The Investment Association

The Role of the Long-Term Asset Fund: IA Position Paper

July 2020

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Executive Summary

In July 2019, the IA published an initial blueprint for a new UK Authorised Fund structure, the Long-Term Assets Fund (LTAF). The core proposal is for an authorised open-ended fund that allows certain categories of retail investors to access long-term illiquid investment opportunities, with dealing terms that are aligned to liquidity of these investments. This paper follows up on the initial blueprint, with more detail on the proposal.

Rationale for the LTAF. The LTAF proposal rests on four fundamental assertions:

- Savers and investors will benefit from a wider set of options to connect pools of long-term capital with long-term investment opportunities.
- There is an ever-greater need within the UK economy for such funding, both for companies and infrastructure projects.
- Defined Contribution (DC) pension schemes and retail investors should also have access to private markets through authorised investment funds to be able to prudently increase such exposures in a diversified approach.
- The UK debate needs to move beyond a comparison of existing open-ended funds and closed-ended funds towards a broader paradigm.

Building on a strong existing fund regime. The LTAF utilises the existing UK Non-UCITS Retail Scheme (NURS) framework as a foundation, building on the important investor protections in that framework while providing a sub-set of rules focusing on investment powers, valuation requirements, and subscription and redemption terms that are better adapted to long-term illiquid asset classes. It is therefore differentiated from the Qualified Investor Scheme (QIS) in a number of ways. In particular, it will have a stricter approach and more structure around the investment and borrowing powers, due diligence on underlying investments, governance rules applicable to retail funds and a recognised kitemark that will enable it to be identified by distributors as applicable for retail funds.

Clear parallels internationally. While the LTAF would be a new structure for the UK, the proposal draws on existing fund structures available to retail investors in other countries, in particular Interval Funds in the US and Spezialfonds in Germany. This also highlights the competitiveness dimension to ensuring the UK fund regime remains innovative and responsive to changing customer needs and evolving capital markets.

Key proposed features. The LTAF seeks to provide investors with access to the following asset classes:

- Private equity
- Private credit
- Venture capital
- Infrastructure, including transport
- Real estate
- Forestry
- Collective Investment Vehicles that invest in private asset classes, including limited partnerships

The LTAF will also be able to hold cash, listed and transferable securities, including money market instruments to provide options for managing portfolio liquidity pending investment in less liquid asset classes.

A central feature of the LTAF design will be flexible subscription and redemption terms that are aligned to the liquidity of the underlying asset classes. In particular, LTAFs will be able to offer infrequent redemption opportunities, e.g. once every 3, 6 or 12 months, depending on the particular investment strategy being pursued, accompanied by notice periods. The valuations requirements will utilise the robust framework provided by the Alternative Investment Fund Managers Directive (AIFMD), ensuring these are conducted independently of the portfolio management function, based on models disclosed to investors in the prospectus. These will be overseen by appropriate governance structures such as valuation committees reporting to the board, as well as the depositary.

With careful eligibility criteria, the LTAF could be made available in the retail and private wealth markets. In additional, the long-term nature of pensions savings, in particular, lends itself to making a small allocation to benefit from the illiquidity premium available over the longer term from private market investments. However, the permitted links rules that apply to unit-linked DC schemes continue to be a barrier to offering these schemes access to illiquid asset classes on DC platforms. Access to illiquid investments should be considered in the context of the overall liquidity available in DC schemes, and the professional process involved in the construction of DC default schemes in which the vast majority of auto-enrolled employee pension contributions are invested.

What this would look like in real life. To help conceptualise the proposals, we outline four hypothetical examples of LTAFs using different investment strategies. These are as follows:

- A Recovery Credit Fund, investing by making private loans and by purchasing loans made and securities issued during the COVID crisis.
- A Renewable Energy Fund, investing in renewable energy projects in the UK, such as wind turbine projects, solar energy farms, tidal power, hydro-electricity and energy storage projects.
- A Private Markets Multi-Asset Fund, that seeks to offer broad exposure to private markets by investing in a range of institutional funds offering exposure to private equity, private credit, infrastructure, real estate and forestry.
- A General Infrastructure Fund, investing in key infrastructure projects, including transport such as road and rail networks, bridges, ports, airports; utility infrastructure such as broadband delivery, telecommunications, power grids and water treatment/pipelines, and energy storage and delivery.

The LTAF has the potential to widen the scope of investors able to invest in private market asset classes, in a structure designed to manage the low levels of liquidity available from these asset classes. As well as broadening the investment universe available to investors, the LTAF can provide a new source of capital to support key policy priorities such as funding the post-COVID recovery, modernising infrastructure, the transition to a carbon neutral economy and supporting innovation in private enterprise.

Overview and Structure of Paper

Looking across the UK economy, and more widely internationally, the investible universe consists of a wide range of companies, some publicly listed, vastly more privately owned. Up until now, mainstream authorised investment funds accessible by retail investors have focused particularly on publicly listed companies, which have the advantage of generally being more liquid and subject to a range of governance requirements which also deliver a high degree of transparency. As private markets expand, and demand for investment capital for long term projects such as public infrastructure increases, there is an important debate to conclude about how investors – including retail and DC pension savers – can participate in these opportunities. With the right approach, long-term, productive investment can be better supported, while providing sustainable, diversified returns for long-term savers.

In 2019, the Investment Association (IA) put forward an initial blueprint for a Long-Term Asset Fund (LTAF). This was part of a major report from the UK Fund Regime Working Group (UKFRWG), which sets out a broader vision for enhancing the competitiveness of the UK investment fund industry both domestically and internationally.[1] This included other fund structures, notably a new Onshore Professional Fund regime, which also provides opportunities in the area of private markets. Clearly, the immediate economic context has changed dramatically as a result of Covid-19, but if anything, the issues under discussion have become even more important as policymakers in the UK and internationally consider how to stimulate long-term growth and maintain competitiveness.

This paper is the next stage in the development of the LTAF, seeking in particular to answer a number of important questions raised by regulators and wider stakeholders following the UKFRWG report. It is in five parts:

- Part One looks at the rationale for the LTAF, emphasising the IA's commitment to provide savers and investors with wider fund options, whether open-ended, closed-ended or forms of hybrid.

- Part Two sets out the justification for the NURS as the foundation for the new fund structure, looking ahead particularly to customer needs in the pensions and retail markets.

- Part Three provides examples from international experience of similar concepts, suggesting that there is a clear precedent for the LTAF and the UK has an opportunity to develop a compelling and competitive new fund vehicle.

- Part Four explores a number of critical features in more detail, including target asset classes, subscription and redemption mechanisms and eligible investors.

- Part Five brings the LTAF to life with four illustrative examples of how it would provide additional choice for savers and investors, and new funding routes for the wider economy.

There are three technical annexes:

- Annex One provides an overall technical specification.
- Annex Two looks in more details at subscription and redemption mechanisms.
- Annex Three explores the remaining obstacles to investment in illiquids in DC schemes via unit-linked funds.

[1] https://www.theia.org/sites/default/files/2020-04/20200330-ukfrwgfinalreport.pdf

1. Why the Long-Term Asset Fund?

The main objective of the LTAF is straightforward, even if the execution inevitably requires careful consideration: **to offer an additional option for investment in less liquid or illiquid assets in a permanent (or evergreen) fund, open to subscriptions and redemptions based on the liquidity and value of the underlying assets.**

The concept rests on four fundamental assertions:

- **Savers and investors will benefit from a wider set of options to connect pools of long-term capital with long-term investment opportunities**, especially in the DC pensions and retail markets which are currently not able to access as wide a set of investment fund vehicles and strategies as the institutional market. The IA has seen clear indications from investor groups that they would like to be able to hold illiquid assets through fund structures that can accommodate regular cash flows and are priced in line with the value of the underlying assets. Current available fund structures are not optimal for delivering this.

