

Rt Hon Nicky Morgan MP
House of Commons
London
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Dear Ms Morgan

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Woodford Equity Income Fund: an effective long-term response

My previous correspondence (14 June 2019) emphasised the importance of regulators and policymakers not viewing the circumstances which forced the suspension of Woodford Equity Income Fund as unique. They are the product of fundamental liquidity mismatches where open-ended funds hold hard to sell assets. The growth of funds with these features creates broader consumer and systemic risks. It was very welcome that your oral evidence session with Mr Carney and his colleagues (Oral evidence 26 June) brought out these issues so clearly.

Since then investors in Woodford Equity Income Fund have had further bad news. It has been confirmed that the current suspension will be maintained. The signs are that this situation could persist for months. This creates significant uncertainty for many retail investors who are understandably worried about the eventual outcome of this process.

These developments confirm the need for policymakers including the Financial Conduct Authority (FCA), to be proactive in their response. The oral evidence provided by the FCA raised important issues about how this agenda should be approached.

Creating accountability

Mr Bailey rightly highlighted the fact that the FCA is unable to independently change the UCITS rules (which govern the operation of Woodford Equity Income Fund). He indicated that the EU should look again at these rules and I very much agree with this view. That said, the Committee (and the FCA) should not conclude that domestic policymakers are powerless to take steps to stop consumer and systemic risks building up in the funds sector in advance of rule changes by the EU.

The UK has powers to influence the product design decisions of providers by enhancing current mechanisms designed to ensure good governance and accountability. The AIC has **recommended** that an asset manager (Authorised Fund Manager, AFM) planning to offer an open-ended fund investing in illiquid assets should publish its view on why the structure chosen is in the best interest of consumers. This would include consideration of the type of investor, the nature of the underlying assets, the redemption policy, the likely levels of cash holdings and the possible impact of these arrangements on investment performance. This would be required when products are launched and annually thereafter. A critical outcome would be to create a business culture within AFMs which considers the consumer interest. It would also create a mechanism of accountability if the fund does not perform as promised.

These obligations should be linked to the existing FCA principles for business. These include, for example, the requirements for firms to have proper systems and controls and to treat customers fairly. This proposal builds on the FCA's rules which will require the governing bodies of AFMs to consider whether funds offer consumers value for money. Our proposal creates a similar mechanism.

The measure is proportionate. We are not proposing, for example, banning illiquid assets in open-ended funds. There may be situations where these structures are entirely appropriate, for example, where the investors are large institutions and they are fully aware that they may have their rights of redemption suspended for significant periods. It should not create a material cost to AFMs or affect the UK's international competitiveness. This obligation would be far less commercially intrusive than the current obligation on AFMs to assess 'value for money' of funds, a requirement which has a direct impact on the pricing of funds.

All we are seeking is for firms to explain their plans to deal with potential liquidity mismatches and relate it to the commitments they have made to investors. This process should stimulate the use of more robust systems for open-ended funds or even encourage the use of other structures which are more suitable for these assets (such as closed-ended listed investment companies). Critically, where an open-ended fund was chosen, and it did not perform as promised, there would be a clearer process which would allow the AFM to be held to account.

We envisage this measure could be constructed in a way which obliges the AFM to provide its assessment to the FCA. This would help create an early-warning mechanism which is not currently in place.

It is difficult to see why this option would not be attractive to the FCA: it builds on existing approaches, reflects the 'outcomes based' approach advocated by Mr Bailey in his evidence, is proportionate, arguably cost free, and should help create a commercial culture which gives proper recognition of consumer interests. It could also help reduce systemic risk arising in the open-ended fund sector, including for UCITS funds, where the FCA has no powers to directly change the rules on illiquid holdings.

Impact of redemption on portfolio composition

The plight of Woodford Equity Income Fund has focussed attention on consumer 'lock-ins'. On this subject, I agree with Mr Bailey, in that, in dire circumstances, this mechanism can help limit some aspects of consumer harm. When a fundamental liquidity crunch hits, it means that remaining investors are treated in the same way. It stops a rush for the exit which could reinforce problems within the fund. However, as I reflected in my previous letter, I am concerned that the regulator must not become too comfortable with this approach. It could precipitate the systemic risks identified by the Bank of England. Also, it is, at best, a double-edged way to protect the consumer interest. The reality is that consumers are significantly disadvantaged where suspensions are required. It would be much better to prevent problems arising in the first place (which is the ambition of the proposal set out above).

