FINANCIAL CONDUCT AUTHORITY

Patient Capital and Authorised Funds

Feedback on DP18/10

Feedback Statement

FS20/2

February 2020

This relates to

Discussion Paper 18/10 which is available on our website at www.fca.org.uk/publications

Please send any comments or queries to:
David Sorensen
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

Telephone:
+44 207 066 8622

Sign up for our weekly
news and publications alerts

See all our latest press releases, consultations and speeches.

Contents

1 Summary 3

2 Retail investors and long-term assets 7

3 Professional investors and long-term assets 11

4 Diversification 13

5 Specialised fund regimes 16

6 Other regulatory barriers 18

7 The long-term asset fund 20

Annex 1
List of non-confidential respondents 23

Annex 2
Abbreviations used in this paper 24

1 Summary

1.1 On 12 December 2018, as part of our response to Her Majesty's Treasury ('the Treasury') Patient Capital Review, we published a Discussion Paper on Patient Capital and Authorised Funds (DP18/10). DP18/10 sought views on whether there are any unnecessary barriers to investing in long-term assets (also known as patient capital) through authorised funds. Long-term assets can refer to a broad range of alternative investment assets intended to deliver long-term returns, including venture capital, private equity, private debt, real-estate and infrastructure. These assets are typically illiquid and often require committed investors with long-term investment horizons.

1.2 DP18/10 provided an overview of the UK's authorised fund regime, set out existing opportunities to invest in long-term assets and invited feedback to help us identify unnecessary barriers.

1.3 This Feedback Statement (FS) summarises the responses we received, including the Investment Association's (IA) proposal for a new type of authorised fund designed to invest in long-term assets – the Long-Term Asset Fund (LTAF).

Who this affects

1.4 This FS will be of interest to:

- operators and investment managers of UK authorised funds and specialised funds (ELTIF, EuSEF and EuVECA), and their depositaries
- intermediaries, such as platform service providers, discretionary wealth managers and financial advisers
- pension plan operators (eg those offering self-invested personal pensions)
- life assurance companies with an interest in patient capital, either by direct investment or through holdings in investment funds
- retail, professional and institutional investors
- ancillary service providers

The wider context

The Patient Capital Review

1.5 In November 2016, the Prime Minister, Theresa May, announced the Patient Capital Review (PCR) to consider how to increase investment in long-term assets, particularly the supply of long-term finance to innovative UK companies. The PCR, led by the Treasury, found that the UK entrepreneurial ecosystem performs well in the early stages of starting a business ie start up stage. However, investment to scale up (ie investment in smaller private companies seeking investment for growth) is not as strong due to demand for long-term finance exceeding supply. The Treasury's final report stated this is having negative consequences for the UK economy, tax receipts and job creation.

1.6 The findings prompted commitment from government departments and public bodies to identify and remove unnecessary barriers to long-term investment. As part of our response, we:

- consulted on changes to our 'permitted links rules to facilitate investment in long-term assets through unit-linked funds (see 1.7)
- published a discussion paper on patient capital and authorised funds (DP18/10)
- hosted an event on 17 January 2019 with an expert panel to discuss our publications and the Government's wider work on patient capital
- participated in the British Business Bank's launch of The Future of Defined Contribution Pensions report

1.7 Also in December 2018, we published Consultation Paper on Proposed Amendment of COBS 21.3 Permitted Links Rules (CP18/40) to address any unnecessary barriers to investment in long-term assets through unit-linked funds. The final rules will be published later in the first half of 2020.

Illiquid assets and open-ended funds

1.8 Open-ended funds holding less liquid long-term assets can have difficulties if investors try to redeem their investments in significant volumes within a short period. This is because fund managers might need to sell assets to meet redemption requests. But it may not be possible to sell less liquid assets quickly without a significant discount. If fund managers are unable to meet redemption requests the fund may have to suspend dealing for a temporary period.

1.9 This happened following the UK referendum on EU membership in 2016, when dealing in several property funds (a type of non-UCITS retail scheme (NURS)) was suspended. While dealing had resumed by the end of the year, the event raised questions about the use of suspensions, as well as effectiveness of other liquidity risk management tools used by open-ended funds invested in inherently illiquid assets. There were further property fund suspensions in December 2019.

1.10 In February 2017, we published a discussion paper on illiquid assets and open-ended investment funds (DP17/1) to consider the liquidity risk management tools available to open-ended fund managers in light of the property fund suspensions, and discuss possible improvements. On 8 October 2018, we then published a consultation paper (CP18/27) which included proposals to improve liquidity risk management in NURSs holding illiquid assets.

