INREV response to FCA CP21/12 – A new authorised fund regime for investing in long-term assets

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About INREV: the European Association for Investors in Non-Listed Real Estate Vehicles

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. We provide guidance, research and information related to the development and harmonisation of professional standards, reporting guidelines and corporate governance within the non-listed property funds industry across Europe.

INREV currently has approximately 460 members. Our member base includes institutional investors from around the globe including pension funds, insurance companies and sovereign wealth funds, as well as investment banks, fund managers, fund of funds managers and advisors representing all facets of investing into non-listed real estate vehicles in the UK and the rest of Europe. Our fund manager members manage more than 500 non-listed real estate investment funds, as well as joint ventures, club deals and separate accounts for institutional investors.

Introduction

INREV welcomes the FCA consultation on the Long-Term Asset Fund (LTAF) and the opportunity it presents to make a real improvement to the structures available for institutional investors, as the largest providers of "patient capital", to invest in long-term assets through UK domiciled vehicles. There are unfortunately significant gaps in the current UK funds toolbox that result in many institutional real estate investors using vehicles domiciled outside the UK that are commercially viable, simple and flexible and can be brought to market quickly. To be successful and offer real choice for institutional investors, we believe that the LTAF will need to be no less attractive than familiar fund structures already available in other jurisdictions.

In our response to the UK Funds Review Call for Input, we indicated our strong support the continued development of the LTAF, which was proposed by the Investment Association, along with the introduction of the Professional Investor Fund unauthorised contractual scheme (**PIF**) and the reform of the rules for Real Estate Investment Trusts (**REITs**).

As we noted in our response to the Funds Review, we understand that the LTAF has been designed to be particularly accessible for defined contribution (**DC**) pension schemes but should also be available for certain qualified individual investors. The LTAF has been also designed to allow investments in a wide range of less liquid assets, but of particular importance is the ability to open up a broader range of options for investment in real assets (real estate and infrastructure) to qualifying investors.

Defined benefit pension schemes and life insurance companies have in recent years become major long-term lenders to real estate and infrastructure, some of the larger ones directly and others through specialist funds. The LTAF can facilitate this opportunity for DC and appropriate individual investors. We believe that this is crucial for long-term investment in view of the increasing proportion of retirement capital that is held in DC schemes and individual investment arrangements.

We welcome the proposal for the LTAF to be able to invest in other collective investment schemes, and strongly advocate that other collective investment schemes include Professional Investor Funds or PIFs constituted as unauthorised contractual schemes (referred to in HMT's UK Funds Review Call for Input 26 January 2021 paragraph 4.22). In view of the PIF (like the LTAF) being implementable via secondary legislation, we suggest that the PIF is implemented on the same timeline as the LTAF. The success of the LTAF, in terms of LTAFs adopting an indirect diversified strategy, would be greatly enhanced if PIFs and LTAFs were to be operational at the same time.

While we understand the necessity to strike a balance between investor protection and further important policy goals, in order to launch a successful product that the market will actually use, we would further caution the FCA to avoid making the mistakes in designing the LTAF that the EU made when designing the European Long-Term Investment Fund (ELTIF). While we are encouraged that the FCA appears to have made efforts to avoid similar mistakes particularly around overly proscriptive portfolio composition, we do have a few specific observations which we have set out in answers to questions below.

We hope our comments in response to the specific questions asked in the consultation that follow will make a constructive contribution to this important effort.

Equality and diversity considerations

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.

We do not consider that these proposals raise any equality and diversity issues.

<u>The Long-Term Asset Fund</u>

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?

Annual assessment & Approved Person
Given the types of risk that LTAFs might be exposed to, we agree that strong governance is required for LTAFs to give investors confidence that they are being managed appropriately and in their interests. This should be achieved by the additional assessment and reporting requirements for the LTAF and the need for there to be an approve person responsible for compliance of these requirements. However, the requirements are high level and, therefore, we would ask that the FCA provides further guidance.

Clear disclosure
We agree that there should be clear disclosures to investors on the LTAF's investment strategies, subscription and redemption terms and charging structures. The trustees of DC default schemes, in particular, will require full visibility of charges given their requirement to comply with the charge cap. Managers investing in the private markets usually play an active role in the management and improvement of the underlying investments. As such, likely performance-linked fees will be a feature in many LTAFs, either at the level of the LTAF itself or at the level of the underlying investments. It is

important that investors have a clear understanding of how any performance-linked fee charged by the LTAF will be calculated.

