Financial Conduct Authority

Discussion Paper DP17/1

Illiquid assets and open-ended investment funds

February 2017

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Annexes

We are asking for comments on this Discussion Paper by 8 May 2017. You can send them to us using the form on our website at: www.fca.org.uk/dp17-01-response-form

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We have developed the policy in this Discussion Paper in the context of the existing UK and EU regulatory framework. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework, including as a result of any negotiations following the UK's vote to leave the EU.

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

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

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Abbreviations used in this paper

AFM	authorised fund manager
AIF	alternative investment fund
AIFMD	Alternative Investment Fund Managers Directive
CIS	collective investment scheme
COBS	Conduct of Business sourcebook
COLL	Collective Investment Schemes sourcebook
ELTIF	European Long-Term Investment Fund
EU	European Union
FCA	Financial Conduct Authority
FSB	Financial Stability Board
FSMA	Financial Services and Markets Act 2000 as amended
FUND	Investment Funds sourcebook
FVP	fair value pricing
IOSCO	International Organisation of Securities Commissions
ISA	individual savings account
NAV	net asset value
NURS	non-UCITS retail scheme
QIS	qualified investor scheme
PRA	Prudential Regulation Authority
PRIIPs	packaged retail and insurance-based investment products
REIT	real estate investment trust
SIPP	self-invested personal pension
SPV	special purpose vehicle
SSaS	small self-administered pension scheme
UCITS	Undertakings for Collective Investment in Transferable Securities

1. Overview

Introduction

1.1 This paper considers some of the risks created when consumers use open-ended investment funds to gain exposure to assets that may be difficult for the fund manager to buy, sell, or value quickly. In this paper we refer to these assets as 'illiquid assets': they may include land and buildings, infrastructure, and financial assets such as unlisted securities.

1.2 Investors may have good reasons to gain exposure to illiquid assets. For example, they may offer opportunities for strong investment returns in the medium to long term. They may help to diversify risk in a portfolio of assets by offering returns that are not correlated to those of other financial asset classes, such as listed equities. Also, investors may want to direct capital to projects that benefit the wider economy by building national infrastructure, providing employment and stimulating long-term economic growth. Fund vehicles are generally well suited to this kind of investment strategy, because they can raise capital on the scale that a major economic initiative requires by pooling many smaller contributions from individual investors.

1.3 However, open-ended funds investing in illiquid assets may experience difficulties if investors expect to be able to withdraw their money quickly and at short notice. Many funds offer daily dealing opportunities to investors, but hold assets that are not revalued on a daily basis. This creates a tension, as assets cannot be sold in a day to meet daily redemption requests. If managers cannot determine an accurate and up-to-date valuation for assets in the fund, they cannot be sure they are offering a fair price to investors wishing to sell.[1] So, if the market for the underlying assets is affected by sudden, severe changes in conditions, leading to price falls that are not fully reflected in fund valuations, some investors might be able to sell their holding for more than it is worth, disadvantaging the remaining investors in the fund.

1.4 The manager of a fund that invests in illiquid assets and offers very frequent redemption opportunities must manage a further tension in how to treat customers fairly. Most consumers that invest in a fund of illiquid assets aim to hold it for the medium to long term, so it is in their interests to preserve the value of the portfolio to generate returns over the same time-cycle. Investors who want to exit the fund create a short-term need for the fund to provide liquidity to pay them, which may mean the manager has to sell assets to raise cash. The more frequently the manager has to accept and process redemption requests, the greater the pressure to generate liquidity, which in a stressed situation could lead the manager to favour the needs of exiting investors over the rest.

1 In this paper we use the term 'fund manager' to refer to the entity that is responsible for operating the fund. For example, for an authorised collective investment scheme this is the authorised fund manager; for a unit-linked life contract, it is the life assurance company.

1.5 Fund managers, in choosing to structure a fund in this way, must be prepared to deal with the resulting risks that may become apparent in a variety of circumstances. They can address the tension between investors' needs by enabling normal dealing to happen wherever possible and putting practical, orderly and clearly-communicated alternatives in place where it is not possible. They can ensure the contractual terms of the fund allow them to apply a range of liquidity management mechanisms, including adjustments to pricing and suspension of dealing. The manager may then use these mechanisms to protect investors' interests when exceptional circumstances make it difficult or impossible to value assets, or meet redemption requests, in a way that is fair to all investors in the fund.

1.6 The measures that are applied must also satisfy our market integrity objective. Since the financial crisis of 2008, there has been a growing international interest in understanding if, and how, the actions of investment funds and fund investors might affect the stability of financial systems. The liquidity of funds is seen as a critical element in this area. At the same time, demand for property investment has been strong and infrastructure as an asset class has been growing in importance.

1.7 The recent experience following the result of the referendum on the UK's membership of the EU, when several fund managers of open-ended property funds suspended dealing in their fund or applied adjustments to its asset valuations, is a clear example of the tensions that arise when trying to balance the competing interests of investors. Although the fund managers acted in what they determined to be the best interests of all investors in their funds and there was no evidence of a spillover effect in the wider economy, there is a question about how effectively the mechanisms worked. There have been previous examples of open-ended funds having to take exceptional measures, such as during the financial crisis of 2008, when a number of funds suspended dealing for extended periods of time.

1.8 We think this is a good time to review our regulatory approach to open-ended funds that invest in illiquid assets. We are publishing this discussion paper to gather more evidence to decide whether more (or different) rules and guidance are needed to support market stability and protect consumers, without preventing them from having access to a diversified range of investment opportunities.

1.9 To reach a conclusion, we want stakeholders to tell us what problems they think exist where open-ended funds hold illiquid assets, how well the current rules address those problems and what further regulatory intervention might be needed. To stimulate debate, we give some examples of possible policy approaches that we could use to intervene.[2]

1.10 This paper is not a general review of fund liquidity measures and it does not try to define which asset classes should be considered inherently illiquid. However, we do take account of current thinking about whether fund liquidity poses risks to financial stability and the measures that we might use to address those risks.

2 Any further work we do will consider our third statutory objective of promoting effective competition in the interests of consumers. When making rules or guidance or carrying out our other general duties, we will consider what is the most pro-competitive way of achieving our aims.

Who does this discussion affect?

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

- operators and investment managers of these funds
- ancillary service providers
- intermediaries, such as platform service providers
- pension plan operators (eg those offering SIPPs and SSaS)
- financial advisers
- life assurance companies with exposure to illiquid assets such as property, either by direct investment or through holdings in investment funds
- discretionary wealth managers
- other professional or institutional investors.

Is this of interest to consumers?

1.12 Consumers who invest directly in funds with an exposure to illiquid assets, or who are exposed to these funds through their pension contributions or their long-term life assurance policies (whether unit-linked or with-profits) are affected by the issues we discuss in this paper. We welcome input from individual consumers and groups representing their interests. This will help us understand what kind of access to illiquid assets consumers want and what degree of liquidity risk – such as restrictions on their ability to sell their holding on demand – they are willing to take on when they invest in this way.

Context

1.13 The market for investment funds allows consumers to access a wide range of investment opportunities in both financial assets (shares, bonds, derivatives) and other asset types, including property (land and buildings) and infrastructure projects. By pooling investors' money and appointing a professional manager to choose and manage a portfolio of assets, funds can provide exposure to asset classes that would otherwise be unaffordable or unobtainable for many investors. This is especially the case for people who do not have significant personal wealth but are indirectly exposed to these assets through contributions to their pension schemes.

1.14 At the same time, there is a need to raise significant amounts of capital for investment in projects that contribute to the national economy. The Government's National Infrastructure Delivery Plan aims to address what the Chancellor of the Exchequer described as 'decades of under-investment' in public infrastructure over the coming years. The Government recently published a paper discussing funding and finance for the Delivery Plan which promises over £500 billion of investment in UK projects, including over £300 billion to be invested by the end of the present parliament in 2020/21.[3] Just over 50% of the total amount is expected to be financed by the private sector, including infrastructure funds.[4]

1.15 The paper also notes that the Government's plans for local government pension schemes to bring their assets together into a small number of pools should be operational by 2018. These pools are likely to allocate between 5% and 10% of their assets to infrastructure – an increase of around £10 billion across the schemes compared to current allocations. One of these pools has already been established as an authorised collective investment scheme and others may decide to adopt this open-ended structure too. The European Long-Term Investment Fund (ELTIF), introduced at the end of 2015 and aimed at professional and certain retail investors, is another vehicle that can provide opportunities to gain exposure to a portfolio of fundamentally illiquid investments.

1.16 There are already rules to ensure that all fund managers manage their funds in the interests of the investors.[5] However, the manager often has considerable discretion to decide how best to meet those interests in a particular market situation. That includes how the fund is structured to enable investors to withdraw or transfer their holding.

1.17 There are essentially two ways for an investor to exit a fund. In an open-ended fund, the fund manager will arrange for investors to be paid the value of their holding (the 'net asset value') out of the assets of the fund, based on an up-to-date valuation of its assets and liabilities. Alternatively, in a closed-ended fund, the investor redeems by selling the interest to a third party for its market value. In a secondary market, the market value of a share may be priced at a discount or premium to its net asset value. Although managers of closed-ended funds must also manage their internal liquidity effectively, these funds do not normally repay investors out of the fund's assets, so the fund manager does not need to provide liquidity within the fund itself to carry out the transaction.[6]

1.18 Since managers can decide the dealing frequency of an open-ended fund, within certain limits, investors generally expect to be able to invest or withdraw at that frequency. The fund manager may occasionally use tools such as 'gating' (limiting the amount that can be withdrawn from the fund at one time) but cannot arbitrarily decide to change the dealing frequency or make it more difficult for investors to sell.

1.19 An open-ended fund offering frequent opportunities for investors to sell their holding at, or very near to, its net asset value may be commercially appealing. This is especially true for investors who value the ability to have continuous access to their investments, even if they intend to remain invested.

3 National Infrastructure Delivery Plan: funding and finance supplement, HM Treasury and Infrastructure Projects Authority, December 2016 www.gov.uk/government/publications/national-infrastructure-delivery-plan-funding-and-finance-supplement

4 Investment needs are not confined to the UK. A recent report considers worldwide infrastructure deficiencies, such as lack of access to electric power or running water, and estimates approximately US$58 trillion of investment is needed over the next 14 years if OECD global growth forecasts are to be met. This compares to a current level of expenditure in the area of US$ 3.5 trillion a year. Source: Citi GPS, 'Infrastructure for Growth', October 2016, © 2016 Citigroup.

5 COBS 2.1.1R & COLL 6.6A.5R for UCITS management companies; COBS 2.1.1R for small authorised UK AIFMs; COBS 2.1.4R for full-scope UK AIFMs and incoming EEA AIFM branches.