- **There is an ever-greater need within the UK economy for such funding, both for companies and infrastructure projects.** In the context of the Covid-19 crisis, this need becomes even clearer. Many thousands of companies that are not publicly listed, and those that do not have access to Venture Capital/Private Equity capital would benefit from funding options that could be provided by capital markets. We set out further below how the LTAF could play a role in channelling this capital to such companies, either directly or through other funding vehicles.

- **DC and retail investors can already access private markets through vehicles such as investment trusts or venture-capital trusts, but they should also have access to similar asset classes through authorised investment funds in order to be able to prudently increase such exposures in a diversified approach**. Clearly, there are challenges – and legitimate concerns - around the mechanics of the LTAF. We address these in detail in this paper, but there needs to be a consistent starting point in the permitted investment universe. The LTAF would also have a core requirement for professional investment management teams, robust infrastructure and strong levels of customer protection, including full transparency (e.g. fees and costs) and consideration of suitability.

- **The UK debate needs to move beyond a comparison of existing open-ended funds and closed-ended funds towards a broader paradigm.** Better matching of dealing frequency at fund level with the nature of liquidity of the fund's underlying investments, notably for structurally less liquid or illiquid assets, will create a flexible and durable new framework.

The last point is critical. The LTAF proposal draws attention to the limitations of the current investment fund universe, which tends to polarise debate between open-ended daily dealing funds and closed-ended funds. Our proposal offers a pragmatic additional structure to widen choice, investor participation and effective mechanisms for capital allocation. The IA supports all forms of investment vehicle, whether closed-ended, open-ended or hybrid. Ultimately, however, there is no model that can perfectly combine near immediate access (e.g. exchange listing or a daily redemption/subscription process) with illiquid assets. Every approach has pros and cons, which will lead to different trade-offs.

For example, an investment trust can be a highly effective way of accessing less liquid assets and should continue to be an important part of the market. But the price of access, and the returns on redemption, are determined by market sentiment towards the investment trust and its portfolio of investments, rather than a strict valuation of the underlying assets. While the net asset values published are a key driver of market sentiment, other factors can also influence market pricing, including the relative demand for the investment trust and short-term reactions to events that are unlikely to materially affect the value of the investment trust's assets.

Access, therefore, comes with the possibility of steep discounts at a time of market uncertainty or potentially premiums when demand is high. There are tools available to the boards of investment trusts to manage premiums and discounts, but these tools can only be used periodically and haven't always been successful at managing large discounts. Directors may be forced to buy-back shares or use other discount control mechanisms to manage discounts which can put an investment trust with illiquid assets under similar pressure as an open-ended fund with similar assets. There are also associated risks such as low levels of liquidity in the shares, which can make it difficult to buy or sell at a reasonable price at a given moment.

A factor that investors wishing to make large, regular investments into an investment trust would need to consider is the effect of these on the traded share price of the investment trust. Other market participants are likely to anticipate these regular allocations and trade ahead of them, increasing the price of access. This is particularly a factor for DC investors, who have frequent inflows – often more frequent than monthly - and generally want to make allocations as soon as they are received.

This does not make a closed-ended vehicle an inferior vehicle in any sense. However, it does point to the need for a balanced discussion about how different investor needs can be met effectively. Otherwise, there is a real danger of setting a standard for authorised investment funds that is so high that it cannot ever be met.

2. What kind of vehicle is the LTAF?

The LTAF should be thought of as a step beyond the conventional world of both open and closed-ended funds. In essence, it borrows from both models:

- From the traditional open-ended fund universe, it takes the idea of a permanent fund that can expand or contract in response to investors' needs, delivering investment returns and a volatility profile that reflects the calculated valuation of the underlying assets, combined with strong product level rules, governance and oversight mechanisms, such as the role of the depositary and the additional responsibilities on an Authorised Fund Manager (AFM) such as independent board members, value for money assessments, etc.

- From the closed-ended model, it recognises that long-term illiquid investment cannot be subject to frequent redemption activity that forces a level of portfolio divestment and/or adjustment that is out of keeping with the nature of the underlying asset. The investment powers we are proposing are also broadly in line with those of closed-ended funds, such as investment trusts.

With redemption windows that could be as infrequent as a year, or even potentially longer where necessary taking into account the underlying assets, the LTAF could, therefore, be thought of either as a more closed open-ended fund, or a more open closed-ended fund.

As we explore in some detail in the UKFRWG Report, aspects of the investment fund regime in the UK already accommodate some of these points. For example, a Non-UCITS Retail Scheme (NURS) can move to a six-month redemption frequency. A QIS can invest extremely widely across the capital market universe but is only available to certain types of institutional investors.[2]

What does not yet exist is a fund structure that has the flexibility to reach across the UK investor universe at three levels simultaneously: eligible investors that include appropriate retail investors and all DC schemes; redemption frequency of more than six months; and wider investment powers. The LTAF bridges that gap, building what is a variant of the NURS structure.

Role of the NURS as a foundation

The NURS starting point is critical. First, the LTAF should benefit from a recognised label or brand that will be more attractive even to professional investors. Investors can immediately understand the nature of the authorised vehicle and what investor protections apply, and can, therefore, focus on the investment proposition rather than having to perform additional due diligence on a wholly new structure. This is one of the reasons the UCITS brand has become popular with institutional investors as well as retail investors, including non-EU institutional investors. An example of the power of labelling in another institutional market is the securitisation market, which uses a kiting system - some investors will only want to access a securitisation with a kitemark.

Secondly, the NURS will fit with investment practice in key parts of the retail and DC pensions market:

- From the perspective of unit linked fund investors, it is a permitted link and therefore easy for unit linked fund investors to confirm that a NURS is qualifying. This is an important benefit given that the vast majority of DC flows still come through unit-linked funds. However, there do remain challenges within the permitted links rules which will need to be resolved in order for

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[2] See pp.68-69 of the UKFRWG report in particular for a discussion of the limitations of existing vehicles.

unit-linked distribution of an LTAF to work most effectively. The issues are highlighted in Annex Three.

- While attractive to some institutional investors, non-mainstream pooled investments (NMPIs), such as unregulated vehicles or QIS, are unattractive to both DC platforms and trustees, as well as private wealth/discretionary managers.

- Multi-asset funds, which gain their exposure to different asset classes mostly by investing in other funds, will typically only invest in other authorised fund products that are marketable to retail investors. Again, the NURS will satisfy this requirement.

All investors should draw comfort from the governance requirements of a NURS, which require the AFM of a NURS to:

- Have a minimum of two independent directors on its board

- Perform an annual value assessment

- Appoint an independent depositary

- Comply with the MiFID II product governance requirements, which include a requirement to monitor the target market and any associated risks.

Important further investor protections apply to a NURS, in particular the requirement for the depositary to segregate assets from those of the AFM and to provide independent oversight of the activities of the AFM in respect of their management of the NURS.

Differentiating the LTAF from the QIS

The LTAF will be differentiated from the QIS in several key areas by having more prescribed and restricted investment powers:

- As an authorised fund structure primarily designed for professional investors, the QIS does not prescribe any spread limits for individual investments, other than a requirement for the AFM to maintain a spread of risk. While it is proposed that the LTAF is permitted to invest in a wider range of eligible investments than other NURS, the LTAF will be subject to the higher standard applicable to NURS of maintaining a prudent spread of risk and we envisage there will be spread limits for each investment (which may vary between different types of assets) at the point of investment.

- The QIS is permitted to borrow up to 100% of the net value of its scheme property – we envisage a lower borrowing limit for the LTAF (no more than 30-50%). These requirements will ensure greater investor protection for investors in the LTAF than in the QIS, reflecting a wider potential investor base.

- The LTAF will require an enhanced standard of due diligence relative to the QIS in advance of making any investment or originating any loans in a private market investment.

