CP20/15: Liquidity mismatch in authorised open-ended property funds

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £7.7trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

About the Association of Real Estate Funds

The Association of Real Estate Funds (AREF) represents the UK real estate funds industry and has 67 member funds with a collective net asset value of more than £70 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the MSCI/AREF Property Fund Vision Handbook.

Executive Summary

The Associations welcome the consultation on the introduction of notice periods in authorised open-ended property funds. Retail investors and DC pension savers should have access to less liquid and illiquid asset classes through the appropriate structures. Access to property as an asset class is an important source of diversification for investors' portfolios as it offers low correlation with other asset classes, as well as providing a source of income return that is important for long-term savers.

The Associations have long been advocates of an extension to the liquidity toolkit for UK authorised collective investment schemes and the use of these liquidity tools by those schemes, where appropriate. While we have not seen evidence that property investment fund redemptions pose a wider threat to financial stability, tools to better manage potential or actual liquidity mismatch in the investment fund universe can play a valuable role in improving the investor experience and reducing any risk of market dislocation. The proposed changes for property funds are also an opportunity to lay the foundations for greater access to other illiquid assets over the long term.

In terms of the key proposed changes, our view is as follows:

- Notice periods should be 90 days not 180 days.
- Notice periods should not be applied to subscriptions.
- The threshold for an FPIP should be 75% investment in immovables and does not need to be aligned with the FIIA definition.
- We agree with the arrangements for a notice period, namely that an irrevocable contract is entered into at the beginning of the notice period, with the value being

received by redeeming investors being based on the price of the fund at the first valuation point after the end of the notice period.
- AFMs should be able to operate different redemption arrangements in share classes in the same fund.
- Notice periods should be taken into account when effecting changes to the fund's terms.
- Notice periods should continue to run during a fund's suspension.
- The FIIA rules should continue to apply to FPIPs, with some limited exceptions.
- A minimum 24-month transition would be needed to implement the proposals.
- Secondary markets can be a useful tool for institutional investors, but barriers exist that prevent the majority of retail investors from using a secondary market.

For this to be successful, both in the near and longer term, there are a number of pre-conditions relating to the wider distribution ecosystem. First, the distribution environment needs to be able to support the introduction of notice periods from an operational perspective. Second, and linked to the first point, asset allocators and fund selectors across the investment and pension landscape need to be comfortable with the use of notice periods, particularly from an operational perspective. Third, the wider tax and regulatory environment for wrappers such as ISAs and pensions need to be reviewed to accommodate illiquid assets.

These three conditions are not currently met and are unlikely to be in the short term. It is essential that the entire ecosystem for authorised funds is able to support notice periods before they are introduced as a tool, particularly if they are to be a regulatory requirement. We wish to ensure that their introduction does not lead to the unintended consequence of investors no longer having access to authorised property funds in their ISA or DC pension portfolios or that property as an asset class becomes unattractive to investors, leading to a widespread disinvestment from these funds. The knock-on effects of large and sudden outflows from these funds on the property market should also be taken into consideration.

In this regard, we will be responding to HMRC's consultation on ISAs and authorised open-ended property funds to reaffirm the need for these funds to be available to investors in ISAs if notice periods are introduced. In our view, the signal being sent by this consultation is that investing in illiquid assets is inappropriate for retail investors. We profoundly disagree and believe this has the potential to send a negative signal about the purpose and direction of the entire proposed policy change. As we explain in more detail in our response, it is undesirable to exclude direct property from ISAs. There are also operational implications for model portfolios currently investing via such funds.

In preparing our response, as well as liaising with our members, the Associations have spoken to investment platforms, consultants, DC pension schemes, transfer agents, wealth managers, depositaries and other trade bodies. Our full response to the questions posed in the consultation can be found below. Due to the challenges of most people having to work from home and there being several consultations for firms to respond to at the current time some parties have advised us they are not submitting their own response. We would encourage the FCA to ensure they receive the views of all stakeholders and not just rely on the responses they receive to the consultation.