6 Shares of many closed-ended funds are traded on secondary markets whose liquidity may be affected by external factors, but this is a characteristic of those markets and is not in the scope of this paper.

1.20 However, this facility may not be in their best interests if the manager is unable to value or trade the underlying assets as frequently as it allows investors to deal. This could create the risk of a 'first-mover advantage' if the first investors to sell are paid from available cash or the sale of highly liquid assets, but later sellers have to be paid through the sale of less liquid assets that incur greater transaction costs. If the manager is not able to sell a portion of each asset to maintain the portfolio's diversity, but has to sell a bigger proportion of the most liquid assets, the remaining investors in the fund are likely to be disadvantaged.

1.21 We are currently carrying out supervisory work to assess how the liquidity of open-ended property funds was affected before and after the EU referendum. Alongside this work, we want to start a broader discussion of how regulation should deal with the challenge that there may be a mismatch between investors' expectations of how liquid their fund is and the fund manager's ability to meet those expectations. Regulation should ideally allow a wide range of investors to share in the potential returns of illiquid assets and give them an appropriate level of protection that reflects their understanding of the nature and risks of the investment, while ensuring that the vehicles they use do not create or exacerbate risks to markets' integrity and stability. We would like to hear views on whether our regulatory regime strikes a fair balance between these aims.

1.22 In the following sections of the paper we:

- describe the liquidity management issues that some UK property funds experienced last year and explain how we responded to them
- describe how current UK regulations apply to funds investing in illiquid assets and offer their managers a variety of tools to manage the fund's liquidity in line with investors' expectations, and
- suggest some possible approaches to developing the regulation of liquidity, to support fund managers in meeting their obligations and ensure good outcomes for investors.

Equality and diversity considerations

1.23 Since this paper does not contain any specific proposals for rules or guidance, it is too early to assess how equality and diversity principles can be applied appropriately or how individuals in protected groups might be affected. We welcome feedback from stakeholders on how any of the possible policy approaches in this paper might impact on equality and diversity considerations.

Next steps

1.24 We want to know what you think about the issues discussed in this paper and would like to receive input from as wide a range of interested stakeholders as possible. Please send us your comments by 8 May 2017, either by using the online response form on our website or writing to us at the address on page 2.

1.25 We will consider your feedback and publish a response later in 2017. If we decide to make proposals for new or amended rules, we will publish a consultation paper.

2. UK open-ended property funds and the EU referendum

2.1 In this chapter we look at how some UK open-ended property funds reacted following the referendum vote on 23 June 2016 to leave the EU. The result of the vote illustrates the kind of one-off event, not widely anticipated by markets, that can put stress on a fund's liquidity management.

The situation before the referendum

2.2 The UK open-ended property fund market is relatively small compared to property investment as a whole.[7] Although estimates vary, at the end of 2015 UK commercial property represented approximately £871 billion, or about 14% of the total UK property market, of which around 55% (£483 billion) was considered to represent investment assets.[8] UK open-ended funds have approximately £35 billion invested in commercial real estate, compared to about £65 billion held in real estate investment trusts and other UK-listed closed-ended vehicles.[9] Life assurance companies are also exposed to property as an asset class. They hold about £914 billion of assets to back their unit-linked contracts, but property represents a relatively limited part of this total: one source puts its value at about £27 billion, another at £48 billion.[10]

2.3 The UK commercial property market had seen a slowdown in growth and increased fund redemptions for about eight months prior to the referendum. We understand that this was due not only to the uncertainty caused by the referendum itself, but also to high market prices and low yields following several years of strong performance since the 2008 financial crisis. Market sentiment in late 2015 and early 2016 was apparently influenced by fears that some major sources of offshore capital that had been flowing into UK property over the previous few years could be drying up.[11] The changes to stamp duty rates on sales of non-residential properties that came in during March 2016 also resulted in a one-off impact on valuations and prices which dampened the market.

7 It is also relatively small compared to investment in authorised open-ended funds as a whole. According to the Investment Association's figures for June 2016, assets under management in authorised property funds represented about 2.7% of all authorised funds – £25.4 billion of a total of £949.7 billion.

8 Source: Investment Property Forum, July 2016.

9 Source: Bank of England Financial Stability Report, July 2016.

10 Source: FCA internal data.

11 Financial Times, 9 February 2016.

2.4 Shortly before the referendum, the five largest open-ended property funds that offer daily dealing made up around one third of the total daily dealing volume and two thirds of the sector's assets under management. In May, three of these funds had moved their pricing to a 'bid basis' (ie the price at which investors could sell was based on what the fund would expect to receive if all assets were sold at that point). We are told managers did this because they were expecting more fund redemptions than purchases as investors generally became increasingly cautious, even though some funds were also seeing significant inflows. In the week before the referendum, the largest funds held between 5% and 15% of their assets in cash.

Reaction to the referendum

2.5 The uncertainty caused by the vote to leave was reflected in market valuations generally, and market commentary suggested that further significant price falls in the commercial property sector were possible. Most managers of UK-domiciled, open-ended property funds then faced two challenges: how to value their property portfolios accurately and how to manage a significant increase in redemptions from 24 June onwards.

2.6 Some independent valuers attached 'uncertainty clauses' to portfolio valuations, to indicate that the valuation they had previously provided was less reliable in the changed situation. The managers of nine of the fifteen daily dealing funds applied fair value pricing (FVP) adjustments of between 4% and 15% in the days after the referendum, so that the values attached to properties in the fund were reduced to take account of the likely fall in their real market value.[12] At this time, the fifteen funds saw cumulative redemptions of 4.1% in total of their net asset value (NAV) in eight business days. Several funds experienced more significant levels of redemptions, the largest being around 8% of NAV.

2.7 Based on our standard risk-based approach, our supervisory work on the largest funds had already become more intensive prior to the referendum, and from the following week we significantly enhanced our monitoring of 26 open-ended funds. They included 19 authorised funds, as well as seven unauthorised collective investment schemes (CIS) that were selected because their investors include intermediaries and vehicles (such as funds of funds) that have substantial exposure to underlying retail clients. Fifteen of the authorised funds offered daily dealing, the rest offered monthly or quarterly dealing.

2.8 In early July we organised a round-table meeting with a group of fund managers and depositaries to consider the situation. The group discussed the idea of a general suspension of property funds, but we were concerned that this could cause a further loss of confidence in the sector and further market decline.

2.9 In the event, each firm decided what to do in the best interests of investors, while keeping us informed of their plans. During the four days from Monday 4 July to Thursday 7 July, six daily-dealing funds were suspended by their managers. These funds were collectively worth about £14.6 billion in assets under management and included some of the largest individual funds. One fund was suspended for a short period so the manager could put in place a 10% price adjustment, to reduce the fund's value by what it considered to be the discount necessary to sell properties rapidly. The brief suspension aimed to give the redeeming investors an opportunity to decide whether to proceed at a discounted price or withdraw their request. The other five firms did not indicate at that point when they were likely to resume dealing and in the event it was some time before they were able to do so.

12 Firms may use different terminology to describe a FVP adjustment, for example 'fair value adjustment' or 'market value adjustment'.

2.10 On 8 July 2016 we published a guidance note on the use of liquidity management tools in exceptional market circumstances. The guidance reminded firms of the procedures they should follow and that fund managers have a duty to act in the best interests of all investors. We did this to make clear our expectations that firms must take all unitholders' interests fully into consideration in managing funds during a period of stress, which includes being prepared to use the full range of tools available to them. We repeat the full text of the guidance in Annex 3 of this paper.

2.11 We also talked to the depositaries of the affected funds to understand the challenges they were facing. The depositary has a role in assessing any proposal by the authorised fund manager (AFM) to suspend dealing in a fund, and should not automatically give its agreement. It must be satisfied that the decision is in the best interest of all unitholders in the fund. We wanted to understand what role depositaries had played in the governance process for reaching the decision whether or not to suspend dealing or apply a FVP adjustment.

2.12 We were concerned about the impact of the fund suspensions and FVP adjustments on unit-linked life insurance funds investing in UK property, partly because many of them gain exposure to the asset class by investing in open-ended funds. We understand that where the underlying fund applied a FVP adjustment, most companies applied a similar adjustment to the unit-linked fund.

2.13 Unit-linked funds with exposure to suspended funds also applied deferral measures. At one point in August, up to 72 unit-linked funds with total assets of £3.8 billion were in deferral, of which 59 with assets of £2 billion were invested in open-ended funds that had been suspended. In some cases, this affected their ability to meet their non-contractual obligations, such as surrenders or transfers. Pay-outs of benefits on maturity or the death of the insured person were not affected.

2.14 In view of this, we extended our enhanced supervision to look at the effects of fund suspensions on the 'value chain' that exposes consumers to the performance of property funds in some way. We wanted to identify risks that could affect a wider range of firms, including financial advisers, discretionary wealth managers, platform service providers and life assurance companies, and to consider how those risks could be mitigated.

Further market developments following the referendum

2.15 Although six daily dealing funds were suspended, the other nine continued to deal throughout the period following the referendum. We focused our supervisory engagement on the daily-dealing authorised funds, by requesting daily data on their fund valuations, available cash positions, other liquid holdings and the imposition of FVP adjustments. We collated the data to give us an overview of how the group of funds as a whole was responding to the situation, and to see if others were likely to have to apply special measures. We believe that allowing the market to operate as the rules intended was justified by the fact that not all funds needed to suspend dealing. We are not aware that any fund managers applied other liquidity management tools such as deferred redemption ('gating').

2.16 We also analysed the liquidity positions and cash flows of the four authorised CIS that offer monthly or quarterly dealing and the seven unauthorised CIS mentioned before. Some of these funds applied FVP adjustments, but all of them were able to maintain enough liquidity throughout the period to meet expected redemptions. Where funds of funds and multi-asset funds had exposure to the suspended funds, we have not seen any evidence that the top-level fund's liquidity was abnormally affected as a result of not being able to deal in units of the underlying fund.[13]

2.17 Significant net outflows from the funds that had not suspended dealing began to decrease quickly from about the middle of July. From then on, net flows into and out of those funds were broadly neutral. Of the five funds suspended as of mid-July, one resumed dealing at the end of September. Three others followed by the first week of November and the remaining fund resumed dealing in mid-December. The funds that had applied FVP adjustments removed them at different times, the longest one being in place for approximately three months. Unit-linked funds were able to resume normal operation as and when the underlying property funds ceased to be suspended.

