APFI RESPONSE TO FCA CONSULTATION DP17/1

With effect: 8 May 2017.

What: This response is provided on behalf of the Association of Professional Fund Investors after having consulted members and Professional Fund Investors ('PFIs'). The following details APFI's final response to the Financial Conduct Authority ('FCA') consultation paper, relating to property and illiquid funds, with responses due by 8 May 2017.

About: The FCA discussion paper DP17/1, in February 2017 the FCA highlighted recent price and gating actions by property funds following the EU Referendum, and sought industry views on the use and practices around the use of property funds and other funds invested in non-daily tradable asset classes, particularly by funds (including unit-linked) that are themselves daily traded. "This paper considers some of the risks created when consumers use open-ended investment funds to gain exposure to assets that may be difficult for the fund manager to buy, sell, or value quickly. In this paper we refer to these assets as 'illiquid assets': they may include land and buildings, infrastructure, and financial assets such as unlisted securities." 1.1, Page 5, DP17/1.

The Association of Professional Fund Investors (APFI) welcomes the FCA examining this area of great interest on behalf of fund buyers and customers. The APFI supports greater transparency relating to the liquidity and trading practices of fund management and how they impact customer outcomes."

Following the EU Referendum and series of actions by property fund providers, and following engagement with the Association of Real Estate Funds (AREF) directly, the APFI issued the following press release: http://www.investmenteurope.net/regions/uk/avoid-short-termism-on-property-urges-apfi/

> *"The Association of Professional Fund Investors (APFI) has urged open ended property fund providers and investors not to give in to short-termism in their response to the volatility that has hit the value of shares in the sector since the Brexit referendum.*
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> *In a strongly worded statement, APFI wrote that participants in the property funds market – including the UK's Investment Association, Financial Conduct Authority and Bank of England, should "act in the best long-term interest of investors, to ensure that accurate not arbitrary fair value adjustments are applied by fund managers and that any redemption restrictions and costs are transparent, prudent but not punitive."*
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> *"It's important to note that the specific issues relating to direct investments in UK real estate market are unlikely to spill over into the wider market (albeit noting the widening discounts on Reits)," Apfi added in its statement.*
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> *"Daily pricing has become synonymous with transparency and liquidity. Yet the move to provide ever shorter liquidity at the fund level (daily, weekly, monthly) to appease retail appetites (which a fund manager can simply not attain on the underlying assets) has created avoidable structural and redemption issues."*
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> *"For example, in recent years we have noted increased retail flows into property funds, as investors chase higher yields during a protracted cycle of low cash and bond rates. Latest events then serve as a good reminder to APFI members, and all professional fund buyers,*

to respect the illiquidity of the property asset class, when investing, and exercise robust due diligence."

"The current market standard is the Association of Real Estate Funds questionnaire (AREF). As markets continue to develop then this is an asset class the APFI may review in future, as part of our global due diligence questionnaire project."

That part of the statement on due diligence is in reference to an ongoing project by the Association. Highlighted previously by InvestmentEurope, it was also raised at the FundForum International Berlin conference earlier this year, including via one of the panel discussions.

Jon 'JB' Beckett (pictured), UK Lead for the APFI, and author of New Fund Order, said: "This is a wakeup call to all investors about liquidity and fund managers about the investor mix on their books. Professional fund investors, acting on behalf of clients, should always carefully allocate property in accordance with a longer term investment horizon."

"This may mean reevaluating the use of property to simply achieve 'diversification'. Fund buyers should always be mindful of the liquidity gap between a funds' net asset value (NAV) frequency and the liquidity and valuation of the underlying assets."

"We call on other industry bodies to instil calm and ensure that their members are following best execution and best practice. We call on the media to report developments factually and to avoid the temptation of sensationalism. We all should be mindful that the exit door in illiquid assets classes may not be wide enough if and when investors head towards it, all at once. Conversely, investors whom do herd out of the asset class, regardless of the cost, may find they later regret the decision."

General Response to DP17/1:

2.3. The APFI agrees with the FCA observation that the commercial property fund sector had already begun to slowdown approximately 6 months prior to the referendum. This in turn began to trigger a series of redemptions and tactical asset allocation trades by large multi-asset funds, diversified growth funds including large pension default auto-enrolment funds. Due to COBS 21 rules, these funds held property exposure through a combination of open ended NURS, UCITS and closed-ended REITs and PAIFs.

2 4. APFI notes that the UK property fund market is relatively concentrated while the investor mix is split between retail investors and institutional multi asset investors. Conventional thinking has encouraged asset concentration and large fund sizes in order to have the capital base to acquire ever larger and more expensive property developments.

