Michael Collins and Tom Bramhill
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

By email: cp21-12@fca.org.uk

25 June 2021

Dear Mr Collins, Mr Bramhill

Re: A new authorised fund regime for investing in long term assets

We are writing on behalf of the British Private Equity and Venture Capital Association (BVCA), which is the industry body and public policy advocate for the private equity and venture capital (PE/VC) industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. Between 2015 and 2019, BVCA members invested over £43bn into nearly 3,230 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ 972,000 people in the UK and the majority of the businesses our members invest in are small and medium-sized businesses. From an investor perspective, when comparing the performance of the UK PE/VC industry with public markets, the five-year and ten-year annual returns were 20.1% and 14.2% respectively, compared to the FTSE All-Share, which returned 7.5% and 8.1% to investors over the same respective time periods.[1]

Overview

We fully support the FCA's ambition to lower the regulatory hurdles to investment in illiquid assets by investors with long-term horizons who can understand the risks involved. The FCA's proposal for a new authorised fund regime (the LTAF) has strong potential to play an important role in facilitating access, by defined contribution (DC) default pension schemes and sophisticated retail investors, to illiquid investments. These include PE/VC funds, which have historically offered diversification benefits and higher returns to a range of UK and international investors, not least to overseas defined benefit and other pension schemes. As well as delivering positive, long-term investment outcomes for investors, UK-run PE/VC funds are a powerful motor of UK growth and employment, and well-placed to support the transition to a low carbon economy. This puts PE/VC funds squarely within the concept of "productive finance", and is the driver behind the BVCA's participation in the Productive Finance Working Group (PFWG), which we welcome as an effective mechanism for including industry insight in the development of policy in this complex area.

Our members' perspectives on the LTAF

If the separate charge cap concerns are ultimately resolved (see below) and the LTAF rules also succeed in overcoming the cited regulatory and operational hurdles, the vehicle is likely to be of significant interest to certain of our member firms as a potential tool for raising capital for investment in PE/VC assets, perhaps primarily from DC schemes in the first instance. Facilitating access by DC default

[1] For further comparative data see the BVCA Performance Measurement Survey 2019.

schemes is our members' first priority here, and it remains to be seen whether firms will seek also to target sophisticated retail investors, at least initially. We are also unsure whether such investors could be accommodated alongside DC investors as participants in individual fund products or not. In any case, we suggest that there should be an option for LTAFs targeting only DC default schemes to operate with greater flexibility, particularly in relation to liquidity management.

However, the proposed flexbility for LTAF products also to accept sophisticated retail investors remains very welcome. We think it is important to the LTAF's prospects that an expansive pool of investors is eligible from the outset, given the evidence that the UK's DC default market alone may take time to consolidate then understand, get comfortable with and start allocating to PE/VC funds. Whilst we do not think PE/VC funds are suitable investments for mass market investors, we would welcome the FCA extending eligibility to the clients of wealth management firms under advisory or discretionary mandates, where a market for illiquid investment products may be developing. We look forward to the output of the PFWG on facilitating demand, and remain on hand to assist in that important workstream as it develops.

If sufficent demand does exist, which we believe ultimately it will, we believe that the LTAF may be a suitable conduit for investment both directly into unlisted companies with strong growth or value creation potential, and indirectly into such assets via fund of fund structures that invest in traditional PE/VC funds. Some of our members may wish to manage direct LTAFs or LTAF funds of funds themselves. Others are keen to ensure that LTAFs are capable of investing in PE/VC funds.

We think it may be more challenging to design LTAFs that are appropriate for investing directly into unlisted companies (as opposed to other PE/VC funds) if there is no option for LTAFs to be closed-ended, or they at least have appropriate access to a full range of liquidity management tools including gating and suspensions, because of the inherent liquidity mismatch between open-ended fund structures and PE/VC assets. Perhaps unlike some other illiquid assets, it is simply not feasible to sell a stake in a portfolio company at a sub-optimal moment (e.g. halfway through a five-year business plan) merely in order to meet redemptions. There is a degree of liquidity available on the secondary market for PE/VC fund interests, although this should not be overstated nor depended on and we would expect any liquidity requirements to be managed at the fund or, ideally, investor level, in both the direct and fund of fund contexts

We also think the development of a secondary market in LTAF interests seems difficult to envisage, because the range of market participants will be limited to DC schemes and sophisticated retail. This is because it seems challenging from a legal and operational perspective for DC default pension schemes or sophisticated retail investors to invest in the same LTAF (as opposed to via an LTAF as a conduit) alongside less-constrained PE/VC investors. The broader, established and experienced PE/VC investor universe is well-tested, imposes many fewer operational challenges and is not subject to charge cap constraints. For this reason, it is important that LTAFs are appealing enough to achieve sufficient scale to operate as stand-alone vehicles for DC default schemes and sophisticated retail, and to invest in PE/VC funds, as funds of funds.

