Focusing on Funds:

The Long-Term Asset Fund (LTAF)

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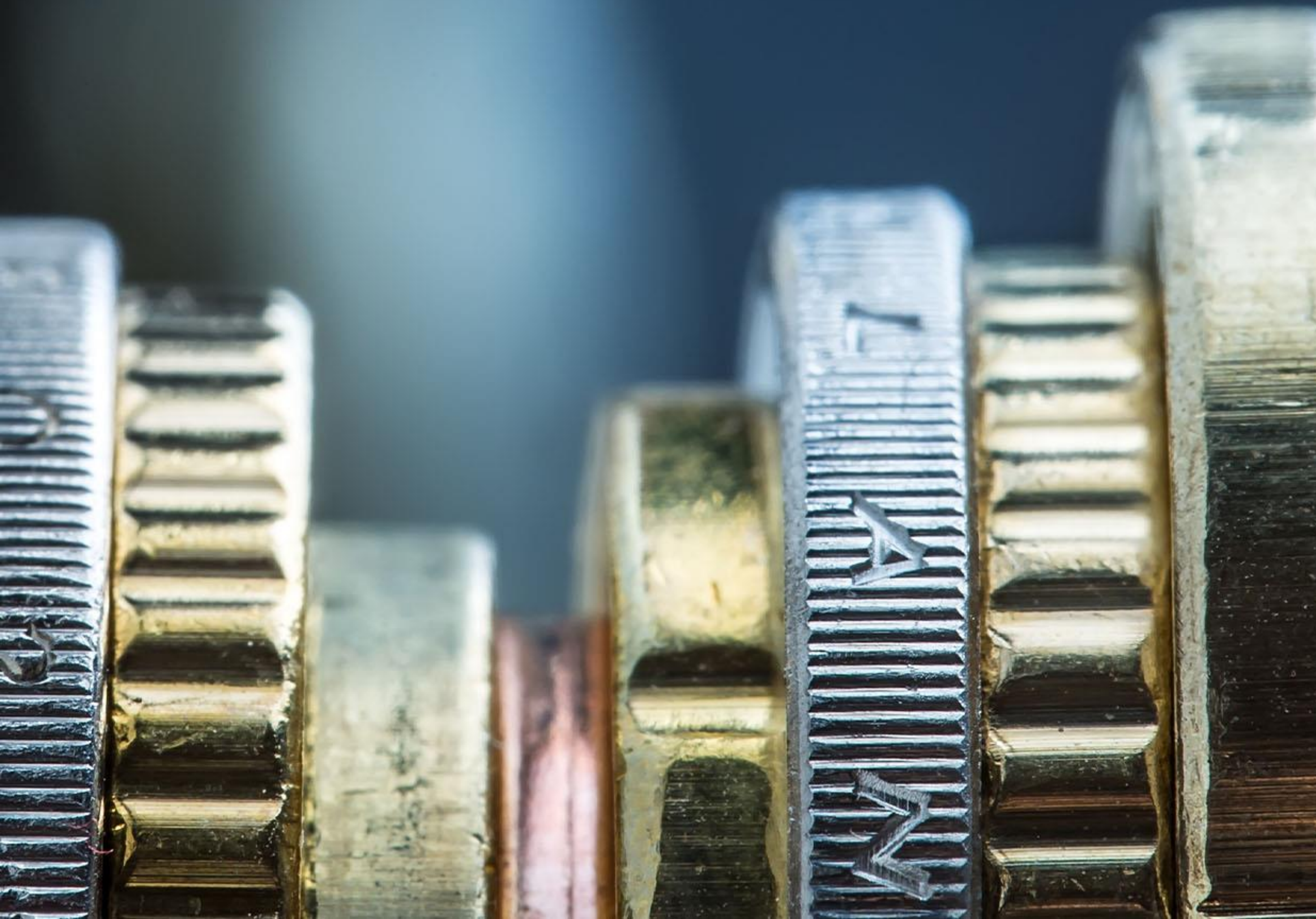

Focusing on Funds – The Long-Term Asset Fund (LTAF)

This Focusing on Funds looks at the new LTAF regime that takes effect today. The LTAF, a new category of UK authorised collective investment scheme is intended to promote investment by professional investors (including pension funds) and sophisticated investors in long-term, illiquid assets.

Why is this relevant to fund managers?

Any new type of fund will be of interest to UK fund managers; and with the UK government actively promoting investment in long-term assets, the degree of political support backing the LTAF will only add to that interest, not only from fund managers, but scheme promotors and investors too. However, while the development of a new category of authorised fund is to be welcomed, what remains to be seen is whether the authorisation process and the prescription of the FCA's rules will enable the LTAF to truly compete with existing, established alternatives.

