

Funds investing in inherently illiquid assets (FIAs) and PS 19/24: a practical guide to the new rules

Jessica Reed and Kya Fear | 5 February 2020

New rules governing authorised funds investing in “inherently illiquid assets” will come into force later this year. They are wide-ranging and will affect NURS with direct or indirect holdings in illiquid assets – such as property.

Key amongst the FCA’s package of measures are new rules governing **fund suspensions**, requirements for **enhanced illiquidity contingency plans** and significant new **disclosure requirements**.

Now is the time for all authorised fund managers to review their funds’ holdings, gauge the applicability of the new rules, and take action where appropriate.

This guide aims to:

- summarise the **background** to the new rules;
- detail the **types of funds** that will be affected by the new rules;
- explain new regulatory concepts: **FIAs** and “**inherently illiquid assets**”;
- explain is **set to change** under the new rules; and
- suggest what authorised fund managers should be **doing now**.

If you require further information on anything covered in this briefing please contact:

Jessica Reed
+44(0)203 375 7518
E: jessica.reed@farrer.co.uk

Kya Fear
+44(0)203 375 7509
E: kya.fear@farrer.co.uk

Alternatively, please contact the firm on 020 3375 7000. Further information can also be found on our website.

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What is the background to the new rules?

The FCA began its recent focus on illiquid assets in authorised funds in 2016, after the EU referendum result led to several retail property funds structured as non-UCITS retail schemes (**NURS**) suspending dealing, leaving unitholders unable to access their investments. Following these events, the FCA announced its intention to investigate issues regarding the illiquid nature of fund portfolios containing immovable property.

The FCA issued a discussion paper on illiquid assets and open-ended investment funds in February 2017 ([DP 17/1](#)). A consultation paper proposing a package of new liquidity safeguards was subsequently published in October 2018 ([CP18/27](#)).

These new rules were finalised in the FCA's policy statement [PS19/24](#), published in September 2019. They will come into force on 30 September 2020 and the FCA has indicated that it does encourage early adoption where this does not conflict with current rules.¹

What fund types are affected by the new rules?

The FCA's proposed new rules have been designed to apply to NURS investing in immovables – such as commercial property – and other “inherently illiquid assets”. During the consultation, the FCA did not think it necessary to make the new rules applicable to UCITS because such funds are not able to invest directly in non-financial assets such as property or infrastructure.²

However, in June 2019, the high-profile UCITS fund, LF Equity Income Fund (formerly the LF Woodford Equity Income Fund), was suspended following significant liquidity issues. This raised the question as to whether the new safeguards should apply more widely.

In September 2020, the new rules will apply only to NURS. However, the FCA is currently considering whether they should be extended to other types of funds. It is also working with the Bank of England's Financial Policy Committee to assess how funds' redemption terms may be better aligned with the liquidity of their portfolios³. It is therefore likely that further proposed liquidity regulation affecting both UCITS and NURS will follow later in 2020.

¹ See paragraph 6.4 of PS 19/24.

² See paragraph 3.21 of CP 18/27.

³ See paragraph 7.13 of PS 19/24 and pp75-81 of the [Bank of England's Financial Stability Report, December 2019](#).

New terms: FIAs and “inherently illiquid assets”

The new rules introduce a new fund category to the FCA handbook – the “Fund Investing in Inherently Illiquid Assets” (**FIIA**). Most of the new requirements apply only to FIAs, although the provisions on mandatory suspensions have broader application. Authorised fund managers (**AFMs**) may find it helpful to refer to our decision tree (see below) when considering how the new rules will apply to their funds.

In essence, an FIIA is a NURS whose objective is to invest more than 50 per cent in “inherently illiquid assets”, or which does in practice invest more than 50 per cent in inherently illiquid assets. In each case, the fund will only constitute an FIIA if it does **not** have limited redemption arrangements in place to reflect the time it might take to sell its inherently illiquid assets, should it need to do so. The new fund category will not apply to any funds in the process of winding up or termination.⁴

“Inherently illiquid assets” are also defined in the new rules. This term covers immovable property and also includes less liquid transferable securities and units of other funds deemed to be FIAs.⁵

So, under the new rules:

- AFMs **must** suspend the dealing in units of **any** NURS, not just those classified as FIAs, where:
 - the fund’s standing independent valuer (**SIV**) has expressed material uncertainty about the value of immovables that account for at least 20 per cent of the fund’s property⁶; or
 - the fund holds at least 20 per cent of its assets in funds which have themselves been mandatorily suspended due to material uncertainty.
- The depositary is not required to agree to this mandatory suspension but must be notified once it has taken place.
- Where the AFM feels that suspension is not in the best interests of investors it may allow the fund to continue dealing, where the depositary agrees. However, this decision must be kept under review.⁷ The FCA expects that the circumstances in which it would be appropriate for dealings to continue would be limited.⁸

The existing suspension rules will remain and will be relevant where an AFM wishes to suspend dealings for other reasons.