1.11 Our final rules were published on 30 September 2019 in PS19/24: Illiquid Assets and Open-Ended Funds and Feedback to CP18/27. They sought to:

- help investors understand dealing suspensions and the circumstances in which restrictions can be placed on redemptions
- reduce the potential for some investors to gain at the expense of others because there is uncertainty about the value of scheme property
- improve the quality of liquidity risk management in NURSs investing in illiquid assets

1.12 The new rules and guidance set out in PS19/24 will come into force on 30 September 2020.

LF Woodford Equity Income Fund

1.13 On 3 June 2019, the LF Woodford Equity Income Fund (WEIF) suspended dealing. The WEIF was a retail scheme authorised in accordance with EU rules for Undertakings for the Collective Investment in Transferable Securities (UCITS). UCITS schemes are a type of open-ended authorised fund designed that can be marketed to all retail investors. The WEIF's suspension demonstrated that liquidity risk is not confined to NURSs and highlights the issues which can arise when other types of authorised retail funds invest in less liquid assets.

1.14 In October 2019, Link Fund Solutions, the authorised corporate director of the WEIF, decided it was in the best interest of investors to close the fund. The liquidation of the fund commenced on 18 January 2020 and will see money returned to investors in instalments. For more information, please see our WEIF news page.

Financial Policy Committee

1.15 We are working with the Bank of England's ('the Bank') Financial Policy Committee (FPC) to assess how authorised funds' redemption terms can be better aligned to the liquidity of the underlying assets. As well as enhancing financial stability, this should also improve outcomes for investors.

1.16 For more information on the work on liquidity risks in open-ended funds, please see the July and December 2019 editions of the Bank's Financial Stability Report.

Summary of feedback and our response

1.17 We received 21 responses from a range of stakeholders, including investment management firms and their representative bodies, law firms and individual investors.

- Chapter 2 summarises the feedback on retail investor access to long-term assets through UCITS schemes and NURSs - the 2 main categories of funds authorised by the FCA in the UK for wider retail distribution. Broadly, respondents agreed these schemes only provide limited options because of restrictions intended to offer a degree of protection.
- Chapter 3 summarises the feedback on professional and sophisticated retail investor access to long-term assets through the third main category of authorised fund – a Qualified Investor Scheme (QIS). Respondents found that QISs are suitable for investment in long-term assets.
- Chapter 4 summarises feedback on diversification rules and their impact on investments in long-term assets through authorised funds. It also covers feedback on the potential for mandatory suspensions in authorised funds investing in long-term assets. Respondents found that diversification rules in authorised funds can be problematic for fund managers investing in long-term assets and requested a more flexible approach to such rules.
- Chapter 5 summarises feedback on specialist fund regimes, such as the European Long-Term Investment Fund, and their role in facilitating investment in long-term assets. Respondents said that limited use of these funds was related to complex operational requirements and demanding suitability requirements.

- Chapter 6 summarises feedback on other regulatory barriers identified by respondents, such as dealing frequencies and the pension charge cap. Respondents pointed to barriers such as a reluctance from distributors to accommodate funds that do not offer daily dealing and tax rules.
- Chapter 7 provides an overview of the IA's LTAF proposal and our initial response. We welcome the proposal from the IA, but have identified areas where we encourage further work on the balance between expanding the types of assets that funds invest in and investor protection.

1.18 A list of non-confidential respondents is provided in Annex 1. We are grateful to all who responded and thank them for taking the time to participate in this discussion.

Next steps

1.19 We have found no inappropriate barriers to investing in long-term assets within our authorised funds regime. Broadly, respondents found the current authorised funds regime fit for purpose for long-term investments by professional and sophisticated retail investors.

1.20 For broad retail distribution funds, barriers do exist which limit the range of available investment options. However, in our view it is not clear that these barriers are inappropriate or how they might be relaxed without introducing a degree of risk that is not appropriate for retail investors. We also note that other investment products, such as investment trusts, already provide alternative ways for retail investors to access long-term investments.

1.21 We will also be considering any rule changes that may be recommended upon completion of the FPC work later this year.

2 Retail investors and long-term assets

2.1 This chapter summarises feedback on retail access to long-term investments through the two main categories of funds that can be authorised by the FCA for marketing to all types of retail investors – UCITS schemes and NURSs. In the rest of this FS, the term 'authorised retail funds' refers to UCITS schemes and NURSs, but not QISs.

2.2 In DP18/10, we asked:

> **Q1:** ***Do the category limits strike the right balance between enabling retail investments in patient capital while ensuring investors can redeem their investments in a timely fashion?***
>
> ***If not, what changes should be made to existing structures?***

2.3 Most respondents agreed that UCITS schemes and NURSs only provide limited options for retail investors to access long-term assets. The main reasons provided were the current investment and borrowing limits are restrictive and the dealing frequencies offered by authorised retail funds, often daily, are not conducive to holding illiquid long-term assets.