Ultimately, this consultation points to the need for a cultural and behavioural shift which recognises that investing in illiquid assets is both important for savers and the economy, and also requires different expectations around fund liquidity. For this shift to be successful, regulators and industry need to work together across the delivery chain to bring about the necessary changes. Ideally, this will result in a regime that can evolve over time better to support both property and wider illiquid asset classes such as infrastructure and private debt as part of a revitalised UK funds regime.

Responses to Questions

Question 1: 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 Associations cannot immediately see any issues that might be relevant.

Question 2: 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 Associations agree that the full liquidity toolkit as permitted by UCITS and AIFMD should be made available to AFMs to use where appropriate for their authorised funds. Notice periods could form an important part of the toolkit, enabling AFMs to manage liquidity more effectively with more visibility of expected redemptions. In addition, as the CP notes, the use of a notice period is likely to enable AFMs to manage authorised property funds with lower buffers in cash or other liquid assets, in case of an unexpected large redemption from the fund.

However, it is clear that the entire authorised funds ecosystem, including critical platform infrastructure, is not ready to support notice periods. Some funds of funds may also not have the processes in place to invest in funds with notice periods.

Introduction of notice periods without full readiness from the ecosystem would create substantial issues at the outset and may, in some cases, lead to investors moving away from authorised property funds as an investment. The Associations strongly support the property sector as a sector for long-term investment by all types of investor and recognise the importance of open-ended funds as a way for retail investors to diversify their portfolios by providing access to investment in property.

Successful introduction of the reforms proposed in CP20/15 can help also to open the way in due course for other vehicles investing in illiquid assets. In this regard, the IA has proposed the introduction of a Long-Term Asset Fund (LTAF) which could facilitate this. A change both in operating infrastructure and approach to portfolio construction could help investors access a wider range of investment opportunities, with property the starting point as an important source of diversification and sustainable long-term return. Conversely, if these reforms cannot be supported across the ecosystem, it may become much more difficult for funds to invest in a wide range of illiquid assets.

As regards scope, we propose an amendment to the definition of an FPIP as any NURS that invests 50% or more in immovables (or in other schemes that invest in immovables to the same extent). We see 75% as a more appropriate threshold. There are some investors who are willing to accept high cash or near cash levels in funds investing in property, and the reduction in returns that may occur from this, in return for having the ability to redeem without a notice period. We propose that funds with less than 75% held in immovables would not have a notice period for redemptions, as 25% or more held in liquid assets would enable them to meet redemption requests and reduce the need to suspend due to liquidity issues in most circumstances.

We do not agree that the definition of an FPIP needs to be aligned with the definition for a FIIA. Investment in assets that are not immovables does not need to be over 50% to address liquidity mismatch; a limit of 25% should be sufficient for this. In practice, the level of immovables would probably be well below 75% (modelling undertaken by a member suggests that in effect the proportion would be no more than 60%) to avoid straying over the limit either by the immovables increasing in value or more likely by liquid assets, such as REITs, suddenly reducing in value.

Question 3: 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?
We agree with each point on the dealing structure proposed, namely that an irrevocable contract is entered into at the beginning of the notice period, with the value being received by redeeming investors being based on the price of the fund at the first valuation point after the end of the notice period. We would appreciate clarity from the FCA that the arrangement would provide the investor and manager with the contractual right to a notice period at the point of deal acceptance. From a tax perspective, it is important to be clear on when the investor loses the beneficial ownership of the shares/units. We would also welcome legal clarity that there would be no contractual right to the expected valuation point advised to the investor, as required under COLL 6.2.22AR (2)(c)(i)), as this would be an expected, rather than guaranteed valuation point.

We accept that there is an element of market risk for redeeming investors, using this structure, but agree that this risk should not be borne instead by the fund and its remaining investors and that this is a fair way to balance the interests of all investors.

We note the drafting of COLL 6.2.22A R (3):

"Where the *fund predominantly investing in property* has more than one *class* of *unit*, the redemption arrangements must apply to every *class* of *unit issued* in the *authorised fund*.

