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Dear David,

RE: DP18/10: Patient Capital and Authorised Funds

The Investment Association[1] welcomes the opportunity to respond to the FCA's Discussion Paper on Patient Capital and Authorised Funds. Our response is in two parts. Part One outlines our overall position, including on some specific issues arising. Part Two responds to the individual questions in the Discussion Paper. There are two appendices providing further detail on our proposal for a Long-Term Asset Fund (LTAF).

Overall, we support allowing investors, including retail investors, to make long-term investment in illiquid assets. We also encourage the FCA to ensure a join up between the different aspects of the policy process in this area, especially CP18/27.

A central challenge is that the current NURS framework would not support significant investment by a fund in illiquid investments, including patient capital. Barriers identified in the NURS regulation include the requirement for funds to have a valuation point at least twice a month and the current investment and borrowing powers restrictions. The disconnect between the valuation frequency of funds and the illiquid nature of the proposed underlying assets would require fund managers to retain a significant proportion of the fund in liquid assets or employ other tools, neither of which would achieve the fund structure desired. In addition, investment and borrowing powers rules are too restrictive for both substantial direct and indirect investment in the types of assets discussed.

[1] The Investment Association is the trade body that represents UK investment managers, whose 200 members collectively manage over £7.7 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

The UK is the second largest investment management centre in the world and manages 35% of European assets.

More information can be viewed on our website.

The Investment Association is a company limited by guarantee registered in England and Wales. Registered number 04343737. Registered office as above.

The IA notes the FCA's discussion surrounding specialist funds and the lack of take-up for such vehicles in the UK. Possible reasons for the low number of these specialist funds in the UK are discussed in Part Two.

The IA is currently leading a forward-looking workstream - the UK Fund Regime Working Group (UKFRWG) as part of Investment Management Strategy II and the HMT Asset Management Taskforce. The FCA also participates in the workstream. In particular, the UKFRWG is developing a set of proposals for an LTAF that are outlined in this response ahead of a final report in the Spring.

The IA considers that any discussion of funds' investment in illiquid assets should include a review of the liquidity toolkit and how it can be enhanced. There was a useful discussion of liquidity tools in DP 17/1 'Illiquid Assets and Open-ended Investment Funds', which does not appear to have been subject to meaningful discussion since, and we would appreciate any further consultation to include proposals on the enhancement of the toolbox.

Any enhancement to the fund regime to allow substantial investment in patient capital and other illiquid assets should consider the current disconnect between the liquidity of such assets and the requirement from platforms and other distributors and the DC pensions market for funds to provide daily dealing. The IA notes that FCA engagement with such parties and other relevant intermediaries on this issue may help to facilitate dialogue and change.

Part One – Overall IA Position

The IA welcomes the discussion on patient capital, in conjunction with the Government's focus on the promotion of patient capital and a review of the current UK investment products to allow wider investment in patient capital.

We note that there is wider work being undertaken on investment in illiquid assets, particularly in the context of CP18/27 on 'Illiquid Assets and Open-ended Funds'. We encourage the FCA to take a joined-up approach to ensure any future work in this area takes account of all initiatives being undertaken. Both the content and timing of regulatory change should aim at a cohesive framework for the industry. Our response to the Consultation Paper on amendments to the permitted links rules (CP18/40) is also drafted to be compatible with proposals being made here. There is a significant opportunity to facilitate good outcomes for fund investors and pension savers as well as investment in the wider economy.

IA member firms have seen demand from investors for a product that will allow for long-term investment in illiquid assets, but such a product would require a subset of rules that would allow for more flexibility on investment and borrowing powers, valuation, dealing frequency and asset registration, while maintaining a strong investor protection framework.

A long-term asset fund could be available to retail investors, with the appropriate investor protections, including meaningful disclosure. The liquidity risk should be made explicit both in the disclosures of the risks pertinent to the fund and the nature of assets held in the fund. Furthermore, their effect on the overall liquidity of the fund and the liquidity management tools that will be employed by the fund manager should also be clearly explained in the fund's offering document.

In order to be made available to retail investors, further work is needed as to whether such a fund would need to be advised or available directly, subject to appropriateness tests if the product is deemed complex under MiFID II complex/non-complex rules. The critical initial point is that in both the DC and wealth management environments, decision-makers are

often more comfortable selecting funds that have a retail status. In that regard, our proposals build on an existing retail vehicle.

The current NURS regulatory framework is not sufficiently flexible to allow any meaningful level of investment in patient capital or other illiquid assets without using complex and costly multi-layer structures of holding vehicles, with some exceptions, such as property. The IA supports the creation of a new type of NURS, with its own investment and borrowing powers framework and additional flexibility in areas such as valuation frequency, giving it the ability to value far less frequently than the current requirement of twice-monthly.

As part of the work on the future of the UK Fund Regime, the IA has been developing a framework for a new type of investment fund, the LTAF. Patient capital would be one of the permissible investments for such a vehicle. Initial proposals are presented in Appendix 1 of this document and a full version will be available in the Spring as part of the final UKFRWG Report. Appendix 2 provides more background on the UKFRWG process itself.

Specific Issues

We respond in detail to the FCA's consultation questions below. There are three key messages in our response:

1. Liquidity. Any fund investing substantially in patient capital or other illiquid assets would, by nature be illiquid and investors would have to be prepared to exchange fund liquidity for a more diversified portfolio and potentially higher returns with less market correlation. As noted elsewhere, appropriate disclosures within fund documentation would have to detail the strategy and its effect on liquidity, the consequences and risks of investing in an illiquid fund and the fund manager's proposed use of liquidity tools to manage any liquidity issues encountered.