Key suggestions regarding the FCA proposals for the LTAF rules

Our members' reactions to the LTAF proposals are broadly very positive, and they have especially applauded the FCA's permissive and principles-based approach. However, there are some key areas in which the draft rules could be altered to make the vehicle more successful as a conduit for DC and sophisticated retail investment into PE/VC funds and assets. Our key recommendations for making LTAFs more effective in this regard are set out below (with our more detailed comments and further suggestions set out at Annex 1, in answer to the FCA's specific consultation questions):

- **Liquidity:** As widely recognised by the international institutional investor community, PE/VC investments in unlisted companies are inherently extremely illiquid and often better suited to the closed-ended vehicles (although we appreciate that the FCA's intention is to create a vehicle that can accommodate a mixture of liquid and illiquid assets, while safely achieving investors' expectations for liquidity). The LTAF rules would ideally therefore follow the example of the EU's increasingly popular ELTIF label by allowing LTAFs to be closed-ended, if that would be more appropriate for a particular investment strategy. Given that a closed-ended option may require legislative intervention beyond the mandate of this consultation, we strongly believe that a high degree of flexibility in the choice of liquidity management tools will be critical to the appropriateness of their use for PE/VC strategies. Limits on the amount of redemptions in any one period ("gating"), long notice periods (up to two years) and suspension in times of market stress must be part of that toolbox. We also suggest that some liquidity management tools that the FCA may deem inappropriate for LTAFs marketed to sophisticated retail investors (e.g. a "gate"/manager discretion to suspend redemptions above a certain proportion of the fund) should nonetheless be allowed for DC default schemes, which have lower liquidity requirements because they are able to manage liquidity at scheme level.

- **Depositary status:** The legal, practical and cost implications of a requirement for depositaries to hold legal title to unlisted assets on behalf of an LTAF are potentially prohibitive (see our answer to Q4). For a depositary to hold legal title would be a significant departure from the PE/VC model, developed under AIFMD, where unlisted assets are typically registered in the name of the fund (or the name of the manager or a nominee company controlled by the manager) and the role of the depositary is to verify that the assets are so held. If the LTAF is to be viable in this sector, the FCA rules must follow the AIFMD requirement for depositaries to satisfy themselves that the AIF/AIFM owns the relevant assets.

- **Frequency of valuations:** PE/VC assets are typically valued for monitoring purposes on a quarterly basis. Providing valuations more frequently than this poses significant operational challenges, which would increase costs for investors and dissuade smaller managers (often growth equity and venture capital firms) from offering LTAF products. LTAF managers should retain the option to provide valuations more frequently than quarterly if their investor base demands, but we see no reason for a regulatory requirement for monthly valuations where these are not required by investors.

- **Authorisation:** The current population of full-scope UK AIFMs within the PE/VC fund industry may be relatively small. Also, most, if not all, PE/VC fund managers will not currently have the necessary expertise, systems or FCA permissions to manage regulated AIFs (the PE/VC industry being based on the management of unregulated AIFs). We therefore suggest that the FCA consider an expedited process for applications for authorisations and variations of permission by firms looking to manage LTAFs.

Carried interest, the charge cap and their relationship with the LTAF

Subject to our comments elsewhere in this response, we believe the LTAF has the potential to help increase the flow of capital from DC default pension schemes into PE/VC funds. We also believe its impact in this regard will be severely limited if its introduction is not accompanied by more fundamental changes to the DC default charge cap calculation methodology than those recently proposed by the Department of Work and Pensions (a multi-year smoothing mechanism and the removal of look through for growth equity and venture capital funds).

We would encourage the FCA to recognise that removing carried interest and performance fees from the charge cap calculation is an essential prerequisite to the LTAF having a significant impact on the amount of DC default investment in PE/VC funds. This change would help to create a level playing field between UK DC default scheme beneficiaries and global pension savers by allowing UK DC pension savers also to invest, via LTAFs and PE/VC funds, in growing, unlisted companies, many of which are innovative UK businesses. At the same time, this change would also help the DC default market to move away from prioritising low costs over scheme members' ultimate returns.

Although the charge cap is beyond the scope of this consultation, the issues are closely related, and we wish to communicate to the FCA the reasons why we believe carried interest and performance fees should not be included in the charge cap calculation. These are set out at Annex 2 to this response. We also wish to communicate our members' support of existing FCA transparency requirements, and to highlight our industry's ongoing commitment to facilitating user-friendly costs and charges disclosures, which is demonstrated amongst other things by our participation, at board level, in the Cost Transparency Initiative.

Please also note that we have provided our perspective on the tax treatment of LTAFs to HM Treasury as part of our response to its review of the UK funds regime, and look forward to discussing this further with the Government

We would be very keen to discuss the contents of this letter with you further. Please contact TomTaylor (ttaylor@bvca.co.uk) if this would be of interest.

Yours sincerely,

Tim Lewis
Chair, BVCA Regulatory Committee

ANNEX 1

BVCA responses to consultation questions

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 see any equality and diversity issues in the proposals.

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?

Yes. We support the focus on clear disclosure and strong governance as an effective means of ensuring investor protection that should also allow for flexibility for LTAFs to invest across a range of different illiquid asset classes. We feel that introducing prescriptive or asset class-specific rules would be unduly complex, and an inappropriate means of regulating a product investing across different sectors and aimed at a variety of investor types.

