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By email: dp17-01@fca.org.uk

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Dear Mark

Response to DP17/1: Illiquid assets and open-ended investment funds

We, the Association of Real Estate Funds[1] (AREF), welcome the FCA's discussion paper as a constructive and timely contribution. In particular the review of the events following the referendum provides a balanced account of the period. We also applaud the FCA observations throughout that there is a risk that imposing restrictions on activities or limits on exposures can be counter-productive both in their short term implementation and in their longer term consequences.

The events following the referendum illustrate that managers need a flexible approach to managing liquidity shocks with the fullest range of tools being available to deploy as the circumstances dictate. Whilst the funds that suspended dealing attracted the most attention, other funds took a different approach and provided liquidity throughout the period by quickly realising assets. It is impossible to say that, in the circumstances at the time, one approach was better or worse than another. It is essential that the benefit of hindsight does not taint views on the actions taken. However, it is clear that the managers of all funds paid great attention to taking steps to protect their clients' interests throughout the period.

There is a complex relationship between valuation and liquidity and it is important to recognise that real estate is regarded as illiquid because of the time it takes to market, negotiate and complete a transaction. However, at times, a seller's reluctance to accept the price a potential buyer is willing to pay is mistakenly regarded as illiquidity. We acknowledge the FCA rulebook recognises that both the manager and the standing independent valuer have a role to play in determining the valuation most appropriate to the circumstances but our members have observed inconsistency by these valuers in the process for estimating fair value adjustments and applying anti-dilution measures. We recommend that the FCA should engage with valuers and managers, and their respective representative bodies, to clarify the role of each party. We would be delighted to assist with such engagement.

[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 £60 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.

We would like to highlight that AREF commissioned an independent review of events following the referendum. This review was conducted by John Forbes Consulting over a similar period to the FCA review and the final report[2] was published on 24 April. We would emphasise that this is an independent report and does not necessarily represent the views of AREF or its members.

Our detailed responses are set out in the annex to the annex that follows. We would welcome opportunity to work with FCA to explore further the issues raised in the discussion paper and in our response.

Yours sincerely

John Cartwright
Chief Executive
The Association of Real Estate Funds

[2] A review of real estate fund behaviour following the EU referendum (April 2017).

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ANNEX: AREF's responses to the specific questions raised

What are illiquid assets?

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?

Our response is made primarily in relation to a single asset class, real estate, but our comments will be applicable to a wider array of real assets with similar characteristics such as social infrastructure. We agree with the FCA's approach of focusing on the characteristics of illiquid assets and would caution against attempting to develop a regulatory definition. We agree with the FCA's approach of exploring a wider range of liquidity management tools for specific asset types which are inherently illiquid as opposed to those for which liquidity may change over time, in different market conditions or in response to specific seismic events.

Liquidity management tools

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?

As a general observation we are of the view that liquidity management tools and their deployment should remain as varied and as flexible as possible with greater focus on ensuring that firms have adequate frameworks, policies and procedures in place which are clear (as far as they can be) as to the deployment of these tools.

We agree that analysing and understanding investor behaviour in different circumstances is a useful point of reference. However, we would caution against over reliance on this as a liquidity management tool – behaviours tend to follow differing rationales (and are therefore often unpredictable) and will always depend on the specific set of circumstances.

Asset valuation is referenced at length in this section of the discussion paper. This is understandable given that asset valuation and liquidity are inextricably linked. We think it is important that it is made clear that asset valuation and anti-dilution measures are identified separately as considerations where the liquidity of a fund and its investments are under pressure and not as liquidity management tools per se. Furthermore, in relation to asset valuation and anti-dilution measures the discussion paper highlights the complexity of asset and fund pricing and the interplay between the two (particularly acute in the context of real estate funds). In this context we have observed a number different interpretations of the rules amongst our membership. We would welcome the opportunity to work with the FCA to help clarify the rules where ambiguity exists.

In relation to deferred redemptions it needs to be acknowledged that the current deferred redemption provision are not practical for daily priced funds (thus only allowing for deferral one day at a time) and hence why they are rarely, if ever used by real estate funds (or, we understand, by authorised funds more generally).

We agree that suspension of dealing is the most significant tool in terms of its impact on investors and other stakeholders but one that most if not all stakeholders have agreed was sensibly and usefully deployed by managers in the aftermath of the referendum result. The suspensions were nonetheless the subject of much 'bad' publicity and as such it is a tool which has been/is demonised by some commentators – efforts on the part of the FCA to help address/reverse this would be welcomed.

