Protecting consumers and limiting systemic risk

Governance and accountability for funds holding illiquid assets

The unfortunate suspension of Woodford Equity Income Fund raises questions over how potential consumer harm and systemic risk can be minimised where funds are used to access illiquid assets. Also, the FCA must maintain confidence in these assets (which offer superior long-term returns, alternative sources of income and additional diversification). These goals will be best achieved by preventing problems from liquidity mismatches arising in the first place. The regulatory response should not be limited to managing problems once they arise.

The AIC has previously recommended (in response to CP 18/27) that the FCA should require firms designing Funds Investing in Inherently Illiquid Assets (FIIAs) to assess whether the structure chosen is most likely to meet consumer needs and deliver on the commitments made to investors. Recent developments indicate that this type of assessment should be required in any situation where an open-ended fund is intending to, or does, offer exposure to illiquid, or otherwise hard to sell, assets.

The AIC **recommends** that the board (or other governing body) of an Authorised Fund Manager offering an open-ended collective investment scheme with investment powers that allow it to hold illiquid, or otherwise hard to sell assets, be required to assess, record and publish its view on why the structure adopted is in the best interests of consumers.

This should be done before the scheme is made available to investors. These conclusions should be reviewed annually. This builds upon the FCA's approach to ensuring that AFMs act in the best interests of investors. From October this year, the FCA is requiring AFMs to consider annually if funds offer 'value for money' and to publish their conclusions. AFMs should also assess, and publish their conclusions on, potential liquidity mismatches and if appropriate mechanisms are in place to manage them. This would involve reviewing, for example, the composition of the underlying portfolio, liquidity 'buffers' and redemption policies. The process should also consider the impact of liquidity management on performance, particularly where high levels of 'cash' holdings mean consumer expectations are not being met and/or the fund is materially underperforming the asset class or competing products.

This process would create a mechanism to protect against future suspensions and ensure that funds meet consumer needs. Depending on the conclusions of this process, the AFM could act to alter the underlying assets, liquidity profile, redemption policy or even change the overall structure (for example, to become closed-ended) to stop suspensions being required and ensure appropriate performance. This approach is proportionate. It does not bar open-ended funds from holding illiquid assets. Instead it ensures that funds are designed in an appropriate manner, with the needs of consumers given proper weight. This measure can be introduced without altering the UCITS rules. Critically, this approach provides the basis for accountability if situations do arise where high levels of redemption requests result in fund suspensions.

The FCA's review of the RDR should consider similar mechanisms for advisers and, potentially, other distributors. That is, advisers recommending access to illiquid assets should be required to explicitly consider if the structure of funds they are recommending (including their redemption and liquidity management policies) is appropriate for their clients.

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