Investment fund liquidity – plugging the leaks

What to expect from the regulators in 2020 after Woodford

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In brief...

We look at the various regulatory initiatives taking place in 2020 in relation to liquidity considerations for open-ended investment funds. These developments are relevant to managers of openended funds seeking to manage their liquidity risk and ensure regulatory compliance going forward.

Following the demise of Woodford Investment Management and the withdrawal of billions of GBP from H20 Asset Management in 2019, the liquidity of open-ended investment funds is a subject increasingly on regulators' radars. More recently, we have seen the suspension of certain property funds as a consequence of the market turmoil during the coronavirus crisis. Accordingly, 2020 will see a series of initiatives intended to address the risks in this space.

Financial stability report

Concerns were most recently expressed by the Bank of England (BoE) and the Financial Policy Committee (FPC) in their December 2019 Financial Stability Report, which emphasized the need for greater consistency between the liquidity of an open-ended fund's assets and its redemption terms. The report noted that the mismatch between redemption terms and the liquidity of some funds' assets means there is often an advantage to investors of early redemption, particularly at times of market stress, echoing similar sentiments expressed by the Financial Stability Board in 2017. In order to mitigate any systemic risk associated with these vulnerabilities the FPC suggested that:

- The liquidity of funds' assets should be assessed either as: (i) the price discount needed for a quick sale of a representative sample of those assets; or (ii) the time period needed for a sale to avoid a material price discount. The US Securities Exchange Commission (SEC) has recently adopted measures of liquidity based on this concept;
- Redeeming investors should receive a price for their units in the fund that reflects the discount needed to sell the required portion of a fund's assets in the specified redemption notice period; and
- Redemption notice periods should reflect the time needed to sell the required portion of a fund's assets without discounts beyond those captured in the price received by redeeming investors.

The BoE and Financial Conduct Authority (FCA) are to consider how the above principles can be implemented into UK law. It is hoped that, in addition to enhancing financial stability, any rule changes will promote funds' ability to invest in illiquid investments, thereby increasing the supply of productive finance to the economy through business and financial cycles.

FCA requirements concerning illiquid assets and open-ended funds

This work follows on from the FCA's September 2019 policy statement on illiquid assets and open-ended funds, which introduced various new rules in relation to non-UCITS retail schemes (NURSs). These rule changes will take effect from September 2020 and require that:

- NURSs holding property and other immovables must suspend dealing when there is “material uncertainty” about the valuation of at least 20% of the scheme property;
- Managers of funds investing in inherently illiquid assets must produce contingency plans for dealing with liquidity risks, with depositaries having a specific duty to oversee the processes used to manage the fund’s liquidity; and
- Additional disclosures must be made in a fund’s prospectus of the details of their liquidity risk management strategies.

These changes follow on the back of the FCA's October 2018 consultation paper on the subject, which was motivated by temporary suspensions and market illiquidity in a number of property funds following the result of the UK referendum on EU membership in June 2016

More recently, in a speech on 19th March, Edwin Schooling-Latter, the FCA's Director of Markets and Wholesale Policy observed that increased use of notice periods and swing pricing (which offers a fund the right to swing its valuation method to represent the true cost of disposing assets and is already permitted under FCA rules) could benefit investors by removing first-mover advantage during times of market stress, thereby reducing the volume of redemption requests and improving financial stability.

European developments

2020 will also see policy intervention at a European level. Steven Maijoor, Chair of the European Securities and Markets Authority (ESMA), a pan-European body of EU member state regulators, highlighted in November 2019 that the issue of fund liquidity would be “at the core” of ESMA's investment management activities. In particular, he acknowledged that:

- The growth of the fund sector by more than 60% since 2013 has increased the possibility that illiquidity in the funds space could affect the operation of financial markets more broadly;
- The “lasting low yield environment” has created “unprecedented challenges” for asset managers, including incentives to shift towards riskier and less liquid assets; and
- There are concerns this “search-for-yield” behavior, coupled with considerable market liquidity, have created mispriced risk and over-valuation of some asset classes.

It is in this context that 2020 will see liquidity risk being placed at the core of ESMA's stress test strategy. This is comprised of three workstreams:

- A stress simulation framework for investment funds, which looks to assess the resilience of the investment fund sector and its capacity to transmit or amplify shocks to the rest of the financial system;
- The publication of guidelines on liquidity stress-testing in Undertakings for Collective Investments in Transferrable Securities (UCITS) and Alternative Investment Funds (AIFs). These will apply from September 2020 and seek to promote convergence in the way national competent authorities supervise funds’ liquidity stress-testing; and
- The publication of Money Market Funds (MMF) stress-testing guidelines which establish common reference parameters which MMFs should include in their stress-test scenarios.

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