THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

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Date: 28 February 2019

Dear Roy,

RE: CP18/40 Consultation on proposed amendment of COBS 21.3 permitted links rules

The Investment Association[1] welcomes the opportunity to provide input to the FCA's consultation on proposed changes to the permitted links rules for the purpose of facilitating greater investment in patient capital assets by retail investors.

As we have previously set out[2], DC pension schemes, and indeed other retail investors, should be able to build fully diversified portfolios in order to realise their financial goals. Pension scheme trustees and providers should be in a position, if they wish, to allocate a proportion of their portfolios to illiquid assets, whose long-term nature should be very well suited to the investment horizon of pension and other long-term investors. The additional diversification and illiquidity premium that these assets can offer could be of considerable benefit to long-term investors. We note also the wider economic benefits that could arise if even a small proportion of DC capital could be allocated over time to assets such as infrastructure, real estate and private equity/debt.

However for a variety of reasons, not all of them regulatory[3], DC schemes' exposure to illiquid assets remains low in comparison to other types of investor.

Investment delivery in the UK DC market is dominated by unit-linked life funds and we have previously identified the permitted links rules as one of the possible reasons why DC

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[1] The Investment Association is the trade body that represents UK investment managers, whose 200 members collectively manage over £7.7 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

The UK is the second largest investment management centre in the world and manages 35% of European assets.

More information can be viewed on our website.

[2] Putting Investment at the Heart of DC Pensions, The Investment Association 2018.

[3] Ibid.

The Investment Association is a company limited by guarantee registered in England and Wales. Registered number 04343737. Registered office as above.

schemes' allocation to illiquid assets remains low. We participated in HM Treasury's Patient Capital Pensions Investment Taskforce, whose work, as the FCA has already recognised, highlighted the barriers created by the permitted links rules.

We therefore welcome the FCA's consultation, which contains a number of helpful proposals, although we think further refinements may be needed in order to help realise the objective of removing some of the potential barriers to retail investors investing in a broader range of long-term assets in unit-linked funds.

Alongside the rule changes proposed in CP18/40, there is a need to consider the current disconnect between the illiquidity of patient capital assets and the convention of DC pension platforms to host funds that provide daily dealing, a feature which is heavily embedded in market practice. The IA believes that FCA engagement with such parties and other relevant intermediaries on this issue will be important in facilitating change.

We respond in detail to the FCA's consultation questions below. There are five key messages in our response:

1. New conditional permitted links. The new categories of conditional permitted links, along with the changes to some of the existing permitted links, are helpful in that they will allow for a wider range of permitted investments that aligns with the FCA's definition of patient capital. We do have a number of specific comments on some of the definitions as we think they are not fully consistent with the policy intention in areas such as infrastructure investment.

2. Investment limits. We believe the existing rules already allow more than 10% of unit-linked fund assets to be held in permitted land and property: the 10% limit is on geared exposure to property and we do not believe any change is needed here. The proposal to remove the 20% limit on holdings of an underlying QIS or UCIS is a welcome simplification that will allow for more flexible and efficient fund construction. However, we do not agree with the proposal to impose an overall fund-level restriction on the allocation to illiquid assets. In the case of existing property funds the proposed rules are inconsistent as they introduce a concept of **either** the existing 10% gearing limit (i.e. up to 110% of fund assets could be invested in permitted land and property) **or** a new 50% overall limit on illiquid assets for those firms choosing to offer the new conditional permitted links. More generally a limit on illiquid asset holdings is arbitrary and would be diluting the benefits of investing in illiquid assets by requiring up to 50% of fund assets to be liquid. Such a dilution may completely change the investment case for illiquid assets and reduce investor demand for them. A restriction at the individual fund level is even harder to rationalise when the fund forms part of a wider investment portfolio, which is likely to be true for the vast majority of investors. Our preferred approach would involve the unit-linked fund manufacturer being responsible for determining the appropriate level of investment in illiquid assets in line with the objective of the fund and its investment policy.

