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Response to Discussion Paper DP17/1 – Illiquid assets and open-ended investment funds (Feb 2017)

The CFA Society of the UK (CFA UK) represents about 12,000 investment professionals working across the UK investment sector primarily as portfolio managers and buy-side analysts among others. Our mission is to educate investment professionals, to promote high ethical and professional standards and to explain the profession to our stakeholders. In our advocacy work, we take as our ultimate objective the best interests of clients.

In our work on regulations, standards and policy, our members are represented by several committees including the Market Integrity and Professionalism Committee. The MIPC has drafted this response on behalf of CFA UK members.

The ability for all investors to access illiquid asset classes such as property, infrastructure, and private equity is a positive feature of the financial industry. Open-ended investment funds play a strong role in providing access to illiquid assets for a range of investors and this includes small/retail level investors. The recent liquidity issues around Brexit were a useful "stress test" for these types of investments and the discussion paper does a comprehensive job of reviewing the experience for fund providers and investors during this challenging time. As investment practitioners with a strong collective experience in how assets trade in stressed situations, CFA UK concludes that the market mechanisms worked efficiently during the Brexit sell off. Our main area of concern is financial knowledge/education for smaller investors, many of whom will not know the difference between an open-ended vs closed-ended fund.

Below are our responses to the specific questions posed in the paper.

Questions:

1. Do you have any comments on our description of the types of inherently illiquid assets that might be held in open-ended funds? Are there others you would consider inherently illiquid?

The description of the illiquid assets was quite detailed. One category to perhaps include are AIM listed stocks that trade only a few times a month and where ownership structure may still include a high level of private equity.

2. Do you have any observations on our analysis of liquidity management tools? Are there other factors affecting the liquidity management of open-ended funds investing in illiquid assets that we should take into account?

We believe that redemption "in specie" is a problematic (and fortunately rare) occurrence. Investors in unlisted/illiquid assets should be aware that the buy-sell spread on such assets widens during periods of financial stress. The liquidity management tools mentioned in the DP are sensible and are/should be fully disclosed in fund documentation.

3. What are your views on these, or other, possible approaches to the treatment of professional investors? Would these approaches be fair to retail investors in the same fund?

Regulatory intervention with different treatment of professional vs retail investors is not a preferred solution as it would divide an already illiquid market. Part of the business requirement of running a competitive fund is to have a well-balanced investor base. Better investor education at the retail level would also be valuable.

4. What are your views on these, or other, possible approaches to the portfolio structure of funds?

Allowing a fund a time period to achieve its targeted portfolio structure makes sense, and the competitive market pressure to achieve an optimal structure around risk and diversification metrics works well over time.

5. What are your views on these, or other, possible approaches to the valuation of illiquid assets?

The problems of asset pricing in distressed market situations are well known to professional investors. Establishing a fair market value for the assets in the portfolio may be challenging in situations of market stress due to the inherent illiquidity of the investments. We think there should be clear and prominent disclosures about liquidity risk in fund literature in sales material and in ongoing reporting.

6. What are your views on these, or other, possible approaches to the fund manager's use of specific liquidity management tools?

The recent experience for managers of illiquid funds, where stressed market conditions post the Brexit vote led to the application of liquidity management tools, is a good example of financial markets coping well (orderly basis) in a crisis.

7. Do you think our analysis of the possible benefits and risks of direct intervention by the regulator is correct? Do you think the FCA should be more proactive about directing the actions of fund managers in a stressed situation, and if so how?

We believe that having the regulator play a role in allowing a fund to implement liquidity tools such as suspending trading carries a strong risk of making the "fire-sale" situation worse and may undermine fund governance. Leaving the decision to the individual fund concerned (specifically, those charged with governance of the fund) allows the market mechanism to function better and provides more certainty to investors and market participants over the exercise of liquidity management tools. Encouraging market participants to review the FCA's analysis/discussion about the recent liquidity stress is a solid proactive measure.

8. What are your views on these, or other, possible approaches to requiring enhanced disclosure for funds investing in illiquid assets?

More visibility into key fund metrics and what constitutes best practice would benefit investors both at the institutional and retail level.

9. What is your view of the benefits and risks of a secondary market in the units of open-ended funds investing in illiquid assets? Should the FCA do more to encourage the development of such a market?

We do not see it as the FCA's role to encourage the development of a secondary market for such funds. It should be left to the industry to determine if demand exists and, if so, facilitate whatever solutions may be appropriate for the benefit of clients.

10. Are there any other issues related to the subject matter of this paper that we should consider?

None that we are aware of.

We are grateful to the FCA for challenging us to consider ways in which investors' interests can be better served. We trust that these comments are useful and would be pleased to discuss them in person.

Yours sincerely,

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About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 10,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 135,000 members in 140 countries, of which more than 120,000 hold the Chartered Financial Analyst (CFA) designation.