We are aware that there are currently authorised NURS that operate limited redemption arrangements for institutional share classes, while operating daily-dealing retail share classes simultaneously. Under the proposed changes, it would not be possible to operate limited redemption arrangements for some, but not all share classes. We draw the FCA's attention to the differing needs of retail and institutional investors and ask the FCA to review this proposed rule.

The Associations are also of the opinion that changes to funds' documentation would be a significant change under COLL 4.3. However, we ask for clarity on the proposal that once a notice period has been applied, for any future changes to the fund the notice period for redemptions should be allowed for when giving investors notice of the change. The example given in the CP is that a fund operating a dealing notice period of 90 days would need to communicate changes to unitholders at least 150 days in advance. It is accepted practice that 60 days is sufficient time for investors to reconsider their investment and redeem units and this could be applied to funds with notice periods too. Using the example above, investors who submit redemption requests within the first 60 days, after the notice of change, would have those deals accepted under the fund's current terms and they would be placed 90 days later under the current terms. Redemption requests received from day 61 onwards would be accepted after the effective date of the change and would be placed 90 days later under the new terms. We do not believe investors need to be given 150 days to make a redemption request after they have been advised of a significant change. The FCA may wish to consider making it clearer in the proposed rules that redemption requests received from day 61 would be subject to the change in the fund's terms.

We also agree that the way in which funds accept subscriptions should not be changed, i.e. there will be no notice periods introduced for subscriptions.

Finally, we agree that AFMs should be required to provide appropriate warnings covering market risk they will be exposed to over the notice period, the length of the notice period and the irrevocable nature of the redemption requests.

Question 4: 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?
As the CP acknowledges, a normal time period for selling commercial property is between 60 and 90 days. We therefore agree that a 90-day notice period would be more appropriate for these types of funds; longer than this is not required. Less than 90 days may not resolve the liquidity mismatch issue that these proposals intend to resolve.

We agree that 90 days is likely to be an acceptable timeframe in which an investor can plan financial affairs. This position is supported by survey research undertaken by a leading investment fund platform[1], which found that 75% of respondents preferred a notice period of 90 days or less for property, with some 7% agreeing with a notice period of 180 days. At the same time, there is not universal support for notice periods in property funds, with 37% of respondents suggesting that they would stop investing in property funds or look to access property funds in a different way.

As noted above, the introduction of a notice period introduces some market risk to those redeeming investors and this risk may increase over time, particularly in volatile markets. Bearing this in mind, along with the average time needed to sell a property at its market value, we are of the opinion that 90 days' notice period is fair to all investors.

The notice period should be aligned with the redemption frequency of the fund. For example, in a daily-dealing fund, 90 days' notice period would be appropriate, but for monthly-dealing funds, 3 months' notice period would better align. We ask that the FCA allows AFMs to apply this flexibility.

Question 5: 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 Associations are of the opinion that the introduction of notice periods would reduce the number of suspensions in open-ended property funds for liquidity reasons. AFMs would have better visibility of upcoming redemptions and in most cases would be able to manage sales of underlying assets in good time to meet those redemption requests.

That said, suspensions are still a valid liquidity tool and are unlikely to be eliminated totally. In addition, suspensions that are not invoked for liquidity reasons, such as when material uncertainty is declared over a substantial amount of a fund's assets, would not be affected by these proposals.

Visibility over the level of expected redemptions upon the lifting of a fund's suspension is an important tool when determining whether a suspension should be lifted and allowing redemption requests to be accepted during a fund's suspension would assist with these considerations. We appreciate that currently under COLL7.2.1R (6) it is permitted to accept

[1] Source: Hargreaves Lansdown

subscription and redemption instructions during a fund suspension, but we understand that this is rarely done. We note that the proposed rules say that, for a FPIP, an AFM must be willing to accept a request to redeem units after the beginning of a suspension unless they have reasonable grounds for refusing to do so. Platforms and transfer agents would have to have the systems and processes in place to enable them to accept redemptions requests during fund suspensions which we understand many do not at present. Also, the proposed rules say that when redemption requests are accepted the AFM must confirm to the unitholder the dates on which it is expected the redemption will be effected. When a fund is suspended this will not be possible; all the AFM can do is advise the unitholder that any deals that could not be placed due to the suspension will be placed on the first valuation point after the fund reopens.

