q10: **What transitional arrangements do you think will be needed to implement the proposals in this paper? How quickly can they be brought into effect?**

Q11: **Do you agree that the proposals in this paper for notice periods are preferable to placing other types of restrictions on funds that offer frequent dealing while investing in property assets (for example preventing them from future marketing to retail clients)? If not, what do you suggest?**

Q12: **Do you think that other types of fund should be permitted to operate notice periods? If so, please explain which other funds and why.**

Q13: **Do you have any views on what further steps the FCA should take to accommodate long-term capital structures?**

Q14: **Do you consider that there are any amendments to the fund rules (or other rules) which we should make to facilitate the development of a secondary market in units in property funds?**

Annex 2
Cost benefit analysis

Introduction

1. FSMA requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as '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.

Problem and rationale for intervention

3. We set out the problem and rationale for intervention in chapters 2 and 3. We consider that there is a lack of resilience in UK authorised property funds that offer daily dealing to investors. This is evident during periods of market stress. We consider that this makes them inefficient because they operate with lower levels of investment assets, and higher levels of cash, than other UK authorised funds. Because investment assets, over the long term, should deliver higher returns than cash, this inefficiency leads to lower returns for investors.

4. We note that they pose risks to consumers of unfair treatment. For example, they pose the risk of the manager choosing to sell the fund's highest quality, most liquid assets to meet redemptions. This may leave remaining investors with a less liquid, riskier and less attractive portfolio of investments.

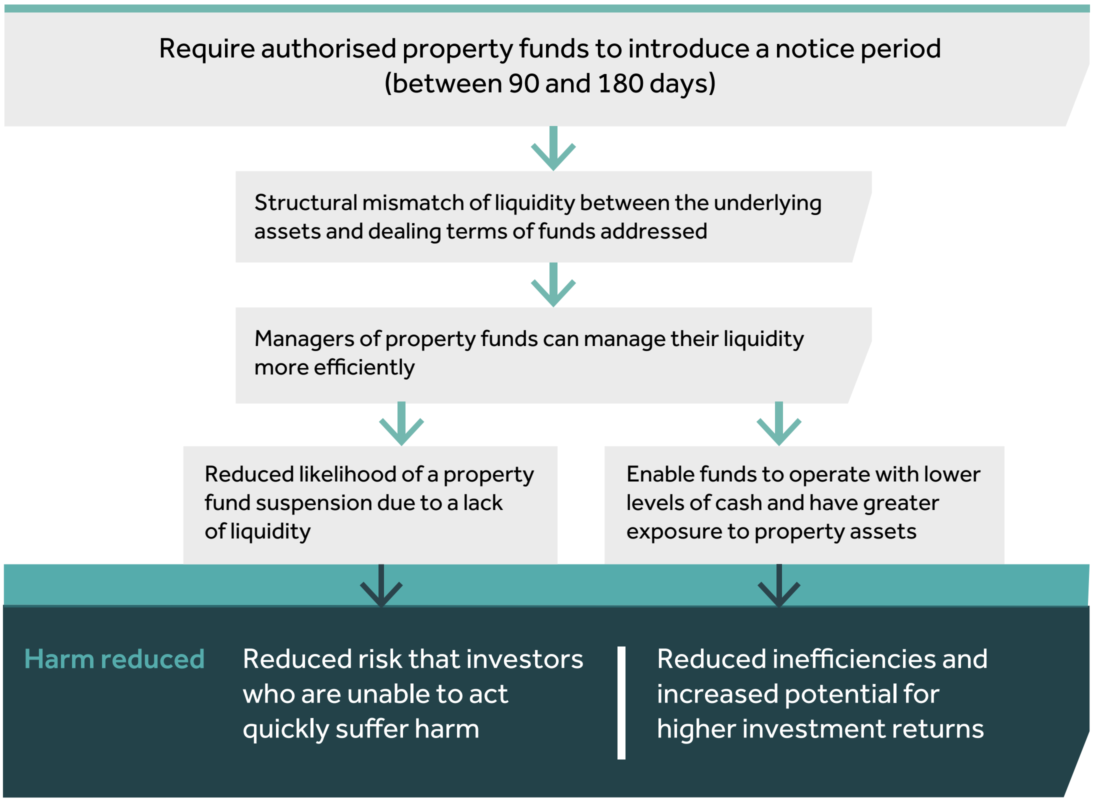
5. We also note that the FPC is concerned that this 'first mover advantage,' particularly during periods of market stress, could potentially pose risks to financial stability, for example by leading managers to sell property below its market value.

6. These problems arise because of the structural mismatch of liquidity between the underlying investment assets and the dealing terms of the funds.

Summary of our proposed intervention

7. We propose to address this structural mismatch by changing the rules around dealing to require authorised property funds to introduce a notice period. This period will be at a minimum 90 days, and may be up to 180 days. We set out in chapter 3 the considerations we have taken into account around different potential notice periods.

Figure 1: Causal chain



Baseline and key assumptions

Baseline

8. Without our intervention, we consider that these funds will continue to operate in the way that they currently do. They will continue to hold high cash balances, of around 15-20% of total assets, to meet potential redemption requests. They will also be at risk of temporary suspension of dealings from time to time due to liquidity issues.

Key assumptions

9. Currently there are 18 daily dealt UK authorised funds which invest directly in property. There are a further 13 UK authorised funds which act as feeders for these funds. No existing non-daily dealing property funds will be affected by our proposals. Based on responses to FCA information requests, the total assets under management (AUM) of these funds, as at 31 March 2020, was around £17bn. They held around 17%, or £2.8bn, in cash. For comparison, the average equity fund holds around 2.5% in cash and the average bond fund around 2%, based on Lipper data.

10. We have used FCA data to assess how many other firms may be affected by these proposals. We estimate that there are 44 relevant distributor firms, including direct-to-consumer platforms, advised platforms and direct distribution platforms. We estimate that there are around 5,500 investment intermediary firms, including financial advisers, banks and building societies, as well as discretionary wealth managers, who will need to consider these proposals, with around 33,000 advisers. We estimate that there are around 125 unit-linked insurance contracts that mirror UK authorised property funds, written by 17 life insurers, with around 350,000 policyholders. We estimate that there are 7 relevant depositaries and 10 relevant transfer agents.

11. We make a number of assumptions regarding investor behaviour:

a. Our proposals do not require investors to switch or sell 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. We also assume that existing investments in these funds will continue to be eligible for stocks and shares ISAs. As noted in 2.21, we are in discussions with the Treasury and HMRC on this point. If this were not the case, we would need to take this into account in our assessment of costs and benefits.

b. We assume that most current investors do not require constant access to their investments, as property funds are long-term investment vehicles. The long-term nature of the investment, as well as the risks associated with holding property investment are disclosed in fund disclosures, so we do not consider that investors would be unaware of the nature of the investment. While some investors may value the convenience of daily dealing, based on our understanding of the long-term nature of the product, we assume that this is not the only factor in the decision to invest in a property fund.

c. A key assumption in our estimations is that investors do not, in aggregate, make significant redemptions from these funds over the evaluation horizon. This is a significant assumption, since there are several ways in which the proposals may affect how much is invested in these funds. Some investors may reduce their holdings in these funds for a number of reasons:

- Switching to alternative investments, eg REITs, in response to the proposed notice periods
- Not investing new money if these funds are no longer ISA eligible
- Reducing their holdings to counteract the increase in risk exposure to property as a result of their fund holding less cash

Other investors may increase their holdings in these funds for other reasons:

- Increased confidence in funds not suspending due to liquidity issues
- Reduced risk of unfair outcomes for investors as described in paragraph 4
- Reduced "cash drag" potentially improving performance

Summary of costs and benefits

12. We have considered the costs and benefits of our proposed intervention. On balance, we consider that the benefits of intervening more than offset the costs to firms of implementing our intervention. We consider that a notice period of 90 days is the minimum that would be required to achieve the policy objectives, and that it may be necessary to require a notice period of greater length, up to 180 days.

