

Primary Market Technical Note

Eligibility of closed-ended investment funds

The information in this note is designed to help issuers and practitioners interpret our UK Listing Rules, Prospectus Regulation Rules, Disclosure Guidance and Transparency Rules, and related legislation. The guidance notes provide answers to the most common queries we receive and represent FCA guidance as defined in section 139A FSMA

Rules

UKLR 11.2

UKLR 11 is designed to cater for a wide range of investment strategies and methods of investment.

Key concepts in UKLR 11 include:

- the requirement to have a defined investment policy which can only be changed materially with the consent of shareholders
- the obligation to have a board independent from the fund manager
- the requirement to invest and manage assets in a way which is consistent with spreading investment risk, and
- a prohibition from conducting significant trading activity

These concepts apply irrespective of the nature of the asset class invested in or the fund's strategy.

The market has taken advantage of the flexibility offered by UKLR 11 and we have seen increasing numbers of funds of a more complex nature – in terms of structure, asset class and investment management – including funds which only hold controlling stakes in their investments.

In the context of assessing the eligibility of a new fund for listing, the majority of our time is spent considering the last two items above. We are particularly concerned to ensure that the entities we list under UKLR 11 are genuinely closed-ended investment funds, rather than trading companies which should more appropriately consider a listing under UKLR 5.

We frequently engage in discussions with applicants, advisers and sponsors regarding the boundary between an entity that is eligible for listing under UKLR 11 and one that is not. This guidance sets out some of the key considerations when determining whether an applicant can be considered to be a closed-ended investment fund, bearing in mind the eligibility requirements set out in UKLR 11.2.3 R and UKLR 11.2.4 R.

The guidance is designed to be asset class and strategy neutral. It is not intended to set out an exhaustive list of factors and not every factor will be relevant in every case, but the intention is to make our thinking process more transparent in the less obvious eligibility cases.

Spread of investment risk

One of the key eligibility requirements under UKLR 11 is that the applicant must spread investment risk. A listed fund should be a risk-spreading vehicle that offers investors diversified exposure to an asset class.

The investment policy required under UKLR 11.2.8 R is the articulation of how the fund will manage its assets and spread its investment risk going forward. The mandatory requirements cover asset allocation, risk diversification and gearing, including maximum exposures. We will carefully examine these statements – in light of the intended asset class – to assess whether the proposed investment policy suggests there is a risk that genuine diversification may not be achieved.

UKLR 11 does not set arbitrary limits to individual exposures, but where the investment policy potentially allows an individual investment to represent a material proportion of the applicant's portfolio, we will

seek to understand why the sponsor believes the proposed policy enables a genuine spread of investment risk. For example, if an applicant proposes an investment policy with limits suggesting in excess of 25% of the portfolio may be represented by a single asset, we would certainly expect to understand how the sponsor has reached its conclusions. Our view on the eligibility of an applicant with such an investment policy will vary depending on the specifics of each case.

Trading activity

A fund must not engage in trading activity that is significant in the context of the fund as a whole. This does not prevent the underlying investments from being trading businesses, but if the fund itself is actively engaging in activity which would more typically be seen in a company listed under UKLR 5, this is inconsistent with what is envisaged as a fund under the UK Listing Rules. As part of the eligibility review, we will need to be satisfied that the applicant is not a commercial company that should be assessed against the eligibility criteria set out in UKLR 5.

In determining whether an applicant is credibly set out as a closed-ended investment fund, we will take into account how the applicant is described in the eligibility submission from the sponsor, the information provided in the draft prospectus, conversations with the sponsor, and other open-source material. There is no definitive list of indicators. However, the sort of factors we will consider may include:

- the asset class – for example, we would spend less time considering a FTSE tracker than a vehicle investing in infrastructure
- for assets that are majority owned and/or require more operational oversight than classic asset classes such as shares or bonds – how the operational aspects will be managed and by whom
- how the applicant is presented and whether there is a clear focus on spreading investment risk
- the rationale for follow-on investments
- how many (if any) staff are employed by the fund, and in what capacity
- the track record of the individuals behind the proposal, and
- the intended use of capital and debt facilities in the context of the specific asset class

Each applicant will be considered on a case-by-case basis and we will assess the proposition as a whole. As such, factors that may be acceptable for a fund in one proposal may, in the context of a different asset class/strategy, render the applicant ineligible for listing under UKLR 11.

Financing arrangements

Allied to our consideration of both of the above elements is an examination of the fund's financing arrangements.

In the context of risk spreading, we will look at how the fund employs its debt facilities and whether certain financing structures undermine what is otherwise a diversified portfolio. Secured debt that sits at issuer level or across multiple assets may imply that, in the event of default, material parts of the portfolio may be at risk, which is, *prima facie*, inconsistent with the concept of risk diversification. We accept that there can be legitimate reasons for debt being employed in this manner. However, as part of the eligibility process, we will challenge the sponsor to understand how it has satisfied itself that the applicant can indeed spread investment risk in spite of the gearing structure, taking into account the proportion of the portfolio covered by any one arrangement.

However, there may be cases where the financing structures are such that they create a concentration of risk within the applicant's portfolio in such a way that we cannot look through to the individual assets that are covered by the financing structure (e.g. a number of assets used to secure a specific loan). In such cases, we may consider the assets on an aggregated basis (or the 'pool') as the investment, which is then subject to the fund's exposure limits and the overriding principle of spreading investment risk.

We do not typically treat secured pools found in real estate funds as creating a concentration of risk. Although this guidance is addressing all asset classes, we note this is a longstanding practice in real estate funds and we are not aware of investor concerns suggesting this poses risks that investors would not expect to encounter in such funds.

Further, as provided for in UKLR 11.2.5 G, there is no prohibition on a fund taking controlling stakes in investee companies. However, it is not consistent with the principle of spreading investment risk to plan to

use one investment's operational cash flow to fund the day-to-day financing of another investment. We would also examine the rationale for the existence of certain facilities, such as overdraft arrangements, to ensure they are not suggestive of the applicant being run as a commercial company. We acknowledge that there are limited justified uses in the context of a fund, such as funding/bridging working capital requirements (which would not be expected to be significant), or for non-investment purposes, such as own share purchases, and we would engage with the sponsor to ensure we fully understand what is proposed.

Ultimately, we would expect a fund to be able to make an investment decision in relation to each asset on its own merits.