- The QIS is not an appropriate structure for the private wealth market, as it has been primarily designed for professional investors and does not include the same level of investor protection requirements as the NURS, within which it is proposed the LTAF will sit. In the DC default scheme market, although trustees are professional investors, the preference is for a retail vehicle, particularly as this works better with the permitted links rules (see below). The QIS is being used successfully for a number of Defined Benefit (DB) pension schemes, such as for pooling Local Government Pension Schemes, and modifying the QIS rules to accommodate a wider investment scope could adversely impact existing QIS.

- The LTAF will be subject to the governance requirements applicable to retail funds, in respect of the risk management oversight, board oversight and depositary oversight. The ability to perform effective oversight will be key to governance.

- The LTAF has the potential to be a recognisable brand or kitemark that would identify a fund using this structure as being suitable for specified investor groups. This could potentially be useful in the context of permitted links, where subject to rule changes around the level of allowable illiquid holdings in a unit-linked fund, it would be straightforward to readily identify a LTAF as being a permitted link.

3. Is the LTAF a new concept?

This is a new approach for the UK market, but comparisons can be seen in models internationally seeking to provide a way for long-term investment vehicles that do not try to square the circle of daily dealing and liquidity in all circumstances. The two closest examples are possibly US Interval Funds and German *Spezialfonds*. We set out the key features of each in the boxes below, noting clear parallels with the LTAF in terms of overall objectives, permitted investments and redemption structures.

Both Ireland (Qualified Investor Alternative Investment Fund (QIAIF)) and Luxembourg (Reserved Alternative Investment Fund (RAIF)) also have flexible fund structures that can accommodate illiquid assets, but these are more restrictive in terms of eligible investors. The European Long Term Investment Fund (ELTIF), available to retail investors, tends to be seen as a closed-ended fund vehicle, with redemptions generally unavailable until the end of the life of the fund.[3]

We note that in the context of the current Covid-19 crisis, both in other parts of Europe and the United States, there has been an intensifying debate about access to private markets. In the US, the Department of Labor has issued a clarification about how 401(k) plans can invest in private equity,[4] while EU authorities are reviewing the future shape of the ELTIF.

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[3] The UKFRWG report has more detail on the ELTIF and potential limitations, see p.67 in particular.

[4] See: https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020

Interval Funds are investment companies available to and marketable to US retail investors that offer periodic redemptions. Technically classed as closed-ended in the US, they nonetheless exhibit characteristics more associated with open-ended funds:

- Their shares are not traded on secondary markets. Instead, the fund makes periodic redemption offers to buy back the shares at Net Asset Value (NAV).
- They are permitted to continuously offer their shares at a price based on their NAV.

An interval fund will make periodic repurchase offers to its shareholders, generally every three, six, or twelve months, as disclosed in the fund's prospectus and annual report. The interval fund will also periodically notify its shareholders of the upcoming repurchase dates. When the fund makes a repurchase offer to its shareholders, it will specify a date by which shareholders must accept the repurchase offer. The actual repurchase will occur at a later, specified date.

The price that shareholders will receive on a repurchase will be based on the per share NAV determined as of a specified (and disclosed) date. This date will occur sometime after the close of business on the date that shareholders must submit their acceptances of the repurchase offer (but generally not more than 14 days after the acceptance date). Source: SEC

Spezialfonds can invest widely across liquid and illiquid investments, with retail and semi-professional investors able to invest in open-ended funds. Investors in Spezialfonds must have the right to redeem their investment at least once a year. The Spezialfond can require that the investor gives up to 12 months' notice in advance of making the redemption request.

Spezialfonds are Alternative Investment Funds (AIFs) established in compliance with Article 26 of the Kapitalanlagegesetzbuch (KAGB). They must have at least 90% of the fund invested in the following asset classes:

- Securities
- Money market instruments
- Derivatives
- Bank credit
- Real estate and land rights
- Investment in real estate companies
- Investment in other collective investment undertakings
- Special investment structures
- Interests in venture project companies, providing the sales values of the investments can be determined
- Precious metals
- Unsecuritised loans
- Investment in private companies, providing the sales values of the investments can be determined

(Source: Dechert LLP – Alternative Investments – Die Möglichkeiten einer Spezialfondsanlage nach § 282

4. What are the key proposed features of the UK LTAF?

At its heart, the difference between the LTAF and existing UK authorised funds rests on two elements: investment powers and subscription/redemption frequency. That frequency, in turn, is heavily determined by the nature of the underlying investment, and expected to reflect the hybrid nature of the LTAF, sitting between conventional open-ended and closed-ended funds.

Investment universe

The IA suggests that the LTAF should be able to invest at least in the following asset classes, in effect giving full access to private markets:

- Private equity
- Private credit
- Venture capital
- Infrastructure
- Real estate
- Forestry
- Collective Investment Vehicles that invest in private asset classes, including limited partnerships
- Cash
- Listed and transferable securities, including money market instruments.[5]

In order to invest in these asset classes, the LTAF will need to have the investment powers to invest in unlisted securities, originate, participate and guarantee loans, and invest in unregulated collective investment vehicles, including corporate and contractual vehicles and limited partnerships, both in the UK and overseas. The list of instrument types and assets that the FCA Collective Investment Schemes (COLL) Handbook would need to permit to allow access to those markets, without unnecessary layering, are outlined in our original proposal in the July 2019 report on the UK Fund Regime and in Annex One: Technical Specifications.

These broad investment powers will be accompanied by a requirement to perform a strict and documented due diligence process, including a review of the applicable legal contracts, before making any investment or originating any loans in a private market investment. We suggest the rules should not be overly prescriptive, beyond setting minimum standards, rather the industry should develop guidance on good practice relevant for each asset class.

Role of funds of funds

Alternative fund structures, including fund of funds, are a common way of accessing private market investments. Wrapping private market assets in a local fund structure is usually a tax efficient way of holding alternative assets, and can assist with legal arrangements in the country of the target investment. This leads to two requirements for efficient investment allocation:

- An LTAF should have full flexibility to invest in other fund vehicles – indeed, one of the main disadvantages of the ELTIF is the restrictions on investing in other funds. The ability to invest overseas is also an important diversification tool, again restricted under the ELTIF.

[5] The LTAF is not intended to be a vehicle primarily investing in these asset class types, but these should be available for the LTAF to use for the purposes of managing cash and also to gain exposure on a temporary basis through listed vehicles, e.g. Real Estate Investment Trusts (REITs), listed infrastructure funds, listed private equity funds, awaiting investment in liquid alternatives.

- An LTAF should be able to invest in funds that are not themselves restricted in their ability to invest in other funds. To achieve this, we propose that the restriction on NURS only being able to invest in other funds that themselves are restricted to investing no more than 15% in other funds is disapplied for LTAFs.

The ability for an LTAF to invest in true fund of funds (i.e. funds which do not themselves have a limit on investment in other funds) will be a crucial advantage over, and point of difference against, other existing products. In particular, this will avoid the need for complex layered structures involving the use of multiple layers of holding vehicles. We understand, however, that disapplying this restriction could give rise to concerns on the part of the Regulator in respect of cross holdings and the overall cost of the structure. If this is a concern, the Regulator could require that the AFM of an LTAF, when investing in any fund which does not have the 15% restriction on investing in other funds, review the arrangement to ensure there are no material cross holdings likely to arise and the overall costs of the structure are not excessive.

In this context, we emphasise that transparency of charges and costs, along with the highest standards of overall transparency, is also being addressed in regulatory and industry initiatives. These include institutional market standard disclosure being delivered through the Cost Transparency Initiative, (CTI), the PRIIPs Regulation, MiFID II and value assessment processes in both the DC and retail funds markets. As such, we expect the overall costs arising from investing in fund of funds structures to be assessed by AFMs regardless of whether the regulator imposes a specific requirement to do so.