13. The main quantifiable benefit that we estimate for consumers derives from the ability of funds to invest more fully in investment property. We estimate that funds will be able to invest around £1-2bn of uninvested cash, potentially leading to higher investment returns, albeit at higher risk. We estimate costs to consumers based on their loss of immediate access to their investments. We also estimate costs because consumers will have to bear market risk during the notice period. We estimate varying costs for consumers based on different lengths of notice periods. Consumers will only obtain the benefits we set out to the extent that they remain invested in the funds. An existing investor might be seeking to redeem when a fund reopens. If the fund does not lift the suspension until these rules apply, that investor would incur these costs without benefitting from higher investment returns.

14. There will be some investors who benefit from higher returns because they have had to wait to redeem their investments, and other investors for whom this leads to a lower return. But we consider this an inherent element of market risk associated with investing in an illiquid asset class. This is also related to the costs that consumers will incur as a result of bearing market risk during the notice period.

15. The costs to firms are principally one-off in nature, from familiarisation with the proposal to implementation of changes to IT systems and processes, changes to legal documents and communication to customers. We assume that the length of the notice period will not impact on the costs for firms to implement the proposed changes.

16. The benefits to consumers would be material and ongoing. There are also some benefits of greater confidence in fair treatment which we have not quantified. This compares to one-off implementation costs. We consider that the benefits should significantly outweigh the costs. As such we consider our proposal proportionate and justified to deliver our consumer protection and market integrity objectives.

Table 1: Summary of quantified costs and benefits

	One-off/ongoing	Costs	Benefits
Familiarisation costs for firms	One-off	£2.2m	
Fund managers	One-off	£2m	
Distributors	One-off	£4.4m	
Intermediaries	One-off	£6.3m	
Unit-linked insurers	One-off	£3m	
Other service providers	One-off	£0.3m	
Total costs to firms	**One-off**	**£18.2m**	
Consumers	Ongoing	£4.2-10.7m per year (90-day notice) £8.4-21.4m per year (180-day notice)	£35-103m per year (not dependent on notice-period length)

Costs of the proposal

Costs for investors

17. There are some potential costs for property fund investors.

18. As discussed in 3.21ff investors would face market risk during the notice period. There may also be an opportunity cost that investors face from not being able to access their money during this period. We have provided an estimate of these costs below.

19. Where investors are unable to submit a timely redemption request, delayed access to funds will, when viewed in retrospect, lead to some doing better and others doing less well. The average return on a property fund over 3 months has been 1.2% and over 6 months 2.5%, and around three-quarters of the time has been positive. But we note in 3.26 that in around a quarter of cases over the past 20 years it has been negative, and on around 6% of occasions the value of the fund has fallen by more than 5%, and in the worst cases by around 10-15%. The worst falls occurred during periods of suspension, so investors were unable to access their money over most of the worst performance periods.

20. Some investors may be waiting for a fund that is currently suspended to lift this suspension so that they can redeem. If the proposals in this paper were to be introduced prior to that fund unsuspending, those investors may incur the costs we set out here, without obtaining the benefits we set out below.

Borrowing costs and risk during notice period

21. For investors holding property funds as part of a pension scheme, we anticipate few unexpected needs to redeem units at short notice. However, investors holding units outside a pension scheme may incur unanticipated liquidity needs and must wait the duration of a notice period for their redemption to be processed, compared to being able to redeem at short notice. To replicate desired cash flows these investors might have to pay for access to credit, such as a bank loan or overdraft to the extent they do not have access to other liquid assets such as units in other daily dealing funds, ETFs or cash in current accounts. In addition to delaying the desired redemption cash flow, the policy also results in some investors being unable to quickly reduce their market risk to property assets.

22. We assume that these investors can borrow at an average interest rate of between 3.5% to 7.5% per annum.[1] This would correspond to a borrowing cost of approx. 0.86% to 1.85% for a 90-day period, or 1.72% to 3.70% for a 180-day period.

23. The compensation for exposure to risk can be calculated using the capital asset pricing model (CAPM). In this standard model, investors require compensation for holding risk that amounts to the current market risk premium multiplied by the real estate beta. The current market premium for UK assets is estimated to be 3.5%,[2] and the property beta has been estimated to be between 0.9 and 1.5.[3] Hence, we estimate the annual risk premium for property assets to be between 3.2% and 5.3% per year. This corresponds to between 0.79% and 1.31% for a 90-day period, or between 1.58% and 2.61% for a 180-day period.

1 https://www.bankofengland.co.uk/statistics/visual-summaries/quoted-household-interest-rates
2 https://www.london.edu/news/21st-edition-of-credit-suisse-annual-book-launches-1761
3 See betas for "Office and Industrial" in Exhibit 3: https://aresjournals.org/doi/abs/10.5555/repm.12.1.u9162602m2556vg7

24. Assuming gross outflows of 10% per year of current AUM (approximately £17bn), this would equate to annual gross outflows of £1.7bn. If no investor is able to anticipate their desired redemption date, this would imply a cost of between £28m and £54m for a 90-day notice period or between £56m and £107m for a 180-day notice period. To the extent investors can anticipate their liquidity needs by the length of the notice period, these costs can be avoided while still being exposed to market risk.

25. The behavioural implications of our proposals are difficult to anticipate. We consider that most investors use property funds as long-term investment vehicles and would not need to access their investments in a way for which they could not plan. On this basis, we assume that between 15% and 20% of redemptions will incur costs to illustrate the potential opportunity and market risk costs. As such, we estimate the ongoing annual cost to investors arising from the notice period to be between £4.2m and £10.7m for a 90-day notice period, or between £8.4m and £21.4m for a 180-day notice period.

Table 2: Estimated cost of notice period to investors (90 days)

	Lower estimate	Higher estimate
Borrowing cost	0.9%	1.9%
Risk premium	0.8%	1.3%
Combined cost (% of unanticipated redemptions)	1.7%	3.2%
Proportion of redeeming investors affected	15%	20%
Estimated annual cost	**£4.2m**	**£10.7m**

Table 3: Estimated cost of notice period to investors (180 days)

	Lower estimate	Higher estimate
Borrowing cost	1.7%	3.7%
Risk premium	1.6%	2.6%
Combined cost (% of unanticipated redemptions)	3.3%	6.3%
Proportion of redeeming investors affected	15%	20%
Estimated annual cost	**£8.4m**	**£21.4m**

Costs to firms

26. There would be costs to firms to implement these proposals. These costs would primarily be one-off costs, including familiarisation costs as well as costs associated with changing systems, updating legal documents and contacting investors. We do not consider that there will be any material ongoing costs for firms, compared to the baseline.

Familiarisation costs and legal review for all affected parties

27. We estimate that a total of around 5,600 firms will have to familiarise themselves with our proposals, most of which are intermediaries. We estimate familiarisation costs of the proposal using our standardised cost model, assuming a document length of 15,000 words, a reading speed of 100 words per minute, and an hourly compliance staff salary (including overheads) of £45.

28. We assume that 2 compliance staff members read the document at the average affected party, corresponding to familiarisation costs of around £230 per firm. Since 5,600 firms will incur these costs, we estimate the resulting total one-off familiarisation costs to be around £1.3m.

29. In addition to familiarisation costs, we also expect firms to incur costs to review around 20 pages of legal text. We assume that, at an average affected party, 1 legal staff member will spend 3 hours reviewing the legal instrument, at an hourly salary (including overheads) of £55. This corresponds to a total of £0.9m in one-off legal review costs.