Has the FCA considered permitting AFMs to accept and settle subscriptions while a fund is not able to settle redemptions due to liquidity reasons? We can understand why subscriptions would not be accepted when a fund has suspended due to material uncertainty. However, we are aware that when some property funds suspended in 2016 there were some investors that wished to invest in the funds and were not able to until suspension was lifted. Accepting subscriptions could actually help the funds to lift suspension more quickly.

Question 6: Do you agree that it is appropriate for FIIA rules to continue to apply to authorised property funds that operate notice periods?
The Associations agree that FIIA rules, with some minor exceptions, such as the removal of the standard risk warning on financial promotions, should continue to apply.

Question 7: Do you agree that property fund NURS currently dealing no more frequently than monthly should not be classified 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?
The Associations welcome the recognition of the distinction between the liquidity issues of daily dealing funds and those which accept deals less frequently.

However, defining NURS dealing no more frequently than monthly differently depending upon when they were launched could cause confusion for investors who may invest in one of these funds that is not a FPIP and one that is.

We appreciate that the FCA may have a concern that funds aimed at retail investors may switch to monthly dealing to avoid the requirement for a notice period. The Associations however acknowledge that these funds should not be subject to a "one size fits all" approach and that the requirements of retail and institutional investors are very different and should be taken into consideration when deciding whether a fund should be classified as an FPIP.

In addition, we would point out that a monthly, or less frequently dealing fund may accept deals up to the valuation point and settle those deals within the standard settlement period of 4 days. Has the FCA taken this into consideration?

Question 8: 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?
Yes, we agree with this approach. Requiring SIPP providers to put up additional capital to cover the risks arising from business that was in place prior to the proposed rule change is disproportionate and would penalise providers. As the FCA notes, this may also result in unintended consequences such as increased client charges to cover the additional capital costs. A transitional rule will avoid these impacts.

However, after any new rules are put in place, SIPP providers may be discouraged from permitting their clients to invest in property funds with notice periods of longer than 30 days if these are considered to be non-standard investments which need additional capital requirements. We therefore support the classification of these funds as standard investments.

Question 9: 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 Associations would like to stress the importance of enabling access to the property market for all types of investors.

We agree that the six areas detailed in the paper: stocks and shares ISAs, investment intermediaries, distributors, unit-linked insurers, other investors and SIPPs will be materially impacted. In turn:

<u>Stocks and shares ISAs</u>

This is a critical area to get right. As described in the CP, the new fund structures as proposed would most likely lead to property funds ceasing to be “qualifying” units in or share of a non-UCITS retail scheme. From our discussions with members, we understand that 20% - 30% of investments in property funds are through stocks and shares ISAs, although we have been informed that it is much higher than this in some individual funds and removing their eligibility status would be detrimental to the funds. If ineligibility proves to be the case, it would be essential for HMT and HMRC to apply an exemption in the ISA Regulations to daily dealing funds with notice periods to allow investment in property funds by stocks and shares ISAs.

If funds with notice periods are not eligible for investment in stocks and shares ISAs, it would not only affect investments through ISAs. Where model portfolios are used, these are usually set for all investments within a particular risk profile, whether they are through stocks and shares ISAs or not. Investment advisers, who use model portfolios, are very unlikely to have a model without property funds for investments through ISAs and a model with property funds where investments are not through ISAs. Most AREF members currently operating daily dealing property funds have confirmed that between 74% and 99.9% of the investments in their funds are through intermediaries and a large proportion of that investment would most likely be in model portfolios. Therefore, there is more than 20% – 30% of investments in property funds at risk if the funds with notice periods are not eligible as stocks and shares ISAs.