Current COLL rules require NURS to value at least twice per month. As the liquidity of the assets held by these funds will be lower and investors will be expected to be investing in the fund for the long-term, the IA would welcome the ability for the fund to value less frequently, where the fund manager feels it appropriate, and as infrequently as every two years.

Fund managers should have access to a range of liquidity tools that they can utilise when there are concerns over liquidity in a fund. It has been previously noted[2] that, other than suspension, the tools that are available are of limited use and the IA has called for the FCA to perform a review and ultimately to enhance the toolkit, to ensure that fund managers can use tools other than suspension in times where a fund's liquidity is compromised. In particular, it would be beneficial for fund managers to be able to continue to accept subscriptions into a fund during periods where they are not able to pay the proceeds of redemptions, as this could go some way to resolving liquidity concerns. Additionally, notice periods have been highlighted as a useful tool where a fund holds illiquid assets.

2. Diversification. As acknowledged by the FCA, the diversification rules for funds can provide a barrier for funds investing in illiquid assets. Funds will often hold assets below the threshold to ensure that inadvertent breaches don't occur e.g. with market movements. This would be particularly true in the case of less liquid assets, where it may be difficult to effect a sale in order to reduce the position and correct any inadvertent breach within the

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[2] Investment Association Response to DP 17/1: Illiquid assets and open-ended investment funds, 8 May 2017

mandated six months. Indeed, correction may require the divestment of the entire position, if this consists of a single indivisible asset, which may not be in the interests of unitholders.

The current investment and borrowing powers regime for NURS, whilst wider than that for UCITS, is still too restrictive for funds who wish to hold a significant proportion of the fund in patient capital and other illiquid assets without the use of complex and costly multi-layer structures of holding vehicles, with limited exceptions in assets such as property. The IA proposes the creation of a separate regime within the NURS framework, which would relax the rules on permitted investments, to allow investment in vehicles such as limited partnerships, unlisted equity and unlisted debt. Spread rules should also be widened, to allow greater investment in off-exchange securities and unregulated collective investment schemes.

3. Valuation. The IA agrees that the way in which patient capital assets are valued will require further consideration and encourages the creation of appropriate valuation methodologies, validated by a suitably qualified, independent expert. These methodologies would be used to review patient capital assets and perform a valuation adjustment, in line with the fund's dealing frequency. Appropriate methodologies would set out how to adjust the value of the fund, to take into account market events and various other factors.

Thank you again for the opportunity to respond and I would be happy to discuss this response with you further.

Yours sincerely,

Rachel Ellison

Fund Compliance Specialist

PART TWO – RESPONSE TO CONSULTATION QUESTIONS

Q1: Do the category limits strike the right balance between enabling retail investments in patient capital while ensuring investors can redeem their investment in a timely fashion? If not, what changes should be made to existing structures?

1. A significant issue in relation to funds investing in illiquid assets is the disconnect between the liquidity of the assets held and the regulatory requirement to offer dealing in a fund at least twice monthly. Where this liquidity mismatch exists, fund managers must employ one or more of the following approaches in order to ensure that the fund remains sufficiently liquid:

    - Retaining a large proportion of the fund in liquid investments, which may create a drag on performance and may not allow the manager to manage the fund as intended.
    - Using short-term borrowing (within current limits) to honour redemption requests.
    - Employing liquidity management tools.
    - Suspending the fund, which fund managers believe should only be used when all other possible options have been exhausted, as it prevents investors being able to access their normal redemption rights and can trigger further panic selling, to the detriment of investors once the suspension has been lifted.

2. For a fund to fully invest in patient capital, the dealing frequency should be directly related to the time it will take to realise the underlying assets. We note the FCA's view, expressed in PERG 9.11.1 G that a period of six months would generally be too long to be a reasonable dealing period for a liquid securities fund. As this paper is looking at illiquid assets, we are of the opinion that the period can be extended beyond six months, to a maximum of two years, where the particular characteristics of the fund justify such a period.

3. Additionally, many distributors require funds to operate on a daily-dealing basis if they are to be sold to retail investors and daily dealing is predominant in the DC pensions market. Distributors may also not be able to support tools that can assist liquidity management, due to their functional capabilities. The IA considers that the FCA, under its competition mandate has a role in facilitating a dialogue with distributors and other relevant intermediaries to make it easier for funds who wish to move away from daily dealing to do so.

4. The IA considers that a new type of investment fund, classified as a NURS, but subject to a separate chapter in COLL would allow such funds to invest substantially in patient capital and to have certain features, for example widened investment and

borrowing powers and the ability to offer reduced dealing frequency would be the solution.

5. The IA would also welcome a review and development of liquidity tools to enable fund managers to invest substantially in patient capital, whilst still providing liquidity to investors. We recognise that some fund managers would still prefer to offer dealing in their funds at a greater frequency than the liquidity of the underlying holdings would allow. The use of fully developed, appropriate liquidity tools, such as notice periods and deferred redemptions would be of great assistance in this respect.

Q2: Is there retail investor demand for a new type of authorised retail fund which can, for example, invest all its capital directly into patient capital assets?