IT implementation costs for firms

30. We expect authorised fund managers, distributors, and life firms will incur one-off costs to adjust their IT systems and procedures to ensure that their systems can incorporate property funds that are subject to a notice period. These one-off IT costs in this CBA are estimated using research on the structure of IT projects. The actual cost will vary depending on the IT systems firms use.

31. We assume that larger firms will need 546 person-days of staff time from staff in 6 different roles (business analysis team, design team, programming team, project management team, test team, senior management) to update their IT systems and implement the changes. Medium firms we assume will need 156 person-days of staff time spread across the same roles to update their IT systems. We use salary information from Willis Towers Watson 2016 UK Financial Services Report to calculate these costs. Small firms we assume will need 22 days of programming at a daily wage (incl. overheads) of £287.

Implementation costs for fund managers

32. Our proposed rules will require authorised fund managers of property funds to adjust their fund documentation, including each fund's constituting instrument, prospectus and Key Investor Information Document (KIID). This will trigger a review of documentation involving compliance, legal and internal sales departments. Based on our understanding of how firms implement such changes, we expect 3.75 person-days of work to identify, draft, review and approve for each affected fund.

33. As there are currently 31 authorised property funds and we are expecting an average £364 daily rate per person, based on salary survey data, the overall one-off costs to update the relevant documents add up to approximately £43,000.

34. We do not expect any significant incremental costs from communicating a notice period in financial promotions for firms involved in the distribution of funds. However, as the proposal will trigger a notifiable event, we estimate, based on our understanding of similar situations, this will cost £1,500 per fund or a total one-off cost of £46,500.

35. In addition, changes to dealing terms will require a certificate signed by a solicitor to the effect that the change will not affect the compliance of the trust deed/contractual scheme deed/instrument of incorporation with our rules/the OEIC Regulations. Based on information from legal services firms, we estimate this will cost £1,500 per fund or a total one-off cost of £46,500.

36. Using our standardised cost model, we estimate IT implementation will cost authorised fund managers (AFMs) a total one-off cost of £1.9m of which eight AFMs will incur costs of approx. £1.7m, three will incur costs of approx. £177,000, and one AFM will incur costs of £6,300.

Implementation costs for distributors

37. Firms accepting electronic dealing requests such as platforms, both direct-to-consumer and advised, and fund managers with direct distribution platforms will also need to update their IT systems.

38. Using our standardised cost model, we estimate this will cost distributors a total one-off cost of £4.4m of which 15 larger distributors will incur costs of £3.2m, and 19 mid-sized distributors will incur costs of £1.1m. For eight smaller distributors, we anticipate a cost of £50,500.

Costs for unit-linked providers

39. Around 17 life firms offer unit-linked funds that mirror authorised funds, with total AUM of approximately £2.3bn using around 125 different mirror funds.

40. Life firms will need to review and implement changes to:

- terms and conditions
- customer communications to ensure they consider for example the situation where the redemption, transfer or surrender proceeds from property unit-linked funds will be deferred for the length of the applicable notice period
- administration procedures to ensure the new processes can be adopted with all the necessary controls and checks
- how to rebalance default schemes
- financial systems to ensure that the money can be tracked through and linked with the relevant policyholders

41. Based on our understanding, we expect 2 person-days of work for all firms to identify, draft, review and approve changes to terms and conditions. We are expecting an average £364 daily rate per firm, using salary survey data. We expect the overall one-off costs to update the relevant documents to be approximately £6,200.

42. We expect firms will need to communicate with policyholders and advisers to explain the changes and to introduce new processes. To communicate the changes, based on our understanding, we expect a cost of £1,000 per mirror fund or a total one-off cost of £126,000. Using our standardised cost model, we estimate the cost of adjusting IT systems for life firms at a total one-off cost of £2.9m of which 12 life firms incur costs of £2.6m and five will incur costs of £295,000.

43. We understand that some providers of unit-linked funds mirroring authorised funds may have contractual obligations requiring them to provide benefits to their policyholders within timeframes that are less than the proposed length of notice period for property funds. Were we to proceed with the rules, some providers may see increases in the amount of capital that they are required to hold for regulatory purposes. Given the contractual requirements between each provider and their policyholder will differ significantly, it is not possible to reliably estimate the additional cost of capital, or benefit that would be obtained from holding any additional capital, to the extent that there might be any net cost or benefit.

Implementation costs for intermediaries

44. Investment intermediaries such as wealth managers and firms with staff that advise on retail investment products, such as financial advisers, banks and building societies and investment managers, will need to review whether a notice period changes their current product or advice, where they use authorised property funds. Wealth managers with model portfolios may need to review their product offerings and alter their asset allocation process. For advisers, based on our understanding, we estimate an average cost of £1,000 for each firm and an average cost of £25 for each individual advisor or a total one-off cost of approximately £6.3m.

Costs for SIPP providers

45. The proposal in Chapter 4 for a transitional rule for capital requirements of SIPP providers, is intended to achieve an outcome that does not lead to any additional costs. This is because the proposal is intended to prevent a potential step increase in capital requirements that might otherwise arise due to existing client investments in property funds becoming 'non-standard assets' due to the introduction of notice periods. Neither would there be any additional benefits that might otherwise arise from any consequential increase in capital requirements.

46. Given the way that the capital rules for SIPP providers operate, it is not possible to reliably estimate the additional cost of capital, or benefit that would be obtained from holding any additional capital should the specific proposal in respect of existing property fund investments not be implemented, to the extent that there might be any net cost or benefit. This is because the overall capital requirements are determined by a formula: Capital surcharge = (√percentage of plans containing non-standard assets) x 2.5 [constant] x Initial Capital Requirement. An important part of this is the percentage of plans containing 'non-standard assets', which will vary for each firm. Further, this percentage would not increase where a client's plan already contains another asset which is already classified as 'non-standard'.

47. In terms of new client investments in property funds put into SIPP plans after the date of commencement of the notice provisions, the existing rules would continue to apply, as would any existing costs and benefits that relate to those rules (and as were set out at the time of consultation and made rules (see CP12/33 and PS14/12 respectively).

Costs for other participants

48. There will be costs for depositaries and transfer agents, mainly process adjustments. Based on our understanding, for depositaries, we estimate an average cost of £25,000 for each firm and for transfer agents £15,000 or a total of approx. £175,000 and £150,000 respectively.

Benefits of our proposal

Increased expected return due to property funds' reduced cash allocation

49. One expected effect of the proposals is that a larger share of the assets under management can be invested in property assets, due to lower cash balances required to manage redemption requests.

50. We have analysed the levels of cash held by other types of property fund that invest in UK property. Most of these funds appear to hold cash balances of less than 10% of assets, with a weighted average of 5% and a median of 4%. Based on this, as well as on estimates provided by firms, we assume that funds might be able to reduce their cash balances to an average of between 5% and 10% under the new structure. This would mean that around 7-12% of the current £17bn funds under management, or between £1.1bn and £1.95bn, would be available to be invested in property assets.

51. Assuming that industry-wide cash holdings are reduced by this amount, the additional exposure to property returns would magnify the expected return to fund investors. To illustrate the quantum of potential benefit from this, we have considered both the theoretical and observed excess return from investments in UK property assets.

52. From a theoretical basis, the potential return on property investments over the long term could also be estimated using the CAPM, as discussed in paragraph 23. This gave an estimated excess return over the risk-free rate of between 3.2% and 5.3% a year.

53. From an observed basis, we have compared the return on the MSCI UK monthly property index with an estimate of the return on cash (using 3-month LIBOR rates). The MSCI UK monthly property index tracks the return on around 2,500 UK commercial property investments. We have available data on this index between December 1986 and May 2020.

