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Don’t let the tail wag the dog

Follow the evidence and set adequate notice periods for property funds

November 2020

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AIC response to:
Liquidity mismatch in authorised open-ended property funds.
FCA Consultation – CP20/15

Don’t let the tail wag the dog

Chief Executive’s foreword

The consumer harm caused where open-ended funds offer frequent redemption while holding hard-to-sell (illiquid) assets is more apparent than ever. Woodford Equity Income Fund, which held unquoted shares, is still in the torturous process of winding up, leaving investors with a long wait to get their money back. Much of the open-ended property fund sector has been suspended for over eight months. These painful episodes had given me hope that regulators would, at last, be fully committed to tackling these issues. Unfortunately, the Financial Conduct Authority’s (FCA) proposals on property funds give me pause for thought.

The problem with funds holding hard-to-sell assets while offering frequent redemption is that it creates a so-called liquidity mismatch. Fund operators are unable to sell assets quickly enough to pay investors who want to leave the fund. This creates incentives for more savvy investors to make the first move to leave, which can lead to a run on the fund, destabilising it and disadvantaging those who do not sell. Harm includes fire sales of assets and suspensions. In the worst case, these effects spill over, undermining asset values in other parts of the market and creating economic instability.

In January 2020, the AIC published Square peg in a round hole which explored these issues. It also proposed a way to address them. Regulators should require providers to offer ‘reliable redemption’. This means ensuring that product providers do not change the basis on which consumers can sell out of a fund, irrespective of how many want to do so. It would also prevent fund operators delivering redemptions by selling assets on the cheap to raise cash (this is particularly harmful for those who choose to remain invested). Our approach would also require fund operators to deliver redemptions in both good and poor markets. This is not an unreasonable demand. Many consumers would be surprised that funds are not already held to these standards.

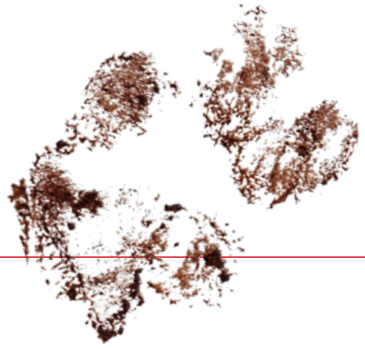
The concern is the FCA's view on how long notice periods should be.

Since we set out our proposals, the COVID-19 economic shock has provided a further example of the problems of liquidity mismatches. The Bank of England's August Financial Stability Report explained how liquidity problems had arisen in the early stages of the crisis, causing funds to experience large redemptions, affecting asset values and potentially transmitting stress to the rest of the economic system. Only unprecedented action by the authorities prevented more serious problems emerging. The Bank reaffirmed its commitment to working with the FCA to address these issues.

So why do I have my doubts?

At first glance, the proposals in the FCA's consultation paper Liquidity mismatch in authorised open-ended property funds, or CP20/15, are a major step in the right direction. They centre around notice periods, which is a key mechanism the AIC identified to deliver reliable redemption. However, a closer look gives serious cause for concern that the proposals will not tackle the root cause of the problem.

The concern is the FCA's view on how long notice periods should be. Looked at from first principles, notice periods should be long enough to allow property funds to sell assets in an orderly way. This removes the critical liquidity mismatch which is the origin of harm the regulator is trying to prevent. Unfortunately, on a reasonable reading of the data available, a 180 day notice period is far from long enough. 180 days is not sufficient to sell around half the commercial properties held by the sector. For individual funds, this timetable will be even more impractical as they have fewer holdings to choose from. The number of properties that each fund holds, and that could be sold within six months, will decline with each transaction. The discussion of transaction times in CP20/15 is so cursory it is difficult to conclude this has been central to determining the FCA's proposals on the length of notice periods.



For the FCA to consult on such limited notice periods is a worry. It consulted on liquidity mismatches following the Brexit referendum. The rules it introduced to solve these problems had not come into effect before circumstances forced it to bring forward new proposals.

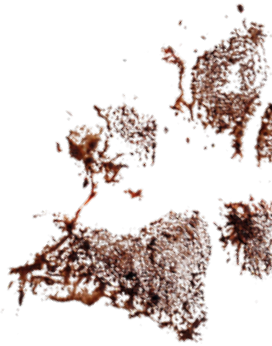
The fact that its proposals again look inadequate suggest that other concerns may be unduly influencing its approach. As the expression goes, it seems to be letting the tail wag the dog. CP20/15 includes more discussion of the impact of notice periods on ISA inclusion, advisers, platforms, providers of model portfolios and SIPPs than it does on how long it might take funds to sell assets to raise cash for redemptions.

The impact of reform on service providers is significant but secondary. The first priority is to make property funds reliable and safe. Achieving this will mean that the market, and consumers, have to adapt to a new normal. But we should remember, the only reason that significant adjustments have to be made today is because providers developed and distributed property funds in the past that have not delivered what they promised.

The FCA is under new leadership. Getting right its response to property fund liquidity mismatches will signal to providers that they must think about broader consumer and regulatory needs when developing products. This would be a great start to the new era. It would show that the regulator is keen to set a new direction, one that better balances the needs of consumers and the broader economy with the commercial interests of providers.

Ian Sayers
Chief Executive
The Association of Investment Companies

The first priority is to make property funds reliable and safe.



1. Executive summary

Effectively managing and mitigating liquidity mismatches in open-ended property funds is essential to protecting consumers and ensuring financial stability. Imposing adequate notice periods on redemptions is the key regulatory mechanism to deliver this.

The evidence indicates that a notice period of 180 days is too short to sell properties in an orderly way. It is therefore insufficient. The data certainly rules out notice periods as short as 90 days. It is surprising this shorter period has been suggested at all. The discussion of notice periods in CP20/15 suggests that other, secondary, factors may be unduly influencing the FCA's view.

Authoritative industry research acknowledges that the data tends to underestimate the time taken to sell properties as it does not cover all the processes involved. The data also does not cover properties that are withdrawn from the process or are otherwise not amenable for sale. Were these factors captured, transaction times would be significantly longer.

A 2004 research paper (see Key data sources on page 12) finds that, even with a dataset biased in favour of the most easily saleable properties, and excluding parts of the process, the average transaction time is 289 days. This exceeds the longer notice period proposed in CP20/15 by three months. This is strong evidence that the FCA's proposals are inadequate, particularly as the research does not explore the impact of poor market conditions, which could lengthen transaction times considerably.

40% of transactions would take longer than eight months.

Over the economic cycle, fund operators will not be able to be confident of selling properties within 180 days to secure required liquidity.

The evidence indicates that a notice period of 180 days is too short to sell properties in an orderly way.

As transactions are completed, the overall liquidity of each individual fund will decline, making it more difficult for it to avoid liquidity mismatches in the future if there is sustained demand for redemptions.

CP20/15 cites a finding from 2014 research (see Key data sources on page 12) that "*60-90 days is the most common period for a property to be sold from when it is first marketed*". This is not sufficient evidence to determine the FCA's regulatory response. It relates to just 11 transactions. Another finding from the same paper is that the average time from marketing date to completion date was 165 days. It concludes that the timetable from marketing to completion for the least liquid assets took 355 days. It also says that transaction times will be longer for certain properties because of their specific characteristics. They will also lengthen during downturns in the economic cycle.

There is no reason to believe that changes in the market may have shortened transaction times. The most recent industry view is that, where processes are streamlined and transaction times are optimised, selling commercial property could take up to 252 days.

The timetable from marketing to completion for the least liquid assets took 355 days.

The arguments advanced by the FCA to support a maximum notice period of 180 days are unconvincing. These include flawed and unrealistic comparisons between property funds and deposit accounts and incorrectly linking the risks arising from longer transaction times with the length of notice periods.

Other issues are given significant, and unwarranted, prominence in the discussion. This includes the impact of notice periods on platforms, model portfolio providers and Individual Savings Accounts (ISAs). Creating a framework that makes property funds safe and reliable for investors and the financial system should be the FCA’s overriding priority. The commercial preferences of providers of financial services and products should be second-order issues.