Impact on market integrity

2.18 While the EU referendum was an unusual market event, the shock was not a wide-spread credit event. As a UK-specific event, it caused a reassessment of future prices of property as well as immediate falls in equity prices, particularly of UK-focused firms. However, UK equity markets recovered relatively quickly, against the background of a sharp devaluation of Sterling and additional monetary policy stimulus.

2.19 The experience of property funds in the period following the EU referendum has provided some valuable insights into the processes that funds with illiquid assets use during periods of stress. When an asset class is suddenly re-priced, and there are potential credit implications, contagion and wider market impact usually occur via two different channels: direct and indirect. The direct channel involves credit, financing and counterparty risk; for example, the exposure of banks and mortgage lenders. The indirect channel relates to the investment and cross-holdings by other market players, ie the exposure of investment funds under discussion here.

2.20 The contagion to other asset classes following the referendum result was relatively limited and there was no immediate significant financial impact through the direct channel.

2.21 There was a small ripple effect through the indirect channel. This was a result of other institutional investors such as insurance companies with unit-linked funds, funds of funds and multi-asset funds owning cross-holdings in open-ended funds. The impact was contained because insurance companies have considerable flexibility to defer discretionary redemption requests from investors in unit-linked saving plans, and investments by funds of funds in the affected open-ended property funds are limited.

13 Such funds may however have been affected to the extent that they were not able to maintain their target asset allocation or rebalance their portfolio during the period of suspension.

2.22 It is possible that the announcement by the first fund to suspend may have led to increases in redemptions from other open-ended property funds that were still dealing normally. However, this channel of contagion is not very clear. The reasons that caused the first fund to suspend would have impacted similar funds in the same way, leading to their suspensions. It is difficult to isolate the impact of the news of a fund suspension from the impact of the EU referendum result.

2.23 Fund managers' use of existing tools, such as suspending redemptions and applying FVP adjustments, helped to avoid an escalation of market uncertainty. However, it also highlighted potential concerns about how appropriate it is for funds to invest in illiquid assets when they offer frequent redemption opportunities.

3. Liquidity management tools

3.1 In this chapter we describe how we currently regulate the management of liquidity in open-ended investment funds and life assurance contracts and what discretionary tools fund managers could use to manage their funds' liquidity profile and respond to investors' redemption requests. Readers may find it helpful to refer to Annex 2, which describes in more detail the rules for authorised funds.

What are illiquid assets?

3.2 There is no generic regulatory definition of what is meant by an 'illiquid asset'. In this paper, we use the term to cover a number of financial and non-financial assets that are unrelated but may share a number of characteristics:

- they are not traded on an organised market, so there is no market maker or centralised mechanism for price discovery[14]
- there may be a significant imbalance between supply and demand which, in a restricted market, makes it difficult for buyers to identify sellers, or vice versa
- it is likely to take time for the buyer and seller to negotiate the price and other terms of the transaction
- valuing the asset is a complex process, using both transactional information and modelling, which may require specialist advice from a third-party source
- physical assets are typically bought and sold in their entirety, ie a buyer may be unable to take a partial stake in the asset unless willing to act jointly with other prospective buyers
- because of these factors, and other possible complications such as restrictions on the free transfer of title, transactions often take a long time from start to finish.

3.3 Asset classes that can normally be traded freely may start to become illiquid at certain points in the economic cycle. Some of the ideas discussed later in this paper may also be relevant to funds that hold such assets, but we are mainly concerned with assets that are inherently illiquid. However, we welcome the views of stakeholders on this point.

14 Price discovery is the process of determining the proper market price of an asset at any given time by studying supply and demand for it.

3.4 Examples of financial assets that are considered inherently illiquid include:

Private shares

3.5 These are shares in private companies, ie companies that have a restricted number of shareholders and do not allow their shares to be traded. They may allow other companies and professional investors to acquire shares, typically as minority shareholders, with a view to the shares eventually being publicly traded. The shares may be non-transferable, meaning that the holder cannot dispose of them to another person without the consent of the company's directors. Instead of investing directly in these assets, a fund might hold an interest in a private equity fund that itself invests in a number of such companies.

Unlisted securities

3.6 These are securities (either equities or debt instruments) issued by a company that has not applied for them to be officially listed or admitted to trading on a regulated market. Unlisted securities may be made available through a public offer (subject to the provisions of the Prospectus Directive).

Special purpose vehicles

3.7 A special purpose vehicle (SPV) is a body corporate set up to securitise assets (taking financial assets, such as a portfolio of mortgages, and using their cash flows to back a security that can be traded by other people).[15] Their shares are generally not intended to be liquid assets.

3.8 There may be other types of financial assets that are generally illiquid, such as certain structured products or securitisations.

3.9 Examples of non-financial assets include:

Property

3.10 Property includes both land and any building for residential or commercial use that stands on it. It may also be referred to as real estate or immovables. It covers both a freehold interest in the property and any interest under the freehold, eg leasehold or tenancy. Property may be held as an investment to generate regular steady income, or with the aim of achieving income and/or capital growth.

Infrastructure assets

3.11 Infrastructure covers any structure or system that supports the economy and organisation of a society. It includes:

- energy generation (power stations)
- utilities (electricity, gas and water transmission)
- communications (broadband installation)
- transport (roads, bridges, railways, ports, airports)
- environmental assets (flood defences, waste facilities, sewerage) and
- social infrastructure (housing, healthcare, urban regeneration).[16]

15 See Glossary definition and chapter 8 of CP16/17 (Quarterly Consultation No. 13), July 2016.
16 The ELTIF Regulation also allows an ELTIF to invest in intellectual property rights and patents.

3.12 Projects of this kind are planned, developed and funded at first by central government, but may involve partnerships with private capital where investors are willing to make a long-term commitment with the aim of achieving income or capital growth.

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

Regulation of open-ended funds

3.13 There is a relatively complex framework of regulation for open-ended investment funds and their managers. We authorise and regulate all UK-based fund managers, and we also have the power under FSMA to authorise and regulate certain UK-based collective investment schemes (CIS), referred to as authorised funds. One of the main aims of the authorised funds regime is to protect investors in open-ended funds with rules to ensure they can use their redemption rights.

3.14 Some authorised fund managers and funds operate under rules implementing the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive. Funds authorised under the UCITS Directive can be promoted to the general public. They can make limited investments in illiquid transferable securities but cannot invest directly in non-financial assets like property or infrastructure.[17]

3.15 CIS not authorised under the UCITS Directive are considered 'alternative investment funds' (AIFs) and their managers may be regulated under the Alternative Investment Fund Managers Directive (AIFMD).[18] As AIFMD does not regulate the funds themselves, there are no general restrictions in EU law on the types of asset that AIFs can hold.[19]

3.16 In the UK, the FCA has the power to make rules about what assets an authorised AIF can invest in. We do this in the Collective Investment Schemes sourcebook (COLL) which categorises this group of funds as either non-UCITS retail schemes (NURS) or qualified investor schemes (QIS). COLL rules allow each category of fund to hold certain types of illiquid assets, as set out in the following table.

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

18 There are some exceptions, owing to exclusions in the Directive and differences between the definitions of 'alternative investment fund' and 'collective investment scheme'. Not all AIFs are CIS.

19 This statement does not apply where the AIF is subject to a specific EU regime such as the ELTIF Regulation, or the forthcoming regulation for money-market funds.

Summary of key rules for NURS and QIS

Rule type	Application to NURS	Application to QIS
Illiquid asset types that can be held	Unlisted transferable securities[21] Land and buildings (COLL 5.6.4R & 5.6.5R)	Any specified investments under the Regulated Activities Order[22] Interests in land and buildings (COLL 8.4.4R)
Ability to hold unlisted securities	Up to 20% of assets may be eligible transferable securities not admitted to or dealt in on an eligible market (COLL 5.6.5R (2))	No restriction
Conditions for holding land and buildings	Must have a good marketable title, either freehold or leasehold or equivalent Must be bought at not more than 105% of the valuation carried out by an appropriate independent valuer Must be revalued by the valuer based on annual physical inspection and monthly reviews (COLL 5.6.18R & 5.6.20R (3))	Must have a good marketable title Must be bought at not more than 105% of the valuation carried out by an appropriate independent valuer Must be revalued by the valuer based on annual physical inspection and monthly reviews (COLL 8.4.11R & 8.4.13R (2))
Risk-spreading for property holdings	Must be an overall prudent spread of risk (COLL 5.6.3R) Each asset must not be worth more than 15% of total assets at its purchase, rising to 25% once in the fund Not more than 20% in value of all assets to be mortgaged, no mortgage to exceed 100% of the purchase valuation No more than 50% in value of total assets to be non-income producing or under development No call option to be granted on a property worth more than 20% of total assets (COLL 5.6.19R)	Must provide a spread of risk taking into account the investment objectives and policy (COLL 8.4.2R) No mortgage to exceed 100% of the purchase valuation No call option to be granted on a property that might unduly prejudice the ability to provide fund redemptions (COLL 8.4.12R (2))
Cash holdings	Only where necessary to enable pursuit of investment aims, redemptions, efficient management (COLL 5.5.3R)	No restrictions
Borrowing	Not to exceed 10% of total assets on any day, to be temporary (depositary to approve if in excess of 3 months), only certain specified banks and institutions can lend (COLL 5.5.5R)	Not to exceed 100% of net value on any day (COLL 8.4.10R)
Redemption frequency	At least once every two weeks (COLL 6.3.4R (1)) unless limited redemption applies in which case at least once every six months (COLL 6.2.19R)	As specified in the fund prospectus, taking account of the reasonable expectations of investors (COLL 8.3.4R (13) & 8.5.12G)

3.17 NURS can be promoted to the general public in the UK. QIS, together with all unregulated collective investment schemes, fall under our rules on non-mainstream pooled investments. This means they can be sold only to professional and institutional investors and certain limited categories of retail investors, for example those classified as 'high net worth'.[22]

20 These must meet the general criteria for eligibility under COLL 5.6.5AR and 5.2.7AR, including being negotiable, capable of reliable valuation, and sufficiently liquid to not compromise the AFM's obligation to provide redemption on request.

21 Except rights under a funeral plan contract or regulated mortgage contract or interests relating to such contracts.

22 See COBS 4.12, in particular the table at COBS 4.12.4R (5): www.handbook.fca.org.uk/handbook/COBS/4/12.html

Regulation of unit-linked life assurance

3.18 Insurers offering unit-linked life assurance contracts not only hold assets directly but are also allowed to invest in CIS, including those that themselves invest in illiquid assets. Unit-linked contracts make extensive use of CIS as underlying investments, to get economic exposure to certain asset classes and markets. Unit-linked contracts are economically similar to CIS because the policyholder or beneficiary usually bears all of the market and expense risks and the value fluctuates in line with the underlying assets.