⁴ The full glossary definition of FIIA can be found in Annex A of PS 19/24.

⁵ The full glossary definition of “inherently illiquid asset” can be found in Annex A of PS 19/24.

⁶ New rule COLL 7.2.-3R.

⁷ New rule COLL 7.2.-1R.

⁸ See paragraph 3.7 of PS 19/24.

AFMs may find it helpful to refer to our decision tree (see below) when considering whether these rules will apply to the NURS that they manage.

Liquidity management

AFMs who manage NURS are already required to have liquidity management systems and procedures in place. They are also required to identify when liquidity tools may be used in normal and exceptional circumstances.⁹

However, the new rules are more prescriptive:

- AFMs who manage FIAs must establish and maintain a detailed “liquidity management contingency plan” setting out their planned response to exceptional liquidity events.
- All third parties relevant to the contingency plan, such as administrators and platforms, are required to give written confirmation to the AFM that they are able to deploy the liquidity tools and communicate with unitholders, as specified in the plan.
- Depositories of FIAs will also have new duties to regularly assess the liquidity profile of the FIA and to take reasonable care to oversee the AFMs liquidity management systems.¹⁰

Increased Disclosure

AFMs who manage NURS are already required to include a description of the fund’s liquidity risk management in the prospectus.¹¹ Information regarding any dilution levy or dilution adjustment policies must also be included.¹²

However, the new rules require more prescriptive and wide-ranging disclosures:

- All financial promotions relating to FIAs will be required to carry mandatory liquidity risk warnings.¹³
- The prospectus of an FIA must summarise the risks of investment in inherently illiquid assets and must also detail the tools that the AFM may use to mitigate such risks.¹⁴
- If an AFM wishes to retain the power for the fund to sell fund assets at a discount in order to secure rapid sale (so called “fire-sales”), this must be disclosed in the prospectus.¹⁵

⁹ See FUND 3.6.3R and Arts 46 and 47 of the AIFMD Level 2 Regulation (EU No 231/2013).

¹⁰ New rules COLL 6.6.3CR, COLL 6.6.3ER and COLL 6.6.4BR.

¹¹ See FUND 3.2.2R(8).

¹² See COLL 4.2.5(18).

¹³ Prescribed text will be set out in the Handbook. See new rules COBS 4.5.16R and COBS 4.5A17R.

¹⁴ New rule COLL 4.2.5R(3)(pa). “Tools and arrangements” include fund suspensions, price adjustments and measures to prevent dilution. Further guidance is included at COLL 4.2.6G(4A).

¹⁵ New rules COLL 6.3.3ER and COLL 6.3.6G(1)(7B).

Action points: What should AFMs be doing now?

- AFMs will firstly need to work out **how the new rules apply** to any NURS that they manage by:
 - identifying any NURSs which will be classed as FIAs;
 - identifying any holdings within a NURS that may be classed as units in FIAs; and
 - identifying any NURSs which, although not FIAs, will be subject to the new mandatory suspension rules.
- Current liquidity **policies and procedures** will need to be reviewed in detail and compared to new requirements. Depending on current policies this may be a gap-fill exercise or may require policies to be redrafted.
- AFMs should engage with the **depository** at an early stage. Key questions to be asked would be:
 - whether the depository expects to modify its services to reflect its new obligations; and
 - how will these additional services be reflected (side letter / amendment to the depository agreement).
- **Other relevant third parties** such as SIVs, administrators, platforms and other distributors should also be engaged at an early stage to discuss:
 - the process for alerting the AFM to “material uncertainty” in valuation;
 - how they will ensure that any financial promotions distributed by them contain the required risk warning;
 - where relevant, how their co-operation will form part of the liquidity management contingency plan;
 - the form in which their written confirmation to the liquidity management contingency plan will be provided, stored and kept up-to-date.
- AFMs should identify the extent to which the **prospectuses** of any affected funds will need to be amended or redrafted. AFMs should also consider:
 - whether any approvals are required for such prospectus changes,
 - how investors will be notified of the prospectus changes, and
 - how these factors will affect project timing.
- AFMs should review and update any **financial promotions** distributed directly (for example, web pages) to ensure that the mandatory risk warning for FIAs is included.

QUICK REFERENCE SUMMARY: KEY REQUIREMENTS FOR FUNDS INVESTING IN INHERENTLY ILLIQUID ASSETS

PLEASE NOTE: This is a high-level summary of the key requirements only. The full text of the new rules can be found in PS 19/24 or the FCA handbook.

