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Equity Fund Suspension Leads FCA To Rethink Illiquid Assets

By **Richard Crump**

Law360, London (June 14, 2019, 5:47 PM BST) -- The deterioration of an equity fund run by one of Britain's most high-profile stock pickers has prompted the Financial Conduct Authority to consider reviewing how investments in illiquid assets are regulated amid criticism that the financial watchdog failed to react to the unfolding crisis.

The FCA has indicated it will introduce new rules for so-called open-ended funds after investors were locked out of Neil Woodford's flagship £3.7 billion ($4.7 billion) fund last week in response to the wave of investors seeking to withdraw their cash after the fund had been under performing.

Woodford's Equity Income Fund ran into trouble when it was unable to sell unlisted stocks fast enough to meet investors' withdrawals. The episode has revived concerns over the regulation of open-ended funds — which promise daily liquidity access to investors — that hold illiquid assets that are difficult to cash out at short notice.

"This is something without shadow of a doubt the FCA will look into and what lessons should be taken into account," said Syedur Rahman, legal director at Rahman Ravelli Solicitors. "I would be surprised if the FCA does not incorporate changes to its rules on open-ended investment funds in response to the wrong type of attention it has attracted."

One thing the regulator may look into are loopholes Woodford might have exploited to skirt regulatory restraints on open-ended funds.

For example, by listing certain companies in which he had a sizeable stake on the small Guernsey stock exchange, Woodford was able to avoid breaching the European Union rules limiting the amount of securities a fund manager can hold in unlisted companies to 10%. The assets counted as quoted holdings for regulatory purposes even though they weren't very liquid given low turnover on the Guernsey exchange.

Eve Ellis, a financial regulation partner at Ropes & Gray LLP, said there is too much potential leeway on how the regulation's provisions are interpreted.

"There is room for interpretation of what is a liquid asset which can lead to issues," she said. "The FCA may look to clarify that. It could decide to be more prescriptive in considering whether something is liquid."

But as cash fled the fund, it had to sell liquid assets in publicly quoted companies in order to meet the redemptions. That, however, increased the percentage of the fund's investments that were in harder to trade companies, many of which were privately owned. Woodford's suspension has raised concerns over whether the open-ended fund model is compatible with illiquid assets.

A critical issue is the proportion of assets that bypass the 10% restriction on unlisted assets, but in reality are illiquid and rarely traded, according to Stephen Elam, partner at Cooke Young & Keidan LLP.

"Where fund managers are hunting for yield in a low interest rate environment and pushing these boundaries, the regulator needed to be aware of that," he said. "The impact is severe as investors do expect liquidity and that redemptions are met."

The FCA has said it could consider whether the Woodford fund breached the rules, however lawyers said the problem is the rule itself. While Rahman said Woodford may have "flouted the spirit of the rules" by using investments that made the holdings appear more liquid, there is no suggestion the fund was technically in breach.

Nevertheless, the suspension has renewed concerns about open-ended funds holding illiquid assets while promising daily liquidity to their investors. Andrew Bailey, head of the FCA, has said the regulator will consider banning daily withdrawals along with other rule changes.

In an open letter in the Financial Times, Bailey said the FCA will consider forcing funds to keep assets in jurisdictions chosen by the investors as part of new rules being developed by the FCA in response to a number of property fund suspensions in June 2016 following Britain's vote to leave the EU.

Rahman said the changes should "consider the volume of unlisted investment assets, an increase to financial reserves and stronger guidance on how illiquid assets should be held."

The episode has also exposed an apparent breakdown in communication between authorities. The FCA said it had been unaware of the decision to list certain assets in Guernsey, but The International Stock Exchange, which operates the market in Guernsey, contradicted those claims.

TISE said earlier in June that it had made several attempts to contact the FCA in April but didn't actually manage to get in touch until May. The FCA's contact with the Guernsey exchange operator is just one of many questions the regulator faces over its slowness to react to the fund's deterioration.

Bailey is set to be grilled by British lawmakers on the influential Treasury Select Committee over the FCA's supervision of the struggling fund. Committee chair Nicky Morgan has already called the suspension of the Woodford fund a "troubling episode."

Morgan has asked for a timeline of the FCA's supervisory contact with the fund or management and a timeline of its contact with the authorities in Guernsey, in relation to the fund.

The FCA might reflect on matters, including "the extent to which it monitored the fund's stress testing, how that was designed and how investment decisions affecting liquidity were made and challenged within the funds," said Cooke Young's Elam.

"Given the size, public profile and importance of these funds, it would be hard to justify why these issues weren't the subject of close regulatory scrutiny," said Elam.

Meanwhile, both the Treasury Committee and the FCA have said Woodford should waive the fund's £100,000 a day management fee while the investors are blocked.

The FCA has said that although it does not approve of suspensions, the regulator doesn't try to keep them from happening if that's what's "in the best interest of fund investors." International securities oversight guidelines also consider suspensions to be a legitimate tool, the agency noted.

Nevertheless, lawmakers are set to demand answers on what should dictate how long a suspension should be and at what point the FCA could intervene, as well as what the watchdog's take is on the fees that funds charge during a suspension.

Bailey has also said the FCA will take another look at fund supermarkets such as Hargreaves Lansdown, which create best-buy lists of favored funds that retail investors often rely on, have been impartial enough when promoting Woodford's fund. The FCA decided in March not to set new rules for best-buy lists following a review.

Hargreaves Lansdown, which heavily backed the fund, also faces questions from the Treasury Committee over its commercial ties with the fund, including whether it received fees for investment in the fund and when it first raised concerns about the amount of illiquid assets it held.

But Ropes & Gray's Ellis said the events will make firms like Hargreaves look to review their own approach.

"You may find they organize themselves and put more robust processes in place. When an event like this happens firms do revisit their procedures," she said.

--Editing by Rebecca Flanagan.

Correction: An earlier version of this story misquoted Eve Ellis of Ropes & Gray. That error has been corrected.
