The Association of Investment Companies

An accident waiting to happen

The dangers of selling LTAFs to retail investors and how to reduce them

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About the AIC

The Association of Investment Companies (AIC) represents closed-ended investment companies whose shares are traded on public stock markets.

The AIC's members comprise over 350 investment companies, with assets under management of over £250 billion.

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An accident waiting to happen

Selling Long Term Asset Funds (LTAFs) to retail investors is an accident waiting to happen. Or, if you prefer, a foreseeable source of financial harm to ordinary consumers. Investors will bear the brunt of inevitable flaws within LTAFs if the distribution of these funds is prematurely extended, without additional consumer protections, to a wider market of retail investors.

Given industry ambitions to sell LTAFs as widely as possible, and the lack of launches in the 11 months since the rules were finalised, this will not be a popular message to firms wanting to set up LTAFs, but it is one that must be heard.

LTAFs are a new fund structure, combining novel redemption arrangements with inherently illiquid assets. As the lamentable experience of daily-traded property funds shows, the industry has a poor record of safely making illiquid assets available to consumers using open-ended funds. LTAFs are likely to repeat these failings with harmful results for consumers.

Liquidity mismatches will inevitably be a feature of the first LTAFs. These arise where the liquidity of the assets does not match the timetable for investors to get their money back. Liquidity mismatches are particularly harmful to retail consumers, who react slowly when funds start to fail and are less able to bear the consequences.

Under the current rules, LTAF operators can adopt arrangements (such as delaying customers' exit from a fund and borrowing to finance redemptions) which will particularly harm retail investors. These practices should be banned before any LTAF can be sold into a wider retail market.

Widening LTAF distribution before the product has been proven, and proper standards imposed, is inviting trouble.

Holding the review before any LTAF has been launched raises questions. Asset managers argue there is *"little incentive"*[1] to launch LTAFs that can only be sold to professional, sophisticated and high-net-worth retail investors. This view should set the regulatory warning lights flashing. If professionals are unconvinced by the LTAFs being developed, these funds are unlikely to be suitable for a wider retail market.

The danger is that LTAFs will benefit from well-known consumer biases that attract inappropriate investment by the unwary. LTAFs will be promoted as a new source of superior returns. This will appeal to those less able to take a considered view of the risks involved. Consumers are unlikely to appreciate the implications of longer notice periods and other liquidity management tools. This increases the risks of poor investment decisions. Limiting purchases to 10% of an individual's savings will not prevent serious harm if things go wrong.

The Financial Conduct Authority (FCA) must stick by its original decision on LTAF distribution to ensure consumer protection. It should only review this position once providers have demonstrated that LTAFs can operate reliably in good and bad markets. The FCA can use the intervening period to regulate LTAFs so that they incorporate the standards required of retail funds.

Providers should focus on developing LTAFs able to appeal to informed investors instead of selling products of unproven quality to those with less capacity to evaluate the risks and who are more vulnerable to financial harm if things go wrong. This will create a strong foundation for the LTAF's long-term success.

Taking the time to get LTAFs right will not reduce the supply of productive finance to UK businesses. LTAFs will not make this type of investment as the structure is not suited to this activity. LTAFs will instead invest in existing and overseas assets.

With the potential for consumer harm so high, and the alarm bells ringing so clearly, there is no excuse for getting this call wrong.

Richard Stone
Chief Executive

Summary

The FCA's original decision to classify the LTAF as a Non-Mainstream Pooled Investment (NMPI) was correct. Nothing has changed to justify altering this decision.

Liquidity mismatches are a known problem for open-ended funds, particularly those holding less-liquid assets. It is rash to expect that a novel structure, such as the LTAF, will not also have the same problem.

The shift into more challenging economic conditions increases the dangers of exposing retail consumers to the liquidity risks intrinsic to LTAFs.

Minimum notice periods on their own will not prevent liquidity mismatches.

Obliging the LTAF manager to set the required notice period is fraught with risk. It is doubtful that LTAF operators can take on this task effectively. The data to make this assessment is sparse and assets vary in their liquidity characteristics. LTAF operators have incentives to set notice periods as short as can be justified.

The liquidity management tools LTAF operators can use will not resolve liquidity mismatches caused by inadequate notice periods. Instead, they will only increase the potential harm that LTAFs will cause for retail consumers.

Governance processes have not prevented liquidity mismatches in the past. In the absence of any evidence to the contrary, concluding that they will resolve this issue for LTAFs is unrealistic.

The FCA's authorisation process cannot be relied upon to prevent LTAFs incorporating liquidity mismatches or other design features that harm retail investors.

Retail consumers are likely to be harmed by these failings and their lack of financial resilience means they will be particularly disadvantaged when LTAF liquidity mismatches crystalise. The consumer biases of retail consumers make them vulnerable to buying LTAFs that do not meet their investment needs.

Limiting investment in LTAFs to 10% of an individual's investable assets does not provide sufficient protection for investors.

Maintaining the current restrictions on LTAF distribution will not deny retail investors access to illiquid assets. They can already invest in them using other structures, such as listed investment companies.

The claim that LTAFs will create greater investment in long-term productive assets does not bear scrutiny. Even if it were a realistic claim, it does not override the FCA's statutory duty to ensure adequate consumer protection.

