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Response by email to cp22-14@fca.org.uk

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Response to FCA CP22/14 Broadening retail access to the long-term asset fund

We, the Association of Real Estate Funds[1] (AREF), welcome the opportunity to respond to the above consultation. We are delighted to see that the FCA are proposing to broaden retail access to the long-term asset fund (LTAF). This will give retail clients the opportunity to benefit from diversification of their portfolio into illiquid assets when investing for the long-term such as for their pension.

We have attached our response to the questions posed in the consultation paper. We would like to highlight some pivotal points in ensuring the success in operating the LTAF.

ISA and SIPP eligibility

We have noted in our responses to Questions 1 and 15 that retail investors like to use tax wrappers such as ISAs and SIPPs when investing. The retail investors, who will be permitted to invest in the LTAFs under the CP22/14 proposals, should be entitled also to invest via ISAs and SIPPs. Not enabling them to use an ISA to invest in a LTAF and discouraging SIPP providers to offer LTAF as it is classified as a non-standard asset, will unreasonably restrict the number of retail clients who will wish to benefit from investing in the LTAF. We appreciate that ISA eligibility is a matter for HMT and HMRC and we have made our views clear to HMT when they consulted on ISA eligibility for authorised property funds with notice periods. The SIPP rules however are within the control of the FCA.

LTAF valuation practice

AREF, RICS and some of our members have been raising concerns with the FCA since April 2022 regarding how the asset valuation rules for the LTAF differ from the QIS. Valuers believe the LTAF rules, as they stand, could be construed as they should provide a “fire sale” valuation. We had expected clarity from the FCA on this before now as this appears to be a relatively straightforward matter. Until the FCA responds we understand that these concerns represent a barrier to managers progressing plans to launch LTAFs.

Liability of external valuer

When AIFMD was transposed into UK law, AREF and other associations requested that the UK Government reform Article 19(10) of UK AIFMD so that valuers are not required to accept unlimited liability for what would be “simple negligence” under UK law. We understand that the FCA and HMT are considering how to remove this requirement. The removal of the requirement could facilitate external valuers being prepared to service the LTAF and other funds that operate under UK AIFMD.

[1] The Association of Real Estate Funds represents the UK real estate funds industry and has around 60 member funds with a collective net asset value of more than £64 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the AREF Property Fund Vision Handbook.

Legal ownership of non-custodial assets

We appreciate that the FCA plan to consult on amending the requirement for the depositary to be the legal owner of a non-custodial assets. We understand that the FCA and the Depositary and Trustee Association (DATA) have been exploring alternative models for the registration of asset such as real estate. We would ask that amendments to the rules are expedited to ensure this doesn't become a barrier to the launch of LTAF.

Platforms

Until more investment platforms can accommodate non-daily dealing funds, we believe this will be a major barrier to most retail clients investing in LTAF and this needs to be resolved.

The FCA's Consumer Duty sets the standard of care that firms should give to customers in retail financial markets. In FCA FG 22/5[2] para 2.20 it states that

> *The platform provider: As a manufacturer, the firm must develop the platform, including decisions over the range of investments it provides, to meet the needs and characteristics of a target market.*

In the case of a platform provider offering investments for pension schemes, we suggest the provider should cover a diversity of liquid to less liquid (often called "alternative") products taking into account the outcomes for the pension holders and need to optimise long-term returns. In this respect, platforms should be giving retail investors access to investments like the LTAF to meet the needs of retail investors who wish to save for the long-term.

Education of advisers

To ensure retail clients are given the opportunity to invest in LTAF when it is appropriate for their long-term investments, we believe that advisers would benefit from education on the LTAF once the new proposed rules have been implemented.

We understand that the Productive Finance Working Group is producing education material on illiquid assets for DC pensions. We would suggest this initiative is expanded to producing educational material for advisers too.

Sequencing of valuations

It has been mentioned to us that where a LTAF is holding multiple types of assets the sequencing of valuations could be an issue. There needs to be flexibility in this, including the ability to use stale valuations for assets that are not valued as often as other assets.

Our detailed response to the consultation is set out in the annex that follows. Please contact either myself (prichards@aref.org.uk) or Jacqui Bungay (jbungay@aref.org.uk), Policy Secretariat at AREF, to discuss any aspect of our response.

