The LTAF: a new authorised fund regime for investing in long term assets

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The notion of opening up the asset classes available to UK authorised funds is a good one. The question is whether the FCA's particular proposal for the new Long Term Asset Fund ("LTAF") vehicle is sufficiently radical to suit the purpose, and will be sufficiently widely available to make the new vehicle a success.

The FCA's Consultation Paper issued in May 2021 on "A new authorised fund regime for investing in long term assets" (CP21/12) sets out the specifics of the FCA's proposals.

It is welcome that the FCA seem committed to follow through on HM Treasury's eagerness to launch LTAFs by the end of the year. (The UK Funds Regime Working Group had put forward a proposal for an authorised open -ended fund structure to invest in illiquid assets such as venture capital and infrastructure and, in its January 2021 paper entitled "Review of the UK funds regime: a call for input", HM Treasury confirmed that it was keen to pursue the initiative.)

As regards service levels, the FCA is volunteering to commit to a service level to authorise a QIS within a month and will strive to authorised funds without undue delay and encourage discussions about an LTAF prior to submission of an application, even though they will not actually commit to authorise an LTAF within a month. Such assurances are helpful in thinking that the authorisation process for an LTAF will be as speedy as possible.

In its Consultation, the FCA is following up on its Feedback Statement of February 2020 summarising the responses to DP18/10 where the basic finding was that authorised retail funds – UCITS and NURS schemes – offer limited opportunity for retail investors to invest in long term assets.

There is an acknowledgement however that restrictions currently imposed by the investment and borrowing powers in COLL for UCITS and NURS funds do provide valuable protection to retail investors so the challenge is to reach a landing point on how a new fund category can be introduced which still provides appropriate protection to retail investors.

A new category of fund

A key point to note is that this is to be a new fund regime – distinct from UK UCITS, NURS and QIS funds. Under the draft Long Term Asset Fund Instrument 2021 which is attached to the Consultation Paper, there is to be a new chapter introduced into the FCA's COLL Sourcebook, as COLL 15, for long term asset funds.

With Brexit, now is the ideal opportunity to review how funds are categorised. Currently we have

- UK UCITS: Obviously the old UCITS scheme category needed to be relabelled and "UK UCITS" is a good temporary measure. Longer term though, what should be proposed for this range of funds and should they be subsumed within a wider range of retail funds?
- non-UCITS retail schemes ("NURS"): If we are introducing new categories of funds, it would be good perhaps to get rid of the NURS label and consider where the boundaries should lie for retail funds (outside of the UCITS prescribed scope).
- Qualified Investor Schemes ("QIS"). Whilst QIS schemes have been taken up for some specific purposes, they have not overall proved to be successful, and a wider review of this category would be valuable.

The proposal is that there will now be a fourth category:

- LTAFs are to be a new category of fund with their own chapter in the COLL Sourcebook containing the rules for LTAFs. An LTAF will be an AIF and only a firm which is a full-scope UK AIFM can manage an LTAF.

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High level framework

The intention is that the new COLL 15 framework will be principles based without detailed or prescriptive rules in many areas.

The LTAF rules are based on the rules in COLL 8 for QIS schemes with additional protections but they have been structured slightly differently.

- **Strong governance and oversight**

  There is a package of measures proposed which is designed to provide LTAFs with robust oversight from the manager, including challenge from the independent directors – the emphasis being on strong oversight within the government's arrangements.

  Governance initiatives around LTAFs are to include:

  – **Assessments of Value**

    LTAFs will be subject to the rules on assessment of value (and note that, for example, where it will invest in second schemes, that assessment must have regard to the risk of layering of costs and charges within a scheme - a point which the FCA propose to tackle with full disclosure of costs and charges.

    The AFM of an LTAF will be required to assess how it has managed the fund in the best interests of the fund, its investors and the integrity of the market in the value assessments.

    The annual report of the LTAF must include details of the AFM's assessment (including minimum considerations of valuation of investments, due diligence, conflicts of interest and liquidity management assessment). This therefore introduces a requirement for the fund manager to assess and publicly report on for additional elements.

  – **Senior Manager prescribed responsibility**

    The AFM must allocate responsibility for complying with the Assessment of Value, the specific assessment of investment valuations, due diligence, conflicts of interest and liquidity management, requirements in relation to independent directors and the COBS 2.1.4R (AIFM's Best Interest Rules) to an approved person.