While a suspension will avoid the worst aspects of a 'fire sale', a suspension will still result in distressed asset sales. The portfolio manager of a suspended fund will need to sell assets to prepare the fund for future reopening and, potentially, high levels of redemption. These asset sales will not be made based on the merits of the investment case. Most likely, it is the most liquid (and potentially most attractive assets) which will be sold first. These disposals will inevitably secure a lower return for investors that would have been the case if there was there no pressure to sell.

The process of selling assets is likely to fundamentally rebalance the portfolio. This is not a result of a change in the manager's investment view: it is being forced by the crystallisation of a fundamental liquidity mismatch and the need to prepare for expected redemptions once a

fund reopens. Investors are seeing the value of their assets reduced, they have no certainty over what assets the fund will be holding when the fund is eventually opened for business and, in the meantime, cannot exit the fund.

Even when an open-ended fund is not suspended, the redemption mechanism can have fundamental implications for portfolio construction which could change its risk and return profile significantly. This creates material concerns for the consumer interest (see annex for further discussion).

The difficulties of managing redemption requests where funds hold hard to sell assets is expected to increase their cash positions. Our assessment is that open-ended property funds (in the UK property direct sector) currently hold, on average, 20% in cash. Some funds may hold up to 30%. These portfolios are significantly underexposed to the target asset class. The cash holdings are not working for the investor with the result that these funds will significantly underperform alternative products (such as investment companies) able to offer full exposure.

Funds with lower holdings may tend to hold slightly lower levels of cash. However, given recent events, and increased consumer awareness of the danger of suspensions, it seems likely that these holdings will increase. Indeed, a prudent regulatory regime might require higher cash buffers. The outcome will be an even greater performance deficit for retail investors, creating disincentives to diversify their portfolios and making it harder for them to reach their financial goals for retirement.

This process, and potential for, suspension where open-ended funds hold hard to sell assets has major consumer implications. This is an issue which should be of concern to policymakers and the FCA. Most importantly, it should encourage the FCA to see suspension as a last resort, not an expected part of how the funds sector operates. It should seek to minimise the likelihood of suspension, which should include creating mechanisms to encourage responsible structuring decisions by product providers which take this issue off the table. The AIC proposal is designed to achieve this outcome.

Role of disclosure

One observation made by Mr Bailey did stand out as surprising. He said that “*Suspension is a tool that is very clearly set out in the prospectus*”. The implication being that he considered this to be fair warning. I disagree with this suggestion.

It is true that the [Woodford Equity Income Fund prospectus](#) includes a full disclosure of the rules applying where a suspension is required. However, I doubt that this provided any real insight to investors about the risk, if they read the disclosure at all.

The information on suspensions is set out on page 24 of a 64-page prospectus. It is an account of the rules and process. This section does not provide any insight into the circumstances when a suspension might arise nor its likelihood. The term ‘suspension’ does not feature in the Risk Factors identified in the prospectus (pages 8 – 10). The 16th detailed warning (out of 21) says “*Unlisted companies are not generally publicly traded. As there may be no open market for a particular security it may be difficult to sell and cause liquidity issues*”. A lawyer might argue a technical case that this addresses the issue of suspension, but this somewhat oblique reference cannot be characterised as an accessible disclosure for the non-professional investor.

The lack of any clearer reference to suspensions in the risk warnings is despite the prospectus being published on 23 July 2018 during (as I understood Mr Bailey’s evidence) a period when the FCA had the fund under an ‘enhanced monitoring’ regime because it had breached its limits on holding illiquid assets. Far more likely to be appreciated by a retail investor is the

fund's redemption policy. The first line of the section in the prospectus devoted to redemptions (section 17.7 on page 22) states "*Shares in each fund may be redeemed on any dealing day*".

It is difficult to see how any ordinary investor would have understood the risk that the fund was likely to suspend. The risk section of the [factsheet for Woodford Equity Income Fund](#) (dated 31 May 2019, just before the fund was suspended) also makes no reference to any risk of suspension. It does, however, note that its investments in unquoted securities may be less liquid and more difficult to value.

The fund's [Key Investor Information Document](#), a regulated disclosure provided to investors before they buy, described as 'accurate' on 18/02/2019, prominently states "*You can buy and sell shares in the fund every business day*". It makes no reference to the possibility of suspension. Its discussion of investments in 'unlisted' companies does refer to the fact that these investments may be more difficult to sell and may raise valuation issues. However, no link is drawn with redemption.

It is surely unreasonable to think that these disclosures provide ordinary investors with any appreciation of the implications of a suspension or how likely such an event might be. The regulator should not be relying upon these materials to reduce the consumer risks which have been brought to the fore by this episode.