3. Investor protection measures. Investor protection is clearly extremely important. We agree with enhanced disclosure in areas such as liquidity risk, but question the practical feasibility of other aspects of the proposals. There are two key issues:

(a) Redemptions/transfers. We perceive a disconnect between the reality of investing in illiquid assets and the expectation in the proposed rules that investor rights in respect of switching funds and taking or transferring benefits should be unaffected. Product providers should be given more leeway here to align the redemption rights of the fund with the liquidity of the underlying portfolio, with the terms of the policy made clear to unit-linked policyholders beforehand. Further measures to protect customers could include consideration being given to whether unit-linked funds that are investing significantly in the

new permitted links would need to be sold to non-DC default retail investors on an advised-only basis, or available directly, subject to appropriateness tests. For DC default strategies, providers and trustee boards will, as now, need to consider the impact of any illiquid asset holdings on the overall liquidity of the portfolio, and ensure that they have sufficient liquidity to meet their members' needs throughout the life of their investment.

(b) Suitability requirement at manufacturer level. The current proposals do not place the requirement to assess the suitability and appropriateness of investments at the right level of the distribution chain and will be very difficult for the fund manufacturer, whose funds are frequently combined within a wider fund or strategy depending upon the needs of the end customer, to carry out:

- In the case of unit-linked funds used by the default arrangements in DC schemes (an example cited in the CP), the unit-linked fund manufacturer may not have visibility through to the underlying investor and so in general cannot be in a position to judge suitability and appropriateness of investments for underlying investors. These obligations should instead sit with pension fund trustees and pension product providers in the trust and contract-based worlds respectively. Indeed, we recommend an approach that recognises the enhanced governance processes in place in both contract and trust-based arrangements (see below).

- In the wider retail market, other intermediaries – notably advisers/distributors in the context of unit-linked life products – are likely to have more immediate visibility of the customer. We note that advisers and distributors advising on and distributing life policies respectively already have specific responsibilities with respect to suitability and appropriateness tests under the Insurance Distribution Directive (IDD).

In summary, we are not convinced that the inclusion of patient capital assets in unit-linked funds is in itself sufficient to warrant an additional set of investor protection requirements over and above what already exists in FCA rules. Retail investors investing via unit-linked contracts can already invest in illiquid assets and recent FCA work on illiquid asset funds has found that liquidity risks in unit-linked and authorised funds are well managed.

4. Facilitating consistency and investment flexibility in DC default strategies. As the FCA notes, the permitted links rules currently look through to the underlying investor, a retail client, meaning all investments must be suitable for retail investors. It is this retail status that necessitates the additional investor protections proposed in the revised permitted links rules. For the reasons discussed in this response, our view is that some of the investor protection proposals in the consultation will prevent DC schemes from being able to invest in patient capital assets. We think the way to address this is by considering how to treat savers in the default strategy as professional investors.

There is a clear rationale for such a move, based on the way that default strategies are designed and governed, which makes them distinct from more typical retail investments. DC defaults can be thought of as retail investments purchased through an institutional oversight process. While individuals do bear the investment risk in DC, the default strategy by definition does not involve individuals making investment choices. Instead default strategies are constructed by trustees and pension providers with the advice of investment consultants and/or professional in-house investment teams.

The construction of the default strategy is therefore a highly professional process. Existing governance requirements for trustees, pension providers and their IGCs include the on-going assessment and review of the characteristics and net performance of the default

strategy to ensure alignment with the interests of relevant members/policyholders[4]. These obligations should already encompass the type of suitability and appropriateness assessments that the FCA is proposing in CP18/40. These investment governance requirements sit alongside other existing investor protections on the default strategy: the charge cap, enhanced cost and charge disclosure and 'value for money' assessments.

In light of these existing protections, DC default investors – and only these investors, not self-select pension investors, nor holders of other insurance-based investment products – should be classed as professional investors. This is likely to make it easier for DC scheme defaults to access patient capital investments as it would not require the additional suitability and appropriateness checks to be carried out in this specific case. The existence of the 'default arrangement' as a distinct legal concept in FCA rules and pensions law[5] provides a well-defined and narrow mechanism on which to apply the revised client categorisation.

We emphasise that outside of unit-linked investments, DC trustees are already treated as professional clients, meaning that DC schemes investing directly or via non-insured funds can already access investments designed for professional investors. Some large DC schemes are already considering accessing illiquid investments outside of unit-linked vehicles as an easier way to gain exposure to these assets. This will create a difference in the availability of asset classes between those schemes investing through unit-linked funds and those not. Those members of schemes investing outside of unit-linked funds may gain access to more diversified portfolios and possibly end up with better outcomes as a result. This is surely undesirable: the interests of members are the same whatever type of scheme they are in, and differences in how investments are accessed should not be responsible for leading to differences in their pension outcomes. Changing the status of DC default investors to professional clients would be a logical way to ensure all schemes – whether trust or contract – can access the same types of investments if they choose.