2.4 The investment limits for authorised retail funds are intended to restrict them to investing mainly in liquid assets. For example, a UCITS schemes can only invest up to 10% of its scheme property in transferable securities which are not admitted to an eligible market (non-approved securities). NURSs can invest in a slightly wider range of assets, including real estate (immovables), but no more than 20% of the value of the scheme property can be invested in non-approved securities, unless the NURS is operating as property funds (a Property Authorised Investment Fund (PAIF)) or a Fund of Alternative Investment Funds both of which have bespoke investment powers.

2.5 These restrictions, respondents said, mean only liquid investment strategies are viable and, therefore, authorised retail funds are unsuitable for investment in long-term assets on a much larger scale.

2.6 Some respondents acknowledged that the investment and borrowing powers restricting investment in long-term assets, are necessary to ensure investors can redeem their investments on demand. Some suggested that any changes to authorised retail schemes to facilitate investment in long-term assets should start by addressing investor expectations of instant access to their money. One respondent suggested that all NURSs should be able to invest in long-term assets without restriction, and that the onus should be on the fund manager to provide a robust and appropriate liquidity management and risk management process.

2.7 As we saw in the property fund suspensions following the EU referendum in 2016, investors' ability to redeem on demand can be problematic for retail funds holding illiquid assets, particularly if such funds offer daily dealing. Some respondents suggested that authorised retail funds holding long-term assets should have greater ability to deal less frequently (currently UK authorised UCITS schemes must deal at least once every 2 weeks), defer redemptions or impose notice periods, providing it is clearly disclosed to the investor. For example, one respondent said the rules should be

changed to allow the authorised fund manager of a NURS to require a 3-month notice period from retail investors and defer payment for 3 months with the option to extend for a further 3 months.

2.8 Of the respondents in favour of facilitating retail investment in long-term assets, most supported the introduction of a new type of authorised retail fund rather than making changes to an existing category of authorised fund.

> **Q2:** ***Is there retail investor demand for a new type of authorised fund which can, for example, invest all its capital directly into patient capital?***

2.9 Most respondents said that there is, or "may be", demand for a new type of authorised fund. Some said there has been some interest from defined contribution pension schemes, discretionary wealth managers and high net worth investors. However, there were few comments on whether there is retail investor interest in a new type of fund, designed to invest in long-term assets. One respondent said there is "little explicit interest from retail investors".

2.10 One respondent noted that investors are already investing in long-term assets through venture capital trusts, investment trusts and other listed investment companies.

> **Q3:** ***If authorised funds marketed to retail investors were permitted to hold more patient capital, what safeguards do you think are needed to adequately protect investors?***

2.11 Most respondents agreed that an authorised retail fund investing in long-term assets would need to ensure its investors are aware of the associated risks through improved disclosures. Respondents said that investors should be made aware from the outset (ie in each fund's "investment policy and objective" stated in their key investor document and prospectus) that long-term assets can take time to sell, and that this could affect their ability to redeem their investments and receive their money in a timely manner.

2.12 Some respondents suggested that, given a fund investing in long-term assets would be less liquid than the existing range of authorised retail funds, it should be restricted to advised sales only. One respondent added that, under MiFID II, it is possible that these funds might constitute a complex product and, therefore, would require an intermediary to perform an appropriateness test before any investment is made. If so, said the respondent, the intermediary should ensure that the investor understands the nature of the fund and its assets. One respondent said that the distribution of these products should be limited to professional and sophisticated retail investors only.

Our response

Respondents were clear that funds authorised for broad retail distribution only provide limited options for retail investors to invest in long-term assets. However, there was acknowledgement that the restrictions imposed by the investment and borrowing powers also provide valuable investor protections.

We are currently working with the Bank's Financial Policy Committee (FPC) to address mismatches between redemption terms offered to

investors and the liquidity of the underlying assets in open-ended funds, including authorised retail funds. This work is closely aligned to many of the suggestions made in response to DP18/10.

For example, as part of this work we are exploring the potential for the use of notice periods as liquidity management tools for open-ended funds investing in illiquid assets.

If our work with the FPC results in proposals to make rule changes, we will consult in the usual way. Please see the latest edition of the Bank's Financial Stability Report for an update on this work.

We note that we do not have strong evidence of significant demand from retail investors for authorised retail schemes to invest in long-term assets. Most of the investors that have expressed an interest are professional investors that can already access long-term assets through QISs and unauthorised investment products.

Furthermore, a range of closed-ended investment products, such as investment companies and venture capital trusts, already provide retail investors with access to investment in long-term assets.

Q4: ***Should NURSs have a broader ability to finance infrastructure projects than is currently possible under our regime?***

If so, what changes do you think are necessary to our Handbook?

