Response to the FCA's Consultation Paper 21/12 on A New Authorised Fund Regime for Investing in Long Term Assets

Submission by the Transparency Task Force, June 25th 2021

About the Transparency Task Force

The Transparency Task Force is a Certified Social Enterprise, meaning that we exist to make an impact, not profit.

The mission of the Transparency Task Force is to promote ongoing reform of the financial sector, so that it serves society better. Our vision is to build a large, influential and highly respected international institution that helps to ensure consumers are treated fairly by the financial sector.

The primary beneficiaries of our work will be consumers; but the sector itself will also benefit through improved market conduct and increased trust in the services it provides.

Our objective is to carry out a broad range of activities that help to drive positive, progressive and purposeful finance reform, such as:

- Building a collaborative, campaigning community; the larger it is the more influence it can have in driving the change that is needed
- Raising awareness of issues; so that society better understands the problems that exist in the financial sector and how they can be dealt with
- Engaging with people who can make change happen; because through such dialogue we can influence thinking, policy making and market conduct

Much of our focus is on rebuilding trustworthiness and confidence in financial services. To make this possible we are busy developing a framework for finance reform which we describe as a "whole system solution for a whole-system problem" as described in our recently published book

Our response to you has been produced by a highly collaborative group of TTF volunteers, our "Response Squad," working together to build consensus, whilst always remaining true to our "North Star" question: "What is best for the consumer?"

For further information about the Transparency Task Force see:
http://www.transparencytaskforce.org

Response to 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.

An argument might be constructed that if (and only if) long term assets are intrinsically superior to other forms of investment and the proposed Long Term Asset Funds (LTAFs) make it easier for people with protected characteristics to access them, then the proposals are progressive. If, however, those asset classes are inferior then making them more widely available to such groups could be regressive.

The consultation paper provides little if any tangible evidence about the relative merits of long term assets, so it is impossible to form a view about any impact on equality and diversity, let alone recommend policies.

Indirectly, the focus on successive 'Stewardship' reviews appears to support and align broader Environmental Social Governance (ESG) factors to long-term investing but these tend to focus on public markets of which few of these are attached to private markets (illiquid). By far the most dominant ESG focus for private markets is Impact investing and herein there is an overwhelming focus on environmental based projects over social factors.

Whereas impact investing is attached to social factors such as social housing, infrastructure debt, education such as school projects, medical centres, assisted learning centres and universities then these can facilitate a narrowing of the attainment gap among disadvantaged groups.

Additionally the industry, investing these funds, continues to face many barriers and challenges in attaining diverse and inclusive representation and this will tend to exacerbate in private markets generally, which tend to be run by those from a narrower set of socio-economic and ethnic groups. It will therefore be incumbent on progressive fund managers to address both D&I within their own firms as much as in the deployment of capital.

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 inherent complexity of illiquid asset classes means that transparency of disclosure and reporting alone will not be sufficient. Failures that have occurred within UCITS regulations highlight that reporting alone is not able to prevent liquidity issues. If a liquidity event occurs and is known then the slower dealing times eases pressure but only to a point, as it may build up pent-up redemption behaviour ahead of a quarterly dealing. Bid-offer spread management and price dilutions are effective in normal conditions but ineffective when there is a run on a fund. Increased reporting will simply amplify behaviour as we saw with the open-ended property funds most recently, where gating was employed.

Additional governance in the form of Investment Oversight Committees and Fair Value Pricing & Liquidity committees will almost certainly be needed to oversee inherently complex strategies.

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?

We agree LTAF will require a high degree of prescription to ensure orderly management.

LTAF should firstly adopt all 17 IOSCO best principles for illiquids and liquidity management. Secondly a fuller framework pulling from IFRS 9/13 is necessary. Implicitly this requires robust and independently composed Fair Value & Liquidity committees at the ACD level. Additional measures for Depositaries should be included to complement, such as; bi-annual portfolio reviews, monitoring of liquidity deterioration of the liquid portfolio versus the illiquid portfolio - a tighter regime in setting valuation than the basic IFRS Level 1, 2, 3 currently.