Subscription and redemption mechanisms

The subscription and redemption mechanisms are arguably the most sensitive for the LTAF, both in terms of policy concerns about alignment of asset class liquidity and fund structures, and in terms of customer protection. Customer protection is particularly important given the overall objective of making the structure available in the DC pensions market and parts of the retail market, subject to safeguards. It is also important to emphasise that some aspects of appropriateness may depend upon the nature of the investment strategy and access mechanisms being offered.

Starting with considerations about the overall architecture, institutional investor funds investing in real and private assets generally have a commitment-based structure. Investors commit the headline amount in their subscription agreement but only transfer money to the fund, as needed, when the manager serves a drawdown notice. The funds are usually closed-ended (though more and more have started to explore liquidity features) and accept investors at various dates throughout a fund-raising period - each such acceptance being a 'closing' of the fund.[6]

A commitment-based approach is unlikely to be appropriate for a fund available to the DC pensions market and parts of the retail market because investors are likely to invest smaller subscription amounts than institutional investors and it would be administratively burdensome for the AFM or fund administrator to deal with the drawdown process in this context. Instead, our central

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[6] At times fund documents provide that if the fund fails to reach a material first closing the manager may choose to terminate the fund and release investors from their commitments. If the fund fails to reach a material scale but some investments have already been made, the manager would reach out to existing investors to discuss a way forward - do they continue with the much smaller fund; do they continue to make investments or do they move to liquidate the investments and the structure. Such a consultation would be harder in the context of a retail fund but possible depending upon governance mechanisms.

assumption is that the LTAF would be subscription-based, and investors would pay the money into the LTAF immediately upon their subscription being accepted by the AFM.

While a subscription approach will be more practical for both the AFM and the investors in this demographic than a commitment approach, this does create practical challenges, notably a potential issue of cash-drag on the performance of the fund, particularly in the early years of the LTAF. The AFM could invest subscriptions in liquid investments until it has pooled a sufficient amount to invest in a real or private market asset, and/or until the investment opportunity has arisen. In this situation, if there is ultimately a failure to reach scale or find suitable investments within a ramp-up period, then the AFM would return the proceeds of sale of such liquid investments and any income accrued or received from the investments made.

The precise operation of the subscription and subsequent investment mechanism would depend significantly on how frequently subscriptions could be made and on the nature of the underlying assets:

- An opening for subscriptions on a daily or monthly basis is obviously very different from a six-monthly or less frequent opening.

- Some asset classes – e.g. commercial property – may be more readily investible (and divestible) than others.

Fundamentally, the LTAF is based around the concept of a clearer match between the frequency of both subscription and redemption opportunities and the liquidity of the underlying portfolio. This could mean that subscription and redemption opportunities may be less frequent and thus cater to buying and selling inherently long-term assets, e.g. Infrastructure investments. Investors could also be required to give advance notice of redemption requests (e.g. six months) in order to assist the AFM of an LTAF to manage liquidity.

It may also be necessary in the case of some LTAFs to have longer settlement periods. This is to allow sufficient time for valuations of underlying assets, that will be used to value subscriptions and redemptions in the LTAF to undergo verifications and audits before they are confirmed. This may be required in particular for LTAFs that invest in other funds, whose initial valuations typically undergo audits before they are confirmed as final. Having a longer settlement period ensures that dealing price can be confirmed as final before the settlement is issued.

Although the ordinary subscription and redemption terms will be structured around the typical liquidity arrangements that the AFM of the LTAF expects to be able to offer, a range of liquidity management tools will be required to deal with a range of scenarios, including stressed conditions and market risks. Liquidity management is explored further in Annex One.

Eligible investors

The discussion on investment powers and subscription/redemption frequency links closely to the discussion about eligible investors. One challenge is that the LTAF may accommodate a very wide range of investment strategies. For example, a six-month redemption period for commercial property (currently permitted under NURS) would be permitted under the LTAF structure. This is a very different proposition from a strategy based on long-term private lending which, for example, might have much more restrictive terms for subscription and redemption. It is arguable that the target market for the former would be different in sophistication to the latter.

It is likely that LTAF distribution rules should be guided by the wider debate about client classification. Most approaches have in common two factors. First, a minimum investable wealth or portfolio size of an investor, and in particular the ability to be able to lock up part of that portfolio for long periods. Second, a minimum level of investing experience or relevant education and experience. This concept would likely work here, while recognising the important role of expert decision-makers in DC default asset allocation.

In terms of currently available products, the ELTIF regulations require that the Alternative Investment Fund Manager (AIFM) or the distributor must provide retail investors with appropriate investment advice and there are specific suitability requirements.[7] An alternative approach may be to consider minimum investment plus self-certification.

Our starting point is that it should be permissible to market an LTAF to all investors for whom it is currently permitted to market a non-mainstream pooled investment (NMPI) under FCA Conduct of Business (COBS) 4.12. This would currently include the following retail investors, who would also be eligible to invest in a QIS:

- Certified high net worth – over £100,000 annual income or £250,000 in net investable assets (i.e. excludes main residence, insurance benefits and pension savings withdrawals).

- Other categories of retail investors, such as certified sophisticated investors, self-certified sophisticated investors, employees of the investment firm.

The critical issue is the access rules for non-NMPI retail investors. Here, we propose a robust approach to customer protection whereby features of the ELTIF distribution rules could be adapted for the LTAF, in particular, suitability screening through investment advisers. The test for marketing to retail investors could include the following features:

- Investment advice required (i.e. not execution only / platform product)

- Investment in the LTAF must not constitute more than a set percentage (e.g. 10%) of the investor's overall investment portoflio at point of subscription

- A two part test: Investor must be well-informed (or other appropriate label), which can be satisfied by a minimum investment size[8], or otherwise certification required from the investor's distributor/private bank that the investor is well-informed (e.g. understands the risks of the investment) (no minimum investment size if certified as such).

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[7] The ELTIF suitability tests for retail investors are as follows:

- Suitability assessment by the manager (AIFM) or distributor, based on investor knowledge and experience, financial situation, risk appetite, investment objectives and time horizon;
- Where investor portfolio is less than €500,000, ensure aggregate investment in ELTIFs is not more than 10% of investor's portfolio;
- The initial investment in one or more ELTIFs must not be less than €10,000;
- Warning letter must be sent if the ELTIF term is more than 10 years.

[8] The European Venture Capital Fund Regulation (EuVECA) and European Social Entrepreneurship Funds Regulation (EuSEF) require a minimum investment of €50,000

It is important that any tests and screens are not made overly complex, or that there are "satisfiers" that are easy to test (with a certificate offering an alternative route to investors that do not meet these). This will be more straight forward for distributors to implement, particularly those using solutions utilising artificial intelligence.

In practical terms, it will be difficult for AFMs themselves to screen retail investors directly for suitability, as is permitted in the ELTIF regulation, hence there will need to be a requirement to ensure that for retail investors who do not meet the requirements for NMPIs, there is either a professionally-led investment decision, or the investment is received through a professional intermediary who has provided suitable investment advice. There will need to be a general duty on distributors /investment advisers to ensure there is a suitability assessment and the investor has sufficient other liquid assets to meet short and medium term needs, and assume risk of the relevant investment.

DC default investors

We have already highlighted the DC market as a key target market for the LTAF. Within DC, we envisage that the LTAF will be distributed through a scheme's default arrangement. This reflects both the commercial reality in DC - with the vast majority of members and assets being in the default arrangement – but also the fact that the construction and governance of the default strategy should allay any regulatory concerns about the LTAF being inappropriately distributed in the DC market.

DC default strategies are professionally designed and governed by trustees and pension providers acting on the advice of investment consultants and/or professional in-house investment teams. Individuals invested in the default by definition do not make investment choices. This makes the DC default distinct from more typical retail investments: it is better thought of as a retail investment purchased through an institutional oversight process.