The challenge would be how to do this without compromising the wider protections enjoyed by retail investors in unit-linked arrangements. The IA would be keen to work further with regulators and other stakeholders to achieve an outcome that provides the investment exposure desired by DC schemes within the spirit of the permitted links regime.

5. Treatment of patient capital investments under Solvency II capital requirements. Finally, although not for the FCA, we raise a potential issue in respect of the prudential regulation of unit-linked insurance firms under the FCA's proposals. It is not currently clear how patient capital investments would be treated under Solvency II's capital requirements regime. If unit-linked fund providers were required to hold additional capital against illiquid patient capital assets, this could act as a disincentive to provide these assets through unit-linked funds. Until there is clarity on how these assets would be treated under Solvency II, unit-linked fund manufacturers may be reluctant to innovate in this area[6]. We suggest the FCA work closely with the PRA as it finalises its proposals, so the latter can provide the required clarity to unit-linked firms.

I hope this response is helpful and would be happy discuss it with you further.

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[4] Trustees' obligations in this regard arise from Regulation 20(b) of The Occupational Pension Schemes (Charges and Governance) Regulations 2015. IGC obligations to ensure that providers carry out their duties on investment governance of the default strategy are set out in COBS 19.5.5 R(2).

[5] See the FCA Handbook Glossary and Regulation 3 of The Occupational Pension Schemes (Charges and Governance) Regulations 2015.

[6] Note also that high capital charges may prove a disincentive to providing exposure to patient capital assets through unit-linked funds compared to other fund structures. This may result in investors in unit-linked funds being unable to access patient capital assets.

Yours sincerely,

Imran Razvi,

Senior Policy Adviser, Pensions & Institutional Market

RESPONSE TO CONSULTATION QUESTIONS

Q1: Do you agree with our proposal to allow investment in immovable structures or installations as above? If not, how could we change it?

1. We agree with the proposal to allow unit-linked funds to invest in immovable structures and installations via the creation of a new permitted link for immovables. However we do not believe that the current definition of a conditional permitted immovable will allow all types of direct infrastructure investment because any such investment will still need to be a permitted immovable and thus meet the requirements of COLL 5.6.18 R(2).

2. This creates an issue because not all infrastructure structures or installations have a freehold or leasehold interest in the land they are on, so the condition in COLL 5.6.18 R(2)(b)(i) cannot be met. An example of this might be a solar energy project on farmland: this type of infrastructure would not hold the freehold or leasehold to the land but instead have a secured tenancy for the duration of the project. This is an important distinction to make, because it means there is no real estate exposure involved in the infrastructure project: the exposure is purely based on the returns of the infrastructure asset – regardless of property and land valuation changes.

3. Many pure infrastructure assets do not own the land (or sea) they are built on and so the reference to COLL 5.6.18 will mean such assets are not able to meet the definition of conditional permitted immovables. Non-exhaustive examples of such assets might be Onshore and Offshore Wind, Solar, Biomass and Broadband. This issue will also apply to the other new conditional permitted link categories where they in turn reference the proposed definition of a permitted immovable.

4. This seems to contradict the FCA's policy intention as expressed in paragraph 3.6 (p12) of CP18/40 and further clarification would be helpful here. Assuming the FCA's policy intention is as reflected in the CP, we believe that creating a new permitted link for infrastructure assets would be the best way forward. This would avoid any unintended consequences of changing the existing permitted immovable definition in COLL in order to better account for the structuring of infrastructure projects.

5. Beyond this, we note that the discussion in paragraph 3.6 of the Consultation Paper suggests limiting the investment to immovable structures or installations on any property within the United Kingdom. The Cost Benefit Analysis at paragraph 21 (page 24) also refers to investment coming into the UK; though this reference may be more understandable as a reference measure of CBA for the FCA and as merely noting a likely consequent impact. We do not read the Handbook provisions (now or as proposed) as limiting permitted immovable investment to the UK – COLL 5.6.18 R (2)(c) and 18A R are clear that non-UK immovables can be used, given the term "United Kingdom" is defined in the Glossary as the three jurisdictions in 18(2)(b)(i) and (ii), and only those three.