    Where the Chair is an approved person, the responsibility must be allocated to the Chair (consistent with the existing prescribed responsibility for the Chair of a governing body under SM&CR in relation to assessments of value, independent directors and compliance with the client's best interest rule for AIFMs (see COBS 2.1.4R).

  – **iNEDs**

    As for other AFMs operating UK authorised funds, the governing body of the AFM of the LTAF must have independent representation on it.

- **Clear disclosure**

In addition to the requirements for a prospectus for a QIS and pre-sale disclosure requirements in FUND 3.2, the LTAF Rules will expressly state that certain disclosures must be made in the prospectus to ensure clear disclosures of what might be complex features – for example in their investment strategy, subscription or redemption terms or charging structures.

Comments are requested on whether any specific requirements ought to be included on LTAFs which might hold themselves out of being sustainable, responsible or delivering some form of impact.

- **Investing mainly in long term and illiquid assets**

  The new COLL 15.6.6 is to set out a rule that the investment strategy of an LTAF must be to invest mainly in long term illiquid assets. The FCA would expect LTAFs to invest mainly (more than 50% of the value of the scheme property) in unlisted securities and other long term assets such as interests in immovable or other collective investment schemes investing in such securities or long term assets. However, a Long Term Asset Fund could have a strategy of investing mainly in a mix of unlisted assets and listed but illiquid assets.

  The FCA is rightly concerned not to have situations where a manager might be forced to sell an asset where it does not consider it in the best interests of the fund to do so – and so, for example, the FCA did not intend the rules to force a fund to sell an investment when it lists on a public market or if its value grows beyond a certain size. Nonetheless, the FCA expect more than 50% in value of the scheme property to be invested in unlisted securities and other long term assets or other CIS investing in such assets.

- **Investment powers**

  Investment powers to be set out in the new COLL 15.6.8 are based on the existing rules for QISs – permitting investment in certain specified investments under the Regulated Activities Order as well as certain types of immovable assets and commodities.

  In a significant addition, there can be investment in loans which meets certain conditions (e.g. that they are not made to individuals or affiliated parties and they do not give rise to any conflict of interest). LTAFs will be able to invest in direct lending, for example as part of a lending syndicate as part of a diversified portfolio of investments. There is discussion with HMT and HMRC on whether there may be tax issues if an LTAF's activities might amount to a trade for tax purposes, so there is an awareness of the need to resolve that issue if it arises.

  In order that there can be effective investment in other CIS that are exposed to relevant assets, there is an appreciation of the need to modify the current QIS rules for investment in other CIS. Currently managers have to establish that a CIS will not invest more than 15% of its assets in other CIS. Whilst that was introduced to reduce the risk of circular investments, it would also preclude use of CIS that themselves invest in other CIS for legitimate reasons, such as it being the most tax efficient way to access private investments in other jurisdictions where there could be a local CIS. Consequently, the FCA propose a principles based requirement that the manager should make reasonable efforts to ensure that the scheme does not indirectly invest in itself, i.e. it tackles the purpose of the original rules.

  There may be use of intermediate holding companies if they meet the definition of a permitted asset for an LTAF and if this is recorded in the fund's prospectus – although tax issues would need to be considered (note the Government's Consultation on "**The Tax Treatment of Asset Holding Companies in Alternative Fund Structures**").

- **Borrowing**

  The maximum level for an LTAF is proposed to be 30% of net assets – higher than the maximum level for a NURS of 10% but less than the maximum permitted for a QIS of 100%. This is set so as to enable LTAFs to operate efficiently without being exposed to excessive risk and gearing up.

  The manager will be obliged to consider the extent to which borrowing (as part of the investment strategy) is consistent with the liquidity profile of the investments and the redemption policy of – and again this will form part of the value assessment exercise (see paragraph 3.10).

  Note though that of course there may be borrowing at the underlying investment level, and the FCA do not intend to set specific limits on that.

- **Prudent spread of risk**

  One change from the approach taken in the existing rules for QISs is that in order to add to a degree of consumer protection, for LTAFs, an LTAF must have a *prudent* spread of risk – as for a UCITS or NURS currently. (For a QIS, it is simply a spread of risk.)