Table 4: Annualised returns of MSCI UK property index compared to cash

	MSCI UK property index	Return on cash	Excess annual return from property
Historical returns (since Dec 1986)	8.6%	5.0%	3.6%

54. Historical returns are not necessarily a guide to future returns. Consistent with our analysis of the potential costs in paragraphs 21ff, we consider a range of expected excess return from property between 3.2% and 5.3%. Under these assumptions, the increased exposure to property returns could give rise to an annual benefit to investors of between £35m and £58m if cash balances reduce to an average of 10%, or between £62m and £103m if cash balances reduce to an average of 5%.

55. It should be noted that the increased exposure to property returns implies an increase in risk. While it may be reasonable to expect positive returns from property on average, it is possible that investors see the value of their investments fall more because of this increased exposure. Moreover, depending on the extent to which assets under management change and the extent to which cash holdings are reduced in response to the proposals, the potential benefit to investors could be both larger or smaller than the above estimate.

Other benefits

56. We also expect other benefits to consumers to arise because of better treatment of investors. We consider that there will be a benefit from a reduced risk of a fund selling its better-quality assets quickly, potentially at a discount, to meet redemptions. We also consider that there will be a benefit of a reduction in harm because there will be a reduced likelihood of suspensions due to liquidity issues. Longer notice periods could increase this benefit, up to a point. These benefits reflect reduced risks, which should improve outcomes for consumers, but these will only be evident in the long term, and the scale of the benefit will depend on future circumstances and market events. Because of that, in our opinion, it is not reasonably practicable to estimate the benefits in a quantifiable way.

57. We consider that there will be benefits to firms managing these products. They will have more stable and predictable revenues, which will enable them to invest with greater confidence in their property fund management business. This benefit is one of greater confidence, but it is hard to assess the scale or extent of it. Because of that, in our opinion, it is not reasonably practicable to estimate the benefit in a quantifiable way.

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 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. Where the draft rules apply both to authorised persons that are mutual societies and other authorised persons, the draft rules must be accompanied by a statement prepared under s. 138K(2) FSMA setting out 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)). 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 advancing the FCA's market integrity objective.

8. In formulating our proposals for consumer protection, we have considered the risks that may arise when an open-ended property fund faces redemption requests greater than the value of the fund's cash or near-cash holdings. Specifically, consumers wishing to redeem their holdings are at risk where other investors act more quickly during a period of stress. As set out above in this paper, our proposed measures should protect consumers by reducing the likelihood of a property fund suspension due to a lack of liquidity, which will in turn reduce the likelihood of runs on a fund. Our proposals should also help to prevent consumers from buying products that are unsuitable for their needs by making the impact of the illiquidity more transparent. We think that the proposals will also reduce inefficiencies and increase the potential for higher investment returns by enabling property funds to hold less cash, and thus invest more in assets with higher expected returns, to the benefit of consumers.

9. We anticipate that our proposals will also have a beneficial impact on the integrity of financial markets due to a closer alignment of fund redemption profile and underlying asset liquidity, which should reduce the number of runs on funds. This will increase the stability and resilience of property funds and related aspects of the UK financial system, in particular by reducing pressure to sell fund assets at 'rapid sale' prices.

10. We consider these proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well because they will result in a closer alignment of the redemption profile of property funds with the underlying assets which they hold. This improved matching of the liquidity of fund units and the fund assets should reduce the number of property fund suspensions arising due to liquidity pressures. It should also remove the incentive for investors to redeem quickly ahead of others, either to receive a better price or to avoid becoming temporarily trapped in a fund. For the purposes of the FCA's strategic objective, "relevant markets" are defined by s. 1F FSMA and include the markets for regulated financial services.

11. 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

12. We have undertaken a cost-benefit analysis of our proposals which is set out in Annex 2 of this CP, and believe that the costs of our proposals are proportionate to the benefits. We have also considered the proportionality of our proposals to the extent that they involve the potential interference with investors' existing property rights (see Chapter 4).

13. Our proposals amend the current framework of rules that apply to funds investing in immovables. They complement the existing requirements that apply to property funds under FCA rules in COBS and COLL, as well as 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 NURS

as this is where we foresee the greatest need for intervention. We have decided against a more radical intervention, for example banning open-ended property funds. 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

14. The asset management industry is an important contributor to economic growth and one of the most important providers of liquidity needed for the smooth functioning of markets. By maintaining the ability of retail clients to invest in such funds, but within more robust structures, our proposals permit investments that could contribute towards the sustainability of UK economic growth.

15. By introducing a more appropriate redemption profile for property funds, we think that the integrity of the financial system within the United Kingdom will be enhanced. This improved integrity within the financial system, and the greater levels of financial stability it creates, should contribute to the sustainable growth of the United Kingdom in the medium to long term. Reducing the incidence of liquidity stresses at funds investing in illiquid assets should, in the long run, improve confidence in this type of investment.

The general principle that consumers should take responsibility for their decisions

16. Our proposals do not remove investors' responsibility for their financial decisions. We expect the proposals to enable consumers to take better-informed investment decisions (as the illiquidity of their investments will be more apparent) and make it more likely that they will invest in products which are suitable for their individual needs.

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

17. We have previously engaged with a broad range of stakeholders on the topic of liquidity management in property funds, through a DP, CP and PS. We have also engaged with various stakeholders on the topic of fund liquidity more broadly through our joint work with the Bank for the FPC. We will continue to engage with stakeholders throughout the consultation process before making any rules.

18. In formulating these proposals, we have had regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime (as required by s. 1B(5)(b) FSMA). It is our assessment that this is not relevant to the proposals we set out in this paper.

Expected effect on mutual societies

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

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

20. 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.

21. By allowing open-ended funds to continue to invest in property but introducing proportionate new rules requiring the use of notice periods, 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 notice periods enable retail investors to take better-informed investment decisions, our measures will promote more effective competition and improve outcomes for consumers.

22. 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 under section 1B(4) of the FSMA. This duty applies in so far as promoting competition is compatible with advancing our consumer protection and integrity objectives.

23. As explained in Chapter 2, our proposals seek to advance our consumer protection and integrity objectives by reducing the likelihood of a property fund suspension due to a lack of liquidity (which may affect retail investors more because they may be slower to react to liquidity issues), reducing the risk that consumers buy products that are unsuitable for their needs, and reducing inefficiencies and increase the potential for higher investment returns. Our rules would generally apply to NURS that are marketed to ordinary retail consumers. They will require new disclosures to be made to retail investors and will better align redemption arrangements with the liquidity of the property being held by the fund. Investors will benefit from increased transparency of the liquidity risks, will have a better understanding of the longer-term nature of investing in NURS property funds and will be at less risk of unexpected fund suspensions. These effects should promote competition between NURS property funds and between those funds and authorised funds investing in other assets, thereby improving outcomes for consumers.

24. Whilst we are not proposing to apply the new rules to existing NURS property funds that already deal on a monthly or quarterly basis, we understand that these property funds are not marketed to ordinary retail investors. These NURS may be subject to competition from authorised property funds that are constituted as qualified investor schemes (QISs); QISs are not intended for ordinary retail investors and would not be subject to the new rules. These NURS may also be subject to competition from unauthorised property funds which are also outside the scope of our proposals and can be marketed to professional investors.

Equality and diversity

25. 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, to 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.

26. As part of this, we ensure the equality and diversity implications of any new policy proposals are considered. The outcome of our consideration in relation to these matters in this case is stated in paragraph 2.24 of the Consultation Paper. We have asked for comments on our provisional views.

Legislative and Regulatory Reform Act 2006 (LRRA)

27. We have had regard to the principles in the LRRA for the parts of the proposals that consist of general policies, principles or guidance and consider that our proposals have been carried out in a manner that is transparent and accountable, as we have previously engaged with a broad range of stakeholders on the topic of liquidity management in property funds (see paragraph 17 above).

28. We consider that our proposals are proportionate and promote our statutory objectives of consumer protection and market integrity appropriately, without creating undue burdens on the asset management industry, nor adversely impacting competition (see paragraphs 12 and 13 above).