3.19 However, these contracts are unit-linked long-term life assurance business, which is subject to the requirements of the Solvency II Directive on insurance companies. Rules set out in the FCA Handbook and the PRA's Rulebook transpose these requirements into UK law.[23] The FCA also regulates the type of assets a unit-linked contract can use, by specifying the assets and indices to which a contract can be directly linked. The relationship between the policyholder (investor) and the firm is quite different in legal terms to participating in a CIS. Policyholders receive payments under the policy but they do not beneficially own any of the assets that generate the payments.

Use of liquidity management tools

3.20 There are a number of different regulatory approaches that can be described as liquidity management tools. These tools can be loosely grouped into those that can be applied as pre-emptive measures, ie to prevent liquidity problems, and those that can be applied 'post-event', ie to manage a problem when it happens.

3.21 Some of the pre-emptive measures primarily serve other purposes but also have a general effect on fund liquidity. For example, investment limits in a portfolio ensure that risk is diversified within the chosen sector or market, but also provide a framework for managing liquidity. Post-event measures, such as deferring redemption requests, are usually used very specifically to manage fund liquidity.

3.22 The rules that apply to the tools described in this chapter also interact with other parts of the FCA's and the PRA's rules, particularly for unit-linked long-term life assurance business. Other legislative and commercial factors outside our remit also drive the structure of investment funds and the way they manage their liquidity. We discuss the role of platform providers and Government requirements relating to Individual Savings Accounts (ISAs) later in this paper.

Duty to manage liquidity risk

3.23 Liquidity management is an essential part of operating a collective investment successfully and so is of particular concern to regulators. AIFMD prescribes detailed rules for liquidity management, although the assets of an AIF do not have to be inherently liquid. The UCITS Directive is less prescriptive about how the fund manager should carry out liquidity management, as the assets should (with limited exceptions) be liquid in order to be eligible for investment.

23 See the permitted links rules at COBS 21: www.handbook.fca.org.uk/handbook/COBS/21/?view=chapter and the PRA rules for SII firms' investments www.prarulebook.co.uk/rulebook/Content/Part/212926/04-01-2017

3.24 In 2013, IOSCO published a report on 'Principles of liquidity management in collective investment schemes' which noted that 'liquidity risk management in collective investment schemes (CIS) is a complex area: poor liquidity can arise from many different sources, some of which are outside the control of the entity operating the CIS'.[24] The 2013 report is currently being updated and we expect that IOSCO will publish a consultation paper on proposed changes later this year.

3.25 We have previously published feedback on the good practice we have seen in our supervisory work on the liquidity management of fixed-income funds.[25] Much of this is equally relevant to the funds we are discussing in this paper, especially the processes and tools that firms use to monitor and analyse their funds.

Portfolio structure and liquidity buffer

3.26 A well-diversified portfolio enables the fund manager to manage disposals efficiently, without harming investors by materially compromising the overall quality of the portfolio. A manager can also limit the absolute size of individual portfolio holdings so that they do not become too large to sell easily – especially where the fund holds physical assets that cannot conveniently be sold off in tranches.

3.27 Allied with portfolio diversification is the amount of cash the manager holds in the portfolio.[26] This cash holding gives the fund manager immediate liquidity to meet expected demands, while acting as a buffer against an unexpected increase in outflows. However, investors' money is intended to be used to meet the fund's stated investment objective and policy, for example to invest in property, or hold working capital to maintain the properties. Any cash that is not fulfilling this purpose may dilute the investment strategy, so managers have to use their judgement when considering how much cash to retain.[27]

3.28 In practice, the amount held may vary considerably. On the one hand, the fund manager can maximise potential market returns by maintaining a low level of cash, but then runs the risk of being unprepared for a sudden adverse change in market conditions or an increase in redemption demands. This could create the risk of a 'first-mover advantage', as explained before.

3.29 On the other hand, a high level of cash is likely to reduce liquidity risk but result in more moderate investment performance (both upwards and downwards), compared to a more fully-invested fund. Past a particular point, investors might see the fund manager as failing to follow the investment aim by not managing the portfolio at the expected level of market risk. Holding more liquid assets does not resolve the fundamental issue of fairness in relation to valuations or deal with the 'first mover advantage' problem. It creates the risk of promising liquidity to early leavers, which could even prompt bank-style 'runs' by investors concerned about being trapped in a completely illiquid fund.

24 FR03/13, www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf See also FR28/2015, "Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 survey to members www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf

25 February 2016, www.fca.org.uk/publications/documents/liquidity-management-investment-firms-good-practice

26 Cash includes 'near cash' which is certain kinds of immediately-repayable deposits and government or public securities.

27 This is an aspect of the wider discussion around the performance and pricing of different investment strategies – see the Asset Management Market Study interim report, in particular chapter 6: www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

3.30 The manager may be holding relatively liquid assets such as listed shares, whose investment returns are correlated with the more illiquid portfolio assets. For example, a property fund may hold shares of real estate investment trusts (REITs) as well as direct property. In this example, a sector-wide fall in property values could reduce the value of the liquid assets at the very time the manager needs to sell them to increase the liquidity buffer. Some sophisticated investors might try to take advantage of arbitrage opportunities in a stressed situation, by selling units of open-ended property funds at their NAV to buy shares of REITs trading at a discount to their NAV.

Redemption charges

3.31 We have seen examples of redemption charges that operate on a sliding scale with a higher charge applying in the first year after investment, then a diminishing series of charges. Finally, no charge is applied after the investor has held units for a certain period (typically five years or more). This structure aims to encourage medium to long-term investment. However, a fund manager is not allowed to introduce any charges without notice, for example in response to unforeseen circumstances, if it has not already disclosed them to investors.

Understanding investors' behaviour

3.32 The behaviour of investors in a stressed situation may vary significantly depending on how the investment serves their needs. Investors in a unit-linked pension fund aiming to provide retirement benefits are usually long-term in nature, whereas some investors may be interested only in a short to medium-term exposure. For example, they may hold a particular sector while it is performing well but decide to move on as soon as problems appear in the market.

3.33 Fund managers may contribute to the liquidity management of a fund by implementing policies that help them understand and anticipate investor behaviour. For example they may include strategies to influence behaviours by ensuring the investor base is diversified, or by restricting the maximum proportion of the fund that can be held by a single investor or group of linked investors. These approaches may help to minimise the risk that redemption requests from only a small number of substantial investors leave the fund manager unable to carry out any redemptions.

3.34 Another possible strategy is to stress-test liquidity by analysing the profiles of investors to try to predict their likely behaviour as a group in certain situations. For example, the fund manager may analyse what proportion of money is typically redeemed in a given period and whether this fluctuates in line with periods of unusually strong or weak investment performance. Some managers engage in active discussions with some of their key institutional investors to inform themselves of clients' intentions. This may extend to the manager and investor jointly planning how to manage large redemptions efficiently, for example by breaking them down into a series of smaller deals. However, managers may find it difficult to gather such information about retail investors who use an intermediary, such as a platform or discretionary investment manager. This is because the intermediary uses nominee accounts, so details of the individual underlying investors are not available to the fund manager. The intermediary may see the details of its investor base as proprietary information and claim the right to charge for sharing it. We would like to hear from both fund managers and intermediaries about the practical issues they see in this area.

Redemption profile and dealing arrangements

3.35 AIFMD addresses the issue of when a fund should be considered open-ended or closed-ended, but it does not specify a minimum frequency for dealing in units of an open-ended fund.[28] The manager has discretion over this except where our rules for NURS apply, as explained earlier in this chapter. A considerable number of managers have elected to offer daily dealing in their property funds.

3.36 The decision about dealing frequency may depend on factors beyond the fund itself, such as the channels the manager uses to distribute it and the investor profile. Investors' ability to access the fund through a platform service provider may be an important consideration for the manager's distribution policy. Some of these providers make it a condition that the funds they distribute should offer daily dealing. Although distribution is obviously important, fund managers should also consider the effect on funds with different liquidity profiles if they are all sold through a platform with a daily-dealing condition.

3.37 Our rules for authorised funds do not allow an AFM to hold a request to sell units for longer than the interval between one fund valuation point and the next, except when deferred redemption or limited redemption are used.[29] This rule actions the principle that investors should generally be allowed to sell their units on demand, as often as the fund manager recalculates the unit price. It prevents a daily-dealing fund from queuing redemption requests over a longer period (for example, a week) while continuing to execute deals daily in the order they are received.

3.38 There is a link between a fund's dealing frequency and the use of notice periods. Some managers apply a cut-off point at a stated time before each valuation point for receiving and accepting dealing requests, so they can process the orders and calculate their aggregate impact on the fund. For daily-dealing funds this may be a matter of hours, whereas for funds operating limited redemption arrangements a longer period is allowed.

28 Commission Delegated Regulation EU 694/2014 of 17 December 2013 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0694&from=EN.

29 COLL 6.2.16R (6).

3.39 These notice periods can be used to manage liquidity in funds. Our guidance suggests that notice periods may reflect the expected length of time needed to dispose of underlying assets, provided it is not more than 185 days for a NURS.[30] Some funds apply different approaches at unit class level. For example, they may require investors in the institutional class to give 90 days' notice but allow investor instructions for the retail class to be received, accepted and executed on the same dealing day.

Asset valuation and anti-dilution measures

3.40 In some circumstances, a fund manager may think that asset valuations have become unreliable, especially if certain assets are normally valued infrequently. For example, there may have been a material change in the market for these assets, or a long interval since the last transaction in a comparable asset. If so, it may be appropriate for the manager to apply a fair value pricing adjustment, such as a discount to reflect the current uncertainty.

3.41 Fair value pricing (FVP) aims to determine what the asset might be sold for under normal market conditions. A FVP adjustment is a way to achieve an accurate price, not a liquidity management tool, although investors that wish to redeem might think it is being used to discourage them from selling. However, the manager's decision would still be justified if it would be in the best interests of investors as a whole.

3.42 To be able to continue meeting redemption requests in a stressed situation, the fund manager may decide the price of units needs a further adjustment to reflect what the fund's assets would be likely to realise if sold at that point. This goes further than fair value pricing by introducing the element of an anti-dilution measure.

Dilution
Dilution is the term used for a situation where redeeming investors deal at a unit price that does not cover the full costs associated with their disinvestment. This means they receive slightly more money for their units than they should.

The manager can use various methods to counteract dilution, as described in Annex 2. The manager can assess whether the fund is experiencing net inflows or outflows in a regular dealing situation and set the price accordingly to cover the associated dealing costs, by using a dilution adjustment. This ensures that all deals bear a proportionate share of the costs, but it is less transparent to individual investors than a dilution levy. The advantage of a dilution levy is that it can be applied in specific cases where the transaction in units has actually caused a cost. However, we believe managers have sometimes been reluctant to use it because unitholders may see it as an exit charge, even though the benefit goes to the fund and not the manager.