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

We do not agree with the proposals referenced in Q2 and Q3; in fact, we have several serious concerns, including:

1. The obligation on the AFM to mark its own homework (par 3.10) represents an obvious conflict of interest and does not deliver independent oversight that protects client interests;
2. The requirement to allocate this responsibility to an approved person (par 3.11) is an insufficient safeguard given that the FCA has never disciplined anyone under the current Senior Managers and Certification Regime[1], pointing to an absence of deterrent effect;
3. The prospectus requirement (par 3.12) is promising, but given that the core proposition appears to be that collective defined benefit schemes would be able to invest in the proposed LTAFs, an asset allocation decision that may be made on individual consumers' behalf, it is unclear to what extent end investors would be exposed to any such promotions and thus able to make informed decisions (we deal later with the questions of whether consumers will be able to understand such material, its relevance over time and the issue of whether LTAFs may be restricted to sophisticated, professional and high net worth investors, and the implications of the same);
4. It is inherent in the nature of long-term assets that the optimum hold period is likely to be long; it is therefore logical that pension money may be considered to be the optimum source of capital for such investment. It is also likely, and perhaps inevitable, that the key characteristics of a LTAF (including, but not limited to, its investment strategy, underlying assets, fund management team, governance structures, taxation, liquidity, gearing, charges, costs and, crucially, returns) will change over time. Obtaining one-time deemed assent to these features through the issuance of a prospectus, however detailed (par 3.13) at the time a client subscribes, is therefore grossly insufficient in ensuring that the AFM's obligation to ensure that its communications with clients are fair, clear and not misleading, because a prospectus that is accurate on day one will not be so 10, 20 or 50 years later. We have profound concerns about the wisdom of launching LTAFs and even about the need for them and on balance we hope they do not progress; but if they do, it is essential that a structure is established for ongoing reporting and communication that reaches underlying investors on an ongoing basis, that updates them about material changes in the factors we have identified and obtains their active (not merely deemed) consent to any departures from the initial prospectus and proposition on the basis of which each subscribed
5. Noting the ramping up of demand for private markets, the size of LTAFs needs careful consideration since we have observed with diversified growth funds (otherwise known as Liquid Alts post UCITS III) that allowing funds to grow to 'supertanker' proportions, beyond immediate scalability, is then detrimental to investment efficiency end outcomes as discussed here; https://citywireselector.com/news/supertanker-funds-all-aboard-or-time-to-jump-ship/a766021
6. The liquidity management of LTAFs needs to set down protocols so that fund managers are not enticed to hold onto illiquids as long as possible and simply use the liquid portfolio to meet large or unexpected redemptions.

[1] It is often, wrongly, claimed that Jes Staley is the exception. This is not so - he was fined under the previous rules, not the SMCR

7. Large investors of LTAFs should be further contractually obliged to allow more gradual program redemptions when over a certain limit (most easily as a % of the liquid portfolio NAV)
8. Depositaries and ACDs should have better transparency and dialogue to field and manage liquidity concerns sooner rather than operating wholly autonomously until the 12th hour, if say deciding to suspend a fund.
9. LTAF fund managers will require some structure and controls to ensure they do not attempt to game redemptions/flows between dealing points or engage in brinkmanship.
10. Pricing of LTAFs should be monitored and reflect the compositing invested. A 90:10 Fund with its majority of assets held in public markets should not cost the same as a 50:50 fund held in more expensive private markets. Some form of subsidy to the investor to reflect the liquidity premium incurred is fair.

Moreover, we are left concerned whether this entire consultation is built on a single, unevidenced and probably fallacious assertion, namely the claim (par 1.3) that 'UK investors currently invest in illiquid assets mainly through closed-ended structures. *But some investors prefer investing in open-ended funds*' (our italics).

What is the evidence that some investors would rather invest in the most illiquid classes of asset via a structure that requires liquidity in those assets in order to be certain of delivering the same to clients?

Unless compelling evidence suggests that there is significant unmet demand, we suggest that the structure best suited to making available the opportunity to invest in illiquid assets is the investment trust (IT). ITs already exist that invest in every one of the asset classes listed in the consultation document, and many of them are long established, very successful and extremely popular.