29. We consider that our proposals are consistent with our previous work on property funds and illiquid assets in general and are targeted only where action is needed.

30. 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
Abbreviations used in this paper

AFM	Authorised fund manager
AIF	Alternative investment fund
AIFMD	Alternative investment fund managers directive
CAPM	Capital asset pricing model
CBA	Cost benefit analysis
COBS	Conduct of business sourcebook
COLL	Collective investment schemes sourcebook
CP	Consultation paper
DP	Discussion paper
FIIA	Fund investing in inherently illiquid assets
FPC	Financial Policy Committee
FPIP	Fund predominantly investing in property
FSMA	Financial Services and Markets Act 2000
FSR	Financial stability report
HMRC	Her Majesty's Revenue and Customs
IA	The Investment Association
IPRU-INV	Interim Prudential sourcebook for Investment Businesses
ISA	Individual savings account
KIID	Key investor information document
LTAF	Long-term asset fund
NURS	Non-UCITS retail scheme
OEIC	Open-ended investment company

PS	Policy statement
QIS	Qualified investor scheme
REIT	Real estate investment trust
RICS	Royal Institution of Chartered Surveyors
SIPP	Self-invested personal pension
SIV	Standing independent valuer
SSAS	Small self-administered scheme
UCITS	Undertaking for collective investment in transferable securities

Appendix 1
Draft Handbook text

NON-UCITS RETAIL SCHEMES INVESTING IN PROPERTY (REDEMPTION ARRANGEMENTS WITH NOTICE) INSTRUMENT [2020]

Powers exercised

A. The Financial Conduct Authority ("the FCA") 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 137D (FCA general rules: product intervention);
(c) section 137R (Financial promotion rules);
(d) section 137T (General supplementary powers);
(e) section 139A (Power of the FCA to give guidance);
(f) section 247 (Trust scheme rules);
(g) section 248 (Scheme particulars rules);
(h) section 261I (Contractual scheme rules);
(i) section 261J (Contractual scheme particulars 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 FCA'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
Interim Prudential sourcebook for Investment Business (IPRU(INV))	Annex B
Conduct of Business Sourcebook (COBS)	Annex C
Collective Investment Schemes sourcebook (COLL)	Annex D

Citation

E. This instrument may be cited as the Non-UCITS Retail Schemes Investing in Property (Redemption Arrangements with Notice) Instrument [2020].

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

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

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

FPIP	a *fund predominantly investing in property*.
fund predominantly investing in property	a *non-UCITS retail scheme* which satisfies the conditions in (1) and (2) and, where applicable, (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 *property related assets*; or (b) at least 50% of the value of the *scheme property* has been invested in *property related assets* for at least three continuous *months* in the last twelve *months*; (2) the *scheme* is not in the process of winding up or termination; (3) where a *non-UCITS retail scheme* operates *limited redemption arrangements*, those arrangements provide for *dealing* in *units* more frequently than once every [90 *days*] **OR** [six *months*]. [Drafting note: *The reference to the frequency of dealing in this provision is subject to the outcome of the consultation in relation to COLL* 6.2.22AR(2)(e).]
property related asset	an asset which is: (1) an immovable (see *COLL* 5.6 (Investment powers and borrowing limits for non-UCITS retail schemes)); (2) a *unit* in another *FPIP*; (3) a *unit* in a *qualified investor scheme*: (a) which would itself meet condition (1) of the definition of a *fund predominantly investing in property* if it were a *non-UCITS retail scheme*;

(b) the *instrument constituting the fund* and the *prospectus* of which do not provide for *limited redemption arrangements* that reflect the time typically needed to sell, liquidate or close out the *property related assets* in which the *qualified investor scheme* invests; and

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

(4) a *unit* in an open-ended *unregulated collective investment scheme* which:

(a) aims to invest at least 50% of the value of the property of the *unregulated collective investment scheme* in assets falling within paragraphs (1) to (3) above;

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

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

redemption arrangements with notice	the arrangements for the *redemption* of *units* in an *FPIP* which must be operated by the *authorised fund manager* in accordance with *COLL* 6.6.22AR (Redemption arrangements with notice).

Amend the following definitions as shown.

[*Editor's note*: The following proposed changes take into account the definitions inserted by the Non-UCITS Retail Schemes Investing in Illiquid Assets Instrument 2019 (FCA 2019/90) which come into force on 30 September 2020.]

fund investing in inherently illiquid assets

<u>subject to (4),</u> a *non-UCITS retail scheme* which satisfies the conditions in (1), (2) and (3):

(1) either:

(a) …

(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 time typically 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;

(4) a *non-UCITS retail scheme* which meets the conditions above and the conditions in the definition of a *fund predominantly investing in property* is an *FPIP* and not a *fund investing in inherently illiquid assets*.

inherently illiquid asset an asset which is:

…

(5A) a *unit* in an *FPIP*;

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

(a) would itself:

(i) meet condition (1) of the definition of a *FIIA* if it were a *non-UCITS retail scheme*; or

(ii) meet condition (1) of the definition of an *FPIP* if it were a *non-UCITS retail scheme*;

…

…

limited redemption arrangements

(1) subject to (2), the arrangements operated by an *authorised fund manager* for the *redemption* of *units* in an *authorised fund* where the *authorised fund manager* holds ~~himself~~ itself out to *redeem units* in that *scheme* less frequently than twice in a calendar *month* in accordance with *COLL* 6.2.19R (Limited redemption).

(2) to the extent that they would otherwise do so, *redemption arrangements with notice* do not fall within (1).

Annex B

Amendments to the Interim Prudential sourcebook for Investment Business (IPRU(INV))

In this Annex, underlining indicates new text.

TP 1 Transitional Provisions applying to IPRU(INV)

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
…					
21	*IPRU-INV* 5.4.11G and 5.9.1R	R	(1) Paragraphs (2) and (3) apply where a *unit* in an *FPIP*: (a) was held by a *person* immediately before the coming into force of *COLL* 6.2.22AR; and (b) has not since been transferred. (2) Paragraph (3) applies to the determination of whether a *unit* in an *FPIP* is a standard asset. (3) The determination of whether a *unit* in an *FPIP* can be readily realised within 30 *days* must be assessed as if the period for *redemption* which applied immediately before the coming into force of *COLL* 6.2.22AR continued to apply.	[Date of coming into force of the instrument] to indefinitely	[Date of coming into force of the instrument]

Annex C

Amendments to the Conduct of Business Sourcebook (COBS)

In this Annex, underlining indicates new text.

[*Editor's note*: The following proposed changes take into account the amendments made by the Non-UCITS Retail Schemes Investing in Illiquid Assets Instrument 2019 (FCA 2019/90) which come into force on 30 September 2020.]

4 Communicating with clients, including financial promotions

…

4.5 Communicating with retail clients (non-MiFID provisions)

…

Funds predominantly investing in property (FPIPs)

4.5.18 R (1) This *rule* applies to any *financial promotion* relating to an *FPIP* except the *FPIP's prospectus*.

(2) Information about the relevant risks (*COBS* 4.5.2R) that a *firm* must give in relation to a *unit* in a *fund predominantly investing in property* includes:

(a) that investors in the *authorised fund* will not have immediate access to their money;

(b) the length of time (the notice period) that it will normally take to determine the *price* of the *units* being *redeemed*;

(c) that once a *redemption* request has been accepted by the *authorised fund manager*, it cannot be cancelled; and

(d) that during the notice period the *price* of the *units* being *redeemed* may fluctuate due to market movements and that this *price* difference could be significant.

(3) If the *financial promotion* is a *non-real time financial promotion*, a *firm* must ensure that the information specified in (2) 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.

