MACFARLANES

By email to: cp21-12@fca.org.uk

Michael Collins and Tom Bramhill
Financial Conduct Authority
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MACFARLANES

25 June 2021

Dear Michael and Tom

Re: a new authorised fund regime for investing in long term assets (CP21/12)

We are grateful for the opportunity to review and comment on the FCA's proposals for the creation of a Long-Term Asset Fund (LTAF).

Macfarlanes is a London-based law firm that is focused on our clients and on delivering excellence in the international legal market. We advise on all types of investment products, from retail funds, through hedge funds and credit funds to private equity funds and real estate funds, across closed-ended, open-ended and listed fund structures. The practice is distinguishable as the only investment management practice in the City which can credibly transcend both the retail and private market fund environments. Few, if any, firms can match the depth and breadth of our offering with true industry experts, across the spread of different asset classes and the liquidity spectrum.

Macfarlanes has been engaged in the thought and discussion around the creation of the LTAF from the earliest stages. We have acted as legal advisers on this topic to the Investment Association prior to the establishment of the UK Funds Regime Working Group and thereafter. Macfarlanes has also been an active participant in the work of other UK industry working groups on the LTAF. In this context, we would like to state our general endorsement of the consultation feedback provided by the Investment Association, the British Private Equity & Venture Capital Association, the Alternative Investment Management Association / Alternative Credit Council, and the Association of Real Estate Funds. Macfarlanes' consultation response focuses on our areas of expertise, acting for clients that span the range of investment products and markets.

We welcome the FCA's commitment to making the LTAF a workable alternative for non-professional investors that wish to access private, less liquid, and longer-term assets with a NAV-like investment return. We agree that the LTAF should not be a daily-dealing fund and that the fund must have strong levels of transparency, governance, and investor protection to be right for the target investor base. We agree with the proposed flexibility in the LTAF's investment rules and structure to permit a wide range of investment strategies and assets within the LTAF. The LTAF's subscription and redemption terms should be aligned with the liquidity of the fund's assets. Investors, wealth managers, and DC scheme trustees should be able to access a broad choice of products that might best suit their needs, and information that enables them to make informed investment decisions.

However, we have identified several problems in the draft rules that might make it impractical or unattractive for market participants to offer the LTAF to investors. We also propose that there are few risks and many benefits in permitting the LTAF to be available to wealth management clients.[1]

In summary, our main comments are as follows:

[1] By "wealth management clients", we refer to advised retail and discretionary portfolio management investors.

- The LTAF's distribution rules should reflect the tough transparency and governance rules that the fund is subject to. If the LTAF is indistinguishable from the qualified investor scheme (QIS) in respect of distribution, but with stronger requirements in other respects, the LTAF is not likely to be viewed as an attractive and viable alternative by the market and by investors.
- Wealth management clients should be eligible to invest in the LTAF. These investors are advised by professional investors (the wealth manager, comparable to the DC scheme trustees) and may have the risk appetite to be well-placed to invest in the LTAF. A more diversified source of subscriptions is also likely to make the LTAF a more viable investment vehicle.
- Some advisers are cautious about recommending complex investments to their retail clients based on the current available methods of distribution. This is because the current methods rely on some element of subjective judgment on behalf of the adviser. We propose a series of objective tests, derived from existing regulations, to ensure greater certainty for advisers and a higher level of investor protection in distribution.
- The burden placed on depositaries by the draft rules is exceptionally high and it is likely to disincentivise their engagement with the LTAF. Specifically, the requirement to validate the manager's expertise in valuation "without qualification" and the requirement for the depositary to legally own the fund's assets are barriers that should be removed.
- The proposed quarterly reporting schedule for the fund's transactions is too short-term and inappropriate for a fund with a long-term investment horizon. Mandatory half-yearly and yearly financial reporting should be sufficient, unless the manager and its investors deem that more frequent reporting should be required.
- The draft rules on the LTAF's participation in loans are too restrictive. We think that the implications do not seem to align with the FCA's policy intentions expressed in the consultation.
- The requirement for the LTAF to have a minimum of 50% of its value in long-term assets should not be treated as a hard and static limit, to accommodate an initial period of increasing investment in long-term assets and any temporary fluctuations in liquidity. Instead, the LTAF's purpose should be amended to require the manager to seek to have half of the fund's value in long-term assets.
- The DC charge cap methodology has a lack of clarity in terms of what is included or excluded in respect of private equity because the rules have not been written with alternative assets in mind. It is therefore difficult for DC trustees to apply the cap. The lack of clarity dissuades DC trustees from considering private assets (including but not only the LTAF).

We appreciate that some of these issues, such as expanding investor access to the LTAF and the Department for Work & Pensions' consideration of the DC charge cap, are proposed for consideration at a later stage. However, we have seen in respect of the launch of other new fund wrappers that perceived deficiencies can mean that the vehicle does not have wide uptake. A successful LTAF launch stands to help people save for their future, to help the wider economy grow and recover, and to alleviate some of the regulatory risks associated with daily-dealing funds investing in illiquid assets. We caution that the ambition for policymakers and for the market should be to get as much of the LTAF framework right first time and to ensure a successful launch that lives up to expectations.

Finally, we append to the end of our response our considerations about the tax treatment of the LTAF.

We would be delighted to assist the FCA in your work. Please do contact Lora Froud, Partner, Investment Management Group (Lora.Froud@macfarlanes.com), Tiffany Cox, Solicitor, Investment Management Group (Tiffany.Cox@macfarlanes), or Gavin Haran, Head of Asset Management Policy (Gavin.Haran@macfarlanes.com), if you have any questions.

Yours sincerely

Macfarlanes LLP

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Macfarlanes' response to the consultation questions

Q1: Do you consider that these proposals raise any equality and diversity issues? If so, please provide further details and suggest action we might take to address these.

We do not foresee any equality or diversity issues due to these proposals.