Although the main purpose of these tools is to ensure the fair allocation of costs between unitholders, they are often categorised as liquidity management tools because they affect the price at which investors deal.

30 COLL 6.2.17G and 8.5.12G.

3.43 In this way the manager can offer investors the choice of selling their investment for significantly less than they were expecting, or maintaining their holding in the hope its value eventually recovers. If investors thinking of redeeming are aware the manager is applying this adjustment, it might cause some or even the majority of them to reconsider whether to go ahead at that time. In that case, the manager might avoid having either to conduct a 'fire sale' of assets or to suspend dealing. However, the manager must make a fine judgement about whether it is in the best interests of investors to allow dealing to continue under these conditions – especially where there is uncertainty about the accuracy of valuations – or to suspend dealing altogether.

3.44 The AFM of an authorised fund, when dealing as principal, can smooth flows into and out of the fund without generating transaction costs that have to be borne by the fund and its investors.[31] This may work to the advantage of investors who are undertaking opposite transactions to the majority, such as choosing to invest at a time when there are significant outflows. Provided the prices used are fair to all investors, including subscribing investors, it may be a particularly useful facility where the fund invests substantially in illiquid assets.[32]

3.45 For the AFM to be able to use any of these anti-dilution mechanisms, the fund prospectus must authorise it so that adequate information is disclosed to investors. However, there is a risk that if they are used only occasionally in practice, investors might be surprised or might not understand the reason for using them. This could cause challenges for an AFM, for example in explaining why the price of a fund has moved significantly from one dealing day to the next even though there is no obvious explanation looking at the performance of the underlying market(s).

Deferred and limited redemptions

3.46 A number of property funds make provision for deferred redemption in their documents but this is by no means standard. The majority of funds with the power to use it state their threshold for redemption requests as 10% of the fund's NAV, but a few funds set a lower figure.

3.47 Some AFMs state in the prospectus what approach they would take to operating the tool (deferring a portion of all dealing requests pro rata is the most usual) but others say nothing about this. The manager could decide, for example, to operate a strict queuing system across all classes, or to prioritise some deals over others. The Investment Association has developed a possible model for firms to apply deferred redemption in an operationally efficient way, which would also give investors more clarity about the possible use of this tool. Fund managers can use other models that are practical and can be clearly explained to investors.

31 Dealing as principal and holding units in that capacity is referred to as operating a manager's box.

32 The asset management market study interim report notes that some managers of dual-priced funds make risk-free profits through box transactions, where inflows and outflows at the same valuation point are matched, so that the manager retains the difference between the prices. This may mean that costs are not being controlled in the interests of investors. See page 139 of the report: www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

Redemption 'in specie'

3.48 Payment 'in specie' allows the manager to fulfil a redemption request without having to sell underlying assets, which could benefit the fund if there is a limited market for the asset or market conditions are driving the price down. It is generally applied only to transactions with institutional investors. It is unlikely that any single retail investor would deal in sufficient size to justify the manager in using this tool, or that it would be fair and reasonable to expect a retail investor either to receive such assets directly instead of cash or to arrange for their sale.

3.49 However, for funds investing in illiquid assets, the use of redemption 'in specie' is rare.[33] Although most property funds include a standard provision for its use in their prospectus, some say either that they do not expect to use it, or that it would be impractical to use it where the fund holds direct property, rather than financial instruments. Its use might also be impractical for funds that hold unlisted securities, since conditions might apply to the transfer of the securities.

Suspension of dealing

3.50 The most significant tool, in terms of its impact on investors and other stakeholders, is to suspend dealing in a fund. IOSCO has recognised the significance to investors of suspension by developing a set of principles for fund managers.[34]

3.51 Our rules for authorised funds in COLL 7.2 and 8.6 require the AFM to exercise a significant degree of judgement, especially concerning what constitutes exceptional circumstances and the best interests of all unitholders. We provide guidance that an AFM should not consider suspension to be in the best interests of unitholders unless any alternative courses of action have been discounted. The AFM might encounter some circumstances that, on their own, would not necessarily be considered exceptional enough to justify suspending the fund. These include, for example, difficulties in realising scheme assets or temporary shortfalls in liquidity.[35]

3.52 Fund managers have some flexibility in the way they manage the suspension and bring it to an end. The AFM can choose to accept dealing instructions during the suspension on the basis that they will be executed at the first valuation point after dealing starts again. Alternatively, it can reject all instructions.[36] We are told that this can cause difficulties in the interactions between AFMs and platform providers, or other unitholders acting as nominees for underlying investors, if those involved want to proceed in different ways.

3.53 Our Handbook does not have specific rules or guidance on what steps the AFM should take to ensure the restart of dealings takes place smoothly, or to inform other market participants that it is restarting. However, we may work with managers in this situation through our supervisory contacts, as we did with the property funds that suspended dealing in July 2016.

33 For exchange-traded funds, it is common for unit creations and cancellations to be settled in specie, but these transactions do not generally affect investors buying and selling units for cash on a secondary market.

34 FR02/12, Principles on Suspensions of Redemptions in Collective Investment Schemes, January 2012 www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf

35 In the past, a 'force majeure' event such as a temporary closure of the markets on which portfolio securities are dealt has meant that assets cannot be valued at accurate market prices, leading to short-term suspensions in multiple funds.

36 The AFM's policy in this respect may depend on whether or not it is permitted to hold client money.

Liquidity management and distribution

3.54 Distributors of investment funds, particularly platform providers and other types of intermediate unitholders[37], can play a significant role in how fund managers approach liquidity management. We give more information on their role in the value chain in Annex 4. We have noted that a number of platforms make daily dealing a condition for funds available through them – a factor which may influence the fund manager's product design process. These conditions may be based on the platform's IT systems capability, regulatory requirements such as it being unable to hold client money pending investment, or simply a commercial decision to distribute only funds that deal daily.

3.55 Distributors may also influence managers' use of tools for managing large redemptions. When deferred redemption or suspension are used, the differences in platforms' operating models may mean that they have conflicting preferences for the fund manager to hold or reject dealing instructions. This can create operational challenges for managers that may be difficult to resolve. There is also evidence that some platforms were operationally unprepared to respond promptly when property fund managers applied exceptional measures in July 2016. This calls into doubt whether firms acted in a timely way to protect the interests of investors. Our supervisory work looking at the actions of certain firms will consider this point.

3.56 Platforms and other intermediate unitholders may object to accepting redemption payments 'in specie', even when selling a large percentage of the fund. This is because they have to pay cash to the various underlying clients whose orders were aggregated to create a single large deal. Their objections make it more difficult for the manager to try to identify the best course of action for all unitholders.

3.57 In addition to these considerations, retail investors often choose to hold their funds in an ISA. Government rules for ISAs require funds to allow redemptions at least once every two weeks in order to be qualifying investments for a stocks and shares ISA.[38] This ensures that ISA investors can exercise their right to withdraw their money or transfer it from one provider to another within 30 days of giving instructions to the ISA manager. In practice, investors and their advisers appear to expect funds that are eligible for ISA investment to offer daily dealing.

3.58 Many open-ended funds also receive significant inflows from institutional investors who are managing money on behalf of others, such as life assurance providers, pension trustees and wealth managers. These institutions may select funds offering frequent redemption because of contractual terms with their own underlying clients that require them to provide liquidity on a frequent – even daily – basis.

3.59 We understand that fund managers often classify platforms and some other types of intermediate unitholders as retail clients. In the next chapter, we discuss some possible approaches for the different treatment of retail and institutional investors. If these approaches were followed, we would be interested to hear from stakeholders whether classifying these unitholders in this way creates conflicts or other issues or whether this is an appropriate measure, given the profile of the underlying clients.

37 See the FCA Handbook Glossary for the full definition of an intermediate unitholder www.handbook.fca.org.uk/handbook/glossary/?starts-with=I

38 See the definition of 'qualifying units in or shares of a non-UCITS retail scheme' in section 2(1)(b) of the Individual Savings Account Regulations 1998 (SI 1998/1870) as amended.

Liquidity management for unit-linked life assurance contracts

3.60 The assets insurers use to back unit-linked contracts must be capable of being valued fairly and accurately on an ongoing basis. The value of the assets must match, as closely as possible, the value of the benefits that the unit-linked contract promises to pay; ie the value of the assets minus charges and expenses, similar to the NAV of a CIS. The insurer must be able to realise the assets in time to meet the policy benefits. This means that they must be capable of being sold in time to meet payments as they fall due. As a result, the NAV for the units underlying a unit-linked contract is usually priced daily, although the valuation points used for property may be less frequent.[39]

3.61 If an asset that is used to back a unit-linked contract fails to meet any of these tests then it ceases being eligible to be used. Where this happens to an asset that represents only a small percentage of the total assets being used to back a unit-linked contract, the effect is usually marginal – the insurer assigns the asset a value of 'zero' for the period it is not eligible and adjusts the value of the benefits the contract will pay to reflect that.

3.62 However, an asset may represent a large percentage, or almost all of the value, of the assets underlying a unit-linked contract. This may be the case for unit-linked contracts investing in property, which often use just one property CIS as their underlying investment. In these cases, if the underlying CIS is suspended it effectively means that the entire unit-linked contract is unable to dispose of its assets to meet payments.

3.63 When such a fund is suspended, unit-linked contracts can in turn suspend discretionary payments such as surrenders from life and transfers from pension contracts. The ability to do this depends on the wording on the insurance contract itself and it typically allows for up to a six-month suspension where the contract is offered to retail policyholders. Insurers must continue to meet all contractual payments – maturities, pensions coming into payment and pay-outs on death – regardless of whether the underlying assets are available in time to meet the payments.[40] In these circumstances, the insurer must meet the payments from its own resources and may need to find the money from other capital sources.

Conclusion

3.64 All fund managers are required to have policies and procedures to manage liquidity risk, although the detail of the requirements varies and the degree of resource that different firms apply to this matter may in consequence vary too. Managers also have discretion in deciding which liquidity management tools they might want to use and if and when to use them. This degree of flexibility enables firms to take a proportionate approach to managing risk. However, if firms fail to make the right choices for the open-ended funds they manage, then it may also lead to inconsistency or to weak protection of investors' interests.

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

39 Rules for stakeholder pensions require daily valuation of funds, which is normally done by an actuarial estimate.

40 Government rules allow some time for certain payments to be made (e.g. up to two years for death benefits) which should help life assurance companies to manage short to medium-term fund liquidity.

