FINANCIAL CONDUCT AUTHORITY

Feedback to consultation paper on liquidity mismatch in authorised open-ended property funds

Feedback Statement

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May 2021

This relates to

Consultation Paper 20/15 which is available on our website at www.fca.org.uk/publications

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1 Summary

1.1 In August 2020, we published our consultation paper CP20/15: Liquidity mismatch in authorised open-ended property funds. We consulted on reducing the potential for investor harm that arises because the terms for frequent (typically daily) dealing in units of some property funds are not aligned with the time it takes to buy or sell the buildings in which the funds invest. This creates a liquidity mismatch between the redemption terms that the fund offers to investors and the fund's assets.

1.2 Property funds often hold a significant cash balance, or other liquid assets, to reduce the risk posed by the liquidity mismatch. Otherwise, they might not have time to sell properties to pay investors who can request their money back at short notice. If a fund runs short of cash, this can cause it to suspend dealings. Investors may request their cash back in anticipation of such suspensions, potentially increasing the problem further.

1.3 To address this, we consulted on whether property funds should be required to have notice periods before an investment can be redeemed. We suggested a notice period of between 90 and 180 days for these funds. We also asked for any alternative proposals.

1.4 Such an approach would have a number of benefits. It would reduce the risks of investors being misled by an offer of daily redemption that it has not proved feasible to maintain. It would also reduce the risks to fund investors and the wider economy of pressure to sell fund assets at speed, rather than maximum price, to meet redemption requests. A further benefit is that it would allow funds to be more efficient, enabling them to hold less cash to manage the liquidity mismatch, and therefore boost investors' returns.

1.5 In this statement, we set out the feedback that we received to CP20/15 and our next steps.

1.6 We will not take a final decision on our policy position until Q3 2021 at the earliest. This is because we have taken the feedback into consideration, specifically around the operational work necessary for fund managers and most other firms to support notice periods. We also need to address some of these operational challenges to make progress on new options for a Long-Term Asset Fund (LTAF), on which we are currently consulting. We will therefore continue to work with industry stakeholders, including through the Productive Finance Working Group (PFWG) jointly set up by the FCA, the Bank of England and Her Majesty's Treasury (the Treasury) to overcome these operational barriers.

1.7 If we do proceed with applying mandatory notice periods for property funds, we will allow a suitable implementation period before the rules come into force, to allow firms to make operational changes. We note feedback that 18 months to 2 years would be an appropriate period.

Who this affects

1.8 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

1.9 This will also interest 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, which are affected by our proposals in this paper

The wider context of this feedback statement

1.10 Chapter 2 of CP20/15 outlined our previous work on illiquid assets and open-ended funds and provided background on the consultation.

Summary of feedback on our consultation

1.11 We received 70 responses from a wide range of stakeholders, including fund managers and depositaries, life assurance providers, and those involved in the distribution chain (transfer agents, platforms, advisers, wealth managers, property valuers and pensions specialists), as well as individual investors.

1.12 Respondents expressed a range of views, though many defended the utility of open-ended property funds as a component of an investment portfolio.

1.13 Only a small number agreed with the proposal of notice periods as consulted on. However, just over half of respondents, who expressed a clear position (56 in total), supported the proposals 'in principle' but subject to the following important conditions:

- the wider 'ecosystem' that supports and distributes investment funds (including platforms' and advisers' systems) being able operationally to support notice periods
- investments in funds with notice periods continuing to be eligible assets for ISA purposes

1.14 The feedback can be summarised under 3 key themes:

- Whether to require notice periods for property funds, this is addressed in Chapter 2
- Consequences of introducing mandatory notice periods, set out in Chapter 3
- Feedback on further points for discussion, summarised in Chapter 4

Consumer protection

1.15 CP20/15 set out that our proposals would help further our consumer protection objective by reducing the number of fund suspensions, preventing unsuitable purchases of these funds by making the impact of the illiquidity of the assets more transparent, and by increasing product efficiency by reducing large cash buffers, meaning that the funds could increase their exposure to property.

1.16 CP 20/15 however acknowledged that our proposals would not remove the possibility of property funds suspending due to material uncertainty over the value of the underlying assets, and therefore the price of units in the fund.

Market integrity

1.17 CP 20/15 set out that we consider that notice periods will deliver a more appropriate, stable and resilient structure for property funds. This would further our statutory objective of protecting and enhancing the integrity of the UK financial system.

Equality and diversity considerations

1.18 We did not think our proposals in CP20/15 would materially impact any of the groups with protected characteristics under the Equality Act 2010. However, we welcomed any feedback on any diversity implications from our proposals by asking:

> **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 […]? If so, please provide details.***

1.19 Under half of the respondents answered this question, most of whom thought that our proposals would affect all investors equally.

1.20 Six respondents thought that the consultation proposals would impact groups with protected characteristics under the Equality Act 2010. Five of the six thought that vulnerable consumers, invested in either the authorised property fund directly or via a unit linked fund, could be negatively affected to a greater degree. They argued that due to their circumstances, they might be unable to understand the consequence of bearing the market risk for the length of the redemption notice period. While acknowledging that vulnerability was not a protected characteristic under the Equality Act 2010, the respondents felt the treatment of vulnerable consumers warranted consideration.

1.21 Respondents thought that ongoing support would be required for all clients, but particularly for vulnerable clients, to ensure they understood the implications of the notice period. They suggested that any changes to notice periods or requirements

for property funds or unit linked providers would need to be clearly communicated in an accessible way for all clients and to give them enough time to make an informed investment decision.

1.22 One trade association stated that some vulnerable customers would need instant access to their investment. They suggested there may need to be specific policies for the most vulnerable customers, such as waiving the notice period. However, should the firm have to pay out the redemption from its own assets and later receive the proceeds from the fund once the notice period expires, then the value of the proceeds might fall during the notice period, causing a loss to the firm.

Our response

We do not see evidence to suggest that our proposals would, on an ongoing basis, directly impact any group with protected characteristics under the Equality Act to a greater degree than they would impact those without such characteristics.

Next steps

1.23 We are carefully considering our next steps in view of the feedback received.

1.24 The proposed LTAF, which we are currently consulting on, will also predominantly invest in illiquid assets. We would not expect LTAFs to deal daily given the requirement for the LTAF to ensure that the investment strategy, liquidity profile and redemption policy of the fund are aligned. The LTAF will therefore likely face some of the same operational barriers that property funds would face, if notice periods were introduced. The PFWG are working to overcome the operational barriers to be able to support and appropriately distribute the LTAF. Property funds may also benefit from this work.