Yours sincerely

Paul Richards

Managing Director, The Association of Real Estate Funds

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[2] Final non-Handbook Guidance for firms on the Consumer Duty

Response to CP22/14

Chapter 2 – The wider context

Q1	**<u>Assessment of the effects of FCA proposals</u>** ***Do you have any comments on our assessment of the effects of our proposals?*** We agree that broadening the scope of LTAF distribution would provide firms with the opportunity to diversify their investor base for any LTAF they launch. Also, it would benefit retail investors by enabling them to diversify part of their portfolio into illiquid assets and therefore reduce their overall portfolio risk. The LTAF could be used as a vehicle to invest in long-term productive finance assets such as infrastructure, commercial and residential real estate. This could provide much needed funding for Government initiatives such as levelling up. <u>ISA eligibility</u> In our response to FCA CP21/12[3] and other recent consultations from the FCA and government on investment in illiquid assets and authorised property funds, we have requested changes to the ISA rules. We believe that the ISA rules should be reviewed to allow the LTAF, and any other authorised funds with notice periods, to be qualifying investments for Stocks and Shares ISAs. Many investors use ISAs as a long-term investment vehicle and we do not see a good reason for having ISA eligibility rules which effectively supersede the FCA's own investor protection rules. It is coming up to 2 years since the HMRC consulted on ISAs and authorised open-ended property funds and to date they have not provided a response on how they plan to widen the ISA rules to permit investment in these type of funds through an ISA. As we explained in our joint response with the IA to this consultation a good way to encourage investment by retail investors in long-term assets would be to ensure they are ISA eligible.

Q2	**<u>Equality and diversity considerations</u>** ***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.*** We do not consider that these proposals raise any equality and diversity issues.

[3] A new authorised fund regime for investing in long term assets

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Chapter 3 – Broadening retail investment coverage

	<u>Restricted Mass Market Investments</u>
Q3	***Do you agree that the LTAF should be recategorised as a RMMI (as per PS 22/10), from its previous category as NMPI, thus broadening retail access to include restricted investors?***
	As we mentioned in our response to CP21/12, wealth managers and financial advisors do not believe that the exemptions within the NMPI rules would be sufficient to distribute LTAFs to the broader retail target market. Also, operating the exemptions requires a complex record keeping exercise. Therefore, we agree that the LTAF should be recategorised as a Restricted Mass Market Investment (RMMI). We believe that this would be a more appropriate category for LTAF, given its authorised status and the high levels of customer protection and governance built into the LTAF regime. We support the requirement for restricted retail investors to only be able to invest up to 10% of their investable assets into an LTAF or other RMMI products in total. Although, it could always be debated whether 10% is the right threshold, we believe that it is a sensible level to ensure non-advised retail investors, who are not classified as high net worth or sophisticated investors, are not overexposed to illiquid assets.

	<u>Risk Warnings</u>
Q4	***Do you agree with the wording of the proposed LTAF risk warning and risk summary? Please explain your answer and suggest alternative drafting if appropriate.***
	"This is a high-risk investment, and you do not have protection against poor performance. Only invest if you're prepared to wait to get your money back. Assets in this fund take a long time to buy and sell. It will take several years to make any money on your investment." We have some concerns with the above proposed risk warning to be communicated to potential investors with financial promotions for a LTAF. We totally agree with the use of plain language for risk warnings; however, the actual risk should not be lost in simplifying the language of the risk warning. *"This is a high-risk investment…"* We do not agree with all LTAF being described as "a *high-risk investment*". As acknowledged in paragraph 2.5 in the consultation paper there is a vast range of illiquid assets, with varying risk profiles. Not all illiquid assets are high-risk investments. For example, an LTAF holding a range of long-lease commercial property with regular income would be much lower in risk than an LTAF investing in a new developments and infrastructure. We believe that the risk-warning should be tailored to reflect the actual risk profile of the LTAF "*… and you do not have protection against poor performance."* A lack of protection against poor performance is true of any investment product and is not specific to the LTAF. We would like to see this removed from the risk warning. *"Only invest if you're prepared to wait to get your money back. Assets in this fund take a long time to buy and sell."* We agree with this section of the risk warning. It focuses on the fact that LTAFs invest in illiquid assets and therefore it could take some time to obtain redemption proceeds. *It will take several years to make any money on your investment.* The expected time horizon to profitability will vary between LTAF so we believe the wording should reflect the time horizon over which the investments in each individual LTAF expect to be profitable. At the bare minimum "will" should be changed to "may" so it says that "*It may take several years to make any money on your investment."*.