In contrast to the proposed LTAF structure, ITs deliver significantly enhanced governance and reporting. There is a independent board[2] that is independent of, and appoints, the investment manager; the board scrutinises the manager's performance and fees and can replace the manager or negotiate fees downward. Every IT is subject to the reporting requirements of a publicly quoted company, publishing annual and half-year reports and required to notify the market via the Regulatory News Service (RNS) of material developments as soon as it becomes aware of them. These documents, together with analysts' reports, are in the public domain and available to all current and prospective investors. Moreover, while the underlying assets may be valued only periodically, a combination of analysts' work and market sentiment provide a real-time, crowdsourced view about performance, expressed through share pricing and discounts or premia to the last published Net Asset Value (NAV).

Finally, there is liquidity at T-2[3], and the shareholder is notified of the price before deciding whether to buy or sell. This is achieved irrespective of market conditions and does not require the investment

---

[2] Except in the cases of a handful of self-managed ITs
[3] Sale proceeds are credited to an investor's account two trading days after a transaction takes place

manager to enter into ‘fire sales’ of assets that may poorly serve those who remain invested and potentially also damage the interests of other shareholders and stakeholders in portfolio companies.

We note that the Patient Capital Review considered that there is a shortfall in supply, relative to demand from prospective investee businesses, of one specific subset of long-term finance, namely early-stage capital for innovative, growing firms. Investment into such firms entails a very high risk of losing much or all of one’s capital, as investors in an IT launched by a prominent member of the Review’s Industry Panel, Neil Woodford, learned the hard way.

Such firms also typically consume, rather than generate, free cash, so are unsuitable for inclusion in pension schemes, except peripherally as speculative investment intended (but perhaps unlikely) to generate capital growth, long before retirement income is required.

We believe there is a risk that bracketing together this early-stage investing with much less risky, cash-generative asset classes such as property and infrastructure and encouraging collective defined contribution pension schemes to invest in them without the active consent of fully informed underlying investors, could be detrimental to their interests and may potentially constitute a future mis-selling scandal.

If there is societal benefit to increasing the supply of patient capital to early-stage businesses, tax incentives should be introduced to encourage it. If they are sufficient, the market will provide investment trusts focused on this type of investment. It should not be achieved through sleight of hand, as happened in a different context with Woodford Equity Income Fund, where consumers who thought they were buying into income-producing big-cap listed stocks were saddled with moonshots.

However, on balance, we must also acknowledge that;

The capital resources of closed-ended structures (ITs) are not themselves infinite and are reliant on sufficient order flow to maintain liquidity. Secondly by being quoted on an exchange the closed ended fund can technically be suspended preventing liquidity. Thirdly closed ended structures often price to discount or premium to Net Asset Value (NAV) and retail investors typically do not understand how changes in the discount/premium can impact returns and income from the closed ended fund. To this extent any imbalance in the order book (demand/supply ergo liquidity) is priced as a discount or premium to the NAV subject to any buybacks or new issuance from the trust.

Nonetheless ITs do operate more effectively than open-ended funds (currently) when invested in illiquid assets (as typified by et Woodford and open-ended property funds) where media induced herding were difficult to control. A significant expansion in the listed closed-ended market would probably be necessary to meet the ambitions of the LTAF proposal.

Consideration too needed that any LTAF investing into closed-end funds on an investment exchange would benefit from the daily dealing of the trusts whilst enjoying slower dealing on the LTAF. It is possible (but tenuous) that such a structure might create feedback effects from the exchange to the closed ended fund and back to the LTAF. We also observe that REITs were not impervious to the reported illiquidity of open-ended property funds with Hammerson, British Land etc all pricing a -20% increase in discount. Yet neither REITs nor AIC received very little criticism or coverage. Instead AIC embarked on a fairly obtuse propaganda campaign to suggest REITs did not have liquidity risk.

Mindful of the above LTAFs may be better structured as Funds of Investment Trusts; whilst ever mindful of the 'Split Caps' debacle of the early 2000s.

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?

We disagree that LTAF is well suited to the DC Default 'auto enrolment' regime/market. Inclusion will be challenging on two accounts;

Firstly the cost 'cap' for pension schemes will be cost prohibitive for most LTAFs. This will lead to cost cutting measures in order to meet the cost cap and will likely lead to sub-optimal outcomes.

Secondly DC Default and 'Pathways' allow varying access to the pension pot from age 55 onwards. They are also linked to Drawdown which implicitly requires a level of sustainable and regular income. Here the Asset mix of the LTAF may be ill-fitting leading to people burning through pension pots in drawdown that otherwise expected. Meanwhile transitioning from LTAF into a more suitable drawdown portfolio itself will be operationally challenging, may create liquidity events and prove costly to customers.