2.13 Most respondents thought that in principle, NURSs should be able to provide retail investors with more access to long-term assets, including infrastructure project finance. While some respondents suggested a general relaxation of investment and borrowing powers, as well as diversification rules to allow any NURSs to invest in long-term assets, others would like separate sub-categories of NURSs designed specifically to invest in specialist asset classes like infrastructure.

2.14 Whilst respondents did not suggest specific proposals for rule changes, some identified COLL 5.6.18R as a restriction preventing direct investment in infrastructure. This rule requires that a NURS can only invest in land or buildings where it is a 'freehold or leasehold interest' or similar if located outside England and Wales. Respondents pointed to certain infrastructure investments not granting a freehold or leasehold interest in the land they are built on, meaning the rule prevents direct investment by NURSs.

Our response

Whilst most respondents found it desirable to enable retail investors to have greater access to investment in infrastructure projects, the feedback received did not identify any infrastructure assets that authorised retail funds cannot currently invest in when using the full range of options available under our existing rules.

Although we recognise NURSs are restricted to acquiring a freehold or leasehold title when investing directly in land or buildings, this is unlikely to be a significant barrier to infrastructure project finance since NURSs can invest in financial instruments, which would include instruments issued by special purpose vehicles used for indirect investment in infrastructure projects, subject to the relevant investment limits.

Once an infrastructure project is completed, our rules currently provide for a special sub-category of NURSs, the PAIF, that can invest the entire fund directly into land or buildings in addition to investing in infrastructure indirectly via financial instruments.

3 Professional investors and long-term assets

3.1 This chapter summarises the feedback on the third main category of authorised fund – the QIS. QISs cannot be promoted to retail investors unless they are sophisticated (sophisticated investors). They are subject to the same terms of promotion as non-mainstream pooled investments. Very broadly, these rules aim to ensure that QISs are only promoted to consumers with extensive investment experience and knowledge of complex instruments, who are better able to understand and evaluate the risks and potential rewards of unusual, complex and/or illiquid investments. In addition, the QIS's authorised corporate director or fund manager must take reasonable care to ensure that the scheme is only invested in by those, to whom it can be promoted.

3.2 In DP18/10, we asked:

> **Q5:** ***Do the current rules governing QISs provide professional and sophisticated retail investors with sufficient access to patient capital?***
>
> ***If not, why not and what changes do you think are necessary to our Handbook?***

3.3 Most respondents agreed that the QIS's flexible investment and borrowing powers and diversification rules make it a viable vehicle for investing in long-term assets. However, some respondents said there is a lack of familiarity with the QISs among some types of investors. This means many professional and sophisticated investors as well as discretionary wealth managers choose to invest in authorised retail funds instead. Therefore, some respondents argued, any changes to facilitate investment in long-term assets should be made to authorised retail funds, and to the benefit of all investors, not just those willing and able to invest through QISs.

> **Q6:** ***If QISs are permitted to hold more patient capital, what safeguards do you think are needed to adequately protect investors?***

3.4 Given that only professional and sophisticated investors can directly invest in QISs, most respondents said that the existing investor protections are adequate and there would be no need for further safeguards.

3.5 Some respondents said that, like authorised retail funds, QISs investing in long-term assets should improve disclosures to communicate clearly the illiquid nature of any long-term assets and that redemptions can be deferred in certain circumstances.

Our response

Most respondents found the QISs a viable vehicle for investment in long-term assets with appropriate investor safeguards given the intended investor base for this product. We continue to expect QISs investing in long-term assets to disclose the risks inherent in their investment strategies clearly to investors.

If professional investors, such as pension trustees, are choosing to use authorised retail funds rather than QISs due to a lack of familiarity, we do not think the right response is to alter the rules for authorised retail funds since this could have the unintended consequence of exposing other types of consumers to harm.

4 Diversification

4.1 This chapter summarises the feedback on the diversification rules for authorised funds. The rules require fund managers to provide a prudent spread of risk to protect investors from a significant loss if any one investment, or type of investment asset, fails.

4.2 In DP18/10, we asked:

> **Q7:** ***Do the current diversification rules strike the right balance between investor protection, while requiring a prudent spread of risk, and sufficient access to patient capital?***
>
> ***If not, do we need a different or more flexible approach to diversification rules?***

4.3 Most respondents said the diversification rules for authorised funds can be problematic for fund managers investing in long-term assets. A few suggested fixed diversification limits should be more flexible, to allow for asset appreciation, or should be replaced by only a requirement for a "prudent spread of risk" without prescriptive diversification limits to give fund managers greater freedom to invest in long-term assets.