We agree that distribution can and does have an impact on liquidity management. Platform providers, also on the receiving end of much 'bad' publicity, are the means through which many retail investors get access to real estate funds which they would not otherwise be able to access. We would encourage the FCA to engage directly with the platforms as key stakeholders to gain a better understanding of how they operate and to identify opportunities for change/improvement which may help address the issues under review.

Treatment of professional 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?

It is acknowledged that institutional investors often have access to more, and more detailed information than retail investors, a function of the manner in which funds are distributed to them – in the case of the former, more often than not direct and in the case of the latter more often than not intermediated. Managers do engage with investors and provide fund information directly but where the relationship is an intermediated one, the extent to which this information makes it through to end investors and its timeliness is not within the control of the manager. All types of investors should be treated the same as far as possible, and fairly without exception.

We do not agree that retail investors and professional investors should not be allowed to invest in the same fund. In fact we think that to segregate in this way could compound the issues further and would remove some of the benefits of having a diverse client base e.g. diversification and scale.

We agree that managers should have adequate awareness of the make up the investors in their funds although acknowledge that obtaining this information from intermediaries is not straightforward – any assistance the FCA can offer in this regard would be welcomed. We are of the view that placing mandatory limits on how much certain investors can hold in a fund is unnecessary and in any case very difficult, if not impossible, to police. Managers should be allowed (and encouraged) to develop liquidity management policies and procedures which have regard to the types of investors (and their typical behaviours – noting the challenges with this stated above) in their funds in particular circumstances.

A particular problem with investor diversification limits is the disruptive consequences of remediating breaches. We would note that the 10% limit on corporate holders in a PAIF is an anti-avoidance measure imposed by HM Treasury. We do not consider it as a viable model for regulating investor diversification more generally. When PAIFs were introduced the industry developed a solution whereby corporate holders were required to access the PAIF via a feeder fund in order that they received the correct tax treatment. The consequences of a corporate's share of a PAIF reaching 10% are severe and the feeder fund allows them to be moved from the PAIF to the feeder without disrupting the underlying portfolio of real estate assets.

Portfolio structure and liquidity buffer

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

In our view liquidity buckets may be helpful but under stress scenarios may prove to be too subjective for funds holding illiquid assets. Furthermore, and generally speaking, when real estate markets are dysfunctional (as they were in the immediate aftermath of the referendum) the ‘dividing lines’ are likely to become blurred and the factors which influence asset liquidity may well be different which could have a significant and immediate bearing on the liquidity profile of the fund.

Retail property funds operate well diversified portfolios and the single largest asset in any of these funds is in the range of 3-6%, not close to any regulatory limit. Imposing restrictions on portfolio structure, the level of liquid assets or the liquidity profile potentially would create additional risk in the fund if it becomes necessary to adjust the portfolio or level of liquidity. Moreover, asset liquidity varies with changing market conditions and the onset of stressed conditions may shift assets along the liquidity profile. This might trigger a need to sell assets to adjust the profile just at the time that markets are least able to accommodate such a shift.

In our view, imposing additional structural requirements or restrictions as a response to a unique liquidity event is likely to be counter-productive overall. Managers need flexibility to manage liquidity in response to the specific shock being faced at the time. There is a material risk that greater restrictions, of the type described in the discussion paper, may not be appropriate to manage future liquidity shocks in different circumstances.

Asset valuation and anti-dilution measures

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

As observed in paragraph 4.20 there is a complex relationship between valuation and liquidity management. Currently valuation in accordance with the RICS Red Book does not take account of the circumstances for which the valuation will be used. Fair value adjustments are an effective tool for ensuring that assets are valued appropriately in the circumstances. However, some of our members have observed inconsistency by standing independent valuers (SIVs) in the process for implementing fair value adjustments. Where a manager has applied an adjustment to the valuation provided by the SIV of a real estate fund, particularly in circumstances where the SIV has qualified its valuation report, it seems counter-intuitive that the manager should be required to agree the reasonableness of the adjustment with the SIV. We would encourage the FCA to engage with valuation firms and the RICS to consider other approaches to the valuation of real estate – we would welcome the opportunity to be involved in this discussion.

The dilution-mitigating features of different pricing methodologies mean some methodologies perform better than others in given circumstances. The majority of retail property funds operate dual pricing because it provides the ability to set a pricing basis that reflects fund flows and at the same time to apply a different price to individual unit deals where appropriate via the large deal provision. Swinging pricing provides greater flexibility to widen the dilution adjustment to provide full protection in stressed sale conditions but is unable to accommodate differential prices for specific deals. The high level of transaction costs (principally Stamp Duty Land Tax) associated with buying real estate make mid pricing with a dilution levy inappropriate and it is not used by retail property funds. There would be benefit in reviewing the options available and considering a hybrid approach such as allowing a swinging priced fund to also apply a dilution levy in certain circumstances, thereby replicating the large deal provision. This is a complex area and we would welcome the opportunity to help the FCA explore these issues in more detail.