As previously noted, any design or launch of LTAF should invoke clear SMCR accountability and approval processes. Master Trusts may be well placed if adequately competent. Presence of IGC will be insufficient alone to manage and more technical Investment Oversight Committees required with independent members. Eg. As at Royal London
https://www.royallondon.com/pensions/investment-options/investment-governance/

Some form of DC Feeder structures might be viable to allow a gradual investment into LTAFs, which could be carefully monitored and controlled and aligned to the product lifestyling feature common to most D.C. products.

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?

Careful review of LTAF should be consistent with COBS 21.3. Secondly assets need to be reviewed on their cash flow merits. Areas of concern pull from past experiences such as Arch Cru and Connaught including; private debt, infrastructure debt, private equity, single project investments, certain REITs, certain VCTs, SEIS and EIS schemes, Alternative Investment Funds (AIFs), offshore LLPs, distressed debt, traded life policies, equity release plans, unrated debt, Hybrid debt, Special Purpose Vehicles, real estate related, direct commodity, crypto currency, structured notes and OTC contracts.

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?

Yes as this restricts the investor types that can access. Careful consideration is needed before exposing LTAF to retail or DC Investors. The QIS regime would be a good starting place.

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.

Yes and we believe the target market should be restricted in the first 3-5 years of LTAF availability to allow time to test outcomes and allow a gradual deployment of capital. To this end UCIS, NMPI, NRRS restrictions and COBS 4/PS13/3 should apply.

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?

LTAF will introduce a much higher degree of complexity, investment flexibility, illiquidity and means to stymie investors from redeeming investments. This can create a conflation of negative factors in the event of a liquidity event. Careful roll out (first within NMPI eligible investors) will be needed. FCA would also need to have a clear view and confidence that financial advisers and wealth managers were sufficiently competent to advise on LTAFs before any broader roll out.

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

The assessment will not prevent investors being mis sold or advised into LTAFs. While an appropriateness assessment will be required at some stage in the LTAF process; the assessment alone would act more of as a placebo than as a protection, Use of LTAFs would be best invested via a competent fiduciary with clear accountability.

We saw similar issues arise following the roll out of UCITS 3 and AIFMD. The fare works and reporting were not enough and robust fund governance and regulatory enforcement will be needed. Deployment of expert independents (iNEDs) may have useful benefits.

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?

Yes and we believe the target market should be restricted in the first 3-5 years of LTAF availability to allow time to test outcomes and allow a gradual deployment of capital. To this end UCIS, NMPI, NRRS restrictions and COBS 4/PS13/3 should apply.

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?

As retail investors can have amassed sizeable investment pots from DB transfers and accrued personal pension plans and ISAs then it is wrong to assume that a minimum subscription level alone would protect Retail investors.

A minimum investment of between £5-50m per investor would be sensible. However LTAF distributors will also need to ensure that their holder mix is not left overly concentrated after a reasonable period of book building. In this respect managing demand liquidity in line with AIFMD requirements and the latest FCA updates is sensible for LTAF.

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

We do not believe FAIFs should be allowed to operate as LTAFs due to the inherent complexity incurred. We believe the FAIF regime could be maintained but to port into LTAF would allow hedge fund style strategies into the LTAF market and potential at spiralling costs.

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

A much clearer focus on recommended holding periods (RHP) that far exceeds the dealing frequency of the LTAF and beyond the UCITS RHP of 5 years.

Consider making LTAFs quasi-mutual (fundholder owned) so that investors are incentivised to lock in their investment for longer. Each anniversary bonuses, profit sharing, AGMs on key issues, remuneration, personnel etc.

Consider fee innovation structures to help promote value and align outcomes.

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?

LTAF could be sold to qualified overseas investors, Institutions and sovereign wealth funds. This would help diversify the investor base in LTAF, but the investor mix would need to be carefully managed.

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?

Potentially LTAF could be added to COBS 21.3 but the obstacles will include:

- Ensuring sufficient governance in situ

- Cash matching to the insurance contract
- Contractual alignment of redemption cycles
- Efficient box management; etc.

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

Yes, but we feel that the LTAF proposition should be fully proven before such links are considered.