6. Member firms have reported some interest from investors such as DC pension schemes, funds of funds, discretionary wealth managers, private banking channels, high net worth investors as well as other intermediaries. There has been little explicit interest from retail investors themselves. However, the development of any new regime would need to ensure that it would be suitable for retail investors and provide appropriate flexibility, whilst recognising the nature of illiquid assets.

Q3: If authorised funds marketed to retail investors were permitted to hold more patient capital, what safeguards do you think are needed to adequately protect investors?

7. Investors should be made fully aware from the outset that such investments may not be easily realised and that this in turn could affect their ability to redeem their holdings or receive their proceeds in a timely manner.

8. Awareness should be provided by the product manufacturer at the outset. Whilst funds investing substantially in patient capital should provide appropriate risk warnings and should detail any liquidity management tools in the prospectus, this should also be explained in the fund's offering document. Other elements to provide in the offering document include a full explanation of the fund's strategy in relation to patient capital, and reference to liquidity tools that could be used, as well as the circumstances of potential use. Where funds will invest substantially in patient capital, prominent, explicit risk warnings should be displayed.

9. It must be acknowledged that most retail investors do not purchase funds directly from the manufacturer, so intermediaries will need to ensure they are capable of providing such products and will need to be responsible for making investors fully aware of the nature of the funds and their assets and of the potential risks involved.

10. In light of this, it has been indicated by some IA members that they would only make such funds available to retail investors on an advised basis. As noted above, further consideration is needed of the challenges of ensuring an appropriate balance between accessibility and investor protection. Under MiFID II, it is probable that funds investing substantially in patient capital could be classified as a complex fund and would therefore require any intermediary to perform an appropriateness test before the investment is made. If this is the case, at this point, the intermediary should ensure that the investor is fully aware of the nature of the fund and its assets and the fact that it may not always be possible to redeem immediately on request, even if daily dealing.

Q4: Should NURS have a broader ability to finance infrastructure projects than is currently possible under our regime? If so, what changes do you think are necessary to our Handbook?

11. Yes, we agree that NURS should have wider access to various types of patient capital and other illiquid assets, including unlisted securities and limited partnerships. We suggest that this power should not be extended to all NURS, which would fundamentally alter the nature, characteristics and therefore the reputation of existing products. Instead, a new type of NURS with a distinct label (similar to the FAIF) should be created to support such investment. As explained above, the IA has been undertaking work to explore introducing a Long Term Investment Fund (LTAF), which would enable investors willing to invest their capital in the long-term to do so in more illiquid assets. Information describing the key features of the LTAF is contained in Appendix 1.

12. The Discussion Paper highlights the restrictions on NURS investing in immovables. A new framework should remove such restrictions and permit wider access to such assets directly, rather than indirectly through holding a transferable security.

13. COLL 5.6.18 (2)(b)(i) does not permit all types of direct infrastructure investment. The rule requires an immovable invested in to be a freehold or leasehold interest. Certain infrastructure investments do not have a freehold or leasehold interest in the land they are built on, so an amendment to this rule would be welcome. The same issues arises in respect of unit-linked funds and we have noted in our response to the FCA's concurrent CP18/40 on permitted links that the creation of a separate category for direct infrastructure might be the most appropriate way forward.

Q5: Do the current rules governing QISs provide professional and sophisticated retail investors with sufficient access to patient capital? If not, why not and what changes do you think are necessary to our Handbook?

14. The QIS rules, as they stand, provide eligible investors with wider access to patient capital and other investments than other NURS. However, similar regimes overseas have even wider investment powers, e.g. the Qualifying Investor Alternative Investment Fund ("L-QIAIF") in Ireland is now permitted to originate and participate in unsecuritised loans. QISs have not been launched in as great numbers in the UK as some of the alternative fund regimes overseas. This could be an opportunity to review QISs' competitiveness against other EU and international products and to promote the QIS as a genuine competitor in this field.

15. However, the QIS is not the right vehicle to use for the significant holding of patient capital products by retail investors, not least because the majority of retail investors are not permitted to directly hold QISs. In addition, many professional and "semi-professional" investors, such as discretionary wealth managers, prefer to invest in products suitable for retail investors. Again, we refer the FCA to the proposed LTAF regime, the features of which are described in Appendix 1.

Q6: If QISs are permitted to hold more patient capital, what safeguards do you think are needed to adequately protect investors?

16. As we outline above, the IA supports the creation of a new type of NURS framework: the LTAF. We think that this structure, rather than an amended QIS structure would be best placed to support funds' investment in patient capital.

17. This could, however, be an opportunity for the FCA to review the QIS regime to establish a level playing field for professional and semi-professional investors and to ensure that they are competitive with similar structures overseas.

Q7: Do the current diversification rules strike the right balance between investor protection, by requiring a prudent spread of risk, and sufficient access to patient capital?

If not, do we need a different or more flexible approach to diversification rules? Please provide an explanation of your answer.

18. The current diversification rules can prove problematic for funds investing in illiquid assets. Due to the investment and borrowing powers restrictions on NURS, investment in patient capital would require some complex structuring, resulting in increased costs and decreased transparency and fund managers must be mindful of liquidity considerations.

19. In reality, fund managers will hold assets below the mandated threshold, to ensure that the threshold isn't inadvertently breached through e.g. market movements. This contrasts with typical portfolios held in infrastructure investments which typically would be a lot more concentrated.