4.
Possible approaches to improving liquidity management

4.1 In this chapter we consider some ways in which we could potentially develop our rules and guidance. We discuss and ask for views about:

- the treatment of professional investors
- portfolio structure
- valuation of assets
- the use of specific tools
- direct intervention by the regulator
- enhanced disclosure
- secondary market provision.

4.2 Our current supervisory work is looking how managers structure and operate their funds to manage liquidity effectively when the fund's assets are inherently illiquid. This includes the tools used and whether fund managers have used and disclosed them consistently and effectively.

4.3 However, some tools may be inadequate for all circumstances, or managers may be uncertain about how and when to use them. There may also be issues beyond the fund manager's direct control that we need to address.

4.4 It has been suggested that we could adapt or extend our rules to improve the liquidity management of open-ended funds. We want to gather evidence about the possible benefits and costs of regulatory change in this area before deciding if changes are needed.

4.5 In scoping these questions, we would not suggest interventions aiming to restructure the existing regime. So, for example, we do not intend to ban open-ended funds holding illiquid assets or prevent retail investors from acquiring units in open-ended property funds. We do not believe such changes would advance our financial stability or consumer protection objectives, because of the predictable costs and negative impact they would be likely to cause. Such fundamental changes to the market framework could trigger fund redemptions, portfolio restructuring, or even fund closures, which at worst might cause some of the risks we were concerned about to happen in reality.

4.6 Instead, we are open to ideas on how the tools available to fund managers might help them to better manage the liquidity of funds that offer regular dealing but hold illiquid assets. The following approaches are examples that we might investigate and develop, either singly or in combination, though the list is not exhaustive and we welcome alternative suggestions. In each case we are concerned primarily with funds that invest wholly or substantially in illiquid assets.

4.7 In addition, the Financial Stability Board (FSB) recently published a number of recommendations that aim to address structural vulnerabilities from asset management activities at an international level.[41] Several of these recommendations address liquidity mismatches between a fund's assets and its terms for redemption. The FSB has asked IOSCO to undertake further work to put some of the proposals into practice. The FCA will be working with IOSCO to achieve this. We therefore welcome any views on how the approaches outlined below may enhance consumer protection and/or improve financial stability.

Treatment of professional investors

4.8 The majority of authorised funds investing in property are set up as non-UCITS retail schemes capable of being promoted to the general public, though in practice professional and institutional investors may hold a significant or even predominant proportion of the fund. Some commentators suggest that this is unsatisfactory for retail investors, because their interests may be different to those of professional investors. As a result they may be disadvantaged, for example through not having as much information as institutional investors in the same fund.

4.9 To protect the interests of retail investors better, one approach would be to have rules that prevent the investment of both retail and professional investors' monies in the same fund. However, this would require significant restructuring of existing funds which might realise the negative results we want to avoid. It might also deter firms from establishing new retail funds investing in illiquid assets, in case it proved too difficult to raise enough capital from investors to make the fund commercially viable within a reasonable time.

4.10 There are, however, less intrusive measures that might help the fund manager to balance the interests of retail and professional investors in the same fund. Many funds already have separate unit classes for the two groups, with different terms and conditions applying to them (eg minimum initial and subsequent investment amounts, charging structures and tariffs). As noted above, a few funds apply different dealing frequencies and notice periods to these classes, on the basis that retail investors mostly deal in low-value amounts that the fund's liquidity buffer can easily cover. The typically larger size of professional investor deals may have a more significant impact on liquidity, so they may need to be managed over a longer timescale.

4.11 A possible approach would be for managers to apply differential treatment at class level, to achieve a fair balance of the interests of investors in the fund as a whole. This would not necessarily require new rules for how classes may be set up, but we could issue guidance to clarify our expectations, or challenge managers through our supervisory and fund authorisation processes if they do not put appropriate class structures in place. However, this would require careful consideration of the possible unintended consequences of forcing retail and professional investors to hold different classes and of allowing retail investors to have a possible first-mover advantage over professional investors.

41 www.fsb.org/2017/01/fsb-publishes-policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/ .

4.12 Another possible approach could be to require the manager of a fund holding illiquid assets to manage the diversity of its investor base more actively, to prevent any one investor or group of connected investors from acquiring more than a specified proportion of the fund. Many authorised property funds already operate under the property authorised investment fund (PAIF) regime which, for taxation reasons, requires the AFM to prevent certain investors holding more than 10% of the fund.[42] Our rules or guidance might build on the PAIF rules by suggesting a specific diversification threshold for all illiquid asset funds, or we might focus on the processes the AFM puts in place to monitor and control this issue.

4.13 Our rules already give AFMs power to gather information about underlying investors from firms that are intermediate unitholders in an authorised fund, so it is not clear that extra rules would be needed for that purpose.[43] However, we could adapt our supervisory approach to challenge AFMs that do not make sufficient use of the current rules, or regulated intermediaries that do not co-operate fully with an AFM's reasonable requests for information about underlying investors.

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

Portfolio structure and liquidity buffer

4.14 As noted above, rules on portfolio diversification and holding uncommitted cash help to reduce the risk that a fund will experience liquidity problems in a stressed situation, including the risk that some investors will have a first mover advantage. We could consider strengthening or adding to these rules to reduce the risk further.

4.15 For example, rules could set a cap on the proportion of the portfolio that could be held directly in illiquid assets[44], or a minimum amount to be held in cash, near cash, or securities whose performance is not closely correlated with that of the illiquid assets. We could give guidance on how to carry out the sale of portfolio assets in a way that reduces the risk of first mover advantage for the fund's investors. However, it is important to ensure that enhancing liquidity within the fund portfolio does not have the unintended consequence of increasing unfairness by creating a preference in favour of exiting investors, that could even prompt a run on the fund.

4.16 Another approach would be to have rules or guidance on the use of liquidity 'buckets' so that fund portfolios are subject to hard or soft limits on the proportion of assets that could be realised for cash within a specific timeframe. The USA is introducing rules of this type for funds that are intended to be highly liquid.[45] It is not clear, though, that such rules are necessary or indeed practical where the fund predominantly holds illiquid assets.

42 The restriction applies where the investor is a body corporate: see COLL 4.2.5R (22A). We know that some fund managers monitor the size of investors' holdings to ensure they comply with marketing rules in certain jurisdictions.

43 COBS 14.4.10R.

44 A rule that formerly applied to authorised funds investing in property required the manager to invest no more than 80% in value of its portfolio directly in immovable assets.

45 See the US Securities and Exchange Commission announcement of 13 October 2016: www.sec.gov/news/pressrelease/2016-215.html

4.17 We could also consider whether the rules that allow one fund to invest in units or shares of another fund should have specific conditions for when the underlying fund invests mainly in illiquid assets. This is relevant to both CIS and unit-linked insurance funds holding, for example, property funds to gain exposure to that asset class, rather than investing in property directly.

4.18 Other requirements could relate to the eligibility of the assets to be held, to increase the probability that a willing buyer could be found without having to mark the asset significantly down.

4.19 Requiring funds to hold a more diversified range of assets might also help their liquidity management. There is, however, a risk that stricter rules could make it difficult for relatively small funds, especially those recently launched, to acquire a range of suitable assets. We would be interested in stakeholders' views as to whether smaller and larger funds could and should be treated differently under the rules for portfolio structure and how this might be done.

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

Asset valuation and anti-dilution measures

4.20 Our current rules and guidance say relatively little about the use of fair value pricing for non-financial assets.[46] Nor, in this regard, do we give guidance on what governance process the fund manager should employ (for example in relation to a valuation committee) or what the role of the independent valuer might be in this process. Although this paper does not address valuation as a wider topic, the interactions between approaches to valuation of illiquid assets in a stressed situation and liquidity management are potentially complex. It might support the wider objectives of this work if we provided greater clarity about a fund manager's valuation obligations for these types of assets.

4.21 There is also little guidance for fund managers about the use of anti-dilution mechanisms to apply a discount to the redemption price of units or shares. Applying this kind of discount can assist the manager in avoiding a preference between the interests of investors. However, there may be a fine line between acting in the well-founded belief that it reflects the true value of the portfolio assets and using it to discourage requests or to 'punish' investors who insist on selling their holding.

4.22 Even if the discount is considered fair when it is introduced, by allowing investors that want to exit the fund to do so, it could have negative effects if the fund is subsequently suspended. Investors who have been able to sell, even at a discount, could then be considered to have had a 'first-mover' advantage compared to those who must wait for the suspension to end. In such cases it might have been in the best interests of investors to suspend dealing at once rather than delaying the inevitable.

4.23 We would welcome feedback from stakeholders, especially from investors and advisers, on their attitudes to anti-dilution measures as an alternative to suspension of dealing and on whether these measures result in fair treatment of customers. We would like to know if stakeholders think it would be helpful to have rules or guidance to clarify how anti-dilution measures may be used in this situation, if at all.

46 There is guidance on this subject in COLL 6.3.6G, in particular section 1 paragraph 7A.

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

Use of specific tools

4.24 In the previous chapter, we noted that fund managers have considerable discretion about whether to use any of the various tools specific to liquidity management. Some managers make provision in scheme documents to use certain powers such as deferred redemption while others do not. There is currently no presumption that it is poor practice not to have the power to use a tool, or that having such a power means the fund manager should regularly use it, but there does seem to be a gap between what the rules envisage and what is done in practice. This may be due to other factors, such as the limited ability of other parties in the value chain to deal with certain mechanisms.

4.25 We could take steps to make it more likely that these tools will be used in practice. These could range from additional guidance on when and how such tools might be used, to requiring managers to make provision in scheme documents for their potential use, or requiring other regulated persons to change their procedures and processes to meet the fund manager's needs.

4.26 An area we could look at specifically is redemption frequency and the use of notice periods. It would be possible to have rules to prevent authorised funds invested in illiquid assets from offering very frequent sale and redemption, which might make it simpler for the fund manager to align its liquidity management process with dealing orders.

4.27 However, we have some doubts that this would be a good idea in practice. It could simply result in an accumulation of multiple orders to be executed at a single point, that would otherwise have been spread across several dealing points. Also, since there is evidence that even daily-dealing funds can successfully manage their liquidity in a stressed situation, we would have to consider very carefully whether the use of such a measure would be proportionate. Besides these concerns, introducing a change of this kind would risk causing negative impacts, as we explained above.

4.28 It would be possible for the rules to allow fund managers to have a queuing system for funds invested in illiquid assets, so that investors' dealing instructions do not have to be carried out at the next valuation point after the manager accepts them. The fund manager would then be able to calculate further in advance how much liquidity is needed to meet redemption requests and could start to sell investments as necessary. This might reduce the risk of transactions being carried out at 'fire sale' prices. We are interested in stakeholders' views on whether this type of arrangement could be operated in a way that is fair to all investors, or whether it is better for the fund to fix a reduced dealing frequency matched to the valuation cycle of the assets.