Background

The provision for the LTAF is part of a wider drive from the government and the Bank of England to direct pension investment towards illiquid UK assets to support the country's recovery after the Covid-19 pandemic. As stated in an open letter from the Prime Minister and the Chancellor to the pensions industry, the government's strategy is to ignite "an Investment Big Bang, to unlock the hundreds of billions of pounds sitting in UK institutional investors and use it to drive the UK's recovery". To further support this strategy, within the Budget 2021 the Chancellor announced a plan to make additional changes to the charge cap - currently 0.75% on the default arrangement of certain employer pension schemes – to encourage trustees of DC pension schemes to consider investing in long-term assets. The structure and nature of the LTAF has therefore been designed to allow investment flows towards assets such as infrastructure, private equity and real estate from investors that have historically been reluctant to invest in long-term assets, despite such assets being in line with their investment horizons. The potential benefits for investors could include higher returns as well as improved risk management due to a wider portfolio diversification.

The FCA consulted on draft rules for the LTAF in May 2021 in its Consultation Paper 21/12 (CP 21/12), and it has recently published the final rules in the its October Policy Statement PS21/14 (PS21/14). These final rules are broadly consistent with the draft rules the FCA consulted on, with the addition of some adjustments made to reflect industry feedback and which are discussed below.

What is the LTAF?

LTAF is a new category of UK authorised open-ended fund. An authorised fund is one which is authorised and regulated by the FCA. The LTAF will sit alongside the other 3, well-established, categories of UK authorised fund: UK UCITS; Non-UCITS retail scheme (NURS); and Qualified Investor Scheme (QIS).

A new discrete chapter of rules within the Collective Investment Schemes sourcebook, COLL 15, will apply to LTAFs, their managers and (in respect of certain requirements), their depositaries.

What form can it take?

LTAFs can take one of the following legal forms:

- authorised contractual scheme (ACS) – either a co-ownership scheme or an authorised limited partnership scheme
- authorised unit trust (AUT)
- open ended investment company (OEIC)

As the legal form of LTAFs is no different from existing legal forms, there is no separate tax regime applicable to LTAFs. This means that LTAFs structured as OEICs whose scheme property comprises predominantly directly-held real estate or shares in REITs (or similar) could elect into the property authorised investment fund (PAIF) regime, which remains subject to the pre-existing tax legislation. This also means that prevailing seeding reliefs may also be available.

LTAFs may also be structured as feeder or master funds.

Who can manage it?

The LTAF is a type of alternative investment fund (AIF) which, as a reminder, is defined under AIFMD as

> *"any collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not require authorisation pursuant to the UCITS Directive".*

In order to ensure a higher degree of consumer protection, only a firm that is authorised as a full-scope UK AIFM with permission to manage an **authorised AIF** and which has the *"knowledge, skills, and experience of managing the appropriate asset classes*" can manage a LTAF.

AIFMs should check that they have the requisite permissions to manage an authorised AIF. Full-scope AIFMs which only have permission to manage an unauthorised AIF or small authorised AIFMs will, if they want to manage a LTAF, need to submit a Variation of Permission ("VoP") application to the FCA. Typically, the CIS Authorisations Team will not consider an application for fund authorisation from a manager until it has the necessary permissions.

In line with the rules for the other types of authorised funds, the FCA also requires the AIFM of a LTAF to:

- appoint a minimum of two independent directors to its board (with independent directors to account for at least 25% of the total board membership); and
- carry out a Value Assessment at least yearly and report publicly on its conclusions.

As the LTAF will be a form of AIF, the rules provide that a depositary must be appointed for the safekeeping of the fund's property; this extends to all property in registered form. This remains a controversial aspect of the FCA's rules as it gold-plates AIFMD requirements in respect of non-custodial assets and the rules, as made, could create risk and liability issues for depositaries. FCA acknowledged in its response that the prevailing rules around ownership of assets for NURSs and QIS, which it has maintained for LTAFs may not work for all the eligible LTAF asset classes. FCA has committed to a consultation on an alternative model in 2022. In the meantime, FCA are open to considering waiver applications from firms and their chosen depositary who wish to launch an LTAF under the current rules. It is to be noted, however, that FCA recommend that firms approach FCA before submitting any such applications.

The LTAF manager must also appoint an external valuer unless exempt under the rules. The FCA has responded to feedback in respect of its proposals on valuation and no longer stipulates that the depositary needs to make an assessment "without qualification" as to whether the manager has the competence to act as an internal valuer. Instead, the requirements of UK AIFMD are reflected.

What can it invest in?