2.5. The APFI notes that many property funds had already built up a cash buffer ahead of the referendum but it was the actions by large multi-asset funds, many of which were internal to the same firm as the property fund manager, which put the property funds under pressure. Such actions should be investigated by the FCA under 'front-running' where such actions were detrimental to external fund holders and professional fund investors. The APFI further encourages the FCA to consider whether internal institutional holders should effectively bear the cost of dilution or price-swings (FVAs) resulting from their actions. The APFI notes the conflict of interest that can arise, within insurers for example, where they have customer assets held both directly and indirectly through multi-asset funds.

2.8. We note the FCA did not engage with fund investor bodies, such as the APFI, when deciding policy on general suspensions. We encourage the regulator to involve investor groups going forward.

2.9. The APFI challenges the prudence of actions taken by fund managers between Monday 4 July and Thursday 7 July when it appeared fund providers suspended dealing not based on their own liquidity and redemption situation but rather in a knee-jerk response to competitors. We ask the regulator to consider if price collusion had occurred in this instance. We also note that such actions appeared aimed at protecting the fund manager more so than 'protecting existing fund holders', which is the typical response in such instances. We ask the regulator to satisfy itself that such actions were warranted in the circumstances, the actions of multi-asset managers and consider merit of remediation for investors who paid levies on exiting, given the relatively short nature of the liquidity tightening around the referendum and subsequent recovery.

The APFI notes that the actions by fund managers shook market confidence, creating widening discount to NAV on most U.K. listed REITs and PAIFs. This created arbitrage opportunities and the APFI asks the regulator to investigate whether any market manipulation took place by multi-asset investors trading in both open and closed ended markets. We also note that many fund managers and overseas investors were able to access UK properties at discount due to the devaluation on Sterling, which is an additional factor for consideration.

2.10. The APFI encourages the regulator to apply liquidity controls and rules upon fund providers in a similar approach to AIFMD. Fund providers should be responsible for protecting retail investors from the actions of institutional investors, and visa versa, potentially leading to the segregation of pools if required. We again note that by and large individual direct holders were not the main source of redemption prior to or following the EU referendum.

2.11. The APFI is supportive of depositories and ACDs challenging fund manager requests to suspend dealing.

2.12. The APFI notes that unit-linked fund providers often manufacture or have influence over the underlying property fund. The APFI encourages the regulator to consider whether (in respect to pooling of open ended funds) unit-linked holders should be segregated from direct holders.

2.13. The APFI notes that it would have been operationally risky and regulatory difficult to not suspend the unit-linked fund of the underlying had suspended as the suspension could trigger a stale NAV Price. However the actions of unit-linked providers should be scrutinised.

2.15. The APFI asks the regulator to consider the impact and operation of Fair Value Adjustments (FVAs) on fund holders during the period in question, whether they were applied fairly, clearly and not misleading.

2.16. We ask the regulator to consider if non-retail Collective Investment Schemes (CIS) offer a more effective operating model for institutional, multi-asset and unit-linked holders and whether any revision to COBS 21 would be beneficial to allow a broader range of options for property investment by professional investors, thereby segregating the risk between retail and professional investor groups.

2.17. The slowdown in outflows post referendum would appear to have been evidence of normal investor behaviour. We ask the regulator to also consider if FVAs and suspensions imbalance normal investor behaviour and creates negative herding. We note that suspensions and gating tends to drive a 'flight' mentality among retail investors, as we saw in 2009-2010. We ask whether special suspension provisions should relate to multi-asset managers and in-house funds?

Response to FCA Questions:

Q1: The APFI is in broad agreement with assets identified but asks that the regulator additionally considers; private debt securities, collateralised debt, AIM listed securities, high yield asset-backed, mortgage-backed, commercial real estate loans, social housing loans, hedge funds ('AIFs') and weekly traded funds and certain types of closed-ended trust.

Q2. The APFI observes that the implementation of liquidity management tools (to date) appears to be for the benefit of the fund manager rather than the fund holder. In exceptional periods of liquidity stress this may be warranted but otherwise unhelpful. In a pooled open-ended fund, the APFI suggests the regulator consider imposing liquidity controls upon fund managers to segregate and protect retail investors from institutional investors (and visa versa). This should encourage institutional investors (including multi asset funds) to make longer term commitments (5-7 years +) and suppress the disruptive effect of tactical asset allocation. It would also focus fund managers to consider investor mix at outset and ongoing. This would have a stabilising effect on the sector, one that focussed on income generation rather than capital speculation.

