The Association of Real Estate Funds
Camomile Court, 23 Camomile Street,
London, EC3A 7LL
+44 (0)20 7269 4677
info@aref.org.uk

David Sorensen
Asset Management & Funds Policy Team
Financial Conduct Authority
12 Endeavour Square
London
E20 1JN

By email: dp18-10@fca.org.uk

28 February 2019

Dear David

Response to DP18/10: Patient Capital and Authorised Funds

We, the Association of Real Estate Funds[1] (AREF), welcome the opportunity to respond to this discussion paper. As we mentioned in our response to FCA CP18/27, Consultation on illiquid assets and open-ended funds, we believe the discussion on enabling investment in patient capital by authorised funds should not be looked at in isolation and should form part of the wider consultation on investment in illiquid assets by open-ended funds. Also, responses to FCA CP18/40, Consultation on proposed amendment of COBS 21.3 permitted links rules, should be taken into consideration too.

We are of the understanding that The IA's UK Fund Regime Working Group are currently developing a framework for a Long Term Asset Fund. We have not been privy to full details about the fund structure being proposed but in principle we support the introduction of a fund suitable for investing in long term assets. We would like to see the Long Term Asset Fund as a NURS with broader investment powers than currently available to NURS to enable significant investment by the fund in illiquid assets, including patient capital.

Daily dealing is not necessarily suitable for funds investing in patient capital; they should be able to have a dealing frequency more appropriate to the long term nature of the assets they are investing in. Although, the COLL rules do not restrict these type of funds to daily dealing; advisers, DC schemes and distributors for retail investors currently demand daily dealing. We would ask that the FCA engage with these parties to explain that their requirement for funds to deal daily restricts investors' access to patient capital via authorised funds. Where it is felt that daily dealing is appropriate for a fund investing in patient capital, we would ask that the FCA consider permitting deferred redemptions for a period of time which matches the expected

[1] The Association of Real Estate Funds represents the UK real estate funds industry and has around 60 member funds with a collective net asset value of more than £72 billion under management on behalf of their investors, including £18 billion on behalf of retail investors in the UK. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the AREF/IPD UK Quarterly Property Funds Index and the AREF/IPD Property Fund Vision Handbook.

period to sell the underlying illiquid assets. We have requested this in both our responses to FCA DP17/1, Illiquid assets and investment funds, and FCA CP18/27.

We have agreed in our response that there should be appropriate risk warnings in investor documentation and intermediaries should ensure investors are aware of these. It may be prudent that authorised funds investing substantially in patient capital should be sold to retail investors on an advised basis.

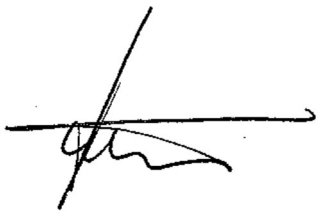
We believe that the current QIS rules appear to be adequate to give these type of funds access to patient capital. Although, this may be the appropriate time to widen the range of assets QIS can invest in to bring them in line with similar products overseas.

We have agreed that it is the responsibility of the AFM to develop a methodology to provide a fair, appropriate and transparent valuation of patient capital held by the fund and this should be independently validated by someone appropriately qualified. As you will be aware from our response to FCA CP18/27 most of our members are not supportive of mandatory suspension when valuers have declared there is material uncertainty in property values. The AFM should decide if the valuation methodology is providing the correct value for the assets held by the fund and if any actions are required such as fair value pricing or, if necessary, suspension in dealing.

You asked why there has been little interest in ELTIFs, EuSEFs and EuVECAs. These are fairly new structures that are not well known or understood; therefore it may take some time for demand for these vehicles to increase. EuSEFs and EuVECAs are not products our members are familiar with but we have identified in our response some reasons which may prevent fund managers or investors from using ELTIFs to invest in UK patient capital.

Our detailed responses to the questions in DP18/10 are set out in the annex that follows. Please contact Jacqui Bungay (jbungay@aref.org.uk), Policy Secretariat at AREF, to discuss any aspect of our response.

Yours sincerely



John Cartwright
Chief Executive
The Association of Real Estate Funds

ANNEX: AREF's responses to the specific questions raised in DP18/10

Liquidity – redeeming investments

Q1: Do the category limits strike the right balance between enabling retail investments in patient capital while ensuring investors can redeem their investments in a timely fashion? If not, what changes should be made to existing structures?

