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By email: dp17-01@fca.org.uk

21 May 2017

Dear Mr Glibbery,

Response to Discussion Paper DP17/1 "Illiquid assets and open-ended investment funds"

The BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. Our members have invested over £27 billion in nearly 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 385,000 people and 84% of UK investments in 2015 were directed at small and medium-sized businesses.

The most common private equity and venture capital funds are limited partnerships and venture capital trusts, both of which are closed ended funds. The FCA's proposals are not relevant to these funds. Accordingly the proposals are not expected to directly affect private equity or venture capital fund managers.

As well as private equity and venture capital fund managers, the BVCA also represents members managing open-ended funds that invest in debt. This response is sent on behalf of those members. The BVCA welcomes efforts by the FCA to engage with industry regarding the important subject of liquidity management. This response addresses the FCA's proposals with regard to liquidity management as set out in Chapter 4 of DP17/01.

General comments

DP17/1 is an ambitious paper. The FCA explains that its origins lie in the experience of investors in certain open-ended property funds in the wake of the EU referendum. Nonetheless, the paper considers options for improving liquidity management for open-ended funds investing in all illiquid asset classes. The paper therefore affects a broad range of funds and a diverse investor base. Designing rules around liquidity management that are adequate for such a wide range of funds will be challenging.

1. Treatment of professional investors

While the BVCA shares the FCA's concern to protect retail investors, the BVCA is concerned that any proposal to introduce regulatory requirements for firms to offer different redemption rights for retail and professional investors invested in the same fund runs counter to the important principle that investors should be treated equally. We agree that professional investors require a lower standard of protection than retail investors. This is reflected in existing rules which limit the types of fund in which retail investors can invest, which is a principle we support. However we are not aware of any existing rules which require investment managers to actively prefer retail investors over professional investors where they are invested in the same product and we have a number of concerns about the creation of any such rules. Many professional investors are managing money on behalf of retail clients and the BVCA is concerned that the end retail investors investing via a fund of funds could receive a structurally worse treatment under this approach. An alternative would be to require funds which accept direct retail investment to provide more explicit warnings to retail investors about the specific risks of investment in open ended funds that hold illiquid assets particularly (please see Section 5 below for a further discussion of enhanced disclosures).

Similarly, should the FCA enhance retail investor rights to the detriment of professional investors, fund managers would face difficult questions about managing the ensuing conflict of interest between retail and professional investors.

The BVCA would be opposed to any proposals which would require existing funds with both retail and professional investors to restructure to separate these investors into different fund vehicles. Such a reorganisation is likely to involve complexity and legal and other costs.

Any requirement for firms to have separate funds for retail investors vs professional investors could act as a barrier to entry for smaller fund managers who have targeted a primarily professional investor base.

2. Portfolio structure and liquidity buffer

Providing appropriate levels of liquidity management is important both for investment managers and for investors. Debt fund managers already use liquidity management tools within their funds. This may include retaining returns in a cash vehicle to pay redemption requests and tax liabilities, investing a portion of a fund in liquid assets or allowing funds to borrow cash up to a specified proportion of the fund's assets to service redemption requests.

Any requirement for firms to hold a minimum level of uncommitted cash in any type of open ended fund would constrain fund management and result in a lower return for investors. We would oppose such mandatory requirements for professional investor funds. Uncommitted cash acts as a significant drag on investment performance, eroding the exposure gained from holding illiquid assets. For instance, most institutional investors in private debt are sophisticated and manage their liquidity needs by investing a portion of their investment portfolio in liquid assets. The role of the fund manager is to act in a discretionary capacity and manage the fund in the best interests of all investors. How investment managers choose to manage levels of uncommitted cash is very dependent on the nature of the fund. Often institutional investors in private debt

funds do not expect their liquidity needs to be met by fund managers holding significant amounts of uncommitted cash.

For retail investors, there are currently limits on the open ended debt funds in which they may invest. Retail investors must invest through a pooled fund, managed by a wealth manager or advisor. These wealth managers will manage their clients' liquidity requirements through other portions of their clients' diversified investment portfolios and are not likely to rely on holdings in private debt or infrastructure funds to meet their client's cash requirements. If that system is maintained then this could be an alternative method of protecting the position of retail investors.