Existing governance requirements for trustees, pension providers and their Independent Governance Committees include the ongoing assessment and review of the characteristics and net performance of the default strategy to ensure alignment with the interests of relevant members/policyholders. These investment governance requirements sit alongside other existing investor protections on the default strategy: a product-level charge cap, enhanced cost and charge disclosure and 'value for money' assessments.

Allocating to a LTAF via a DC default should, therefore, satisfy any concerns about DC investors accessing a LTAF. However, as we outline in Annex 3, aspects of the permitted links rules still make this significantly more complicated and difficult for illiquids than we believe it should be, despite recent changes.

Valuation mechanisms

Valuations of hard-to-value assets require a robust model and strong governance. This is a key focus for the boards of AFMs or AIFMs, depositaries, auditors and investors, particularly where that valuation is being used to determine the entry or exit price for investors. It is also important to emphasise that valuation challenges exist for all less liquid and illiquid assets regardless of the fund vehicle. The LTAF does not introduce anything new in this respect, although clearly there are pricing considerations in terms of how subscription and redemption models operate. It is essential that investors have confidence that the price reflects as accurately as possible the price of the underlying assets, noting this is more challenging with private assets, for which there is little transaction and market data on which to base valuations. The needs of particular investor groups will also need to be considered, e.g. platforms and DC investors will require regular price feeds for portfolio valuation and charge calculation purposes.

The IA proposes that AIFMD valuation requirements in FCA FUND 3.9, accompanied by the detailed rules in Articles 69 to 74 of the AIFMD Level 2 Regulation[9], are the baseline for valuation rules. These already provide detailed requirements for valuations and are designed to be adaptable for a range of asset classes, while ensuring the valuation process is independent of the management of the fund and is subject to robust governance. We note that, unless disapplied, the requirements in COLL 6.3 (with the exception of COLL 6.3.3AR-6.3.3DR, which apply only to UCITS), would also apply to an LTAF if this is a subset of the NURS. These rules provide a strong basis for the valuation requirements of the LTAF. According to the AIFMD, valuation is a function of the AIFM; consequently all AIFMs already have in place AIFMD appropriate valuation policies and it would be operationally easier and cost effective for the LTAF to be on-boarded using, as much as possible, existing processes and procedures. These include strict requirements on the documentation of procedures for model based valuations.

We acknowledge standardisation around the calculation of the NAV will be important, but given the variation in asset classes, and the scope for rapid developments in information transmission and best practice, we suggest that highly prescriptive rules around the calculation of the NAV are likely to be counterproductive. We suggest this standardisation will be best developed through industry guidelines, tailored to and taking into consideration the characteristics of specific asset classes, and readily adaptable to changing circumstances where required.

Transparency of the valuation process will be important to ensure investors understand and have confidence in the pricing of their investments, including the valuation models used, the governance process, information sources and the identity of any external valuers. The AIFMD already requires that the pre-contractual investor disclosure (typically the prospectus) includes a description of the fund’s valuation procedure and the pricing methodology for valuing assets, including the methods used in valuing any hard-to-value assets, in line with the valuation requirements noted above.

In the case of advised retail investors, appropriate disclosures in relation to the valuation process at the point of sale could be considered. These would be less detailed than the full disclosures given in the prospectus (as required by the AIFMD) but would cover the key issues and limitations with the valuation process. A reference to the valuation process could also potentially be considered in the annual reports.

An important related issue is how to price a fund between redemption points, particularly where it is the illiquid component of a strategy that is itself overall daily priced: for example, a DC default strategy. As highlighted above, the LTAF component will have a model-based valuation. This will generate a price that can then be fed through into the calculation of the overall default strategy price, which happens on a daily basis. In practice, a stale price is likely to be used between formal valuation points, but it is also possible to estimate a daily adjusted price on the illiquid component. This emphasises the need for robust and well scrutinised valuation methodologies.

[9] Commission Delegated Regulation EU No. 231/2013

5. What might this look like in real life?

The potential application of the LTAF is extremely wide, from long-established illiquid asset classes such as commercial property to corporate lending or infrastructure funding. It offers the flexibility for an LTAF to focus on one type of asset class, or for it to be completely diversified – this diversification is not generally available in unregulated funds, which tend to focus on a particular asset class. We provide below four illustrative, hypothetical examples of different LTAF strategies, which demonstrate the extent of application. Additional detail on how some of the mechanisms will operate are provided in Appendices One and Two, using the Credit Recovery Fund as a particular example.

Although offering different strategies, the intended target market for each fund would be DC default funds, multi-asset funds, private wealth and family office investors, and advised investors with over £100,000 in investable assets. Each fund would also be available to UK and international professional investors. These investors will be looking to commit a small allocation of their overall portfolio to offset volatility elsewhere in their portfolios, will be able to commit their capital to an investment term of at least 10 years, and will be able to draw on liquidity from elsewhere in their portfolio if this is required.

Unauthorised AIFs and QIS would not be suitable vehicles for these proposed funds as these do not offer sufficient investor protections required by retail investors, including those where investment decisions are led by professionals, and these are not permitted to be marketed to the categories of investors envisaged. An investment trust structure would be more suited for retail investors, but valuations and return profiles may deviate from the value of the underlying assets, which is less suited to investors prioritising performance profiles in line with those of the underlying assets over frequent liquidity opportunities, and the equity-like return profile would limit the benefit of diversification for those looking to offset volatility elsewhere in their portfolios.

Recovery Credit Fund

Investment strategy

The fund will invest by both making private loans and purchasing loans made and securities issued during the COVID 19 crisis. Loans may be directly originated and will typically be made to companies with annual revenues in excess of £30m. The loan portfolio may also include syndicated loans. Other holdings may include structured financial instruments such as asset-backed or mortgage-backed securities.

Following a [two year] ramp up period, no more than 5% of NAV at the point of investment is invested in any single loan issue, and no more than 10% of NAV at the point of investment is exposed to any issuer/borrower.

The loan book has a range of maturities from 2 years to 10 years, with around 7% of loans maturing every six months after the end of the initial 2 year ramp up period.

The fund will be allowed to make use of side pockets in the event of non-performing loans.

Subscription and redemption terms

To build scale, the fund launches with an initial offer period with a founders share class with a discounted annual management charge for the first 2 years of the fund, after which it is scheduled to increase. The founders share class is available for the first 2 years of the fund, after which it will be closed to new subscriptions. A new perpetual share class is opened after the first two years of the fund.

Following the initial offer period, the fund offers monthly subscription points on the last business day of each month. During the initial 2 year ramp up period, no redemptions can be made from the fund. After 2 years, the fund permits redemptions every 6 months, on the last business day of June and the last business day of December. Investors must also give 6 months notice if they want to redeem. Any redemption requests received within 6 months of the next valuation point are held over until the next valuation point. Once submitted, a notice of redemption cannot be withdrawn.

Renewable Energy Fund

Investment strategy

The fund will invest in renewable energy projects in the UK, such as wind turbine projects, solar energy farms, tidal power, hydroelectricity and energy storage projects. Investment in these projects will typically be made through unlisted equity and debt security instruments. The fund can also invest in firms involved in home energy products (e.g. solar panels) and energy saving projects such as insulation and smart meters, though these will make a typically smaller proportion of the fund.

No more than 10% of the NAV will be invested in any single project. The fund will typically retain 5-10% in cash, and a further 10% invested in listed or transferable securities in the renewable energy sector. The latter is intended to provide a liquidity buffer while ensuring the fund is invested in accordance with the main objective.

The fund invests in projects of varying sizes and in varying stake sizes. This gives the fund some additional liquidity options, while also ensuring significant exposure to long term projects.

Subscription and redemption terms

The fund offers annual redemptions only, on the last business day of June, and requires at least 9 months notice of redemptions (i.e. redemption notices must be submitted by the last day of September of the year before).