20. Inadvertent breaches in cases such as the one mentioned above must be corrected as soon as practicable in the best interests of investors, in any event within six months. Where an illiquid asset must be sold to correct a breach, a sale may not be possible within the six month window. Property funds are permitted 24 months to correct investment breaches and a similar approach for funds investing substantially in other illiquid assets would be helpful. In addition, in some cases correction may require the divestment of the entire position rather than a partial divestment to reduce the size of the position, if this consists of a single indivisible asset. This would result in the fund losing its entire exposure to that particular asset, which may not be in the interests of investors.

21. The diversification rules should be made more flexible for a fund to invest substantially in patient capital. Investment in limited partnerships should also be permitted. Current spread rules on transferable securities and collective investment schemes should be widened, if necessary distinguishing between asset classes. The limits on investment in unregulated collective investment schemes should also be relaxed in this case. In addition, funds should be encouraged to invest indirectly in patient capital through other funds by abolishing the 15% second scheme restriction for funds of this type. Any increase in the flexibility of investment and borrowing powers must be accompanied by additional flexibility in liquidity management options.

22. The FCA should also bear in mind the lengthy lead-in time when investing in patient capital and should ensure that there is a derogation permitted from any such rules for some time after a fund is launched. Such a period should be at least three years, with the option to apply to the FCA for an extension, if necessary.

23. It has been noted that there is an increasing demand for funds to be able to invest in fully funded structures. The diversification rules should enable funds to invest in these structures and hold sufficient liquid assets, including collective investment schemes pending any capital calls.

24. The IA would like to reiterate the opinion that such relaxation of the rules would not apply in the case of all NURS, but in a particular chapter of the COLL rules, that would cover a specialist framework, which we refer to as the LTAF (see Appendix 1).

Q8: If authorised funds' scope to invest directly into patient capital assets other than immovables is increased do we need a remedy similar to the proposed mandatory suspension to avoid investors being treated unfairly? If you agree that suspension rules would be appropriate, please set out your suggestions as to what such a remedy would look like. If you do not think suspension rules would be appropriate, please explain why not.

25. In our response to CP 18/27 'Consultation on illiquid assets and open-ended funds', the IA made it clear that it does not agree with a hard limit for mandatory suspension.

26. On this point, the IA reiterates its call for the FCA to take this opportunity to review and enhance the liquidity management tools that are available in the UK, and consider tools, such as long notice periods for redemptions and side pockets, that are available in other jurisdictions. In particular, it is essential that funds can defer redemptions while continuing to accept subscriptions, to aid the flow of liquidity in the fund.

Q9: Why do you think the specialised funds have not been used in significant volumes?

27. The IA agrees that EuSEFs, EuVECAs and ELTIFs have not been taken up in the UK at any great volumes, but notes that such funds are a recent innovation and past experience shows that new structures are not taken up in great volumes for some time.

28. ELTIFs, which became available in the UK in 2016, were intended as a vehicle to enable both retail and professional investors to gain access to long-term investments. Fund managers of ELTIFs must be authorised as an AIFM and retail investors are subject to specific protections and restrictions. The ELTIF has so far not gained any traction in the UK, largely because of the restrictions on investment powers (especially with regards to property and loans), lifecycle, redemptions and on sale to retail investors and also because many distributors have not expressed any interest in making ELTIFs available on their platforms.

29. EuSEFs and EuVECAs are in existence in the UK, but not in any great number. Such funds were not primarily intended as retail vehicles, rather to allow small AIFMs the ability to distribute their funds cross-border, and are only available to a limited population of retail investors with significant investment capital (often referred to as "semi-professional investors").

30. Specific reasons for the lack of traction in these funds are discussed below.

Q10: Are there specific features of these funds which prevent fund managers or investors from using them to invest in UK patient capital?

31. EuVECAs and EuSEFs are not open to the majority of retail investors and the minimum investment amount of €100,000 (which has recently been reduced to €50,000) has also discouraged some investors, along with the relatively low investor protection provisions. It should be noted the primary intention for the EuVECA and EuSEF regimes were not to create a retail product, but to facilitate the wider distribution of venture capital funds and social enterprise funds managed by small (sub-threshold) AIFMs by providing an identifiable label and the ability to market their funds to professional investors in other EU member states without opting into the full AIFM regime. The provisions for "retail" investors were aimed at a small sub-set of sophisticated retail investors (often referred to as semi-professional investors), generally local authorities, small charities and associations, etc., rather than individual investors. It is therefore unsurprising these products have not been launched for the retail market.

32. It has been reported that many distributors have been unwilling to host the specialist funds on their platforms. Although EuSEFs and EuVECAs are not available to most retail investors, the lack of visibility on platforms means that retail investors and their advisers wouldn't be able to see an ELTIF as an option.

33. With regards to ELTIFs, additional eligibility restrictions imposed by a jurisdiction's available legal forms and regulatory structures, e.g. investors in ELTIFs structured as Luxembourg SIFs or RAIFs must also be "well-informed" has prevented investment by a large proportion of retail investors that the ELTIF was designed to accommodate.

34. The safeguards for investors into an ELTIF are seen as being so stringent they outweigh any benefits that were envisaged from these types of funds. One specific difficulty identified is that for non-advised sales an obligation to assess an investor's suitability is placed on the manufacturer, which is outside of their normal area of responsibility.

35. The cost disclosure requirements for ELTIFs are unclear, which results in a lack of uniformity with disclosure, making it unclear for investors wishing to make a comparison.