Q2: Do you agree that clear disclosures and additional governance (as set out in 3.9-3.13 and 3.39-3.43), in addition to the existing rules, provide appropriate levels of protection for potential investors in an LTAF? If not, what alternative approach would you suggest?

The FCA proposes a high level of transparency, including wide-ranging investor disclosures, and a robust level of governance. The latter reflects the governance requirements that apply to UK authorised funds, such as the requirement for the authorised fund manager (AFM) to have independent directors and to undertake and disclose annual value assessments. The LTAF will have additional levels of disclosure and governance in respect of the requirement to undertake assessments of the fund's liquidity, due diligence, valuation, and conflicts of interest. The LTAF will also be subject to strict levels of oversight by its depositary.

We agree that the LTAF should have clear disclosures and strong governance. This is because the LTAF will be a new product with the potential to invest in a wide variety of assets, and with a target intermediated retail investor base. Transparency will give investors and their trustees or advisers the information that they need to make informed decisions; while the LTAF's additional governance should provide markets with confidence that investors are adequately protected.

We do have concerns about certain elements of the draft proposals, particularly in relation to the depositary requirements and the proposed reporting schedule, which we address in response to question 3 below.

Finally, as a general matter, the LTAF's strong transparency and governance requirements should be reflected in the fund's distribution rules. If, as currently stands, the LTAF is comparable to the QIS in respect of its distribution rules, but with tougher rules in other respects, managers and markets will question whether the LTAF is a genuine alternative that serves different investors' needs. For reasons that we detail in response to questions 7 to 14, the LTAF should be readily accessible to wealth management clients. However, we propose a stronger level of investor protection, comprising a series of objective tests, to permit distribution to this investor class.

Q3: Do you agree with the detailed requirements (on purpose, investment powers, borrowing, valuation, redemptions and subscriptions, due diligence, knowledge, skills and experience, and reporting) which we propose for the LTAF? If not, which requirements do you not agree with, and why? What alternative requirements would you suggest?

Purpose

The FCA proposes that the LTAF invest mainly in long-term assets or in other funds that invest in these assets. We agree with this. We understand the regulator's desire to avoid the circumstance that a fund with a UCITS-like liquidity profile might be inappropriately labelled and sold within an LTAF wrapper to investors seeking a different level of liquidity and investment returns.

However, we urge caution about setting a hard requirement for at least 50% of the fund to be invested in long-term assets. Many LTAFs will have an initial period in which the fund increases its investments in less liquid assets. In the meantime, it might have a greater proportion of investments in liquid assets. It might also be the case later in an LTAF's life that its level of long-term assets decreases below the threshold for an interim period; for instance, when making distributions to investors in the fund or if a private market investment were to list.

To overcome these challenges, we suggest that the LTAF's purpose should be amended to require managers to seek to have half of the LTAF's investments in long term and/or illiquid assets. This assessment should be undertaken on a dynamic basis rather than as a snapshot in time.

In practice, there will be many LTAFs that are almost entirely illiquid. Meanwhile others might have a more liquid profile; for example, an LTAF serving a DC pensions scheme that expects a large flow of contributions into and drawdowns from the scheme. The overriding principle of the rules should be to accommodate the variety of potential investor needs and investments, while ensuring that the LTAF's objectives and investment plan are overall appropriately long-term and/or illiquid.

Investment powers

The consultation proposes that the LTAF should have investment powers that are like those of the QIS. Although the rules in respect of the LTAF's investments in second schemes are less prescriptive than those of the QIS. We support the FCA's approach to investment powers, which give the LTAF sufficient flexibility to be a useful and viable vehicle for its intended purpose.

However, we have identified three areas that merit further consideration:

1. Prudent spread of risk

First, the LTAF has a requirement to have a prudent spread of risk. This is a stronger requirement than the QIS, which must have a spread of risk, but it is comparable to the requirement for a NURS. There is currently no widely accepted definition of "prudent spread of risk". This is not problematic for the NURS given the detailed spread rules applicable to NURS funds. However, this comes into focus in the context of the LTAF due to its flexible investment and borrowing powers. The main challenge for the LTAF is that we understand anecdotally that in the absence of guidelines many depositaries will be concerned about complying with their obligation to monitor the LTAF's prudent spread of risk. Reluctance on behalf of depositaries could undermine the LTAF's take-up in the market. Consequently, we request that guidance is provided at the outset on what is meant for an LTAF to have a "prudent spread of risk" to avoid these problems.

One can look to the tribunal ruling in Arch Financial Products LLP v FCA, which noted that a prudent spread of risk should be considered from the perspective of a reasonable fund manager taking into account the published investment objectives and policy of the fund. Our view is therefore that a "prudent spread of risk" can be interpreted to mean managing risk within the range of reasonable decisions available and can mean different things to different managers. When aiming to provide a "prudent spread of risk" in the context of the LTAF, it will be important for managers to find a reasonable balance between long term asset allocation (in line with the overarching objective of the LTAF) and maintaining sufficient cash or near cash liquidity in light of the composition of the investment portfolio and market conditions at the time. Managers should aim to meet the expectation of investors that the investment strategy can be maintained through full investment but also need to be reasonably satisfied that (i) sufficient liquidity can be maintained through the use of liquidity tools; and (ii) redemption is possible, where requested.

2. Investment in loans

Second, we appreciate that the consultation does not propose a restrictive treatment of the LTAF's ability to invest in loans. However, the relevant section as drafted (COLL 15.6.8R) is likely to make many LTAF managers nervous about participating in loans or perhaps deter them altogether. To draw some examples from the drafting:

- COLL 15.6.8R(2)(a) lists a broad number of persons to whom a loan cannot be originated, including:
  - (i) A natural person – This seems fine and we understand the policy position here.
  - (ii) A "fund" – This would be problematic in the context of the LTAF's investment strategy. A "fund" includes an AIF or a CIS and therefore includes private equity funds which are typically structured as limited partnerships. Investments in a private equity fund may be structured with an equity/loan split (which cannot be negotiated with the general

partner/manager of the underlying private equity fund). As such, this rule could prevent the LTAF from participating in a large number of private equity transactions. This structure is particularly prevalent in UK-domiciled limited partnerships. This seems like an unnecessary restriction and could artificially divert investment away from UK-based limited partnerships to offshore structures (e.g. Channel Islands or Cayman Islands) where the equity/loan split is not seen.