6. We do not agree with any territorial restriction as we do not see why unit-linked fund investors should be denied access to investments in overseas infrastructure projects. Such a restriction would limit retail investors' ability to access a more diversified range of infrastructure investments. We would therefore suggest that any

limitation to UK infrastructure would be inappropriate and that the existing definition in COLL is sufficient.

7. Finally, although the FCA has not asked explicitly for feedback on this point, we observe that the proposed definition of a conditional permitted loan may be too narrow in scope. In particular it could be limited to real estate because of the reference to collateral for the loan being fully secured by *'…a mortgage or charge on conditional permitted immovables...'*. This may prevent loans being secured against other assets besides real estate. We note also that a requirement for loans to be fully secured will rule out loans made on an unsecured or partially secured basis. While these loans will be riskier than fully secured loans, they may come with higher potential rewards as a result.

Q2: Do you agree with our proposal to remove, for firms that meet the conditions above, the current 10% limit on the proportion of fund assets that may be held in land and property, relying instead on the overall limit in illiquid investments? If not, what percentage would you suggest is appropriate?

8. Our reading of the definition of permitted land and property in COBS 21.3 is that unit-linked funds can already hold more than 10% of their assets in permitted land or property. There is however a 10% limit on the fund's ability to gain geared exposure to property. Technically firms could therefore invest up to 110% of fund assets in permitted land and property. We do not think any change is required here.

9. However, the proposed rules are confusing as they would allow firms to invest up to 110% of unit-linked fund assets in permitted land and property, while restricting firms choosing to offer investments in the new conditional permitted links to a 50% limit on illiquid assets. These positions are inconsistent.

10. In our view, the way to resolve this is to avoid the imposition of the 50% limit on investment in illiquid assets. As we discuss in further detail in our response to Q6, we do not favour such limits, which can only ever be arbitrary and constrain the fund manufacturer's ability to design suitably diversified portfolios that meet investors' needs.

11. For funds that are designed to hold illiquid patient capital assets, our preferred approach would be for:

    - Limits on illiquid holdings to be removed and for it to be left to the discretion of the unit-linked fund manufacturer to ensure that the assets held are consistent with the investment objectives of the fund;
    - The fund manager to manage liquidity in line with what has been offered to investors prior to investment; and
    - The liquidity implications of being invested in the fund to be made clear to investors prior to any investment being made (a point we discuss further in our answer to Q7).

Q3: Do you agree with our proposals only to allow additional investments if the conditions in paragraph 3.17 are satisfied?

12. We disagree with the FCA's proposals to allow investments in patient capital assets by unit-linked funds only if all the consumer risk mitigation proposals in CP18/40 are satisfied. While we think the additional disclosure around liquidity risk is a reasonable expectation, we have a number of concerns over the feasibility of some

of the other proposals in practice and as a result expect that product providers and unit-linked fund manufacturers may not feel comfortable in offering patient capital investments. We discuss these concerns in more detail in our answers to Qs7-8.

13. That said, we acknowledge that further work may be needed to determine whether retail investors outside of DC default strategies should be able to access patient capital investments on an advised basis or whether they can be made available on a non-advised basis subject to appropriateness checks being carried out.

14. More generally, while investor protection is always paramount, we are not convinced that the inclusion of patient capital assets in unit-linked funds is in itself sufficient to warrant an additional set of investor protection requirements over and above what already exists in FCA rules.

15. Patient capital covers a number of different asset classes, but their unifying feature is that they all exhibit varying degrees of illiquidity. However, liquidity risk is just one of a number of risks that investors may need to consider and it is not clear that its presence alone justifies an additional set of investor protections for unit-linked funds investing in patient capital, particularly as part of a long-term investment strategy.

16. We would note that retail investors investing via unit-linked contracts can already invest in illiquid assets and the FCA's 2016 review of property funds and subsequent work on illiquid assets found that liquidity risks in unit-linked and authorised funds were well managed. It is therefore not clear what the FCA's concern is specifically in relation to patient capital assets.

Q4: Do you agree with our proposal to relax the requirement for unlisted securities to be 'realisable in the short term' and to replace this with a liquidity test at the level of the investment fund, as set out above? If not, how could we change it, if at all? Do you think either of the alternative asset-level restrictions would work better?