There are also dangers in imposing a cap on the proportion of a fund's portfolio that can be held directly in illiquid assets for professional client funds. Investment managers currently actively manage liquidity in their funds. If the FCA imposes a cap on illiquid assets, investors may simply expect firms to invest up to the cap. A cap is unlikely to take into account the nature of the portfolio held by the manager, the prevailing market conditions or the risk of investor redemptions.

We note the FCA's reference to the introduction of liquidity 'buckets' in the US. Some of our members do operate liquidity 'buckets', maintaining a certain portion of the funds' assets in liquid assets in order to provide liquidity management to investors. We note there may be downsides to mandating this approach for all funds. It may not be appropriate for every fund, depending on the investment objectives of investors. Furthermore, any requirement for firms to classify a fund's assets into different 'buckets' is likely to require an element of subjective judgment on the part of firms categorising fund investments. Given this, it would be difficult for firms to consistently classify assets into 'buckets' mandated by the FCA. It would therefore be challenging for investors to compare different funds with different proportions of assets in notionally the same 'bucket'. Given that holdings in liquid assets may act as a drag on performance, the classification of assets into liquidity 'buckets' may create conflicts of interest.

3. Use of specific tools

Liquidity management tools are not suitable for every institutional fund, for example, some open-ended funds have one or two professional investors for whom liquidity management tools such as suspension of dealing would be inappropriate. The BVCA would not therefore support rules mandating that fund managers have the power to use these tools for institutional funds, where professional clients receive professional advice on the terms of the funds in which they invest and can choose funds with liquidity management tools or not. For instance, the frequency of dealing is often negotiated with large institutional investors and in such cases it does not appear appropriate to impose a regulatory standard on top of the contractual arrangements.

4. Direct intervention by the regulator

We share the FCA's reservations about the effectiveness of future direct intervention by the FCA, particularly for institutional funds. We consider that the potential for unintended consequences are real and that even the prospect of regulatory intervention is likely to have a significant, distorting effect on market behaviour.

5. Enhanced disclosure

While we note the BVCA's concerns about the effectiveness of investor disclosures, professional investors, who often make significant investments in BVCA members' funds, do consider disclosures in fund documentation closely, the terms of which are often individually negotiated with investors and their advisors.

If the FCA is minded to make changes in this area, clearer disclosures and risk warnings may ameliorate the policy issues identified by the FCA in DP17/1 better than some of the other proposals discussed in DP17/1. Enhanced disclosure requirements would avoid the significant additional operational costs, complexities and conflicts which could arise with some of the other proposals. The BVCA notes the feedback and responses set out in Feedback Statement FS16/10 "Smarter Consumer Communications" and the FCA's work in this area. The BVCA considers that a glossary of terms within fund documentation or a common glossary prepared by the industry (similar to the "Glossary for Investors" being developed by the Investment Association) could further help retail investors understand important terms in fund documentation.

6. Secondary market provision

The FCA's proposals on secondary market provisions are of interest and the BVCA would welcome the opportunity to review further proposals from the FCA, or from other respondents to this discussion paper, in due course.

The BVCA considers that the present proposals are not sufficiently developed for the BVCA to provide substantive comments. The BVCA simply notes that it would not support the introduction of mandatory requirements around secondary market provisions as these are unlikely to be suitable for every fund, for instance funds which have large institutional investors which have negotiated bespoke terms with the fund manager prior to investment.

Conclusion

The BVCA welcomes the FCA opening a debate with this discussion paper. The scope of the current discussion paper is broad. Should the FCA decide to take this project further, the BVCA would welcome the FCA publishing a further discussion paper on this topic, to solicit comments on a more specific set of proposals.

If you do have any further questions, please do not hesitate to contact me (tim.lewis@traverssmith.com).

Yours sincerely,

Tim Lewis
Chair, BVCA Regulatory Committee