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?

Purpose

We agree that 50% is an appropriate minimum expectation for the proportion of illiquid assets to be held by LTAFs (after any 'ramp-up' period). In practice, we would expect LTAFs to hold a higher proportion of their value in illiquid assets (even 100%), in order to reduce as far as possible any reduction in performance that more liquid investments, held to cover redemption rights, might entail. However, we agree that this should be a high-level requirement that is flexible enough to avoid divestments being driven by compliance reasons, for example where a portfolio company holding is floated on an exchange. To aid this interpretation, we suggest the FCA frame this as an expectation that the manager should seek, overall, to invest the majority of an LTAF's capital in illiquid assets.

Investment powers

Given the potential role of funds of funds in offering liquidity solutions and diversification benefits to LTAF investors, we strongly agree with the proposal to allow LTAFs to invest in other collective investment schemes (CIS). However, it is important that the same requirement to achieve a prudent spread of risk does not apply to an LTAF's investee CISs, which, as typically unregulated AIFs, will not be subject to a similar requirement, and which may in some cases have been established for the purposes of holding a single asset.

We are also concerned that the proposed 24-month 'ramp-up' period is too short in a PE/VC context. This is because PE/VC deal pipelines take time to develop and a relatively small number of individual large transactions can each take many months to execute. Standard PE/VC funds will agree an 'investment period' of typically three to five years, which is effectively the market's consensus on how long it is likely to take a PE/VC fund manager to identify and acquire a sufficiently diverse and promising portfolio of unlisted companies. This is reflected in the EU's European Long-term Investment Fund (ELTIF) rules, and we strongly suggest the LTAF framework take the same approach. This point also relates to our suggestion below that LTAFs should be permitted not to offer redemptions during an initial lock-in period of up to five years.

More broadly, we note that there is no clear definition of "prudent spread of risk". Anecdotally, we understand that depositaries are concerned that a lack of clarity in the definition makes it difficult for them to fulfil their monitoring role in respect of the requirement. One can look to the tribunal ruling in Arch Financial Products LLP v FCA, which noted that a prudent spread of risk should be considered from the perspective of a reasonable fund manager taking into account the published investment objectives and policy of the fund. Our view is therefore that a "prudent spread of risk" can be interpreted to mean managing risk within the range of reasonable decisions available and can mean different things to different managers. When aiming to provide a "prudent spread of risk" in the context of the LTAF, it will be important for managers to find a reasonable balance between long term asset allocation (in line with the overarching objective of the LTAF) and maintaining sufficient cash or near cash liquidity in light of the composition of the investment portfolio and market conditions at the time. Managers should aim to meet the expectation of investors that the investment strategy can be maintained through full investment but also need to be reasonably satisfied that (i) sufficient liquidity can be maintained through the use of liquidity tools; and (ii) redemption is possible, where requested. It would be helpful if the FCA could provide some further clarity in this regard.

Borrowing

We think 30% of an LTAF's net assets would potentially be a workable borrowing limit for LTAFs that used a fully paid-in subscription model to fund asset acquisitions, and welcome the proposal to apply this at fund rather than portfolio level. However, we also think a higher limit would allow greater freedom of product design and that the rules should be flexible enough to allow LTAFs to use a drawdown/commitment model if there is sufficient demand, in which case the limit should be based on total or outstanding commitments from investors.

PE/VC funds do not use a fully paid-in subscription model for funding acquisitions because it can take several months or longer to identify, diligence and execute an M&A transaction, during which the PE/VC fund manager would have to manage liquid assets whilst investors' capital remained effectively on stand-by. The same is true, albeit to a lesser extent, for PE/VC fund of funds, as PE/VC fund investments are also complex and negotiated to a timeframe considerably longer than that required for the execution of trades in a liquid context. The need to manage a short-term, liquid portfolio alongside a fund's core, illiquid investment policy would add complexity, risk and inefficiency, and damage returns. PE/VC funds therefore invariably use a drawdown /commitment model instead, where fund investors commit to providing capital (up to a maximum amount) on the manager's request, as and when the fund makes investments.

Within this framework, PE/VC fund investors often agree to grant fund managers short-term (usually three to 12 months) fund-level borrowing powers for hedging purposes, to make investments at the speed required in a competitive market (a drawdown notice period is typically ten days to allow investors to manage liquidity) and to reduce the administrative burden on all parties that more frequent drawdowns from investors (each time the fund makes an investment in a portfolio companies) would otherwise impose. Such debt facilities are typically guaranteed against investors' capital commitments to the fund and as such do not increase risk (as they do not increase investors' exposure) nor substantially increase returns (as they are not comparable to 'gearing' or 'leverage' where debt is used alongside an equity investment to enhance returns). PE/VC investors typically impose contractual limits to such borrowing powers of between 20% and 30% of the total capital committed to the fund (or outstanding from investors), which conveniently mirrors the FCA's proposed percentage but differs in its suggested basis for the calculation.