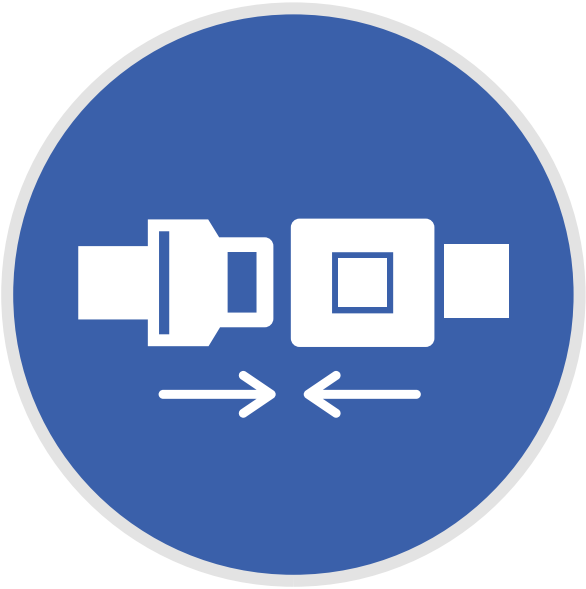
Getting notice periods right will protect consumers. It will also create a market where they have genuine choice; a choice between open-ended property funds with appropriate notice periods and an exit at Net Asset Value (NAV) versus competing products, such as investment companies (including UK REITs), which offer an immediate exit at a price set by the market. Consumers will retain access to property investments, but this will be achieved in a fair, safe way.

The FCA's proposal to introduce notice periods to prevent liquidity mismatches in open-ended property funds will only be effective if sufficient notice periods are imposed. The AIC **recommends** that notice periods of 12 months be adopted. This model reflects the German regulatory approach, which has proven to be commercially successful while also protecting consumers.

Given this real-life example, and recent experience in the UK market, the FCA should explain why it is confident it does not need to adopt notice periods of 12 months in order to protect consumers and the wider economy. At present, notice periods are primarily a matter for providers to determine. Once the FCA prescribes a period, the balance of responsibility shifts. If, as we believe, 180 days is inadequate to prevent widespread suspensions in stressed market conditions, consumers and other stakeholders will rightly question why the German model was ignored when the evidence so clearly supports a 12 months' notice period.

Adopting the AIC's recommendations will deliver the FCA's objectives, protect consumers and secure a proportionate commercial outcome.

The FCA should explain why notice periods of 12 months are not needed to protect consumers.



2. Evaluating the evidence

CP20/15 identifies the outcomes the FCA is seeking to achieve by addressing potential mismatches in liquidity in open-ended property funds. (see paragraph 2.15). These are to reduce the:

• likelihood of suspensions because of a lack of liquidity;

• harm for consumers who remain within the fund; and

• likelihood that consumers buy products that may not suit their needs.

Ensuring that property funds effectively manage and mitigate liquidity mismatches is essential to achieving these outcomes. Imposing sufficient notice periods is the key regulatory mechanism to deliver this.

It is welcome that the FCA has now accepted the principle of requiring notice periods to resolve the problems with liquidity mismatches. It is therefore all the more disappointing that its starting position is to propose a maximum notice period no longer than 180 days.

The FCA has indicated that it will consider arguments for longer periods, but the fact that it is consulting on proposed rules creates fears that it may be narrowing the options prematurely. The draft rules, alongside the supporting arguments advanced, create an impression that it sees 180 days as the longest period that is likely to be required to mitigate liquidity mismatches and deliver on its objectives.

The FCA should think again. It should consider the required length of notice periods from first principles. That is: how long is required to sell properties (considering their idiosyncratic characteristics and the impact of the economic cycle); and what are the implications of the length of the notice period.

The evidence indicates that a notice period of 180 days is inadequate to sell properties in order to meet investor redemption requests in an orderly way. This being the case, the FCA should certainly rule out a notice period as short as 90 days.

The FCA should think again.

The substantive discussion in CP20/15 on the academic evidence on the time taken to sell properties is limited to one short paragraph (para 3.22). It cites "*One paper*" (without a specific footnote) saying that this research finds that "*60-90 days is the most common period for a property to be sold*". The supporting commentary does note that this finding may be "*skewed*" because of issues with the data and that "*in many cases it can take significantly longer*" to sell properties.

The decision not to explore the evidence on transaction times more fully in CP20/15 is surprising. This issue is central to setting an effective notice period. Reviewing the evidence indicates a somewhat different view of the time required to sell commercial properties in an orderly process.

Key data sources

Evidence that 180 days' notice is insufficient to prevent unacceptable liquidity mismatches for funds holding direct property is provided in two authoritative research papers:

- Liquidity in Commercial Property Markets, Research Findings, April 2004, Investment Property Forum (IPF). This document includes five working papers. Particularly significant is Working paper two: Deconstructing the Transaction Process, Research Findings. April 2004.
- Time to Transact: Measurement and Drivers, September 2014, Investment Property Forum (IPF) Research Programme 2011-2015. This follows up Liquidity in Commercial Property Markets and looks at a wider range of factors than the earlier paper. It explicitly references the 2004 research and seems to be the one referenced in CP20/15.

This research indicates that property funds would need more than 180 days to arrange for orderly sales of many of their property holdings to provide liquidity across the economic cycle. The indication is that it would take longer than 180 days to sell nearly half, if not more, of commercial properties held by open-ended funds.

Partial coverage of the sales process

It would take longer than 180 days to sell nearly half, if not more, of commercial properties held by open-ended funds.

These studies acknowledge that they underestimate the time taken to sell properties. One reason is that the data collection does not cover all the processes involved.

The 2004 study findings are based on 187 transactions. The authors identify various stages in the process (page 37):

Stage 1: Property portfolio decision to sell a particular sector or sub-sector

Stage 2: Decision to sell a particular asset

Stage 3: Pre-marketing period

Stage 4: Marketing period

Stage 5: Due diligence period

Stage 6: Exchange to completion.

The transaction period in the data is based upon the first record of the proposed sale to completion (see page 32). The authors note that the first record of a transaction is often when an agent is appointed. In reality, this will not be the start of the process. Other activity is usually required before this point. It is difficult to generalise about the time taken for these processes because of the idiosyncratic nature of the assets. Other factors, such as the reasons for a sale and the composition of the owner's portfolio, are also relevant.

This caveat over the data offers a first reason to conclude the transaction timetable identified by the research is optimistic. A prudent regulatory approach would assume that extra time, perhaps even a month or two, should be added to any figures to reduce the potential for a liquidity mismatch.

Bias towards deliverable transactions

The authors of the 2004 IPF research state that the data used in the paper "*will almost certainly exclude some properties that were withdrawn from sale and never brought back to the market. As a result, the data presented here will tend to understate the total length of the sales process*" (page 32). This is a second, and more significant, reason to conclude that the findings on the timetable to sell commercial property identified in the research are optimistic. CP20/15 notes that there is a "*skew in the distribution of time taken*" but does not give this issue sufficient emphasis.

The authors of the 2004 research observe "*Properties are sold because they can be… A large number of prospective problems… which may inhibit sales, are identified in Stages 2 and 3 of the decision making process – therefore the number of aborted sales in the database appears low*" (page 37). They continue "*if sales were a sample of all properties in portfolios, it would be expected that they would include more properties with attributes which inhibit sale and, therefore,* ***potential time to sale would extend well beyond those observed average times for the actual sales.***" **[emphasis added]**

This is a critical issue. Its regulatory significance is magnified as the liquidity of each individual fund's portfolio will decrease over time if it experiences net redemptions. The fund operator will be obliged to sell their most attractive holdings. The remaining properties will be less liquid. Again, this should predispose the FCA to a prudent approach that favours a longer notice period.

Conclusions of the 2004 research

40% of transactions would take longer than eight months.

