UK FUND DEVELOPMENTS AND REGULATORY UPDATE

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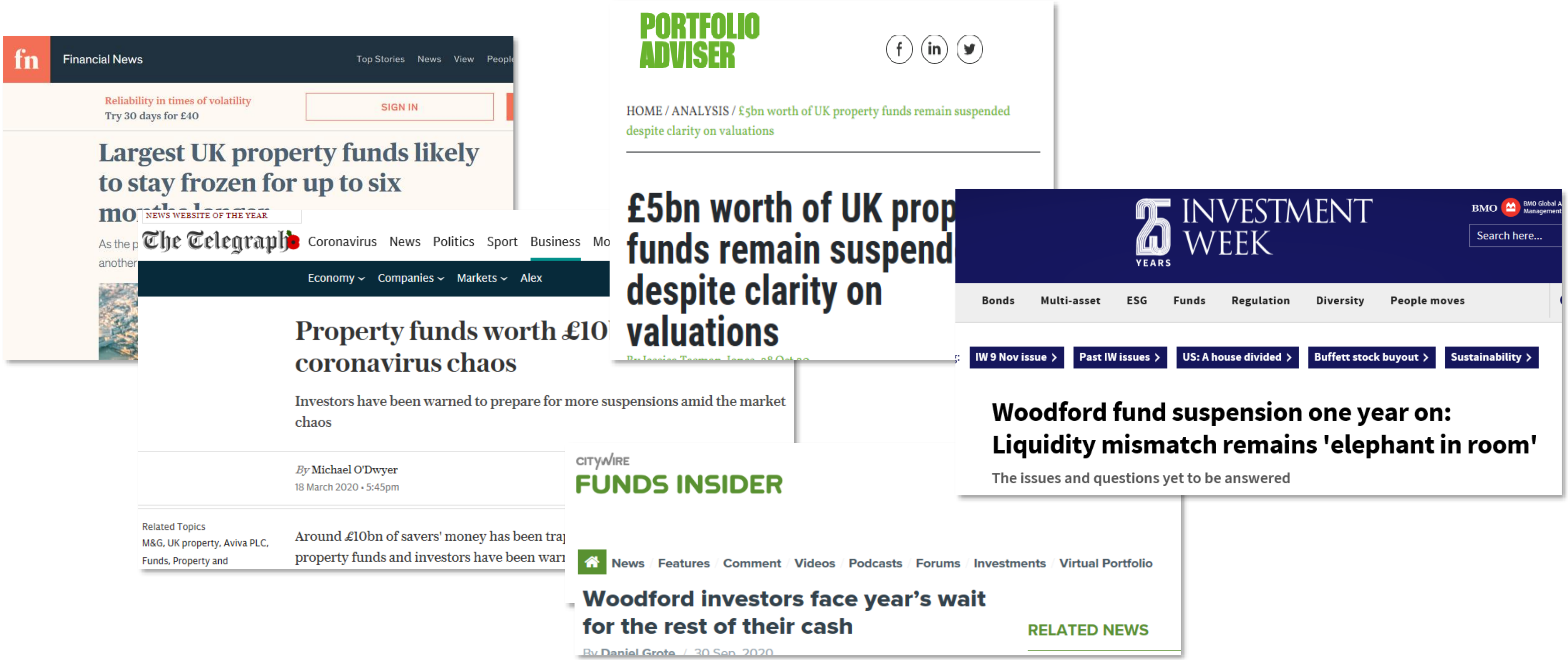
Agenda

1. Fund Liquidity - a hot topic



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Property funds worth £10… coronavirus chaos

Investors have been warned to prepare for more suspensions amid the market chaos

By Michael O'Dwyer
18 March 2020 • 5:45pm

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Woodford fund suspension one year on: Liquidity mismatch remains 'elephant in room'

The issues and questions yet to be answered

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Woodford investors face year's wait for the rest of their cash

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1. Fund Liquidity - recent events

2016

June: EU Referendum sparks mass redemptions
Following the UK's 'Leave' vote, several large property funds suspended as investors rush to withdraw assets

2019

June: Woodford Equity Income Fund suspended
Increase in redemption requests leads to this once £10. 2bn fund reducing to £3.7bn by May 2019. The fund is unable to meet redemptions due to a high level of holdings with low liquidity

2019

October: Woodford Equity Income Fund wound up
The fund's Authorised Corporate Director advised that progress had not been sufficient to allow 'reasonable certainty' about when repositioning would be fully achieved, so a decision was made to terminate the fund

2019

December: uncertainty causes gatings
Investor uncertainty arising from UK events including the Brexit extension and General Election lead to increased outflows. A large property fund is gated to allow the fund to raise cash levels

2020

March: property fund suspensions due to Covid-19
'Material uncertainty' about property values at the start of the first UK lockdown causes eight fund managers to suspend dealing in open-ended property funds

1. Fund Liquidity - ESMA guidelines

Guidelines

- ESMA has published its final Guidelines on liquidity stress testing (LST) for UCITS and AIFs. The Guidelines apply to managers, depositaries and national regulators

