Long Term Asset Fund

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Do the final rules make the LTAF regime a game-changer?

In this brief paper we look at what an LTAF is, what are the changes in final rules and whether these changes would make the LTAF a game-changer for DC pensions schemes.

At a glance...

We see the Long-Term Asset Fund ('LTAF') as a welcome development in the illiquid space and think the changes in final rules show the Financial Conduct Authority's ('FCA') strong commitment towards the LTAF regime. We believe there are still some areas which need more consideration, and we would be engaging with fund managers to get an understanding of their plans for the development of their forthcoming LTAF funds.

Background

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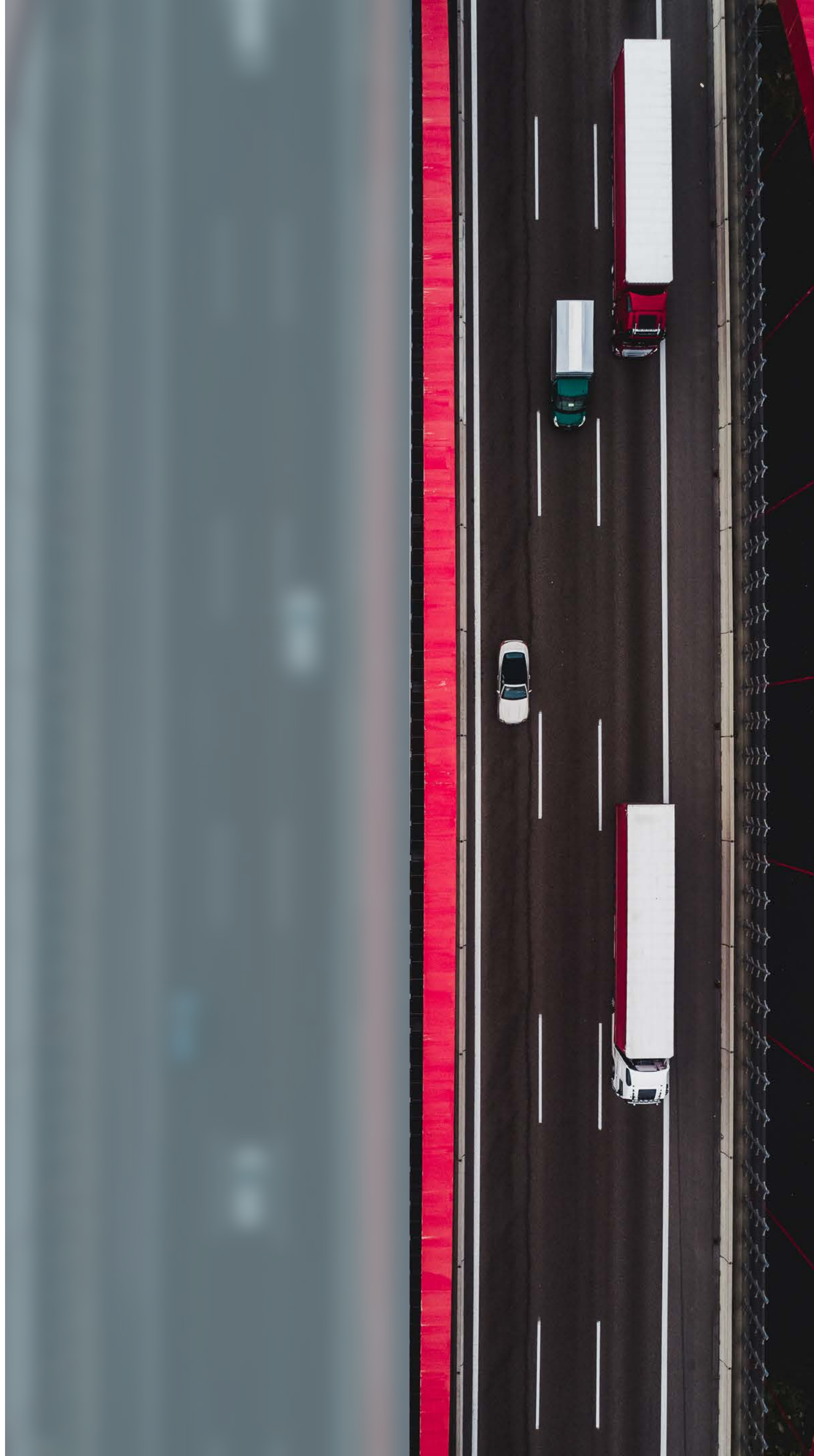
The FCA has found that a large proportion of investors with long-term investment horizon are not investing in illiquid assets. In fact, the FCA reported that according to a recent survey commissioned by the Department for Work and Pensions ("DWP"), two-thirds of DC schemes do not invest in illiquid assets. They note that DC pension schemes with default funds in particular are not investing enough in this space despite the long term nature of their investment horizon. The FCA also noted that an ability to invest in illiquid assets can not only provide a useful alternative investment opportunity for long-term investors but also support economic growth and the transition to a low carbon economy for UK.