4.4 Fund managers are required to correct inadvertent breaches of diversification limits as soon as possible having regard to the interests of investors and in any event within 6 months. Where the breach concerns an illiquid asset that is not an immovable, it might not always be possible to sell part or all of the asset within the maximum permitted window. Some respondents said this causes fund managers to hold long-term assets well below mandated thresholds to mitigate the risk of inadvertent diversification breaches. Respondents said a more flexible approach is needed when setting diversification limits and correcting inadvertent breaches.

4.5 Under existing rules for NURSs, fund managers have up to 24 months to correct inadvertent breaches involving immovables, such as commercial property. A few respondents think a similar approach should be adopted for breaches involving illiquid assets in all open-ended funds.

Our response

Diversification rules are intended to prevent fund managers from investing fund assets in excessively concentrated portfolios. Concentrated portfolios have heightened investment risks – their value tends to be more volatile, with wider dispersion of investment returns around the expected return, and with a greater chance of sustaining a large unexpected loss. A diversified portfolio can be used by fund managers to create products where a part of the portfolio is in higher-risk assets with attractive risk/reward profiles e.g. to create a portfolio which gives the highest expected return for a given level of volatility, or, the lowest volatility for a given level of return. One of the key

advantages of investing collectively through authorised funds, versus direct investment in assets by individual investors, is the ability to achieve diversification relatively easily.

The possible benefits for long-term asset investment of more flexible diversification limits would need to be weighed against the probable costs to investors of being exposed to greater investment risk.

The British Business Bank's Future of Defined Contribution Pensions report supports this view. The report shows that certain types of long-term assets such as private equity and venture capital can potentially provide higher expected returns than listed equities. However, there is also greater expected volatility of returns due to the bankruptcy risk of smaller companies. For funds investing directly into these types of assets it may even be appropriate to have higher levels of diversification than normally required for authorised retail funds in order to protect consumers from unexpected losses.

For sophisticated retail and professional investors fund managers can currently use QISs to provide more flexible portfolios with a broader range of investments. QISs are not subject to the requirement to have a 'prudent' spread of risk, nor do they have to adhere to prescriptive diversification limits, but they are required to take reasonable care to ensure that the scheme property of a QISs provides a spread of risk, taking into account various matters such as the investment objectives and policy of the scheme.

Q8: ***If authorised funds' scope to invest directly into patient capital assets other than immovables is increased do we need a remedy similar to the proposed mandatory suspension to avoid investors being treated unfairly?***

If you agree that suspension rules would be appropriate, please set out your suggestions as to what such a remedy would look like. If you do not think suspension rules would be appropriate, please explain why not.

4.6 CP18/27 (see para 1.10 above) proposed mandatory suspension in NURSs holding immovables where there is material uncertainty about the valuation of assets. The intention was to prevent investors buying or selling units or shares in funds holding assets that are over or under priced.

4.7 Most respondents did not agree that wider application of mandatory suspensions would be helpful. Some said it would be better to develop a set of valuation guidelines for long-term assets, to be used in times where there is material valuation uncertainty. A few said it would be better to develop other ways of managing liquidity, such as notice periods, deferred redemptions and side pockets. One respondent said side pockets could be used to hold specific assets with uncertain valuations, while allowing the rest of the fund to function as normal.

4.8 One respondent supported mandatory suspensions, as proposed in CP18/27, explaining that investment in long-term assets presents the same regulatory and consumer protection concerns as investment in immovables. This respondent also said they supported the other measures proposed in CP18/27, such as improved disclosures.

Our response

PS19/24, published after DP18/10 closed, introduced a new rule on mandatory suspensions for funds mainly investing in inherently illiquid assets. A fund manager must suspend dealing if the fund's standing independent valuer has expressed material uncertainty about the value of immovables that amount to 20% or more of the scheme property. However, the fund manager may continue dealing if they have agreed with the depositary that it is not in the best interest of investors to suspend.

We are currently exploring in our work with the FPC what other liquidity management tools, such as notice periods and pricing adjustments, could be introduced to help funds manage their liquidity in ways which avoid systemic risk and detriment to their investors.

5 Specialised fund regimes

5.1 This chapter summarises feedback on the 3 types of specialist fund that facilitate investment in long-term assets. They are:

- European Long-Term Investment Fund (ELTIF)
- European Social Entrepreneurship Fund (EuSEF)
- European Venture Capital Funds (EuVECA)

5.2 ELTIFs can only be authorised by us if managed by a 'full-scope UK alternative investment fund manager'. Full-scope managers are firms authorised by us, subject to the full requirements of the Alternative Investment Fund Managers Directive (AIFMD). They may also manage EuSEFs or EuVECAs following a registration of these funds with us.

5.3 In addition, EuSEFs and EuVECAs can be managed by 'small UK alternative investment fund managers' (a subset of which are not authorised by us) who have to comply with a limited number of requirements, mainly relating to reporting, as set out in Article 3 of the AIFMD.

