MACFARLANES

ILLIQUID ASSETS AND OPEN-ENDED FUNDS

Liquidity management is a topical issue in the funds world and it was thrown sharply into focus for managers of open-ended funds following the unexpected Brexit referendum result. This was particularly so for those managers of funds investing in property who were forced to suspend dealing because they could not meet redemption requests.

The FCA was proactive in engaging with such managers in the week leading up to the referendum and has since undertaken supervisory visits to gain a deeper understanding of the liquidity challenges faced in extraordinary market circumstances.

On 8 February the FCA published Discussion Paper 17/1 "Illiquid assets and open-ended investment funds" which revealed what it had learnt from the "test" provided by the referendum and its subsequent supervisory work. Whilst it was generally happy with the way in which mangers dealt with the liquidity crunch, the FCA now seeks to promote discussion on whether any additional rules or guidance would be helpful in assisting managers to comply with their liquidity management obligations.

THE ISSUE

Regulated, open-ended funds are permitted to invest, within limits, in certain illiquid asset classes, such as private or unlisted shares, real estate and units in unregulated collective investment schemes which may themselves hold illiquid assets. Investors are entitled to redeem their interests in such funds at net asset value. Whilst these funds are not obliged to offer daily subscription and redemption opportunities, many of them do in order to meet the requirements of platforms or other intermediaries that are distributing the fund.

In extraordinary market circumstances, such as those immediately following the referendum vote, managers may experience an atypical run of redemption requests. This creates three key issues for the manager:

- Does it have enough liquidity in the portfolio to meet the redemption requests?
- In the prevailing market conditions can it accurately value the underlying assets which need to be sold in order to facilitate the redemption request?
- If the manager is able to sell some of the portfolio, does it risk giving the redeeming investors a "first mover advantage" in that if the first investors to redeem are paid from cash or the sale of highly liquid assets, later redeemers will need to be paid through the sale of less liquid assets which might be harder to sell and might incur greater transaction costs?

AIM OF THE FCA

The FCA is absolutely clear that it is not intending to prevent open-ended funds from holding illiquid assets. Rather it is looking for the industry's thoughts on whether further tools or guidance are required to help managers deal better with liquidity challenges.

CURRENT TOOLS

The FCA details the current liquidity management tools available to firms. These include pre-emptive measures, such as careful portfolio construction, effective liquidity risk management and the imposition of redemption charges; and post event measures such as fair value pricing, deferred and limited redemption, in specie redemptions and suspensions.

The FCA recognises that there is reluctance to use some of the available tools due to uncertainty around regulatory expectation. It also recognises that the market will not necessarily tolerate use of some of the available tools. In particular the FCA notes that many of the rules in the FCA Handbook were drafted before the proliferation of intermediated services for investors and that some of the existing tools available to managers are simply not palatable, or easily operationally achievable, for many distributors.

OPTIONS FOR DEVELOPING LIQUIDITY MANAGEMENT TOOLS

The FCA sets out a non-exhaustive list of ideas for discussion which include the following:

- Treating professional investors differently from retail investors by having them invest in separate unit classes (as is typically the case anyway) with different dealing frequencies and redemption notice periods; or requiring managers to be more active in looking at the diversity of the investor base.
- Restricting the percentage of the fund that can be invested in illiquid assets; or imposing US style liquidity "buckets".
- Introducing rules or guidance on fair value pricing obligations or the use of anti-dilution measures so that managers can feel more comfortable in imposing a charge on redeeming investors - in other words attempting to remove the "first mover advantage".

- Direct intervention - the FCA requiring managers to suspend dealing of their funds.

- A requirement to disclose more clearly illiquidity risks to investors (the FCA recognising that most investors do not read the prospectus which is where most of the details regarding liquidity risks will currently be found).

- The FCA wants to understand whether there are perceived barriers to secondary market sales of regulated fund interests, which it sees as an alternative to redemption.

CONCLUSION

The FCA seeks stakeholder comments on its suggestions by 8 May 2017, after which it expects to publish a response later in 2017.

All managers currently operating, or considering establishing, open-ended funds investing in illiquid asset classes are strongly encouraged to join the debate on this topic. It is clear that the FCA is seeking to help managers to meet the challenges faced and therefore a good level of engagement is important in order to ensure a more robust and well understood framework, for both managers and investors.

CONTACT DETAILS

If you would like further information or specific advice please contact:

TIM CORNICK
PARTNER
INVESTMENT MANAGEMENT
DD +44 (0)20 7849 2510
tim.cornick@macfarlanes.com

LORA FROUD
PARTNER
INVESTMENT MANAGEMENT
DD +44 (0)20 7849 2409
lora.froud@macfarlanes.com

FEBRUARY 2017

This note is intended to provide general information about some recent and anticipated developments which may be of interest.
It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

Macfarlanes LLP is a limited liability partnership registered in England with number OC334406. Its registered office and principal place of business are at 20 Cursitor Street, London EC4A 1LT.
The firm is not authorised under the Financial Services and Markets Act 2000, but is able in certain circumstances to offer a limited range of investment services to clients because it is authorised and regulated by the Solicitors Regulation Authority.
It can provide these investment services if they are an incidental part of the professional services it has been engaged to provide. © Macfarlanes February 2017