It may be that the administrative challenges of using the drawdown/commitment model in a retail context will be prohibitive for LTAFs targeting retail investors, and we understand that some DC schemes may favour a fully paid-in subscription model as well. In instances where the drawdown/commitment model is ruled out by such practicalities, then a borrowing limit fixed in relation to net assets would be appropriate. However, the appeal of the LTAF to PE/VC fund managers would be increased if the rules gave the option of mirroring existing practice and using the drawdown/commitment model. This would require flexibility in the rules for any borrowing limit to be measured against investors' commitments (total or outstanding) rather than net assets. In either context, we think that 30% is a potentially workable figure for PE/VC funds, although see no reason not to increase this to allow greater flexibility, in particular as regards liquidity management for LTAFs aiming to hold a greater portion of the fund in illiquid strategies from the outset.

Valuation

We agree with the proposal to use the existing AIFMD framework as the starting point for the LTAF rules on valuations, as it has proven to be broadly effective for the PE/VC fund industry to date, although we wish to reiterate that liability issues mean external valuation is impractical under the current AIFMD rules with the effect that PE/VC valuations are almost universally carried out in-house. Specifically, we are concerned about how the LTAF's draft rules link 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. 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 part of the EU's review of AIFMD, ESMA has acknowledged this issue. We suggest that the external valuer should only be subject to unlimited liability to the AIFM for any losses suffered by the AIFM from the external valuer's serious error or intentional failure to perform its tasks.

It should be relatively clear to managers of LTAFs carrying out valuations in-house what "in line with best practice" would look like in the PE/VC context, as the International Private Equity Valuation (IPEV) board publishes high-quality, uniform and globally-accepted guidelines that are regularly reviewed and updated to reflect evolving best practive. To the extent an LTAF holds non-PEVC assets, different standards would also have to be used in parallel.

With regard to frequency, PE/VC industry practice has largely settled on conducting quarterly valuations. This reflects the underlying assets' illiquidity whilst allowing an appropriate degree of reporting to investors for monitoring purposes (rather than providing a dealing price). In the absence of more regular liquidity options, we see little need for the LTAF rules to require valuations to be carried out more frequently than quarterly. Monthly valuations of PE/VC assets might be feasible for larger firms managing LTAFs but we query whether the extra cost of conducting them (which will be borne by the fund) would bring any benefit to investors, whilst it would raise the barrier to entry for smaller firms with fewer resources. It should also be noted that quarterly might even be too frequent for funds invested in other asset classes, particularly if their dealing terms are also much less frequent.

We are also concerned by the proposal to require depositaries to determine "without qualification" that the AFM has the requisite capability to carry out independent valuations of an LTAF's assets. In a

PE/VC context, where accurate valuation of unlisted holdings requires specialist expertise as well as close and detailed knowledge of the asset in question, it would be extremely challenging, if not impossible, for a depositary to confirm the competence of the AFM to conduct asset valuations internally, especially "without qualification". As a result, we would expect AFMs to conclude that the current proposals would require the appointment of an external valuer despite the likelihood that a functionally separate element of the AFM itself will be best placed to perform valuations. This would be both wasteful and expensive, which could be a significant issue for a DC default market with a sharp focus on costs (if indeed it is possible, given the above-mentioned liability concerns under AIFMD). Instead, we propose that the AFM board be responsible for determining the AFM's competency in this regard (or if necessary, an external specialist auditor).

Redemptions and subscriptions

This is a key concern for the BVCA. It is difficult to square an open-ended fund model with a PE/VC investment strategy focussed on long-term capital growth. PE/VC investments are inherently and unavoidably illiquid and returns are driven by growth and value creation that is only fully realised after a holding period of three to seven years, typically according to a business plan put in place when the fund makes its initial investment. Any risk of an LTAF being forced to sell a business (or a significant minority stake in it) for the sole purpose of meeting redemptions, before the investment has hit growth or value milestones that were set out on acquisition, would undermine its usefulness for PE/VC investment strategies.

The logic that illiquid, capital growth assets whose fruition cannot reasonably be interrupted to meet redemptions are best held in closed-ended vehicles fits well with the apparent consensus that DC schemes should be able to manage liquidity at scheme level (as it potentially also fits with appropriately regulated retail access). We would therefore ideally like to see an option for firms to offer a closed-ended version of the LTAF, where this would match specific investors' expectations. The EU's ELTIF rules require ELTIFs to be closed-ended unless certain conditions are met (e.g. redemptions can only begin after a five-year lock-in period, appropriate liquidity management systems must be in place, redemptions must be limited to a certain amount etc.). This is an element of the ELTIF structure that the EU designed effetively from the outset, and part of the reason for the increasing popularity of this vehicle, alongside subsequent reforms and the further liberalisation currently being developed by the European Commission. From a competitiveness standpoint, we believe the UK should take note of these developments, at the risk of being disadvantaged as a PE/VC fund management jurisdiction, and we would welcome the opportunity to discuss legislative change in this area with HM Treasury.