36. ELTIFs may have a secondary market, which would provide for some liquidity, but such a market is not guaranteed and their closed-ended nature means that trading would not be at a price consistent with their net asset value. In cases where there is no active secondary market, investors will see their capital tied up for a minimum of five years.

37. ELTIFs require a minimum investment of €10,000, which must represent a maximum of 10% of the investor's total assets. This can be restrictive for the majority of retail investors.

38. The diversification and borrowing limits of ELTIFs, whilst wider than the standard NURS limits are not seen as providing so much of a difference from NURS limits to promote establishment of an ELTIF. In addition, the ability to invest in unregulated collective investment schemes has not been extended from the standard NURS rules. In relation to long-term assets, ELTIFs are a useful vehicle for investment in infrastructure, but are less able to invest in private equity.

39. The restriction on investment in other collective investment schemes makes the ELTIF a less attractive vehicle. In particular, a fund's inability to derogate from the restriction when initially making investments after launch is too prohibitive, especially in the context of fully funded capital structures, where the ability to invest in funds other than other ELTIFs, EuSEFs and EuVECAs would allow for a faster deployment of capital. Member firms have reported a growing market demand for fully-funded structures.

40. Some regulators have restricted the permitted investments to EU investments, which has dissuaded investors wishing to access a more global bias.

41. ELTIF regulation restricts investment in "financial undertakings". There has been a lack of clarity and practical guidance from regulators concerning these types of assets. Similarly, the eligibility of certain real assets is unclear, e.g. in the context of commercial property or housing an asset must be "integral to, or an ancillary element of, along-term investment project that contributes to the union objective of smart, sustainable and inclusive growth", which is difficult to interpret.

42. Regulators have not implemented a common process for funds to register and notify for the purposes of cross-border marketing, which has increased the time taken for funds to be marketed.

43. From a tax perspective, there is an issue with the double tax treaty requirements. The definition of "qualifying portfolio undertaking" has been shown to create a number of impractical consequences.

Q11: Are there other areas where the currently regulatory framework creates unnecessary barriers, either directly or indirectly, to investing in patient capital?

44. Tax. Investors should be provided with incentives to invest in such funds and tax is one area in which such incentives can be developed. The tax regime should be reviewed alongside any new fund regime allowing substantial investment in patient capital to ensure that the product is efficient for investors, the fund and the fund manager and that the tax regime is not too complex to be attractive. The IA recognises that changes to the tax regime is not within the FCA's remit, but urges the FCA to work alongside HMRC and HMT in the development of any new fund regime.

45. As mentioned above, distributors often require funds that they host to be daily-dealing, which can be a challenge for a fund which intends to substantially invest in illiquid assets. The IA repeats its observation that the FCA may have a role, under its competition remit, in facilitating a dialogue with distributors and other relevant intermediaries to make it easier for funds who wish to move away from daily dealing to access these distribution channels.

46. One way to allow investment in patient capital funds by retail investors would be the relaxation of the ISA regulations to permit investment by ISAs in such funds, in a similar way that Innovative ISAs can invest in peer to peer loans and certain crowdfunding schemes such as mini bonds. The Lifetime ISA could be one appropriate vehicle to invest in patient capital, but its specific age restrictions do not make it the right product for all saving groups. The IA would welcome the cooperation of the FCA and HMT to allow this.

APPENDIX 1 – FOUNDATION FOR A LONG TERM INVESTMENT FUND (“LTAF”)

We present here an initial set of proposals that will form part of a more detailed paper as part of a final report from the UKFRWG (for more detail on this Group, see Appendix 2).

The objective of the long-term asset fund (LTAF) proposal is to identify the features required for a UK investment fund specifically investing in long-term illiquid assets or patient capital. For the purposes of this paper, patient capital will include non-listed investments typically with a long investment horizon such as real estate, private equity, infrastructure, venture capital and private credit, in line with the definition provided by the FCA in its discussion paper on patient capital.

Our proposal is built on a modified NURS structure capable of being sold to professional and retail investors with the following key characteristics:

- Utilise existing authorised NURS structure
- More flexible investment and borrowing powers
- Flexible dealing frequency
- Option to list
- Liquidity management tools such as notice periods and limited/deferred redemptions
- Model based valuations
- Strong investor protection measures
- Avoidance of any additional tax leakage

What is the problem that needs to be solved?

None of the three categories of authorised funds (UCITS, NURS and QIS) are truly suitable for retail investors to gain access to private market investments. Although a UCITS is available to retail investors, the investment restrictions applicable to a UCITS under COLL make it unsuitable given that it is primarily restricted to investments in listed investments and other UCITS and NURS, meaning there is little scope to access private market investments.

Whilst a QIS has sufficient investment flexibility to allow it to access private market investments, its unsuitability for retail investors, other than sophisticated investors, means it is also unlikely to be an option for the DC market, despite the FCA’s proposed changes to the permitted links rules. Although the QIS structure could be useful for certain types of wealth managers with professional clients, their high net worth clients are typically categorised as retail investors, who will not always be classed as sophisticated investors. Private wealth managers are generally reluctant to recommend or invest in QIS on behalf of these clients, particularly since QIS are classed as Non-mainstream Pooled Investments (NMPIs), which are subject to strict suitability requirements intended to prevent these being sold to retail investors other than those considered to be sophisticated.