The FCA has therefore worked with the government and industry to design the LTAF regime to encourage and facilitate more investment in long-term illiquid assets through an appropriately designed and managed investment vehicle. The FCA has made clear that all LTAFs must be authorised by the FCA and that they can only be managed by authorised full-scope UK Alternative Investment Fund Managers ("AIFMs").

The FCA considers the DC pension schemes as the target market for LTAFs.

LTAFs are structured as open-ended funds with appropriate structural safeguards to provide some degree of investor protection. Traditionally, investors had access to long-term assets via closed-ended structures such as limited partnerships, venture capital trusts and investment trusts. However, the FCA hopes that the provision of an authorised fund with an open-ended structure should eliminate, to some extent, the illiquidity issues associated with closed-ended funds and help the UK compete on a global stage.

The idea of LTAFs was first proposed in 2019 by the Investment Association and since then the government, regulators and industry have worked together to develop proposals on the LTAF regime which were recently finalised.



Evolution of Long Term Asset Fund

The timeline below shows the evolution of LTAF:

June 2019	November 2020	May 2021	October 2021	November 2021	2022
LTAF was proposed by Investment Association in its UK Fund Regime Working Group	Chancellor of exchequer announced ambition to launch the first LTAF within a year	FCA published its consultation paper "CP21/12: A new authorised fund regime for investing in long term assets (fca.org.uk)"	FCA published its policy statement "PS21/14: A new authorised fund regime for investing in long term assets (fca.org.uk)"	LTAF regime was launched on 15 Nov. 2021	The FCA is planning to do further consultations in a few areas

What has changed in the final LTAF rules?

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Since the publication of its proposal, the FCA has held various consultations and taken wider industry feedback to develop the rules.

The final rulebook has addressed some key industry concerns in several areas which include:

- Investment Strategy and Powers
- Liquidity
- Valuation
- Distribution
- Permitted link rules

More details on the final changes can be found in the appendix.

What has changed in the final LTAF rules?

We see the LTAF regime as a welcome development and are supportive of the FCA's proposals to extend the range of vehicles which allows DC pension scheme members to access long-term investments such as illiquids. Having an FCA authorised fund which invests in long-term assets broadens the choice to investors by widening the investment options available. More importantly, we believe the purpose of launching the LTAF regime is to provide an open-ended fund structure that enables investment in illiquids while offering structural safeguards, additional oversight, and governance of an FCA authorised fund.

Please see our following thoughts on some of the areas which we believe remain areas of concern:

Liquidity

There are some existing open-ended illiquid funds for DC schemes that offer daily liquidity mainly facilitated via an allocation to diversified listed private markets. But a potential problem with such funds is that they can create a liquidity mismatch, which is both hard for fund managers to deal with and potentially brings wider systemic risks.

The FCA wanted consistency between the notice required from investors to redeem and how long it will take an LTAF realistically to sell its assets. So, one of the changes the FCA made to the final rules include the LTAF requiring at least a 90-day notice period with no more frequent than monthly redemptions.

Although the changes to the liquidity rule might help with the liquidity mismatch issue for the managers, the idea of waiting 90 days to get money out of funds might not be welcomed by members and platform providers. Members of DC pension schemes expect their pension funds to be priced daily, as well as being able to switch or access funds without any delay. Some platforms might not be operationally ready to accommodate this. Schemes will also need to explore how to manage liquidity within the default fund, when a certain proportion in an LTAF is not readily realisable. We believe this is something that would require careful and detailed planning to ensure smooth functioning of schemes' operations.

Depository ownership

For now, the FCA will retain the rule which requires the depositary to take legal ownership of an LTAF's assets. Given the burden that this places on depositaries, the FCA will consider modifying or waiving the rule in specific instances. Given any changes to the legal ownership rules affect all types of UK authorised funds, the FCA will consult separately on proposed amendments in the first half of 2022. We believe the depositary community is hoping for an amendment in due course to avoid becoming the legal owner of an LTAF's assets.