  An LTAF manager must consider whether the fund's exposures are sufficiently diversified including, where relevant, exposures to underlying investments through structures such as holding companies or CIS. The FCA expect a prudent spread of the different risks to which an LTAF is exposed – although there will be a 24 month period to achieve a prudent spread of risk post set -up.

- **Investment due diligence**

  Managers will be required to undertake due diligence on their investments in line with good practice and to disclose in the prospectus how they do this.

  This follows on from full-scope UK AIFMs already being subject to rules on due diligence around investments in their AIFs – applying a high standard of diligence in the selection of ongoing monitoring of investments and ensuring that they have adequate knowledge and understanding of the assets in which the AIF is invested, with additional requirements for assets with limited liquidity.

- **Knowledge, skills and experience**

  As mentioned above, management of LTAFs will be restricted to full-scope UK AIFMs. Senior personnel of a full-scope UK AIFM must (currently) be sufficiently experienced for the investment strategies pursued by the AIFs it manages (Article 21 AIFMD Delegated Regulation).

  Firms will need to provide evidence of this as part of the authorisation process for an LTAF. If there is delegation of portfolio management by an AIFM, the other investment management firm must be able to demonstrate that they themselves possess the knowledge, skills and experience necessary to understand the activities, and in particular the risks involved in those activities.

- **Clarity on charges**

  Full disclosure of charges is of course to be expected but the FCA propose additional requirements for LTAFs:

  – to provide examples of how any performance fee will operate, equivalent to the requirement for UCITS and NURS in COLL 4.2.5R(13).

  – Also, there will be a requirement for full disclosure of all costs and charges incurred directly or indirectly by the scheme (and, as mentioned above, LTAFs will be subject to the requirement to carry out an assessment of value which must consider charges in the context of the value that they offer).

- **Reporting**

  There is a concern that investors should have comprehensive and distinct reporting for LTAFs:

  – **a separate value assessment report:** Whilst, as explained above, the value assessment requirements will apply to LTAFs, as for other authorised funds, firms will not have the option to produce a composite report. LTAFs are likely to be significantly different from other authorised funds and the FCA wish the LTAF report with its additional elements to be distinct.

  – **quarterly updates:** In addition, there must be quarterly reporting to investors within twenty business days of the quarter end on investments in the portfolio, transactions during the period, and any significant developments of which the investors ought to be aware. The aim of the FCA is to enable investors to monitor the activities of the manager. This might go a little bit towards over-disclosure – or creative writing of the quarterly updates - but the general notion of keeping investors informed is sensible so that investors have an awareness of the nature of the LTAF's activities.

- **Depositary concerns**

  Depositaries will likely have some concerns about riskier assets within, potentially, a retail type of funds, and consequently the extent of the Depositary's role.

  One specific issue is the requirement for some non -custodial assets to be registered in the name of the Depositary. In the same way that Depositaries have been worried about holding property assets, they may seemingly be worried about some of the LTAF types of assets. Might this limit the choice of Depositaries which are willing to be involved with LTAFs?

- **Valuation**

  It is clear the FCA is concerned about the need to have confidence in the valuation of assets held by an LTAF – and also need confidence that an LTAF will be able to meet their liquidity needs.

  Paragraph 3.26 of the FCA's Consultation Paper notes that a fair and accurate valuation of an LTAF is particularly important, whilst acknowledging that most of the assets will likely be illiquid and many will not have regular market prices.

  One of the FCA's solutions to this is to require the manager to appoint an external valuer unless it can demonstrate that it has the competence and experience to value assets of the type in which the LTAF invests. If the manager acts as the valuer, it is to be required that it values the fund's assets in line with good practice.

  As the LTAF is an AIF, the valuation standards will be those set out in FUND 3.9 for an AIF, as supplemented by detailed rules in the AIFMD Delegated Regulation on the obligations of managers of AIFs when valuing fund assets.

  The FCA clearly think that it is important to the success of the LTAF that investors have full confidence in the valuation of an LTAFs assets.

  One can appreciate the issue for some investors, such as DC pension schemes or diversified multi asset funds, which in turn will have their own valuation concerns.

  If the FCA is proposing requiring LTAF assets to be valued at least monthly and the price published in line with NURS rules, this will give some transparency, and of course those prices could be used by the investors, so there is a need to look at valuation and pricing – but we just question the ways in which whatever protections one builds in, these can be entirely reliable.