	<u>Risk summary template</u> We note that when introducing the risk summary there is differing language used in the consultation document compared to the draft rules. In the consultation document (p16), it says *"Due to the illiquidity of the LTAF fund structure, the Financial Conduct Authority (FCA) considers this investment to be high risk".* However, in the draft rules (4 Annex R1) the risk summary contains the wording *"Due to the potential for losses, the Financial Conduct Authority (FCA) considers this investment to be high risk."* As we have mentioned above, illiquid assets have varying risk profiles and not all should be considered as high risk. Also, there is potential for losses in many types of investments even some not considered as high risk. We believe the language used here conflates the investment risk of some LTAFs. We have the following further comments regarding the risk summary template: *"2. If you decide to exit early you won't get your money back quickly…"* An investor wouldn't receive their money back quickly whenever they decided to exit. This does not happen only if they exited early. *"3. It will take a long time to make profits…"* For the same reasons as we have mentioned above we believe this should say "*It may take a long time to make profits".* "• *LTAFs will rarely make payments of income. You should not expect to get your money back this way"* This may not be appropriate for all LTAF, some may make regular payments of income. Also, we are not sure what is meant by the phrase "*You should not expect to get your money back this way".* Investors wouldn't receive back the money they invested in the LTAF through receiving income from a fund.

Q5	<u>**Cooling off period**</u> ***Do you agree that when investors buy units in an LTAF, they should not have to comply with the 24-hour cooling off period?*** We agree there is no need for there to be a 24-hour cooling off period for investing in a LTAF or the reason described in the consultation paper.

Q6	<u>**Protections for retail fund investor**</u>**)** ***Do you agree that the retail fund rules noted above should be applied to LTAFs with retail investors?*** We have no objections to applying to Authorised Fund Managers (AFMs) managing LTAFs the disclosure and other rules, noted under section 3.29 of the consultation paper, that already apply to AFMs managing UCITS schemes and NURS. These rules will provide additional protection to retail investors but shouldn't have any material impact on the attractiveness of the LTAF for professional investors. In particular, as we mentioned in our response to CP21/12, we feel that it is important that investors have a clear understanding of how any performance fee charged by the LTAF are calculated.

Q7	***Should the LTAF regime have any other additional protections that are already available for mass-market retail fund regimes?*** We do not believe that the LTAF regime requires any other additional protections that are already available for mass-market retail fund regime.

	<u>Appropriate Assessment</u>
Q8	***Do you agree that the LTAF should require an appropriateness test for all potential retail investors?*** We agree that.an appropriateness test should be conducted where potential investors in an LTAF are non-advised clients. This should ensure all investors are fully aware of the risks and illiquid nature of the LTAF. We have a comment to make regarding part of the draft guidance on assessing appropriateness for an LTAF in COBS 10 Annex 3. *When determining whether a retail client has the necessary knowledge to understand the risks involved in relation to a long-term asset fund, a firm should consider asking the client questions that cover, at least, the following matters:* *(3) the possibility that it could take the client many years to make profit on the money they invest, and that payments of income may be limited or non-existent;* *(5) the risk of the LTAF's investments failing and the associated risk of the client losing all of the money invested;* As we have mentioned, above in responding to Question 4, the risk profile of an LTAF will depend upon the type of assets they invest in and some may not be high risk. Also, some LTAF may pay income. The guidance should make it clear that the questions addressed to the retail client should be appropriate for the characteristics of the LTAF being marketed.

	<u>Funds of Alternative Investment Funds (FAIFs)</u> (3.37 – 3.40)
Q9	***Do you agree with the proposal to enable a FAIF to invest up to 35% into a single LTAF?*** We agree with the proposal to enable a NURS FAIF to invest up to 35% into a single LTAF. Although, in practice, investment by NURS FAIFs in a single LTAF would probably be considerably lower than this threshold. This is because "headroom" would be required to ensure continued compliance with the threshold should the value of the LTAF position change materially relative to the rest of the portfolio. However, this higher threshold allows a NURS FAIF to make a meaningful allocation to a single LTAF.
Q10	***Should we apply a limit to the value, as a percentage of the Net Asset Value (NAV), that a FAIF can invest in multiple LTAFs?*** We do not agree with the proposal to apply a total upper investment limit of 50% of a FAIF into LTAFs. We do not understand the reason given in section 3.40 that this limit is required "to stay under the Funds with Inherently Illiquid Assets (FIIA) threshold." If the AFM elects to hold more than 50% of their fund in aggregate in LTAFs, they will recognise that the FIIA rules will apply and need to comply with these. Also, a fund only becomes a FIIA if it allows regular redemptions. a NURS