Use of specific tools

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

The existing FCA provision to defer redemptions to the next valuation point is of no benefit to property funds because it is insignificant in the context of the period required to sell real estate. It would be beneficial if deferrals could be made across multiple valuation points subject to a provision that investors must receive their proceeds within 185 days of their redemption request. Unlike full suspension this would enable funds to continue to issues units; an activity that would provide the much needed liquidity to mitigate redemption pressure and shorten, compared to full suspension, the delay in paying out redemptions.

We would encourage the FCA to refer to deferred redemptions being placed in a pool and not in a queue. Queuing implies preferential settlement of redemption requests in order of receipt whereas pooling facilitates the full or partial (i.e. pro-rata) settlement of all pooled requests as liquidity becomes available.

Developments in the distribution of funds has changed dramatically in recent years with the increasing significance of platforms and, in particular, the explosion in the use of model portfolios by the advice channels in response to RDR. This has led to a shift in the nature of the decision-making processes as model portfolio managers make allocation decisions on behalf of many underlying clients – such a model has features in common with institutional clients whereby a small number of decision makers can move large sums of money.

The FCA should be alert to the risk that fund managers are unable to manage relationships with model portfolios as they can with conventional institutional investors. For example, a fund manager and institutional client might agree an exit strategy whereby the client would unwind a large position in a fund in an orderly manner in the interests of both the client and the on-going fund. Without access to information about platforms' end clients it is not possible for fund managers to take such a proactive approach to immediate demand for redemptions. We would support a solution whereby fund managers receive access to information about the platforms' end clients.

With regard to redemption frequency and notice periods we share the view that this is unlikely to have a meaningful impact in practice for the reasons outlined in paragraph 4.27 of the discussion paper.

We would note in addition that the ISA Regulations prohibit the use of the range of tools made available to fund managers by the FCA, and that it would be helpful if the FCA were to

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encourage HMT to consider providing terms for property funds that facilitated the application of the FCA rules.

Direct intervention by the regulator

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?

We agree with the FCA's analysis of the possible benefits and risks of direct intervention by the regulator. Prior to the referendum and in the immediate aftermath, AREF facilitated regular discussions between managers of property funds and kept the FCA and the Bank of England informed. It has been suggested that it would in future be helpful if the FCA were to be more active in setting out their expectations of managers at an earlier stage.

Enhanced disclosure

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

We note the FCA's observation that pre-sale disclosures are not yet standardised for authorised funds other than UCITS. However, regulations are now enacted that will standardise such disclosures from the start of 2018. Funds other than UCITS will be able to provide a UCITS-style KIID in accordance with the FCA rules set out in the Policy Statement PS17/6 or a PRIIP KID in accordance with EU Regulations. Both options include specific disclosure requirements in respect of liquidity of the underlying assets.

In our experience fund managers currently make appropriate disclosures about liquidity risks in the pre-sale documentation. However, this does not extend to trying to predict the specific circumstances in which such risk might crystallise. We would caution against being overly prescriptive as to the disclosure of specific circumstances which may trigger liquidity issues as this in itself would need to carry a significant 'health' warning.

Secondary market provision

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?

Secondary market trading would introduce additional costs, disclosure requirements and potentially conflicting regulatory regimes with no certainty of the price that liquidity would be obtained at, if at all.

Currently there are three models for secondary trading: two involving trading units on formal stock exchanges and a third relying on informal matching facilitated by fund managers or third party brokers. In the latter, stressed market conditions tend to cause liquidity to recede or to be available only between forced sellers and opportunistic buyers at significantly discounted prices.

Trading funds on-exchange can take two forms. Firstly, the investment trust model of a closed-ended fund trading at a market price that may be at a significant discount or premium to its NAV. Although the long-term performance tends towards that of the underlying assets, investors with immediate or short-term liquidity needs might find themselves exposed to significant discounts as a consequence of wider market sentiment unrelated to the underlying asset class.

Secondly, the exchange-traded fund model of an open-ended fund with a mechanism to control the supply of units on the exchange in order to ensure its market price does not vary significantly from its NAV. Such mechanisms usually involve the issue or cancellation of units by in specie transfer of the underlying investments. It is difficult to see how such a mechanism could exist for a property fund.

It would appear that under stressed conditions secondary market trading is likely to offer liquidity only at significantly discounted prices. Under normal market conditions it is difficult to see a demand for a secondary market as investors would ordinarily trade their units through the manager.