HMRC consultation on ISAs and authorised open-ended property funds

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £7.7trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

About the Association of Real Estate Funds

The Association of Real Estate Funds (AREF) represents the UK real estate funds industry and has 67 member funds with a collective net asset value of more than £70 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the MSCI/AREF Property Fund Vision Handbook.

Executive Summary

The joint AREF-IA response to the consultation focuses on the overall policy direction with respect to the position of property funds within ISAs. Fund managers, ISA managers, wealth managers, platforms, investment advisers and ISA investors themselves will be in a better position to respond to the data, operational and behavioural points raised in the consultation questions.

We broadly support the greater use of notice periods for illiquid investments, including property. While we welcome the proposal by HMRC to ensure that existing property holdings can be grandfathered within ISA wrappers, we fundamentally disagree with the wider direction of travel, which would either prevent new investment in property funds (the preferred HMRC option) or investment in new property funds (option B). The signal being sent, in effect, is that the ISA is no longer seen as a legitimate wrapper for retail savings in property funds. In this regard, we are also concerned that the timing of this consultation, overlapping with CP20/15, damages the chances of the reform process being a success given the importance of ISA access for direct property funds.

Our response argues that it is increasingly important for retail investors, including those investing through ISAs, to have access to various types of assets, including less liquid assets such as property. Access to property as an asset class is an important source of diversification for investors' portfolios as it offers low correlation with other asset classes, as well as providing a source of income return that is important for long-term savers. The Government and FCA have a longstanding commitment to wider investment in illiquid assets, such as property and infrastructure and a removal of the capability of retail investors to invest in property funds through ISAs would be damaging to this agenda.

We request that ISA rules are changed to allow property funds with notice periods to be held in stocks and shares ISAs. This should be allowed for investors already holding property funds in ISAs, any new investments in existing property funds and further investment in new funds.

Response to Consultation

The Associations have long supported the extension of a range of tools that can be used to better manage potential or actual liquidity mismatch in investment funds. We provided a joint response to the FCA's consultation on liquidity mismatch in authorised open-ended property funds in November, where we welcomed the proposal to introduce notice periods for authorised open-ended property funds, but urged the FCA to ensure that the entire funds ecosystem was ready and able to accommodate notice periods.

<u>Importance of ISA regime</u>

A critical point in our response to CP20/15 was the risk of unintended consequence of investors no longer having access to authorised property funds in their ISA portfolio and that property as an asset class would then become unattractive to investors, leading to a widespread disinvestment from property funds. We also advised that the knock-on effects of large and sudden outflows from these funds on the property market could be substantial and would need to be considered.

From our discussions with members, we understand that 20% - 30% of total investments in authorised property funds are through stocks and shares ISAs. We have been informed that for some individual property funds investment via ISAs are much higher than this and removing the ability for new investors to invest in them through ISAs would be detrimental to the funds. If notice periods are introduced to open-ended property funds as proposed, it would be essential for HMT and HMRC to allow new investment in property funds through stocks and shares ISAs.

If funds with notice periods are not eligible for investment in stocks and shares ISAs, it would not only affect investments through ISAs. Where model portfolios are used, these are usually set for all investments within a particular risk profile, whether they are through stocks and shares ISAs or not. Investment advisers, who use model portfolios, are very unlikely to have a model without property funds for investments through ISAs and a model with property funds where investments are not through ISAs. Most AREF members currently operating daily dealing property funds have confirmed that between 74% and 99.9% of the investments in their funds are through intermediaries and a large proportion of that investment would most likely be in model portfolios. Therefore, there is more than 20% – 30% of investments in authorised property funds at risk if the funds with notice periods are not eligible as stocks and shares ISAs.

The Associations acknowledge and support the proposal to allow ISA account investors to retain their holdings in property funds after the introduction of a notice period and to top up their holdings in these funds (model 2). However, we disagree with the proposal that "new" investment in such funds be prohibited and ask that HMRC and HMT allow an exemption for funds with notice periods that satisfy the dealing frequency test, which would allow investment in all authorised open-ended property funds, not just those already held by the ISA. Allowing investment in existing funds only would limit investor choice, prohibiting investors from accessing property using a fund most suitable to them. Over time, as investors liquidate their holdings or as funds wind up, overall investment in property funds will dwindle to a point where questions over the continuation of these funds will be raised.

Paragraph 4 of the consultation states that "any change (to the ISA regime) which introduces different criteria for specific products within an investment class should be readily understood by a retail customer." As most investors would have experienced the time it takes to sell their own home, they would likely understand the need for notice periods for property fund redemptions. An important point, as always, is pre-sale disclosure and the importance of the investor understanding the key features of the product they are about to purchase. A full explanation of a notice period, and its consequences for any investor would ensure that the investor is fully aware of the impact on them before they purchase the fund. We do not believe this is affected by whether the investments are held in a tax wrapper or not.

<u>Property and the current regime</u>

As detailed in the consultation, the ISA regulations define "qualifying units in or shares of a non-UCITS retail scheme" as:

a. The instrument constituting the scheme secures that redemption of the units or shares in question shall take place no less frequently than bi-monthly (see Rule 6.2.16(6) of the Collective Investment Schemes Sourcebook omitting the words "Except where (7) applies, and ", read with Rule 6.3.4(1), whether or not those Rules apply to the scheme), and
b. A provision for suspension of dealing in exceptional conditions in accordance with Rule 7.2 of that Sourcebook (or any foreign procedure which is a direct foreign equivalent of that Rule) shall not be treated as a provision contrary to paragraph (a) of this definition.

We believe that daily-dealing FPIPs would be a qualifying investment for ISAs under this definition.

However, the ISA Regulations state that ISA investors must be able to access funds or transfer assets between ISA Managers within 30 days (with exceptions for suspended funds) and the introduction of a notice period would prove problematic for ISA encashments or cash transfers. We agree that in some cases, short-term access to cash is of importance, but highlight the fact that, due to the loss of tax advantages when money is withdrawn from an ISA, investors will only withdraw funds after careful consideration. Property funds encompass a small proportion of the total invested in ISA portfolios.

In our joint response to the FCA CP, we have suggested that notice periods should be no more than 90 days in length and to provide an exemption to property funds, allowing access to them with 90, rather than 30 days' notice would result in more benefit than it would prevent harm.

As acknowledged in paragraph 3 of the consultation, there is an exception in the ISA rules for Innovative Finance ISAs, where savers are not always able to transfer all of their ISA investments within 30 days. When this is the case, there is no certainty when those assets can be transferred. With property funds with notice periods, if an investor has to liquidate their holding in the property fund to transfer their ISA, they would know that the transfer could take place shortly after the end of the notice period.

It should be noted that Managers would still be able to remove the ISA wrapper, or effect an in-specie transfer of the stocks within 30 days. The FCA is in the process of implementing new rules requiring platforms to enable in-specie transfers where requested by the investor. We suggest that a similar provision be applied to ISA transfers, so that the transfer could take place within 30 days.

Where UCITS or non-UCITS retail schemes have suspended dealing under current ISA rules, the 30-day rule can be extended. We would suggest that, where an investor has requested a transfer in cash, the 30-day rule could be extended for non-UCITS retail schemes with notice periods and there is a set period of time after the end of the notice period when the transfer should take place.

[CONCLUSION]