The AIC proposal set out above differs fundamentally from current disclosure requirements. Yes, it involves a disclosure, but this would be far more helpful to consumers and their advisers. Critically, it requires a judgement to be made by the governing body of the AFM. This will provide qualitative information to investors. However, given the likelihood that many will not read this material, its arguably more significant function is to provide a process by which the AFM can be held accountable for its product design/management decisions and which can provide an early warning to FCA. Its broader purpose is to influence the culture and behaviour within the regulated firm, not just to inform the purchasing decisions of retail investors.

Next steps

I very much hope the Committee will continue to seek information to inform the public debate and ensure the regulator develops a full and urgent response to the consumer and systemic risks created by open-ended funds holding illiquid assets.

Indeed, it would be extremely welcome if the Committee was able to support this proposal or, at the very least, if it could press the FCA to give it serious consideration.

Further discussion of this agenda will be invaluable in securing a suitable policy response able to protect consumers and reduce systemic risk.

If you or your colleagues would care to meet to discuss the issues raised in this letter or if require any other information, please do not hesitate to contact me.

Yours sincerely



Ian Sayers
Chief Executive

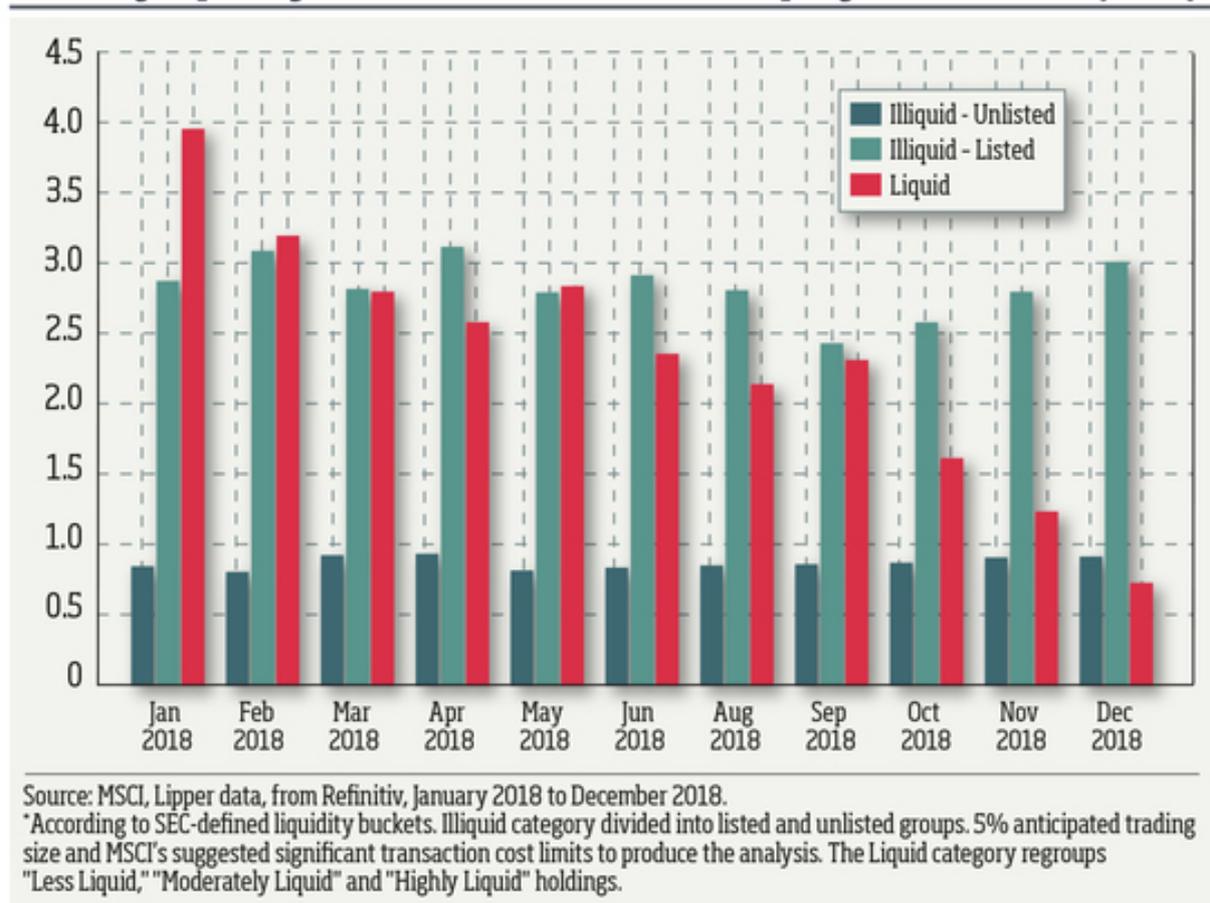
Annex: Impact of redemption on portfolio composition

The experience of Woodford Equity Income Fund suggests that, even outside a period of suspension, the redemption mechanism has the potential to have a substantial impact on portfolio composition. This could have significant implications for investors.