The only one of the three categories of authorised funds which offers any potential solution for retail investors is the NURS. This structure can be used to engineer a portfolio that provides access to private market investments; but this is a complex and costly structuring process. Without this structuring, the current NURS’ suitability is limited in a number of ways:

- **Investments in collective investment schemes**. For a "standard" NURS, no more than 20% of the portfolio may be invested in unregulated limited partnerships. As most private market investments tend to be held through unregulated collective investment schemes, this restriction is unhelpful. However the restriction was relaxed when the FAIF regime was introduced. A NURS FAIF can invest up to 100% in unregulated collective investment schemes provided no more than 35% is invested in any one such scheme. All of the funds we have seen established in this market to date have been launched as NURS FAIFs in order to take advantage of this additional flexibility.

- **No direct investment in limited partnerships**. Most private market investments are held through a limited partnership. Pursuant to COLL, a NURS cannot invest directly in such a structure as it cannot redeem at NAV. Managers are therefore having to introduce layers of intermediary vehicles to access private market limited partnerships; either through an open-ended collective investment scheme or through a corporate vehicle;

- **Second Scheme.** A NURS is further restricted in that it cannot invest in another collective investment scheme which itself invests more than 15% of the value of the scheme property in units in collective investment schemes. As such, if an open-ended collective investment scheme is used in the portfolio, its further investment in private market limited partnerships is limited.

- **20% unlisted securities limit.** As mentioned above, a NURS could access private market investments via a corporate vehicle. However a NURS cannot invest more than 20% of the fund's scheme property in unlisted shares and no more than 10% in the shares of any one issuer. This makes access to private market investments via corporate structures challenging too. We have seen managers negotiate this by investing in collective investment schemes which in turn invest in corporates, which in turn hold the private market limited partnership investments, or private market investments directly. This restriction also makes it challenging for managers to access senior loans, which are often desirable as part of the private market portfolio, but which are often unlisted.

- **Inflexible Spread and Diversification Rules.** NURS set strict limits on the percentage of the fund that can be held in each asset, and in some cases each asset type. These require inadvertent breaches of these limits, such as those due to market movements, to be corrected as soon as practicable in the best interests of investors, in any event within six months. It will not always be possible to arrange a sale of an illiquid asset at a competitive price within six months. In addition, if a position consists of a single, indivisible asset, it may only be possible to correct the position by divesting the entire asset rather than a partial divestment to reduce the size of the position, depriving the fund of all exposure to that asset. NURS are currently permitted a derogation period after launch of up to six months where the full spread rules do not apply – it is unlikely to be possible for funds to be fully invested in illiquid assets in this time.

- **Limited Borrowing Powers.** A NURS' borrowing cannot exceed 10% of the value of the scheme property of the fund on any day. The borrowing abilities of a NURS are therefore inadequate for a fund requiring greater borrowing capacity in order to access private market investments. However, typically, some borrowing can be incorporated lower down in the structure.

- **Cannot guarantee.** A NURS cannot provide any guarantee or indemnity in respect of the obligations of any person and none of the scheme property of a NURS may be

used to discharge any obligations arising under a guarantee or indemnity with respect to the obligations of any person. This is restrictive because, if a manager wants to introduce some borrowing somewhere in the portfolio structure, there are restrictions on the ability to use scheme property as security for that loan. It is not clear whether that restriction on using scheme property as security relates only to direct scheme property of the NURS, or whether it means all indirect scheme property held within the structure somewhere.

In addition, COLL 6.6.12R (for UCITS and NURS) and COLL 8.5.4R (for QIS) requires non-financial instruments to be registered in the name of the depositary, increasing the cost of transferring title and impacting depositaries in areas such as environmental and health and safety legislation, and drawdown commitments for partnership interests. We understand this requirement is already a concern for many depositaries in respect of property funds, and the further challenges of being the registered owner for the wider range of long-term private assets proposed may deter depositaries from being willing to act for LTAFs, thus having implications on the ability for asset managers to bring innovative products to the market.

As highlighted in the above, although a NURS offers the only potential option of the three types of authorised funds available, there is still currently a need to do some complex structuring to create a private market investments portfolio that works within the COLL restrictions. This structuring results in additional costs and decreased transparency for investors. Any portfolio constructed must also have regard to the liquidity management requirements, explored below. As such, creating a more flexible investment and borrowing power regime only works if more flexibility is introduced in liquidity management options; as the two go hand in hand.

What is the target market?

From discussions with both asset managers and potential investors, the IA anticipates the target market being the following:

- **DC market**. The IA has heard of interest from managers and trustees of DC schemes, particularly default schemes, wanting to make an allocation to long-term investments to provide diversification and the potential for uncorrelated returns. DC schemes typically take two forms:
    - Trust-based schemes can access non-insured funds as professional investors because the scheme trustees are treated as professional clients under FCA rules, but trustee generally feel more comfortable with selecting retail funds.
    - Insurance-based: any DC scheme accessing investments through a unit-linked insurance contract must look through to the underlying investor, the retail client. In the unit-linked world, the investment must therefore be suitable for retail investors and comply with the permitted links rules in COBS 21. We have responded separately to CP18/40 on changes to the permitted links rules, including a proposed change to the client categorisation status of DC default investors. Notwithstanding that proposal, we believe an LTAF constituted as a NURS would be a permitted scheme interest under COBS 21.3 and able to invest in the broader range of illiquid assets under the FCA's definition of patient capital. We do have some broader concerns about the impact of the FCA's proposed 50% limit on holdings of illiquid assets in a unit-linked fund, which we discuss in our response to CP18/40 and which may also affect an LTAF linked to a life wrapper.