1.25 Given the cross-over between the LTAF proposal, and the possible introduction of notice periods for property funds, we will also take account of feedback to our LTAF CP and wider progress on the LTAF before finalising our policy on notice periods for property funds.

1.26 If we proceed with introducing mandatory notice periods for property funds, we will allow for a sufficiently long implementation period before the rules come into force.

2 Notice periods for property funds

2.1 Chapter 3 of our consultation outlined why we think it is appropriate to introduce notice periods for authorised open-ended property funds. We asked:

> **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?***

2.2 The vast majority of respondents answered this question and were broadly evenly split for and against our proposal.

Support for notice periods

2.3 Those who support the proposals thought that notice periods would improve consumer protection and encourage long-term thinking amongst investors. One respondent suggested we go further and require one year's notice for redemptions, as has been done for property funds in Germany.

2.4 Many of the positive responses were however in favour 'in principle' subject to conditions being met, including:

- the need for the whole 'ecosystem', including key players in the distribution chain, such as platforms, wealth managers and unit linked providers, being able operationally to support and distribute the funds with notice periods
- assurance that the funds would retain their status as qualifying investments for ISAs if notice periods were introduced

Opposition to mandatory notice periods

2.5 Those opposed to the proposal argued that imposing mandatory notice periods would do the following.

- Substantially reduce investor and adviser demand for open-ended property funds, eliminating an important element of consumer choice and reducing diversification in retail investors' portfolios. They did not think that Real Estate Investment Trusts (REITs) offered an appropriate substitute due to their price volatility.
- Trigger substantial outflows from property funds, leading to the kind of liquidity crisis we were trying to avoid.
- Not take account of substantial differences between the different investor needs, and liquidity profile in each of the different property funds. They did not think that a blunt "one size fits all" solution was appropriate.
- Not lead to a substantial reduction in the level of cash which property funds would need to hold in order to manage the fund's liquidity. One respondent estimated

that fund cash levels would nevertheless fall to 10% of assets under management if notice periods were introduced.
- Not solve the concern around first mover advantage. Investors who put in their redemption notice ahead of other investors, would, they argued, still benefit from being the first in the queue during periods of stressed liquidity.
- Present substantial challenges to discretionary and wealth managers operating model portfolios when rebalancing client portfolios, potentially leading to the portfolios breaching agreed risk bands.

2.6 A few respondents suggested waiting to see the impact of the Funds Investing in Illiquid Asset (FIIA) rules which we introduced in September 2020 via PS19/24, before making more rules in this area. Our FIIA rules introduced remedies to:

- improve disclosures to retail investors of the risks involved when investing into funds primarily holding inherently illiquid assets
- improve the quality of liquidity risk management
- clarify when property funds need to suspend due to material uncertainty of valuations

Our response

Open-ended property funds are unlikely to be suitable for investors with short-term investment horizons and a need for immediate liquidity. We do not think that a relatively short notice period should fundamentally undermine the investment rationale for investors with a longer-term investment horizon and without need for daily liquidity, such as pension savings in accumulation.

The liquidity mismatch in open-ended funds with less liquid assets remains a source of concern for regulators across the globe, with policy and regulatory responses generally focusing on aligning redemption terms with the liquidity of the underlying assets. We think it important that the infrastructure evolves to support a wider range of investment funds, including funds that deal less frequently. The lack of operational investment to support a wider range of fund structures, including funds that deal less frequently, is reducing consumer choice and preventing innovation.

Given the concerns raised about the operational complexities, as well as to mitigate the risk of substantial outflows within a short period, we would, if we proceed with requiring a notice period, allow a suitable implementation period before rules come into force.

The LTAF
The LTAF will be a new authorised open-ended fund structure that is being designed specifically to facilitate investment in long-term, illiquid productive finance assets. The redemption terms of the LTAF will need to match the liquidity of the underlying assets that it invests in. The LTAF will likely be faced with many of the same operational difficulties that would be faced by property funds if we introduce notice periods. The PFWG is working to create the operational infrastructure necessary to support the distribution of the LTAF, and other non-daily dealt funds.

We will therefore not finalise our policy position on whether or not to introduce notice periods for property funds until we receive feedback to the LTAF consultation. This means that, if we do proceed with introducing notice periods, we expect that the earliest that we would finalise the rules would be Q3 2021.

ISA eligibility
The introduction of a notice period would mean that these funds might no longer be qualifying investments for stocks and shares ISAs. We have liaised with the Treasury and Her Majesty's Revenue and Customs (HMRC) on this.

HMRC published a consultation on ISAs and authorised open-ended property funds on 28 October 2020. We recognise that the loss of ISA eligibility could offset the other benefits of applying the proposed notice periods. We will take the effect on ISA eligibility, as well as the impact of our policy statement PS19/24, into account in our final decision. We explore the feedback in response to the ongoing ISA eligibility of property funds, if notice periods were introduced, more fully in our response in Chapter 3.

Alternative proposals to address the structural liquidity mismatch

2.7 Respondents suggested a range of alternative proposals for addressing the liquidity mismatch, including:

- not making notice periods mandatory, but instead optional for fund managers
- only applying mandatory notice periods to institutional investors who typically carry out large deals which can lead to liquidity issues within the fund
- changing the diversification rules to require funds to hold either a minimum percentage cash balance or a maximum percentage of physical property assets
- allowing subscriptions to continue when funds suspend for liquidity purposes (but not when suspensions are driven by material valuation uncertainty)
- allowing fund managers to defer some or all redemptions for a longer period than the currently permitted one day, when needed

Our response

On optional notice periods
Our rules already permit Authorised Fund Managers (AFMs), managing Non-UCITS retail funds (NURS) to manage the liquidity mismatch through limited redemptions and notice periods. The FIIA rules allow AFMs managing illiquid NURS the choice of either adapting the fund's redemption arrangements to align with the liquidity of the underlying assets, or for the fund to be classified as a FIIA and become subject to the additional requirements this brings. None of the property funds altered their redemption terms following the implementation of the FIIA rules, and all opted instead for the funds to be classified as a FIIA.

We understand that given the wider operational difficulties, AFMs would not unilaterally implement notice periods if they remained optional. The current liquidity mismatch would therefore remain.

On notice periods for large trades
We acknowledge that typically (but not always) it is unexpected large trades from institutional investors and wealth managers that lead to crystallised liquidity events within funds. That could justify us applying notice periods only to large trades. However, this approach could lead to different investors being treated differently, and many small retail investors often lie behind the large trades undertaken by institutions. We will consider this further and will provide additional feedback if we proceed with final rules.

On different solutions for different funds
Our rules are aiming to set a minimum standard to reduce the likelihood of liquidity driven suspensions.