The 2004 report notes (on page 37) that:

"*Over the whole data the average transaction time is 298 days, over 9 months. However, this average is skewed by a small number of transactions of very long transactions and* ***the median transaction time is 190 days****, or just over 6 months. Around 25% of transactions take between 50 and 100 days and 60% get completed within 8 months.*" **[emphasis added]**

This extract gives a very different impression of the time taken to sell commercial properties when compared with the comment on transaction times in CP20/15:

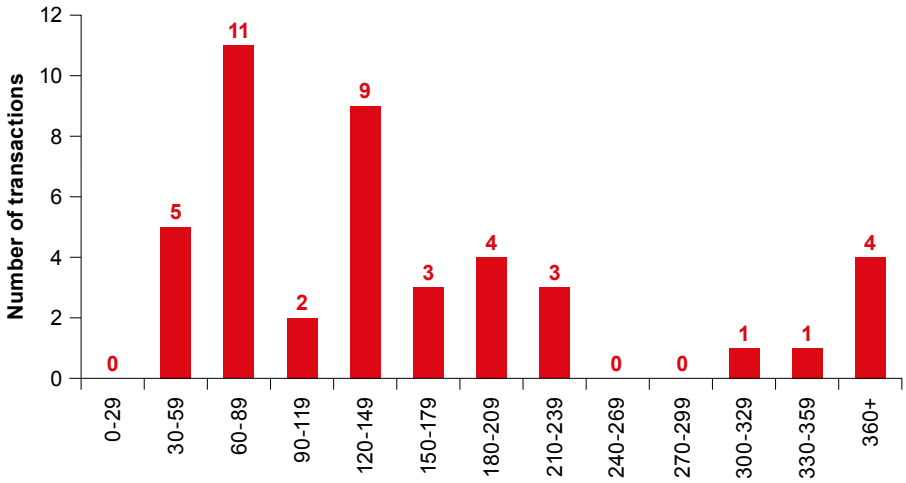
- Even with a dataset biased in favour of the most easily saleable properties, and excluding the earliest stages of the process, the average transaction time (298 days) exceeds the longer notice period (180 days) proposed in CP20/15 by 3 months.
- The average transaction time can only be brought close to the proposed 180 day notice period by excluding more difficult transactions. There is no regulatory justification for doing this. The underlying data is already significantly skewed towards excluding properties that cannot be sold. The number of properties that cannot be sold would, doubtless, increase in weaker, albeit unexceptional, market conditions. Such market conditions would increase demands for redemption and increase the risks of forced sales from a limited pool of properties. This enhances the need for a prudent regulatory approach and indicates a longer notice period is required.
- Even on the data available, 40% of transactions would take longer than eight months. This not a small proportion of commercial property assets. It is a substantial component. It indicates that, over the economic cycle, fund operators are unlikely to be able to rely on selling properties within six months to secure required liquidity. The FCA should also be concerned that after transactions are completed, the overall liquidity of the fund will decline, making it difficult to avoid liquidity mismatches in the future if there is sustained demand for redemptions.

The problem of declining liquidity is just one dimension of the risk to consumers. The character of the fund would change, with retail investors being progressively shifted into a different type of property exposure (less liquid and riskier). This will make it more likely they will be harmed by remaining in the fund and end up being invested in a product that is not suitable for them.

A more balanced view of the 2014 data

The 2014 research seems to be the source of the observation in CP 20/15 (para 3.22) that "*60-90 days is the most common period for a property to be sold from when it is first marketed*". The comment relates to the chart shown in Fig 1 (below). While it is an accurate description of this specific datapoint, it does not justify setting a notice period at 90, or even 180 days.

Fig 1: Distribution of time in days (marketing to completion)



Source: Time to transact - Measurement and drivers, Page 19, International Property Forum, September 2014.

- The data covers 43 transactions. Of these, 16 took less than 90 days. This is an insufficient sample to support a regulatory conclusion that 90 days might be a sufficient notice period. The data is already skewed towards transactions that can be completed, and therefore does not include the entire sales process. The size of the sample also seems inadequate given it covers a period of some 10 years.
- A prudent regulatory view would not focus on the small part of the data that supports a shorter notice period. It would recognise the risks highlighted by this research – namely that 37% of transactions recorded took over 150 days. This is a substantial proportion of transactions. Again, this is especially significant given the skew in the data.
- Separate data in the 2014 report (see Table B3, page 42) shows that the average time from marketing date to completion date was 165 days.

- Commentary supporting the data indicates that funds facing sustained redemptions, which required asset sales to be undertaken, would see transaction times increase and the liquidity of the portfolio decline. The paper notes that more attractive assets tend to be sold more quickly, stating "*Top quality offices… were quicker to transact than other offices, while lower quality offices… and portfolios of buildings took longer to transact*" (page 32).
- The data for marketing to completion show that the least liquid assets (90th percentile) took 355 days to navigate the process. So, a year or more was required for a material number of transactions, even in a self-selecting group of properties where any sale was possible.

These findings indicate that the evidence cited in CP20/15 should not be used as the basis for a regulatory conclusion on the required length of notice periods. Rather, the research findings as a whole reinforce the conclusion that, for many properties, a transaction within 180 days will not be possible. In turn, a notice period of 180 days is too short to deliver the FCA's regulatory objectives.

The research findings as a whole reinforce the conclusion that, for many properties, a transaction within 180 days will not be possible.

The specific characteristics of properties offered for sale

The rules also need to accommodate funds that specialise in properties that are inherently less liquid. This could be because of, for example, their location, commercial type or value. While the data does not provide clear insight into these issues, the authors do consider these factors. For example, the 2014 research comments "*it also appears that transactions outside London and the South East take longer*" (page 24). The research also concluded that "*Price agreement was reached much more quickly for small lot sizes (below £10m) than for properties in larger lot size bands*" (page 32). Also, that "*Shopping centres took longer to transact than other types of property, while standard retail units and standalone retail warehouses transacted more quickly*" (page 32).

If notice periods are not set by reference to the liquidity of the fund's specific portfolio, a prudent regulatory conclusion is that notice periods must be long enough to suit funds irrespective of the assets held. This again indicates that notice periods longer than 180 days are required.

Impact of the economic cycle

The FCA has recognised that open-ended property funds must have redemption arrangements that operate in weaker as well as strong markets. Edwin Schooling Latter, Director of Markets and Wholesale policy observed, "*Fund structures need to be such that they work through the economic cycle*" (Open ended funds investing in less liquid assets, speech by Edwin Schooling Latter, Director of Markets and Wholesale Policy, 19 March 2020).

Ensuring redemption operates throughout the economic cycle requires an appropriate notice period given that the 'first mover' incentives that destabilise open-ended funds are particularly strong during poorer market conditions (for further discussion of first mover incentives see Square peg in a round hole, page 8).

The 2014 research observes "*The assumption would be that in deteriorating markets where there are fewer buyers relative to sellers, prices fall and fewer real estate transactions occur*" (page 20). The authors support this position with data from the purchasers' perspective. They note that "*transaction times lengthened as the* [2009] *downturn commenced and continued to lengthen during the recovery* [to June 2011]". The authors also say that the data "*does not include time lost in withdrawn or aborted transactions. According to RCA/PD data… the proportion of aborted deals rose during 2008 (deals that might have begun during the boom phase of the market). Thus, liquidity will have reduced much more in the downturn than figures on time to transact can indicate alone*" (page 21).

Slowdowns in transactions are a normal part of the economic cycle. They are not 'exceptional' circumstances (such as those created by COVID-19). The regulatory requirements for open-ended property funds should accommodate these normal changes in market sentiment. This once again supports the conclusion that 180 days is insufficient to sell properties in an orderly process.

Streamlined property transactions

Fund structures need to be such that they work through the economic cycle.

The IPF published Streamlining transactions: Improving liquidity in commercial real estate (November 2018). It sets out best practice to speed up the process for selling and buying UK real estate and minimise execution risk. It provides an industry view of how long commercial property could take to sell if best practice were followed. This perspective is inherently optimistic because the timetable indicated will only be achieved in optimum circumstances. These include where:

- Both the buyer and the seller seek to facilitate a smooth transaction process. As the paper puts it "*At the start of the transaction the onus lies with the seller to streamline the process but, as the transaction progresses, there is an expectation that both seller and buyer will facilitate the sale and acquisition process*" (page 1). Just from a practical perspective, it seems unlikely that this will always be the situation. After all, the fact that best practice is not being achieved is why the IPF prepared this guidance in the first place.

  It is also questionable that the commercial incentives of buyers and sellers will always align to facilitate a smooth, swift process. If a fund is a forced seller of properties, for liquidity purposes, then it may benefit a prospective purchaser not to facilitate a streamlined process for its own commercial reasons – for example, to help negotiate a better price.