Independent representative on AFM governing board
We agree that similar to AFM of other authorised funds, there should be a requirement for the AFM of a LTAF to have independent board representation.

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?

<u>Purpose of the Fund</u>
We agree with the proposed investment strategy of a LTAF; that it invests mainly in assets which are long-term and illiquid in nature, or in other CIS which invest in such assets. However, the FCA have provided guidance in COLL 15.6.7 that investing mainly in long-term illiquid assets means that "*more than 50% of the value of the scheme property should be in unlisted securities and other long-term assets such as interests in immovables or other collective investment schemes investing in such securities or long-term assets. However, a long-term asset fund could have a strategy of investing mainly in a mix of unlisted assets and listed but illiquid assets.*" Should this be viewed as a hard limit? If, for example, a fund was operating a hybrid strategy where the illiquid assets held by the fund were just over 50%, large inflows could bring its illiquid assets below the 50% limit. Due to the nature of illiquid assets it would probably take time for the fund to be able to invest in further illiquid assets to bring them over 50% again.

We suggest that this 50% test is adopted as guidance at the time investment decisions are made for new investments and AFMs are not required to recalibrate portfolios at a later point where market events might mean this test is breached. We also suggest the FCA include explicit guidance to the extent that a LTAF may maintain a more liquid portfolio during a "ramp up period", which period should be set out in its prospectus.

Such guidance will also be important to depositaries, who will have to require clarification of this position to ensure they are satisfied that the fund is still meeting the LTAF investment rules.

Investment powers
We agree that, as it is intended for the LTAF to eventually be available to a broad range of investors, an appropriate degree of consumer protection for investors would be achieved by the LTAF requiring to have a prudent spread of risk.

Given the highly illiquid nature of the assets LTAFs would be investing in, we do not feel that 24 months after a LTAF is launched, would be sufficient time for a LTAF to achieve a prudent spread of risk. We suggest that this initial period is five years, matching that provided in the ELTIF Regulation. Or, alternatively, there should be a provision for the manager to apply for an extension of this initial period.

We welcome the proposal for the LTAF to be able to invest in other collective investment schemes. In relation to other collective investment schemes:

- We suggest the ability to invest in other collective investment schemes includes the Professional Investor Funds or PIFs constituted as unauthorised contractual schemes (as indicated in our introduction). In view of the PIF (like the LTAF) being implementable via secondary legislation, we suggest that the PIF is implemented on the same timeline as the LTAF. The success of the LTAF, in terms of LTAFs adopting an indirect diversified strategy, would be greatly enhanced if PIFs and LTAFs were to be operational at the same time.

- We agree that the ability to invest in other collective investment schemes includes limited partnerships. However, a limited partnership would constitute a “Property Investment Partnership”, and hence encounter the problem of Stamp Duty Land Tax applying to transfers of units in a limited partnership: see: https://www.gov.uk/hmrc-internal-manuals/stamp-duty-land-tax-manual/sdltm34010.

In addition, it is sensible that there is no limitation on second schemes investing in other collective investment schemes, and agree with the approach for the manager to instead undertake sufficient due diligence through the structure to ensure there is unlikely to be any circular investment back to the LTAF.

We agree that there should not be any specific diversification requirements, beyond the overarching requirement to have a prudent spread of risk: a requirement to be assessed at the LTAF level. We do not believe it is necessary or desirable to require second schemes to have a prudent spread of risk. The collective investment schemes that the LTAF will invest in are likely to be unauthorised schemes that would not have this requirement, and moreover this would prevent the LTAF from investing in collective investment schemes that have been used to wrap a single asset, e.g. for tax or operational efficiency purposes – such arrangements are fairly typical in private markets.