In the ISA regulations “qualifying units in or shares of a non-UCITS retail scheme” is defined as:

a. The instrument constituting the scheme secures that redemption of the units or shares in question shall take place no less frequently than bi-monthly (see Rule 6.2.16(6) of the Collective Investment Schemes Sourcebook omitting the words "Except where (7) applies, and ", read with Rule 6.3.4(1), whether or not those Rules apply to the scheme), and
b. A provision for suspension of dealing in exceptional conditions in accordance with Rule 7.2 of that Sourcebook (or any foreign procedure which is a direct foreign equivalent of that Rule) shall not be treated as a provision contrary to paragraph (a) of this definition.

We believe that daily-dealing FPIPs would be a qualifying investment for ISAs under this definition.

However, the ISA Regulations state that a transfer of assets between ISA Managers must be completed within 30 days (with exceptions for suspended funds) and the introduction of a notice period would prove problematic for cash transfers. We ask that the FCA, in conjunction with HMRC and HMT, allow an exemption for funds with notice periods that satisfy the dealing frequency test.

We note that HMRC published a consultation on ISAs and authorised open-ended property funds on 28th October. This consultation proposes permitting ISAs already invested in property funds to retain their investment should notice periods be introduced. We note that new investment in these funds would not be permitted. The Associations will be responding to this consultation, proposing that new investment in such funds with notice periods be permitted.

<u>Investment Intermediaries providing advice</u>

As noted in the CP, investment intermediaries providing advice will need to reconsider whether the new fund structure is appropriate for their clients. In particular, whether a delay in access to cash would be appropriate for that investor's needs. This could lead to property funds being deemed unsuitable for a number of advised investors.

The adviser is not authorised to trade on behalf of the client, they can only recommend action, and doing so means giving advice (understanding client circumstances and providing a suitability report etc.). Redeeming funds with notice periods turns one advice event into two – one to decide to sell and one when the cash is available to re-invest, as the total proceeds will be unknown until the end of the notice period.

Advisors perform regular, often annual reviews of clients' portfolios and the review will lead to a rebalance of the portfolio, to reflect weightings in different asset classes. This would result in the rebalancing and transfer issues discussed below in the "Other investors" section.

<u>Distributors</u>

Some distributors, such as investment platforms, currently offer funds that incorporate notice periods, which are domiciled in other jurisdictions. A number of distributors have indicated in discussions with AREF and the IA that they are operationally capable of hosting funds with notice periods and others are confident that they could update their systems, given enough of a transition period. From our discussions with distributors, they would need a transition period of at least 12 months to make system changes. This is only part of the changes that would be required across the ecosystem as we explain in response to Question 10.

However, we are concerned that if some of the clients of investment platforms are indicating that they would not invest in funds with notice periods, due to having to change current processes (see response above under Investment Intermediaries and below under Other investors), that platforms will consider there is insufficient demand for the product. This could lead to platforms not investing the significant amounts required to update systems and processes to enable investors to invest in funds with notice periods. We have seen examples of this before; there are still investment platforms that do not offer PAIFs because of the cost of updating systems for income streaming. In addition, the introduction of non-resident CGT has led to some offshore platforms removing UK authorised property funds from their offering, citing costs and additional administration oversight of implementing the tax requirements as the reason.

Unit-linked insurance and DC pensions

The CP makes clear the distinction between unit-linked funds that invest directly into authorised property funds and unit-linked funds that access property directly. The former class of unit-linked contract will be directly affected by the imposition of a notice period on property funds.

In this case, our conversations with unit-linked providers suggest that insurers will likely have three options if they want to allow investors to continue to have access to property funds with notice periods. The first two are not straightforward, while the third option changes the investment case for property. All three options reinforce the point made in our introductory comments about the need to ensure that the ecosystem can align with the proposed changes to property funds ahead of full implementation.

Firstly, they could amend the terms and conditions of the insurance contracts that they have with investors. The introduction of a notice period could be viewed as a detrimental amendment to the terms and conditions as it would place limits on the customer's ability to access money by taking the benefit or transferring to another provider, as these products do not allow in-specie transfers and so would need to wait for the redemption to be completed. Such a change would require the insurer to contact customers and seek their permission to change contractual terms. This option appears unappealing to insurers as it is operationally burdensome and may adversely affect investor confidence.