The liquidity mismatch is potentially less acute for PE/VC funds of funds because there is a degree of liquidity via the secondary market for PE/VC fund interests. However, even in that context, long notice periods of up to two years should be expected and the ability to limit redemptions at any dealing point to a certain proportion of the fund ("gating") will be critical. We think that LTAF managers should be allowed the flexibility to offer such limitations on annual redemptions with investors as they deem appropriate for adequately protecting a particular LTAF's investor base, be they based on a pro rata, first-come-first-served or other model (subject to authorisation by the FCA, which may deem certain terms more or less appropriate for different types of investor). It is also important that the rules also allow LTAFs to feature initial lock-in periods, matching PE/VC fund investment periods (typically three to five years), that will allow managers to build appropriately balanced portfolios and build up liquidity options. We therefore welcome the FCA's proposal to allow a wide range of liquidity management tools and require LTAF managers to explain on authorisation how the fund's investment and liquidity strategies are appropriately matched.

Liquidity management is also potentially less significant a concern in relation to LTAFs targeting DC default schemes only, which should be able to manage scheme members' liquidity needs at scheme level relatively easily, than it is for sophisticated retail investors, who may require greater liquidity protections to be enshrined in regulation. With this in mind, we suggest that, if the FCA deems certain tools to be inappropriate for sophisticated retail investors, the rules should nonetheless allow greater flexibility in the choice of liquidity management tools for firms offering LTAF products exclusively to DC investors.

Due diligence

The FCA's proposals are compatible with existing PE/VC fund best practice and we do not foresee them preventing LTAFs from investing directly into unlisted companies.

However, the proposed LTAF rules include the QIS and NURS due diligence requirements for investments in collective investment schemes, which are problematic for certain private markets strategies. For example, managers of funds of funds are subject to onerous due diligence requirements in relation to the target portfolio fund, both pre-investment and on an on-going basis. Guidance on this is detailed and may not be practical to follow, especially in context of secondary fund acquisitions (where access to the underlying portfolio fund manager may be restricted). Moreover, many of the due diligence requirements seem duplicative in relation to an existing UK/EEA AIF managed by a full scope UK/EEA AIFM. This difficulty should be reflected in the LTAF rules and the AIFMD approach followed, at least in the fund of funds context.

Knowledge, skills and experience

In theory, we agree that the proposed restriction of LTAF management to authorised full-scope UK AIFMs would provide the requisite comfort that prospective mangers are equipped with adequate systems and controls and that their senior personnel have sufficient experience to purse PE/VC investment strategies.

However, in practice we suspect that the initial uptake of LTAF management may be limited by this requirement for two reasons. The first is that the current population of full-scope UK AIFMs within the PE/VC fund industry may be relatively small. Many larger firms, in particular, have recently adopted alternative structures for various reasons, including to maintain or improve access to EU investors, and to benefit from a range of fund vehicles introduced over the past decade by other jurisdictions that are designed to work particularly well for both PE/VC fund managers and their international PE/VC investor bases. The second reason is that most, if not all, PE/VC fund managers will not currently have the necessary expertise, systems or FCA permissions to manage regulated AIFs (the PE/VC industry being based on the management of unregulated AIFs). PE/VC firms wishing to manage LTAFs would need to hire additional AFM expertise and submit to an authorisation period of potentially six months or more to secure the necessary variation of permission (although we note the FCA's objective of avoiding undue delay pending review after one year's experience of the authorisation process). We are hopeful that third-party AFMs may have the expertise and appetite to provide oversight for PE/VC investments, although this market may take some time to develop.

We therefore suggest that the FCA consider an expedited process for applications for authorisations or variations of permission by firms looking to manage LTAFs.

Reporting

We welcome the FCA's focus on transparency and proposal that the value assessment report be linked to the annual report, but consider that quarterly reporting on investments, transactions and developments is unnecessary and will add costs with little benefit in a long-term PE/VC context, where transactions are relatively infrequent. Reporting of this frequency might also misalign investors' expectations compared with the longer-term nature of the LTAF's investments. We suggest that annual and interim reports of this nature would be sufficient, subject to the discretion of the fund manager to provide more frequent reports if its investor base so requires.

We would also like to highlight that it would be extremely challenging for PE/VC firms to finalise and publish annual reports within four months of year-end for portfolios of unlisted companies that are often SMEs with fewer resources and not subject to the same reporting frameworks as listed companies. This timeframe would be even more problematic for PE/VC funds of funds, whose reporting is dependent on underlying managers providing information for investee funds. We suggest that the proposed requirement instead be aligned with the AIFMD requirement for reports to be produced within six months of the end of the relevant accounting period.

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

We have a specific concern regarding the proposed requirement that an LTAF's assets be registered in the name of the depositary, which would be the legal owner. We strongly suggest that the LTAF despostary rules should instead follow current industry practice for PE/VC assets, which is based on the AIFMD requirement (A21(8)(b)) for a depositary to satisfy itself that the relevant AIF owns the assets in question, using documentation provided by the AIF/AIFM and any available external evidence. This is because, from a portfolio transactional perspective, transferring ownership of an asset to the depositary would be costly and time consuming and would make it very difficult to re-register the asset, whilst from a secondary market perspective, PE/VC fund interests (typically limited partnership interests) are highly likely to be subject to restrictive constitutional clauses on transferability. It would also be very difficult for an LTAF to switch depositary, and challenging for a depositary to accept the implications of legal ownership, which might range from complying with building and licensing conditions through to the impact on the depositary's own carbon and broader sustainability reporting obligations. For all these reasons, we think the current proposal risks preventing despositaries from accepting LTAF mandates, thereby potentially threatening the viability of the vehicle. We would welcome the opportunity to discuss potential solutions to this problem with the FCA in more detail.