New rule	Summary of requirement	Some suggested actions for AFMs
<p>COLL 7.2.-3R COLL 7.2.-2R COLL 7.2.-1R</p>	<p>The fund suspension rules for NURS will be amended, as follows:</p> <ul style="list-style-type: none"> • If the standing independent valuer (SIV) of a NURS expresses material uncertainty regarding the valuation of a least 20 per cent of the fund’s property, dealings must be temporarily suspended unless the AFM and the depositary agree that it would not be in the bests interests of investors to suspend dealings. • If a NURS holds at least 20 per cent of scheme property in other funds which have had dealings suspended because of the above new rule, that fund must also temporarily suspend dealings unless the AFM and the depositary agree that it would not be in the bests interests of investors to suspend dealings. <p>Depositary consent is not required when a fund is suspending dealings for either of these reasons. The depositary must give its approval for the restart of dealings.</p>	<p>Note that these rules apply to all NURS, not just FIAs.</p> <p>Review the fund’s prospectus to ensure that the new suspension rules are adequately reflected.</p> <p>Where the fund is an FIIA, ensure that the new suspension rules are factored into the liquidity management contingency plan.</p> <p>Discuss the new rules with the depositary. Ensure these are reflected in operating procedures / service level agreements.</p>
<p>COBS 4.5.16R COBS 4A.17R</p>	<p>The following standard risk warning must be included in any financial promotion relating to FIAs (except the prospectus and NURS-KII):</p> <p>“[Name of fund] invests in assets that may at times be hard to sell. This means that there may be occasions when you experience a delay or receive less than you might otherwise expect when selling your investment. For more information on risks see the prospectus and key investor information document.”</p>	<p>Review all factsheet and investor literature (including relevant webpages) to ensure that the required risk warning is enclosed.</p> <p>Liaise with relevant distributors and other third parties (platforms, IFAs etc) to ensure that the standard risk warning is included in all financial promotions relating to the fund.</p>

<p>COLL 4.2.5R(3)(pa)</p>	<p>The prospectus of each FIIA must include additional disclosures regarding:</p> <ul style="list-style-type: none"> • the risks of the scheme holding illiquid assets; • how such risks might crystallise; • the tools and arrangements which may be used to mitigate the risks; and • an explanation of the of the circumstances in which such tools and arrangement would be deployed. <p>“Tools and arrangements” include fund suspensions, price adjustments and measures to prevent dilution. Further guidance is included at COLL 4.2.6G(4A).</p>	<p>Review the risk warnings included in the fund’s prospectus to ensure adequate detail is included regarding illiquid assets.</p> <p>Review all prospectus disclosures relating to fund suspensions, price adjustments and dilution to ensure that these reflect any new policies and contingency plans (see below).</p> <p>Consider including examples to explain the circumstances where these tools could be used.</p>
<p>COLL 6.3.3ER COLL 6.3.6G(1)(7B)</p>	<p>So-called “fire sales” of immovable assets (i.e. rapid sale of immovable assets at a discounted price) will only be permitted if this is expressly stated in the prospectus.</p>	<p>Add this disclosure to the fund’s prospectus if required.</p>
<p>6.6.3CR</p>	<p>The AFM must establish a liquidity management contingency plan for the fund. This should cover at least the factors set out in COLL 6.6.3CR (1) – (6) including:</p> <ul style="list-style-type: none"> • how the AFM will respond to a liquidity event; • the tools the AFM may use and how the AFM and the depositary will work together to deploy these; • the likely consequences for investors; • how the AFM will work with delegates and other relevant third parties (including administrators and platforms) to deploy the management tools and communicate with investors; 	<p>Review current suspension policies, dilution policies and liquidity plans to identify areas where more detail is needed.</p> <p>Involve the fund’s depositary and any relevant third parties, such as administrators and platforms at an early stage of discussions.</p>

	<ul style="list-style-type: none"> • the operational challenges (including the operational challenges of using liquidity tools themselves and the challenges likely to arise from working with third parties); and • arrangements for internal and external communications, including communication with investors, the media and the FCA. 	
COLL 6.6.4BR	<p>The depository will be required to make its own assessment of the fund's liquidity on a regular basis. It will also be required to oversee the AFM's liquidity management procedures.</p> <p>In addition, the depository must establish an escalation procedure to be followed where rules and guidance are relating to liquidity are not being complied with.</p>	<p>Open discussions with the fund's depository at an early stage.</p> <p>Review the depository agreement to ensure that these duties are reflected. A side letter or addendum may be required.</p>

FUNDS INVESTING IN INHERENTLY ILLIQUID ASSETS: DECISION TREE.

"Please note, this is a high level guide to the application of the regulations only. The full text of the new rules can be found in PS 19/24 or the FCA Handbook."

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