Secondly, insurers could continue to facilitate dealing for their investors without a notice period by taking the risk onto their own book. This would transfer the uncertainty as to price (market risk) to the insurer and may result in a need to hold additional capital. This too, is unlikely to be acceptable to insurers.

The third option is that insurers hold more cash or invest in liquid alternatives to property funds (most likely REITs) as part of the unit-linked fund's investment strategy. While this may be preferable to the insurer from an operational and business risk perspective, it fundamentally alters the investment strategy of the unit-linked fund and dilutes the benefit of the property fund holding as it reduces the diversification benefits through lack of correlation, and increases the volatility: It in effect negates the benefit of the underlying property fund being able to hold less cash as a result of having a notice period. This is unlikely to be an acceptable outcome to investors in unit-linked funds seeking property exposure.

The consequence is that unit-linked insurers may choose not to offer unit-linked funds invested in NURS property funds, which will ultimately result in disinvestment from the asset class and property funds losing a major type of investor in these types of funds. From an end investor perspective, losing access to property would clearly be a bad outcome if it worsens the risk and return characteristics of a portfolio.

Insurers that offer directly invested unit-linked property funds have more flexibility, since the FCA proposes not to apply the rules for NURS to these unit-linked funds. In this case, the insurer could choose to apply a notice period or not. However, it raises the question of whether it is appropriate to treat a customer differently based on how they have invested, in what are essentially, substitutable products. A cautious approach would be to treat these two types of unit-linked fund the same, in which case the same observations as above apply.

For completeness we note that unit-linked contracts may also be run on a model portfolio basis and the issues described below in relation to rebalancing (see Investment Intermediaries and Other investors) would be relevant.

Unit-linked property funds (both linked to NURS and directly invested) are increasingly used in **DC pension schemes** in the workplace and non-workplace market, typically blended as part of a wider portfolio but also offered to investors as a self-select option. DC schemes may see redemptions from property funds for a variety of reasons that are unrelated to market stress, for example:

- Member-driven events such as taking retirement benefits or transfers to other funds or providers;

- Bulk transfers of scheme members – perhaps because of a change in the scheme's strategic asset allocation, a desire to switch from one property fund to another, or one of the participating employers in a master trust or contract-based arrangement switching to a new arrangement.

The presence of notice periods on property funds complicates the execution of all these actions and, mirroring the actions faced by insurers offering unit-linked funds, DC schemes have a number of options, all challenging:

- Hold more cash to deal with the additional liquidity needs – at the cost of creating a drag on returns.

- Holding liquid alternatives to property funds (most likely REITs) as part of the scheme's property exposure. REITs could be used entirely in place of property funds or alongside them as part of a wider property allocation, with liquidity needs met through the REIT element of the property portfolio. In both cases the investment benefit of property is diluted by the need for liquidity.

- Disinvesting from property entirely and investing only in liquid asset classes.

None of these options is attractive to DC schemes currently invested in or wishing to invest in property. Furthermore, the direction of travel is contrary to DWP and FCA policy, which seeks, rightly, to provide DC schemes with more options to invest in illiquid assets should they wish to. The risk is that these proposals are seen by DC schemes as contradictory to wider DWP/FCA policy on illiquid assets for the DC market.

Fundamentally, the challenges arise in DC because of the widespread prevalence of the daily pricing and dealing model across the market. There is acceptance that over time it could be desirable to move away from providing DC pension scheme members with liquidity that they do not necessarily need throughout their accumulation phase and allow them to capture the benefit of an illiquidity premium. Indeed, evidence from the more mature Australian DC Super industry suggests that, given appropriate time, DC pension schemes can adapt to notice periods[2]. However, the lesson from Australia is that it is important to communicate clearly the benefits of notice periods and give investors and providers ample time to prepare for their introduction. It is important to recognise therefore that, if the FCA moves ahead with its' proposals for notice periods, it must only happen on a timeframe that the wider DC distribution ecosystem can support.