	FAIF is permitted to have limited redemptions, would not necessarily fall into the FIIA regime if it offers limited redemptions. If a FAIF comes close to, or even breaches, the 50% threshold, it would be a challenge to quickly dispose of units in the LTAFs the NURS FAIF is holding. Therefore, the NURS FAIFs are likely to invest at a much lower level than 50% of the fund into LTAFs limiting their ability to allocate a significant investment into LTAFs even where this aligns with their investment strategies and liquidity commitments.
Q11	***Do you agree that COLL 5.7.9R (1) and (2) should be switched off for FAIFs that invest in units of LTAFs, given the existing detailed LTAF due diligence rules?*** We welcome the rules in COLL 5.7.9R (1) and (2) being switched off for NURS FAIFs that invest in LTAFs, given the LTAF regime already requires the schemes to comply with these requirements. We pointed out in our response to CP21/12 that in order for a NURS FAIF to be able to operate a portfolio of LTAFs, or a portfolio including LTAFs, COLL 5.7.7R (2) would need to be amended to remove the requirement for a second scheme to have a prohibition on investing no more than 15% of its value in other collective investment schemes. We are pleased to see this is not a requirement for LTAF under the proposed amendments to the rules. We would like NURS, that are not FAIFs, also to be able to invest in LTAFs. This would allow NURS with a multi-asset strategy the opportunity for greater diversification and NURS that invest in illiquid assets to invest in LTAFs. The investment profile and the allocation to LTAFs would need to take into consideration the overall liquidity profile of the NURS and would be different for a multi-asset strategy NURS than for a NURS that invest in illiquid assets.

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Chapter 4 – Broadening pension scheme coverage

	<u>Broadening pension scheme coverage</u> **(4.1 – 4.15)**
Q12	***Do you agree with our proposals to extend distribution of the LTAF beyond defaults in qualifying schemes?***
	We support broadening the distribution of the LTAFs to self-select options in qualifying schemes and agree that protections should be in place to prevent investors over-exposing themselves to the LTAF-linked fund. However, we disagree with preventing individuals from investing in the LTAF to a greater extent than the level of investment by the default arrangement of the same qualifying scheme. Self-select investors, by definition, want something more tailored to their own circumstances and the default arrangement may not necessarily be appropriate for them. We believe self-select investors could be prevented from overexposure in LTAF by limiting them to investing 10% of their assets in LTAF at the point of making the investment. This would be in line with the RMMI 10% threshold and would be easily verifiable by the pension scheme.
Q13	***Do you agree with our proposals to extend distribution of the LTAF more widely where investors in a long-term unit-linked product have appropriate professional support on fund selection as above?***
	We agree with extending the distribution of the LTAF to investors in a long-term unit-linked product. However, we don't understand why investors in an insurance wrapped LTAF would require professional support on fund selection whereas the same investors could invest direct in the same LTAF without advice under the RMMI framework. This inconsistency could be resolved by the FCA permitting distribution of unit-linked LTAFs under the RMMI framework.
Q14	***Do you agree with our proposal to make rules to give equivalent status to that of LTAFs under the permitted links rules to other illiquid assets where the conditions for securing an appropriate degree of consumer protection can be met?***
	We agree with giving equivalent status to that of LTAFs under the permitted links rules to other illiquid assets where the conditions for securing an appropriate degree of consumer protection can be met. This enables DC default arrangements to use differing fund structures to access illiquids but with suitable consumer protection. We do not believe that the policy intention to treat equally all illiquid asset funds in a DC default unit-linked context has been achieved in the draft rules, as the 35% cap has not been lifted. We assume that this is an oversight, and that the intention was to lift the cap in respect of default arrangements.

	<u>**Self-Invested Person Pensions (SIPPs)**</u> **(4.16 – 4.17)**
Q15	***Do you consider there to be any unintended consequences from categorising the LTAF as a non-standard product for SIPPs?***
	We do think there are unintended consequences from categorising the LTAF as a non-standard product for SIPPs. It will reduce the likelihood of LTAFs being sold through SIPP wrappers. There are additional capital costs for SIPP providers to allow non-standard assets in their SIPPs, for example, extra insurance may be required. Which means that most SIPP providers refuse to allow them in their SIPP. Where SIPP providers do make non-standard assets available the additional costs are passed onto the investor, this may act as a disincentive to invest, even where an LTAF may be suitable for inclusion in a portfolio. Where retail investors wish to obtain the tax benefits of investing in LTAF within their ISA (please see our response to Question 1) and SIPP allowances, they will not, in most cases, be able to do so. This is likely to result in lower allocations to LTAFs. We would ask the FCA to reconsider the decision to treat LTAFs as non-standard assets in SIPPs.