The FCA expects LTAFs to invest “at least” 50% of its asset value in long-term, illiquid assets. These could include:

— Private equity

— Private credit

— Venture capital

— Infrastructure

— Real estate

— Forestry

— Collective Investment Vehicles that invest in private asset classes, including limited partnerships

— Precious metals

— Unlisted securities

Despite the government’s call to direct investors’ capital towards UK assets to promote national financial recovery, LTAFs are not limited to investment in UK-only assets.

There is an over-arching requirement for the manager to maintain, at all times, a prudent spread of risk. This aligns to the FCA’s designs to have high levels of flexibility. Indeed, FCA took on-board comments through the consultation to amend certain of its investment proposals, including those pertaining to loans, removing some of the prescription on the types of permitted loans.

There remain, however, some disappointing constraints particularly around the due diligence that managers will need to undertake in relation to investment in certain schemes. Any manager wishing to invest more than 20% in unregulated schemes, QISs and other LTAFs must effectively – on a reasonable efforts basis - replicate the due diligence requirements imposed on NURSs. This could limit the appetite for managers wanting to operate fund of fund strategies.

Who can invest in it?

The LTAF framework has been designed primarily to target professional investors, particularly DC pension schemes, as well as sophisticated retail investors (as defined in COBS 4.12.7 R) in line with non-mainstream pooled investment (NMPI) rules. Following consultation, the FCA has marginally widened the distribution rules to allow LTAFs to be marketed to certified high net worth individuals.

The FCA is planning to consult in the first part of 2022 on a potential relaxation of the LTAF promotion rules to potentially allow for distribution to retail investors “in a controlled way”. While it remains to be seen what exactly the FCA mean by this, such a move could benefit not only a broader range of investors seeking portfolio diversification but also fund managers; as enabling access to a wider investor-base would bring with it more scale, thereby providing a greater chance of product viability.

What else should I know about the LTAF?

Redemptions

The redemption policy of a LTAF must be aligned to its investment strategy and the liquidity profile of the scheme. It can also be expected that the distribution strategy and intended target market should also be taken into account in defining the redemption policy. It is clear that LTAFs are not intended to be daily dealing. At an absolute minimum, the rules require investors to give 90 days’ notice of redemption requests and dealing to effect such requests is not allowed more frequently than monthly.

The rationale behind these redemption terms is to achieve consistency between the notice required from investors to redeem and how long it will take the LTAF realistically to sell its assets, in order to avoid a liquidity mismatch within the fund and potential wider systemic risks. Given FCA concerns around liquidity in authorised funds, it is anticipated that the FCA will closely scrutinise not only the proposed redemption provisions in the draft documentation but also the liquidity profile and monitoring documents submitted as part of the application for authorisation.

In setting the redemption terms, managers wishing to structure their LTAF as an OEIC should be alive to the requirements of section 263(3) Financial Services and Market Act 2000; namely the requirement to satisfy the “investment condition” in order to qualify as an “open-ended investment company”. The investment condition broadly encompasses a requirement that a reasonable investor would expect to be able to realise their investment in the scheme within a reasonable time. As the FCA sets out in PERG 9.7, In the FCA's view, what underlies the test is what a reasonable investor (taking into account the characteristics of the target investor) would think they were getting into if they were contemplating investment in a particular body corporate.

Commitments

Closed-ended funds often operate a commitment approach to subscriptions. The FCA have not ruled out such an approach applying for LTAFs and it is possible to structure subscriptions in this way, although the rules are silent on the point. Early pre-application discussions with FCA are recommended if a manager wishes to adopt such an approach.

Borrowing

The ability for LTAFs to borrow is limited. Borrowing is capped at 30% of the net asset value (NAV) of the scheme; as such this may constrain investment in infrastructure and other similar asset classes. The capping of the extent of borrowing is more restrictive than the QIS, which may borrow up to 100%, and potentially puts the LTAF at a disadvantage to other private funds.

Reporting

Distinct from requirements in relation to other authorised funds, LTAF managers will be required to produce quarterly reports providing basic information on portfolio developments. This is intended to compensate for the fact that investors will not be able to readily find market information on the illiquid assets in which the scheme is invested. The report needs to be produced within 20 business days of the end of the relevant quarterly reporting period. This is in addition to annual and half-yearly reporting requirements.

How does the LTAF compare to offshore alternatives?

In the table below we give an overview of how the key features of the LTAF compares to some of the most popular off-shore alternatives: Lux Specialised Investment Funds (SIFs) and Irish Qualifying Investor Alternative Investment Funds (QIAIFs).