- The optimum timetable relies on property owners having properties permanently 'ready for sale' (Key principle 1, page 1). Commercial factors, notably costs, mean that this approach is not always adopted. As the 2004 research puts it, "*An investor may have a policy of maintaining (achieving a position where) all assets are ready for sale… All things being equal, this will reduce the sale period but has a cost and there is a trade-off issue*" (page 30).

- Also, achieving the optimum transaction time can be prevented by factors outside the control of the seller. The 2004 research notes that the transaction process can be influenced by "*temporary intractable factors*" (page 26). It says that "*Although these are often predictable and will disappear over time, crucially they tend to be outside the control of the owner. Imminent rent reviews and potential lease terminations are the main problems. The additional risk associated with unknown future income due to imminent rent reviews or potential lease expiries can reduce the pool of potential buyers and hence the price obtained. Whilst these issues can be anticipated, they are not easy to resolve in advance.*"

There are significant obstacles in achieving a 'streamlined' sales process. Nonetheless, were such a process to be achieved, the IPF envisages the timetable set out in Fig 2.

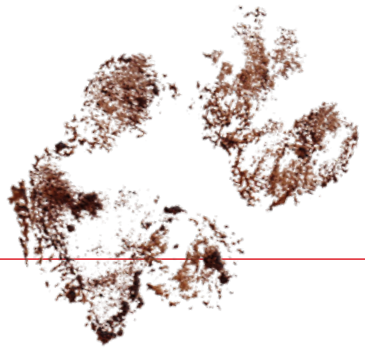
For many property transactions the best timetable could be as long as 252 days.

Fig 2: Key steps for an asset transaction

Key Step	Typical timetable
Seller's pre-marketing stage	1-4 months
Marketing	2-6 weeks
Heads of terms	1-2 weeks
Pre-contract	4-8 weeks
Exchange contracts Pre-completion Completion (closing)	2-4 weeks
Total weeks* **Total days**	13-36 **91-252**

Source: Streamlining transactions Improving liquidity in commercial real estate. Annex 1. Page 6 & 7, Investment Property Forum. November 2018. *Assuming 1 month = 4 weeks

Even an optimised, streamlined process indicates that for many property transactions the best timetable could be as long as 252 days. This is further evidence that a 180 day notice period is inadequate to prevent liquidity mismatches in open-ended property funds.



The call for additional evidence

It may be that the time taken to complete transactions has changed since the 2004 and 2014 research. It is conceivable that, at the margins, improvements to processes have sped up transactions. However, the idea that this will have a significant impact is implausible.

Many of the issues which drive longer transaction times are inherent to property as an asset class. Every property has its own unique character, be it location, structure, condition, tenants etc.

If there have been improvements in processes, these are likely to be marginal and affect only a minority of transactions. After all, we would expect such developments to be reflected in the IPF paper on streamlining processes, which tends to confirm that the time taken to transact for many properties remains longer than 180 days.

Buyers and sellers continue to be affected by factors that can have a major impact on their ability to complete a swift transaction, even if their desire to achieve one is strong. The 2004 research notes that delays arise, once formal marketing commences, in the due diligence phase, between the heads of terms and exchange because of "*changes in status of purchaser or tenant, discovery of inherent problems, changes in market conditions and problems in raising funds.*" (page 105). There is no reason to assume any of these factors have changed since these observations were made.

The 2004 and 2014 data is also compelling as it was compiled by the industry in a process that was designed to inform its own understanding of the market. It was not seeking to influence regulatory debate. The preparers had no incentive to reduce transaction times. Instead, the authors provided a candid view of the process and explained that the data underestimates how long it takes to complete deals. The same considerations may not apply where data is provided to inform the current debate.

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3. Distractions and diversions

CP20/15 raises issues unrelated to transaction times that do not provide a justification for short notice periods.

Comparison with deposit accounts

CP20/15 states "*For the consumer, we consider that 90 days is likely to be an acceptable time frame in which to plan financial affairs. For example, many deposit takers offer term deposits which require 90 days' notice.*" (para 3.24).

This is an astonishing observation. Comparing property funds to deposit accounts and suggesting that consumers should view them in a similar manner is inappropriate.

Deposit accounts are savings products that present no risk to capital. Used in conjunction with instant access savings accounts, they help manage an individual's short-term financial needs. There is a straightforward trade-off between agreeing to limit access to a person's money and securing a higher, pre-agreed, interest rate.

Property funds have very different purpose and characteristics. The investor's capital is at risk. They are explicitly long-term investment products. As the Money Advice and Pension Service puts it in its online guide to indirect property investments "*Indirect property investment might be for you, if you… are ready to commit to a long-term investment*."

The FCA implies that property investment funds should be viewed on the same basis as deposit accounts and that it is unreasonable for investors in property funds to take a long-term view on their financial position. This is quite simply wrong. Funds and deposit accounts serve different functions. They are not interchangeable. They may be suitable for very different types of investor – for example, with very different capacity for loss and attitudes to risk.

Comparing property funds to deposit accounts and suggesting that the consumer should view them in a similar manner is inappropriate.

When property funds have notice periods, these will be communicated clearly. Their length does not make it more or less difficult to get this information across.

The length of notice periods could be a factor for investors to consider when assessing if these funds are suitable and how they might fit into their financial arrangements. This should not affect the FCA’s decision on the length of notice periods. Indeed, making a notice period clear, and explaining its implications, is far better for consumers than the current situation where investors are promised daily dealing when the reality is this may be withdrawn, without notice and for an indeterminate and extensive period of time

The comparison is also flawed because notice periods on deposit accounts can be planned with certainty by the provider. Honouring these notice periods presents no risk to the consumer making a withdrawal nor to other individuals holding the same product.

The same cannot be said of property fund redemptions, where transactions required to raise cash are uncertain and, if pursued on a fire sale basis, could undermine returns for all investors: those withdrawing their cash and those remaining within the fund. There is no first mover incentive in a deposit account.

Risks associated with trying to sell a property

CP20/15 observes that "*The risk associated with the time taken to sell a property is another relevant factor* [to establishing the length of the notice period]" (para 3.25).

The 2004 research it cites does find that length of time taken to sell a property affects the risk to investors. For example, it states "*Selling time is often unknown and exposes investors to additional risks*" (page 90). However, this risk is inherent in the underlying assets. A property that takes longer to sell will incorporate greater risk than one that takes a short time to sell. But the time taken to sell the asset is not determined by the notice period on fund redemptions. It is independent of this consideration.

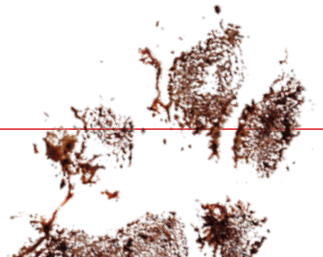
Indeed, setting inadequate notice periods is more likely to increase risks to investors. The 2004 report observes that "*When a property is held for a long time and the marketing time is small relative to the holding period… the difference between the ex ante total returns and the ex post total returns diminishes.*" (page 91).

Short notice periods will increase the likelihood that the fund will have to sell because of redemption pressures. That is, they may shorten the holding period, forcing a sale earlier than if the investment case alone informed the decision to sell. This dynamic will tend to reduce holding periods and increase risks.

The harm to consumers of inadequate notice periods is further magnified because it is prime properties (those with shorter marketing and transaction periods) that will be sold due to redemption pressures. This will increase the proportion of the portfolio with longer marketing times. This will increase risks to investors. It will make it more likely they are invested in a product that is not suitable for them.

The FCA's conclusion should be that these risk factors support longer notice periods, not shorter ones. Surprisingly, it seems to use this evidence to support the opposite conclusion.

Setting inadequate notice periods is more likely to increase risks to investors.



Preventing investor exits in market downturns

CP20/15 notes that notice periods will mean that investors may be unable to exit the fund during poor market conditions. The intention of this observation is not entirely clear. It could be taken as an argument for limiting notice periods (because the freedom of investors to leave the fund is curtailed, or "*eliminated*") when the opposite conclusion is more appropriate.