Given the foreseeable risks to consumers, no changes should be made to the distribution of the LTAF at this time.

The FCA should review this position after LTAFs have become established and shown how they operate in good and poor markets. Such a review would consider if LTAF operators have been able to set sufficient notice periods to prevent liquidity mismatches and how they have used liquidity management tools.

Before allowing LTAFs to be marketed to a wider retail market, the FCA should introduce a two-tier LTAF regime.

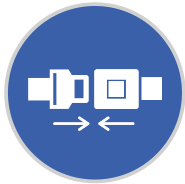
One tier of LTAFs would retain the current rulebook and not be distributed to a wider retail market.

The other tier of LTAFs would incorporate additional consumer protections to make them suitable for wider retail distribution. The additional consumer protections required include:

- Banning liquidity management tools that disproportionately disadvantage retail investors. These tools include deferrals, borrowing to meet redemptions, and imposing 'lock in' periods longer than the standard notice period.
- Enhanced governance, including requiring an annual statement that the arrangements of the LTAF are consistent with the consumer duty.
- Requiring suspension when there is a material uncertainty in asset values.
- Additional risk warnings.
- The introduction of a cooling-off period.

Only when these measures have been introduced, and the FCA has reviewed market experience, should LTAFs be considered for distribution to a wider retail market.

If this approach is not taken, then consumers will suffer foreseeable harm and the FCA will not be delivering its statutory duties to protect them.



A premature review

The LTAF is an untested product. It combines inherently illiquid assets, with uncertain and idiosyncratic liquidity profiles, with a novel structure.

The FCA's original decision to classify the LTAF as a NMPI was correct. NMPI distribution is limited to professional, sophisticated and high-net-worth investors. LTAFs can be bought by pension funds (including defined contribution (DC) schemes), discretionary managers and other funds. The potential market is large and enables LTAFs to be launched while protecting retail investors.

Nothing has changed to justify the FCA altering its original decision.

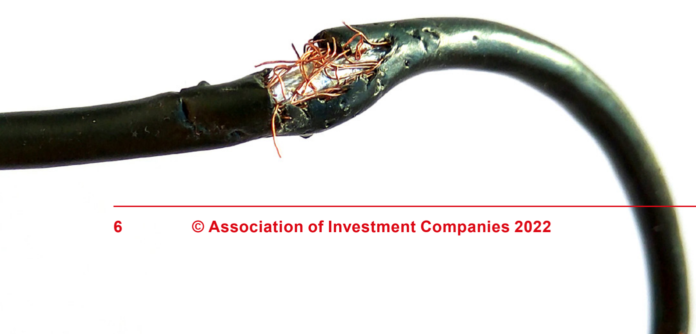
The FCA cannot take an informed view of whether the LTAFs will operate as intended. It has no information on what LTAFs will invest in, how their redemption arrangements will be structured nor how they will perform in less favourable market conditions.

The consultation is premature given the recommendations of the Personal Finance Working Group (PFWG). The PFWG, convened in November 2020 by the Bank of England (the Bank), HM Treasury, and the FCA, has been considering widening retail distribution of the LTAF (an approach supported by many of its members). It recommended that the FCA should

"review the application of the Financial Promotion rules to the LTAF, including the classification of the LTAF as a non-mainstream pooled investment (NMPI), ***once LTAFs are established****."*[2]

LTAFs are not 'established': none have been launched. The reasons for the FCA's decision to limit retail distribution remain compelling. There is no evidence to suggest otherwise.

At the same time, there is every reason to believe that wider retail distribution is likely to be a cause of serious harm to investors.




STOP

Liquidity mismatches will arise

A liquidity mismatch arises in a fund where the assets held cannot be sold quickly enough to satisfy redemption requests (unless they were to be sold at a discounted price).

Liquidity mismatches harm retail consumers. In periods of high net redemptions (requests to leave the fund) the manager can be forced to sell assets to raise cash to pay exiting investors. The assets sold are the most attractive and liquid. This depletes the quality of the portfolio. Invariably, assets are sold at a lower price than if the transaction was unforced. This also reduces the return to investors. These dynamics encourage further exits, exacerbating the problem.[3]

LTAF operators unable to pay redemptions may seek to stem outflows. They will be able to 'defer' redemptions: delaying exits until the next redemption opportunity. This will mean a wait of at least three months beyond the stated notice period, but the delay could be considerably longer. Retail investors will be unable to stop their losses. They have less capacity than institutions to manage implications of such losses. The LTAF rules allow repeated deferrals if the liquidity mismatch persists.

The LTAF may be forced to suspend dealing altogether. Consumers will continue to pay fees with no opportunity to exit. They will continue to suffer the consequences of falls in asset values. The manager's efforts to raise cash to reopen the LTAF will further erode the attractions of the portfolio. In the worst cases, suspension will lead to the forced closure of the fund – with another lengthy wait before the retail investors get their money back.

A liquidity mismatch was the underlying cause of the collapse of the Woodford Equity Income Fund (WEIF), one of the most high-profile fund failures of recent years.

Liquidity mismatches create the same potential harm for institutional investors, but institutions are better able to assess these risks and bear the financial consequences.

