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April 2020

The suspension of open-ended investment funds

On 18 March 2020, the Financial Conduct Authority ("**FCA**") published a statement on its website concerning the suspension of open-ended commercial real estate investment funds. The FCA states that:

- It understands certain standing independent valuers have determined that there is currently material uncertainty over the value of commercial real estate ("CRE"). In this situation, it is not possible to establish a fair and reasonable valuation of CRE funds. As a result, some managers of open-ended CRE funds have temporarily suspended dealing in units of those funds and others are likely to follow for the same reason.
- Managers of open-ended funds can use suspensions in line with their obligations under applicable regulations. In these circumstances, suspension is likely to be in the best interests of fund investors.

The statement was made following turbulence in the UK CRE market as the UK began to feel the economic effects of Covid-19, which made it harder accurately to value the real estate assets held by CRE investment funds and to liquidate those assets quickly enough in the face of the increasing frequency and value of redemptions.

Publication of the statement demonstrates the importance that the FCA attaches to its new rules designed to ensure better protection of retail investors in non-UCITS retail schemes ("**NURS**"), which do not come into force until 30 September 2020. It also serves as a salutary reminder of the importance that all fund investors should be treated equally and fairly, when valuation and liquidity problems arise. Failure to do so exposes those with an element of responsibility for managing open-ended investment funds to the risk of enforcement action.

This article will be of interest to authorised fund managers, depositaries, ancillary service providers, intermediaries, firms communicating financial promotions to retail clients for funds investing mainly in illiquid assets, and investors, retail or otherwise, who have direct exposure to the funds.

Suspension of dealing

Suspension of dealing in authorised open-ended funds is currently provided for by the FCA's rules where, due to exceptional circumstances, it is in the interest of all the unitholders in the authorised fund.[1] The FCA's current guidance on suspension however notes that difficulties in realising scheme assets or temporary shortfalls in liquidity may not on their own be sufficient justification for suspension.[2]

Most open-ended funds that are marketed to investors opt to deal daily. This means that, under normal market conditions, investors can redeem their holdings every business day, at a price based on an up-to-date valuation of the fund's assets and liabilities (the net asset value ("**NAV**") of the fund). The NAV informs the unit price that an investor pays to enter or receives to exit the fund. Funds remaining open for dealing during market conditions in which the NAV, and hence the unit price, cannot be determined with a sufficient degree of confidence present a risk that investors are treated unfairly. An investor exiting the fund may receive a unit price significantly lower or higher than its underlying value. Those investors who remain invested in the fund might be impacted by the dilution of NAV caused by redemptions when valuation is uncertain. Where the NAV cannot be known with certainty, the fund manager may decide it is necessary to suspend the fund.

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[1] The FCA's Collective Investment Schemes Sourcebook ("**COLL**"), 7.2.1R: https://www.handbook.fca.org.uk/handbook/COLL/7/?view=chapter

[2] COLL 7.2.2G(1).

Noteworthy suspension events

In June 2016, dealing in several real estate funds was temporarily suspended following the result of the UK referendum on EU membership. That came amid speculation about a possible drop in commercial real estate prices causing uncertainty as to the value of those funds.

Last year, there were two further significant fund suspension events. In June 2019, the Woodford Equity Investment Fund was suspended, attracting significant media attention (and a related FCA investigation), due to an inability to liquidate assets quickly enough to meet an increased number of redemptions.[3] In December 2019, the M&G Property Portfolio, which has £2.5 billion of assets under management, was temporarily suspended because the relatively illiquid nature of real estate assets meant that it was difficult immediately to meet sudden and sustained levels of redemptions.[4] Whilst the circumstances of the suspensions related to a lack of liquidity rather than uncertainty as to the fund values, both serve to demonstrate the frequency of suspension events.[5]

These suspension events and the market uncertainty caused by Covid-19 raise questions about how fund managers use different liquidity risk management tools and how to strike a fair balance between the interests of investors wishing to redeem their holdings and those wishing to remain invested in the fund under difficult market conditions.

Suspension is, therefore, an important tool for protecting investors in open-ended funds from material loss of value in extreme market conditions. However, suspension is not currently mandatory.

FCA's new rules

In view of these events and questions about how fund managers use different liquidity risk management tools, including suspension, the FCA has consulted on and published a new set of rules with the aim of reducing the risk of poor outcomes to retail investors in authorised open-ended funds.

In Policy Statement PS19/24, the FCA confirmed it was introducing new rules focused on NURS, the type of fund through which ordinary retail clients most commonly invest in illiquid assets, principally commercial real estate. The rules focus on three broad areas (the latter two of which are beyond the scope of this alert):

- suspension of dealings in funds;
- improving the quality of liquidity risk management; and
- increased disclosure.

The new rules, subject to one exception, will make it mandatory for authorised fund managers managing NURSs holding property and other immovables to suspend dealing when a standing independent valuer has expressed 'material uncertainty' about the valuation of at least 20% of the scheme property.[6] A similar requirement will apply if the NURS invests at least 20% of the value of the scheme property in units of one or more other authorised funds for which dealings in units have been temporarily suspended.

However, an authorised fund manager may continue to deal in the units of NURS where they have agreed with the fund's depositary, acting reasonably, that to do so is in the best interests of investors.[7] When making that determination, the authorised fund manager and the depositary must not rely solely on a fair value price adjustment. During the period of material uncertainty, the decision not to suspend dealing in the fund must be reviewed, at least every 14 days.

Enforcement risk

The FCA's statement on 18 March 2020 looks like an attempt to encourage managers of CRE funds to adopt the new rules early, and suspend more readily than might be thought appropriate under the current COLL guidance. It follows a letter from the FCA to the Boards of authorised fund managers in November last year, which encouraged early adoption of the rules.[8] Once the rules do come into force, they will be more stringently applied.

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[3] https://www.fca.org.uk/news/news-stories/update-lf-woodford-equity-income-fund
[4] https://docs.mandg.com/docs/UK/Investor/MandG-Property-Portfolio-Investor-Letter.pdf
[5] Although the Woodford Equity Investment Fund is a UCITS, not a NURS, COLL 7.2.1R applies equally to UCITS.

[6] COLL 7.2.-3R(2) and 7.2.-1R(3): https://www.handbook.fca.org.uk/instrument/2019/FCA_2019_90.pdf
[7] COLL 7.2.-3R(3): https://www.handbook.fca.org.uk/instrument/2019/FCA_2019_90.pdf
[8] https://www.fca.org.uk/publication/correspondence/letter-effective-liquidity-management-good-practice-authorised-fund-managers.pdf

With the interests of retail investors at their core, it is reasonable to assume that in the event those with responsibility for managing NURS (and open-ended investment funds more generally) do not abide by the rules, the FCA, where appropriate, will use its enforcement powers to send a message to the industry about the importance of compliance. That may result in the imposition of substantial financial penalties and, for individuals found to be culpable, sanction including public censure or, in the case of more egregious beaches, prohibition.

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