(iii) A "firm" – This rule seems arbitrary. A "firm" is, in summary, a regulated firm. It would be helpful to understand the policy position behind this restriction and the potential concern with the LTAF making loans to regulated firms. An example here that might be relevant for the LTAF is an investment in a fintech company. Such investment may be structured as part equity and part (shareholder) loan. Based on this proposed rule, an LTAF could participate in such investment financed partly as a loan only up until the fintech company became FCA regulated and would need to disinvest at that point in order not to breach this rule. This seems like an odd outcome.

(iv) An "affiliated company" of a "firm" – As with (iii), this rule seems arbitrary and it would be helpful to understand the policy position behind this rule. An "affiliated company" is any entity in any group of a regulated business, so this casts a very wide net over entities to which an LTAF cannot originate loans. An LTAF manager would be nervous about making a loan to the same company in a group even if the loan has nothing to do with the business conducted by the regulated firm because of this limb (iv).

(v) A person who intends to use, or uses, the credit for the purpose of investing in a security, derivative, crypto asset derivative, an unregulated transferable crypto asset, precious metals, or a commodity contract traded on an RIE or a recognised overseas investment exchange – Our concern is that this limb appears to prevent an LTAF from making use of relatively standard investment structuring. For example, it is common practice to establish an acquisition / investment holding vehicle, through which the ultimate target company is acquired / invested in funding acquisition vehicles that are set up to facilitate the LTAF investments. One consequences of this restriction is that it might be seen as preventing an LTAF from funding the acquisition / investment holding vehicle via shareholder loan, since the acquisition / investment holding vehicle would then use the proceeds of the shareholder loan to make the underlying acquisition / investment. If the LTAF invests in the holding company, the holding company will want to make an acquisition (i.e. "use the credit for the purpose of investing in a security") and the holding company may request financing by way of a shareholder loan. Again, this seems like an odd outcome, and appears unnecessarily to limit an LTAF's ability to structure its investments.

- COLL 15.6.8R(2)(b) requires that "the investment in the loan does not give rise to any conflict of interest" – It is already the case that managers operating several authorised funds invest in assets which give rise to a conflict of interest which they try to prevent or manage and, as a last resort, disclose to investors. Hence the need for conflict of interest and allocation policies. For example, if a manager is responsible for managing an LTAF, another authorised fund, and a segregated account, and all three of those funds/accounts participate in a loan there would be a potential conflict of interest as the interests of those three clients could diverge, resulting in the LTAF not being able to participate in the loan. This restriction could be off-putting to managers who would like to give their LTAFs access to investments made by their other funds/accounts. It seems overly restrictive to prohibit the transaction altogether rather than relying on the protections afforded by the policies the manager already has in place to deal with conflicts. The AIFMD already provides rules for conflict of interest that are sufficient.
- COLL 15.6.8R(2)(c) lists a number of persons who must not have a commercial interest in the loan:

(i) the "authorised fund manager" – The AFM necessarily has a commercial interest in the loan performing well given its obligation in managing the LTAF and therefore wanting the loan to perform well. We agree that it makes sense to restrict the origination of a loan *for the benefit of the AFM*, but it must be the case that all AFMs of an LTAF necessarily have a commercial interest in loans originated from the LTAF they manage, for it to perform well.

(ii) a "relevant person" – This captures directors, partners, employees of the firm, employees of appointed reps/tied agents, and persons directly involved in providing services to the firm or its appointed reps under an outsourcing or delegation arrangement. This seems to cast

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a very wide net and we wonder if this should be limited to such persons *of the AIFM or its delegates.*

(iii) a person providing services to the authorised fund manager – This seems to cast a wide net, but we understand the policy position.

(iv) an affiliated company or an associate of any person in (i)-(ii) – This seems overly broad and we would suggest removing.

In practice, the current drafting in COLL 15.6.8R(2)(a)(ii) calls into question whether you can invest in a private equity fund where the commitment is structured as a loan capital split, and these investments are likely to be a key target for some LTAF strategies. It is also foreseeable that managers will want the LTAF to invest alongside other investment products and for those parallel investments to be pooled through a holding vehicle, and for the holding vehicle to be funded by way of loans (including one from the LTAF). This arrangement might fall foul of COLL 15.6.8R(2)(a) (v) and (iv), and COLL 15.6.8R(2(c)(iv), given the holding company could be an “affiliated company” or “associate” and has an obvious commercial interest.

We do not believe that the policy intent is to restrict the LTAF in the way that is implied by reliance on the restrictions noted above. We would appreciate clarification from the FCA.

3. Second scheme rules

We also consider that the drafting in COLL 15.6.2R (1) requires further consideration. Whilst it has been brought across from the existing FAIF and QIS regime, we do not believe it achieves the policy intent as drafted. The effect of the rules is that where an LTAF is investing in a feeder fund, the “second scheme rules” should be applied to any scheme in which the feeder’s master fund invests. We do not believe that would have been the legislative intention as it results in the rules biting at the wrong level, which could prove unhelpful and onerous. Instead we consider that the “second scheme rules” should be applied one level up, at the level of the feeder’s master fund.

Borrowing

The FCA proposes that the LTAF should have a maximum borrowing limit of 30% of the total value of the fund. This is greater than the NURS at 10% but lower than the QIS at 100%.

We do not foresee difficulties for most investment strategies if borrowing is capped at 30% of the fund’s value. However, we note that where managers are intending to invest a substantial portion of the portfolio in less liquid assets, e.g. 80%, there is likely to be a greater need to borrow to meet the fund’s cash flow needs.