For fund managers

- Wide ranging guidelines covering design scenarios, policies (which should be documented in UCITS and AIF RMP) and frequency of liquidity stress tests for the funds they manage
- Recommendation that managers notify their national regulators of material risks and actions taken to address them

For depositaries

- Verification that the fund manager has in place documented procedures for its liquidity stress testing programme
- Where depositaries are not satisfied that LST is in place they should take action as per any other evidence of a potential breach by a manager, which could include reporting this to its local regulator in line with local requirements

European Systemic Risk Board (ESRB) requests ESMA to develop guidance for managers for the stress testing of liquidity risk for individual AIFs and UCITS

ESMA consulted on the guidelines during the first half of 2019

Final report containing the Guidelines as well as feedback on the consultation published in September 2019

The Guidelines took effect from 30 September 2020

1. Fund Liquidity - thoughts from the FCA

“Firms should recognise that effective liquidity management is an irreducible, core function for all open-ended funds”

- FCA letter to fund boards, November 2019

‘Ensuring effective liquidity management in funds is a central responsibility for any Authorised Fund Manager (AFM) and it remains their responsibility even if they delegate investment management to another person’

“Where we identify potential liquidity issues in funds, including through our regular interaction with depositaries, we will ensure that AFMs take prompt action to mitigate or resolve them.”

- Dear CEO, Asset Management Portfolio Letter, January 2020

1. Fund Liquidity - FCA developments (i)

FCA Policy Statement 19/24 introduced a new 'type of fund': ***Funds investing in inherently illiquid assets, (FIIAs)***, where a fund is invested at least 50% in inherently illiquid assets. The new rules:

- Require a non-UCITS Retail Scheme (NURS) to temporarily suspend when the independent valuer has expressed "material uncertainty" about the value of at least 20% of the property held by the fund. This suspension requirement also applies to fund of funds holding 20% of its investments in property funds which are themselves subject to such a suspension;

- Contain requirements for detailed contingency plans to deal with liquidity risks;

- Introduce new duties for depositaries to oversee the processes used to manage the liquidity of FIIAs; and

- Set out various disclosure requirements applying to the fund names, prospectuses and financial promotion material of FIIAs. The disclosures will include reference to liquidity management tools to mitigate risks and how they would typically be employed.

The rules took effect in September this year but the FCA requested early adoption of the proposal where managers and depositaries felt it is appropriate. Indeed most authorised property funds suspended dealings on account of material uncertainty expressed by valuers at the start of the first lockdown in March.

1. Fund Liquidity - FCA developments (ii)

Reflecting the continued concern of the UK and indeed international regulators over liquidity within collective investment schemes, the FCA has now proposed new measures in its latest consultation paper CP20/15

Headline: A plan to require non-UCITS Retail Schemes ('NURS') which invest at least 50% in immovables (to be defined as Funds predominantly invested in property, or 'FPIPS'), to implement a notice period for unitholders redeeming their investments.

The FCA is aiming to:

- Reduce the likelihood of a property fund suspension due to a lack of liquidity, which will in turn reduce the likelihood of significant levels of withdrawals from a fund.
- Reduce the risk that consumers buy products that are unsuitable for their needs by making the impact of the illiquidity more transparent.
- Reduce inefficiencies and increasing the potential for higher investment returns by enabling property funds to hold less cash, and have greater exposure to property assets

The issue is caused by a mismatch between the dealing frequency of units in daily dealing open-ended property funds and the underlying property assets in which they invest. This has resulted in several property fund suspensions since the EU referendum.

1. Fund Liquidity - FCA developments (iii)

The proposals have caused significant debate, for example:

- The 50% rule for FPIPS – is this too low? 75% has been suggested by as more appropriate.
- The length of the notice period – the FCA have proposed either 90 days or alternatively up to 180 days, the latter being significantly longer than the time taken to complete most property deals.
- Will the change affect the eligibility of property funds with regard to ISAs, and what will be the effect on distribution channels?

The consultation ended on 3 November 2020 and the FCA intends to implement rules in 2021. However, following the CP publication, the Bank of England launched (jointly with the FCA) their delayed survey into vulnerabilities associated with liquidity mismatch in open-ended funds. So expect further developments!

2. AIFMD review

AIFMD Article 69 states:

“By 22 July 2017, the Commission shall, on the basis of public consultation and in the light of the discussions with competent authorities, start a review on the application and the scope of this Directive.”

What did the EC do?

- Appointed KPMG to conduct a general survey and evidence-based study on the impact of AIFMD
- Consulted the Expert Group of the European Securities Committee (EGESC)
- Presented the key elements of findings to ESMA and sought its input
- In June 2020 published a report to the European Parliament and Council (also a requirement of Article 69), the main points being that:

  - The AIFMD has improved monitoring of risks to the financial system and cross-border capital raising for investments in alternative assets

  - The AIFMD has helped create an internal market for AIFs and reinforces the regulatory and supervisory framework for AIFMs in the EU

  - National private placement regimes differ among Member States and creates an “uneven playing field” between EU and non-EU AIFMs

  - AIFMs are operating with more transparency for investors and supervisors

  - The AIFMD depositary regime is functioning well, although the lack of a depositary passport is at odds with the spirit of the single market.