We prefer to avoid excessive complexity in any rules we implement. Funds will continue to be able to go beyond these minimum standards where they wish.

On cash levels and diversification
At the time of our consultation, property funds held cash balances of around 15%-20% of total assets, mainly to meet potential redemption requests. Persistently holding cash at significant levels and/or beyond the level stated in each fund's investment strategy means the fund is not fully invested. We acknowledge that some of the funds do not charge fees for the cash element of the fund and that investors who choose to invest in, or remain in a fund, are in effect accepting the high cash balances that these funds run.

We do not accept the premise that if a notice period is introduced, managers will be unable to reduce their current cash holdings, at least to some extent.

The possibility of reducing 'cash drag', due to the improved alignment between redemption terms offered and the liquidity of the underlying assets, will vary from fund to fund. We will consider this further and will provide additional feedback if we proceed with making final rules.

On allowing subscriptions during suspensions
We understand that allowing subscriptions to continue during fund suspensions due to liquidity concerns within the funds, could help the fund to raise liquidity through subscription proceeds as opposed to selling the underlying assets. However, we are conscious of the consumer protection issues that could occur if retail money continued to flow into the fund, and the fund remained suspended for a long period of time, meaning that investors would be unable to redeem their investments.

We agree it would be inappropriate to allow subscriptions to continue if a fund had suspended due to valuation uncertainty, due to the uncertainty over the value of the subscribing units.

On diversification requirements
We have raised the possibility of requiring further diversification in property funds, for example, by requiring property funds to hold a minimum balance of liquid assets. However, requiring these funds to hold less property would fundamentally change their nature, and risk profile, as they would become mixed-asset funds not property funds. Requiring a minimum cash balance would also permanently embed 'cash drag' into the fund and would not resolve the first mover advantage.

On deferrals
The current deferral rules (in our collective investment schemes sourcebook, COLL 6.2.21 R) only allow for redemptions to be deferred to the next valuation point in circumstances where the authorised fund has at least one valuation point on every business day. This means that redemptions can only be deferred to the next business day. The current deferral rules are therefore not currently a useful liquidity management tool for property funds. We can see some benefit in providing greater flexibility within the deferral rules to allow for either all trades to be deferred for a short period of time, to allow for a property transaction to complete, or to defer large trades for a longer period.

We are aware that system changes across the value chain would be required to facilitate this. We are considering our deferral rules in light of the survey findings of the Bank of England's and FCA's joint review into open-ended fund liquidity, that were published on 26 March 2021. Deferral periods are, in effect, very similar to notice periods.

Proposed dealing structure

2.8 The consultation proposed 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

2.9 We therefore asked:

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?***

2.10 About two thirds of respondents answered this question. Responses were evenly divided between those broadly agreeing and disagreeing with our proposals.

2.11 Respondents who supported the proposed dealing structure of the notice period, thought that the proposal struck the appropriate balance between the interests of investors wishing to redeem their holdings and those who remained in the fund.

2.12 A number of respondents stated that fund managers should have the discretion to allow investors to revoke their redemption requests if this were in the interest of fund investors.

2.13 Those against the proposal typically argued that the element of market risk borne by redeeming investors during the notice period would make open-ended property funds an unattractive proposition.

2.14 An alternative structure put forward was to move to fixed redemption dates, perhaps twice a year, with a fixed notice period six months before each. Fund managers would then have six months to plan for their liquidity needs. This structure would restrict first mover advantage as there would be no particular benefit in submitting a redemption request early if the fund was also subject to a set six-month notice period.

Our response

Optional notice periods and revocation of redemption requests
We expect that providing fund managers with discretion to waive notice periods would result in this becoming the norm, as property funds are able to meet the redemption demands of investors most of the time. This would lead to retail investors expecting daily redemptions, leading to potential consumer harm should a notice period no longer be waived. The situation might, from a retail investor's point of view, end up akin to the situation today where suspensions are imposed when liquidity issues arise. No longer waiving notice periods could also potentially trigger further outflows, as this could be seen as an early warning that the fund's liquidity was deteriorating.

Granting investors the right to revoke redemption requests could result in other fund investors being unfairly treated, depending on the point within the liquidity cycle at which the redemption was revoked. For example, a fund manager may have sold a property in order to meet the redemption request, and the fund will have incurred the transaction costs. It would therefore not be fair on remaining investors within the fund, for the redemption to be cancelled at that point. Allowing for redemption requests to be revoked also adds to the operational difficulties of the proposal.

Under our proposals, should investors change their mind about redeeming, they will be able to re-subscribe for the same amount on any dealing day, eg when the redemption order is executed, albeit they will potentially incur transactions costs.

Fund managers have a fiduciary duty to avoid preferential treatment of investors, so both options would also lead to difficult decisions as to which investors' revocations should be granted, or notice periods waived, given the risk not all requests could be accommodated.

The suggested alternative structure is helpful, but it would risk some retail investors having to wait up to a year should they just miss a cut-off time for providing six months' notice, which is a significantly longer redemption span than they would currently expect. It could also lead to the clustering of redemption requests, and therefore potentially the clustering of property sales, which might be unhelpful and disadvantageous to the remaining investors in the fund.

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?***

2.15 Almost three quarters of respondents answered this question and the overwhelming majority supported a shorter notice period. Over a dozen respondents restated their opposition to any notice periods or requested a notice period of no more than one month. Only a few respondents thought that the notice period should be 180 days or more. One respondent requested a notice period of one year, as has been applied in Germany, in order to restore confidence in property funds.

2.16 A number of respondents argued that between 60 and 90 days is a reasonable timeframe in which to sell commercial property at market value, suggesting that a 180-day notice period would be excessive.

2.17 The majority of respondents emphasised that a long notice period would aggravate their concerns about redeeming investors bearing the market risk during the notice period and thought that 180 days would negatively impact investors' ability to transfer between pension providers. Respondents thought that an excessively long notice period would trigger substantial outflows from the funds. Although respondents warned that notice periods might not be popular with investors, some indicated that investors would understand and accept the rationale for a 90-day period but not longer.

2.18 It was also suggested that notice periods of 90 days, 13 weeks or 3 months should be permitted at the fund manager's discretion since not all months are the same length.

Our response

Finding the optimal notice period length is a balance between lowering the risks of fund suspensions, by addressing the liquidity mismatch, and providing retail investors with speed of access to their investment. The market risk borne by the investors during the notice period also needs to be considered.

A majority of respondents preferred a notice period of 90 days rather than 180 days. However, some property sales will take longer than 90

days, so selecting this notice period would only partially mitigate liquidity mismatch in property fund portfolios.