17. We agree with the proposal to relax the requirement for unlisted securities to be 'realisable in the short term'. This should allow for unit-linked funds to hold unlisted securities that, on an individual basis, are not always realisable in the short term.

18. We agree also with the proposal for a liquidity test at the level of the fund, such that the unit-linked fund manufacturer is able to demonstrate that the investments are realisable on a timeframe necessary to meet the liquidity requirements of the fund. This is consistent with our view that it should be the unit-linked fund manufacturer that is responsible for ensuring there is appropriate liquidity to meet investor demand in line with what was offered prior to investment.

19. For the same reason as set out in paragraph 10 above we do not favour the asset-level restrictions that the FCA has considered as alternatives to the fund-level liquidity test.

Q5: Do you agree with our proposal to remove, for firms meeting the investor protection conditions, the current 20% limit on holdings of assets through QIS/UCIS and instead rely on the overall limit of 50%? If not, how could we change it?

20. We agree with the proposal to remove the 20% limit on a unit-linked fund's holdings of an underlying QIS or UCIS as these fund structures may more readily accommodate patient capital investments. Increasing the extent to which they may

be used in unit-linked funds should therefore aid the goal of giving retail investors the ability to access patient capital investments. However, in line with our answer to Q2, we do not think this should be replaced by a fund-level limit on illiquid assets of 50% because of the constraint this represents on the provider's ability to design the fund's portfolio.

21. While we recognise that QIS and UCIS are intended for professional or sophisticated retail investors, when offered to retail investors through a unit-linked contract the normal protections available to retail investors would apply. In addition the FCA's proposal to require risk warnings in relation to liquidity would be a further important protection for retail investors prior to investment.

Q6: Do you agree with our proposal to set an amalgamated overall threshold limit for firms meeting the conditions as above? If not, what could we change? Do you agree with the percentage level proposed, or if not, what should it be and why?

22. Compared to the asset class-level restrictions in the current rules, we believe that an overall limit of 50% of the unit-linked fund's holdings being permitted in illiquid assets is an improvement and should allow for greater access to illiquid assets as well as simpler portfolio structuring than is currently the case.

23. However, at a more fundamental level we question the use of any limit, whose level can only ever be arbitrary, on illiquid asset holdings in a unit-linked fund that is specifically designed to provide investors with access to illiquid assets. From an investor perspective this would be diluting the benefits of investing in illiquid assets by requiring up to 50% of fund assets to be liquid. Such a dilution of the benefits of illiquidity may completely change the investment case for illiquid assets and reduce investor demand for them when accessed through unit-linked funds.

24. A restriction at the individual fund level makes even less sense when the fund is viewed as part of a wider investment portfolio. Many investors will use individual funds as building blocks in a diversified investment portfolio and the overall exposure to illiquid assets may be low. For example, our discussions with asset managers and DC pension schemes suggest that these schemes envisage no more than 10-20% of their default strategy assets being invested in illiquid assets. Trustees and providers constructing the default can blend different funds to achieve the desired level of exposure to illiquid assets. The same can be said of a retail investor using an illiquid fund as part of their wider portfolio. It is not clear in this context what benefit a fund-level restriction on holdings of illiquid assets provides.

25. As well as the dilution of the very illiquidity benefits that the investor wishes to gain exposure to, an arbitrary investment limit could expose investors in the fund to forced asset sales (potentially at disadvantageous prices) in order to avoid breaching the limit. The consequence of this is that unit-linked providers are likely to hold illiquid assets at a level significantly below the proposed 50% limit in order to reduce the risk of ever breaching it[7]. This would further dilute the benefits of illiquidity, altering the investment case as well as being potentially misleading: a fund that was designed to provide exposure to illiquid assets would have less than half of its assets allocated to illiquid investments.

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[7] We have already heard feedback from some unit-linked fund providers that the existing 20% limit on QIS holdings provides the same incentives and so QIS holdings in unit-linked funds, where used, tend to be some way below the 20% threshold.

26. Our preferred approach would involve the FCA not setting a limit but instead requiring the unit-linked fund manufacturer to be responsible for determining the appropriate level of investment in illiquid assets in line with the objective of the fund and its investment policy. The fund manufacturer would be responsible for managing liquidity in line with this objective and this would naturally determine the appropriate balance between liquid and illiquid assets in the fund.