Separately, whilst we welcome the decision to allow LTAFs to originate loans, we are concerned by the prohibitions in draft COLL 15.6.8R, which prevent LTAF loans being originated to various parties including individuals and affiliated companies or associates. PE/VC fund investments in portfolio company acquisition vehicles are very often structured partly as shareholder loans for a variety of commercial reasons including to avoid the fund's investment overwhelming the equity held for incentive purposes by the company's management team. We are also concerned that these prohibitions may severely restrict standard co-investment arrangements, which otherwise seem likely to play an important role in encouraging DC default schemes into this asset class. We propose that instead the rules be based around a principles-based obligation for the manager to identify and manage conflicts. We believe that certain LTAFs are very likely to invest into (in the case of fund of fund structures), and/or invest or lend in parallel with, other funds or structures managed or advised by the relevant manager (or sponsor in the event that a manager-for-hire model is used) and where the sponsor's staff may have representative directorships. Conflicts requirements therefore need to remain outcomes- and principles-based. We note that the EU's ELTIF rules were regarded as too constrictive in this respect, contributing to that vehicle's limited initial popularity.

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 agree with the proposal to remove the 35% limit on illiquid investments where an LTAF forms part of the default arrangements of a DC scheme, and to categorise an LTAF exposure as a permitted link in its own right.

More broadly, we recognise that existing market structures often (but not always) feature DC trustees investing exclusively through insurer-provided platforms, designed around unit-linked life insurance policy contracts. However, we suggest that the FCA should be at least neutral as to the means by which a DC trustee might in future obtain its scheme's exposure to LTAFs. In fact, we suggest that the Productive Finance Working Group might consider encouraging a move away from this market structure. From a legal perspective, the unit-linked life policy contract: (a) gives no property right in the underlying fund to the trustee; (b) gives the trustee no cause of action in respect of the mismanagement of the underlying notional fund, by reference to which returns are calculated; and (c) in these respects and others gives rise to legal uncertainty. We do not think undue weight should be given to current market features (such as operational desires for daily valuation or greater liquidity) where such features arise only out of unit-linked-life arrangements which are themselves far from perfect.

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?

Our response is restricted to PE/VC funds and direct investments, which we consider to be appropriate assets for DC default schemes, particularly when investing through LTAFs subject to the proposed governance, disclosure and other investor protection requirements.

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?

We support the FCA's proposal to allow LTAFs from the outset to be distributed to certain types of retail investor who can understand the risks involved. We suggest a distinct set of rules for the LTAF, as opposed to a design necessarily modelled on the QIS. It should also be noted that the LTAF's stronger proposed governance requirements (which we support) mean that the vehicle, considered as a whole, already exceeds the level of protection afforded to QIS investors.

Although sophistication and understanding of risks do not correspond with wealth, we generally have in mind what might be described as "wealthy" investors (below generally accepted thresholds of high net worth, but above "mass affluent"), who are likely to be either the client of a discretionary wealth manager or advised by certain larger and more sophisticated non-discretionary wealth managers. The thresholds in COBS 4.12.6R of annual income of £100,000 or more, or net (investible) assets of £250,000 or more appear to us to be rather lower than we have in mind. In other countries, investors of the type we have in mind are described as "semi-professional" investors.

Permitting a degree of access to PE/VC assets for such sophisticated and high net worth investors would: (a) allow those investors to improve their portfolio construction; and (b) increase the likelihood that certain LTAF designs will achieve sufficient scale.

However, as for DC default schemes, we believe that even this advised retail market remains characterised by a considerable degree of nervousness about investing in closed-ended or less liquid funds. This suggests that the current rules, whilst theoretically permissive in many cases, are insufficient in themselves to encourage eligible investors to commit to closed-ended or less liquid structures. We believe that the solution lies in a mixture of: (1) good product design (and please refer, in particular to our concerns above on liquidity mismatch); (2) investor education, which we hope will be taken forward by the PFWG's recommendations this summer; (3) specific LTAF distribution rules and/or guidance, which we hope may provide more objective access criteria (see below) that wealth managers and advisers may be more readily persuaded to rely upon; and (4) the adoption by the FCA of a clear and appropriate stance on this topic.

In terms of HM Treasury's broader aim of bolstering the competitiveness of the UK's funds regime, the LTAF should compare favourably to similar frameworks such as the Luxembourg RAIF and may offer a genuine alternative to comparable vehicles available to certain UK retail investors, such as Investment Trusts and UK ELTIFs.

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.