The FCA and the Bank reviewed liquidity issues in corporate bond funds and found[4] that professional investors are better than retail investors at identifying strains on the fund and selling early to try to avoid liquidity crunches. Other experience points to the same conclusion. Many institutions sold WEIF before it failed, leaving retail investors trapped within the fund. Some three years later, consumers are still waiting to get their money back.

It is striking that institutions that could invest in LTAFs, and which were supposed to be their primary market, have not been supportive of the structure.

If institutions are unconvinced that the LTAF meets their needs, it is an obvious warning signal that the first LTAFs are unlikely to be suitable for wider retail distribution.

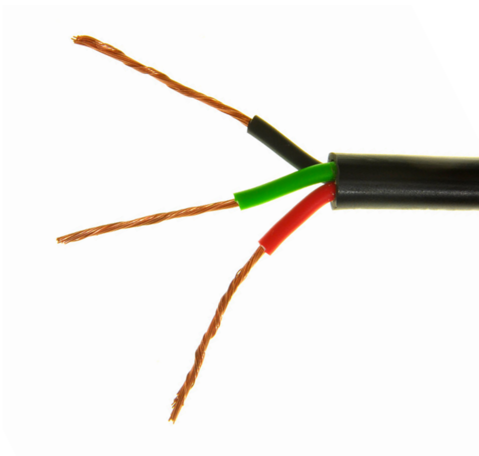
> “Funds often experience large investor withdrawals at times of market volatility”
>
> Bank of England. December 2019[5]

Liquidity mismatches are foreseeable

Liquidity mismatches are a known problem for open-ended funds, particularly those holding less-liquid assets. Mark Carney, when Governor of the Bank of England, highlighted the extent and impact of liquidity mismatches, warning that

*"**over half of investment funds have a structural mismatch between the frequency with which they offer redemptions and the time it would take them to liquidate their assets.** Under stress they may need to fire sell assets, magnifying market adjustments and triggering further redemptions – a vicious feedback loop that can ultimately disrupt market functioning."*[6]

As liquidity mismatches are so extensive in existing products, it is rash to expect that a novel structure, such as the LTAF, will not also have the same problem. Particularly given the assets it is intended to hold.



"The UK's long-term asset fund (LTAF) structure is not proving popular, with the FCA not receiving any applications for it since its launch in November 2021."

Citywire. 3 August[7]

A history of underestimating liquidity challenges

The Bank has discussed how portfolio liquidity can be assessed, distinguishing between a 'top-down' and 'bottom-up' approach. It noted

"There are trade-offs between a 'top-down' asset liquidity based classification (whereby liquidity is classified by asset-class), and a 'bottom-up' securities based approach (whereby funds allocated securities to specific 'liquidity' categories). A top-down framework allows for a more consistent measurement of the liquidity of funds' holdings, but may camouflage idiosyncratic liquidity risks within an asset class. A bottom-up framework would allow fund managers to consider the inherent liquidity profile of their securities, but assessment of liquidity is challenging and ultimately based on both information and judgement."[8]

The Bank's analysis highlights the fundamental problem with expecting firms to set adequate notice periods. The target assets of LTAFs (such as property, private equity and debt, infrastructure etc.) have idiosyncratic liquidity characteristics. Even holdings in the same class will differ in ways that will make their liquidity difficult to assess. The liquidity profile of each will change according to market conditions. Stressed markets will make them more difficult to sell, some will become unsellable. The assessment of how long the notice period should be is made even more difficult as it must work for the whole portfolio.

"assessment of liquidity is challenging and ultimately based on both information and judgement"

Bank of England. 13 July 2021[9]

It is easy to see how over-optimistic assessments of only a few individual assets could create a fundamental liquidity mismatch.

Evaluating the liquidity of LTAF assets is made even more difficult as public data on the liquidity of these assets is limited and the range of investments that can be held is wide. LTAF operators will have to lean even more heavily on their own judgement but without the data to support their conclusions.

Asset managers have a track record of poor judgement in relation to liquidity assessments. FCA and Bank research found that

"managers of corporate bond funds may be overestimating the liquidity of their holdings. Managers of some of these funds considered a large proportion of their holdings to be liquid in almost all market conditions, and most funds considered the majority of their holdings to have 'high valuation certainty'. Liquidity conditions for corporate bonds, particularly in market stress times, would indicate otherwise."[10]

> "Managers of most funds appeared to overestimate the liquidity of their holdings and some funds displayed notable 'liquidity optimism'"
>
> Bank of England and FCA. March 2021[11]

The 'liquidity optimism' of managers of bond funds arises despite ample market experience. The potential for misplaced optimism in LTAFs is surely greater given the diversity of assets, lack of available data and manager incentives to draw conclusions that support shorter notice periods (which make their products more commercially attractive).

The open-ended property sector illustrates how commercial incentives can influence product design. Daily redemption became the norm despite the reasonable conclusion being that direct property holdings can take months to sell, even in favourable markets, and that daily redemption creates a liquidity mismatch.