5.4 The specialist funds are not widely used across Europe and we have received only a handful of applications for registration of EuSEFs and EuVECAs and no applications for authorisation of ELTIFs.

5.5 In DP18/10, we asked:

> **Q9:** ***Why do you think the specialised funds are not being used in significant volumes?***
>
> **Q10:** ***Are there any specific features of these funds which prevent fund managers or investors from using them to invest in UK patient capital?***

5.6 Respondents agreed there has been little interest in these specialised funds. Most respondents said this is due to complexity of the operating requirements and that many distributors are unwilling to host these funds on their platforms.

5.7 Some respondents said investor protections, like minimum investment criteria, are too stringent, limiting the number of potential investors and making these funds unattractive to product manufacturers. For example, EuSEFs and EuVECAs can be marketed to retail investors if they invest at least EUR 100,000 and state in writing that they understand the risks. ELTIFs can be marketed to retail investors, subject to a suitability test and receiving appropriate investment advice. However, if their financial investment portfolio is less than EUR 500,000 additional requirements apply, see article 30.3 of the ELTIF regulation.

5.8 A few respondents said that the investor suitability requirements are impractical, because responsibility sits with product manufacturers, not distributors. They explained this is burdensome for product manufacturers who are unlikely to have a direct relationship with investors and instead rely on information about investors passed to them by distributors.

5.9 One respondent said the ELTIF's eligible asset criteria are unclear and need further explanation by regulators.

5.10 One respondent said specialised funds have not been used because similar investment strategies can be developed within investment vehicles under the AIFMD, without such onerous obligations. One other said the lack of investor demand for access to long-term assets reduces the commercial incentives to launch a specialised fund.

Our response

We have taken the received feedback on the strengths and weaknesses of these specialist fund types into our broader considerations of how to design a regime for authorised funds to invest into long-term assets. This feedback is valuable to mitigate the risk of creating new fund types of limited consumer benefit and commercial viability.

6 Other regulatory barriers

6.1 This chapter summarises feedback on other regulatory barriers to investment in long-term assets.

6.2 In DP18/10, we asked:

> **Q11:** ***Are there any other areas where the current regulatory framework creates unnecessary barriers, either directly or indirectly, to investing in patient capital?***

6.3 Most respondents said a key barrier to investment in long-term assets is in distributors' reluctance to accommodate funds that are not daily dealing. One respondent said some platforms have been unwilling to contemplate weekly or fortnightly dealing funds, so funds offering less frequent dealing opportunities have had limited opportunity to access investors. A few respondents suggested we engage with platform providers to encourage innovation and help them host funds with a variety of dealing frequencies, some of which would be more suited to investing in long-term assets.

6.4 On dealing frequency, a few respondents said that the Individual Saving Account (ISA) rules also require funds to offer frequent rights to redemption to qualify for tax advantaged status as ISA investments. Those respondents said that any changes to allow less frequent dealing in authorised funds would also need to be reciprocated in the ISA rules.

6.5 Some respondents identified the pension charge cap as a barrier to defined contribution (DC) pension scheme investment in long-term assets. The pension charge cap is a limit on the charges within default funds for qualifying workplace personal pension schemes for the purposes of auto-enrolment, equivalent to 0.75% per year of funds under management. Respondents said the cap means DC scheme trustees are wary of the higher fees usually charged when investing in long-term assets. One respondent suggested that performance fees, which are paid on top of the ordinary management fees for positive returns, should be excluded from the charge cap. They argue this would enable DC scheme trustees to invest more in long-term assets without fear of breaching the pension charge cap.

6.6 One respondent noted and welcomed The Pension Regulator's guidance to pension trustees on investing in illiquid assets. However, they called for more to be done to improve pension trustees' training and guidance on investing in long-term assets. They said this would drive demand for investment in long-term assets by the UK's growing DC pensions market.

6.7 One respondent said barriers exist in the distribution of other investment products (eg unauthorised funds) that can already invest in long-term assets. They explained that intermediaries, such as independent financial advisors, are biased toward open-ended funds that invest in listed equities. They said the reason for this is that intermediaries are too focused on low fees, over value for money, and are fearful that diversification into alternative asset classes, like long-term assets, would create compliance risk. This respondent suggested we consider these points as part of our Retail Distribution

Review. This issue has also been raised in response to our Call for Input for the Evaluation of the Retail Distribution Review and the Financial Advice Market Review, and is being considered as part of that review.

Our response

As set out in our response in Chapter 1, we are currently working with the FPC to address mismatches between redemption terms offered to investors and the liquidity of the underlying assets in authorised retail funds. As part of this work, we are exploring notice periods for open-ended funds investing in illiquid assets. This will likely include discussions with distributors about the operational implications of any such changes where authorised retail funds use platform providers. Any proposals for change that arise from this work would be subject to public consultation in the usual way.

