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Insights

FCA CONSULTS ON A NEW CATEGORY OF UK AUTHORISED OPEN-ENDED FUND TO INVEST IN ILLIQUID ASSETS

THE LONG TERM ASSET FUND (LTAF)

11 May 2021

SUMMARY

The FCA has launched its consultation (the Consultation), open for feedback until 25 June 2021, on a new category of authorised fund vehicle designed to accommodate investment in illiquid assets, the Long Term Asset Fund (LTAF). The LTAF rules embed longer redemption periods, greater disclosure requirements, specific liquidity management and governance features that would differentiate the LTAF from other open-ended authorised funds and provide investors with the necessary confidence to invest in less liquid and potentially higher risk assets. This could be an exciting alternative to the Non-UCITS Retail Scheme (NURS) or Qualified Investor Scheme (QIS) for authorised fund vehicles such as PAIFs, CoACS and AUTs investing in real estate, infrastructure, private equity or private debt and that are targeting professional, sophisticated retail and DC pension scheme investors.

Originally proposed by the Investment Association in its June 2019 Final report to HM Treasury Asset Management Taskforce, the LTAF has been championed by the Chancellor of the Exchequer in November 2020 when he announced the first launch would be available this year.

In this briefing, we set out some overview comments along with key proposals of interest in the Consultation.

Overview thoughts

- In its FS21/8 Feedback (published alongside the Consultation) to the FCA's August 2020 Consultation paper CP20/15: Liquidity mismatch in authorised open-ended property funds the FCA states that it intends to delay finalising its policy on introducing mandatory notice periods for property funds (to Q3 2021 at the earliest). This is to allow more time to address operational issues around the introduction of a notice period for non-daily dealt funds and pending feedback on the LTAF Consultation.

- The FCA rules on mandatory suspension of dealings where there is material uncertainty about the valuation of at least 20% of scheme property, (that applied, amongst others, from September 2020 under the FCA Policy Statement PS19/24 on illiquid assets and open-ended funds), will not apply to LTAFs. The LTAF is designed for investors with long-term investment horizons who do not need immediate liquidity. In addition, the AFM can deploy a wide range of liquidity management tools.

- We will need to continue to monitor developments as policy makers make progress with their scrutiny of regulatory regimes and fund regimes in a broad and international context. The LTAF is also being considered by the Productive Finance Working Group (jointly led by HM Treasury, the FCA and the Bank of England). In parallel with the development of the LTAF, we await government output following the recent HM Treasury's review of the UK funds regime and consultations on Taxation of asset holding companies in alternative fund structures. The Consultation itself does not discuss tax issues for the LTAF.

Key LTAF proposals

A high-level principles-based approach

- The Consultation sets out a high-level principles-based framework for the LTAF, rather than prescriptive rules in all areas. Importantly, there is an expectation (rather than an obligation) that at least 50% of the value of the scheme property is invested in long-term illiquid investments (ie unlisted securities, interests in immovables or indirect interests in such long-term assets via other collective investment schemes (CIS)).

- Only full-scope UK AIFMs can act as authorised fund managers (AFMs) of LTAFs, and they must demonstrate to the FCA that they possess the necessary expertise and skills for their proposed investment strategies (whether or not they intend to delegate).

- The term LTAF is to be used only by those AFMs operating this type of fund under the LTAF FCA rules.

Anticipated target market: initially QIS eligible investors and DC schemes

- Initially, eligible investors are to be based on the QIS framework: professional clients and those retail clients who are sophisticated investors under COBS 4.12.4R. In addition, the FCA proposes amendments to the permitted links rules to make LTAFs available to DC pension schemes (by allowing the LTAF to be treated as a conditional permitted link for retail investors via occupational or workplace pension investments and by exempting the LTAF from the 35% limit on illiquid investments within any unit-linked fund). Where the fund is an Authorised Contractual Scheme, additional investor eligibility requirements still apply.

- The Consultation raises options and discussion points for the wider distribution of LTAFs to non-sophisticated retail investors in the future, but following further consideration of the NMPI rules and as part of the feedback on current proposals on wider changes to the financial promotions regime (DP21/1).

More flexible investment powers

- The proposed LTAF investment parameters are also based on the QIS; although LTAFs can invest in certain loans in addition. Some of the QIS restrictions are relaxed, in particular the restriction that no more than 15% of its value can be invested in underlying funds of unregulated CIS, is substituted with a principles-based requirement on the AFM to ensure that the scheme does not indirectly invest in itself. Others remain, for instance the LTAF cannot invest more than 20% in QIS, other LTAFs or unregulated schemes unless the AFM has carried out due diligence and the CIS/other schemes comply with the relevant legal and regulatory requirements (on an ongoing basis).

- An LTAF will be subject to an overarching requirement to have a prudent spread of risk (as is the case for UCITS and NURS, the QIS rules provide simply for a spread of risk) – this will be applied to its investments within a 24 month period.

- The Consultation contemplates a fund that is a QIS seeking authorisation as an LTAF in due course, if it proposes to operate in accordance with the new LTAF rules.

Borrowing

- The proposed LTAF borrowing limit is 30% of NAV (more restrictive than the 100% limit for a QIS) but with no look through to borrowing in underlying investments. This is designed to enable LTAFs to operate efficiently without being exposed to excessive risk.

Wide toolkit to manage liquidity

- On the basis that daily dealing is not realistic for funds investing in highly illiquid assets, an AFM of an LTAF will have discretion to set dealing frequency to align with the liquidity of its investment strategy. It can also deploy a wide range of liquidity management tools (eg use of notice periods for redemptions/subscriptions, deferred and limited redemptions). It will have to disclose details in its prospectus.

- However, the FCA does not expect an AFM to sell assets unexpectedly or to rely on suspension as a means to manage liquidity, other than in exceptional circumstances if it is in the interests of the investors.

- The Consultation raises a discussion point on how the industry can help AFMs to engage with investors to address complex scenarios around individual investor liquidity needs and fund liquidity events.

Additional reporting

- The SMCR prescribed responsibilities (namely, assessment of overall value, requirement for independent directors on AFM boards and acting in investors' best interests) apply to AFMs of LTAFs. In addition, an AFM must appoint an approved person to assess and report on the LTAF's investment valuations, due diligence, conflicts of interest and liquidity management.
- In addition to the half yearly and annual reporting requirements for AFMs, an LTAF's AFM must deliver quarterly updates to investors. These updates are to cover portfolio investments, including details of any transactions during the period (together with an explanation of how the transaction is consistent with the LTAF's investment objectives, policy and strategy) and any significant developments in the investments for which investors require reasonable notice.

Strong focus on investor protection

We would highlight a few points on the LTAF investor protection measures (being one of the key LTAF features).

- Unless the AFM has the necessary competence and experience to do so (assessed on authorisation and on an ongoing basis by the depositary), it must appoint an external valuer to fulfil the valuation function. For the purposes of property investments, a standing independent valuer appointment may be preferred.
- To provide transparency for investors, LTAFs must publish monthly valuations, regardless of their dealing policy.
- An LTAF prospectus is to include examples of how any performance fee will operate and its maximum amount (this is equivalent to the UCITS and NURS requirement, but not applicable to QIS).
- AFMs are to carry out due diligence (to ensure compliance with the objectives, investment strategy and any risk limits of the scheme) "in line with good market practice" and to disclose in their prospectus how they do this. In practice we would expect most AFMs to conform to this standard.

Subject to feedback to the Consultation, the FCA plans to publish a final policy statement and final handbook rules later in 2021.

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MEET THE TEAM

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