To be clear, setting notice periods of sufficient length to prevent unplanned suspensions is an active consumer benefit. It removes first mover incentives, which destabilise funds and is a cause of consumer harm in property funds. The current opportunity for some investors to leave a fund quickly is achieved at the expense of others. As CP20/15 puts it, this process means that those selling are "*leaving losses with remaining investors*". Their liquidity is achieved to the detriment of those who remain.

In this context, adequate notice periods are not the problem. They will protect consumers. They will mean that all investors can secure an orderly exit, at NAV, on a reasonable, predictable timetable without some investors benefiting at the expense of others.

Relevance of these arguments

The discussion in CP20/15 on the length of notice periods seems intended to support a requirement of between 90 and 180 days. In fact, many of the points raised are either irrelevant to the policy question under consideration or support the case for longer notice periods.

Discretion for managers to apply longer notice periods

Adequate notice periods are not the problem. They will protect consumers.

CP20/15 observes that managers have discretion to set longer notice periods. It is unlikely that they will do so voluntarily. After all, current practice has been for property funds to offer daily redemption despite the consumer harm and other risks arising. Commercial incentives have tended to override other factors and push the market, particularly for retail products, to the shortest redemption periods allowed.

Some stakeholders still do not see the need for any notice period to be applied. This reflects a longstanding view that preventing liquidity mismatches is not a priority.

An industry report published in 2017 noted that "*It is widely recognised that there is a mismatch between the liquidity of the underlying asset and the liquidity of the fund vehicle in daily traded funds.*" (*A review of real estate fund behaviour following the EU referendum. A report for The Association of Real Estate Funds*, 24th April 2017, page 24).

The same report discussed some of the problems this mismatch creates, particularly in light of lags in asset valuations. It noted that there is "*a strong argument that exiting investors have been overpaid to the detriment of remaining investors*" (page 25). It also reflected on the issue of "*valuing to reflect a forced sale of some or all of the assets of the fund*" noting that "*The shorter the time frame assumed for making sales, the more extreme the resulting pricing adjustment is likely to be.*"

The report discussed a hypothetical case involving two fund managers observing that "*If fund manager A having assessed its cash flows and pattern of redemptions assumes it has six weeks to effect a sale while fund manager B with a greater redemption obligation to meet assumes two weeks giving a buyer no time to complete effective due diligence, the write down in values by fund manager B would be expected to be significantly greater. As the timing is driven by the cash available to meet redemptions the two fund managers could arrive at materially different values for the same asset and would indeed be expected to do so.*" (page 25).

While the report's introduction does mention the need for the industry to focus on the best interests of consumers, the idea of offering daily redemption while holding highly illiquid assets is not questioned in any fundamental way. While acknowledging that there are some "*flaws in the overall structure*" the report finds that "*there is nothing to suggest that the concept of a daily traded fund is wrong. The issues are in the detail of how the mechanisms currently operate*" (page 7).

The report makes clear that some stakeholders consider that the most harmful consequences of liquidity mismatches should be accepted rather than eliminated, saying "*A number of fund managers were of the view that 'fund suspension' needs to be regarded as part of the normal, day-to-day tools of managing a fund rather than something bordering on the catastrophic. The stigma of suspending a fund needs to be removed.*" (page 30).

This indicates that it is unlikely that longer notice periods will be voluntarily adopted to help manage liquidity mismatches.

It is unlikely that longer notice periods will be voluntarily adopted to help manage liquidity mismatches.

Notice periods and the distribution of property funds

Much of the debate over the impact of notice periods has focused on distribution issues. This seems to be a significant factor in the proposal for a maximum notice period of 180 days.

Distribution issues should not determine the debate over the length of notice periods. Creating a regulatory framework that makes property funds safe for investors and the financial system should be the FCA's overwhelming priority.

Platforms and model portfolios

Benefits for a minority of consumers

One key discussion point has been whether notice periods might affect the use of property funds in model portfolios and their availability on platforms.

It is true that commercial providers distributing property funds subject to notice periods will have to manage the consequences of these changes. However, there is no reason in principle why investment platforms could not offer funds that are not traded daily. There is no fundamental reason why they could not manage notice periods (including queuing for redemptions) in the way proposed in CP20/15.

The 2017 report prepared for the Association of Real Estate Funds (AREF) notes that "*The platforms through which retail investors primarily invest in open-ended real estate funds only provide for daily trading and cannot queue investors during deferrals, suspensions or for trading periods that are longer than daily. The platforms interviewed in the preparation of this report have indicated that it would be possible to develop the capacity to deal with both, but at present there is no demand from intermediaries.*" (page 33).

The report continues saying that intermediaries themselves take the view that they "*need the capacity to subscribe and redeem daily in order to operate model portfolios*" (page 33). However, the inclusion of these funds within model portfolios raises its own questions.

The report notes that "*The need for daily liquidity is driven by the operational requirements for individual investors to move money in and out rather than any desire to invest on a very tactical daily basis*" (page 34). That this factor (daily trading) has played such a role in how property funds are distributed is therefore problematic, particularly when its impact on consumer returns is considered. As the report puts it, "*the ability to redeem on a daily basis comes at a significant cost in terms of the cash drag and potentially the choice of investment assets. The primary beneficiaries of this are the minority of investors who are making short term tactical use of open-ended funds rather than the model investment portfolio investors who use the daily redemption facility in relatively small amounts for operational needs.*" (page 34).

Daily trading open-ended property funds creates significant downsides for many retail investors.

Another section of the paper notes "*A relatively small proportion of discretionary fund managers took advantage of the liquidity of daily traded funds to make significant changes to their holdings. The majority of retail investors are therefore paying for liquidity that they do not use. Unfortunately, the operating structure of model portfolios requires reallocations between asset classes to be affected across all asset classes at a single trading point. This locks investors into daily liquidity even though it is not aligned with a long-term investment in an illiquid underlying asset.*" (page 17).

The daily trading of open-ended property funds creates significant downsides for many retail investors, both those invested directly and those exposed via model portfolios. The benefits, such as they are, accrue to a small proportion of investors and tend to suit the needs of distributors rather than secure better long-term investment outcomes.

Ironically, recent lengthy suspensions in the property funds sector have created a proxy for notice periods. Those offering property funds in model portfolios have had to deal with these assets separately for a prolonged period. These assets have not been able to be bought or sold to rebalance model portfolios. A key difference in the current situation is that investors have been denied liquidity, which they had expected to enjoy, when this turned out not to be deliverable. This would not be the position if adequate notice periods had been applied upfront.

Increasing risks to financial stability

Offering daily traded property funds on platforms and via model portfolios that demand instant rebalancing creates additional risks for investors and broader financial stability.

As the report prepared for AREF puts it "*The changes introduced under RDR coupled with technological change has accelerated the speed of execution of changes in investment by retail investors. Intermediaries can change allocations to real estate across all investors at the press of a button. This has the capacity to significantly increase the risk of a "run on the bank" for open-ended funds. The growth in investment via model portfolios increases the risk of a herd mentality. Although there are huge numbers of different model portfolios, they are constructed from the same building blocks increasing the risk of collective behaviour.*" (pages 16 and 17).

The FCA should prioritise creating stable funds and a distribution process which treats all investors fairly. That means a system which does not inappropriately trade-off the interests of one group of investors against another or exacerbate the risks of contagion and spill over risks.

The FCA's view of notice periods should not be inappropriately swayed by current distribution preferences or legacy systems which were developed to distribute funds with arrangements which are now recognised as inappropriate and a source of consumer harm.

The FCA should develop its position on notice periods on the regulatory merits of the issue.

Inclusion in Individual Savings Accounts (ISAs)

CP20/15 states that whether property funds qualify for ISAs will be taken account in its final decision (paragraph 4.8). As a matter of principle, the availability of a tax wrapper should not determine the FCA's position in ensuring adequate consumer protection and protecting financial stability.

The FCA should set notice periods on the regulatory merits of the issue. It should seek to prevent consumer harm and maintain financial stability. ISA inclusion should be a secondary consideration. That said, the AIC considers that HM Treasury and HMRC should, in any event, take active steps to mitigate any negative tax consequences of reform on retail investors. As a minimum, the AIC **recommends** that HMRC should 'grandfather' existing holdings in property funds so that they can continue to be held in ISAs.