The regulator might wish to increase the limit to accommodate a broader range of alternative strategies. If so, we believe that the restrictions that the consultation contemplates, that managers should ensure that borrowing is aligned with the fund’s liquidity and redemptions, are sufficient. Although if the FCA were to consider that further protection is needed, it might be helpful to set a limit on the term of borrowing. Credit managers tend to borrow for short duration, less than a year, and such a term limit might be practical.

Valuation

The consultation proposes that the LTAF should be subject to the existing FUND 3.9 approach to valuation, in addition to the AIFM’s obligations to value assets under the AIFMD. The FCA proposes to permit managers to value the LTAF’s assets if they have the knowledge, skills, and experience to do so, or to appoint an external valuer that has the relevant expertise. Given the diversity of assets that the LTAF might invest in, and the range of expertise among AFMs, we welcome this flexible approach. We also recognise the importance of regular valuations, not least for the benefit of DC schemes that must report the value of their schemes to their members.

We note two challenges in respect of the valuation provisions of the LTAF. The first relates to the depositary. It is particularly important to address this challenge because if depositaries perceive that their obligations are too onerous, they will not be willing to act as depositary and the LTAF will be untenable.

First, the draft rules in COLL 15.2.6 R (2) set an exceptionally high burden for the depositary's oversight of the AFM's valuation capabilities. The depositary must undertake an assessment of the AFM's competence to independently value the assets in question and decide "without qualification". Given that depositaries do not undertake valuation, they will understandably feel concern about making a determination under such a strict burden. This could end up with the unintended consequence that an AFM with the necessary expertise might nonetheless not be capable of finding a depositary that is willing to confirm their expertise. The effect would be a *de facto* requirement to contract an external valuer and incur an additional, and possibly unnecessary, cost for the fund. The obligation should be on the AFM to determine and demonstrate that it has the necessary expertise to perform the valuation and, if necessary, validation of the AFM's competence should be given by an external valuer that itself has the relevant expertise.

Second, the LTAF rules link to Article 19(10) of the AIFMD, which imposes unlimited liability on valuers for negligence in respect of their valuations. The result has been that AIFMs find it difficult to procure external valuers for their AIFs.[2] The application of these rules to the LTAF creates a challenge for the new vehicle. Some AFMs, particularly host AFMs, might not necessarily have the relevant expertise to value the fund's assets and will need to seek external support, but will find a lack of valuers willing to perform the role for the LTAF. This is doubly challenging if the rules on depositary's oversight of valuation are not changed. AFMs will be compelled to seek an external valuer and yet find a scarcity of firms willing to do the role. A ready solution is to distinguish between 'simple negligence' and 'gross negligence' and to only seek to apply unlimited liability to valuers if they make serious or intentional errors in their valuations (constituting 'gross negligence').

Redemptions and subscriptions

The FCA proposes to allow managers to align their subscription and redemption terms with the liquidity of the LTAF's assets, but the fund will not be daily-dealing because of the less liquid nature of its holdings. We agree that this flexibility is necessary due to the potential diversity of investment strategies and assets that might be held by the LTAF.

Assuming that the LTAF's dealing opportunities and the liquidity of its assets are aligned, the primary concern should be to ensure that the manager clearly explains to investors the fund's approach to liquidity risk management. This should include the fund's dealing windows, any notice period, and the potential use of liquidity risk management tools. Given the concerns that have been raised in response to the gating and suspension of some open-ended funds, it will be crucial to explain the possibility that these tools might be used in certain, limited circumstances (albeit with less likelihood than in a daily-dealing fund because of the LTAF's less frequent dealing windows).

Investment due diligence, and knowledge, skills, and experience requirements

The FCA proposes to restrict eligibility to manage the LTAF to full-scope AIFMs of authorised AIFs.

Full-scope AIFMs of authorised AIFs are required to have adequate systems and controls relating to the operations of authorised AIFs, and senior management who have experience in the LTAF's investment strategies. This is sensible given the LTAF is an authorised investment fund and given the fund's private market investments and long-term investment strategies.

These entities are also obliged to apply a high level of diligence in the selection and ongoing monitoring of their assets. We agree with this approach.

[2] ESMA has also acknowledged this problem: ESMA letter to the European Commission on the AIFMD Review, dated 18 August 2020.

Reporting

The consultation proposes that AFMs should produce an annual report in respect of the LTAF's liquidity, due diligence, valuation, and conflicts of interest. It is also proposed that the LTAF should report quarterly to its investors on the fund's investments.

We agree that AFMs should be required to assess the fund in respect of these features of the LTAF and to report on the results. We appreciate that it is difficult for the regulator to be prescriptive about these assessments due to the variety of potential investment strategies that might be included in the LTAF. However, considering the experience of some managers regarding annual value assessments, it would be helpful if the FCA could provide some guidance on its expectations for the LTAF's annual assessments. This would give managers some reassurance about their compliance with the rules and encourage reporting that is useful and comprehensible to investors.

We disagree with the proposal for the AFM to report quarterly to the LTAF's investors about the fund's transactions. We appreciate that quarterly reporting has been proposed to enable investors to monitor the activity of the LTAF and that the same frequency of reporting is common market practice for closed-ended private equity funds. However, our concern is that a quarterly reporting requirement for a long-term open-ended vehicle such as the LTAF in respect of transactions undertaken in the previous quarterly reporting period both (i) introduces an unnecessary burden on the LTAF manager that may not be transacting frequently (or at all) during that period, given the long-term nature of the investments, and (ii) encourages short-termism on the part of the LTAF manager and its investors. Although both a closed-ended private equity fund and the LTAF have long-term strategies, the open-ended nature of the LTAF and its associated redemption opportunities may encourage investors to withdraw from the fund on the basis of the three month-snapshot, thereby undermining the long-term objectives of the LTAF. As well as the costs and administrative burden of quarterly reporting, managers would also need to ensure that the relevance of the quarterly reporting information in the context of the long-term objective is adequately explained to investors in order to counteract the risk of short-termism.