2. AIFMD review - ESMA policy changes

Notably in terms of risk / liquidity management, delegation, leverage and reporting. The call here is for more granular level 2 regulation for UCITS management.

Harmonisation of AIFMD and UCITS

Delegation of activities, regulatory arbitrage, use of seconded staff, delegation of ‘supporting tasks’, and ‘white-label service providers’. In all cases ESMA appears sceptical that the current prevalence and extent of such activities is compatible with the delegation and substance rules of the AIFMD and UCITS regimes

Delegation and Substance

The suggestion is that AIFMD measures for calculating leverage should be aligned with a two-step approach recently recommended by IOSCO for assessing leverage in investment funds.

Leverage

The focus is on providing clarity in relation to home and host supervisors in cross-border activity.

Harmonisation of supervision

ESMA acknowledges ongoing discussions on the merits of a depositary passport. ESMA does not actively recommend the creation of a passport in AIFMD and the UCITS Directive, though is aware the EC may study its benefits and risks. ESMA also recommends issuer CSDs should not be counted in the custody chain, unlike investor CSDs

Depositaries

2. AIFMD review - EC consultation

- The European Commission (‘the Commission’) have opened their consultation – a questionnaire to be completed online, and it will run until 29 January 2021.

- 102 questions are divided into seven sections:

  - Functioning of the AIFMD Regulatory Framework, Scope and Authorisation Requirements
  - Investor Protection
  - International Relations
  - Financial Stability
  - Investing in Private Companies
  - Sustainability/ESG
  - Miscellaneous

- It’s clear the Commission wants to obtain feedback on as many of ESMA’s issues and concerns as possible and interestingly includes questions on harmonisation of the AIFMD with UCITS – Has the Commission stepped outside the scope of the review as provided for within Article 69?

- There had been speculation the Commission would hold an open hearing and new rules proposed in 2021. The consultation however is silent on next steps so we will have to wait and see!

2. Fund governance – Asset Management Market Study (i)

Some of the findings of the FCA's Asset Management Market Study final report, published in 2017:

- Price competition is weak in a number of areas of the industry, especially actively managed funds
- Evidence of sustained, high profits over a number of years
- Investors are not always clear what the objectives of funds are
- Fund performance is not always reported against an appropriate benchmark
- Concerns about the way the investment consultant market operates

And the remedies:

- A strengthened duty on asset managers to act in the best interests of investors
- Introducing an all-in fee
- Requiring asset managers to be clear about the objectives of the fund
- Clarifying and strengthening the appropriate use of benchmarks
- A market investigation reference to the CMA on the institutional investment advice market
- Requirement for managers to return risk free box profits to funds

3. Fund governance – Asset Management Market Study (ii)

Two new requirements emerging from the Market study have kicked in this year.

- **Value Assessments**: For authorised funds a manager has to each year conduct an assessment to justify payments out of a fund in the context of overall value given to unitholders. As a minimum these are the topics that have to be included:

  - Quality of service
  - Performance
  - AFM costs – general
  - Economies of scale
  - Comparable market rates
  - Comparable services
  - Classes of units

- The first assessments were due this year and it would appear they have come in different shapes and sizes. The flexibility allowed on the information required over and above the minimum requirements has led to varied report styles and levels of detail, as well as inconsistencies as to how and where they are published, for example simply on websites or as part of the fund's annual report and accounts.

- **iNEDs**: A fund's Board is now required to have a minimum of two independent members making up at least 25% of the board's membership. iNeds must not have been paid by or had a material business relationship with the fund group for three years.

The FCA advised they were to review the effectiveness of value assessments during 2020. We eagerly await the findings.

4. Covid-19 – regulatory forbearance

The FCA introduced a page on their website in April 2019 entitled **‘FCA expectations regarding funds in light of coronavirus (Covid-19)’**. For the most part it constitutes a set of allowances, or forbearance relating to activity within funds during the coronavirus pandemic. The areas covered:

- Delaying annual and half-yearly fund reports – Authorised Fund Managers have been given an extra 2 months for the publication of annual reports and an extra 1 month to publish half yearly reports. **NOW ENDED**

- Virtual general meetings – The FCA have advised they see no supervisory concern in general meetings being held in virtual format, so for instance a unitholder can be considered to be present at the meeting if they are participating in or have joined a virtual meeting. This is unless fund documentation does not contain details about arrangements that are additional to what is prescribed by the rules

- Ensuring compliance with limits on value at risk (VaR) – The FCA are hesitant to forbear here and consider firms should have made appropriate arrangements. However firms with difficulties should advise their supervisory contact.

- Electronic signatures – FCA are willing to accept Form 21s and Form 12s to be electronically signed during the pandemic.

- Other topics – Various allowances and expectations are outlined concerning MiFID reporting, repo use for liquidity management, CASS, paper-based / manual processes (focusing on ensuring continued ability for physical subs & reds) and AIFMD transparency reporting.


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