Borrowing

We have no objections to the maximum level of long-term borrowing that an LTAF may undertake being set at 30% of net assets. However, we believe that there should be flexibility for short-term borrowing facilities up to 100% of NAV to allow for subscription lines and working capital facilities which are common in the private fund arena to smooth investing and liquidity and which we do not consider should significantly alter the risk profile for a retail product. We also suggest that a higher limit is permissible for the stated “ramp up period”, to enable new funds to secure seed portfolios and asset pipelines. We understand that the lack of such flexibility has been one of the identified problems for ELTIFs.

Co-investment

Another key issue for the ELTIF regime is the lack of flexibility to allow managers and other clients to co-invest in assets alongside the fund itself. The LTAF will be more successful if it is able to make co-investments alongside other funds and co-investment vehicles operated or advised by the manager and, accordingly, managers need to have some flexibility as to how they manage arrangements on behalf of their other clients and their own “skin in the game”. We understand the FCA need to protect the interests of retail investors but, rather than prohibit conflicts, we suggest that an enhanced requirement on the AFM to ensure that it is treating investors in the LTAF fairly in circumstances where there is any co-investment by the manager’s other clients and/or affiliates should ensure they receive appropriate protection.

Valuation
We agree with paragraph 15.2.6 R (4) of the draft LTAF regulations which enables an LTAF fund manager to either perform the valuation function themselves or by a standing independent valuer. However, we are concerned how this this paragraph links to Article 19(10) of UK AIFMD. Given that the LTAF fund manager will be a full scope AIFM. Article 19(10) states that an external valuer has unlimited liability to the AIFM for any losses suffered by the AIFM as a result of the external valuer's negligence or intentional failure to perform its tasks. We have recently written to the FCA and pointed out that there are differing interpretations of what actions constitute "negligence". "Negligence", sometimes also called "simple negligence", can be interpreted to mean relatively minor mistakes, and is distinguished from "gross negligence" which is used to mean relatively more serious mistakes. As a result, in the UK, many real estate valuers, adopting professional guidelines from their industry body, the Royal Institution of Chartered Surveyors (RICS), are unwilling to accept unlimited liability for "simple negligence".

As part of the review of AIFMD in the EU, ESMA have acknowledged this issue. In our response to the EU Commission's review of AIFMD we suggested that it should be noted that that, under Article 19(10): "the external valuer is subject to unlimited liability to the AIFM for any losses suffered by the AIFM only from the external valuer's serious error or intentional failure to perform its tasks." We have suggested to the FCA that they take a similar stance in relation to UK AIFMD.

As we have mentioned above, it will be challenging for the depositary to perform an assessment and determine that the AFM has the necessary knowledge, skills and experience to perform an independent valuation of the asset classes concerned. Depositaries, who do not themselves perform valuations, may not have the appropriate knowledge within their firms to assess the AFM's capabilities, particularly to a standard where they can do this without qualification. It is therefore possible that many depositaries may refuse to undertake to make such a determination, requiring an AFM to appoint an external valuer even though it possesses the appropriate capabilities to perform the valuation, or that depositaries will have to hire this experience, leading to significant increases in depositary fees charged to the LTAF.

This would be undesirable, given a key target market identified for the LTAF is DC default schemes, which are subject to a charge cap and therefore very cost sensitive. We agree with the suggestion made by the IA that it should be the responsibility of the AFM Board to determine that the AFM possesses the knowledge, skills and experience to perform the valuations itself. If the FCA believes it necessary to require external assurance of these capabilities, this would be more appropriately performed by an external auditor possessing the necessary skills itself to perform the determination, rather than the depositary.

Where a LTAF is investing in other collective investment schemes, we believe that the valuation process for the LTAF should also consider the valuations undertaken on underlying investments held by the other collective investment schemes. If those collective investment schemes have themselves been subject to external valuations, requiring the LTAF itself to have an external valuation would be an unnecessary duplication of costs.

<u>Valuation frequency</u>
We note that it is proposed that LTAF's assets should be valued at least monthly. Monthly may be suitable for some LTAFs; however, for some, with very limited dealing frequencies and with assets that are particularly difficult to value, monthly valuations may not be required, adding unnecessarily to the costs of the LTAF. We agree with the IA's suggestion that this minimum requirement is reduced to once

a quarter, in line with the AIFMD regulatory reporting frequency for most full scope AIFMs. This could be supplemented with a requirement for AFMs of LTAFs to have regard for the need of their investors when setting valuation frequencies, particularly when they are required to use regular price feeds.