It would be preferable to adopt a more flexible approach that requires managers to make transactional reports to their investors but on a pre-determined cycle that is sensible given the fund's investments and redemption terms and investor's expectations. At the very least, funds are required to make fuller financial disclosures bi-annually and annually, which might be sufficient for many funds.

Q4: Do you have any other observations on the proposed regime for LTAFs?

The draft rules in COLL 15.7.2R (2)(c) will require the depositary to register scheme property in its name or that of its delegate. This goes beyond the AIFMD, which does not require non-custodial assets to be registered in the depositary's name but provides that the fund or the fund manager should be the registered owner of the assets. The depositary's ownership of the assets has several unwelcome consequences. This potentially includes an increase in the costs charged by the depositary to the fund to finance the depositary's obligations in respect of the assets, and anti-competitive barriers that make it more difficult and costly for managers to change the depositary of their fund. We note that it might be challenging to transfer the ownership of certain assets, such as those structured as limited partnerships, from a previous depositary to a new one. We recommend that the LTAF rules should instead align with the AIFMD requirements in FUND 3.11.23R. More specific detail on these points can be found in the annex of the Depositary and Trustee Association's response to this consultation, which we have prepared.

Q5: Do you agree with our proposals to allow investments in LTAF for default arrangements of DC schemes if the conditions as outlined above are satisfied? If not, how would you change them to make them more workable for DC default arrangements?

The consultation proposes to make the LTAF available to DC pension scheme members within the scheme's default investment option, if the LTAF is deemed suitable and if the scheme member receives a risk warning.

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We agree that the LTAF should be available to DC scheme members. Retirement income is an under-utilised source of capital for long-term investment. As pension savers live longer, it is important to facilitate investment in assets that have the potential to offer higher yields, even more so during a time of chronically low interest rates. Asset managers will benefit from the opportunity to grow their assets under management and to achieve greater economies of scale. Providing finance for long-term investment should benefit the wider economy through increased productivity and economic growth. Policymakers should welcome the potential of the LTAF to level up the regions of the country through investment, and to help the UK recover from the effects of the pandemic in a way that is more sustainable.

To achieve this aim, it is essential that DC scheme trustees can be confident that the LTAF is deemed to be suitable for their scheme members, and that any regulatory and operational barriers that might hamper investment in the LTAF can be addressed. Fundamental in this regard is the designation of the LTAF as a permitted link, as referred to in our response to question 16.

Equally important is to ensure that the DC charge cap for the default option can accommodate the LTAF. The charge cap was designed in an environment in which DC scheme investments in alternative assets were rare. We do not believe that the overall level of the cap at 75 basis points (and excluding transaction costs) is problematic. Although investment in private assets is by its nature more expensive than investment in public listed assets, we understand anecdotally that most DC schemes have sufficient headroom to accommodate the higher costs of the LTAF while remaining within the bounds of the charge cap, if the issues that we identify below are also addressed. It is important to note that the cap applies on an aggregate basis across the scheme's portfolio of investments and that the LTAF is likely to be one relatively small part of the portfolio within the default option.

More critical is that the charge cap guidance was not written with investments in alternative assets in mind. As such, it is difficult for DC scheme trustees to read across some of the requirements in the context of an LTAF. For example, the concept of transaction costs is clear and understood in the context of liquid investments, but it is less clear what constitutes a transaction cost when entering a private market investment. We appreciate that the FCA's consultation does not address the charge cap and that the Department for Work and Pensions has recently made a public statement of their policy. Suffice to say that we deem it necessary for the charge cap guidance to be clarified in this context if the LTAF is to be a viable option for DC schemes. It is important that the methodology behind the charge cap keeps pace with market developments and investors' needs. Overall, we believe that the policy focus must move from costs alone (which are important but not the sole criteria by which an investment strategy should be judged) to also consider assets and investment returns, and how these three factors work together to achieve or fail to achieve value for investors. We hope that policymakers across government and the regulators can continue to work together to ensure the LTAF's success.

Q6: Are there any assets which can be included in an LTAF which may be of concern regarding wider use for DC schemes? If so, which assets are you concerned about and why, and how would you mitigate the risk involved?

We do not find that there are any assets that are eligible to be held by the LTAF, but which cause concern if held by a DC scheme.

Q7: Do you agree that LTAFs should initially be treated as QIS for distribution purposes? Do you agree that LTAFs should be subject to the same guidance as QIS on sophisticated and high net worth retail investors? If not, what alternative approach would you propose?

The consultation proposes that the LTAF should essentially have the characteristics of the QIS, a fund vehicle for professional investors, in respect of distribution, but with tougher governance and other requirements that pertain to a fund vehicle that is deemed to be fit for certain retail investors. We disagree with this approach. There is no reason that DC scheme members should be deemed eligible to invest in the LTAF, but that sophisticated retail investors that are reliant on a professional adviser or wealth manager should not be deemed equally eligible to access the LTAF. Indeed, we highlight benefits that would arise from permitting this investor class to invest in the LTAF.

As a general matter, if the LTAF is not considered to be sufficiently different to the QIS (except in respect of its more stringent governance and other rules), the LTAF is not likely to be judged by markets to be an attractive and necessary new vehicle. The LTAF should compare favourably to comparable fund vehicles such as the Luxembourg RAIF, the UK Investment Trust, and the European Long-Term Investment Fund to offer investors a genuine alternative. We have seen in respect of other fund wrappers that an unsuccessful launch can undermine its future success, perhaps fatally. We hope that the LTAF's structure and rules are seen to be largely right from the outset.