180 days is likely to be a better mitigant, but, even then, it doesn't guarantee adequate liquidity.

90 days may be more acceptable to current fund investors, but less effective in reducing liquidity mismatch and the need to hold cash balances, than the 180-day option.

A notice period of 180 days would be more effective in reducing the liquidity risk. However, 180 days is a longer time for investors to bear the market risk of the redemption notice, increasing the chance that investors' circumstances and market conditions could change materially within the notice period. We will consider the evidence base for the length of notice period, taking into account feedback that we have received, if we determine to implement notice periods.

Interaction with notice periods

2.19 Under the proposals, fund managers would not be able to cancel redemption requests that were placed prior to a fund suspending. We also proposed that investors would be permitted to place redemption requests during a fund suspension, although they would not be able to purchase units. We proposed that the period during which a fund is suspended would count towards completion of the notice period, though redemptions would not need to occur until the fund re-opened. We asked:

> **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?***

2.20 60% of respondents answered this question. Most agreed with the proposal but said it would not currently work operationally.

2.21 Most respondents also noted that the proposals would not prevent all suspensions. Some respondents asked us to be clear how the notice period would interact with suspensions triggered by the activation of the material valuation uncertainty clause.

2.22 Most unit linked providers asked for clarity on how the suspensions would interact with unit linked mirror funds. Some suggested it is unclear if a unit linked provider could defer redemptions, should the underlying open-ended fund be suspended for liquidity issues.

2.23 Seven respondents, who agreed with the proposal, outlined the importance of platforms and transfer agents needing to upgrade their systems to be able operationally to support the queued redemptions during the suspension. They emphasised the need for a sufficient implementation period to allow platforms and transfer agents to update their systems.

2.24 10 respondents disagreed with the proposal that any period of suspension should still count as part of the notice period. They argued the following.

- First mover advantage would persist ie the earlier notice is given the earlier the redemption occurs, with the first movers most likely to be paid out immediately following the end of a suspension period. Instead, they suggested moving the fund to fixed notice and redemption dates to enable all investors to participate equally at each redemption.
- Investors should be able to cancel redemptions during suspensions. They did not think it is reasonable for investors to remain committed to a transaction where neither price nor date can be guaranteed. They argued that allowing investors to cancel redemptions would improve the fund's liquidity position and re-subject those investors to the notice period if they subsequently re-instate their redemption instruction. They thought this would benefit both parties.

2.25 24 respondents proposed variants on the proposal, including the following.

- Allowing funds to suspend redemptions for liquidity reasons (as opposed to difficulties in setting a fair and accurate fund price due to material valuation uncertainty) but to accept subscriptions. This would help the fund's liquidity, enabling suspensions to be lifted more quickly. Respondents pointed to investors who wanted to invest into property funds when they were suspended in 2016 but were not able to until suspension was lifted.
- Instead of requiring the AFM to confirm to the unitholder the dates on which the redemption will be effected, when the redemption requests are accepted during a suspension, the AFM should simply advise that any deals that could not be placed due to the suspension would be placed at the first valuation point after the fund reopens.
- Three trade associations and a number of firms argued that because it is not usually known when a suspended fund will reopen, declaring a date that the redemption is likely to be met, is effectively a guaranteed transaction date.

2.26 Some respondents, including 2 trade associations, agreed that AFMs should operate an order queue during the suspension (unless they have reasonable grounds for refusing to do so), and that the suspension time would count towards the notice period. They argued that the order queue would provide the AFMs with better visibility of upcoming redemptions and in most cases would enable them to manage sales of underlying assets in good time to meet those redemption requests. When determining whether a suspension should be lifted, visibility over the level of expected redemptions on resumption of dealing is an important tool. Allowing redemption requests to be accepted during a fund's suspension would help with these considerations.

Our response

There was consensus that a period of suspension should be counted as part of the notice period. If we do proceed with implementing notice periods, we believe that including the suspension time as part of the notice period could be one way to manage redemption demand. Alternatively, investors who submit their notice in good time before a suspension will in effect have to wait twice, as they will have to resubmit their notice again, once the suspension lifts.

With regards to the suggestion of having fixed notice and redemption dates, please see the final paragraph of our response to question 3.

We accept that transfer agents and platforms are not currently able to support order queues throughout suspensions. But if a sufficient implementation time period is allowed to address this, we do not think it is an insurmountable challenge.

We do not see a reason why notice periods in conjunction with suspensions should work in different ways depending on how a suspension was triggered.

Nor do we see any reason why fund suspensions, in funds subject to a mandatory notice period, should be managed differently in unit linked funds from how suspended funds are dealt with today.

Our rules propose that investors would be permitted to place redemption requests during a fund suspension. We agree that running an order queue would help AFMs manage the fund's liquidity.

We will continue considering respondents' concerns about the requirement for the AFM to specify the date of deal execution, for any redemption requests submitted during the suspension period. We expect to provide additional feedback on this, if we proceed with final rules to implement notice periods.

Interaction with FIIA rules

2.27 We proposed that funds within scope of our proposed notice period rules would be subject to all the FIIA rules except for the prescribed risk warning for retail investors (Conduct of business sourcebook 4.5.16R and 4.5A.17R). We asked:

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

2.28 Half of the respondents answered this question. A large majority of these agreed that it is appropriate for FIIA rules to continue to apply to authorised property funds operating notice periods.

2.29 A handful of respondents agreed, subject to modifications (such as removing the requirement for these funds to provide a financial promotion risk warning), that it is appropriate for FIIA rules to continue to apply to authorised property funds that operate notice periods.

2.30 Two respondents disagreed. They thought applying notice periods in conjunction with FIIA rules would cause a large amount of investor redemptions.

Our response

There is a broad consensus that if we do proceed with the proposal to introduce notice periods, the funds within scope of the proposal should continue to be caught by the FIIA rules, as set out in our consultation.

We disagree with the suggestion to remove the requirements for property funds to provide a financial promotion risk warning, as a notice period would not wholly eliminate the risk of property funds suspending. Funds could still suspend due to material valuation uncertainty. We think it is appropriate for this risk to be highlighted to retail investors via financial promotion warnings.

As no convincing counter-arguments were made, we expect that the FIIA rules should be retained in their current form, whether or not notice periods are taken forward.