We note that most of the non-listed real estate investment industry follows the INREV Guidelines, which do not require monthly valuations. The Guidelines only require that external valuations be performed at least once per year for all properties, while additional valuations generally based on desktop reviews may be undertaken more frequently. In practice, these are more often done quarterly than monthly.

Valuation results must be included in annual and interim reports, which provide details of any significant changes that have or could have a material impact on, *inter alia*, the vehicle's value. Additional investor updates can always be provided more frequently when circumstances compel them. Sudden events that could significantly affect value could trigger such updates and following the INREV Guidelines should be specified in fund documentation.

Redemptions and subscriptions
We agree with the proposal to not be prescriptive on how LTAFs should manage their liquidity. As you have stated, the manager of an LTAF is obliged to ensure that the investment strategy, liquidity profile and redemption policy of the LTAF are consistent and should use this as the basis for selecting the most appropriate liquidity tools. A key element of this decision-making is the profile of the investor base and their requirements. Also, we agree that suspension of dealing is a tool for exceptional circumstances for the protection of fund investors, for example, when there is material uncertainty around the valuations of the assets held by the fund.

As indicated, we understand the intention of HM Treasury and the FCA is that the LTAF would operate within the framework established by (and not involve any amendment to) FSMA. On this basis, we note that in FCA CP21/12 paragraph 3.32 it is envisaged that LTAFs could operate by way of *"long notice periods potentially in excess of …90-180 days*…".

Without being prescriptive on liquidity, we suggest it would still be helpful to have guidance (equivalent to Questions & Answers 8 and 9 in PERG 9.11.1G) as to the maximum acceptable period between dealing days as well as the maximum acceptable notice period. Market pressure from investors will always to have as much liquidity as possible but product designers must consider what is appropriate for the particular asset mix being targeted. Given that the LTAF, understood to be an authorised open-ended fund operating within the parameters of FSMA, such guidance would help define the boundary between an acceptable portfolio for this product and otherwise when a closed-ended or hybrid institutional product such as the Professional Investor Fund unauthorised contractual scheme would be more appropriate.

Investment due diligence
We agree that it is important that the manager carries out due diligence that is commensurate with the risks of investing in private assets.

Knowledge, skills and experience
We agree with the proposal that LTAF should only be manged by firms with the permissions to operate as a full-scope UK AIFM. Also, we agree that firms wishing to act as the AIFM and to delegate portfolio management to another firm must be able to demonstrate that they themselves possess the knowledge, skills and experience necessary to understand the activities, and in particular the risks

involved in those activities. Firms applying for authorisation should expect scrutiny in line with the complexity of the asset class. The requirement to evidence this as part of the authorisation process appears appropriate to us.

Disclosure of charges
As per our response to Question 2, we agree that there should be full disclosure of all costs and charges incurred by the fund and for clarity, these should include examples of how any performance fees operate.

Governance
The governance proposals in the consultation are all appropriate for a LTAF, although managers would welcome guidance from the FCA to help them understand how to achieve the regulator's expectations in respect of the LTAF's annual assessments.

Reporting
We believe any timeframe more frequent than quarterly reporting is too frequent for a fund that is investing in long-term assets. Information on transactions and activities undertaken by the LTAF will be provided to investors on a half-yearly basis in the annual and interim reports. We would suggest that it should be at the discretion of the AFM whether it would be beneficial to investors to provide additional reporting.

Authorisations
We understand that the FCA will not wish to give a hard commitment to a rapid turnaround for authorisations for LTAFs as it gets to grips with this new product. However, we should strongly like to encourage the FCA to commit to a "best efforts" style obligation to ensure it has staffing and resources not only to process new LTAF applications but also from managers who wish to set up a new UK AIFM/AFM for this purpose or who have an AIFM but need to upgrade their permissions to include managing an authorised AIF, including those EEA AIFMs which are passported into the UK under the temporary permissions regime.

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

We would like to point out a barrier there may be to LTAFs investing in real estate. PAIFs and CoACSs can take advantage of the 100% relief from Stamp Duty Land Tax (SDLT) for the seeding of properties into an authorised PAIF or CoACS. We would ask that this tax relief is extended to LTAFs, including ones that are not PAIFS, to enable them to transfer property into the fund when the fund is setting up.