Even after property fund liquidity mismatches were exposed in the financial crisis and after the Brexit referendum, managers have maintained an overly optimistic view of the liquidity of property holdings. In its response to the FCA's proposals[12] for longer-notice periods for property funds, the industry supported a three-month (90-day) notice period. The AIC reviewed the evidence available at the time.[13] This supported a conclusion that a year would be required to allow property holdings to be sold in good and challenging economic circumstances without a liquidity mismatch arising.

An EU analysis[14] of the liquidity of properties held by Alternative Investment Funds confirms the AIC's view that 90 days is not sufficient. It found that only:

- 20% of commercial property holdings could be liquidated in under 90 days
- 2% of industrial holdings could be liquidated in under 90 days
- 30% of residential holdings could be liquidated in under 90 days
- 15% of other property holdings could be liquidated in under 90 days.

This contrasts with the overly optimistic view that 90 days is a sufficient notice period to prevent a liquidity mismatch in property funds. The EU's conclusions were based on data gathered at the end of 2019. Subsequent changes in market conditions suggest that property transaction times have increased since then. This makes support for a 90-day notice period for open-ended property funds even less viable.

The FCA has expressed concerns about liquidity optimism within the wider alternative asset management sector. In a letter to alternative managers, it said

"We have seen firms overestimate liquidity in the context of stressed or fast-moving markets and have also witnessed situations where leveraged structures have come under strain. Robust risk and liquidity management is essential at any time, but especially so given increased market volatility and rising interest rates which is leading to several new coexistent risks for alternative asset managers."[15]

This also supports a conclusion that LTAF providers are likely to exhibit misplaced liquidity optimism.

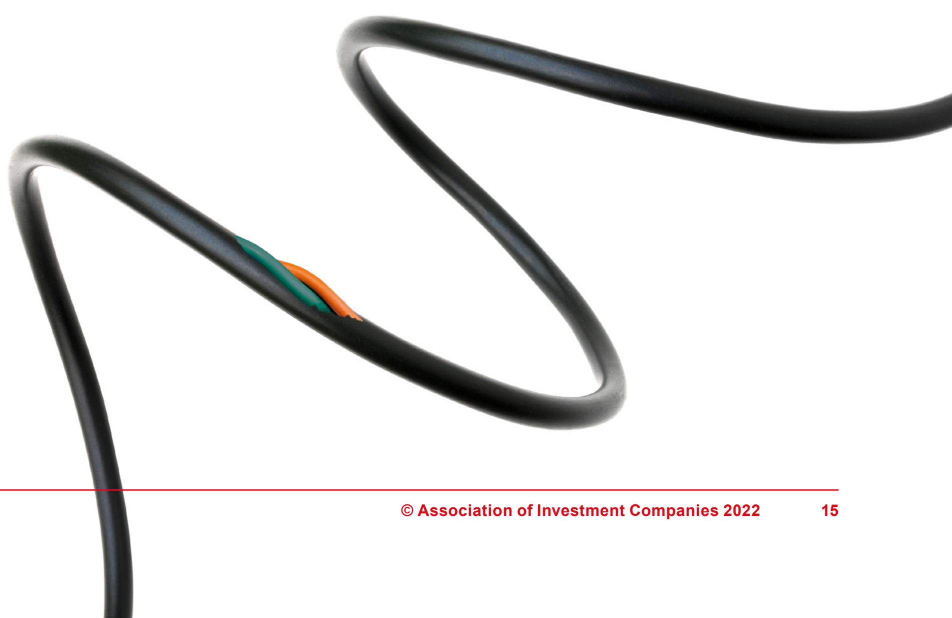
A high risk of liquidity mismatches

Economic and geopolitical uncertainty has resulted in high inflation and increased market volatility. These conditions have precipitated net withdrawals for established open-ended funds.

Funds holding less-liquid assets face a greater risk of high withdrawals in such conditions. The Bank has found that

"The sensitivity of fund flows to their performance is higher when funds hold less liquid assets. Research considering different markets and regions shows that outflows from ***funds are more sensitive to fund performance when funds hold more illiquid assets and when market liquidity conditions are worse."***[16]

The shift into more challenging economic conditions increases the dangers of exposing retail consumers to the liquidity risks intrinsic to LTAFs.



Minimum notice periods will not prevent liquidity mismatches

LTAFs must have notice periods of at least 90 days. This baseline requirement will not prevent liquidity mismatches. The FCA[17] has said

"In practice, we would expect that many LTAFs would have notice periods significantly longer than 90 days."

It continued

"Managers of LTAFs must make their own decisions on the appropriate terms for their funds, based on the investment objectives, investment policy and investment strategy of the LTAF."

The decision not to prescribe notice periods was taken because different LTAFs will have different needs depending on the assets held. These can vary substantially. Obliging the LTAF manager to set the required notice period is fraught with risk. It is doubtful that LTAF operators can take on this task effectively.