Scope

2.31 Similar to our FIIA definition, we proposed that the scope of the notice period rules would apply to any NURS that invests 50% or more of its assets in immovables (or in other schemes that invest in immovables to the same extent). If a fund operates limited redemption arrangements, the new rules would apply to any fund where those arrangements provide for dealing in units more frequently than the length of the notice period (see paragraph 3.29 of CP 20/15 for a worked example). 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. We asked:

> **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?***

2.32 Just over half of the respondents answered this question.

2.33 15 respondents disagreed with this proposal as they did not understand the logic of imposing notice periods on new funds that deal on a monthly/quarterly basis and on existing funds that move to such dealing frequencies, but not to existing funds that currently deal less frequently than monthly. Respondents questioned why, if the latter 'have typically not suffered the same history of suspension due to liquidity concerns', we assume that new funds would.

2.34 They submitted that the proposed notice period should not apply to funds which are able to manage liquidity effectively on the current pricing basis and extended this argument

to existing, or new, daily priced funds as well as monthly or quarterly priced funds. However, most did not see any argument for treating existing monthly or quarterly priced funds differently from newly authorised funds with the same dealing frequency.

2.35 By distinguishing between funds operating the same dealing periods in this way, the rules may effectively create an incentive for retail investors (especially those whose money is managed in a more 'institutional' way by discretionary investment managers) to invest in existing monthly dealing funds that may be open to, but not specifically targeted at, retail investors, rather than in newer funds subject to a 90 day notice period. They argued that there should be a level playing field for all funds dealing more frequently than quarterly. To treat funds differently could cause investor confusion.

2.36 In the interests of fairness and competition, most of the 15 respondents who disagreed with this proposal, argued that there should be equal treatment of all funds with the same characteristics. A fund's launch date should have no bearing on the rules to which it is subject. Most also argued that the use of different notice periods for different types of fund introduces additional complexity. It was argued that it would be particularly challenging for firms to explain the difference between the types of funds to investors. This could incentivise funds to restructure to offer monthly dealing to avoid a 90 or 180-day notice period.

2.37 Most respondents said that as long as these funds were not available to retail investors they should not be subject to notice periods. However, for those funds that were available to retail investors it was suggested that the same rules should apply to funds dealing more frequently than quarterly, to align with the notice period.

2.38 A few respondents pointed out that redemptions for funds that deal less frequently than daily, are paid out at the next dealing day. For example, for a fund with monthly redemptions on the last day of the month, a redemption request made in September would be paid out in October, and therefore pose similar risks to daily dealt funds without notice periods. They suggested that if there is a fixed notice period of 90 days, then notice periods should be implemented for funds that redeem more frequently than at 90-day intervals, but not for funds that redeem at 90 days or more.

2.39 A handful of respondents welcomed the distinction made in the consultation paper between the liquidity issues of daily dealing funds and those which accept deals less frequently. They recognised that most short-term liquidity events in daily traded funds are caused by a higher than expected level of redemptions by investors that chose daily dealing. Funds that accept deals less frequently tend to attract long-term institutional investors who do not require cash at short notice. They saw no reason for these types of funds to be classified as FPIPs or to operate notice periods. They were unclear on what benefit a change in this space would bring or what risk such a move would look to address. They argued that these funds should not be subject to a 'one size fits all' policy, given that the requirements of retail and institutional investors are different.

2.40 However, respondents acknowledged that while these funds are not typically marketed to retail investors, there is a risk that they could be more actively marketed if longer notice periods are introduced on other NURS. As long as there would be no opportunity in the future for these funds to be marketed to retail investors, they agreed with the proposal.

Our response

In line with the feedback received, we will consider whether to extend a mandatory notice period to NURS currently dealing less frequently than monthly, but more frequently than the mandatory notice period.

Whilst in principle we recognise the arguments submitted to ensure a level playing field and avoid regulatory arbitrage, we need to consider whether extending a mandatory notice period would be disproportionate, given that most retail exposure to property funds is through daily-dealt funds without notice periods. While we have observed some fund suspensions in property funds that deal less frequently, those suspensions occurred due to valuation uncertainty, as opposed to liquidity issues. The suspensions have also not resulted in significant issues due to the funds' experienced institutional investor base.

We will consider this further if we do decide to proceed with applying mandatory notice periods.

3 Consequences of making this change

3.1 Our consultation recognised that the potential introduction of the proposed notice periods may cause these property funds to be treated differently under some other regulations, affecting other market participants, as well as investors in these funds. Chapter 4 of the consultation set out the consequences that we identified and explained our proposed approach to them.

SIPP provider capital rules

3.2 Many investors invest in these funds through their Self-Invested Pension Plan (SIPP). A SIPP provider is required to hold adequate capital, eg in the event that it needs to close its business and run off or transfer its book of pension schemes to another administrator. If SIPP providers do not hold adequate capital, there is a significant risk that investors can end up funding an administration wind-down of the provider, out of their own pension assets. This undermines market confidence and can cause significant consumer harm.

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

3.4 The proposals set out in CP20/15 to introduce minimum notice periods for daily dealing property funds would mean that such funds would no longer be strictly capable of being readily realisable within 30 days, and therefore property fund assets within a SIPP plan would move from being a standard to a non-standard asset. Where relevant client plans do not already contain non-standard assets, this may lead to a capital surcharge being applied.

3.5 We proposed a transitional rule to avoid a capital surcharge for SIPP providers that are managing pre-existing client plans that contain property funds that are treated as standard assets. We designed it so the implementation of notice provisions would not make a difference to the existing capital requirements for SIPP providers for units in property funds already within their clients' SIPPs. 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. We asked:

> **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?***

3.6 Just under half of the respondents answered this question, of which about two thirds agreed with the introduction of a transitional rule to ensure that there was not a stepped increase in capital requirements. Without the transitional there was widespread concern that the increased capital requirements that SIPP providers

would need to bear as a result of the implementation of the notice period would result in them no longer offering property funds going forward, rather than bearing the additional capital charge.

One third of the respondents who answered this question did not think that the proposed transitional would sufficiently help smooth the implementation of notice periods more generally, and cited operational difficulties and the need for investors to bear the market risk during the notice period as rationale.

Our response

We acknowledge that if we do proceed with implementing notice periods, a transitional rule relating to the SIPP provider capital rules could help reduce redemption pressure on property funds and reduce the chance of additional costs being passed on to investors.

If we do proceed with our proposal, we acknowledge that a long implementation period would be required to smooth the overall transition.

Unit-linked life contracts

3.7 Our consultation also considered the potential impact on unit linked life assurance contracts that offer investment into daily dealing authorised property funds. For these specific contracts, insurance firms would need to decide how to process transactions if notice periods were introduced. The insurer would need to decide whether to continue permitting 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. We asked:

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?***

3.8 45 out of 70 respondents answered this question; most agreed that we had correctly identified the key material impacts of introducing notice periods.