4.29 Many of the rules in our Handbook were designed before the proliferation of intermediated services for investors, so they did not anticipate either the challenges or the opportunities that these distribution channels can introduce. We would be interested to hear stakeholders' views on the interaction we believe there to be between distributors' processes and fund manager liquidity management practices.

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

Direct intervention by the regulator

4.30 We have various powers to intervene in firms' activities, including a power to require a firm to take action or not. We did not consider it appropriate or necessary to use this power after the referendum to require fund managers to suspend dealing in certain funds. The fund managers that suspended their property funds did so because of their individual situations, taking account of the nature of their funds' assets, their liquidity profiles and the behaviour of their investors.[47]

4.31 The fact that fund managers made these decisions individually, acting on their specific needs and circumstances, indicates an orderly market. However, we believe that managers may be reluctant to be the first one to implement a suspension, even when they are aware there are widespread problems, because of the fear of reputational damage. In such cases it is perhaps understandable – even if not desirable – that they would prefer the regulator to make the judgement call.

4.32 The FSB's policy recommendations to address structural vulnerabilities from asset managers suggest that, if appropriate, regulators should provide direction in extraordinary circumstances about open-ended funds' use of liquidity risk management tools. This intervention would address the risk to financial stability that might be caused by fund managers' reluctance to suspend their funds. In particular, there is a concern that funds could be forced into a situation where they have to 'fire-sell' assets at very low prices to be able to meet redemption requests. Widespread 'fire sales' could depress asset prices in a way that has a knock-on effect to other funds and institutions and causes a risk to the financial system.

4.33 However, such action by regulators would carry risks. Suspensions of individual funds at their own initiative may indicate there is an orderly market where funds react appropriately to their individual circumstances. A direction by a regulator to suspend some or all funds investing in a particular asset class might, however, send a signal that investors should not have confidence in that entire asset class and not just specific funds. This would risk causing the very run on funds the intervention was intended to prevent.

4.34 Further, it would also fall to the regulator to determine when to lift the suspension. This implies a judgement about an asset class that more properly sits with the manager. It also assumes that the regulator would have access to extensive data about the funds to make evidence-based judgements, which might not be the case in a rapidly-developing situation.

4.35 IOSCO and national regulators will undertake more detailed consideration of how direct intervention by regulators might be made to work. The financial stability implications are not necessarily clear and potential unintended consequences of the proposal will need to be assessed carefully.

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

47 Although FSMA gives us particular powers of intervention in relation to authorised funds, we are not suggesting that any change in the scope of authorisation (e.g. by requiring open-ended funds that invest in certain illiquid asset classes to become authorised) would be desirable.

Enhanced disclosure

4.36 The regulatory system focuses strongly on ensuring that potential investors are made aware of the nature and risks of an investment product and of any restrictions on withdrawing their money, before they buy it.[48] Similarly, rules on periodic reporting aim to ensure that investors receive sufficient and clear information about their investment's performance and any significant changes to the way it is managed.

4.37 This paper does not aim to discuss or prompt debate about whether investors (especially retail customers) have a sufficient understanding of the characteristics and risks of illiquid asset classes like property, or whether it is right for investors to be able to buy an illiquid fund without any check on its suitability for their needs. We might, however, consider as part of this discussion if the information needs of such investors are being adequately met.[49]

4.38 For authorised funds other than UCITS schemes, existing pre-sale disclosures are not yet standardised. A firm may issue a NURS key investor information document, a key features document or a simplified prospectus to a retail investor.[50] These are all meant to be brief documents that describe the principal features of the fund under normal operating conditions. They may note, as a potential risk, that investors may be unable to withdraw their money in certain circumstances, but they are not explicitly required to explain in detail what those circumstances might be.

4.39 A full prospectus is also available on request to all investors in an authorised fund. This should explain more fully the possible use of fair value pricing and liquidity management tools such as limited or deferred redemption and suspension of dealing. However, we are told few investors ask for the prospectus and we have found that some AFMs do not make it easily accessible for them by, for example, publishing it on their website alongside key investor information documents. Annual and half-yearly reports would be expected to mention any problems the fund has experienced, but these might not be published until many months after the relevant event occurred.

4.40 As a result, it is not clear how well investors understand the particular risks of a fund that invests in illiquid assets but offers frequent redemption opportunities to investors, or how aware they are of the steps that its manager might take to deal with liquidity problems. We have explained in other publications our view that disclosure has a limited ability to change consumer behaviour, so it would be unwise to assume that simply adding more details in fund documents about the issues covered in this paper will produce better outcomes.

4.41 We would, however, like to hear from stakeholders with suggestions about how enhanced or better-targeted communications might help investors understand the possible impact of fund liquidity problems on their own situation. We also welcome feedback from stakeholders on any examples of good and poor practice in investor communications when a fund has faced liquidity problems, so that we can assess whether guidance on this point might be helpful.

48 See also paragraphs 4.77 to 4.80 of the market study interim report concerning switching costs.

49 The consumer research we carried out for the asset management market study included questions about consumers' attitudes to fund liquidity. See for example question 29 on pages 98/99 of the interim report, Annex 3: www.fca.org.uk/publication/market-studies/ms15-2-2-annex-3.pdf

50 The PRIIPs Regulation will cause these to be replaced by the key information document from 1 January 2018, although we have proposed to allow firms that have adopted the NURS key investor information document before that date to continue using it until 31 December 2019.

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

Secondary market provision

4.42 By definition, an open-ended fund is one in which investors have the right to require the fund operator to redeem their units or shares at agreed intervals. Besides this right, an investor can also sell their interest to another person who then becomes the beneficial owner of the shares or units. It is possible for shares of funds to be listed, or admitted to trading on a regulated market, to encourage these transactions to take place in addition to direct redemption. It would not, however, be practical where the shares or units are held in a personalised tax wrapper such as an ISA or SIPP.

4.43 A way of matching prospective sellers and buyers may be helpful to some investors if the opportunities for direct sale and redemption are infrequent. Even if a fund is not listed, arrangements can be made by an intermediary. Some fund managers offer to provide a matching service to help investors in certain, usually illiquid, funds to find a buyer. This is a commercial choice on their part and there is no suggestion that it would be appropriate to require every manager of illiquid funds to provide this service.

4.44 Rather, we are interested to receive feedback on whether more could or should be done to encourage market-led development of alternative redemption mechanisms. We would like to know whether there are perceived regulatory barriers to providing such a service and whether it could pose risks that are not immediately apparent to those who might wish to use it. Obvious questions are:

- at what price would the transaction take place?
- to what extent might it be priced differently to a simultaneous direct transaction with the fund manager?
- how might a fair price be determined if the transaction does not coincide with a fund valuation?

4.45 Some managers might decide that an open-ended fund is not the best vehicle for the assets they wish to invest in and that it would be in investors' interests to convert it to, or replace it with, a closed-ended fund whose shares are traded on a secondary market. A change of this kind would mean investors giving up their right to redemption on demand and it might result in transactions taking place at a premium or discount to net asset value, as is normally the case for shares of listed investment companies. Again, we are interested in stakeholders' views about whether more could or should be done to make it easier for an open-ended vehicle investing in illiquid assets to become closed-ended.

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

Conclusion

4.46 The various approaches outlined above are not an exhaustive list; nor are they mutually exclusive. They could be developed in combination to address different aspects of the problems identified in relevant funds, or we could differentiate between funds that invest wholly or substantially in illiquid assets and those that invest a smaller proportion of their assets in this way. Any proposals we decide to make as a result of this discussion paper would have to include careful consideration of the transitional effects of moving to a different approach.

4.47 We are keen to receive feedback on the interaction between the ideas in this paper and the asset management market study and the extent to which the possible remedies set out in the market study interim report might complement any of the approaches in this paper.

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

Annex 1
List of questions

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

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

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

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

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

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

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

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

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

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

Annex 2
Liquidity tools for authorised investment funds

1. In chapter 3 we describe how we currently regulate the management of liquidity in open-ended authorised CIS. This Annex explains in more detail some of the relevant rules that apply to these funds.

2. Whether as an ordinary part of on-going fund management, or in response to unusual or stressed market conditions, the tools described below must be used in the context of the authorised fund manager's duty to act in the best interests of all investors. The depositary also has a part to play, since its oversight function is not merely one of advising or monitoring. For example, it has the power to require the AFM to suspend dealing in a fund, and it can object to a proposal by the AFM to suspend if it is not satisfied the decision would be in the best interests of investors.[51]

Liquidity risk management

3. UK regulation of liquidity management in investment funds is principally based on EU legislation. AIFMD and the UCITS Directive both set out how the AFM should conduct risk management generally, and AIFMD prescribes detailed rules for liquidity management. These include duties to conduct regular stress testing under both normal and exceptional conditions, and to ensure that each fund's investment strategy, liquidity profile and redemption policy are consistent.[52] The UCITS Directive is less prescriptive about this, although it includes requirements to use an appropriate liquidity risk management process and where appropriate to conduct stress tests to assess the fund's liquidity risk under exceptional circumstances.[53]

Portfolio structure

4. Detailed rules apply to authorised funds that can be marketed to retail investors (UCITS schemes and NURS), including on the types of assets that can be held and the minimum number of different assets that must be held.[54] These rules aim to ensure that investment risk is set at an appropriate level and that the fund's assets are adequately diversified. For example, a NURS investing directly in properties cannot hold more than 25% of its value in a single property or group of adjacent properties.[55] These diversification rules do not apply for the first two years after the fund is launched, to give the AFM time to raise enough capital to buy a spread of investments.[56]

Liquidity buffer

5. The AFM may hold uncommitted cash and 'near cash'. However, the amount held must not exceed what may reasonably be regarded as necessary to enable units to be redeemed, or the other permissible purposes specified in the rules.[57]

51 COLL 7.2.1R (1) and 8.6.3R (1)
52 FUND 3.6.2R to 3.6.4G
53 COLL 6.12.11R
54 COLL 5 and 8.4
55 COLL 5.6.19R
56 COLL 5.6.3R
57 COLL 5.5.3R

Redemption charge

6. The AFM can impose a redemption charge (sometimes called an 'exit charge') on investors, if it is properly disclosed to them before they invest.[58] This may be in addition to, or instead of, an initial charge, although it is unlikely the AFM could justify any charging structure as fair to customers if it involves significant charges at both the entry and exit points.