4.5.19 G The *rules* in *COBS* 4.5 do not apply to the form or content of a *NURS-KII document* (see *COBS* 4.1.7AR (Modification relating to the KII Regulation)). Specific requirements apply to the *NURS-KII document* for an *FPIP* (see *COLL* Appendix 2 (Modifications to the KII Regulation for KII-compliant NURS)).

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

…

Funds predominantly investing in property (FPIPs)

4.5A.19 R (1) This *rule* applies to any *financial promotion* relating to an *FPIP* that is addressed to, or disseminated in such a way that it is likely to be received by, a *retail client*, except the *FPIP's prospectus*.

(2) Information about the relevant risks (*COBS* 4.5A.3UK) that a *firm* must give in relation to a *unit* in a *fund predominantly investing in property* includes:

(a) that investors in the *authorised fund* will not have immediate access to their money;

(b) the length of time (the notice period) that it will normally take to determine the *price* of the *units* being *redeemed*;

(c) that once a *redemption* request has been accepted by the *authorised fund manager*, it cannot be cancelled; and

(d) that during the notice period the *price* of the *units* being *redeemed* may fluctuate due to market movements and that this *price* difference could be significant.

(3) If the *financial promotion* is a *non-real time financial promotion*, the information specified in (2) 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.

4.5A.20 G The *rules* in *COBS* 4.5A do not apply to the form or content of a *NURS-KII document* (see *COBS* 4.1.7AR (Modification relating to the KII Regulation)). Specific requirements apply to the *NURS-KII document* for an *FPIP* (see *COLL* Appendix 2 (Modifications to the KII Regulation for KII-compliant NURS)).

…

TP 2 Other Transitional Provisions

(1)	**(2) Material to which the transitional provision applies**	**(3)**	**(4) Transitional provision**	**(5) Transitional provision: dates in force**	**(6) Handbook provisions: coming into force**
…					

2.-1C	*COBS* 4.5A.19R(2)	R	Until [*exit day*] the reference to *COBS* 4.5A.3UK is to be read as a reference to *COBS* 4.5A.3EU.	[Date of coming into force of instrument] to [*exit day*]	[Date of coming into force of instrument]
2.-1D	The changes to *COBS* 4.5 and *COBS* 4.5A set out in Annex C of the Non-UCITS Retail Schemes Investing in Property (Redemption Arrangements with Notice) Instrument [2020].	R	(1) For the purposes of the changes referred to in column (2), a *non-UCITS retail scheme* which falls within paragraph (2) below is deemed not to be a *fund predominantly investing in property*. (2) A *non-UCITS retail scheme* falls within this paragraph if: (a) it meets the conditions for being a *fund predominantly investing in property*; and (b) on the coming into force of *COLL* 6.2.22AR (Redemption arrangements with notice), the *instrument constituting the fund* and the *prospectus* of the *authorised fund* provided for *limited redemption arrangements* that involved *dealing* in *units* no more frequently than once a *month*.	[Date of coming into force of instrument] to indefinitely	[Date of coming into force of instrument]
2.-1E	*COBS* TP 2.-1DR	G	*COLL* 6.2.19R (Limited redemption) provides that in respect of a *non-UCITS retail*		

			scheme with *limited redemption arrangements*, the *scheme* must provide for *sales* and *redemptions* at least once every six *months*.				
…							

Annex D

Amendments to the Collective Investment Schemes sourcebook (COLL)

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

[*Editor's note*: The following proposed changes take into account the amendments made by the Non-UCITS Retail Schemes Investing in Illiquid Assets Instrument 2019 (FCA 2019/90) which come into force on 30 September 2020.]

3 Constitution

…

3.2 The instrument constituting the fund

…

Table: contents of the instrument constituting the fund

3.2.6 R This table belongs to *COLL* 3.2.4R (Matters which must be included in the instrument constituting the fund).

…	
	FPIPs: redemption arrangements with notice
13A	For an *FPIP*, a statement setting out the arrangements for the *redemption* of *units* in the *authorised fund* (see *COLL* 6.2.22AR (Redemption arrangements with notice)).
…	

…

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* or a *fund predominantly investing in property* 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* or *property related assets* and how those risks might crystallise;
		…	
	…		
…			
Dealing			
17	The following particulars:		
	…		
	(ga)	in the case of an *FPIP*, the arrangements and procedures relating to *redemptions* of *units* in the *authorised fund* (see *COLL* 6.2.22AR(2) (redemption arrangements with notice));	
	…		

…

Guidance on contents of the prospectus

4.2.6 G … …

(8) In relation to *COLL* 4.2.5R(3)(pa)(i) and *COLL* 4.2.5R(17)(ga), the *prospectus* of a *fund predominantly investing in property* should prominently state:

(a) the normal period that *unitholders* will need to wait from the *authorised fund manager* accepting a *unitholder's* instruction to *redeem units* in the *FPIP* to:

(i) the determination of the *price* for those *units*; and

(ii) payment of the appropriate proceeds of *redemption* to the *unitholder*;

(b) that the notice period may be extended when the fund is suspended in accordance with *COLL* 7.2 (Suspension and restart of dealings); and

(c) that once the *authorised fund manager* has accepted a *unitholder's* request to *redeem units* in the *FPIP* it is irrevocable and they will not be able to withdraw that request.

…

4.3 Approvals and notifications

…

Significant change requiring pre-event notification

4.3.6 R …

(3) The notice period in (1) must be of a reasonable length (and must not be less than 60 *days* or, where it applies, the period in (4)).

(4) Where the *authorised fund* is a *fund predominantly investing in property*, the notice period in (1) must not be less than the total number of *days* produced by adding:

(a) 60 *days*; and

(b) the number of *days* in the period specified for the purposes of the *redemption arrangements with notice*.

…

5 Investment and borrowing powers

…

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

…

Funds predominantly investing in property (FPIP)

5.6.5F G The *Glossary* definition of a *fund predominantly investing in property* (or *FPIP*) includes 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 *property related assets*.

…

6 Operating duties and responsibilities

…

6.2 Dealing

…

Purpose

6.2.2 G …

(3A) (a) This section sets out the *redemption arrangements with notice* that an *authorised fund manager* must operate in relation to a *fund predominantly investing in property* (or *FPIP*). The purpose of these arrangements is to ensure that the *redemption* policy of the *FPIP* better reflects its liquidity profile given the time typically needed to sell, liquidate or close out *property related assets*.

(b) Under these arrangements, where a *unitholder* makes a request to *redeem units* in the *FPIP*, the *price* which the *authorised fund manager* must pay the *unitholder* in respect of the *units* being *redeemed* must be determined [at least 90] OR [180] *days* after the *day* on which the *authorised fund manager* accepted the request.

…

…

Sale and redemption

6.2.16 R …

(3) Subject to *COLL* 6.2.19R (Limited redemption), ~~and~~ *COLL* 6.2.21R (Deferred redemption) and *COLL* 6.2.22AR (Redemption arrangements with notice), the *authorised fund manager* must, at all times during the *dealing day*, on request of any qualifying *unitholder*~~,~~:

(a) effect the *redemption* of *units*; or

(b) for a *fund predominantly investing in property*, undertake to effect the *redemption* of *units* at the applicable time,

in accordance with the conditions in the *instrument constituting the fund* and the *prospectus* unless ~~it~~ the *authorised fund manager* has reasonable grounds to refuse such *redemption*.

…

(6) Except where (7) or (7A) applies, and subject to *COLL* 6.2.21R (Deferred redemption), the *authorised fund manager* must *sell* or *redeem* units at a *price* determined no later than the end of the *business day* immediately following the receipt and acceptance of an

instruction to do so, or at the next *valuation point* for the purposes of *dealing* in *units* if later.

…

(7A) The *authorised fund manager* of an *FPIP* must:

(a) *sell units* at a *price* determined no later than the end of the *business day* immediately following the receipt and acceptance of an instruction to do so, or at the next *valuation point* for the purposes of *selling units* if later; and

(b) *redeem units* at a *price* determined in accordance with the *redemption arrangements with notice* for the *authorised fund*.