As touched upon in our response to Q7, whilst the NMPI model is theoretically sufficient to allow LTAFs to be distributed to the more sophisticated/wealthy elements of the retail market (in some cases to a greater degree than we necessarily consider appropriate), anecdotally we believe there remains considerable hesitancy towards investing in closed-ended funds amongst wealth management advisers and IFAs, and (to some degree) discretionary wealth managers. In this context, we believe that simpler and more objectively verifiable criteria than those currently applicable under the NMPI rules would be more appropriate for the more illiquid investment propositions for which LTAFs are intended.

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 the LTAF should be highly suitable for retail investors who are clients of discretionary wealth managers. In most cases, this should not require the making of a financial promotion to the underlying client, but when discussing questions of "eligibility" of investors, it would be helpful for the FCA to make this expressly clear. We see no intrinsic reason why an advised wealth management investor should be treated differently to a DC default pension scheme saver for the purposes of investment in LTAFs. In both cases, an investment professional acts as an intermediary. Indeed, with additional protections such as we suggest below, and the relative sophistication and risk appetite of many wealth management clients, arguably these investors are ideal sources of capital for LTAFs.

In relation to certain advised retail clients (typically but not exclusively clients of a non-discretionary wealth manager), we believe that there may be a reluctance on the part of regulated firms to try to make use of the NMPI exemptions in COBS 4.12.4R. As a trade association representing the (largely wholesale) private equity and venture capital industry, our experience is largely anecdotal and there may be merit in the FCA conducting further research into the issues we raise here. However, if these exemptions were working as they should they would likely have facilitated greater investment into existing unregulated products. We speculate that there may be a number of reasons for this hesitancy, as follows. First, the requirement that financial promotions to categories of investor exempt under COBS 4.12.4R must nevertheless satisfy the content requirements of COBS 4 for retail investors, which may be challenging and/or resource intensive for advisory firms, when describing long-term illiquid products. Second, a reluctance on the part of advisory firm to bear the moral and regulatory hazard of a preliminary assessment of suitability required under categories 2 (self-certified high net worth investors) or 9 (self-certified sophisticated investors), particularly in light of the FCA guidance in COBS 4.12.9G to 4.12.11G.

(We note that similar exemptions are available under Articles 48 and 50A Financial Promotion Order and equivalents under the Promotion of Collective Investment Schemes Order but only in relation to funds which invest directly (i.e. not indirectly, as with a fund of funds) wholly or predominantly in unlisted shares or bonds, which may not be the case for all strategies contemplated for the LTAF, such as direct lending funds. These exemptions would render a promotion an "excluded communication" for the purposes of COBS 4 including COBS 4.12.4R, and (in contrast to Categories 2 and 9) do not feature a preliminary assessment of suitability.)

Category 8 (sophisticated investor so-certified by a third party FCA authorised firm) has never had much traction because of the likely unrewarded liabilities which would attach to a firm issuing such a certificate.

Unless further FCA research can resolve these concerns, the NMPI route does not appear to us to be ideal for LTAF products to be distributed to retail investors. Instead, we suggest that clearer, objective guardrails, as detailed in our response to Q14 below, could serve as an alternative model for promoting LTAFs to retail investors. This approach also acknowledges the stringent governance, valuation and due diligence requirements being proposed for LTAFs.

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

We are hesitant about whether a mere appropriateness test (i.e. a firm's assessment that its client can understand the risks involved) would be sufficient protection for retail investors. In any case, we believe that advisers would remain reluctant to distribute on this basis because of the uncertainties and risks involved for advisers.

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 do not think the NRRS rules, designed for a different context, should be transplanted into the LTAF context. We think the current momentum created by the Government, Bank of England and FCA’s concerted efforts, engaging with industry, to identify and remove barriers to greater investment in productive finance creates fertile ground for the FCA to be more ambitious in designing a new distribution framework that could address existing problems and achieve the requisite degree of confidence in LTAF investments amongst the advised retail investment market.

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 do not think that restricting retail participation to LTAFs that secure a minimum level of investment from unaffiliated professional clients would serve as sufficient protection for retail investors.

The LTAF should be flexible enough to allow both professionals and certain retail clients to participate, and any co-mingling of these investors in a single vehicle could in theory help some LTAFs achieve greater economies of scale. However, we suspect that professional and retail investors will more commonly invest via distinct vehicles tailored to their particular needs, such as their time horizons and liquidity requirements. Restricting retail participation to vehicles that had already secured a minimum level of professional investment would reduce flexibility and hamper firms' ability to design different products for different investors.

We believe that it would be far preferable to ensure adequate protection for retail investors via other mechanisms that reflect such investors' particular characteristics and do not create a dependency on the investment decisions of professional investors.

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

It would be necessary to remove the caps on a second scheme's investment in other schemes (15%). The prudent spread of risk requirement on second schemes should also be revisited in light of our concerns about how the requirement applies to the LTAF more generally.

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

As noted above, we think exposure to LTAFs is already appropriate for the retail clients of discretionary wealth management firms, which are analogous to the beneficiaries of DC default schemes in this context.