Governance will not prevent liquidity mismatches

Governance processes have not prevented liquidity mismatches in the past. Concluding that the governance processes applied to LTAFs will resolve this issue is unrealistic. In August, the FCA wrote to managers of alternative assets, saying

"When we wrote to firms in January 2020, we stated our concern that investors could be exposed to inappropriate products or levels of investment risk. While our ban on the mass marketing of speculative investments to retail clients has led to a reduction in harm, inappropriate distribution and marketing practices by firms targeting mainstream investors remains a concern. We have seen examples of informal governance processes compounded by poor due diligence and inadequate investor categorisation leading to investors with a lower risk appetite accessing high risk products that may not match their objectives."[18]

The same letter said

"We have also seen situations where firms have bypassed their own processes to make sales or increase Assets under Management, these being examples of conflicts that lead to investor detriment. Furthermore, internal firm conflicts can cause indirect harm to investors. Situations where dominant shareholders make material decisions independent of the firms' governance structure can also lead to conflicts and increase the risk of poor outcomes for investors."[19]

Even considering the diplomatic language of this correspondence, this is a very negative assessment of the standards within firms managing alternative assets.

Concerns about governance and consumer protection are among the reasons for the introduction of a consumer duty. However, it is too early to conclude that this duty, which is in its infancy, will achieve the standards required.

The consumer duty will not apply to firms until July 2023. The FCA intends to publish a policy statement in response to a consultation process and final Handbook rules early in 2023. The FCA will not have had the opportunity to assess whether the duty has had the desired influence on product design. Nor will it have had time to consider whether other aspects of firms' governance have addressed its concerns.

As the Investment Association has noted

"the introduction of a non-daily dealing structure in a daily dealing retail and DC delivery environment is a major cultural and logistical challenge."[20]

We agree with this view. The creation of the LTAF represents a huge cultural challenge for potential providers. The creation of the consumer duty cannot be assumed to have addressed the long-standing cultural problems with optimism bias and other potential causes of liquidity mismatches. The FCA must have evidence that firms have met these challenges before it considers wider retail distribution.

"inappropriate distribution and marketing practices by firms targeting mainstream investors remains a concern."

Financial Conduct Authority. 9 August 2022[21]

Short notice periods will harm consumers

Shorter notice periods will be preferred by LTAF providers as they will be attractive to retail investors and to firms, such as Independent Financial Advisers (IFAs), discretionary managers, providers of model portfolios and platforms. Shorter notice periods (as close to 90 days as possible) could be more easily integrated into quarterly cycles of portfolio rebalancing. Longer notice periods will make it more difficult for distributors to offer, recommend or purchase LTAFs on behalf of retail investors. Retail consumers will prefer to lock their investments up for the shortest period possible and are unlikely to appreciate the risks they face from LTAF liquidity mismatches.

The experience of the property fund sector shows how liquidity risks have been a secondary consideration for fund operators in comparison with the desire to attract funds under management.

LTAF operators are expected to justify shorter notice periods by claiming that other liquidity management tools mitigate the risks of mismatches. Unfortunately, a lack of clarity in the FCA's position increases this risk.

> **"For a fund to be fair to all investors, we would expect redemptions to be met from the sale of a representative sample of the investment portfolio."**
>
> Financial Conduct Authority. October 2021[22]

The FCA said that it *"would expect redemptions to be met from the sale of a representative sample of the investment portfolio."*[23]

There is no consensus on what this means. A prudent reading of the FCA's view is that the LTAF operator should be able to sell assets from the least liquid part of the portfolio in any one redemption window, in good and poor markets. This would ensure that, if asset sales are needed, the process will not result in the most liquid assets being sold first and the portfolio becoming more concentrated and less liquid.

This interpretation is inconsistent with commercial incentives to set notice periods as short as possible. If LTAF providers can justify an alternative reading of the FCA's expectation regarding the sale of a 'representative' sample of assets, by using liquidity management tools alongside a shorter notice period, they will do so.

These tools can be particularly harmful to retail investors. They include:

- **Relying on asset sales over a series of redemption periods:** Planning to use more than one redemption period relies on market conditions allowing a planned sale and the liquidity of assets not reducing. This is a dangerous strategy. It means that when market conditions worsen, the LTAF will be vulnerable to increased redemption requests across redemption windows. The operator will be less able to sell assets without a discount. Buyers will exploit the time pressure imposed on the LTAF operator. Longer negotiations, and the threat of withdrawal, will be used to force sales at deep discounts (which is unfair to investors). Alternatively, there will be no asset sale and redemptions will be deferred or the LTAF suspended.
- **Relying on phased asset sales from a mature portfolio:** An LTAF operator might plan successive sales from mature assets, with sales falling into each redemption period. This not a credible plan. Assets may not have predictable, optimum holding periods. There is no guarantee that the LTAF operator will be reliably able to find willing buyers. Even more seriously, when market conditions deteriorate, assets representing the entire portfolio may see declining liquidity, crystallising the intrinsic liquidity mismatch.

- **Liquidity buffers:** Asset managers have discussed offering LTAFs with mixed portfolios, allowing them to provide exposure to inherently illiquid assets alongside liquid asset classes. This is a troubling proposal. The LTAF would not be selling a representative sample of the assets to fulfil redemption requests. Instead, the intention would be to sell the liquid portion of the portfolio to alleviate the need to sell assets from the least liquid part of the portfolio in any one redemption window. This approach is actively harmful to retail investors. As the Bank has stated

  "Liquidity buffers may actually increase first mover advantage if investors anticipate the fund may use the most liquid part of the portfolio to pay redeeming investors."[24]

  Retail investors are less able to respond quickly to emerging liquidity problems. They are likely to be left in the LTAF once it has exhausted its liquidity and the liquidity mismatch has crystallised.

