The Association of Investment Companies

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Illiquid assets and open-ended funds

The AIC's response to DP17/1

The Association of Investment Companies (AIC) is the trade association for the closed-ended investment company sector, representing 344 investment companies with £150bn of assets under management. Investment companies are closed-ended collective investment funds whose shares are publicly traded, usually on the main market of the London Stock Exchange. They invest in a broad range of assets including listed equity, unquoted shares of SMEs, property, infrastructure and debt (including business-to-business loans).

The risks posed by open-ended funds investing in illiquid assets were seen after the EU Referendum vote in 2016 when fund managers took the decision to 'gate' large property funds. Work by the Financial Stability Board (FSB) has highlighted the risks for wider financial stability of funds that invest in illiquid assets and offer daily redemptions. At the same time, there is a growing desire from the government to increase investment into illiquid assets and an increasing investor demand for alternative assets as part of a search for yield.

To facilitate effective exposure to illiquid assets, the AIC makes two **recommendations** that the FCA should consider requiring:

- that the design of new products should take account of whether the structure of a fund is appropriate for its underlying assets; and
- there should be clear disclosure to retail investors of the risks posed by open-ended investments funds that invest in illiquid assets.

Open-ended versus closed-ended funds

The risks created by an open-ended structure investing in illiquid assets such as property or infrastructure are set out clearly in DP17/1. This is not a theoretical risk for consumers. Following the Referendum vote last year most of the largest open-ended property funds were closed for varying periods of time or only permitted withdrawal of investments with the imposition of price adjustments (see Annex). Yet the Referendum vote was not a financial crisis and had a relatively small effect on markets. During the financial crisis at least one property fund closed and never re-opened. Temporary fund closures deny investors the ability to change their investments if needed. These risks to consumers are inherent in products that offer daily liquidity but invest in assets which cannot be sold rapidly to meet increased withdrawals.

The managers of open-ended funds can put in place a variety of protections to avoid the situation of being unable to meet withdrawals. However, these may come at a cost to investors. For example, holding a buffer of liquid assets is likely to reduce the return made by the fund. Other protections, such as only allowing redemptions if a price adjustment is made, could significantly reduce the payout that a consumer receives and raises questions about protecting the interests of different groups of investors.

Closed-ended funds such as investment companies which invest in illiquid assets do not present the same risks to consumers. Investors buy shares which are traded on a regulated market, not units in a fund. Changes in demand do not result in the fund changing in size and

there is no need to trade the assets in the fund. Instead, investors buy and sell their shares through secondary markets, primarily the London Stock Exchange. Changes in demand will be reflected in the share price.

Closed-ended funds do not have to maintain the same liquidity buffers as open-ended funds. Nor do closed-ended funds have to consider the other actions used by open-ended funds to tackle liquidity risks.

A comparison between open and closed-ended property funds shows that open-ended have far higher holdings of cash, so are not fully invested (see Annex). A recent article in the Financial Times set out the cash holdings of major UK open-ended property funds. These ranged from 17.7% to as high as 29.5% of the fund's total assets. This will mean that investors who aim to earn income from investing in property will only have between 70% - 80% of their investment deriving income from property. The remainder will be in cash and earning a very low return. This level of cash in the fund could also impact upon an investor's planned asset allocation and their exposure to property will be lower than they expect.

The 'cash drag' from liquidity buffers is one of the reasons why closed-ended funds investing in property typically outperform open-ended (see Annex). Choosing a closed-ended fund structure for investing in illiquid assets not only lessens the risks for consumers, it is also likely to produce a better return.

Addressing the risks of open-ended funds

There are significant sums invested in open-ended property funds. Substantial regulatory changes to existing funds could risk investors being stuck in funds where the nature of their investment has changed. The FCA should consider options for future launches of funds and measures that would apply to existing investments in open-ended funds.

Product Design

When launching new products to invest in illiquid assets, product manufacturers should assess the structure for the fund and whether it is appropriate for the assets in which it invests. This was an FSB recommendation.

In its paper (*Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*) the FSB recommends that: "*authorities should have requirements or guidance stating that funds' assets and investment strategies should be consistent with the terms and conditions governing fund redemptions both at fund inception and on an ongoing basis*". In explaining this recommendation, the FSB notes that "*If a fund's investment strategy involves holding a substantial amount of illiquid assets the relevant authorities could consider requiring that the fund impose restrictions on redemptions, offer less frequent redemptions or be organised as a closed-ended fund*".