3.9 However, a significant number thought the cost of the impact was underestimated. Respondents also expressed concerns about the readiness of the wider retail and pension funds 'ecosystem' to support the changes.

3.10 We received feedback that the notice period proposal would increase complexity to unit linked products due to the balance sheet implications of providers taking a potentially uncertain amount of liability by taking on the market risk during the notice period. In some instances, the insurer would need to pay out a set amount at the beginning of the notice period, yet they would not know the value of the disinvestment until the end of the notice period. This would particularly impact life policies which offer a fixed monetary withdrawal option, or event-driven contractual payments such as death. Respondents argued that the insurer taking on market risk went against the original objective of unit linked products where investors bear the market risk.

3.11 However, we also received feedback that given property funds are not typically volatile products, the market risk during the notice period would likely be minimal (and in all events limited to the value of the units at the time of the redemption request). Regardless, the market risk would be minimal compared with the overall size of the insurer's balance sheet. We also received suggestions that in most circumstances the market risk could be managed by the unit linked provider, by matching subscriptions and redemptions via their box management process, thereby minimising the market risk that they would bear.

3.12 Furthermore, we received feedback relating to the potential consequential impact on tax reporting requirements for insurance products, as well as operational difficulties for unit linked providers to apply notice periods contractually and operationally.

3.13 Distributors, such as investment platforms and other service providers, would need to amend and upgrade their systems in order to support funds if we introduce notice periods. We were told that approximately 74% of the funds are distributed via investment platforms, yet there is apparently little incentive for investment platforms to upgrade their systems for a relatively small number of funds.

Wider considerations

3.14 Respondents pointed to areas where the impact of a notice period could potentially have a material negative effect on the distribution of units in property funds, potentially bringing the viability of these funds into question. One respondent pointed to the need to consider the cumulative effect of all impacts, including:

- the operational complexities of rebalancing of model portfolios
- SIPP wrappers no longer being able to use property funds, as they might become non-standard assets due to the implications of higher capital requirements (as discussed above)
- suitability and appropriateness tests could be impacted as property funds might no longer be readily realisable securities

Stocks and shares ISAs

3.15 Under current tax legislation, units of NURS can be qualifying investments for the stocks and shares component of an ISA if account holders are able to access the funds or transfer them to another ISA within 30 days of making an instruction to their account manager. Therefore, if notice periods were introduced, and no change was made to ISA eligibility and transfer rules, such property funds would no longer be qualifying investments for a stocks and shares ISA.

3.16 To mitigate the impact on ISA holders and ISA managers, if the change is introduced, the Government consulted on whether to allow existing investments in open-ended property funds to remain qualifying investments for a stocks and shares ISA, while new investments in such funds would be ineligible for such ISAs as a result of the proposed notice periods.

3.17 One respondent emphasised that any restrictions on the ISA eligibility of the property funds 'would have exceptionally negative effects on the prospects for successful change in the open-ended property fund market'. Respondents pointed to between 30% to 40% of investments in property funds being held through stocks and shares ISAs, with potentially much higher proportions in some individual funds. If the introduction of notice periods meant that no new investment (including top-ups) were ISA eligible, it would bring the ongoing viability of property funds into question. The loss of the tax status might cause investors to turn to other products.

Our response

We will take this feedback into account when determining our final policy position and will consider the cost implications through our cost benefit analysis.

Operational difficulties across the ecosystem
We understand the operational challenges that the industry will need to overcome to support notice periods and non-daily dealt funds more generally going forward.

As stated above under our response to question 2 we will not finalise our policy position on whether to introduce notice periods for property funds until we receive feedback to the LTAF consultation. If we do proceed with notice periods, following consultation feedback we will allow for a suitable implementation period before the rules come into effect, and note feedback that 18 months to 2 years would be an appropriate period to allow implementation of the required operational changes.

Distributors
Some platform providers have told us that systems can be upgraded in order to support funds with notice periods going forward. Given the continued domestic and international regulatory focus on liquidity tools, including notice periods for open ended funds, we expect more funds with notice periods to be launched in the future.

Given investors' search for yields in a continued low interest rate environment, we see benefit in investment platforms ensuring their systems can support and distribute a greater range of funds and products in the future, including non-daily dealt funds.

We will continue to work with the Treasury, the Bank of England and industry stakeholders on this.

Unit linked insurance products
We have considered the potential impact of notice periods on unit-linked life products at 3.8 above. Our consultation did not propose changing the permitted links rules alongside introducing notice periods for open-ended property funds. However, we propose amending the permitted linked rules to facilitate investment in LTAF funds. As stated above we will take into account feedback on our LTAF CP (including permitted links) before finalising our policy on property fund notice periods.

Stocks and shares ISA
We continue to engage with the Treasury and HMRC on this. We will take the situation of ISA investors into account in our final decision, noting that if Treasury and HMRC were to take their proposals forward current retail investors will continue to benefit from ISA eligibility for funds they already hold in ISAs.

3.18 We recognise that our proposals to introduce notice periods for property funds present operational challenges for some stakeholders, who will need time to prepare to implement them fully and effectively. Our consultation therefore explicitly asked:

> **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?***

3.19 40 out of 70 respondents answered this question.

3.20 A significant number expressed concerns about the readiness of the wider retail and pensions funds ecosystem to support the changes, and therefore requested up to a 2-year implementation period before the rules come into effect to allow for the required operational changes. The arguments put forward for a substantial lead-in time included the:

- need for intermediaries/advisers to get to grips with the changes and amend offerings such as model portfolios or centralised investment propositions
- impact on the suitability/appropriateness of what might now be complex products, and hence for intermediaries potentially to have to reassess all of their client base, and to make adjustments to client portfolios
- need for fund managers to work out the details of the new fund structure and amend the prospectus and other documentation/promotional material for the funds themselves
- operational, procedural, contractual and legal implications of moving to a fund with a notice period (platforms and transfer agents in particular would need to make systems changes to accommodate these)
- need to obtain clarity from HMRC on ISA eligibility and treatment of the funds for SIPP purposes

Our response

If we proceed with applying mandatory notice periods we would allow a sufficiently long implementation period to ensure systems and procedures are ready and properly tested.

Arguably, existing and potential investors affected by the changes should be informed sooner rather than later that future redemptions will be subject to notice, so there would be a case for imposing an earlier start date for changes to documentation and updated warnings on financial promotions.

4 Further points for discussion

4.1 Chapter 3 of our consultation welcomed feedback from respondents on alternative ways to address the liquidity mismatch which do not involve notice periods. We asked:

> **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?***

4.2 Just over half of respondents answered this. Responses were evenly split three ways between those who supported notice periods, those who proposed alternatives and respondents who did not express an opinion.