- **Borrowing to fund redemptions:** This is another particularly risky option for retail investors. Borrowing to meet redemptions increases the risk to remaining investors, who will bear the costs. As the International Organization of Securities Commissions (IOSCO) has warned, a fund operator

  "should take exceptional care if utilising tools such as temporary borrowing to manage liquidity. Not only will the [collective investment scheme] *CIS incur a financial cost for this, but if the temporary borrowing does not solve the problem, then the CIS may need to suspend or windup and it will at this point be leveraged, potentially with exacerbated problems.*

  Investors in the CIS that benefit from the borrowing (by being able to redeem) may not be the ones paying the costs of it"[25].

As discussed, the investors remaining in an LTAF are more likely to be retail consumers than institutions. The LTAF operator is either relying on future cash inflows or underlying assets to service this debt. Neither source of cash can be relied upon in poor market conditions or when performance is poor. Using debt finance to service redemptions serves a short-term need but will increase the ongoing need for cash. This will exacerbate problems where notice periods are not sufficient, with retail investors bearing the costs.

Relying on positive cash flows: Relying on positive cash is precarious. Investors, including DC pension schemes, may change their decision to allocate to an LTAF, particularly if performance and/or market conditions are deteriorating. This could leave an LTAF with shorter notice periods dangerously exposed to a liquidity mismatch.

Deferring redemptions: Planning to use deferrals as part of an LTAF's strategy to satisfy redemptions means the redemption arrangements are inadequate. Historically, the FCA has identified deferrals (like suspensions) as an *"exceptional"* liquidity management tool[26]. Using an exceptional liquidity management tool represents a departure from the arrangements promised to investors.

Using exceptional tools is not desirable; they should only be used to avert a greater harm (such as forced asset sales at a discount or ones that exhaust the liquidity in the portfolio). Planning to use deferrals builds poor consumer outcomes into a fund structure. This should not be acceptable in any LTAF, especially one marketed to retail investors.

It is a concern that the FCA has indicated a change of policy regarding deferrals for LTAFs. Its policy statement said

"Suspension of dealing is not a liquidity management tool. It exists to protect investors in exceptional circumstances. We do not consider that tools such as deferrals and limits to redemptions or subscriptions should be put in the same category as suspensions."[27]

This change of view was adopted without a consultation. It does not recognise that retail consumers are particularly vulnerable to the negative effects of deferrals in funds with illiquid assets and longer notice periods.

The FCA said that its LTAF rules *"create a framework that reflects the IOSCO principles for liquidity management."*[28] The AIC does not agree. IOSCO states

"under certain circumstances, CIS may be allowed to limit redemption rights or otherwise manage the consequences of redemptions, if permitted by applicable law and regulation, by the use of various additional liquidity management tools. However, an ability to limit, defer or suspend redemption rights, if permitted by applicable law and regulation, should not be seen as freeing the responsible entities from their duty to endeavour faithfully to meet redemption demand in an orderly fashion. ***Such additional liquidity management tools may be relied on in liquidity management planning, but only in instances of stressed market conditions*** *where to do otherwise could lead to management of the CIS which is not in the best interest of investors or lead to undermining of the investment strategy."*[29]

IOSCO places deferrals and suspensions in the same category. It sees both tools as 'additional' to normal tools, another way of saying that they are exceptional.

IOSCO says additional tools (deferrals and suspensions) should only be used in response to stressed market conditions where not using them would not be in the best interests of investors. Later in the same paper, IOSCO says that exceptional liquidity management tools should only be used as a *"last resort"*.

The FCA's position on deferrals by LTAF operators does not meet the IOSCO standard. It does not view deferrals as an additional/exceptional liquidity management tool. It does not limit their use to stressed market conditions.

Allowing fund operators to use deferrals as a planned liquidity management tool is arguably acceptable for Undertakings for the Collective Investment in Transferable Securities (UCITS). UCITS invariably offer daily dealing and hold assets that can easily be sold to meet redemptions. The use of deferral for a UCITS means delaying a client's redemption until the next dealing date i.e. the next business day. This has no material negative impact on retail investors.

The situation for LTAFs is very different. Deferral may mean waiting at least an extra three months (or six months when this is added to the minimum 90-day notice period). The wait should be even longer for most LTAFs as three months is unlikely to be a sufficient notice period. During the additional time waiting for their money back, retail investors cannot stop their losses and will continue to pay charges. The use of deferrals for LTAFs would be a source of significant consumer harm.

The liquidity management tools listed above are short-term measures that do not resolve liquidity mismatches caused by inadequate notice periods. They create the conditions for a bigger, more harmful failure to come. Like sticking a finger in a leaking dam and assuming the problem is fixed, without recognising that the pressure is building, and the structure is fundamentally unsafe.

LTAFs must adopt higher liquidity management standards before they can be considered for distribution to a wider retail market.

The authorisation process will not protect consumers

The FCA's authorisation process cannot be relied upon to prevent LTAFs incorporating liquidity mismatches or other design features that harm retail investors.