27. If the FCA is not minded to move away from an overall limit than we would at a minimum propose an increase in that limit, although any number would be arbitrary. In light of our comments in paragraph 25, we think a limit of 75-80% would at least allow for a reasonably high allocation to illiquids that would be consistent with a fund offering investors exposure to illiquid assets.

Q7: Do you agree that the obligation on firms to provide adequate risk warnings about liquidity and investment risk would contribute to better understanding of those risks by investors in unit-linked funds?

28. We agree that it is important to ensure investors are aware of the risks in relation to being invested in illiquid assets alongside the other risks that will be inherent in any investment strategy pursued. In that regard we agree with the obligation on firms to provide policyholders with the information proposed in the new COBS 21.3.1G R(1)-(3) alongside the information already required on investment strategy and risk in COBS 21.2.4R.

29. In providing this information we are of the opinion that liquidity risk should be clearly presented as another risk that needs to be considered alongside other investment risks. However, we would not favour placing any special emphasis on liquidity risk over and above other risks, otherwise there is a possibility that illiquid funds may appear riskier to potential investors in comparison to other types of investment. We mention this only because we note from the FCA's proposals in CP18/27 on illiquid assets that the emphasis on disclosure of liquidity risk seems greater in comparison to other risks faced by investors.

30. The proposed requirement on firms to provide consumers with adequate risk warnings about liquidity and investment risk in relevant disclosures at an appropriate point in the investor's decision-making process should be straightforward to provide as part of existing fund documentation prior to any investment being made, and should help inform the decision-making of those investors that look at the documentation prior to investment. This will adequately cover those retail investors accessing unit-linked funds outside of DC automatic enrolment default strategies.

31. In the case of DC default strategy investors, however, it is not clear if these investors will ever look at such literature, and therefore whether the requirement would have any effect on their behaviour. The nature of default strategy investors is that they are generally disengaged from investment decision-making and so highly unlikely to look at any literature relating to their investment strategies. Since membership of the default strategy is so high[8], this amounts to millions of investors who are unlikely to look at the risk warnings.

32. We do not see this as a problem. Since the construction and ongoing oversight of the default strategy is carried out by professionals (either trustees acting on the

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[8] The proportion of members in the default strategy is on average 94% for Group Personal Pensions and 99.7% for master trusts. Source: The Future Book: Unravelling workplace pensions 2017 Edition, PPI, 2017.

advice of investment consultants or in-house investment teams, or in the contract-based market, investment professionals at insurance companies), we consider the risk warnings to be less relevant for individual investor decision-making in the specific context of auto enrolment DC defaults. It is the professionals constructing these default strategies that need to take into account liquidity risk when designing defaults.

33. Our proposal to treat DC default investors as professional clients would remove the obligation to supply these disclosures to these investors, although they could still be made available for any investor wishing to read them.

Q8: Do you agree with our proposal to require provider firms to ensure that any unit-linked investment does not interfere with retail investors' rights to switch funds, take benefits or to withdraw or transfer funds? And our proposal that links to the new categories of investment are only offered/taken up in suitable and appropriate investment contexts? If not, how would you change it?

34. Before discussing the specific proposals in this area, it is important to distinguish between the different elements of the distribution chain in the market for unit-linked investment products, as this has implications for the feasibility of the investor protection obligations that the FCA proposes imposing on unit-linked fund manufacturers.

35. Unit-linked funds are typically sold as part of a product offered by another provider e.g. a trust-based pension scheme, contract-based pension plan, or a retail insurance-based investment product (IBIP). The manufacturer of the unit-linked fund will treat as its client the pension fund trustee or the insurance company providing the pension or IBIP, although as the FCA has noted, the permitted links rules require all unit-linked investments to be suitable for the retail investor that ultimately bears the investment risks of these products.

36. In many of these products, particularly DC default strategies, a number of different unit-linked funds from different manufacturers may be blended together to create an overarching strategy that provides exposure to different asset classes and markets. The implication of this is that individual unit-linked fund manufacturers may have little or no visibility through to the underlying investors in their funds nor the wider context in which their fund may be being used.

37. As a result we think the proposals in this section do not apply at the correct level of the distribution chain and are therefore not currently feasible – individual unit-linked fund manufacturers will not be in a position to ensure that the investment strategy does not interfere with policyholders' rights, nor will they be in a position to assess the suitability and appropriateness of the investments for the investors in their funds.