The fund offers monthly subscriptions at NAV, which may be invested in liquid securities until suitable projects become available.

Private Markets Multi-Asset Fund

Investment strategy[10] The fund seeks to offer broad exposure to private markets by investing in a range of institutional funds (corporate and limited partnerships) offering exposure to private equity, private credit, infrastructure, real estate and forestry. The fund can also invest in listed securities providing exposure to the above asset classes. Since the fund will invest mainly in closed ended funds by staggering lifecycles, it anticipates investment in the listed securities to be higher during the early ramp up years as it awaits suitable entry points in the underlying funds, and reducing its investments in listed securities as more of the fund is invested on a rolling basis in closed ended funds offering exposure to underlying funds. The fund aims to stagger the maturities of the underlying closed ended funds, providing a pool of liquidity that can be either rolled over into new investments or used to meet redemptions. The fund has a borrowing facility of up to 30% of NAV. It ensures that at any one time, it holds sufficient cash or listed securities to cover at least 70% of all committed capital. It anticipates being able to meet the remaining capital commitments from future inflows, but has borrowing facilities in place to meet its commitments should it not receive the future flows.
Subscription and redemption terms The fund allows subscriptions every two weeks, on the 15th (or last business day before) and the last business day of each month. It has quarterly redemption points, but investors must give a minimum of 6 months notice. The fund retains the ability to defer redemptions where these are over 10% of the fund.

10 The Multi-Asset Fund is not dissimilar to a NURS Funds of Alternative Investment Funds (FAIF) in design, but a key difference is that a number of the underlying funds in which it holds are structured as limited partnerships. Had this been structured as a NURS FAIF, the fund would have needed to use three layers of holding vehicles, whereas under the LTAF structure the fund has been able to hold these directly without requiring the holding vehicles, reducing the overall cost and complexity of the structure.

General Infrastructure Fund

Investment strategy The fund will invest in key infrastructure projects, including transport such as road and rail networks, bridges, ports, airports; utility infrastructure such as broadband delivery, telecommunications, power grids and water treatment/pipelines, and energy storage and delivery; primarily for the purposes of generating reliable income streams. Investment in these projects will typically be made through unlisted debt security instruments and unlisted equity and quasi-equity instruments, although some assets may also be held via collective investment vehicles. No more than 10% of the NAV will be invested in any single project. The fund will typically retain 5-10% in cash. The fund will also be able to invest in listed or transferable securities relating to infrastructure, e.g. if there is temporarily a surplus of cash awaiting suitable investment opportunities, though these are not expected to exceed 20% of the fund's overall assets once the fund is fully invested. Holdings in cash, listed and transferable securities are expected to be much higher as a percentage of the fund in its first two years following launch, while the fund is building scale and awaiting completion of private investment transactions. The fund will invest in projects of varying sizes and in varying stake sizes. This gives the fund some additional liquidity options, while also ensuring significant exposure to long term projects.
Subscription and redemption terms The fund offers annual redemptions only, on the last business day of September, and requires 12 months notice of redemptions (i.e. redemption notices must be submitted by the last day of September of the year before). The fund offers monthly subscriptions at NAV, which may be invested in liquid securities until suitable projects become available.

Annex One: Technical Specifications

This Annex presents a technical summary of the LTAF proposal, with a number of specific further key elements discussed, including liquidity management, concentration, diversification, carried interest and governance structures.

Overall summary

The IA has proposed that the LTAF has the following features:

- Governed by an adaption of the existing authorised NURS framework.

- Investment and borrowing powers designed for illiquid investments.

    - Allow up to 100% to be invested in unauthorised collective investment schemes (as with the existing NURS FAIF rules).
    - Allow direct investment in limited partnerships.
    - Dis-apply second scheme restriction[11] on collective investment schemes.
    - Allow up to 100% to be held in unlisted securities.
    - Spread and diversification rules that are appropriate to the illiquid nature of the asset classes.
    - Allow a wider range of derivatives to be held for hedging purposes.
    - Ability to originate or participate in loans.
    - Extended borrowing capacity to enable private transactions.
    - Ability to guarantee loans.
    - Initial investment/ramp-up period after launch.
    - Ability to invest in listed transferable securities, authorised funds and liquid assets.

- Dealing frequency (non-daily) aligned with the liquidity of the underlying assets.

- Strong but practical investor protection measures, such as appropriate investment advice, investment maximums.

- Option to list/provide secondary trading of units.

- An effective suite of liquidity management tools, including notice periods, redemption gates.

- Model based valuations.

- Registration of assets – permit registration in the name of the fund or AFM acting on behalf of the funds, as well as in the name of the depositary.

- Tax efficiency – no additional leakage in structure, competitive VAT treatment and seeding relief.

- Tax incentives could be used to encourage long term investing through LTAFs investing in projects the Government is keen to support, e.g. ESG, patient capital, infrastructure.

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[11] COLL 5.6.10 R(3) requires a second collective investment scheme to have a restriction on itself investing no more than 15% of the value of its scheme property in units in other collective investment schemes.

The IA envisages the following target market for the LTAF:

- DC market, particularly DC default arrangements.
- Private wealth/discretionary managers
- Professional Investors, e.g. pension schemes, sovereign wealth funds
- Multi asset funds/funds of funds
- Local Government Pension Scheme (LGPS) investors

To be able to access all these target investor groups, the LTAF should be capable of being promoted to retail clients, even if there are restrictions on distribution in the mass retail market (i.e. advised and/or MiFID II complex/non-complex product categorisation).

Changes to FSMA and Other Legislation

Having reviewed the primary legislation, we do not believe changes will be required to the Financial Services and Markets Act 2000 (FSMA) or the Open Ended Companies Regulation 2001 (OEIC Regulation).

It is our view that the definition of an open-ended investment company in the OEIC Regulations does not need to be amended to accommodate the LTAF. However, it is possible the OEIC Regulations will not allow a fully closed-ended option.

Specific issues under consideration

Liquidity Management

Alongside the obvious importance of fund-level liquidity management processes, liquidity management for the LTAF should be considered in the context of this being a relatively small, satellite allocation that is part of a broader liquid portfolio – the eligible investor requirements are intended to ensure that investors only make allocations to the LTAF where they have sufficient overall liquid assets in their portfolio. The liquidity requirements of investors would therefore be expected to be met from liquid assets in their portfolios rather than from the LTAF. In this context, longer liquidation timescales for LTAFs should be manageable for investors.

Within the LTAF itself, a wide range of liquidity management tools should be permitted such as redemption deferrals and redemption gates. Most funds for institutional investors have a clear provision that the manager is not under an obligation to sell assets in order to honour redemptions as that could force them to sell assets early and at the detriment of existing investors.

Having a broad liquidity toolkit is important, as some liquidity tools will work well with some investment strategies and some will be less useful. It is important the AFM of the LTAF can select the liquidity management tools most appropriate for the investment strategy and asset classes of the applicable LTAF. We envisage the liquidity tools employed, an indication of the circumstances in which they would be used and the order of preference in which they are likely to be deployed (the liquidity tool kit "ladder") to be disclosed in the prospectus, mirroring the disclosure requirements introduced by the FCA in Policy Statement PS19/24 for Fund Investing in Inherently Illiquid Assets (FIIA).

Stress testing will be an important component of liquidity management, and in this respect, the ESMA Liquidity Stress Testing Guidelines, which also cover less liquid asset classes, set appropriate standards. The dealing frequency means that stress testing will probably not be required that frequently, but the underlying securities mean that the asset side liquidity will need sophisticated stress testing. Reverse Stress Testing may help to identify what market events, derivative calls, investor calls could cause the LTAF to break and not meet those calls. Plans would need to be put together to mitigate those risks.

Keeping subscriptions open while suspending redemptions could bridge liquidity. If there is certainty of valuation, then it seems reasonable to allow investors who want to subscribe into the fund to do so. It should be noted the target market will be professionally led and professionally-advised investors, rather than regular non-advised retail investors, who will be making long term decisions about the investment opportunity.