The ISA rules are set out in the Individual Savings Accounts Regulations 1998, which are the responsibility of HM Revenue & Customs (HMRC), see gov.uk for an overview. It is a misunderstanding that our rules, or HMRC rules, prescribe that UK UCITS schemes and NURSs must be daily dealt for ISA eligibility. HMRC rules permit UCITS schemes to be held within ISAs as well as certain NURSs. Our rules require at least fortnightly redemption for UCITS schemes and HMRC rules require the same for NURSs to be held in a stocks and shares ISA. For NURSs this must be stipulated in the instrument constituting the scheme. Schemes that apply 'limited redemptions' (as defined in the COLL section of the FCA Handbook) will not be eligible for an ISA. Nor will any scheme that has an FCA waiver to its normal redemption rules. But this does not preclude deferred redemption, provided it is implemented within the rules set out in our Handbook. QISs are not ISA eligible. We note that many retail investors invest in authorised retail funds through stocks and shares ISAs. We will engage with HMRC at the appropriate time if we consult on any changes to apply notice periods or reduce dealing frequency for authorised retail funds investing in less liquid assets, if these would have implications for ISA eligibility.

The pension charge cap is set out in the Occupational Pension Schemes (Charges and Governance) Regulations 2015, which are the responsibility of the Department for Work and Pensions (DWP). As recently as September 2019, in response to calls to reform the current 0.75% cap, the DWP told the Financial Times there is no compelling evidence that any additional changes to the charge cap are needed to allow investment in venture capital or growth equity.

7 The long-term asset fund

7.1 The IA responded to DP18/10. Their response included a draft proposal for a new type of authorised fund (the LTAF), designed to invest in long-term assets. This was the most substantive response to the DP. This chapter provides an overview of the IA's LTAF proposal and our initial response.

7.2 On 31 July 2019, the IA published its full LTAF proposal as part of the UK Funds Regime Working Group's Final Report to the Asset Management Taskforce. Please see the final report for detailed information on the LTAF.

7.3 The proposal would see the existing NURSs structure adapted to accommodate a new type of fund intended to have the following characteristics:

- authorised retail fund
- flexible investment and borrowing powers
- flexible dealing frequency
- improved liquidity management
- model-based valuations
- strong investor protection measures

Authorised retail fund

7.4 The IA anticipates that the target market for the LTAF would be DC pension schemes, professional investors and private wealth/discretionary portfolio managers. They also expect some interest from advised retail investors with large investment portfolios. However, they think there would be limited interest from retail investors investing directly in LTAFs or on an execution-only basis. The IA considers it is important the LTAF should be capable of being marketed to retail investors, whether advised or execution-only, where the fund manager assesses this to be appropriate.

7.5 DC pension schemes and professional investors can already invest in long-term assets through QISs and a range of other investment products, including investment trusts and unauthorised funds. However, the IA observe that the trustees of DC pension schemes, as professionals responsible for making investment decisions on behalf of DC members, choose not to invest in QISs and unauthorised investment products because they are more comfortable investing in authorised retail funds. The IA suggest for the LTAF to attract investment from DC pension schemes, it needs to be an authorised retail fund.

7.6 The other main target investor group, the high net worth clients of private wealth/ discretionary portfolio managers, are usually treated as retail investors. This also supports an argument that the LTAF be an authorised retail fund.

Flexible investment and borrowing powers

7.7 The IA propose the following changes to the NURSs investment and borrowing powers to create a bespoke arrangement for the LTAF to facilitate investment in long-term assets:

- allow up to 100% of the fund's net asset value (NAV) to be invested in unauthorised collective investment schemes
- allow direct investment in limited partnerships
- Remove a restriction on funds investing into schemes, which in turn invest into other schemes (second scheme restrictions) on collective investment schemes
- Allow up to 100% of NAV to be held in unlisted securities
- Relaxing of diversification rules
- Allow a wider range of derivatives to be held for hedging purposes
- Introduce an ability to originate and participate in loans
- Introduce an ability to guarantee loans

Flexible dealing frequency

7.8 The IA propose that the LTAF have flexible dealing frequencies, able to offer anything between daily dealing up to every two years. The IA say this flexibility will allow fund managers to align the LTAF's dealing frequency with the liquidity of the underlying assets.

Improved liquidity management

7.9 The IA propose that the LTAF should be able to use notice periods for redemptions to provide fund managers with sufficient time to sell underlying assets. They suggest that deferred and limited redemptions could be useful liquidity management tools for LTAF fund managers.