Fee

The fee issue also needs to be carefully addressed. The DWP is considering how to accommodate the fees within the DC charge cap to ensure the charge cap rules do not present a barrier to the success of the LTAF regime. The charge cap applicable to DC pension schemes is an important factor and it remains to be seen how successful this will be for LTAFs.

Aon’s current view of the final LTAF changes

We think FCA has accommodated the majority of the industry’s feedback. The final changes are in a positive direction but there remain some areas of concern which need to be addressed. In our opinion, the final changes do not yet make the LTAF regime a game changer for DC pension schemes. However, we will be engaging with fund managers to get an understanding of their plans for the development of their forthcoming LTAF funds. We will continue to monitor this space and will keep our clients informed of future developments.

Appendix: Changes in final rules

This table shows the changes in rules since the last consultation

Category	What were the concerns in previous consultations	What has changed since the last consultation	Does the change in final rules resolve the concerns
Investment strategy and powers	To secure an appropriate degree of consumer protection for investors in LTAFs, we plan to require an LTAF to have a prudent spread of risk. The original proposal noted that LTAFs should have 24 months to achieve a prudent spread of risk.	The final rules do not include the original proposal that LTAFs should have 24 months to achieve a prudent spread of risk. Instead, the LTAF is allowed time to build up its portfolio, but it should not engage in excessive concentration of risk during the start-up period.	The final rule is a welcome change as it provides some flexibility to the LTAF. However, it is important that the LTAF does not engage in excessive concentration of risk during this time.
Liquidity	The original proposals allowed an LTAF's manager discretion to set dealing frequency to align with the liquidity of its investment strategy while also allowing the fund to be daily dealt.	The final rules impose requirements for an LTAF of a mandatory notice period of at least 90 days for redemptions and a requirement that LTAFs cannot offer redemptions more frequently than monthly.	The changes to the liquidity rule might help with the liquidity mismatch issue for the manager. However, the idea of waiting 90 days to get money out of funds might not be welcomed by members and platform providers.
Valuation	The proposed rules on who carries out valuations provide that, for a manager of an LTAF (rather than an external valuer) to carry out valuation, the depositary must determine "without qualification that the manager possesses the knowledge, skills and experience required".	The manager of an LTAF will be required to appoint an "external valuer", unless it can demonstrate that it has the competence and experience to value the types of assets in which the LTAF invests. In a change to the draft rules, under the final rules the depositary will only be required to determine that the manager of an LTAF has the "resources and procedures" for carrying out a valuation of the assets.	The UK's current Alternative Investment Fund Managers Directive ("AIFMD") states that an external valuer is liable to the manager of the fund in respect of which the external valuer is appointed for any losses suffered by the manager because of the external valuer's negligence. There is no corresponding revision to the rules to ensure that external valuers are only liable in instances of gross, rather than simple, negligence in valuation, although the FCA and HM Treasury recognise that this is currently a barrier to external valuers being appointed to all alternative investment funds. For the market for external valuers to work better, they are exploring a relaxation of some of these rules which derive from AIFMD.
Distribution	The distribution of LTAFs to retail investors was a very controversial aspect of the initial consultation with quite diverging views during the consultation period.	The FCA has taken the significant step of allowing LTAFs to be sold to certificated high net worth investors as part of a diversified portfolio via an amendment to the non-mainstream pooled investment ("NMPI") rules. The NMPI rules are widely regarded as quite strict and often unworkable either for their complexity or for their attendant liability concerns (or both). This means LTAFs will be subject to the NMPI promotion rules meaning they can only be promoted to professional investors and only limited retail investors.	There were some concerns in opening up investment in less liquid assets to the mass retail market so the FCA has only opened LTAFs up to limited retail investor with strict NMPI rules to be followed. After acknowledging that respondents had significant concerns about the use of the NMPI rules for LTAFs, the FCA has stuck to its guns and provided for the NMPI rules as a "first step" in allowing retail access to LTAFs. It will consult in the first half of 2022 on broader access.
Permitted link rules	Previously there was a 35% cap on illiquid investments within any unit-linked fund. DC pension schemes are the target market for LTAFs and this rule meant that LTAF managers would find it difficult to market LTAFs to DC pension schemes.	To make LTAFs more attractive to DC pension schemes, the FCA will change the 'permitted links' regime, to treat an LTAF as a permitted link in its own right. This will exempt LTAFs from the 35% cap on illiquid holdings that currently applies to unit-linked funds.	The FCA has taken on board feedback received during the consultation and has made some changes to its permitted link rules to ensure its policy aims are achieved.

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About

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