4.3 Quite a few respondents repeated the arguments against implementing notice periods they set out in response to question 2, and we have considered these responses in chapter 2.

4.4 Respondents who favoured notice periods over other solutions suggested the following.

- Notice periods would be preferential to more drastic measures such as a ban on retail sales.
- Despite misgivings that notice periods would reduce the attractiveness of such funds, it would be the cleanest way to address the liquidity mismatch.
- Notice periods would give investors greater certainty, which is preferable to continued or prolonged suspension of dealings, as long as the investment and operational challenges did not result in the property funds no longer being offered to retail investors. In that case, it would be better to accept the status quo and the risk of occasional suspensions.
- The proposal is better than suspension because investors can continue to buy units in the fund, thereby reducing the need to dispose of portfolio assets.

4.5 Others opposed the proposal and said that alternative options of some kind are preferable, suggesting the following.

- We address the potential risk that retail investors don't fully understand the effect that a liquidity mismatch can have on their investment, and requiring all retail investor sales to be made through advisory or discretionary intermediaries.
- As retail investors represent only 1% of their fund's assets this justifies maintaining the status quo.
- Notice periods could be introduced on an optional basis. This could be at unit class level, including only for classes that are open to institutional investors, thus allowing one class to continue offering daily dealing while another is subject to notice periods. They argued that institutional investors whose activities have a greater impact on the fund would be more comfortable with the prospect of notice periods.
- Discretionary managers who make large investments in the sector should understand and accept the long-term nature of the assets and not be able to make large redemptions 'on a whim'.

- Managers should be able to implement notice periods at discretion, so investors aren't left unable to access their money 'in good times'.
- Flexibility within the deferred redemption rules, to allow large deals to be deferred for up to several months while others continue to deal.
- Making dual pricing mandatory for property funds would encourage long-term investment and applying the pricing consistently would help transparency and investor understanding.
- Combining client appropriateness / suitability tests and enhanced product governance to monitor who units are sold to, would provide ample safeguards.

Our response

Given the complexity of the policy and the crossover with the LTAF work, we continue to work with stakeholders to weigh up the benefits and drawbacks of the alternative proposals that have been put forward.

We expect to finalise our policy position once we receive feedback to the LTAF consultation.

4.6 Our current rules permit some types of UK authorised funds to use limited redemption arrangements, which may involve notice periods. There may be other types of funds where the manager might consider it appropriate to be allowed to operate a notice period. We therefore asked:

> **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.***

4.7 36 out of 70 respondents answered this question, of which 11 responses did not have a clear position as to whether they agreed or not.

4.8 9 respondents were against notice periods for any funds as they felt it was too complicated and would negatively impact consumer choice and outcomes. Specifically, they disagreed with notice periods for open ended funds if it meant the funds would not be ISA eligible or classified as standard assets for SIPPs. They argued that removing these funds as standard investments in SIPPs and qualifying investments in ISAs would likely result in them ceasing to be available through retail platforms.

4.9 12 respondents thought that if the authorised fund manager believes that notice periods would improve consumer outcomes within the fund, it should be permitted (as under UCITS and AIFMD rules) but not required to operate notice periods. However, they acknowledged that notice periods may reduce the attractiveness of the fund for some investors.

4.10 Some suggested that fund managers should be able to reach decisions about the appropriateness of notice periods with full knowledge of each fund's asset mix and investor base and to consult with investors to determine the likely impacts of a notice period being imposed. Some respondents argued that an approach driven by the characteristics and circumstances of individual funds, rather than by regulatory mandate, is likely to be more flexible and nuanced as it is in each fund manager's

commercial interests to ensure that the needs of different types of investors are adequately catered for.

4.11 Most of the respondents agreed that notice periods were not appropriate for funds that invest in liquid assets, and those – with either a diverse investor base or an investor base comprised of one person or family – who are in close contact with the investment manager. Funds holding assets where liquidity can vary in changing market conditions, such as corporate bond funds, would also find it more appropriate to utilise other liquidity tools in times of stress.

4.12 A number of respondents said they would welcome consideration being given to notice periods for other FIIAs. They argued they did not understand why the FCA would address the perceived illiquidity concerns in property yet simultaneously advocate authorising vehicles investing in other illiquid assets such as infrastructure.

4.13 Some suggested that the FCA should consider introducing notice periods for funds that invest in illiquid equities, micro-cap funds, high yield fixed income funds and frontier markets.

4.14 One respondent said that notice periods should only be applied to new funds where they have been specifically launched and marketed on the basis of having and using the notice period. This would help ensure that investors are not 'forced' into an arrangement that they did not opt for, but have actively chosen it in the belief that it will provide some 'redemption notice premium' that standard funds would not.

4.15 Three respondents thought that notice periods were preferable to occasional suspensions of unit dealing, as notice periods would offer consumers greater certainty and allow time to manage liquidity.

Our response

If we proceed with introducing mandatory notice periods for FPIPs, we would continue to allow for their voluntary use by other funds whose investment objective, policy and strategy makes them a suitable liquidity management tool. We will continue to challenge the dealing frequency and the range of liquidity management tools for all FIIAs, and FPIPs, and other funds that have significant exposure to illiquid assets during the authorisation process. We would expect all non-UCITS funds to comply with FUND 3.6.2R.

4.16 While the consultation did not make specific proposals on accommodating long-term capital structures, the consultation welcomed views on this topic. We asked:

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

4.17 32 out of 70 respondents answered this question.

4.18 2 respondents disagreed and did not think that the FCA needs to take further steps to facilitate long-term capital structures, but did not explain why.

4.19 Most of the respondents welcomed and supported the work that is currently being undertaken on the LTAF. Respondents also recognised that the industry needs to help play its part in meeting the demand from the Government for increased investment in infrastructure (and other productive finance assets) while ensuring good outcomes for retail customers.

4.20 Respondents said it is important that any funds to be marketed in the UK under the future Overseas Funds Regime should be subject to the same requirements as UK authorised funds, to ensure a level playing field.

4.21 A trade association encouraged long-term capital structures, with appropriate diversification to help improve overall fund stability, returns and consumer outcomes.

4.22 One respondent suggested that where a client's investment horizon is aligned to liquidity profiles, additional restrictions should not be imposed on the client.

4.23 One respondent was supportive of long-term capital structures being available to retail investors. However, for them to be attractive they would need to meet an expectation of instant access in normal circumstances. The manager of such structures would therefore need to manage the liquidity mismatch, as opposed to simply attempting to remove it. The respondent felt that the current range of liquidity management tools (if deferred redemption were improved) and clear disclosure for clients would solve the issue.