Borrowing

7. The AFM is allowed to borrow to provide a cash injection to the fund. In the case of UCITS schemes and NURS, borrowing must be occasional, temporary and limited in value, to prevent the build-up of leverage in the fund.[59] Borrowed cash cannot exceed 10% of the fund's assets. The period of borrowing cannot exceed three months without the prior consent of the depositary, who must be satisfied that the borrowing is temporary in nature. Only certain types of institutions and banks may provide the loan. QIS are allowed to borrow up to 100% of their value and the rules do not require the borrowing to be temporary.[60]

Fair value pricing

8. A fair value price is what the AFM believes to be a fair and reasonable price for an investment when the usual independent price models and sources (such as a market feed) are unavailable, unreliable or out of date. There are specific rules for an authorised fund that invests directly in property, to cover the process for appointing a standing independent valuer (SIV) and its duty to value each property.[61] For firms that must meet the full requirements of AIFMD, rules for the valuation process of each fund apply to the AFM.[62]

Redemption frequency and limited redemption

9. A NURS that invests substantially in property may put in place arrangements to limit the frequency of sales and redemptions to a minimum of once every six months.[63] The instrument constituting the fund and the prospectus must authorise the use of the limited redemption tool and set out how it works. The interval between the date of receiving and accepting the unitholder's instruction and the transaction date must not exceed 185 days.[64]

58 COLL 4.2.5R (22) and 8.3.4R (15). The use of a redemption charge is permitted by COLL 6.7.7R.
59 COLL 5.5.4R and 5.5.5R.
60 COLL 8.4.10R.
61 COLL 5.6.20R.
62 FUND 3.9
63 COLL 6.2.19R also allows a NURS operating as a fund of alternative investment funds, or with an investment objective to provide a specified level of return, to put in place limited redemptions. Those funds are not in the scope of this paper.
64 COLL 6.2.16R (7).

10. The AFM has flexibility to treat unit classes of the same fund differently by applying limited redemption arrangements to some classes, as long as they do not prejudice the interests of any unitholders, and to set different frequencies for sales and redemptions.[65] For a QIS, the rules do not require any maximum interval between dealing days; it depends on the reasonable expectations of the investors and the fund's particular investment objectives and policy.[66]

Understanding investors' behaviour

11. COBS 14.4.10R allows the AFM of an authorised fund to ask firms that are intermediate unitholders for information about the beneficial owners of the units, such as a breakdown of the number of units attributable to each owner or the distribution channels used to sell the units. The intermediate unitholders must respond readily to any reasonable request from an AFM for this information when it is for the purpose of liquidity management.

Dealing as principal

12. AFMs are able to deal as principal in units of the funds they manage[67], so that they can sell units to incoming investors and redeem them from outgoing investors on their own account. This usually involves operating what is known as a 'manager's box' so that sales and redemptions can be partly or fully matched and netted off, without the need to create or cancel corresponding units in the fund. There is also no need for any transaction in the assets making up the fund's portfolio.

Anti-dilution measures

13. Dilution is the term for a situation that could arise if redeeming investors deal at a unit price that does not cover the full costs associated with their disinvestment, so they receive slightly more money for their units than they should. Those costs are borne by the fund, which could result in a dilution of its value that disadvantages the remaining investors.

14. For authorised funds that are valued and dealt in at a single mid-market price, the AFM may apply a dilution levy.[68] In the case of an investor selling units, this is a specific charge applied to the value of the deal, which is then repaid to the fund to cover a proportion of the costs of selling underlying assets to meet the redemption. The alternative for single-priced funds is to use a dilution adjustment, which is connected with the use of swing pricing.[69]

65 COLL 6.2.19R
66 COLL 8.5.12G.
67 Section 72AA of the Regulated Activities Order (RAO) gives firms this right where they hold the Part 4A permissions of managing AIFs or managing UCITS.
68 COLL 6.3.8R
69 A single-priced fund is normally valued on a mid-market basis so that the same price can be used for investors buying and selling units. The AFM can adjust or 'swing' the dealing price to take account of whether there is a net inflow or outflow of money, so that the costs of buying or selling assets for the fund portfolio are allocated as fairly as possible between investors staying in the fund and those entering or leaving it.

15. For a fund which is dual-priced, the portfolio is normally valued on both an offer basis and a bid basis and separate prices are calculated from those valuations. The difference between them is called the full dealing spread. The valuation prices are limits within which the AFM can set dealing prices on a narrower spread.[70] The AFM can adjust the dealing spread from one dealing point to the next, depending on dealing flows. The dealing prices will normally be set to include any expected dealing costs, so the effect is similar to that of a dilution adjustment

Deferred redemption

16. The AFM of a fund that provides daily dealing in units is allowed, but not required, to operate deferred redemption arrangements, sometimes referred to as 'gates'. This facility and the use of limited redemption arrangements are in most cases mutually exclusive and some funds may not be allowed to use either of them.[71] The instrument constituting the fund and the prospectus must authorise the use of this tool and set out how it works.

17. In the prospectus, the AFM must specify a percentage of the fund's net asset value as the minimum threshold for applying deferred redemption. If requests for redemptions at a particular valuation point exceed that threshold, the excess amount may be deferred to the next valuation point.

18. The AFM must ensure all unitholders that want to sell their units at a particular valuation point are treated consistently, but the exact way in which deferred redemption works is for the AFM to decide and specify in the fund prospectus.

Redemption 'in specie'

19. Redemption 'in specie', also called redemption in kind, refers to a transaction where the redeeming investor receives a portion of the assets in the fund portfolio of the same value as the units sold, instead of a cash payment.[72] The fund prospectus must specify in what circumstances, if any, the AFM will arrange for payment in this way.[73]

70 COLL 6.3.5BR

71 COLL 6.2.21R

72 COLL 6.2.15R for UCITS schemes and NURS. The AFM may offer to sell the assets outside the fund and transfer the net proceeds to the investor, so that the fund does not incur transaction costs.

73 COLL 4.2.5R (17)(d) and 8.3.4R 13 (7)

Suspension of dealing

20. Our rules allow the AFM to apply a temporary suspension of all dealing (issue, sale, redemption and cancellation of units) with the prior agreement of the depositary, in exceptional circumstances and if it is in the interests of all investors in the fund.[74] The depositary may also, at its own initiative, require the AFM to suspend dealing subject to the same conditions. We may use our powers of intervention under FSMA (s.257 et al.) to require suspension on various grounds, including the desirability of protecting investors' interests.

21. The suspension must last no longer than is justified, taking unitholders' interests into account, and must cease as soon as practicable after the exceptional circumstances that triggered it no longer apply. Our rules do not prescribe a maximum duration or any particular actions that the AFM should take to try to hasten the end of the suspension.

22. The AFM must inform us immediately the suspension begins and must notify investors as soon as practicable, explaining the reasons for the suspension. The AFM and depositary must then review the suspension at least every 28 days and inform us of the position, keeping investors informed by publishing sufficient details on a website or by other means.

23. Finally, when the AFM is ready to restart dealings it must inform us in advance and confirm to us as soon as suspension has ceased.

74 COLL 7.2 and 8.6. AFMs wishing to carry out fund mergers and reconstructions may use very short-term, planned suspensions (typically for a single valuation point) with advance notice to investors, to ensure the change is performed efficiently. These events are generally not a matter of regulatory concern as they do not represent risks to liquidity management or asset valuation.

Annex 3
Guidance note on fund suspensions

Following the result of the EU referendum, we are aware that some asset managers are experiencing higher than normal levels of redemption requests from investors in their funds.

Fund managers have a duty to act in the best interests of all investors. Therefore they must consider how to ensure the on-going fair treatment of all investors in their funds in the context of the current market conditions.

Fund managers have a range of tools available to manage their funds through periods of market disruption or when specific events take place to ensure the best interests of all investors are safeguarded.

The FCA expects all fund managers to understand fully their duties and responsibilities, as well as the tools they have in relation to all of the funds they manage, which will largely depend on the terms set out in that fund's prospectus and the instrument constituting the fund. Further, the FCA expects them to have a clear understanding of how and when such tools might be used.

It is the duty of the fund manager to ensure that assets are valued fairly and accurately and to ensure that any subscriptions or redemptions of units take place at a fair price. Failure to do so may lead to some investors gaining at the expense of other investors in the same fund.

If a fund has to dispose of underlying assets in order 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.

In exceptional circumstances, fund managers should consider whether it would be in investors' best interests to suspend dealing in a fund or range of funds. We request that managers of authorised funds contact us in advance of any proposed suspension.

Where fund managers have chosen to temporarily suspend dealings in funds, they will need to consider when to resume dealings in the interest of investors. Funds holding a large proportion of assets that may be, in certain circumstances, illiquid or hard to value such as commercial property may consider that the suspension should be lifted and investors given the opportunity to redeem at a revised valuation of the units in the fund. This redemption price might reflect the price at which illiquid assets can be realised in a shorter than usual timeframe. In these circumstances, fund managers should ensure that:

- the revised redemption price and the opportunity to cancel are clearly communicated to investors who have submitted a request to redeem their investment before or during the fund's suspension;
- this communication explains the options that are available to investors and includes details of how to cancel the redemption requests; and
- investors are given sufficient time to make their decision and to seek appropriate advice. This timeframe should take into account the types of investor in the fund and whether communications to these investors need to take place through an intermediary.

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Annex 4
Platform providers and investment funds

In September 2016, gross retail sales into UK domiciled funds by UK fund platforms represented 46.1% of gross retail sales and other intermediaries represented 23.9%.[75] These figures highlight the importance of these distribution channels. Intermediate unitholders sit between the fund manager and the end investor and are usually responsible for providing both pre-sale fund information, such as the key investor information document, and post-sale information such as details of corporate actions. The fund manager has a relationship with the distributor and may have no information about the underlying investors or their behaviours. The distributors will in many cases conduct their relationship with the end-customer through a financial adviser.

Growth of platforms 2010-2016:

	September 2010		September 2016	
Gross retail sales	£m	%	£m	%
Direct	730	8.9	1139	7.7
UK platforms	2944	36.0	6820	46.15
Other intermediaries*	4514	55.1	6819	46.15
Total gross retail sales	8188	100	14,778	100

*includes execution-only brokers, independent financial advisers, discretionary managers, UK and non-UK intermediaries

As authorised firms, these distributors must meet regulatory requirements in relation to systems and controls, client money, and conduct of business. In 2013 we introduced a requirement for intermediate unitholders to provide, when requested by a fund manager, information on the beneficial owners of a fund that might be needed to facilitate liquidity management of the fund.

75 Source: Investment Association press release www.theinvestmentassociation.org/media-centre/press-releases/2016/press-release-statistics0916.html

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