We also consider that the proposed LTAF rules provide sufficiently robust investor protections to render the product appropriate for certain advised retail clients. However, as discussed above, existing routes already provide some access to illiquid investments for these investors yet, anecdotally, these channels seem to be failing to inspire enough confidence to work effectively in other contexts.

Part of the solution may be for the FCA to make a clear statement that LTAFs are broadly appropriate for advised retail investors and to modify its guidance on COBS 4.12.9G to 4.12.11G. More concretely, we think certain objective eligibility criteria would be extremely helpful, in particular we would suggest: (a) limits on the proportion of an individual's investible portfolio that can be allocated to LTAFs (mirroring the approach DC schemes are likely to take in practice, which amongst other things will ensure sufficient liquidity from other sources) or FCA guidelines as to what such proportion might typically represent; and (b) minimum investment amounts. In relation to minimum investment amounts, the €100,000 minimum in the ELTIF rules may be a good reference point, or the €200,000 minimum used in Germany to define a semi-professional investor, but it would be even better to allow an investor to diversify an exposure across more than one LTAF: there could be a higher minimum investment amount of approximately this magnitude for allocations to any number of LTAFs by a particular investor.

Separately, the BVCA would like to continue to discuss with the FCA the possibility of amending the quantitative criteria for elective professional client designation (linked to COBS 4.12.4R Category 7 and PRIIPS KIID), which are unworkable in a private investment fund context. We note that the European Commission is presently consulting on a liberalisation of EU law in this respect. However, we do not consider this to be the core focus in the context of LTAF.

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?

The LTAF should be capable of being marketed to the full variety of institutional investors, such as defined benefit pension schemes, sovereign wealth funds, charitable foundations and others, as well as family offices. This openness could theoretically help LTAFs achieve scale. However, we query whether institutional investors that do not require authorised fund structures would choose to invest via LTAFs over the standard unregulated structures that are tried-and-tested and offer greater flexibility and lower costs.

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?

Subject to our concerns expressed above about unit-linked life policies generally, yes, we believe that LTAFs should be made permitted links.

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

No comment.

ANNEX 2

Carried interest and performance fees:

- From a policy perspective, carried interest should not be counted as a cost for the purposes of the charge cap calculation. Carried interest is not a cost, rather it is an after-the-event profit share i.e. it is only paid from realised profits if and when pension savers have already seen their capital returned plus a preferred return. This means that carried interest payments present no risk of eroding pension savers' capital, as they are not made if an investment stagnates or falls in value. They are only made if the investment ultimately returns a substantial profit (usually above 8% on a portfolio-wide basis) to the pension saver when sold after several years. This is one of the fundamental strengths of the PE/VC fund model, and it makes carried interest fundamentally different to an ongoing and unavoidable cost such as a traditional management fee, which continues to be charged on pension pots in a stagnating or falling market. It also means that carried interest's exclusion from the charge cap would present no risk of managers charging high fees despite poor performance, as its payment is inherently dependent on substantial, realised outperformance.

- Carried interest improves investors' returns. This is because it provides a critical alignment of fund managers with investors over the long-term (during the 10- to 12-year (or longer) lifespan of a typical PE/VC fund). It has been the market standard approach for decades because the performance of a PE/VC investment depends on more than just making a good initial investment decision. Longer term support from funds helps portfolio companies to fulfil their initial promise and strategic plans, grow in value and therefore provide returns based on capital appreciation to the fund's investors when the business is sold, usually at the conclusion of a multi-year business plan put in place on investment (or longer in the case of some venture capital funds). This is why carried interest does not pay out until the fund manager has returned investors' capital plus a preferred return (typically 8%, on a portfolio-wide basis).

- The carried interest model is supported by investors around the globe (including the world's largest, most sophisticated pension funds) as an effective method of aligning the long-term interests of investors and managers. It seems unlikely that fund managers or their existing investors (whose support would be required, not to mention the existence of legal requirements for managers to treat all investors fairly) would accept a bespoke arrangement for DC default scheme investors that was an effective long-term alignment tool but not based on carried interest or a similar performance incentive. Any such bespoke arrangements would likely not be in the interests of DC schemes anyway, as they would potentially: (a) lead to a misalignment of the manager's and the investors' interests over the long-term; and (b) exclude much of the PE/VC fund manager market which we imagine would likely prefer to concentrate on fundraising from the broader institutional investor community, which largely supports the carried interest model, and which does not present the same operational and economic challenges.

- Appropriately designed performance fee arrangements can also operate as effective long-term alignment tools that could be used by LTAFs in the best interests of their investors. Given the requirement for fairness amongst pension members in paying 'their share' of performance fees related to the time period they were exposed, some performance fee mechanisms incorporate a high water mark that is crystallised at (a minimum of) the dealing frequency. For example, a program with daily liquidity is required to crystalise performance fees into the unit price daily. Such a high water mark provides meaningful alignment of interests between investors and fund managers as investors would only pay performance fees on 'net new performance'. In the case of negative performance periods, the fund manager is required to generate performance beyond any previously set high water mark (at a share class level, not investor level) which serves as a meaningful incentive mechanism for the fund manager. If a new high water mark is not set (in this example, on a daily basis), no performance fees are payable by the investor.