Wealth management clients are comparable to DC scheme members in that they are retail investors that choose to invest via an investment professional, whether by obtaining investment advice or by outsourcing their decision-making to a discretionary portfolio manager. However, wealth management clients may also have the knowledge and risk appetite to invest in the type of assets that the LTAF is likely to hold. We cannot see good grounds for preventing these investors from accessing the LTAF. In fact, we can see benefits. In the early stages, DC schemes are likely to gradually increase the capital that they allocate to the LTAF (for example, NEST announced that it will increase its investment in private assets from 9% to 15% of its portfolio over time). Wealth management clients can deploy capital to the LTAF quickly, helping the vehicle to become viable at the initial stage of its life and thereafter. Managers will also welcome the opportunity to access an investor base that is ideally placed to invest in the LTAF and to grow their assets under management.

The avenues to retail access that the consultation considers might work for some investors and their intermediaries, although we can see some potential problems. We think that an alternative LTAF-specific model should be introduced to facilitate wealth management investment. This model should provide a high level of investor protection, consistent with the LTAF's strong governance, and give advisers confidence that their investors are eligible to invest in the LTAF if the fund is right for their needs. In response to the questions that follow, we detail the potential issues with the existing models for retail access and in response to question 14, we detail the series of objective tests that we propose advisers should apply to assess LTAF eligibility.

Q8: Do you see any barriers within the existing NMPI rules that will prevent the LTAF from being distributed to the target market set out in 5.4? If so, please provide details and evidence of the barriers.

The NMPI rules contain exemptions that permit distribution to retail investors in certain circumstances. In theory, the NMPI rules could facilitate the LTAF's distribution to wealth management clients. However, anecdotally, some wealth managers are concerned that certification-type rules such as NMPI require an element of judgement on behalf of advisers. This type of assessment can be challenging, costly, resource intensive, and its uncertainty may deter wealth managers from including the LTAF in their offering to their clients. Consequently, we believe that an objective model is needed to facilitate the LTAF's distribution by providing advisers with greater levels of certainty about their investors' eligibility.

Q9: Do you think that the LTAF should be available for promotion more widely than to retail investors permitted to invest in NMPI? If not, why not?

Yes. As we have indicated above, the LTAF should be eligible to wealth management clients that meet a certain threshold. We question whether the NMPI rules alone could achieve this aim.

Q10: To what extent do you think the appropriateness assessment would help to protect retail investors in the LTAF?

In theory, the LTAF is unlikely to be deemed a non-complex product as defined in MiFID II. An appropriateness assessment could be a means of facilitating distribution to retail investors.

However, the appropriateness assessment entails the adviser deciding whether an investor can understand the risks involved in investing in an LTAF. Therefore, it is beset by similar problems that we have outlined in respect of the NMPI rules. A more objective series of tests for the LTAF would make it easier and clearer to recommend the LTAF to an investor and would also provide a higher level of investor protection.

Q11: Do you think that the NRRS regime would work as a way of restricting investment in LTAFs, permitting them to be promoted to restricted investors? If not, why not?

The non-readily realisable securities (NRRS) rules provide a limited way of marketing investments to retail investors. However, the rules were not designed with investment funds in mind and we do not recommend transferring the NRRS rules across to apply them to the LTAF. For instance, the NRRS requires an investor to self-certify. Some advisers are likely to be nervous about relying on a certification regime with an element of subjective judgement, as we have previously indicated. It is preferable to draft rules that are specifically tailored to the LTAF, its intended purpose, and its target investor base.

Nonetheless there is one element of the NRRS that could be usefully applied to the LTAF, in conjunction with other objective tests. The NRRS rules cap the proportion of a client's investable portfolio that might be placed in the investment in question. The effect of this is to ensure that a retail investor, whilst having a minimum level of diversification in their portfolio, is not potentially over-committed in relatively risky investments. However, this requirement alone will not be sufficient because, even if investments are capped, the amounts invested could represent a significant amount of an investor's total wealth and therefore put the investor at significant risk if losses occur.

Q12: Do you think that a minimum level of investment from professional clients would provide sufficient protection for retail investors? If so, what would an appropriate minimum level be?

The consultation suggests that the due diligence undertaken by professional investors in the LTAF could act as a form of quality screening for retail investors in the same fund. We acknowledge that this is a reasonable view, but we caution against setting a requirement for a minimum level of investment from professional investors in a fund.

Co-mingling of professional and retail investors can deliver benefits to investors in the fund as the FCA indicates. If co-mingling occurs it can also help the LTAF generate greater scale and for the manager to realise greater economies of scale. As we have indicated previously in our response, this is an important incentive for regulators to permit retail investment in the LTAF. In the earlier stages, DC schemes are likely to take time to gradually increase the capital that they allocate to the LTAF. Retail investment (subject to strong investor protection) can help the LTAF build scale in the initial stages of its life and thereafter.

While we expect some co-mingling to occur, it is also true that many funds will target a distinct investor type, whether retail or professional or specific DC workplace schemes, due to their needs. Requiring a minimum level of professional investment would undermine this.

Furthermore, the type of retail investors that we suggest are well suited to the LTAF, wealth management clients, are equivalent to DC pension scheme members in many respects and may be more sophisticated and better able to bear risk in some cases. Furthermore, we suggest that eligibility should be restricted to retail investors that are advised by a professional (i.e. a wealth manager). We also suggest that investors which invest via discretionary portfolio management should be eligible to invest in the LTAF because in this case the retail investor has effectively outsourced their investment decision-making to a professional. Both advised wealth management clients and those investing via segregated mandates are reliant on professional investment expertise.

Finally, to reiterate, we propose that certain retail investors should be eligible to invest in the LTAF subject to stringent objective tests applicable to the individual investor.

Q13: What changes would need to be made to the FAIF regime to enable FAIFs to operate a portfolio of LTAFs?

The consultation contemplates that FAIFs should be able to invest in a portfolio of LTAFs. We welcome this flexibility.

However, the requirement for the FAIF's second schemes to invest no more than 15% of their portfolio in other funds will need to be lifted to ensure consistency with the LTAF's own flexibility to invest in other funds.

Q14: What other options could we consider to make the promotion of the LTAF to retail clients more appropriate?