This has been a topical issue due to COVID-19 when funds had to choose between: (1) suspending the calculation of NAV (and consequently subscriptions and redemptions); and (2) the deferral of redemptions which in principle leaves open the possibility of continuing to accept subscriptions.

Concentration

There can be advantages and disadvantages in holding a relatively large stake in an underlying investment, depending on the transaction type. The IA recommends that this is a decision best left to the discretion of the AFM, and prescription should be avoided in respect of either a maximum or minimum level of concentration in the underlying assets (as is currently the case for NURS). Some transaction types might favour the fund having a significant stake in the underlying investment, whereas in other cases, it may be preferable for the fund to have a smaller stake. It is also possible that the AFM of an LTAF might arrange an investment for multiple clients alongside the LTAF in a single tranche – the ability to make investments on behalf of multiple clients will open up further investment opportunities for the LTAF.

AFMs will need to consider what level of concentration is appropriate for the investment strategy being pursued, the characteristics of the asset class in which the investment is being made, the risks associated with the concentration and what the impact of the size of the stake is on the ability to liquidate the asset. AFMs may wish to consider documenting the expected levels of concentration and the associated risks in the investment policy so that this is clearly understood by investors and those performing oversight functions, such as the board, risk and compliance teams, the depositary, etc.

Diversification

The rules could cover a minimum number of investments and a limit on the percentage of the scheme property that can be invested in a single asset. Rules should be set at the date the LTAF makes the investment or commitment allowing for fluctuations in the portion of the portfolio attributed to an investment, based on the size of the investment – not only will liquidity be a challenge, but given the nature of the investments, it may not be possible to reduce position sizes without disposing of the entire asset. Some regulatory parameters would be helpful for customers and these are typically defined for unauthorised funds in the fund prospectus. The prudent spread of risk rule will apply to LTAF, as with other NURS.

Carried interest

NURS are permitted to have performance fees, and to invest in underlying funds that have performance fees, and in this respect, we would expect the same to apply to the LTAF. Traditionally, performance fees in closed-ended venture capital, private equity and private debt funds are calculated and paid to managing partners in the form of capital at the end of the lifecycle of the fund. However, in the case of an open-ended fund, such as a LTAF, investing in such funds, it is important that the eventual carried interest is calculated and accrued for on an ongoing basis, so that the likely eventual charge is accounted for in the price investors who redeem their shares in the LTAF receive, so they are not advantaged over investors who remain in the LTAF when the carried interest is paid in respect of the underlying fund.

Our members advise, however, that accounting for carried interest has changed in recent years. While private equity funds traditionally only accounted for carried interest when paid, investors found this hard and as such, many private equity funds now accrue for carried interest over time.

An accrual accounting arrangement for carried interest would need to be a condition of a LTAF being able to invest in a private equity fund to ensure fair valuations of the LTAF at each subscription and redemption point. However, based on member feedback we do not anticipate such a requirement being a significant barrier to LTAFs investing in private equity.

It should be noted that control of overall costs, including performance fees, will be a key consideration for LTAFs intending to target investment by DC pension default funds, as these are not only subject to scheme-level charge caps, but trustees of these schemes are particularly sensitive on price.

Governance Structure

As a subset of NURS, the LTAF will be subject to the fund governance rules that apply to all UK authorised funds. At least a quarter of the board of the AFM that oversees the LTAF has to consist of independent directors, with a minimum of 2 independent directors on the smallest boards. The AFM board is also required to undertake and report on a detailed assessment of value annually. This requires a detailed assessment of the quality of service, the performance of the fund against the objective and the costs and charges of the fund. In addition, the LTAF is required to have an independent depositary, overseeing that the activities performed by the AFM comply with limits on investment and borrowing powers, monitoring cash flows, that subscriptions and redemptions and valuations have been performed in line with the rules and terms set out in the prospectus.

The ability to perform effective oversight will be key to the governance of the LTAF. The board of the AFM will play an important role in overseeing liquidity management and stress testing, ensuring it is satisfied the LTAF is being managed so it can deliver on the stated investment outcomes, and where required direct the AFM to take action to put in place further measures.

The option of an LTAF having an advisory committee along the lines of a Limited Partnership Advisory Committee (LPAC) could be considered. This option could be attractive to a LTAF with a small number of targeted investment channels, e.g. DC funds or platform investors. However, the value of an advisory committee would depend on the investor base, and as such, we do not propose there should be a mandatory requirement for an advisory committee for a LTAF. The advisory committee option for the LTAF could be based on the existing model for advisory committees for Charity Authorised Investment Funds (CAIFs) set out in COLL 14.3, which is also optional.

In the case of underlying funds that the LTAF might invest in which themselves have LPACs, our members note that LPACs will consist of investors in the fund, whose interests tend to be aligned with other investors. As such, they consider the likelihood of conflicts arising due to the existence of LPACs is low, even where the LTAF, or the portfolio manager managing the investments of the LTAF, is not represented on the committee. Consideration of whether any such conflicts are likely to arise will need to be assessed on a case-by-case basis, and will form part of the detailed due diligence on long-term investments referred to earlier in this paper. It is possible that in some cases, the portfolio manager of the LTAF may be invited to participate on a LPAC, especially if the investment in the fund is alongside investments in the same fund for other mandates of the portfolio manager. We do not consider that particular rules are required around LPACs of underlying funds, other than a general requirement that where the portfolio manager sits on the LPAC of a fund that the LTAF invests in, they must act in the best interests of the investors of the LTAF in their representations on the LPAC.

Annex Two: Potential Subscription and Redemption Mechanisms

This Annex provides some more detail about how the subscription and redemption models could work under the LTAF, using the Recovery Credit Fund example as a model.

<u>Investment strategy</u>. The fund is investing by both making private loans and purchasing loans and securities made during the COVID 19 crisis. No more than 5% of NAV at the point of investment is invested in any single loan issue, and no more than 10% of NAV at the point of investment is exposed to any issuer/borrower. The loan book has a range of maturities from 2 years to 10 years, with around 7% of loans maturing every six months after the end of the initial 2 year ramp up period.

<u>Subscription and redemption terms.</u> To build scale, the fund launches with an initial offer period with a founders share class with a discounted annual management charge for the first 2 years of the fund, after which it is scheduled to increase. The founders share class is available for the first 2 years of the fund, after which it will be closed to new subscriptions. A new perpetual share class is opened after the first two years of the fund.

Following the initial offer period, the fund offers monthly subscription points on the last business day of each month. During the initial 2 year ramp up period, no redemptions can be made from the fund. After 2 years, the fund permits redemptions every 6 months, on the last business day of June and the last business day of December. Investors must also give 6 months notice and any redemption requests received within 6 months of the next valuation point are held over until the next valuation point. Once submitted, a notice of redemption cannot be withdrawn.

<u>**How this would work in practice**</u>

<u>Subscriptions</u>. The fund offers monthly subscription points on the last business day of each month. Any subscriptions received during the month are held over until the next subscription dealing point, and units are allocated at NAV at that dealing point. At this point, the cash is transferred into the fund. The AFM allows regulated entities who request subscriptions to settle the subscription amount up to two business days after the valuation point.

<u>Redemptions</u>. With around 7% of loans maturing every six months after the end of the initial 2 year ramp up period, the AFM will therefore have around 7% liquidity at each redemption point from maturing loans. The AFM will have received 6 months' notice for redemptions, hence will know how much of this is available to roll over into new loans and how much will need to be conserved for redemptions. In addition, the AFM is confident it can find a buyer within 6 months for up to 8% of the loan book, giving a total liquidity threshold of 15% at each valuation point. The AFM will assess the impact on the future liquidity of the portfolio ahead of selling any loans ahead of maturity.