The FCA does not *"expect"*[30] to authorise an LTAF that cannot sell a representative sample of its assets. The lack of market experience and insight into how LTAFs will operate in practice makes achieving this aim fundamentally difficult.

The FCA intends to use data to bolster the authorisation process.
Nikhil Rathi, FCA Chief Executive, recently wrote

"We are being tougher on firms who want authorisation to operate in the UK, using data more systematically to ask the firms we supervise more rigorous questions".[31]

A data-led approach cannot be relied upon because the FCA will not know which assets an LTAF might hold. At an asset class level, it will not have sufficient data to evaluate the liquidity claims of managers. Instead, the FCA will have to rely on assessments by managers which, as discussed above, are prone to liquidity optimism.

Even LTAFs launched with 'seed' assets (that is assets transferred into the fund at its inception) will not be able to provide sufficient information to protect consumers from liquidity mismatches. Even if the liquidity of seed assets is realistically evaluated (which is doubtful), the LTAF will acquire further holdings. The liquidity profile of these will not be known during the authorisation process. The FCA cannot determine if assets bought in the future will match the liquidity expectations of the LTAF operator at launch.

This makes it impossible for the authorisation process to include a robust assessment of whether LTAF notice periods are adequate. The FCA may consider this acceptable for professional, high-net-worth and sophisticated investors. They are certainly not risks that should be accepted for a wider retail market.

Known consumer behaviours increase the danger

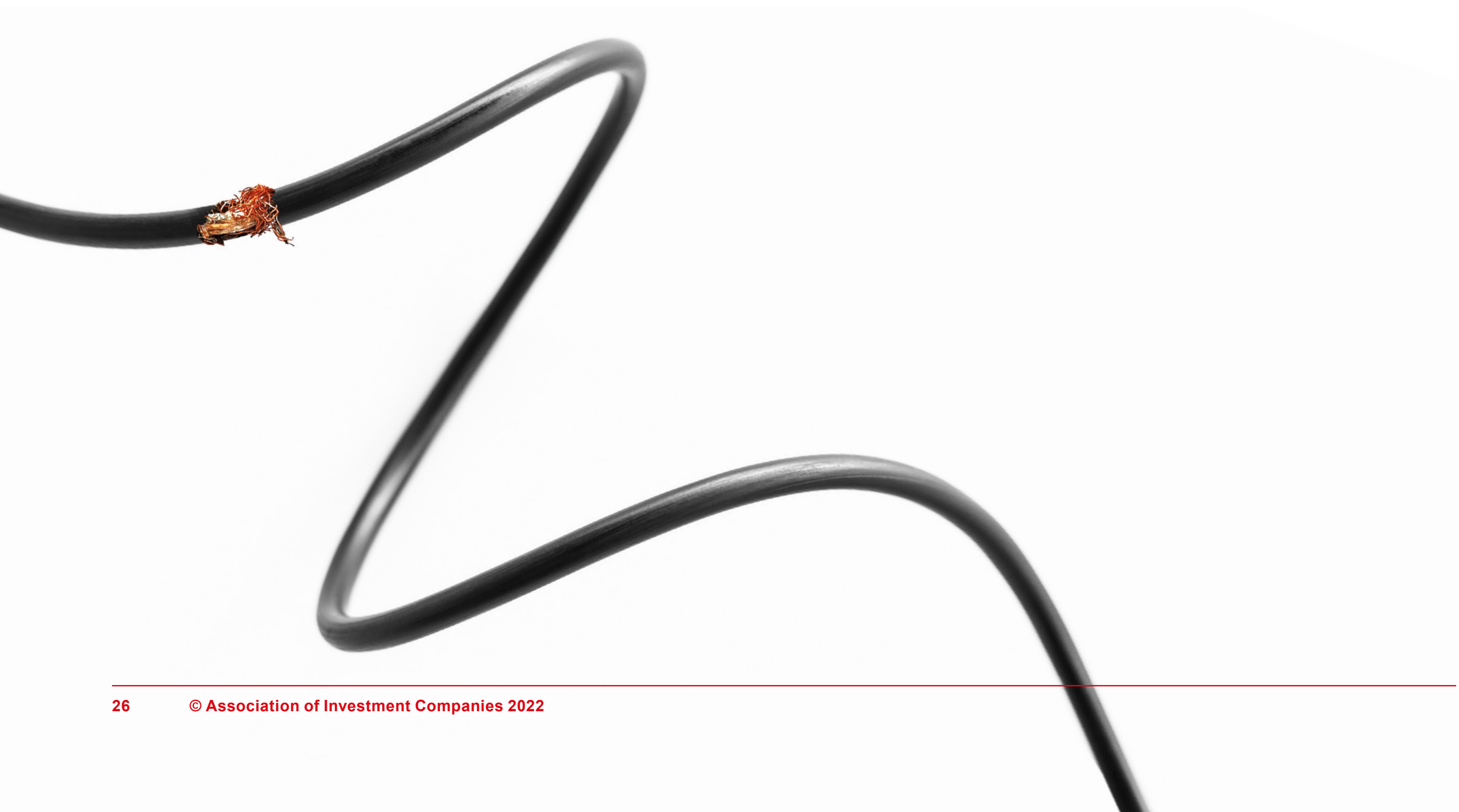
Inertia: Consumers are less likely to react to emerging liquidity problems than institutions. Mingling their investments with institutions increases the risk of harm. Previous suggestions[32] that allowing retail investment alongside institutions will protect consumers are unfounded. Institutions will be able to exhaust available LTAF liquidity at the expense of retail consumers.