38. Instead, these obligations should apply at the level of the product provider/distributor – the pension scheme or insurance company – which does deal directly with the underlying investor. Where a retail investors purchases an IBIP on an advised basis, the obligation could be put on the adviser.

Investor rights in relation to switching funds, taking benefits or withdrawing or transferring funds

39. With regards to ensuring that any unit-linked investment does not interfere with retail investors' rights to switch funds, take benefits or to withdraw or transfer

funds, our view of the FCA proposals is that they may inadvertently result in a lack of patient capital-based funds being offered by product providers.

40. Although the FCA is clear in the CP that it wants firms to have the option of offering illiquid investments, the protections (COBS 21.3.1B R(1)) in respect of the investor rights set out in COB 21.3.1C currently read as though the existing rights enjoyed by investors should continue even if the investments are held in illiquid assets. Clearly, a holding in illiquid assets may impact an investor's ability to exercise their rights promptly, and we perceive here a contradiction between the policy intention and the rules which is likely to result in product providers taking a cautious approach and not offering illiquid investments, giving greater importance to the need to maintain investors' current rights under the policy.

41. Instead, product providers should have some flexibility in this area, such that investors' rights *can be realised in as timely a fashion as possible*, subject to the underlying assets being sold at a price that does not disadvantage them.

42. At an intuitive level, investors will understand the difficulty in selling investments such as property or infrastructure in a reasonable amount of time and at the price desired and they will be willing to accept illiquidity in the expectation that these assets will yield a long-term return. Such investors will therefore understand that a fund may have difficulty realising the proceeds of the sales of its underlying assets and that they may not immediately be able to realise some of their rights under the policy. These issues could be further explained under the proposed risk warnings in COBS 21.3.1G.

43. Further measures to protect customers could include consideration being given to whether unit-linked funds that are investing significantly in the new conditional permitted links would need to be sold to non-DC default retail investors on an advised-only basis, or available directly, but subject to appropriateness tests being carried out by the product provider/distributor.

44. For DC default strategies, providers and trustee boards will, as now, need to consider the impact of any illiquid asset holdings on the overall liquidity of the portfolio, and ensure that they have sufficient liquidity to meet their members' needs throughout the life of their investment.

Assessing the suitability and appropriateness of conditional permitted links for retail investors

45. As we have stated earlier in our response, we are not convinced that the ability to invest in a wider range of patient capital assets alone is justification for an additional set of investor protections beyond what already exists in FCA rules; after all, unit-linked investors can already access some illiquid asset classes.

46. However, if the FCA intends to proceed with the proposals for assessing the suitability and appropriateness of the conditional permitted links for unit-linked investors in COBS 21.3.1B R(2) and 21.3.1DG, then, as we explain in paragraphs 35-37, the manufacturer of any individual unit-linked fund is unlikely to be in a position to make these assessments.

47. Instead these obligations should sit with the product provider, distributor or adviser, if used. In trust-based DC pension schemes this would be for the scheme's trustees, while in contract-based DC schemes and IBIPs, the obligation would lie with the product provider/distributor/adviser (the latter, if used). In these cases the

connection with the end investor is direct, in contrast to the position of the unit-linked fund manufacturer.

48. If the FCA were minded to consider our proposal to treat DC default strategy investors as professional clients, this would negate the need to perform the suitability and appropriateness checks in relation to the conditional permitted links for those clients. As we have argued in our cover letter this can be justified because these checks are being carried out at the level of the overall default strategy under existing FCA and DWP rules.

49. For any self-select funds made available outside DC default strategies, or in any IBIP, the suitability and appropriateness assessments can be carried out by trustees and product providers as appropriate and we note also the rules in relation to suitability and appropriateness under the Insurance Distribution Directive (IDD), which are relevant here.

50. While pension scheme trustees are outside the FCA's regulatory perimeter, they are already subject to prudent person rules and codes of practice[9] from The Pensions Regulator (TPR) that require them to ensure the appropriateness of all investments offered to their scheme members, after having taken advice from a suitably qualified person. TPR could, if it felt it necessary, make these requirements more explicit in the context of patient capital investments specifically.

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[9] Code 13: Governance and administration of occupational trust-based schemes providing money purchase benefits, TPR, 2016.