As mentioned in Chapter 3 of the consultation, depositaries have noted that there are issues with the requirement for some non-custodial assets in an authorised fund to be registered in the name of the depositary. We note that The FCA would welcome engagement with depositaries and fund managers as to how an alternative model might work.

As we mentioned in the introduction, while we realise the issue is not within the remit of the FCA, we see the success of the LTAF as a package including with the successful conclusion of the tax treatment of AHCs in alternative investment funds consultation and VAT consultation and therefore encourage their successful and timely resolution.

Proposed amendments to the permitted links rules (COBS 21.3)

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 fully support the FCA's proposals to allow DC default arrangements to invest in an LTAF. The exemption of an LTAF, held by a DC default, from the 35% limit on an individual unit-linked fund's illiquid holdings better reflects the reality of DC portfolio construction. It will give DC schemes flexibility in choosing how to structure their default portfolios and should assist in speeding up the adoption of LTAFs by DC schemes wishing to make such allocations.

We agree with the FCA including guidance clarifying that the insurer is expected to consider the concentration risks at the default level associated with an LTAF allocation, as part of the ongoing suitability and appropriateness assessment of the default investment strategy.

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?

We do not have concerns about the specific asset classes that an LTAF could hold, from the perspective of a DC investor. As long as the DC scheme trustees receive sufficient information to understand the assets the LTAF is investing in.

Distribution of the LTAF

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?

Distribution of the QIS is limited to sophisticated investors only in COBS. Adopting this same requirement for LTAF would make its distribution more limited than that of other unauthorised investment funds, such as Unauthorised Unit Trusts and Luxembourg RAIFs, which arguably have less investor protection than both the QIS and the LTAF. The LTAF will have more investment restrictions and stricter governance requirements than the QIS. These additional requirements will provide for stronger investor protections than those of the QIS, and should therefore enable a broader distribution than the QIS.

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.

We support the AREF response to this question.

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?

We believe that as the LTAF will be investing in high quality assets and will come with additional customer protections in respect of governance and disclosure, it should be available to some retail investors; namely, wealth management clients. These types of retail investors would have long time horizons and access to high quality professional support on asset allocation and fund selection, such as private wealth clients using discretionary fund managers.

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

Given the robust governance and investor protections built into the LTAF regulatory framework, we believe that LTAF is suitable for marketing to retail investors. Although, this should be subject to restrictions to ensure investors understand that the long-term nature of the commitment; the limited redemption terms, the risks inherent in investing in the underlying asset classes and are ultimately able to risk the capital that is committed to the LTAF.

As acknowledged in the consultation, an LTAF is likely to be classified as a complex product and thus the distributors will need to conduct an appropriateness test for all prospective retail investors in an LTAF.

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?

We can see the benefits of the NRRS regime as the rules would restrict the exposure of an ordinary retail investor accessing an LTAF through a direct offer financial promotion to no more than 10% of their net worth. Although, the NRRS relies on a self-declaration by the investor; it may be more appropriate for the distributor to look at the portfolio the investor has under their management or advice to assess it is within the threshold.

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?

We agree that there would be challenges with requiring a minimum level of investment from professional clients to protect retail investors. For that reason, we do not think that this is a workable proposal.

Co-mingling of investment between retail and institutional investors can help the LTAF build sufficient scale, especially if DC schemes gradually increase their capital allocations to the LTAF over time. While we expect that there will be instances of co-mingled investment, many LTAFs will be designed for a distinct investor base (for instance, a particular DC scheme). Consequently, it would not be realistic or helpful to require professional investment or to set a threshold for professional investment where it is present.

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

We support the AREF response to this question.

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

We support the AREF response to this question.

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?

Any institutional investor with a long-term investment horizon and the appetite to tie up part of their capital for a longer time-period could benefit from the LTAF structure. This could include investors such as DB pension schemes, insurance companies, sovereign wealth funds and large charities. We are not aware of any barriers that would prevent these investors from having an LTAF marketed to them.

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?

We support the AREF response to this question.

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

We support the AREF response to this question.

Q18: Do you have any comments on our cost benefit analysis?

We support the AREF response to this question.