4.24 One investment platform thought there was room for a number of different types of investments in the retail market, including those of limited liquidity, as well as different dealing / transaction frequencies. They argued that clarity is important for clients to understand how these investments are likely to behave in different market conditions and in different liquidity scenarios.

4.25 One authorised fund manager suggested that enforced changes introducing mandatory dual pricing across property funds would go some way towards encouraging longer term investment. Applying a consistent approach to dual pricing across the board would also help promote transparency and investor understanding.

4.26 One wealth manager suggested exploring the fund of alternative investment funds (FAIF) structure. They thought the FAIF satisfies many of the features which investors look for when investing in less liquid assets. Common standards for valuation of assets and legal ownership could reduce the costs and risks of investing in illiquid assets for consumers outside a market which has historically been accessible mainly to ultra-high net worth clients.

4.27 One respondent called for an easier route for defined contribution pension schemes to access long-term real assets such as property.

Our response

We have considered and taken into account all of this feedback in the development of the LTAF, which we are currently consulting on.

4.28 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. We asked:

> **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?***

4.29 32 out of 70 respondents answered this question.

4.30 Very few respondents were unequivocally positive about the prospect of having a secondary market for both retail and institutional investors, whereas several were sympathetic to a secondary market solely for institutional investors.

4.31 Respondents who were in favour of a secondary market facility included:

- Two respondents who thought a secondary market should definitely be developed either alongside notice periods or as an alternative, arguing that it solved the difficulties with model portfolios, ISA eligibility, and capital requirements for SIPP providers.
- One respondent who suggested that all brokers should have their permissions modified to allow them to arrange deals in units of authorised as well as unauthorised funds.
- Some respondents who noted that there are already limited existing arrangements that work well enough for institutional investors.
- Matched trading could work by providing liquidity, especially for discretionary investment managers and funds of funds.

Arguments for

4.32 A small number of respondents favoured an optional secondary market for retail investors, and suggested that:

- there is a 'small but growing' German secondary market where retail property funds are otherwise subject to a 12-month notice period
- the secondary market should be developed ahead of the wider proposals
- there was no need for additional rules to enable the development of a secondary market
- Although most investors are in these funds for the long term, the market would give them a real choice (albeit at a cost) if they wanted to exit during a suspension
- Platforms would be able to develop systems for trading between clients on the same platform, or possibly even for trading between platforms

Arguments against

4.33 The majority of those who answered this question did not support the idea of the development of a secondary market to facilitate liquidity.

- They said it's incompatible in principle to have a secondary market operating alongside an open-ended fund offering regular redemptions. Some respondents noted that there would be little or no reason for ordinary investors to buy units on the secondary market as they can do so directly. Consequently, it would be a sellers' market and units would be bound to trade at a discount to NAV, with the imbalance contributing to price volatility. This would create arbitrage opportunities for smart players with access to capital to buy units at a discount and then give notice to redeem them at NAV, thus profiting over those who invest directly. This could make matters worse than the current perceived first mover advantage.
- It would result in poor outcomes for retail investors. Many respondents said there would be great uncertainty over what would be a fair price for units on the secondary market.
- A few respondents argued that retail investors who were desperate to sell quickly would be willing to accept a loss and that this is a fair alternative to being locked in either for a fixed period or indefinitely if the fund is suspended.
- Most said that retail investors would either not understand how the price was arrived at, contrary to the principle of a secondary market in which a willing buyer and seller agree what is a fair price, or their desire for immediate cash in hand and fear of the market moving against them during a notice period could sway their judgment.

4.34 A couple of respondents thought that such a market might be too shallow, especially in the early stages when lacking critical mass. A potential lack of buyers, especially in stressed situations when redemption volumes are higher, might make the overall process slower than giving notice. The market may also dry up during periods of uncertainty.

4.35 Several suggested modifications or alternatives that might work better, including:

- limiting the amount of issuance that could be traded, or restricting it to a special unit class
- limiting the secondary market to institutional investors
- matching redemptions with new issues of units

4.36 Notably, market participants who could be in the market for developing the necessary infrastructure to support and facilitate a secondary market, did not answer this question, perhaps suggesting that they would not be interested in developing it.

Our response

We acknowledge respondents' concerns that a secondary market could result in some investors profiting at the expense of others (potentially retail investors), with investors selling out of their positions at a discount, compared to investors who buy and sell units directly via the AFM.

A long implementation period before any requirement for notice periods may increase incentives and opportunity to explore such conversion, but we do not propose to require it in our rules.

Annex 1
List of non-confidential respondents

Aegon UK

AJ Bell

Association of member-directed pension schemes

Association of British Insurers

Association of Investment Companies

Association of Pension Lawyers

Beckett Asset Management

BMO Global Asset Management

Brewin Dolphin Ltd

British Property Federation

Chapters Financial

Continuum (Financial Services) LLP

Depositary and Trustee Association

Donald Tosh

Embark Group

GP3 Financial Solutions Ltd

Hargreaves Lansdown

Hugo McCloskey

Incillation Ltd

European Association for Investors in Non-Listed Real Estate

Interactive Investor

Investment Property Forum

Janus Henderson Investors

John Forbes Consulting LLP

Kirk Rice LLP

Legal & General Investment Management (Holdings) Limited

London Stock Exchange Group

M&G plc

Mark Watts

NatWest TDS

North Star Advisory

Parmenion

Pensions and Lifetime Savings Association

Phoenix Group

Phoenix Wealth Management Ltd

The Personal Investment Management and Financial Advice Association

Principal & Prosper Holdings Ltd

The Royal Institution of Chartered Surveyors

Royal London Group

Schroders investment Management

Scottish Widows

Society of Pension Professionals

Standard Life Aberdeen plc

Standard Life Savings Ltd

The Association of Real Estate Funds

The Investment Association

Thesis Unit Trust Management Ltd

Threesixty Services LLP

The Investing and Saving Alliance

Wade Financial Services Ltd

Wellian Investment Solution

XPS Pensions Group

Annex 2
Abbreviations used in this paper

Abbreviation	Description
AFM	Authorised fund manager
AIFMD	Alternative investment fund managers directive
COLL	Collective investment schemes sourcebook
CP	Consultation paper
FAIF	Fund of alternative investment fund
FIIA	Fund investing in inherently illiquid assets
FPIP	Fund predominantly investing in property
HMRC	Her Majesty's Revenue and Customs
ISA	Individual savings account
LTAF	Long-term asset fund
NURS	Non-UCITS retail scheme
PS	Policy statement
PFWG	Productive Finance Working Group
SIPP	Self-invested personal pension
UCITS	Undertaking for collective investment in transferable securities

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