	LTAF	Lux SIF	Irish QIAIF
Jurisdiction	United Kingdom	Luxembourg	Ireland
Regulatory Authority	FCA	Commission de Surveillance du Secteur Financier (CSSF)	Central Bank of Ireland (CBI)
Type of fund	Open-ended	It may be open-ended or closed-ended	It may be open-ended or closed-ended

	LTAF	Lux SIF	Irish QIAIF
Redemption terms	Minimum 90-day redemption notice, no more frequent than once a month	Flexibility in relation to redemption terms	CBI requires that the time between submission of a redemption request and payment of settlement proceeds usually must not exceed 90 calendar days
Structure	— Body corporate (OEIC) — Unit trust — Contractual form (Co-ownership ACS) — Limited Partnership (LP ACS)	— Body corporate (SA, SCA, S.à r.l., SCoSA) — Contractual form (FCP) — Limited partnership (SCS, SCSp)	— Investment company — Unit trust — Common Contractual Fund (CCF) — Investment Limited Partnership (ILP)
Management	Full-scope UK AIFM only, which may delegate in accordance with AIFMD (as implemented in the UK)	When structured in contractual form (FCP), the SIF must always be managed by a Luxembourg management company within the meaning of Luxembourg law of 17 December 2010 related to undertakings for collective investment. Corporate vehicles may be managed by an external AIFM (which may either be a registered or authorised AIFM, as applicable) or may be self-managed entities. A limited partnership must have at least one limited partner and one general partner. The limited partnership may, but need not be, managed by the general partner. Each of the general partner or the limited partner can serve as the SIF's AIFM; alternatively, the SIF can appoint a third-party AIFM. The AIFM may delegate some of its functions in accordance with AIFMD.	Corporate vehicles may be managed by an external AIFM or may be a self-managed entity. Unit trusts and CCFs must appoint an Irish-domiciled AIFM. The ILP is managed by a general partner. The general partner can be the AIFM under AIFMD or can appoint an AIFM.

	LTAF	Lux SIF	Irish QIAIF
Investment Restrictions	At least 50% in long-term, illiquid assets. The principle of prudent spread of risk applies. This requirement matches the standard expected of a UCITS or NURS but is more onerous than that of a QIS, which is only required to have a spread of risk. May only borrow up to 30% of the scheme's NAV.	No restriction on eligible assets. The main requirement for the SIF is in principle not to invest more than 30% of its assets in securities of the same type issued by the same issuer.	QIAIFs are subject to very few investment restrictions and no borrowing or leverage limits apply. For example, corporate vehicles must comply with the aim of "spreading investment risk" and must include this requirement in their constitutional document.
Eligible Investors	— Professional and sophisticated investors — Certified high net worth individuals If the LTAF takes the form of an ACS, additional eligibility criteria apply.	Investors who qualify as "well-informed investors", which are institutional investors, (ii) professional investors, or (iii) investors who have confirmed in writing that they adhere to the "well-informed" investor status, and who either invest a minimum of EUR 125,000 in the SIF or have been assessed by a credit institution, investment firm or management company which certifies the investors' expertise, experience and knowledge in adequately appraising an investment in the SIF.	Qualifying investors must invest at least €100,000 and: — Certify they are an informed investor and provide certain written confirmations; or — Be a professional client, as defined by MiFID; or — Receive an appraisal from an EU credit institution, MiFID firm or UCITS management company that they have the appropriate expertise, experience and knowledge. CCFs only permit institutional investors.

Timing

COLL 15 is effective from 15 November 2021.

In line with other forms of authorised AIFs, the FCA has up to 6 months from the date on which it receives a complete application to make a determination on the application. The FCA has not yet published any indicative shorter timeframes for their review, and it is expected that the first LTAF applications will take the full 6 months to allow the FCA to get comfortable with the documentation. While the length of time for authorisation could be perceived as a disadvantage, some categories of investor might welcome the fact that the scheme will be subject to the full rigour of regulatory scrutiny rather than a lighter-touch regime.

How can we help?

Our funds and tax teams have been involved in several working forums drafting responses to the FCA's LTAF consultation and have been closely monitoring developments, as well as speaking with industry participants, including distributors and potential investors about any perceived challenges presented by the LTAF.

Our UK authorised funds team has a Tier-One ranking in the UK's Legal 500 Guide and has significant experience and expertise in setting-up all forms of UK authorised funds across all asset classes. Drawing on internal specialist sector expertise, particularly in real estate, private equity and infrastructure and our experience in structuring commitment subscription approaches for other authorised funds, we can help support any fund manager, or investor, interested in the LTAF through:

- Planning and structuring
- Drafting and submitting VoP applications
- Drafting scheme documents
- Advising on, and drafting waiver applications
- Dialogue with FCA
- Obtaining FCA approval
- Ongoing advice and support

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