  The difficulty is that, if the LTAF's assets simply are illiquid and do not have market values, the fund's valuations may not be reliable and/or might tend to be undervalued in order to take a cautious approach. One can improve the general external assurance by having independent valuers but one cannot solve the difficulties in valuing illiquid assets.

  One fundamental fact to remember is that no fund structure can solve underlying investment issues. If there is a long term asset and there is simply no way of working out the value until later in a project or the assets duration, whatever rules are imposed at the fund level will not solve the underlying issues.

  Perhaps the focus should more be on fair pricing rather than that there is confidence in each and every valuation?

- **Dealing in units**

  The FCA's proposals on the important area of subscriptions and redemptions is that they do not expect any LTAF to offer daily dealing. The question is what they might expect instead.

  Essentially, the only novel feature is that the LTAF is a non-daily dealing fund.

  Whilst the Consultation Paper says that this could lay the ground for other non-daily dealing funds in the future – and in particular the FCA is not taking a decision on whether to introduce notice periods for open-ended property funds until they receive feedback from the LTAF consultation – this whole approach of bolt-ons is perhaps showing some short term expedient or potentially inadequate approach, rather than taking a radical change of approach.

Whilst the proposals focus on ensuring that there is competence in valuing the scheme assets, whether by the manager or using an external valuer, and a role for the Depositary in being responsible for taking reasonable care to ensure that the scheme is managed in accordance with the rules on valuation, none of this will actually solve the underlying issues. Perhaps there could more usefully be an emphasis on the need for fair dealing in units in the scheme, rather than the current FCA focus on fair valuations of scheme property?

- **Liquidity management**

The prospectus for an LTAF will need to set out the liquidity management tools used including notice periods.

The tools used may include:

– notice periods on subscriptions and redemptions;

– deferral of redemptions;

– limit on the amount of the fund that could be redeemed at any dealing point. Notice period could be in excess of the 90-180 days recently proposed for property funds.

An assessment of liquidity management will be part of the value assessment described in paragraph 3.10 of the FCA's paper.

Thankfully, suspension is not viewed as a means of managing fund liquidity – inevitably, suspension has negative reactions from investors and should only be used in exceptional circumstances.

On liquidity management, the FCA refer to Articles 46-49 of the AIFMD Delegated Regulation: An LTAF should have tools available to manage liquidity that are appropriate to the types of asset in which it invests, taking into account any borrowing or other features of the fund that could create liquidity pressure. The manager should be able to manage liquidity so that it is not forced to sell assets unexpectedly or over a time period when it could not achieve an appropriate value. Careful consideration of the investor base of the AIF should be required.

Note Article 47 of the AIFMD Delegated Regulation requires managers to consider the investor profile when monitoring the liquidity profile of a fund's assets and, for example, DC default funds will have liquidity needs so LTAFs will need to assess their investor base and their requirements carefully. Indeed the FCA indicate that managers may need to make additional agreements with investors to deal with liquidity events. The FCA ask whether pension funds and managers could contract to deal with complex scenarios and whether there is merit in a cross industry solution or standard. Certainly on a fund by fund basis, managers could have subscription documents which ask for indications of liquidity expectations of investors even if such cross industry solutions are not devised. **It is not just a case of making full disclosures to investors but also achieving investors' buy-in to the nature of the liquidity of the LTAF units they acquire, so having contractual agreements with them on the investor's liquidity requirements is a good idea.**

Distribution challenges

Even assuming that the LTAF product works, the key to whether it will be successful will be whether it can be distributed to a sufficiently wide range of investors who may wish to invest in it.

The FCA is proposing initially to restrict the distribution of LTAFs by subjecting them to the same distribution rules as the Qualified Investor Scheme. Given the lack of enthusiasm for setting up and distributing QIS schemes, this is a setback for those who wish to adopt the LTAF and encourage its take-up. Essentially, much of what could be done with the new LTAF could have been achieved on a QIS and that vehicle has not been successful to date, which begs the question as to whether or not it will be under the LTAF label?

The only concrete change which it is proposed would differentiate an LTAF from a QIS so far is having the new category of LTAF and some indications that there will be consideration of distribution of LTAFs to some retail investors.