<u>Other investors</u>

As referred to in the CP, some firms, such as wealth managers, offer a centralised investment proposition, or model portfolio arrangement. Such portfolios are subject to regular review and as result of market movements or a change in strategy managers will rebalance the holdings in the portfolio. Such rebalances often take place on a monthly or quarterly basis and are performed instantaneously. The inability to sell one part of the portfolio for a particular period would result in property funds becoming less attractive to managers who offer a model portfolio service. They may make the decision to not include a property fund in investors' portfolios, not because it is inappropriate for the investors but because of the operational difficulties of rebalancing the portfolio during regular reviews. As investment in property should be for the long term, investments in property funds could be made outside model portfolios as fixed amounts which are reviewed less often than the rest of the portfolio. However, this may need intermediaries to be convinced that it is worthwhile adjusting their processes to enable their investors to invest in property funds.

There are some other practical consequences that should be borne in mind and should be resolved before the rules are made final.

If an investor wishes to switch out of a property fund into another fund, the subscription side of the switch would have to take place at the expiry of the notice period, distributors and transfer agents would need sufficient time to develop the system capability to hold onto the subscription order for the notice period.

Uncertainty as to the price of both sub-funds for a longer period of time may also deter investors. Although the price of the property fund the investor is withdrawing from, is unlikely to change dramatically during the notice period, this may not be the case for the fund they are wishing to switch into.

[2] Notice periods on property funds have existed for some time in the Australian Super industry and the market has successfully adapted. Fiduciaries of Super funds are required to carry out liquidity stress-testing of their multi-asset portfolios under different market cash-flow and member demographic scenarios

Transferring between products or platforms would be a time-consuming process. For a transfer between platforms where the investor holds a share class particular to the transferring platform and has given notice of his intention to redeem, the transferring platform would be unable to convert the holding to a common share class to enable the transfer.

JISAs can't be partially transferred and there are some restrictions on ISA transfers so managers would be unable to transfer until the notice period had expired.

In the case of the death or divorce of the investor, again the process would be lengthened as the fund would not be sold until the end of the notice period, rather than immediately after probate is granted or a settlement is reached.

<u>SIPPs</u>

As mentioned in the CP, capital adequacy rules for SIPP providers require that any investment held in a SIPP as a standard asset is realisable within 30 days. SIPP providers that allow investment in non-standard assets must hold additional capital.

For SIPP providers that currently do not allow investment in non-standard assets, the introduction of a notice period would necessitate a choice: either the provider would prevent SIPPs from holding property funds or it would accept the additional capital requirements.

Where a SIPP provider continues to not permit investment in non-standard assets, investors may decide that it is easier to redeem their investment in property funds than transfer to a SIPP provider that offers non-standard assets.

Where a SIPP provider decides to permit investment in non-standard assets, there is a risk that the increased capital requirements would be passed onto investors through an increase in fees.

<u>Transfer Agents</u>

Transfer agents are also an important part of the ecosystem and will be impacted by the proposals. They would need time to update their systems and processes to accommodate funds with notice periods.

As redemption instructions are irrevocable, an investor who changes their mind during a notice period would not be able to cancel their deal. There is a risk that they would instead reinvest the proceeds of the redemption back into the fund as soon as they are realised. This could result in the manager having to sell and purchase underlying assets in the fund, with the associated costs being incurred. Managers may require transfer agents to ensure that they have adequate processes in place to be certain that such investors can be identified and bear the transaction costs in these cases.

Member discussions have concluded that the application of swing pricing to counter the effects of dilution would be very difficult to apply and consequently, the application of dual pricing would be the preferred option.

Current guidance (COLL 6.2.17 G) permit AFMs to identify a point in time in advance of a valuation point (a cut-off point) after which it will not accept instructions to sell or redeem units at that valuation point. The Associations do not consider that a cut-off point would be appropriate where a notice period is in place and suggest that COLL 6.2.17 G make this explicit.