- **Professional investors.** These include institutional investors such as pension schemes, sovereign wealth funds, etc. These have flexibility to choose between a wide range of investment options in long-term investments, including direct, unauthorised funds (including offshore and onshore funds), authorised funds for professional or sophisticated investors such as QIS, QIAIFs (Ireland), or SIFs (Luxembourg), in addition to retail funds.

- **Multi asset funds/fund of funds**. These are usually authorised funds that seek to provide diversified, uncorrelated returns, often within a targeted risk range. The potential of diversification and uncorrelated returns from an allocation to long-term investments is likely to be attractive to managers of these funds. While these are generally considered professional investors, fund regulations usually restrict these to investing either predominantly or exclusively in authorised funds.

- **Private Wealth/Discretionary Portfolio Manager**. There is interest in the potential for diversification into a broader range of asset classes. While the clients of private wealth managers are typically high net worth, they are nonetheless usually still classified as retail investors, and therefore there is a preference in this audience for retail funds.

- **Retail investors**. Some interest is expected from advised retail investors with larger portfolios, who may be recommended a small allocation to long-term investments as a component of a wider investment portfolio. Interest from direct or execution-only retail investors is expected to be limited. The IA suggests that LTAFs should be capable of being sold to groups of retail investors, whether advised or execution-only, who have been identified as being appropriate for the target market by the manager. Any fund offered to retail investors, whether direct or advised, will need to be a regulated, authorised product.

To be able to access these target investor groups, we consider that the LTAF should be capable of being promoted to retail clients, even if there are restrictions on distribution in the retail market (i.e. advised and/or MiFID II complex/non-complex product categorisation). This is particularly important both for the DC market and, as explained above, this is often a feature required for wealth managers.

Provisional recommendations

The key recommendations for the LTAF are currently as follows:

- **An open-ended investment fund structure:** Any new regime should be open ended. Investment Trust Companies already provide a solution for investors wanting closed ended structures, but target investor groups, particularly DC pension investors, have expressed a preference for an open-ended fund structure over a closed-ended structure. DC pension investors have large monthly inflows, which need to be invested quickly to maintain target investment allocations. For the purposes of portfolio diversification, listed closed ended funds such as investment trusts tend to give an equity-like return profile, whereas open-ended investment funds are structured so that returns reflect the values and volatility profiles of the underlying investments for the purposes of reducing correlation with other asset classes.

- **Utilise existing authorised NURS structure:** All existing authorised fund structures have limitations as vehicles for investing in long-term and patient capital assets, but the IA proposes that the existing Non-UCITS Retail Scheme (NURS)

structure can be modified to accommodate a new sub-set of rules for the LTAF, similar to the FAIF. This sub-set would have its own label, but use the existing structures and rules of the NURS in respect of operational responsibilities and investor protection. The NURS is a retail fund regime, therefore could be distributed to both retail and professional investors (subject to suitability). The existing legal structures of authorised funds could be utilised, depending on the requirements of investor groups, i.e. corporate (Investment Company with Variable Capital), trust (Authorised Unit Trusts), contractual/partnership (Authorised Contractual Schemes). This would be more straightforward than starting with an entirely new fund structure.

- **More flexible investment and borrowing powers:** The LTAF should be able to invest in limited partnerships and the ability to invest in unlisted securities should be more extensive. The main differentials from the existing NURS rules would be as follows:

  - *Allow up to 100% to be invested in unauthorised collective investment schemes*. Private market investments tend to be held through unregulated collective investment schemes. Similar to a FAIF, an LTAF will need to be able to invest up to 100% in unregulated collective investment schemes.
  - *Allow direct investment in limited partnerships.* Private market investments are usually held through limited partnerships, therefore it is important that an LTAF would be able to directly hold interests in limited partnerships to avoid the need to utilise costly and less transparent multiple layers of intermediary holding vehicles.
  - *Disapply second scheme restriction on collective investment schemes*. Local collective investment schemes are often the most tax efficient way to access private investments in overseas jurisdiction, and some of the underlying investments themselves may be structured such that they constitute collective investment schemes. The requirement for a 15% restriction on investment by second schemes in collective investment schemes should therefore be disapplied for second schemes to be held by LTAFs.
  - *Allow up to 100% to be held in unlisted securities.* The overall proportion of the LTAF that can be invested in private unlisted securities should be unrestricted. Investments are unlikely to be made directly in infrastructure – these investments will normally be accessed through unlisted equity or unlisted debt. Many early stage companies will not be listed, therefore direct investment in these will require the LTAF holding unlisted equities. LTAFs may also find it efficient to access private market investments via a corporate vehicle. LTAFs will also need to able to access senior loans, which are often desirable as part of the private market portfolio, but which are often unlisted.
  - *Spread and diversification rules that are appropriate to the illiquid nature of the asset classes.* The rules for LTAFs should provide for an appropriate spread of risk, but a more flexible approach will be required to the spread rules than for other types of NURS. Spread limits in relation to an asset should be focused at the point of investment. Where an illiquid asset breaches a spread limit, the rules should recognise it may not be possible to divest the holding within a limited timeframe or make a partial divestment to reduce the size of the position. Where this is the case, the LTAF should be permitted to consider this in relation to the diversification of the entire portfolio and, where appropriate, continue to hold the position but not add to this. In the period after launch, LTAFs should have a derogation period from the spread rules of at least 3 years with the option to apply to the FCA

for an extension if necessary. The diversification rules should also enable LTAFs to commit capital to fully funded structures and to hold sufficient liquid assets, including collective investment schemes, to cover future calls on committed capital.