Due to the deficiencies in the existing means of marketing the LTAF to retail investors, and the distinctive nature of the new fund, we find a need for a set of requirements that are specifically tailored to the LTAF.

Furthermore, given that the LTAF is proposed to have a strong level of investor protection, such as in relation to its transparency and governance, the rules for its marketing to retail investors should also ensure a strong level of investor protection.

This should be founded on objective tests to give intermediaries certainty and clarity about their investors' eligibility for the LTAF. These tests can be derived from other regulatory regimes in which the FCA can have some confidence that the tests work. Despite the LTAF's originality, managers and markets will also have some familiarity with these requirements.

We propose the following objective tests:

- The investor should be advised or invest via discretionary portfolio management. The advice requirement is comparable to the (E)LTIF regime and ensures a level of professional oversight.
- The proportion of an investor's total investable portfolio that is invested in an LTAF should be capped at e.g. 10%. As noted in respect of the NRRS rules, this would allow a minimum level of diversification whilst ensuring an investor is not overly committed to the LTAF.
- The investor should have a minimum investable amount, e.g. £100,000. In Germany, a semi-professional investor classification sets this amount at €200,000 and the ELTIF has a €100,000 minimum. Unadvised retail investors with €100,000 are also eligible to invest in the EuVECA / RVECA, an unauthorised closed-ended venture capital fund. It is also notable that a semi-professional classification is being considered on a pan-EU basis as part of the EU's MiFID II Review. A similar requirement would put the UK in a comparable position in respect of the 'democratisation' of private assets, but also ensure that an eligible investor is reasonably able to bear risk in respect of their total wealth.

We suggest that these tests are practical but also sufficiently tough to restrict retail eligibility.

Q15: Who else do you think the LTAF should be capable of being marketed to, and why? What are the barriers currently preventing this from happening?

Beyond DC pension schemes and wealth management clients, we believe that all professional investors should be permitted to invest in the LTAF. This would include DB pension schemes and insurers, for instance.

Such investors already have means by which to access private, less liquid, and longer-term assets. However, the open-ended nature of the LTAF and the prospect of a NAV-like return (as opposed to an equity-like return in respect of closed-ended funds) gives eligible investors an alternative option that might be suited to their needs.

We are not aware of any barriers that might prevent these professional investors from accessing the LTAF.

Q16: Do you think we should enable wider use of the LTAF as a permitted link or conditional permitted link to long-term contracts of insurance? What do you see as the main obstacles to this and how would you resolve them?

The LTAF must be designated as a permitted link to facilitate investment in the unit-linked market.

Q17: Do you have any views on how permitted links might be expanded to other fund structures or direct investments in illiquid assets?

We do not have views on this topic at this stage.

Q18: Do you have any comments on our cost benefit analysis?

We broadly agree with the FCA's cost benefit analysis and have no comments.

Appendix: Tax points which arise in LTAF structures

This note is intended to supplement Macfarlanes' response to the FCA about the appropriate tax treatment of the LTAF. While many of the tax issues addressed here are common issues which are encountered in the UK authorised funds regime in general, we have sought to highlight where they are particularly relevant to the LTAF given the nature of its investments and the nature of the persons who may invest in it.

As a preliminary point, we would assume and expect that it would be possible for an LTAF to take any of the current legal forms for authorised investment funds (i.e. principally open-ended investment companies or authorised contractual schemes (ACS)). While there has been much commentary on the suitability of the LTAF for the DC pensions market which is likely to favour an ACS model, we are also aware of very significant interest in structuring LTAFs for the mass affluent market and high net worth individuals who currently have limited access to alternative asset classes. We think it is key to the successful launch of the LTAF regime and its quick take up that there are no barriers put in place in addition to the current taxation regime.

Further, we would assume that the LTAF would be able to select any of the existing AIF regimes – including the property authorised investment fund (PAIF) and tax-elected fund (TEF) regimes where available/appropriate and also to be capable of forming a bond fund. As these are all features of the current tax landscape for authorised funds, again we would hope this would not be controversial, but we reiterate that there is broad interest in such funds and no new barriers should be erected in the way of those who may wish to implement them within the existing landscape.

Issues with the current landscape

The Investment Association has made a number of submissions previously in relation to well-known tax issues with the authorised funds regime which apply equally here. In particular the VAT issues with operating an authorised fund will be equally relevant to an LTAF as to any other UK authorised fund.

We would also reiterate in particular that the fact that an investment into a UK fund would be a remittance for a remittance basis user is a significant factor in preventing managers from establishing UK fund structures. Even if such investors represent only a minority of the potential market for investors, they remain an important and rich minority and their ability to invest would be enough to cause managers to establish funds outside the UK. The extension of business investment relief (as applies for investments made by remittance basis users in UK trading companies) to investments in an LTAF would require minimal legislative change and result in no loss of tax and we would particularly urge this change in the context of LTAFs as well as other fund structures in general.

However, those submissions should be taken as read and so we have focussed the points made here only on those that are particular to LTAFs.

Firstly, two general points are that there should be a generous stamp duty and stamp duty land tax (SDLT) seeding relief for converting structures (irrespective of the structure used) and naturally wider discussions around the exemption of wider UK authorised funds would also address many of these issues.

<u>Balanced funds</u>

As will become clear in the examples which follow, the balanced fund issue is one which is extremely acute for an LTAF which invests in illiquid alternatives. The balanced fund issue, by way of reminder, is created by the fact that an authorised investment fund will be exempt on its dividend income and gains, but subject to tax on its interest income received.

If a fund has more than 60% of its investments in credit assets then it will be a bond fund and able to make interest distributions which are deductible thus ensuring that interest is not in practice subject to tax in the fund. However, if a fund is not a bond fund, then it will suffer tax on interest before distributing it as a dividend.

In general, authorised funds under existing structures therefore seek to either pursue equity or debt investment strategies as a balanced strategy between the two creates this tax inefficiency. A manager who wants to pursue a balanced strategy would be best advised to use a non-UK fund structure.