Under MiFID, the Commission Delegated Directive (of 7.4.2016, Article 9) requires a MiFID manufacturer to establish procedures to ensure that the design of a financial instrument "*does not adversely affect end clients"* (Article 9 (2)).

In addition, *"Member States shall ensure that investment firms consider whether the financial instrument may represent a threat to the orderly functioning or to the stability of financial markets before deciding to proceed with the launch of the product+* (Article 9 (4)).

Article 9 (10) requires a scenario analysis to %*assess the risks of poor outcomes for end clients posed by the product and in which circumstances these outcomes may occur+*.

Article 9 (6) requires firms to ensure that compliance reports to their management body %*systematically include information about the financial instruments manufactured by the firm, including information on the distribution strategy. Investment firms shall make the information available to the competent authority on request+*.

Article 9 says that %*Member States shall require investment firms to comply+* with Article 9 when they manufacture financial instruments. In order to comply, product manufacturers should have to consider whether the structure they propose for a product could impact upon the stability of the market and whether it will deliver the right outcome for investors. Firms must be able to justify their choice of structure. In turn, the FCA will need to provide clarity about its expectations for product design. This should be done by providing guidance when it introduces MiFID.

Through its supervision, the FCA will be able to assess firmsqadherence to this requirement. This will ensure that firms fully consider the appropriate structure for new funds. It may also lead to better returns for consumers overall, if more closed-ended funds are launched.

The AIC **recommends** that the FCA ensures that when a manufacturer launches a new fund for retail investors that invests in illiquid assets, it must be able to demonstrate that it has considered the most appropriate structure for that fund. This should include consideration of whether:

- the structure will create liquidity mismatch risks;
- the redemption policy is appropriate for the fundqs assets; and
- it will deliver the best outcome for consumers and the objectives of the fund.

The AIC also **recommends** that the FCA requires that the outcome of this consideration should be published in the fund prospectus or similar public disclosure.

Product Disclosure

DP17/1 discusses ±enhanced disclosureq and notes that it is unclear whether investors understand the risks of open-ended funds. Disclosure requirements will increase from next year through PRIIPs and MiFID and may help to address this issue.

Under MiFID, the Commission Delegated Directive (25.4.2016, Article 48 (1)) requires the disclosure to clients of %*a general description of the nature and risks of financial instruments…..*[including] *the functioning and performance of the financial instrument in different market conditions, including both positive and negative conditions, as well as the risks particular to that specific type of instrument in sufficient detail to enable the client to take investment decisions on an informed basis+*. Article 48 (2)(c) requires the provision of %*information on impediments or restrictions for disinvestment….*[including] *possible constraints and the estimated time frame for the sale of the financial instrument before recovering the initial costs of the transaction in that type of instrument+*.

PRIIPs includes liquidity risk as part of the summary risk indicator (SRI). If the product presents a liquidity risk or is illiquid then the SRI must include a statement warning about this. A product would be considered to have a materially relevant liquidity risk where the liquidity of its underlying investments is less than its reimbursement frequency or it may be difficult to divest under certain market conditions. It is considered illiquid if the manufacturer can restrict the ability of investors to exit their investment.

Although the FCA cites concerns about the effectiveness of disclosure, it is important that retail investors are given sufficient information to enable them to understand the features and risks of open-ended funds which invest in illiquid assets. It is likely that many are unaware of the risk that they will not always be able to exit a fund at the time of their choosing. Products where the manufacturer has the ability to restrict redemptions clearly fall under the criteria set out in Article 48 above and the criteria for the PRIIPs SRI. Compliance with MiFID and PRIIPs will ensure that firms make clear disclosures about this risk.

The AIC **recommends** that the FCA ensures, through its supervision of firms, that firms comply with MiFID and PRIIPs and that retail clients are given appropriate information about the risks of open-ended products with illiquid investments.

Converting open-ended to closed-ended funds

One of the questions raised by the FCA is whether open-ended funds can convert to a listed closed-ended fund. The AIC is unaware of any funds having made such a change. Whilst this could be a long-term solution for addressing illiquidity in an open-ended fund, it is unlikely to be a suitable response to sudden changes in a fund or the market. The current timetable for listing on a public market would prevent a rapid change to a closed-ended structure.

