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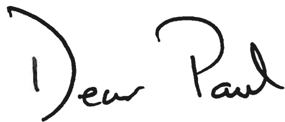
6 August 2019

Our Ref: PQ190719A

Your Ref: HL17477



RE: Review of the case for the UK establishing its own requirements for liquidity standards for Undertakings for Collective Investment in Transferable Securities

I write with reference to your written question of 19 July 2019 asking whether Her Majesty's Government has ever formally reviewed the case for the UK establishing its own requirements for liquidity standards for Undertakings for Collective Investment in Transferable Securities (UCITS) at higher levels than specified by EU Directives; or whether the UK is currently bound by EU rules and cannot introduce higher standards. As this question falls within our remit, HM Treasury asked us to respond to you directly.

The UCITS Directive is generally minimum harmonising. This means that Member States may apply stricter or additional requirements to UCITS established in their territory than those set out in the Directive, as long as they are of general application and do not conflict with the Directive. It would therefore be possible to tighten the liquidity standards for UCITS schemes established in the UK, subject to the usual processes required by the Financial Services and Markets Act 2000, including formal consultation.

There are two significant drawbacks to this course of action.

First, under EU law, the FCA could not unilaterally extend any such measures to UCITS established in the EEA (as opposed to the UK) and marketed in the UK under EU passporting rights. Currently, the number of EEA funds marketed in the UK exceeds the number of UK funds marketed in the UK. So, tightening the liquidity standards for UK funds would not be sufficient to protect UK investors from harm. As you will know, the location of investment funds is also highly mobile. That said, the FCA has been an active and strong supporter in recent years of work done within the European Securities and Markets Authority to develop harmonized liquidity stress testing of investment funds. This should establish a stronger test EU-wide.

The second reason for judging that strengthening the existing UCITS standard would not be sufficient is that the UCITS legislation sets an overall objective that funds should be liquid. But it supports this with detailed rules that may be, in some areas, not sufficient to ensure liquidity. To take the case of the Woodford Fund, exchange listing and liquidity are not synonymous. Listing does not mean that trading occurs. Moreover, something does not become liquid by stating an intention to list in the future. There is an argument that these more detailed rules do not override the overall requirement for liquidity, but that seems to me to create possible conflicts in the rules that need clarifiying.

My view is that there is merit in considering the new SEC approach in the US which creates a purposive test of liquid status and supports this with requirements around governance, systems and controls etc. The purposive test is to require fund managers to allocate assets to liquidity

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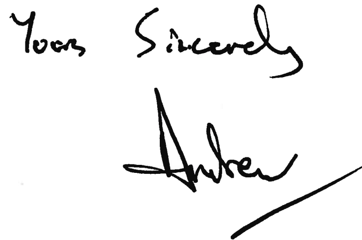
buckets based on the estimated time it would take to sell the asset. This should give an overall picture of the liquidity of the assets of the fund. It does not rely on assumptions that seek to link liquidity to, for instance, listing status.

There is another important reason for advocating a different standard rather than a stronger version of what we have now. I have argued elsewhere that fund liquidity policy should not cut off support for investment in start-ups, and innovation in areas such as AI and Biotech. It would be a mistake to do this. But investors need to know what they are exposed to in their holdings of collective funds including UCITS. They need to be able to choose what exposure to liquidity they have using meaningful and easy to locate information.

As noted in the Bank of England's July 2019 Financial Stability Report,[1] the FCA will be working with the Bank of England to consider how redemption terms for funds established in the UK might be better aligned with the liquidity of their assets, and the effectiveness of existing measures aimed at dealing with the misalignment of redemption terms and asset liquidity.

I hope that this is helpful. In view of the public interest in the subject, the FCA will publish this letter.



Andrew Bailey
Chief Executive

[1] https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/july-2019.pdf?la=en&hash=976688AB50462983447A8908BE079743A3E3905F