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Three things you need to know

- The UK Financial Conduct Authority ("FCA") issued guidance (the "Guidance") on the suspension of fund redemptions.
- The Guidance applies to all FCA-authorised managers involved in managing investment funds, not only to managers of real estate funds.
- The Guidance is meant to address how fund managers approach the on-going fair treatment of investors in current market conditions, where a suspension of valuations or redemptions is being considered.

FCA Guidance on Fund Suspensions

Introduction
On Friday 8 July, the FCA issued the Guidance in response to recent developments in the UK real estate fund market. While the Guidance is a response to the suspension of redemptions from certain funds in that sector, it appears to be applicable to all asset managers. This means that the Guidance will potentially be relevant to any situation where a suspension of valuations or redemptions is being considered in relation to an investment fund, the assets of which are managed by an FCA-authorised firm.

The Guidance is also one of the first examples of the FCA’s regulatory response to market stresses arising following the result of the UK’s referendum on leaving the European Union.

Application of the Guidance
The Guidance is addressed to "asset managers" and "fund managers" interchangeably. Neither of these terms are defined in either statute or the FCA Handbook of Rules & Guidance. This creates uncertainty about the range of FCA-authorised firms to which the Guidance will apply.

It would seem logical to assume that two categories of firm are definitely subject to the Guidance:

I. FCA authorised firms which are authorised as "alternative investment fund managers"; and
II. FCA authorised firms which are authorised as "UCITS management companies".

What is less certain is the extent to which the Guidance is applicable to FCA authorised firms which are authorised as MiFID investment firms, predominantly carrying on the activity of managing portfolios of investments for collective investment schemes. This category covers a significant range of firms, including
many UK-based investment managers of private equity funds, UK-based managers of hedge funds (particularly those where the "headline" manager is headquartered in the United States) and UK-based investment managers of UCITS funds, where the headline management of the fund itself is being carried out by another entity (as will often be the case with respect to UCITS funds being promoted around the European Union under the passporting regime provided for by the UCITS directive framework, where the management of the fund itself will often be carried on in Ireland or Luxembourg).

Requirements of the Guidance

The apparent purpose of the Guidance is to state the FCA's expectations of how "fund managers" are required to act in situations where market disruption or specific events occur, which potentially result in a fund receiving requests for redemptions or withdrawals which cannot be met a) out of the available assets of the fund, and/or b) within the normally-stated period for execution and settlement of redemptions or withdrawals.

The Guidance requires fund managers to adhere to the following practices:

I. fund managers are required to "understand fully their duties and responsibilities" as well as the tools available to manage stress on liquidity within the fund;

II. fund managers are required to ensure that disposals of fund assets to provide cash with which to effect redemptions or withdrawals are carried out in a way that does not disadvantage investors who are remaining in the fund (or are investing in the fund during a period of stress); and

III. in circumstances where temporary suspensions have been implemented, fund managers are required to consider lifting the relevant suspension (presumably at the earliest opportunity) and providing a revised basis on which the valuation of any interest in the fund should be calculated in the circumstances.

What is the status of the Guidance?

Under section 139A of the Financial Services & Markets Act 2000 ("FSMA"), the FCA is permitted to issue various categories of guidance, including "general guidance". Ostensibly, the Guidance would appear to be intended to operate as general guidance. Although general guidance is not technically "binding", any FCA-authorised firm not adhering to standards set out in general guidance is significantly exposed to potential enforcement action by the FCA if it is unable to provide compelling and justifiable reasons for its failure to comply. Firms failing to comply with general guidance are also potentially exposed to claims being made against them by clients for breaches of FCA rules, where the requirements set out in FSMA for such claims are met.

However, section 139A FSMA sets out a statutory obligation on the FCA to:

I. consult publicly before issuing general guidance;
II. publish statements as to the manner in which the guidance in question advances the FCA's statutory objectives; and

III. generally, publish a draft of the relevant guidance inviting comments and responses before finalising the relevant guidance.

It is very clear that these requirements have not been adhered to with respect to the adoption of the Guidance. This calls into question whether or not the Guidance has been properly adopted, which in turn raises questions about the status of the Guidance in the FCA's hierarchy of rules, guidance and other pronouncements. It is probably best understood as being an explanation of how an authorised firm, in the view of the FCA, could comply with its obligation to “act with integrity” in times of market stress (although neither this principle nor any specific FCA rule is referred to in the Guidelines).