An [article in Investment Week](#) (25 June 2019) provided an analysis of the changing liquidity profile of Woodford Equity Income Fund in 2018. No doubt there is some room for debate on specific aspects of the methodology used. Indeed, the article rightly includes a commentary from Woodford Investment Management with its observations on the approach used.

Notwithstanding details of this nature, the general picture seems clear. Over the period examined (see chart) the proportion of most liquid holdings (shown in the red bar) falls substantially and steadily. The amount held in illiquid, unquoted assets, remains virtually unchanged.

Monthly liquidity breakdown of Woodford Equity Income fund (£bn*)

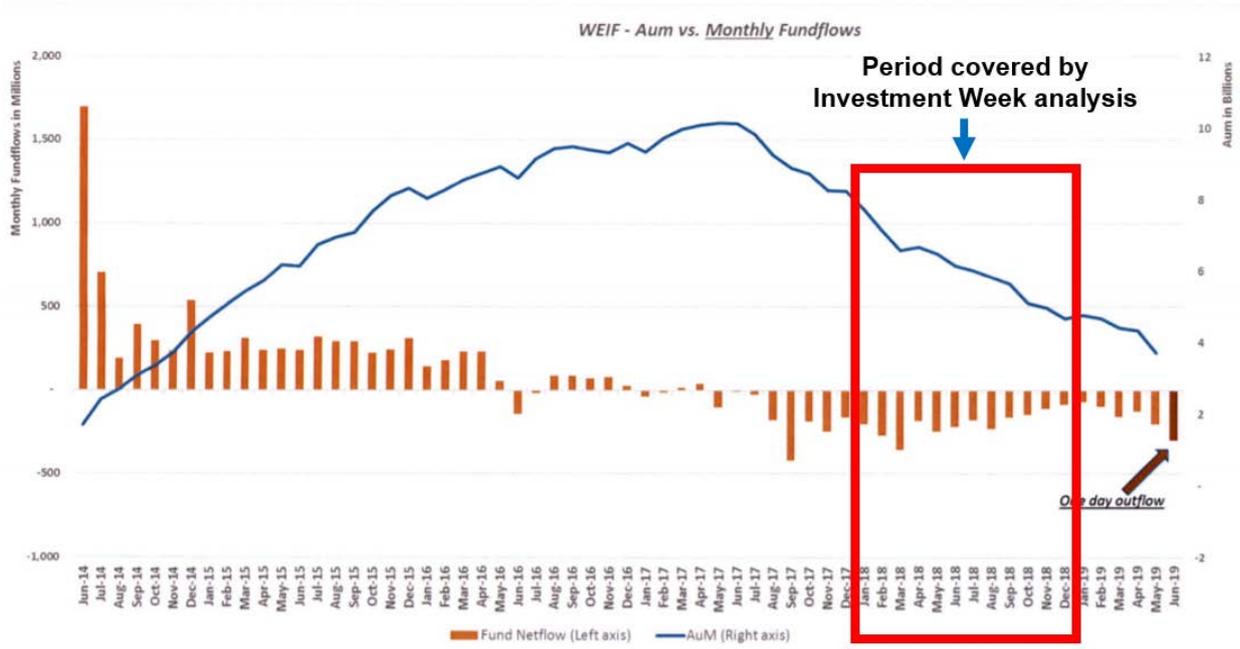


The overall picture is of a fund whose underlying assets change materially during those 12 months. The question is why. One possibility is that the change of assets was driven by a change in the investment view of the portfolio manager. However, it would be surprising if this was the case. Other facts seem likely to have had an impact. For example, the challenge of managing redemptions was a significant issue for the fund over that period and this seems likely to have had a material impact.

The chart below does not answer this question definitively but, on an initial assessment, makes it seem likely that redemptions were a major factor.

It shows that over the same period analysed in the Investment Week article, Woodford Equity Income Fund was having to respond to a high and sustained level of redemptions.

Woodford Equity Income Fund: Assets under Management vs monthly fund flows



Source: Andrew Bailey Letter to Nicky Morgan. 18 June 2019. Chart 2 (with AIC annotations).

This suggests that, even in the absence of suspensions, the process of managing redemptions when a fund holds illiquid assets, could be a driver of portfolio composition.

If these changes are being made to manage liquidity issues rather than on the investment case, this could be a significant source of consumer detriment.

It also seems likely that many retail investors holding the fund would have been unaware of this shift or its impact on the fund risk and performance potential.

This is a matter which deserves further regulatory consideration.