- **Availability to unit linked insurance products**

  The clear initial focus is on DC pension schemes in unit linked long term insurance products and so Chapter 4 of the CP21/12 considers the permitted links rules (COBS 21.3).

  Currently LTAFs, as an authorised fund that is not a UCITS or a NURS, would fall under the "permitted scheme interests" Category 3 or "conditional permitted scheme interests" categories, depending on whether the LTAF was invested in assets treated as permitted links or conditional permitted links for COBS 21.3 purposes. Instead, investments in this category are limited by the overall 35% aggregate percentage limit across all conditional permitted links and permitted scheme interests.

  With the LTAF, there are now two areas of focus:

  – Removing the 35% limit on illiquid investments where an LTAF fund forms part of the default arrangements of a pension scheme, while retaining requirements on insurers to provide risk warnings and ensure the fund is suitable for the ultimate investors. The mechanism will be allowing links to an investment in LTAF but carving out LTAF from the definition of QIS for COBS 21.13 purposes. An LTAF will be available as a conditional permitted link only in respect of default arrangements (and not for retail investors investing outside of the pension environment).

  – The FCA will also clarify that investment in LTAFs does not count towards calculation of the 35% limit. It will be up to the trustees of an occupational scheme or the operator of a workplace scheme (insurer or SIPP operator) to decide on the proportion of the default arrangement to be invested in illiquid assets. Guidance will though encourage insurers to consider the concentration risks associated with inclusion of an LTAF in a default arrangement.

  Note that LTAF unit linked investment provision will only apply for default arrangements in occupational workplace pensions – not self-select options available to pension scheme members and not for non-workplace personal pensions. The 35% limit will also continue to apply for the other investments that a default arrangement may make in other conditional permitted links.

  The proposed upshot is that in fact LTAFs will really only be feasible for insurance based occupational workplace pensions, and will not be available to the other increasing number of those who have personal pension arrangements. This is a serious limitation on marketability. Whilst we appreciate that one has to start somewhere, starting from a position of allowing distribution into one element of the marketplace but not to others is overly favouring one part of the market to the detriment of those who find themselves in the other.

  The FCA might look at allowing insurance contracts to be linked to investments in LTAFs more widely than just when used as default arrangements for DC schemes. This seems to be an inevitability and should be considered sooner rather than later. Why there should be such an over-focus on default arrangements in DC schemes is unclear. **We suspect that it will, sooner or later, be important to amend the unit linked rules so that LTAFs can be available for all unit linked products, and then to rely on the insurance company's appropriate exercise of its responsibilities in setting its permitted links.**

- **COBS 4.12 application, and NMPIs**

  Outside of the COLL Rules, permitted link rules in COBS 21 and certain definitions, an LTAF is to be included in the definition of, and will be treated as, a Qualified Investor Scheme in the FCA's Handbook. This is particularly relevant in the context of rules in COBS 4.12 on Non-Mainstream Pooled Investments (NMPIs).

  Chapter 5 of CP21/12, which discusses distribution of the LTAF more widely, indicates that it is thought that the case is made clearly for professional investors, in particular DC pension schemes as part of their default arrangement, but acknowledges that there also may be interest from advised high net worth retail investors and advised sophisticated retail investors. Nonetheless, perhaps the FCA proposals are too restrictive?

Effectively by restricting LTAFs in the same way as QISs, this means that, under the NMPI rules, an LTAF can only be promoted to professional clients and certain types of retail client, as set out in COBS 4.12. Given the current limitations in COBS 4.12 (which itself was made more restrictive when the NMPI phraseology was introduced), this is severely limiting.

To take a relevant analogy, whilst retail investors can access VCTs, the position will be that sometimes sophisticated retail investors will not be able to access LTAFs. The fact that a NMPI can only be marketed to certified high net worth investors and self-certified sophisticated investors following a preliminary assessment of suitability conducted by the firm promoting the investment may preclude some from going that route because they do not wish to undertake assessments of suitability.

Thankfully, the FCA say they can see the argument for broadening the potential investor base beyond the current restrictions for QIS, given the LTAF will be held to higher standards in a range of areas. It is important that the FCA do indeed follow through on this issue and widen out the distribution possibilities.