'Reasonable period' for redemption

CP20/15 raises the currently accepted view that Non-UCITS Retail Schemes (NURS) "*are required to redeem investors at least once every 185 days and therefore notice periods could not exceed this length of time*" (paragraph 3.27). This observation raises fears that the FCA may be letting extraneous issues affect its view on the length of notice periods.

The FCA's priority should be to set notice periods of sufficient length to mitigate and manage the risks of liquidity mismatches in property funds. The length of these periods should not be restricted by the existing legal or regulatory framework. If the current rules create barriers to longer, but necessary, notice periods then these rules should be changed to allow the necessary regulatory protections to be implemented.

If the conclusion is that notice periods exceeding 185 days are required to create stable and safe open-ended property funds, but that such notice periods are unacceptable for retail investors, then the answer is not to restrict notice periods. It would be to prevent these funds being sold to retail investors. This would not be a source of consumer harm. It would be a benefit. It would deliver the FCA's objective to protect consumers. It would not deny consumers access to property as an asset class as they would be able to gain exposure via investment companies (such as UK REITs), which do not create the risks identified.

In any event, we believe that notice periods longer than 185 days are compatible with the existing legal and regulatory requirements of NURS and, indeed, the definition of an "*open-ended investment company*" set out in the Financial Services and Markets Act 2000.

We believe that notice periods longer than 185 days are compatible with the existing requirements.

The convention of requiring redemption at least as frequent as 185 days is based on a view of how long a reasonable investor would expect to have to wait before realising their investment. The current view of property fund redemption has been encouraged by promises made by fund operators. The conclusion that this view is unrealistic is supported by the repeated suspension of property funds as well as the evidence on the time it takes to sell commercial properties in an orderly process. The 'reasonable' investor's view can, and should, change over time and with experience. The view that a prolonged period (over 185 days) may be required before an investor can get their money back is reasonable given recent events, which have seen much of the property fund sector suspended for well over six months.

The FCA's own guidance makes clear (PERG 9.8.9) that there is significant variation possible in different investments and that the expectation of investors will be influenced by a wide variety of factors. These include the underlying assets. It states "*where the underlying property in which the body corporate* [in this case, a fund] *invests is relatively illiquid; in this case, the period within which realisation of an investment may be regarded as reasonable may be longer than it would be for property which has greater liquidity*".

The investor's view is also substantially influenced by the terms on which a product is sold to them in the first place. Were the terms of the product to involve, say, notice periods of a year and this was set out in marketing and key information, then it would be unreasonable for an investor to expect that they could realise their investment in a shorter period.

Current views of notice periods allowed for NURS should not influence the FCA's view on the length of notice periods. The FCA should not dilute required standards (and impose inadequate notice periods). It should follow the evidence to ensure that the legal and regulatory framework sets proper standards.

Securing genuine choice for investors

One of the arguments that some stakeholders make against notice periods is that they will deny investors property exposure via a fund offering frequent redemption and an exit at NAV. Looked at more critically, the reality of what funds deliver is rather different.

Property exposure

Open-ended property funds have only been able to operate with frequent redemption because they maintain significant cash holdings. It is not uncommon for daily traded property funds to hold over 20% in cash. According to the latest figures available, the five largest cash holdings within these funds were 30%, 24%, 23%, 23% (for those reporting data at the end of August 2020) and 27% (for one reporting data at the end of September 2020).

Investors may be seeking exposure to property but much of their exposure via property funds is to cash. This reduces their holdings in the target asset class, affects the overall balance of their portfolio and depresses returns.

Daily redemption on demand

The promise of property funds has been that investors can redeem on demand. This has proved untrue on too many occasions, starting with the financial crisis, then Brexit and now more recently COVID-19. Over the course of 2020, many funds were suspended for months. This arose because of valuation uncertainties. This is another dimension to the liquidity mismatch problem.

From the investor perspective, the technical reasons for funds withdrawing their promises of daily redemption are not that relevant. Far more important is that, yet again, open-ended funds have not been able to honour the redemption offer that investors accepted in good faith.

Property funds have only been able to operate with frequent redemption because they maintain significant cash holdings.

Exiting at NAV

There are questions over the extent to which daily dealing funds holding property do deliver exit at NAV. As the 2017 report prepared for AREF put it, "*it is widely recognised that valuations are based on historical data and therefore tend to lag the market. Even if this was not the case, there would still be a mismatch. Funds are paying out redemptions using cash balances and then selling assets to replenish the cash buffer. In a falling market, by the time the asset is sold, the value will have fallen. There is therefore a strong argument that exiting investors have been overpaid to the detriment of remaining investors. Similarly, when investors subscribe for units in a rising market, by the time the cash is invested into assets, prices will have risen. There is therefore a strong argument that entering investors have been undercharged to the detriment of existing investors in a rapidly rising market.*" (page 25).

A genuine choice

Offering investors access to property funds that do not deliver what they promise is not a genuine choice.

A genuine choice will be provided by a regulatory system that ensures open-ended property funds provide greater exposure to the target assets and offer an exit at NAV once they have given reasonable (and explicit) notice.

Prospective purchasers of property funds would be able to consider them in comparison with other opportunities to gain indirect exposure to a property portfolio. That is, closed-ended investment companies traded on the stock market, such as UK REITs (see Square peg in a round hole, page 34, for further discussion of the investment company model). These products offer daily opportunities to trade at a price set by the market.

Investors will then have a genuine choice. Both structures will perform as intended, and neither will require fire sales at times of market stress, which not only harm investors in the fund but also spread contagion to other funds and the broader economy.

Offering investors access to property funds that do not deliver what they promise is not a genuine choice.

4. Tackling liquidity mismatches in property funds

An effective regulatory response will manage and mitigate liquidity mismatches in open-ended property funds. This will be achieved by requiring appropriate notice periods.

Structure of notice periods

CP20/15 sets out a proposed framework for notice periods (para 3.15). This requires that:

- Each investor's redemption request would be received and recorded, then processed at the end of a notice period.
- The investor would receive the value of their investment, based on the unit price of the fund at the first valuation point following the end of their notice period.
- Redemption requests would be irrevocable, so that investors cannot place orders and withdraw them before the end of the notice period if market conditions change.

This proposal is clear and amenable to effective investor communication. It provides the basis for those exiting the fund to be paid an amount that accurately reflects the true NAV of the portfolio. This should deliver fairness to those remaining within the fund as well as those securing redemption.

The AIC agrees with this proposed framework and **recommends** that it is adopted as the basis for regulating liquidity mismatches in open-ended property funds.

An effective regulatory response will manage and mitigate liquidity mismatches.

Length of notice periods

The FCA intends to establish notice periods that will suit a broad range of property funds. It is not, for instance, requiring property fund operators to assess the liquidity of property holdings and, on that basis, set a notice period specific to the fund. This approach has been broached in the past, and it does have its attractions as it will maximise commercial flexibility. That said, it creates a more complex compliance and supervisory challenge. The reality is that if liquidity were measured appropriately, most operators of property funds would reach similar conclusions on required notice periods.

With these considerations in mind, the AIC agrees that establishing a common notice period for all property funds is the correct approach. It will help manage the fact that the assets held within a fund portfolio will change over time. It will recognise that the liquidity of each individual holding may decline due to external factors. This would include, for example, the broader economic environment and property-specific issues (for example, changes to the tenancy situation). Setting a sector-wide requirement, on a prudent basis, reduces the risk that funds would have to change notice periods as the liquidity profile of their assets declines. The AIC agrees the FCA's proposed 'one-size-fits-all' approach is the appropriate starting position.

The notice period required must therefore be sufficient to allow properties to be sold in an orderly process, without significant discounts. It must operate effectively in all normal market conditions, including weaker markets which are part of the economic cycle. The duration of the notice period must be sufficient bearing in mind the wide range of properties that could be held and the different investment remits of individual funds.

The FCA has previously said an adequate notice period may not need to be based on the time taken to sell the least liquid assets (*Open ended funds investing in less liquid assets,* speech by Edwin Schooling Latter, Director of Markets and Wholesale Policy, 19 March 2020). Even if this position is accepted, the proposed maximum 180 day notice period is insufficient. On the evidence, a large proportion of assets (perhaps as much as half or more, depending on the fund) could not be sold within this period. Liquidity mismatches, and their negative consequences, would not be sufficiently mitigated and managed by this proposal.