Collateral damage?
In spite of the stated context, the Guidance impacts on areas beyond the conduct that fund managers are expected to engage in with respect to the operation of suspensions. In particular:

I. the Guidance includes a statement that "fund managers have a duty to act in the best interests of all investors" and a further statement that the obligation of the fund manager during a period of stress is to "ensure the best interests of all investors are safeguarded". This is a misstatement of the legal analysis in the majority of fund structures, where the fund manager's duty is likely to be to act in the best interests of the fund, rather than the investors in that fund, and the FCA's own rules require that fund managers “treat investors fairly”; and

II. the Guidance states that it is the duty of the fund manager to ensure that assets are valued "fairly and accurately and to ensure that any subscriptions or redemptions of units take place at a fair price". Again, this is a significant misstatement of both the legal and regulatory analysis regarding the obligations of fund managers in respect of valuation of assets and the net asset values at which subscriptions or redemptions are to be affected.

Where are the missing links?
As well as fundamentally misstating the legal position of a fund manager with respect to issues around dealing, suspension and valuations, the Guidance fails to address a range of other fundamental issues which are relevant to these questions. Of particular note is the omission of any reference to the following key issues:

I. the Alternative Investment Fund Managers Directive ("AIFMD") regime, which has now been fully implemented in the UK, creates a regulatory framework imposing a range of obligations on fund managers subject to AIFMD with respect to liquidity management. Given the issues currently at hand in the Guidance, it is concerning that no thought appears to have been given to how the statements in the Guidance can be reconciled to the relevant provisions of the AIFMD framework. Similar obligations are imposed on managers of UCITS funds; and
II. while recognising that the tools that fund managers have in managing liquidity are a function of a fund’s offering and governing documents, the Guidance does not specifically address the key issues that (i) the basis on which assets should be valued, and (ii) the way in which dealings in units of the fund should be conducted, together with the rights, duties and obligations of the governing body of an investment fund, are constrained by the constitutional and offering documents of that fund. In particular, the Guidance imposes a number of obligations on the fund manager which are very likely to be fundamentally incompatible with those constitutional and offering documents. For example, it is very unlikely that there will be a legal basis on which the governing body of the fund or the fund manager can unilaterally change the basis on which the price for dealings in units of the fund are to be ascertained.

What’s on the menu?
As will be apparent to those who have read the Guidance, our relatively cursory consideration of the issues raised by the Guidance is considerably longer than the Guidance itself. It is our view that the Guidance has been extremely poorly considered and has been published by the FCA with little thought of the wider implications of its actions in trying to address the considerable stresses currently occurring in the real estate investment fund space. For many people, this will be reminiscent of a number of the short term regulatory actions taken during the early stages of the financial crisis of 2008. The Guidance also appears to show a degree of ignorance as to the regulatory changes implemented in the wake of the crisis to manage issues such as the ones now arising in the real estate fund space.

This would appear to suggest that the FCA has not learned lessons from the less-than-orderly unintended consequences which resulted from a number of the regulatory initiatives implemented during 2008 and 2009. In many instances the practice of "rulemaking by FAQ" solved one immediate problem, only to open additional issues up with long-term consequences for the authorised firms affected by them. The Guidance suggests that there is a significant likelihood that the FCA will once again adopt a "shoot first: ask questions later" approach to its regulatory mandate during the current period of disruption and stress. This is likely to be less than welcome news to regulated firms which are already contending with the significant business uncertainty created by the result of the UK referendum.

What should I do?
The Guidance creates uncertainty for any FCA-authorised firm involved in the management of fund assets, where there is a potential mismatch between the liquidity of the portfolio of the fund and the liquidity terms provided to investors. Firms potentially dealing with these issues across a wide range of sectors will now also have to contend with regulatory guidance on these issues, which in many instances will directly contradict the legal analysis of their duties, rights and obligations.

We would encourage those firms which are subject to the AIFMD and UCITS regimes to consider carefully their existing liquidity management policies and to take steps in the short term to identify any potential mismatches between the liquidity in their portfolios and the liquidity terms afforded to investors.
We would very strongly encourage that any firm considering implementing a suspension of valuation or dealings in the short term seeks detailed legal advice urgently, so that they can ascertain the potential risks presented to the firm by implementing a suspension in accordance with the fund's terms where those terms are not consistent with the expectations of the Guidance.

We would expect a number of industry bodies and associations to seek to persuade the FCA urgently to clarify and refine the Guidance. We would encourage all participants in the industry to engage with any efforts by the relevant industry bodies and associations to seek to resolve some of the uncertainties created by the Guidance.
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