Q3. The proposals appear sensible and worthy of further consideration. Fund managers should have a fiduciary responsibility to manage the investor mix and redemption profile of the fund on an ongoing basis. Any rules should protect retail investors with sufficient buffers in place to deal with any herding. Proposals should consider whether Contingent Deferred Service Charges (CDSC) should be mandatory for divestment of retail investors within 1 year and within 5 years for institutional (professional investors) as a substitute or option for current suspension and FVA provisions.

Q4. We note that through fund manager actions and current fee structures, fund holders were impacted by 1) high cash positions during periods of low cash rates and hence sub-property returns ('out of market'), 2) reduction in capital through fair value adjustments and 3) above average annual management charges (typical to the sector) and total annual portfolio costs arising from property divestment. We ask the regulator to consider whether fund holders should be discounted (fees) for assets not held in property over a period of time. We believe that funds investing into property funds should be subject to specific controls to investment period and redemption volume.

Q5. The APFI believes that current practices protect the fund manager rather than the fund holder. More regulation in respect to illiquid assets in open-ended funds is necessary. The APFI has particular concern over the use of anti-dilution and FVA practises and lack of recognised standards.

Q6. The APFI is supportive, specifically with regards to provisions in 4.26 relating to frequency and notice periods, any provisions should be aimed at protecting fundholders over fund managers and retail investors over institutional investors. Specifically the regulator should impose controls that reduce the likelihood of front-running by internal multi-asset managers.

Q7. The APFI does not believe that self-regulation is currently effective to protect the interests of fundholders and stabilise the property fund sector. Particularly we are concerned that AREF operates too closely to the Investment Association and that some form of prescriptive rules and oversight is required.

Q8. APFI notes that many of the risks, currently inherent, arise from the cross-pooling of retail and institutional investors, greater disclosure will in itself not improve this situation and we encourage the regulator to address practises by fund managers and how they manage their investor mix and engage multi asset fund managers. Technically the asset class is in many ways easier to relate to retail investors, than other asset classes, as commercial properties have physical presence on the high street, in retail parks, offices and so on. The payment of rents are again easy to educate. Where complexity arises is through market operations and actions, which should be directly supervised.

Q9. APFI observes the developments in bond trading platforms in the secondary market and that they appear to aid liquidity generally. However a far greater factor is the actions by the growing AUM controlled by multi-asset funds and how they engage with property fund managers. The increasing use of property as an income and bond substitute has resulted in growing tactical asset allocation, which the APFI observes destabilises the sector, leading to liquidity tightening and asset bubbles. Longer-term investing is a more resilient approach.

Q10. We draw again the regulator's attention to the actions by multi asset funds with large distributors, investing into internal property funds and the potential trial for market manipulation through 2016.

We thank the FCA for the opportunity to respond to this discussion.

For and on behalf of the APFI.

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About the APFI:

Founded in 2011, the Association of Professional Fund Investors was created by and for its membership. It enables professional fund investors to share ideas, ensure best practices and network with their peers.

Our Aim

APFI is dedicated to the advancement of the interests of professional fund investors and voicing the collective perspective of its members concerning key topics and trends within the global asset management industry.

Our Focus

At its core, APFI serves as a forum for its members to drive the development and the exchange of global best practices in the areas of research, analysis, due diligence and selection of asset management products. APFI seeks to build strong collegiate relationships among its members through a global networking framework. APFI advances the voice and perspective of the professional investor to industry dialogues on product development, regulatory and distribution topics concerning the global asset management industry.

APFI strives to enhance the competitiveness and overall quality of asset management products in the marketplace through its members continuously demanding exceptional quality from asset managers. Further, APFI seeks to ensure first class client servicing, reporting and transparency from asset managers.

APFI believes that the inclusion of the investors' viewpoint is crucial to the sustainable growth of the asset management industry. APFI acts to ensure the continued recognition of the importance of professional fund investors and advance their role within the asset management industry. APFI is independent of commercial interests and is owned and controlled entirely by its members.

Our Philosophy

There are some simple truths that APFI members see as central. Certainly there are others and we invite new members to add ideas but here are the basics:

Funds are bought by professional fund investors, not sold to them.

Hot concepts are the basis for short-lived bubbles; APFI members seek to isolate funds and their managers that have sustainable investment merit.

A strong competitive environment for funds is crucial, of which open architecture is a key component.

A well thought out, sophisticated approach to fund research is forward looking and past performance is only a limited aspect of the selection process.

There is no 'right way' to analyse and select funds – APFI members utilise a broad range of techniques and methodologies.

Professional investors work most effectively in an environment of independence and objectivity.

Ends.