The FCA should set notice periods at 12 months.

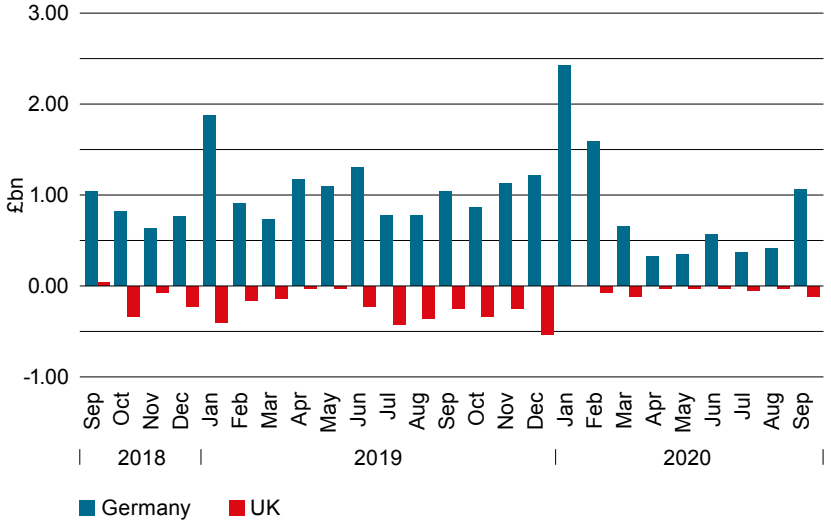
The AIC **recommends** that the length of notice period must be long enough to allow a substantial majority of the assets to be sold in an orderly process in both normal and reasonably foreseeable (i.e. extreme but plausible) stressed market conditions. This is the standard set by IOSCO, of which the FCA is a member (Recommendations for Liquidity Risk Management for Collective Investment Schemes, Final Report, International Organization of Securities Commissions, Recommendation 3, February 2018).

With these considerations in mind, and on the basis of the evidence, the AIC **recommends** that the FCA should set notice periods at 12 months.

A prudent approach is required because, as explained above, as assets are sold to meet redemption pressures, it is likely that the most liquid are sold first, meaning that remaining investors are exposed to a fund where the proportion of properties that can be sold within the notice period is declining. The rules have to recognise the position of individual funds, which will have fewer choices when seeking liquidity and therefore be less liquid than the asset class as a whole.

As well as providing suitable regulatory protection, this approach could help create a more successful property funds sector. This view is supported by the experience in Germany, where the regulator requires a one-year notice period for property funds.

Fig 3: Estimated fund flows for German and UK property funds



Source: Morningstar. UK and German fund flows excluding feeder funds and fund of funds. To: 30/9/20.
*UK and German fund flows and asset sizes excluding feeder funds and fund of funds.

In the last two years, the UK property fund sector has seen consistent outflows, stemmed in recent months by widespread suspensions. By contrast, Germany has seen inflows, even during the height of the COVID-19 pandemic.

Since September 2018, the German property fund sector has grown from £84bn to £126bn*. The UK sector has shrunk from £23bn to £17bn. The idea that notice periods are 'bad for business' is simply not true.

Critically from a regulatory perspective, German funds have continued to operate as intended. They have not suspended nor reneged on promises made to investors. The model is both commercially attractive and delivers for consumers.

Exceptional cases

From the evidence, it is difficult to conclude that notice periods of less than a year will be feasible in the vast majority of circumstances. However, the FCA does, rightly, seek to be proportionate in its regulatory approach. For most property funds notice periods of 12 months will unquestionably be the correct approach. But there may be rare instances where individual funds could operate shorter notice periods without crystallising liquidity mismatches.

For most property funds notice periods of 12 months will unquestionably be the correct approach.

The FCA may want to introduce some flexibility into the regime to accommodate these rare exceptions. If so, it must ensure that this is done with suitable regulatory protections in place. If the FCA intends to allow additional flexibility in exceptional circumstances the AIC **recommends** adopting the following approach:

- An operator of a property fund may reduce notice periods to a minimum of nine months, on a case-by-case basis, where (based on an assessment of the underlying assets and the investment strategy) it can give a strong assurance that redemptions can be met in both normal and reasonably foreseeable (i.e. extreme but plausible) stressed market conditions. This would include confirming that these arrangements will be able to operate over the course of the economic cycle. This commitment will reflect the recommendations made on liquidity management by IOSCO (Recommendations for Liquidity Risk Management for Collective Investment Schemes, Final Report, International Organization of Securities Commissions. Recommendation 3, February 2018).
- If the operator of a property fund with reduced notice periods is unable to maintain these arrangements in normal and reasonably foreseeable (i.e. extreme but plausible) stressed market conditions, the FCA should have powers take enforcement action. This could include fines or other remedies, including paying compensation to investors and/or providing liquidity to the fund to remedy the position.
- Notice periods of less than 12 months would need explicit approval from the FCA.

These are reasonable conditions for shorter notice periods. After all, if a fund operator felt unable to provide the required commitment and meet the standards imposed, it suggests that it believes there is a material risk of liquidity mismatches arising.

5. Consultation questions

Many of the issues raised explicitly by CP20/15 have been addressed in the previous sections of this paper. Additional observations are set out below.

Q1: Do you consider our proposals impact any groups with protected characteristics under the Equality Act 2010? Do you consider there are any issues which may be relevant to our obligations under the Equality Act (see paragraph 2.24)? If so, please provide details.

The AIC has no comments on this question.

Q2: Do you agree with our proposal to introduce notice periods for UK authorised property funds? If not, what alternative proposal would you have to address the structural liquidity mismatch?

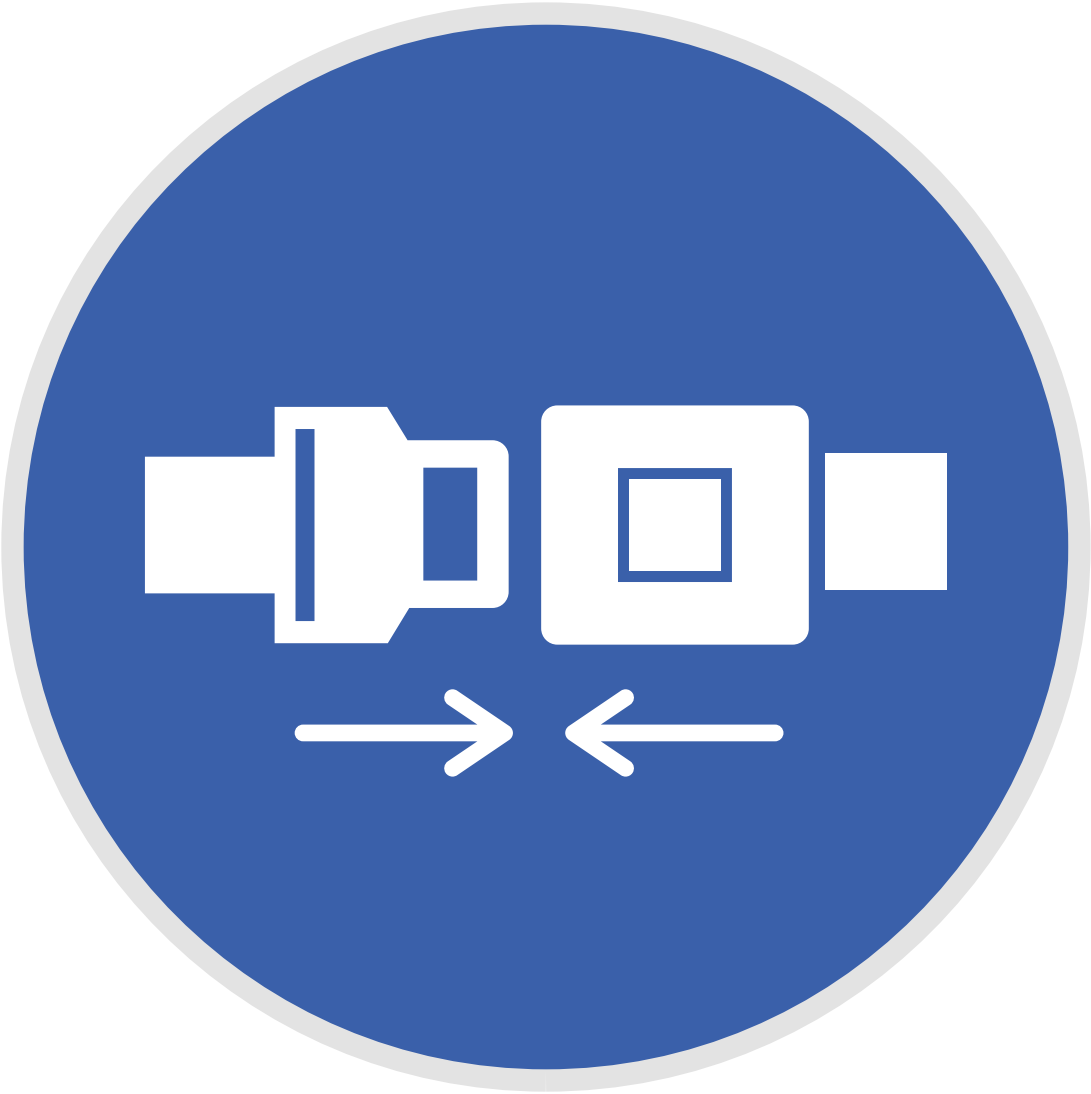
The AIC agrees that notice periods should be a central mechanism in resolving liquidity mismatches in open-ended property funds. They were identified in Square peg in a round hole as the best option to ensure that investors receive 'reliable redemption'. Delivering reliable redemption means:

- The basis on which an investor can leave the fund (in timescale, volume or price) should not change, irrespective of the level of redemptions;
- Redemption processes must not rely on assets being sold cheaply to raise cash to meet redemption requests; and
- Redemption arrangements must operate in both normal and foreseeable stressed market conditions.

Achieving reliable redemption will secure the FCA's overall objectives for open-ended property funds. The FCA will only achieve reliable redemption, and secure its objectives, if the notice period is sufficient.

The AIC's detailed views on this question are set out in the opening sections of this paper.

Redemption arrangements must operate in both normal and foreseeable stressed market conditions.



Q3: Do you agree that notice periods should be structured as described in this chapter? If not, why not and what alternative proposal would you suggest?

Yes, the AIC agrees with the structure of notice periods as set out in this paper. For further discussion see page 36 of this paper.

The evidence indicates that notice periods of both 90 days and 180 days are insufficient.

Q4: The instrument sets out two alternative notice periods with lengths of 90 days or 180 days in COLL 6.2.22AR(2)(e). Which of these is the best? If neither, what alternative length would you propose and for what reason?

The evidence indicates that notice periods of both 90 days and 180 days are insufficient to adequately manage and mitigate liquidity risks in open-ended property funds.

The AIC **recommends** that property funds be required to impose notice periods of 12 months. In exceptional circumstances, and where suitable conditions are observed, the AIC **recommends** that operators of property funds be allowed to apply to the FCA, on a case-by-case basis, to reduce notice periods to a minimum of six months.

See earlier sections of this paper for evidence to support a 12 month notice period. Also, the conditions applying where a fund operator seeks a shorter notice period are set out on page 41 of this paper.

Q5: Do you agree with our proposal regarding the interaction of notice periods and suspensions? If not, what alternative approach would you propose and why?

The AIC agrees with the proposals regarding the interaction of notice periods and suspensions.

Q6: Do you agree that it is appropriate for FIIA rules to continue to apply to authorised property funds that operate notice periods?

The AIC agrees that the FIIA rules should continue to apply to authorised property funds that operate notice periods

Q7: Do you agree that property fund NURS currently dealing no more frequently than monthly should not be classed as FPIPs, and so would not need to operate notice periods? Do you agree that all other property fund NURS dealing at monthly or quarterly intervals (whether existing funds moving to such dealing arrangements or newly authorised funds) should be classed as FPIPs and be required to operate notice periods?

As long as there would be no opportunity in the future for these funds to be marketed to retail investors, the AIC agrees with this proposal.

Q8: Do you agree that we should introduce a transitional rule to avoid the potential of a step increase in the capital requirements of SIPP providers? If not, what alternative proposal would you make?

The AIC agrees with this proposal.

Q9: Do you agree that we have identified the other products and services that the change to notice periods would materially impact? If not, what other impacts should we consider?

The AIC has provided comments on the impacts of notice periods on other service providers earlier in this paper. The AIC has no additional comments.

Q10: What transitional arrangements do you think will be needed to implement the proposals in this paper? How quickly can they be brought into effect?

The AIC has no comments on how long it will take to implement required systems changes. However, it would urge the FCA to introduce the new regime as swiftly as possible. Liquidity mismatches in open-ended property funds remain a significant concern. The longer they are allowed to persist, the greater the risk to consumers and the financial system.

Q11: Do you agree that the proposals in this paper for notice periods are preferable to placing other types of restrictions on funds that offer frequent dealing while investing in property assets (for example preventing them from future marketing to retail clients)? If not, what do you suggest?

The AIC agrees that notice periods are an appropriate means to manage liquidity mismatches and are compatible with securing the best interests of consumers. The AIC would not support preventing marketing of these funds to retail consumers as long as suitable notice periods are imposed. On the evidence available, notice periods must be set at 12 months to provide adequate consumer protection. In exceptional cases they could be reduced by up to three months, if regulatory safeguards are applied.

Q12: Do you think that other types of fund should be permitted to operate notice periods? If so, please explain which other funds and why.

Yes. Other open-ended funds incorporate liquidity mismatches, which could give rise to consumer harm and systemic risk. These issues have been discussed, for example, in a recent Financial Stability Report (Bank of England, Financial Policy Committee, August 2020).

Where such risks arise, these funds should be required to operate notice periods. The AIC would be pleased to discuss this further with the FCA.

Other open-ended funds incorporate liquidity mismatches, which could give rise to consumer harm and systemic risk.

Q13: Do you have any views on what further steps the FCA should take to accommodate long-term capital structures?

The FCA should, of course, be aware of the economic value of structures that are able to provide long-term capital to the UK economy and businesses. However, in considering its approach to these structures, its primary goal should be to deliver on its statutory objectives to protect consumers and maintain financial stability.

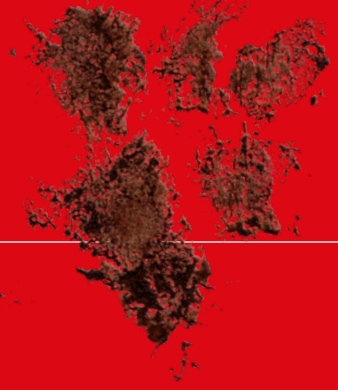
The FCA's primary goal should be to deliver on its statutory objectives to protect consumers and maintain financial stability.

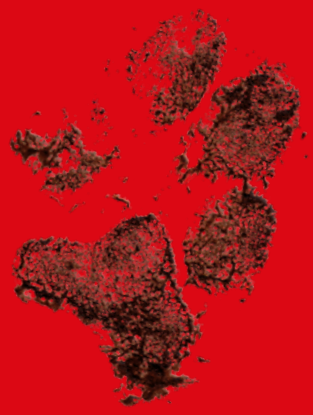
In addition to setting rules targeted on the issues raised by specific asset classes, the FCA should seek to embed a culture where fund operators properly consider whether a fund structure is appropriate to the redemption policy and investment strategy being offered to investors. The AIC **recommends** that, irrespective of the underlying assets, fund operators should be required to publish an annual statement confirming that they expect a fund to be able to maintain redemption on the terms set out in foreseeable, including stressed, market conditions.

The regulatory requirement should be designed to achieve the IOSCO standard that states that the investment strategy and objectives of the fund should "*give strong assurance that redemptions can be met in both normal and reasonably foreseeable (i.e. extreme but plausible) stressed market conditions*" (Recommendations for Liquidity Risk Management for Collective Investment Schemes, Final Report, International Organization of Securities Commissions, Recommendation 3, February 2018).

Q14: Do you consider that there are any amendments to the fund rules (or other rules) which we should make to facilitate the development of a secondary market in units in property funds?

The AIC has no comments on this question.





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