Model-based valuations

7.10 Since market prices are rarely available for long-term assets, the IA suggest fund managers would need to use a valuation model to consider a range of economic information relating to both the asset and the wider market. The IA believe it will not be practical to undertake daily valuations of long-term assets, but think that monthly or quarterly valuations would be more realistic. Where the LTAF is dealing at intervals more frequent than the valuations, the IA propose that daily or weekly adjustments to the fund's NAV should be made for accrued income, inflow and outflows, purchases and sales of assets. The IA say this approach would need to be disclosed to investors to give them confidence that the NAV reflects the true value of the underlying assets.

Strong investor protections

7.11 The IA suggested that if redemption opportunities are going to be less frequent than currently permitted in authorised funds, it might be reasonable to have investor suitability requirements like those required by the ELTIF. The IA suggest it might be appropriate to require investors to receive advice and/or put a limit on the amount of an individual's investable assets or pension pot that can be invested in an LTAF. The IA added that any requirements intended to provide investor protection would need to be practical for both investment product manufacturers and any intermediaries.

Our response

Finding comprehensive solutions to facilitate long-term investment through authorised funds merits careful consideration given the potential advantages for both investors and the broader economy as set out in the Government's PCR. Therefore, since the LTAF proposal was published in July 2019, we have discussed with the IA how a specialist fund type sitting within our current NURSs framework could be introduced while maintaining an appropriate degree of protection for consumers.

More work is required before we consider consulting on changes to our rules.

The proposal is unclear on which types of assets would be eligible for inclusion in an LTAF's portfolio and what contractual commitments an LTAF could make. A clear definition of in-scope assets is required to assess what a prudent spread of risk would look like and whether sufficiently reliable and fair valuations can be achieved for each asset. We also welcome more clarity on how the LTAF would deploy liquidity tools to ensure redemptions are met in line with investors' expectations.

We will consider further as the IA continues its own work on the proposals. We will also consider how the proposals might relate to the work being done by the Bank of England and FCA as part of the FPC's consideration of liquidity issues in open-ended funds (see paragraph 1.15 to 1.16).

Annex 1
List of non-confidential respondents

Aberdeen Standard Investments

Aon Hewitt Limited

Association of Consulting Actuaries

Association of Investment Companies

Association of Real Estate Funds

British Private Equity & Venture Capital Association

Company Institute and Faculty of Actuaries

Depositary and Trustee Association

Implementation Taskforce for Growing a Culture of Social Impact Investing in the UK

Investment Association

Investment Property Forum

John Forbes Consulting LLP

Joshun Sandhu

M&G Prudential

Mills & Reeve

Quoted Companies Alliance

Schroders

Annex 2
Abbreviations used in this paper

AIFMD	Alternative Investment Fund Managers Directive
COBS	Conduct of business sourcebook
COLL	The Collective Investment Schemes sourcebook
CP	Consultation Paper
CP18/27	Consultation on illiquid assets and openended funds and feedback to Discussion Paper DP17/1
CP18/40	CP18/40: Consultation on Proposed Amendment of COBS 21.3 Permitted Links Rules
DC	defined contribution
DP17/1	DP17/1: Discussion Paper on Illiquid assets and open-ended investment funds
DP18/10	DP18/10: Patient Capital and Authorised Funds
DWP	The department for Work and Pensions
ELTIF	European social entrepreneurship funds
EuSEF	European social entrepreneurship funds
EuVECA	European venture capital fund
FCA	The Financial Conduct Authority
FUND	The Investment Funds sourcebook
FPC	Financial Policy Committee
FS	Feedback Statement
HMRC	Her Majesty's Revenue & Customs
IA	The Investment Association
Illiquid assets CP	CP18/27: Consultation on illiquid assets and open-ended funds and feedback to Discussion Paper 17/1 illiquid assets
LTAF	The Long-Term Asset Fund

NAV	Net asset value
NURS	A non-UCITS retail scheme
PAIF	Property Authorised Investment Fund
Permitted links CP	Consultation on proposed amendment of COBS 21.3 permitted links rules
PCR	The Patient Capital Review
PS19/24	Illiquid Assets and Open-Ended Funds and Feedback to CP18/27
QIS	A qualified investor scheme
REIT	Real estate investment trust
The Treasury	Her Majesty's Treasury
SIV	Standing Independent Valuer
SME	Small and Medium Enterprises
TPR	The Pension Regulator
UCITS	An undertaking for collective investment in transferable securities
UK	United Kingdom of Great Britain and Northern Ireland
WEIF	The LF Woodford Equity Income Fund

All our publications are available to download from www.fca.org.uk. If you would like to receive this paper in an alternative format, please call 020 7066 7948 or email: publications_graphics@fca.org.uk or write to: Editorial and Digital team, Financial Conduct Authority, 12 Endeavour Square, London, E20 1JN

Pub ref: 007076

© Financial Conduct Authority 2020
12 Endeavour Square London E20 1JN
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk
All rights reserved