To enable authorised funds to invest substantially in illiquid assets such as patient capital, we would suggest the FCA look at permitting a new type of NURS with wider investment and borrowing powers and the ability to offer reduced dealing frequency. We are of the understanding that The IA's UK Fund Regime Working Group are currently developing a framework for a Long Term Asset Fund. We are, in principle, supportive of this new type of investment fund, classified as a NURS.

There can be challenges with providing daily dealing on a fund with illiquid assets. To manage this, when there is high redemption demands, the funds have to either retain high levels of cash, use borrowing or suspend dealing in the fund. As we have mentioned in our responses to FCA DP17/1 and FCA CP18/27 there are no other practical liquidity tools for funds with high levels of holdings in illiquid assets. In our responses we have requested the ability for funds holding real estate to defer redemptions for up to 185 days. We believe that a new type of investment fund, permitted to fully invest in patient capital, should be able to defer redemptions for a period of time that matches the expected time period for realising its assets. This would enable funds to possibly have daily dealing for subscriptions but longer dealing periods for redemptions.

A NURS operating as a FAIF may use limited redemption arrangements for up to 185 days. The FCA may wish to consider giving NURS that invest in patient capital the option to do this too. The limited redemption period should reflect the liquidity of the underlying assets held by the fund. For some types of illiquid assets this may need to be longer than 185 days.

By giving a NURS investing in patient capital the ability to defer redemptions longer than one valuation point or use limited redemptions, may enable the fund to hold less cash, for liquidity purposes, and invest more in patient capital.

Although, daily dealing is not required in COLL, there is a demand for this from model portfolio managers, to enable them to re-balance their portfolios daily, and from the DC pensions market. Also, advisers and distributors' systems and processes are based on daily dealing. We feel that this will not change unless there is intervention by the FCA; we would encourage the FCA to enter into a dialogue with distributors and other relevant intermediaries to explain that their practices are restricting retail investors' access to wider investment opportunities.

Q2: Is there retail investor demand for a new type of authorised retail fund which can, for example, invest all its capital directly into patient capital assets?

We believe that there would be a demand for an authorised fund investing in long term assets. This should not only be suitable for retail investors to invest in directly but should be for various intermediaries, investing on behalf of retail investors, including DC pension schemes, and

discretionary wealth managers. Although, it would have to be made clear to investors that this is long term investment product due to the nature of the assets it would be holding.

Q3: If authorised funds marketed to retail investors were permitted to hold more patient capital, what safeguards do you think are needed to adequately protect investors?

There should be appropriate risk warnings in investor disclosures; including in the fund objectives and investment policy. Disclosure documents should clearly state that due to the illiquid nature of patient capital, redemption periods for the fund may be longer than funds holding more liquid assets. The fund prospectus should detail any liquidity management measures that may have to be employed by the fund. When retail investors purchase funds through intermediaries; they should be made fully aware of the nature of the funds and the risk warnings in the disclosure documents.

Fund managers may decide that authorised funds investing substantially in patient capital should be sold to retail investors on an advised basis. Under MiFID II, it is probable that these type of funds would be classified as complex funds and would therefore require any intermediary to perform an appropriateness test before the investment is made. If this is the case, at this point, the intermediary should ensure that the investor is fully aware of the nature of the fund and its assets.

NURS investment in immovables

Q4: Should NURSs have a broader ability to finance infrastructure projects than is currently possible under our regime? If so, what changes do you think are necessary to our handbook?

As we have mentioned earlier, we believe there should be a separate category of NURS, with its own section within COLL 5, which has wider investment powers including the ability to finance infrastructure projects.

Professional and sophisticated retail investors' access to patient capital assets

Q5: Do the current rules governing QISs provide professional and sophisticated retail investors with sufficient access to patient capital? If not, why not and what changes do you think are necessary to our handbook? If our rules do not provide sufficient access for QISs to fund patient capital please suggest which handbook changes could be changed to address this.

The current QIS rules appear to be adequate to give these type of funds access to patient capital. We agree with The IA that the FCA should review whether the range of assets QIS can invest in should be wider in line with similar products overseas. This may increase the interest in investing in QIS.

Q6 If QISs are permitted to hold more patient capital, what safeguards do you think are needed to adequately protect investors?

QIS fund managers must take reasonable steps to ensure the fund provides a spread of risk. We do not think this would change if the funds could hold more in patient capital and therefore there would be adequate protection for investors.

Diversification – managing risks appropriately

Q7: Do the current diversification rules strike the right balance between investor protection, by requiring a prudent spread of risk, and sufficient access to patient capital? If not, do we need a different or more flexible approach to diversification rules? Please provide an explanation of your answer.