- *Allow a wider range of derivatives to be held for hedging purposes*. LTAFs may need to hedge against a broader range of risks given the nature of the underlying assets, for example the possibility of adverse weather conditions disrupting an infrastructure project which the fund has an investment in. Derivatives beyond those usually permitted for NURS should be permitted provided these are for the purposes of hedging an identified risk in the portfolio. Similarly, the LTAF should have the ability to take insurance contracts against identifiable risks in the portfolio or related to the management of assets in the portfolio.
- *Ability to originate or participate in loans*. Private investments are often made by way of loans, particularly for infrastructure projects. LTAFs should have the flexibility to directly lend.
- *Ability to guarantee loans.* A LTAF will require the ability to provide a guarantee or indemnity - if a manager wants to introduce some borrowing somewhere in the portfolio structure, it may be necessary to use scheme property as security for that loan.

- **Flexible dealing frequency:** Subject to any platform/operational issues being solved, it should be possible have a product which offers a dealing frequency of anything between daily to annual, or even up to every two years. It would be sensible to allow flexibility so that subscription days and redemptions days do not have to match.

- **Option to list:** The option to list would provide investors with an opportunity to at least transfer their investment on the secondary market if they wanted liquidity during a deferred or limited redemption period, rather than having to wait until a redemption day. Non-listed secondary exchanges should be permissible.

- **Liquidity management**: The level of dealing frequency would drive the liquidity management tools which could be used. LTAFs should able to use notice periods for redemptions – this tool is particularly suited to funds investing in long-term assets as a suitable notice period for redemptions allows the manager sufficient time to sell relatively illiquid assets for a suitable price, even where dealing is frequent. Deferred and limited redemption are useful but from member experience, the FCA seems reluctant, from a policy perspective, to accommodate any flexible interpretation of their use. The FCA therefore expects there to be an opportunity at least every six months for an investor to redeem. This is not really practical in the context of private market investments and further flexibility is fundamental to the LTAF regime. Other liquidity management tools could be developed, such as side pockets.

- **Model based valuations**: Since market prices are rarely available for long-term assets such as private equity, private debt, real estate, and valuations of unregulated collective investment schemes are valued infrequently, the manager of an LTAF will need to use a valuation model, considering a range of economic information relating to both the particular asset concerned and the wider market. This is likely to be an involved process, and may require the use of an external valuer such as a property surveyor, and so will not be practical to undertake on a daily basis. Monthly or quarterly valuations will be more realistic. Where daily or weekly dealing is used, the valuation is likely to be based a less frequent full valuation, with daily/weekly adjustments made for accrued income, inflows and

outflows, purchases and sales of assets. This will need to be pre-defined and disclosed to investors in summary form to give them confidence the NAV reflects the true value of the underlying assets in the portfolio.

- **Strong investor protection measures**: If redemptions were going to be more infrequent than is currently possible, for example, every two years, then perhaps that would trigger requirements similar to those in the ELTIF regulation such as appropriate investment advice needing to be taken and/or limit on the amount of an individual's assets/pension pot which can be invested in the fund. Any proposals in this regard would need to be practical for both manufacturers and intermediaries.

- **Registration of assets:** COLL 6.6.12R and COLL 8.5.4R should be revised for LTAFs and QIS to allow private market investments to be registered in the name of the AIF or the AIFM acting on behalf of the AIF, subject to appropriate protections to ensure assets cannot be sold without the knowledge or consent of the depositary, as opposed to the current FCA requirement for non-financial instruments to be registered in the name of the depositary.

- **Avoidance of any additional tax leakage** The LTAF should not give rise to an extra level of tax which increases leakage for investors compared to their position had they invested directly. The existing tax regime for AIFs is a good starting point here. Seeding relief would be required and it will be important that the LTAF can be seeded by one investor.

- **Tax incentives**: The ISA rules should be modified to ensure that LTAFs are qualifying investments for ISAs, even where dealing is less frequent than every two weeks. The government may wish to consider offering further tax incentives for investors in LTAFs investing in particular projects such as UK patient capital or infrastructure projects for longer periods, similar to those available for investment in VCTs/EIS.

APPENDIX 2 – BACKGROUND TO THE UK FUNDS REGIME WORKING GROUP

1. Through the HMT Asset Management Taskforce, in early 2018, the IA committed to look at how to help the UK retain and build on its global competitive position and pro-actively facilitate the existence of a world-class, customer focused fund management centre.
2. To achieve this, the IA set up the UK Funds Regime Working Group, participants of which are a range of senior figures with significant expertise in the funds industry. There are also representatives from Government, FCA and the Financial Services Consumer Panel.
3. This is a high profile and important project for the industry. In particular, it is considering the shape of post-Brexit regulatory, tax and broader operating environment for UK-domiciled funds and, as deemed necessary, will provide concrete proposals for change.
4. The IA submitted an interim progress report to the HMT Asset Management Taskforce in July 2018. This report included a proposal to look at access through funds to less liquid asset classes, where the UKFRWG believes there is scope to explore further how changing customer needs are best met by the UK fund regime.
5. The Group aims to produce a final report in early Q2 2019.