Sale and redemption: guidance

6.2.17 G …

(5) (a) Paragraph (1) does not apply to an *authorised fund* that is a *fund predominantly investing in property* in relation to a request to *redeem units*.

(b) Instead, the *prospectus* of a *fund predominantly investing in property* may allow the *authorised fund manager* to identify a point in time in advance of a *valuation point* (a cut-off point) after which it will not accept instructions to *redeem units* at the relevant *valuation point*.

(c) The cut-off point for a *redemption* of *units* should be no earlier than close of business on the *business day* immediately preceding the start of the period specified for the purposes of *COLL* 6.2.22AR(2)(d). This is because the *valuation point* at which the *price* of the *units* being *redeemed* is determined comes at the end of that period (see *COLL* 6.2.22AR(2)).

…

…

Redemption arrangements with notice

6.2.22A R (1) The *instrument constituting the fund* and the *prospectus* of a *fund predominantly investing in property* must provide for *redemption* arrangements that are in accordance with this *rule*.

(2) The *redemption* arrangements must ensure the following:

(a) On receipt of a request from a *unitholder* to *redeem units* in the *fund predominantly investing in property*, the *authorised fund manager* either accepts that request or informs the *unitholder* of the grounds on which it refuses to do so (see *COLL* 6.2.16R(3) (Sale and redemption)).

(b) If the *authorised fund manager* accepts the *unitholder's* request in (a), the *redemption* request is deemed to be irrevocable.

(c) Where the *redemption* request in (a) is accepted, the *authorised fund manager* confirms to the *unitholder*:

(i) that the *redemption* request has been accepted and cannot be revoked; and

(ii) having regard to the period specified for the purposes of (d), the dates on which it is expected that the *redemption* will be effected and the appropriate proceeds paid.

(d) The *authorised fund manager* determines the *price* for the *units* being *redeemed* pursuant to the *unitholder's redemption* request in (a) at the first *valuation point* following the end of the period specified in the *instrument constituting the fund* and the *prospectus*.

[(e) The period referred to in (d) must be:

(i) at least 90 *days* after the acceptance of the request to *redeem*; and

(ii) no more than [180] *days* from the acceptance of the request.]

OR

[(e) The period referred to in (d) must be [180] *days* after the acceptance of the request to *redeem*.]

(f) The *authorised fund manager redeems* the *units* at the *price* determined in accordance with (d) and pays the *unitholder* the appropriate proceeds of *redemption* in accordance with *COLL* 6.2.16R(4) and (5).

(3) Where the *fund predominantly investing in property* has more than one *class* of *unit*, the *redemption* arrangements must apply to every *class* of *unit issued* in the *authorised fund*.

Redemption arrangements with notice: guidance

6.2.22B G (1) *Redemption arrangements with notice* do not affect the frequency and *days* on which *units* in a *fund predominantly investing in property* are *sold*. This can be determined by the *authorised fund manager* subject to *COLL* 6.2.16R and *COLL* 6.3.4R(1).

[(2) In determining the period specified in the *instrument constituting the fund* and the *prospectus* under *COLL* 6.2.22AR(2)(d), the *authorised fund manager* should have regard to the obligation on *AIFMs* in *FUND* 3.6.2R that the investment strategy, liquidity profile and redemption policy of each *AIF* it manages are consistent.]

[Drafting note: *This provision is subject to the outcome of the consultation in relation to COLL* 6.2.22AR(2)(e).]

(3) Where a *fund predominantly investing in property* is a *feeder AIF* of a *master AIF* that is also a *fund predominantly investing in property*, the *redemption* arrangements of the *feeder AIF* should take into account the *redemption arrangements with notice* of the *master AIF*.

(4) Where a *fund predominantly investing in property* has more than one *class* of *unit*, the *redemption* arrangements need not apply to a conversion of *units*.

(5) If a transfer of *units* in the *fund predominantly investing in property* is allowed, the *redemption* arrangements should not apply to such transfers.

(6) Further specific requirements apply where a *fund predominantly investing in property* is suspended under the *rules* in *COLL* 7.2 (Suspension and restart of dealings) (see *COLL* 7.2.1-AR).

…

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*
…						
Notes:	…					

	(6)	**COLL* 6.6.3CR, *COLL* 6.6.3DG, *COLL* 6.6.3ER and *COLL* 6.6.3FR apply only to the *authorised fund manager* of a *FIIA* <u>or an *FPIP*</u>.
	(7)	**COLL* 6.6.4BR, *COLL* 6.6.4CR, and *COLL* 6.6.4DG apply only to the *depositary* of a *FIIA* <u>or an *FPIP*</u>.

…

Additional functions of an authorised fund manager of a FIIA <u>or an *FPIP*</u>

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

…

6.6.3D G Compliance with *COLL* 6.6.3CR may enable a *full-scope UK AIFM* that is an *authorised fund manager* of a *FIIA* <u>or an *FPIP*</u> 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* <u>or an *FPIP*</u> must obtain written confirmation from any relevant third party identified in the contingency plan under *COLL* 6.6.3CR(4) that the third party will be able to undertake the matters specified in (2) as soon as is reasonably practicable.

…

6.6.3F R The *authorised fund manager* of a *FIIA* <u>or an *FPIP*</u> 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 <u>or an *FPIP*</u>

6.6.4B R The *depositary* of a *FIIA* <u>or an *FPIP*</u> must:

(1) regularly make its own assessment of the liquidity profile of the *FIIA* <u>or the *FPIP*</u> and the liquidity risks presented by the *scheme property* of a *FIIA* <u>or an *FPIP*</u>;

(2) take reasonable care to oversee the *authorised fund manager's* liquidity management systems and procedures on an ongoing basis, using the assessment it has made under (1), to ensure the *FIIA* <u>or the *FPIP*</u> is managed in accordance with the following *COLL rules* and, in the case of a *FIIA* <u>or an *FPIP*</u> managed by a *full-scope UK AIFM*, the following *FUND rules* and provisions in the *AIFMD level 2 regulation*:

…

…

6.6.4C R The *depositary* of a *FIIA* <u>or an *FPIP*</u> managed by a *small authorised UK AIFM* 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.

6.6.4D G Subject to certain specified exceptions, the *depositary* of a *FIIA* <u>or an *FPIP*</u> managed by a *full-scope UK AIFM* is generally prohibited from delegating its functions (see in particular, *FUND* 3.11.26R (Delegation: general prohibition) and *FUND* 3.11.28R (Delegation: safekeeping)).

…

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 <u>or an *FPIP*</u>), that the *FCA* would reasonably view as significant.

…

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*
…						
<u>7.2.1-AR*</u>	<u>x</u>	<u>x</u>		<u>x</u>	<u>x</u>	x

…						
Notes	…					
	<u>(5)</u>	<u>*COLL* 7.2.1-AR applies only to the *authorised fund manager* and *depositary* of a *fund predominantly investing in property*.</u>				

…

7.2 Suspension and restart of dealings

Requirement

7.2.-3 R (1) ~~This~~ <u>Subject to *COLL* 7.2.1-AR, this</u> *rule* applies to the *authorised fund manager* of a *non-UCITS retail scheme* if at any time:

…

7.2.-2 R (1) ~~This~~ <u>Subject to *COLL* 7.2.1-AR, this</u> *rule* applies where the *authorised fund manager* of a *non-UCITS retail scheme* is required to temporarily suspend *dealings* in *units* in the *authorised fund* under *COLL* 7.2.-3R(2) or *COLL* 7.2.-1R(3).

…

7.2.-1 R (1) ~~This~~ <u>Subject to *COLL* 7.2.1-AR, this</u> *rule* applies where the *authorised fund manager* and the *depositary* agree that *dealings* in *units* in the *authorised fund* should continue under *COLL* 7.2.-3R(3) and, if relevant, following a review under this *rule*.