We agree, due to the illiquid nature of patient capital, a fund may hold these assets at a level well below the threshold set out in the rules because it would be difficult to correct a breach of the diversification rules within a period of 6 months. The current COLL rules permit funds holding immovables, such as property, 24 months to correct inadvertent breaches. We would suggest funds holding patient capital are permitted a correction timeframe which reflects the time it could take to sell the underlying assets.

However, we would ask the FCA to consider making the diversification rules for a NURS investing in patient capital more flexible to reflect the nature of the assets. For example, if there is an inadvertent breach the entire position may need to be sold as partial divestment may not be possible. The fund should be able to hold onto the asset if it is in the best interest of investors.

Valuation – treating investors fairly

Q8: If authorised funds' scope to invest directly into patient capital assets other than immovables is increased do we need a remedy similar to the proposed mandatory suspension to avoid investors being treated unfairly? If you agree that suspension rules would be appropriate, please set out your suggestions as to what such a remedy would look like. If you do not think suspension rules would be appropriate, please explain why not.

We agree that a methodology should be developed by the AFM to provide a fair, appropriate and transparent valuation of patient capital held by the fund. Also, if a model is used for valuing the assets, this should be validated by a suitably qualified individual who was not involved in the process of building the model, such as an external auditor.

In our response to FCA CP18/27, we confirmed that most of our members did not support mandatory suspensions when valuers do not have transactional evidences to confirm the valuations they are providing and therefore declare material uncertainty. As the AFM is

responsible for valuing the fund's property, they should decide if the valuation methodology is providing the correct value for all assets held by the fund and if any actions such as fair value pricing or, if necessary, suspension in dealing is required.

Patient capital in specialised funds (ELTIFs, EuSEFs and EuVECAs)

Q9: Why do you think the specialised funds have not being used in significant volumes?

As ELTIFs, EuSEFs and EuVECAs are fairly new structures these products are not well known or understood. Therefore it may take some time for interest in these vehicles to increase.

ELTIFs are only able to invest in commercial property that contributes to smart, sustainable and inclusive growth or to the EU's energy, regional and cohesion policies. Also, it would seem that EuSEFs and EuVECAs cannot invest in commercial property so this may deter fund managers from using these fund structures.

Q10: Are there specific features of these funds which prevent fund managers or investors from using them to invest in UK patient capital?

It is understood that distributors are unwilling to host these specialist funds on their platforms. This reduces the visibility of these products to investors and their advisers.

Eligible investment assets for ELTIFs should include real assets with a value of more than EUR 10 000 000 that generate an economic and social benefit. Also, investments in commercial property or housing is permitted to the extent that they serve the purpose of contributing to smart, sustainable and inclusive growth or to the EU's energy, regional and cohesion policies. We believe these requirements for ELTIFs have led to some confusion around which type of assets an ELTIF can invest in so maybe more clarity is required on this from the FCA.

Also, we believe that the safeguards for investors into an ELTIF are seen to be too stringent and in some cases impractical. For example, the assessment of an investor's suitability is placed on the manufacturer, not the distributor. As the manufacturers does not have a direct relationship with the end investor they have to rely on information provided by the distributor.

There is a minimum investment of €10,000 in ELTIFs, which must represent a maximum of 10% of the investor's total assets. This can be restrictive for retail investors. EuVECAs and EuSEFs are not open to the majority of retail investors and the minimum investment amount of €100,000 (recently reduced to €50,000) could also discouraged some investors.

The diversification and borrowing limits of ELTIFs, whilst wider than the standard NURS limits, may not be seen as providing so much of a difference from NURS limits to promote establishment of an ELTIF. In addition, the ability to invest in unregulated collective investment schemes has not been extended from the standard NURS rules.

Concluding remarks

Q11: Are there other areas where the current regulatory framework creates unnecessary barriers, either directly or indirectly, to investing into patient capital?

The FCA should work with HMRC and HMT to ensure investors could be provided with appropriate tax incentives to invest in funds that can invest in patient capital. One way of doing this is enable the Long Term Asset Fund to be a qualifying investment for ISAs. This may require modification to the ISA rules if dealing on the fund is less frequent than every two weeks

As we have mentioned above, the FCA should enter into a dialogue with distributors and other relevant intermediaries to explain that their practices are restricting retail investors' access to wider investment opportunities. Distributors should permit non-daily dealing funds on their platforms.