Any subscriptions received during the notice period will also increase the liquidity pot available for the next redemption point. The AFM reserves the right to charge a dilution levy of up to 5% on redemptions in the event it has to sell any of the loan book in order to meet redemptions – this is paid to the fund to cover any selling costs.

For example, an AFM has received notices to withdraw £25m at the next valuation point. £15m of loans are maturing at the next valuation point. The AFM is projecting to get £6m of subscriptions during the notice period. The AFM, therefore, decides to raise a further £3m by selling loans to meet the redemptions, with the remainder coming from cash retained by the fund.

The AFM therefore applies a dilution levy of 0.6% to the redemption. This is equivalent to 5% of the £3m portion of the overall redemptions which the AFM (or its portfolio manager) had to raise by selling assets, and covers the dealing costs incurred by the fund in selling those assets.

To ensure redemptions do not exceed the 15% liquidity threshold at any one redemption point, the AFM applies a redemption gate of 15% of the NAV on a first come first served basis. If the volume of redemption notices exceed 15% of the NAV, any further notice periods are queued to the next 6 monthly redemption point. Investors subject to the redemption gate are notified that their instruction will be carried forward. Any inflows are offset against the redemptions under notice, and if more inflows are received during the notice period, more investors in the redemption queue can be brought forward to the next valuation point.

<u>Potential role of side pockets</u>. A side pocket is a tool that can be used to shield part of the portfolio. The advantage of this approach is that the distressed part of the portfolio can be removed from the active part of the portfolio, allowing the rest of the portfolio to continue to operate without the impairment of the distressed assets.

We recognise that the ability to use side pockets potentially adds complexity to the product and would result in very specific disclosure requirements. We would welcome further discussion with the Regulator and wider stakeholders on the benefits and disadvantages to retail investors of having this tool available.

Annex Three: LTAF and Illiquid investments for the DC pensions market

As part of the wider work that the IA has been carrying out for the LTAF, the auto-enrolment DC workplace pensions market has been identified as a key source of demand for new illiquid asset strategies. In particular, the market consensus based on discussions with schemes, investment consultants and investment managers is that a 10-20% illiquid allocation as part of a default strategy could bring enhanced return and portfolio diversification benefits to DC investors.

Both HM Treasury and the DWP have also been keen to encourage investment by DC schemes in illiquid assets.

The main route for distribution of funds into the DC market is via insurance platforms, which DC schemes use to access unit-linked life policies ("life funds"). Default strategies will typically be constructed (mainly by schemes and their advisers) using multiple fund building blocks on the platform to create an overall strategy. The FCA estimated in 2019 that the unit-linked market accounts for around £1 trillion of AuM, with most DC pension savers investing via unit-linked contracts.

Any discussion on fund structures for illiquid assets in DC, therefore, needs to consider the investment rules for life funds, and how they interact with the proposed LTAF structure.

Investment rules for life funds: "permitted links"

The permitted links[12] are the investment rules for life funds and apply where the investment risk is borne by a policyholder who is a natural person[13].

The permitted links rules had long been seen as a barrier to DC schemes being able to access illiquid assets because, with the exception of property, they did not include illiquid asset categories as permitted investments for life funds.

At the end of 2018, following the recommendations of HMT's Pensions Investment Taskforce on which the IA participated, the FCA consulted[14,15] on rule changes to the permitted links to facilitate greater access to illiquid assets beyond property by investors in life funds, while maintaining an appropriate degree of investor protection.

Following a long delay (in large part due to the intensified FCA focus on illiquid assets in open-ended funds through the second half of 2019), the final rules were published[16], effective immediately, on 4 March 2020.

Illiquid assets as permitted links

The new rules expand the ability of life funds to invest directly in a wider range of illiquid asset classes – unlisted securities, immovables and loans – and to a greater extent in underlying funds such as NURS, QIS or UCIS that invest in illiquid assets. Collectively, these new investments are known as "conditional permitted links" and can be invested conditional upon the unit-linked fund manufacturer meeting a number of new investor protection requirements:

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[12] COBS 21.3

[13] This distinction means that they do not apply to DB schemes investing via life policies.

[14] FCA CP18/40

[15] IA response to CP18/40

[16] FCA PS20/4

- A cap of 35% of the unit-linked fund's total assets being invested in illiquid assets (excluding permitted land and property – see below).

- Disclosure of information to the investor about liquidity risk, the tools used to mitigate it, an explanation of the circumstances when these tools would be used and the impact on investors, including on the investor's ability to exercise rights permitted under the life policy.

- Ensuring the on-going suitability and appropriateness of the investments, both individually and in combination with other investments within a linked fund, having regard to the expected time horizon of the investment and the purpose for which it is held.

Unit-linked funds can already hold property and such holdings are unaffected by the rule changes. In particular, the 35% cap on illiquid assets at fund level and the additional investor protections do not apply to unit-linked funds that invest in permitted land and property as already defined in the rules.

The interaction with the LTAF

We have proposed that the LTAF is constituted as a NURS, with additional flexibility provided relative to the existing NURS regime, in order to make the structure better suited to illiquid assets.

As far as the permitted links rules are concerned, a NURS is a permitted link (a "permitted scheme interest" in the language of the rules), and a life fund can invest in a NURS investing in illiquid assets in the way the IA proposes under the LTAF, subject to the 35% cap on the life fund's overall illiquid asset exposure[17].

Do the permitted links rules remain a barrier to adoption of illiquids by DC schemes?

In short, the answer to this question is 'yes'. While greater access to illiquid assets in life funds is theoretically now possible under the new rules, we do not think they quite work, as a result of the overall 35% limit imposed on a life fund's illiquid asset holding.

In particular, a life fund wrapping a NURS/QIS could only do so if the underlying NURS/QIS had a 35% limit on illiquids. From an LTAF perspective this would negate the whole point of the product, which would almost certainly be designed to have a higher exposure to illiquid assets. So in order to comply with the 35% limit, an LTAF would have to be blended with another fund or funds. Thus, the revised rules would mean more layers for unit-linked investment via underlying funds and a more costly and opaque structuring process.

The revised rules appear designed with an overall customer asset allocation in mind, rather than the operational reality of multi-asset investment strategies in the DC pensions or retail unit-linked market, in which funds are used as building blocks in a wider strategy.

For example, a DC strategy may seek to achieve its target investment exposure across multiple funds, which could include a fund investing wholly in illiquids as a diversifier within the portfolio. While the overall strategy could be kept within a 35% limit, the fund would not qualify. This would potentially require different market structures to deliver the strategy.

[17] A reading of the current rules suggests that a NURS, not being a conditional permitted link, could in fact be invested in by a unit-linked fund without the 35% illiquid asset cap applying. However, this reflects the fact that a NURS as currently constituted could not invest in illiquid assets beyond property. Our assumption is that an LTAF constituted as a NURS would be subject to the 35% cap on a unit-linked fund's illiquid holdings. This would be consistent with the FCA's policy intention for having the cap in the first place.

A proposed way forward

The analysis suggests that while the 35% cap is a real barrier, the solution is a simple one. All the FCA needs to do is to remove the 35% cap on illiquid assets at the unit-linked fund level.

If the Regulator is worried about inappropriate allocations to illiquid assets, then this could be replaced by a limit at portfolio level, i.e. at the DC default strategy level. This would better reflect how DC strategies are constructed.

That said, we do not believe a cap is necessary: the construction of the DC default strategy is a highly professional process, with strategies constructed by trustees and pension providers on the advice of investment consultants and/or professional in-house investment teams. Both trustees and providers are subject to regulatory requirements to ensure the on-going suitability of the overall portfolio with respect to liquidity, amongst other factors.

THE INVESTMENT ASSOCIATION

The Investment Association

Camomile Court, 23 Camomile Street, London, EC3A 7LL

www.theia.org

@InvAssoc @The Investment Association