In CP21/12, the FCA put out some options for consideration. Given the additional protections which apply to LTAFs over QISs, it seems the FCA are open to the suggestion that LTAFs can be marketed to retail investors but they think it unlikely to be desirable to permit an LTAF to be marketed directly to retail investors without any restrictions. The question is what those restrictions ought to be:

- **Use the existing rules which categorise certain investments as non-complex and place restrictions on the distribution of all other investments?**

  This would bring into play the COBS 10A rules. The FCA wonder if distributors will need to conduct an appropriateness test for all prospective retail investors in an LTAF as it is unlikely that a fund could be both an LTAF and a non-complex financial instrument under COBS 10A.4.2 UK.

- **Treat the LTAF as a non-readily-realisable security (NRRS), rather than a NMPI?**

  This option has its attractions. It would add in the possibility of the restricted investor category and then be subject to the appropriateness assessment mentioned above. Restricted investors described in COBS 4.7.10R are those who declare that they have not invested more than 10% of net assets in NRRS in the previous twelve months and will not do so in the coming twelve months.

  If this route is used, an ordinary retail investor accessing an LTAF through a direct offer financial promotion would be limited to no more than 10% of their net worth, and the FCA seem encouraged that this limit could potentially provide enough protection whilst still allowing investors to participate in any potential investment gain. It is arguable the 10% is too low when taken not just for a particular LTAF but overall for non-readily realisable securities? It would however be a start.

- **Insist on an LTAF having a minimum proportion of investment from institutional investors unconnected to the manager before it can be marketed to retail investors?**

  In a way, this option would rely upon professional investors' such as large DC schemes' own due diligence processes before they invest in a particular LTAF.

  It would be a bit of a novelty for authorised funds to rely on the presence of institutional investors to provide a level of assurance to retail investors about the quality of a particular authorised fund. Generally one looks at the quality of the authorised fund because of the authorised fund rules for that. For that reason and due to the complications of monitoring and disclosing investors' details, this seems to be an odd approach to develop.

  As the FCA rightly point out, investment from institutional investors does not lead to retail investors having a better understanding of the risk

- **Resurrect the idea of funds of alternative investment funds (FAIFs) which have existed as a possibility for a long time is one option for retail investors to gain exposures to LTAFs, on the basis that the LTAFs could be the underlying funds of the FAIF?**

  This in theory could be possible, once a number of LTAFs are available in the market place, but it might presuppose that a particular management group set up a number of LTAFs which might take some time to reach critical mass.

It will be important that the FCA do indeed follow through on this issue of broadening out the potential investor base beyond the current restrictions for QIS and widen out the distribution possibilities for LTAFs. The success of an LTAF will depend upon an ability to promote it to a broader investor base than is initially proposed. And, in the interests of fairness, it seems illogical, from the investors' perspective, initially to focus on only one part of a market place and the default option of occupational workplace pensions at that.

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Will the LTAF succeed?

The LTAF is a good idea, but there is a risk that the LTAF will remain, like the QIS and FAIF options, a good idea which simply does not gain traction.

There are two key areas which will influence the outcome for LTAFs: whether the fund structure suits its purpose and whether LTAFs can be sold effectively to investors who wish to invest in them. On both counts, it seems that the FCA's proposals are a little bit tentative and may not be sufficient to enable the new LTAF structure to take off.

LTAFs could go the same way as QISs (on which the FCA proposals are based) and also ELTIFs. (Whilst ELTIFs have been on-shored as LTIFs so that the specialist EU fund range is possible pursuant to the UK's Long Term Investment Funds (Amendment) (EU Exit) Regulations 2019, no UK LTIFs have been launched. The EUSEFs (on-shored as SEFs) have seen limited uptake too.) It is important that this new LTAF proposal is more attractive both to fund managers and to investors.

This major initiative with the LTAF should be part of a welcome levelling up process so that the UK authorised fund regime offers a viable alternative. (It is noted that closed-ended investment products like investment trust companies and venture capital trusts do currently provide retail investors with access to investment in long term assets.)

It could also be the first step in the evolvement of UK authorised funds so they widen out their relevance more generally. With Brexit, we have the ideal opportunity to undertake a fundamental review of the relevant scope for, and regulation of, UK authorised investment funds so that they simply do not remain for use for the UK retail investment market only. We have a good opportunity for a radical review which should not be overlooked.