There would be a significant number of practical considerations to be addressed. Initially it is likely that the fund would have to obtain the approval of the FCA and/or the investors. The process of listing is likely to create significant costs for the fund and the manager may have to secure the agreement of investors to that investment. The governance structure of the fund would have to be changed with the introduction of an independent Board. While these issues may not be insurmountable, they may be sufficient to deter open-ended funds from considering that option. It is unclear whether any of these requirements could easily be removed, without potentially harming the interests of investors. In addition, some platforms that host open-ended funds are unable to hold listed entities, which would require investors to move their investments. The FCA could consider this issue as part of its platform market study.

The FCA should not only seek to mitigate problems arising from holding illiquid assets in open-ended funds. It should also seek to stop these problems arising by ensuring that the fundamental design of products is appropriate and that investors in existing funds have access to sufficient information to understand the risks.

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To discuss the issues raised in this paper please contact:

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Annex

1: Actions taken by open-ended funds after the Referendum vote

Fund	Size*	Action taken post-EU referendum
M&G Property Portfolio	£4.0bn	Suspended from 5th July until 4th November (91 days / 13 weeks)
L&G UK Property	£2.6bn	Price adjustment of -15% announced on 7th July, removed on 8th September by which time adjustment had been reduced to -7.5% (63 days / 9 weeks)
Aberdeen UK Property	£451m	Fund suspended on 5th July until 13th July. Initial price adjustment of -17%, gradually reduced and removed on 30th September (87 days / 12 weeks)
Aviva Investors Property	£1.3bn	Suspended from 5th July until 15th December (163 days / 23 weeks)
Henderson UK Property	£1.0bn	Suspended from 6th July until 14th October (100 days / 14 weeks)
Standard Life UK Real Estate	£509m	Suspended from 5th July until 17th October (104 days / 14 weeks)
Threadneedle UK Property	£215m	Suspended from 6th July until 26th September (82 days / 11 weeks)

Source: Fund group websites and press reports. Fund sizes are current as at 20/4/2017 and from Morningstar.

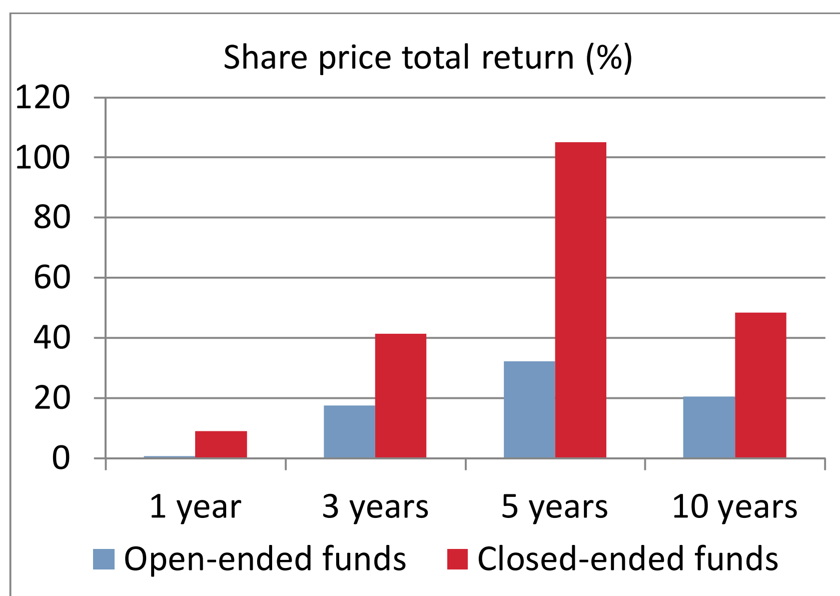
NB: the fund sizes shown above do not include the associated feeder funds . ie the part of the fund which is only available to wholesale investors. All the funds above, with the exception of Aviva Investors Property, have associated feeder funds. In some cases the overall value of the funds is significantly in excess of the figures shown above.

2: Asset distribution, open vs closed-ended property funds

	Open-ended IA Sector: Property Morningstar: Property Direct UK	**Closed-ended** AIC Sector: Property Direct – UK Morningstar: Property Direct - UK
Direct Property	**86%**	**97%**
Shares	**1%**	**0%**
Cash	**13%**	**3%**

Source: Fund factsheets / AIC website, October 2016

3: Open-ended vs closed-ended performance



Source: AIC using Morningstar (periods to 31/3/17), showing arithmetic average returns. Clean share classes used for open-ended funds.