Question 10: 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 Associations suggest that a transition period of at least 24 months be allowed to adopt the proposals. There are operational, procedural, contractual and legal changes required by many of the parties effected by the proposed changes. It is important that, if the introduction of a notice period is to be mandatory, all funds transition on the same date, to prevent any competitive advantage for certain funds.

Question 11: 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?
We strongly believe that retail investors should have the ability to invest in property via authorised property funds and notice periods would address the FCA's concerns of liquidity mismatch. However, the operational and investment challenges, detailed in our responses to the questions above, could mean that property funds with notice periods may not be offered to retail investors as an investment option. This would not be a good outcome.

One avenue to explore would be an enhancement of the deferred redemptions rule and we encourage the FCA to consider this as part of this work. The Associations would be happy to discuss alternative solutions with the FCA.

The other alternative to wider use of notice periods would be a maintenance of the current regime, which has seen enhanced liquidity management regulation introduced for so-called FIIAs. This would mean that direct property funds remain subject to periodic, albeit infrequent suspension in the event of adverse liquidity events (or even rarer, market valuation uncertainty). In the view of both Associations, suspension is an effective but clearly unpopular tool, and we agree that a structural solution to liquidity mismatch would be preferable. However, that structural solution cannot be implemented at the cost of funds being unavailable to investors that have otherwise enjoyed long-term, comparatively low volatility returns over many years.

Question 12: Do you think that other types of fund should be permitted to operate notice periods? If so, please explain which other funds and why.
The Associations fully support the extension of available liquidity tools to the full toolkit permitted under UCITS and AIFMD. Managers should be permitted to use whatever tools are appropriate for their funds.

Notice periods are not appropriate for funds holding liquid assets and those with an investor base comprised of investors who are in close contact with the investment manager. Funds holding assets where liquidity can vary in changing market conditions, such as corporate bond funds would also find it more appropriate to utilise other liquidity tools in times of stress.

However, notice periods will be appropriate for other fund types where a large proportion of the assets held are inherently illiquid. We would welcome, as a next step, the availability of notice periods for other funds investing in illiquid assets (FIIAs).

Question 13: Do you have any views on what further steps the FCA should take to accommodate long-term capital structures?
As detailed in previous discussions and consultation responses, AREF and the IA is supportive of the widening of access to a wide range of asset classes, including inherently illiquid assets to all investors, subject to the appropriate protections.

To this end, the IA has formulated a proposal for a Long-Term Asset Fund, published in summer 2019, which has been discussed in detail with the FCA.

Question 14: 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?
There may be willing sellers of the units in a secondary market, to avoid the notice period. The incentive for investors to buy units on the secondary market is that they may be able to buy below the normal entry spread.

Secondary markets operate efficiently in other jurisdictions – for example, in Germany, which has longer notice periods for open ended real estate funds than is proposed in CP 20/15. The development of secondary markets potentially addresses the problems cited by advisers, DFMs and platforms with regard to not being able to include property funds in CIPs/model portfolios, and could also potentially address the ISA eligibility and SIPP capital adequacy rules. Whilst the majority of existing investors in property funds are taking a long-term view, being able to redeem their shares on a secondary market means they could potentially access their capital immediately if their circumstances change – albeit at a price which may be lower than NAV.

The Associations do see secondary markets being used by institutional, rather than retail investors and note that the potential smaller size of deals by retail investors could act as a barrier, as there is no infrastructure for handling small lot sizes. This carries the risk of institutional investors being able to get a better return than those investing directly into the fund. If retail investors were to use the secondary market, there is a risk that they may not understand the price they are paying for liquidity and discounts could grow to unfair levels, especially in times of market stress. The risk of consumer harm in this scenario is significant.

However, Property Authorised Investment Fund rules in the UK do limit corporate investors to holding less than 10% of a fund's shares. As the custodian of shares on a secondary platform may be a PLC or other corporate entity, this could necessitate a change to the PAIF rules to exempt that type of platform. Alternatively, a fund could restrict the percentage of its shares on secondary markets - perhaps by issuing a different class of shares only tradeable on a secondary market.