…

7.2.1 R (1) The *authorised fund manager* may, with the prior agreement of the *depositary*, and must without delay, if the *depositary* so requires, temporarily suspend the *issue*, *cancellation*, *sale* and *redemption* of *units* in an *authorised fund* (subject to *COLL* 7.3.1-AR, referred to in this chapter as "*dealings* in *units*"), where due to exceptional circumstances it is in the interest of all the *unitholders* in the *authorised fund*. Where an *authorised fund* is a *regulated money market fund*, the *authorised fund manager* must ensure that any such suspensions are consistent with the *Money Market Funds Regulation*. <u>Where the *authorised fund* is a *fund predominantly investing in property*, the *authorised fund manager* must ensure that any such suspensions comply with *COLL* 7.2.1-AR.</u>

…

(3) ~~During~~ <u>Subject to *COLL* 7.2.1-AR, during</u> a suspension:

…

<u>7.2.1-A R (1) Paragraphs (2) to (7) apply where *dealings* in *units* of a *fund predominantly investing in property* are suspended under *COLL* 7.2-3R, *COLL* 7.2-1R or *COLL* 7.2.1R.</u>

<u>(2) Subject to paragraphs (4) to (6), an applicable notice period for a *redemption* request accepted before the beginning of the suspension of the *authorised fund* remains binding on the *authorised fund manager* and the *unitholder*.</u>

<u>(3) The *authorised fund manager*:</u>

<u>(a) must be willing to accept a request to *redeem units* made after the beginning of a suspension under the *rules* in this chapter; and</u>

<u>(b) must accept such a *redemption* request unless it has reasonable grounds for refusing to do so.</u>

<u>(4) Where (5) applies, all *days* are counted when calculating the length of the applicable notice period including any *days* on which *dealings* in *units* of the *authorised fund* are suspended.</u>

<u>(5) This paragraph applies where the *authorised fund manager* accepts a *redemption* request before or after the beginning of a suspension of *dealings* in *units* under the *rules* in this chapter.</u>

<u>(6) If suspension of the *authorised fund* continues beyond the end of the applicable notice period for the *redemption* request, the *authorised fund manager* must determine the *price* for the relevant *units* at the first *valuation point* after the restart of *dealings* in *units*.</u>

<u>(7) For the *authorised fund manager* and the *depositary* of a *fund predominantly investing in property*, the *rules* in this chapter apply as follows:</u>

<u>(a) references to "*dealings* in *units*" (see *COLL* 7.2.1R(1)) are to be construed in accordance with paragraphs (2) to (6) of this *rule*;</u>

<u>(b) references to the "applicable notice period" are to the notice period specified for the purposes of *COLL* 6.2.22AR (Redemption arrangements with notice) as it applies to a *redemption* request;</u>

<u>(c) *COLL* 7.2.-2R(5) and *COLL* 7.2.1R(8) do not apply in relation to a *fund predominantly investing in property*;</u>

<u>(d) the details which the *authorised fund manager* must publish under *COLL* 7.2.-3R(3)(d) or *COLL* 7.2.1R(2C) must keep *unitholders* appropriately informed about:</u>

(i) the suspension including, if known, its likely duration; and

(ii) the effect of the suspension on the *sale*, *issue* or *redemption* of *units* in the *authorised fund*; and

(e) the obligations in *COLL* 6.2 (Dealing) apply to the extent necessary to comply with paragraphs (2) to (6).

…

Guidance

7.2.2 G …

(1A) Except in the case of *FIIAs* and *FPIPs* (for which see (1B) and (1C) below), 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* determine that it is in the best interests of *unitholders* to suspend *dealing*, they should ensure that any alternative courses of action have been discounted.

…

(1C) Although the *redemption arrangements with notice* that *authorised fund managers* of *FPIPs* are required to operate are intended to mitigate the risk of liquidity shortfalls, there may nevertheless be circumstances where suspension is also genuinely in the best interests of *unitholders*. For example, it may not be possible to execute *redemption* requests by the end of the notice period specified under *COLL* 6.2.22AR (Redemption arrangements with notice) without significantly depleting the *scheme's* liquidity, and/or without selling *scheme property* at a substantial discount to its open market value. However, the *rules* in this chapter are modified to take into account the particular *redemption* arrangements that *authorised fund managers* of *FPIPs* are required to operate.

…

…

Appendix 2 Modifications to the KII Regulation for KII-compliant NURS

…

CHAPTER III

CONTENT OF SECTIONS OF THE KEY INVESTOR INFORMATION DOCUMENT

SECTION 1

Objectives and investment policy

Article 7

Specific contents of the description

1. The description contained in the 'Objectives and investment policy' section of the *NURS-KII document* shall cover those essential features of the *KII-compliant NURS* about which an investor should be informed, even if these features do not form part of the description of objectives and investment policy in the *prospectus*, including:

…

<u>(ba)</u> <u>for a *fund predominantly investing in property*, the arrangements for *redeeming units*;</u>

…

…

SECTION 2

Risk and reward profile

Article 8

Explanation of potential risks and rewards, including the use of an indicator

…

6. A *KII-compliant NURS* having a significant exposure to immovables as permitted under *COLL* 5.6.18R (whereby significant exposure is understood as an exposure of at least 20% in value of the *scheme property*):

(a) shall not include a synthetic risk and reward indicator in the 'Risk and reward profile' section of its NURS-KII document; ~~and~~

(b) must instead include a full narrative disclosure of risks that are materially relevant to the fund within that section of the NURS-KII document; <u>and</u>

<u>(c)</u> <u>where the *KII-compliant NURS* is a *fund predominantly investing in property*, must explain:</u>

<u>(i)</u> <u>that an investor who seeks to *redeem* their investment in the *KII-compliant NURS* will not receive the proceeds of *redemption* until the end of the relevant notice period;</u>

(ii) that during the notice period the investor will bear the market risk; and

(iii) that once it has been accepted, the *redemption* request cannot be revoked.

…

TP 1 Transitional Provisions

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
…					
Amendments made by the Non-UCITS Retail Schemes Investing in Property (Redemption Arrangements with Notice) Instrument [2020]					
51	The changes to *COLL* 3, *COLL* 4, *COLL* 5, *COLL* 6, *COLL* 7 and *COLL* Appendix 2 set out in Annex D of the Non-UCITS Retail Schemes Investing in Property (Redemption Arrangements with Notice) Instrument [2020].	R	(1) For the purposes of the changes referred to in column (2), a *non-UCITS retail scheme* which falls within paragraph (2) below is deemed not to be a *fund predominantly investing in property*. (2) A *non-UCITS retail scheme* falls within this paragraph if: (a) it meets the conditions for being a *fund predominantly investing in property*; and (b) on the coming into force of *COLL* 6.2.22AR (Redemption arrangements with notice), the *instrument constituting the*	[Date of coming into force of instrument] to indefinitely	[Date of coming into force of instrument]

				fund and the *prospectus* of the *authorised fund* provided for *limited redemption arrangements* that involved *dealing* in *units* no more frequently than once a *month*.		
52	*COLL* TP 1.51R	G	*COLL* 6.2.19R (Limited redemption) provides that in respect of a *non-UCITS retail scheme* with *limited redemption arrangements*, the *scheme* must provide for *sales* and *redemptions* at least once every six *months*.	*COLL* 6.2.19R (Limited redemption) provides that in respect of a *non-UCITS retail scheme* with *limited redemption arrangements*, the *scheme* must provide for *sales* and *redemptions* at least once every six *months*.	[Date of coming into force of instrument] to indefinitely	[Date of coming into force of instrument]
…						

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FINANCIAL
CONDUCT
AUTHORITY

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