

UKLA Technical Note

Eligibility of closed-ended investment funds

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LR 15.2.2R,
LR 15.2.3AR
and
LR 15.2.4AG

LR 15 was introduced in 2007 and is designed to cater for a wide range of investment strategies and methods of investment. It opened up listing to a broader range of funds, including private equity and hedge funds.

Key concepts in LR 15 include:

- the requirement to have a defined investment policy that can only be changed materially with the consent of shareholders
- the obligation to have a board independent from the fund manager
- the need to spread investment risk, and
- a prohibition from conducting significant trading activity

These concepts apply irrespective of the nature of the asset class invested in or the fund's strategy.

Since then, the market has taken advantage of the flexibility offered by LR 15 and we have seen increasing numbers of funds of a more complex nature, in terms of structure, asset class and investment management, including funds that only hold controlling stakes in their investments.

In the context of assessing the eligibility of a new fund for listing, most of our time is spent considering the last two elements. We are particularly concerned to ensure that the entities we list under LR 15 are genuinely funds, rather than trading companies that should more appropriately consider a listing under LR 6 or LR 14.

We frequently discuss with applicants, advisers and sponsors the boundary between an entity that is eligible for listing under LR 15 and one that is not. This guidance sets out some of the key considerations that we take into account when determining whether an applicant can be considered to be a closed-ended investment fund, bearing in mind the eligibility requirements set out in LR 15.2.2R and LR 15.2.3AR.

Spread of investment risk – LR 15.2.2R

One of the key eligibility requirements under LR 15 is that the applicant must spread investment risk. A listed fund should be a risk-spreading vehicle that offers investors diversified exposure to assets they would otherwise be unable to access.

The investment policy required under LR 15.2.7R is the articulation of how the fund will manage its assets and spread its investment risk. The mandatory requirements cover asset allocation, risk diversification and gearing, including maximum exposures. We will carefully examine these statements – in light of the intended asset class – to assess whether the proposed investment policy suggests there is a risk that genuine diversification may not be achieved.

LR 15 does not set arbitrary limits to individual exposures, but where the investment policy potentially allows an individual investment to represent a material proportion of the applicant's portfolio, we will seek to understand why the sponsor believes the proposed policy enables a genuine spread of investment risk. For example, if an applicant proposes an investment policy with limits suggesting in excess of 25% of the portfolio may be represented by a single asset, we would certainly expect to understand how the sponsor has reached its conclusions. Our view on the eligibility of an applicant with such an investment policy will vary depending on the specifics of each case.

Trading activity – LR 15.2.3AR

A fund must not engage in trading activity that is significant in the context of the fund as a whole. This does not prevent the underlying investments from being trading businesses, but if the fund itself is actively engaging in activity that would more typically be seen in a company listed under LR 6 or LR 14, this is inconsistent with what is envisaged as a fund under the Listing Rules. As part of the eligibility review, we will need to be satisfied that the applicant is not a commercial company that should be assessed against the eligibility criteria set out in LR 6 or LR 14.

In determining whether an applicant is credibly described as a closed-ended investment fund, we will take into account how the applicant is described in the eligibility submission from the sponsor, the information provided in the draft prospectus, conversations with the sponsor and other open source material. There is no definitive list of indicators. The sort of factors we will consider may include:

- the asset class – for example, we would spend less time considering a FTSE tracker in comparison with a wind farm fund
- for assets that are majority owned and/or require more operational oversight than classic asset classes such as shares or bonds – how the operational aspects will be managed and by whom
- how the applicant is presented and whether there is there a clear focus on spreading investment risk
- the rationale for follow-on investments
- how many (if any) staff are employed by the fund, and in what capacity
- the track record of the individuals behind the proposal, and
- the intended use of capital and debt facilities in the context of the specific asset class

Each applicant will be considered on a case-by-case basis and we will assess the proposition as a whole. As such, factors that may be acceptable for a fund in one proposal may, in the context of a different asset class/strategy, render the applicant ineligible for listing under LR 15.

Financing arrangements – LR 15.2.4AG

Allied to our consideration of both of the above elements is an examination of the fund's financing arrangements.

In the context of risk spreading, we will look at how the fund employs its debt facilities and whether certain financing structures undermine what is otherwise a diversified portfolio. Secured debt that sits at issuer level or across multiple assets may imply that, in the event of

default, material parts of the portfolio may be at risk which is, prima facie, inconsistent with the concept of risk diversification. We accept that there can be legitimate reasons for debt being employed in this manner. However, as part of the eligibility process, we will challenge the sponsor to understand how it has satisfied itself that the applicant can indeed spread investment risk in spite of the gearing structure.

There may be cases where the financing structures are such that they create a concentration of risk within the applicant's portfolio in such a way that we cannot look through to the individual assets that are covered by the financing structure (e.g. a number of assets used to secure a specific loan). In such cases, we would consider the assets on an aggregated basis (or the 'pool') as the investment, which is then subject to the fund's exposure limits and the overriding principle of spreading investment risk.

Further, as provided for in LR 15.2.4AG, there is no prohibition on a fund taking controlling stakes in investee companies. However, it is not consistent with the principle of spreading investment risk to plan to use one investment's operational cash flow to fund the day-to-day financing of another investment. We would also not expect financing structures to include facilities such as overdraft arrangements. Such activity is suggestive of the applicant being run as a commercial company.

Ultimately, we would expect a fund to be able to make an investment decision in relation to each asset on its own merits, without needing to take into account whether it will be detrimental to other parts of their portfolio to exit or increase an investment.