LTAFs are likely to be balanced funds in all cases because of the asset classes they invest in. For example, if an LTAF invests in a private equity fund, that private equity fund is going to be funding its underlying portfolio companies with a mixture of equity and debt. That is almost always the case for a wide variety of commercial and legal reasons as well as tax reasons (for the avoidance of doubt: this is the case globally and not just in the case of UK private equity).

By definition, therefore, an LTAF structured as an open-ended investment company (OEIC) operating under the existing AIF rules will be tax inefficient as that underlying interest income will be subject to tax in the LTAF. This would be particularly problematic for DC pension investors who would not have been subject to this tax had they invested in a fund structured as an ACS. However, as an ACS would not be suitable for other investors (due to the complexity of tax reporting and lack of platforms which will support it) this will effectively mean that LTAFs for a mix of investors are not currently viable.

One response might be to attempt to persuade investors and platforms to make more use of the tax-elected fund regime which allows a fund to make interest distributions even if it is not a bond fund. While this model does deal with the issue of taxes in the fund, it is operationally complex and as a matter of practice investors and platforms will simply continue to use non-UK structures if the UK offers only complex alternatives.

There are two potential solutions to this issue:

- Grant LTAFs exemption from tax on interest received, without the need to have separate streams of dividend and interest distributions. This would result in an effective saving for investors investing in person compared to current structures of course, for so long as the dividend rate is less than the full income tax rate. However:
    - it would make no difference to the position for DC pension funds and since these are expected to be the bulk of investors there would be no loss of tax; and
    - it is no different from what any investor can access in non-UK fund structures, which is what will be used if LTAFs cannot be made to work; thus there is no real loss of tax even for taxable investors – the tax would never be paid in any event.
- The final option would be to allow LTAFs to elect to be bond funds – this would address the issue for DC pension funds but would make the LTAF less appealing than non-UK funds for taxpaying investors.

It is also worth noting that since the LTAF manager will not be in control of the underlying investments, they will not be able to prevent the fund from becoming a bond fund when the 60% threshold is reached. This could have the effect of LTAFs flipping into and out of the bond fund rules depending on the value of underlying equity and debt in the underlying private equity funds. We would therefore recommend that, whatever solution is adopted (assuming it is not the third one) the bond fund rules should be switched off for LTAFs which state in their investment objectives that they intend to run a balanced strategy.

<u>Distribution of income on a current basis</u>

Another issue with investing in underlying private fund structures is that they often provide debt to ultimate investee companies on a basis such that interest will accrue rather than be paid. This will also be the case for certain kinds of credit fund.

One of the issues with the AIF regime is the requirement to distribute income on an annual basis, when income may not in practice be received in cash form and be capable of being distributed. While many existing funds can manage this cashflow issue in practice since it is usually only relevant to a small part of the portfolio, whereas with a fund investing in mezzanine debt, private equity or infrastructure, this will be a major issue for large parts of the portfolio.

Therefore, it will be important that there be a carve out from the requirement to distribute income to limit that obligation to, say, 90% of the cash income actually received in the year (10% to provide some flexibility), with a requirement to distribute any income actually received as and when it is received. I.e. an election should be available to operate income distributions on a cash paid rather than an accrual basis.

Use of special purpose vehicles

Often an LTAF will not wish to make direct investments itself. Unlike with the world of listed securities and widely available regulated funds, private investments will require the investor to take on direct contractual liabilities. Examples would include obligations under limited partnership agreements and side letters, shareholder agreements and asset related liabilities which could put the assets of the wider LTAF at risk as they would be available to any successful claimant under such provisions.

Therefore, it will often be necessary to use a special purpose vehicle to make investments. Ideally this would be the use of simple UK companies – however they have the issue that they would have their own tax liabilities as the exemptions for AIFs do not extend to their subsidiaries. This could be solved by using non-UK companies, but this would defeat the policy intention. Partnership special purpose vehicles can also be used (as they often are in PAIFs) but they have other disadvantages and complications.

Therefore, a welcome feature of an LTAF regime would be the ability to elect that specified holding companies are treated as part of the LTAF and benefit from its exemption. We would suggest that the legislation state specifically that the elected subsidiary is to be treated as one with the LTAF for the purposes of determining income to be distributed (subject to the rules on cash pay discussed above). Other rules, such as the obligation not to enter into trading activities, should equally apply to such subsidiaries. We consider that the opportunities for avoidance would in practice be very limited but a targeted anti-avoidance rule should be included in any event to prevent any rolling up of income or attempts to use the LTAF structure to avoid tax on trading income.

The outcome of the consultation on UK asset holding companies could of course also be relevant to this question, but the two regimes could equally operate in parallel.

Case studies

We have now set out comments on each of the case studies set out in the Investment Association's Position Paper from July 2020 to illustrate these points:

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.

This credit fund will most likely lend through a subsidiary finance company in order to ensure that the LTAF does not have a direct contractual exposure to underlying investors. On the basis it is recovery credit, it would be quite likely that this fund would lend on terms which allow a portion of the interest to roll up.

Therefore, to operate without tax leakage, this fund would need the LTAF exemption to extend to its subsidiary and to elect for the cash basis of income distribution discussed above. It is likely to be a bond fund such that the balanced fund issue should not arise.

<u>Renewable energy fund</u>

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.

As the projects are likely to be funded with a combination of equity and debt, this is likely to be a balanced fund and so will be tax inefficient to the extent of the interest which arises. In addition, that interest is likely to be on a roll up basis early in the life of investments and so the fund would most likely need to make use of the cash basis for distribution discussed above.

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.

To the extent of the limited partnership investments, as the underlying portfolio companies are likely to be funded with a combination of equity and debt, this is likely to be a balanced fund and so will be tax inefficient to the extent of the interest which arises. In addition, that interest is likely to be on a roll up basis early in the life of investments and so the fund would most likely need to make use of the cash basis for distribution discussed above.

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.

The same balanced fund issues would also arise in respect of this structure.

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