Optimism bias: Retail investors have a bias to assuming things will go well (otherwise why invest?). They are less aware of the emerging liquidity mismatches and how redemption tools (such as borrowing to pay redemptions, the impact of deferrals etc.) can harm their finances.
The FCA explained this trait saying

"Self-directed investors appear to be particularly vulnerable to inappropriate high-risk investments. Across most high-risk investment categories, a significant portion of investors either are not aware – or do not believe that – they could lose some or all their money. For example, over four in ten (45%) did not view 'losing some money' as a potential risk of investing."[33]

Impact of novelty on the evaluation of risk: Some investors will be attracted to LTAFs simply because they are new. As the FCA has explained

"Investment decisions are highly influenced by emotional and social drivers such as gut instinct, novelty and perception of other people's investment success. Four in ten investors (38%) are being driven solely by these types of motivating factors."[34]



Failure to align investments with risk appetite: LTAFs are higher risk products. They combine target assets that are not usual to open-ended funds with complex, innovative redemption arrangements, which will not allow investors a swift exit to stop losses. The FCA's research suggests LTAFs may therefore be bought by investors who are particularly unsuited to such investment. It has found that

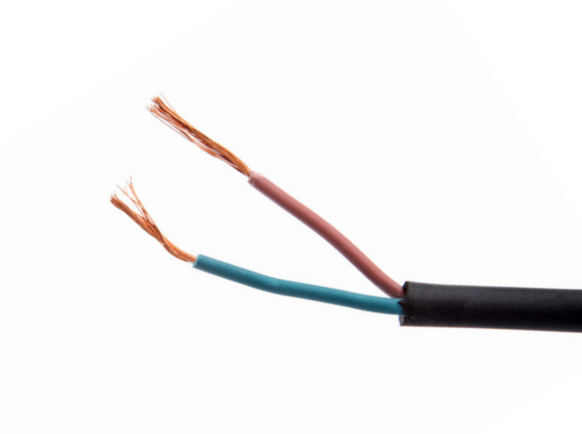
"self-directed investors also seem more likely to jump into higher risk investment types more quickly than more traditional audiences, who typically built up to risk over time. This pattern appears to be driven by newer self-directed investors being attracted by more 'innovative' high-risk, high-return investment types like investment-based crowdfunding and cryptocurrency.

"Investment decisions are highly influenced by emotional and social drivers such as... novelty"

Financial Conduct Authority. April 2021[35]

These investors do not appear to be matching the risk of their investment with their own risk appetite. Half (51%) of newer self-directed investors who invested in high risk products score their risk appetite as less than eight (on a zero to ten scale). This indicates they had an average openness to risk. In addition, they do not appear to be able to absorb losses from their risky investments. Nearly two thirds (59%) claim that a significant investment loss would have a fundamental impact on their current or future lifestyle such as household bills and credit commitments becoming a burden."[36]

The consumer biases of retail investors make them particularly vulnerable to buying LTAFs that do not meet their financial needs.



> **"Self-directed investors appear to be particularly vulnerable to inappropriate high-risk investments"**
>
> Financial Conduct Authority. April 2021[37]

Limiting exposure does not protect consumers

Limiting investment in LTAFs to 10% of an individual's investable assets does not provide sufficient protection. Even if the difficulty of accurately assessing the investable assets of investors not taking advice are set aside, relying on the 10% limit would not secure the FCA's duty to protect consumers.

The financial risks to households across the UK are growing. Consumers are increasingly vulnerable to deteriorating economic circumstances. Rising interest rates threaten to make mortgages unaffordable and increase the superficial attractions of risky LTAFs, which may offer the prospect of higher returns. Household budgets are under huge pressure from rising energy bills. Even with government intervention, consumers will be paying more than in recent years. Inflation, currently around 10% with predictions that this rate might double, will reduce the value of the 'rainy day' reserves retail investors may have saved. These reserves are already being drawn upon as economic pressures mount. The Office for National Statistics[38] reported in August 2022 that *"almost a quarter (23%, around 11 million people) used savings to cover costs*" as the cost of living increased. This number may well increase given that 89% of adults, or 46 million people, report that their household expenses have increased. This is up from the 62% of people giving the same answer in November 2021.

LTAFs will be heavily marketed to gain traction in the market. It is likely that consumers may invest more in LTAFs than they can afford or is appropriate for their economic circumstances.

Any notion that a consumer can 'afford' to make an unsuitable investment in an LTAF because they are limited in the sum they can invest, is simply wrong. This attitude ignores the realities of how many households manage their financial affairs. For many consumers a poor investment decision, especially one which they are unable to exit, would cause serious financial harm. This outcome is entirely foreseeable.

On the other hand, the purported consumer protection argument for allowing wider retail distribution is baseless. Supporters of changing the rules have argued

"by preventing retail access, the FCA would be forcing retail investors to invest in higher-risk, potentially unregulated or speculative assets in search of higher returns."[39]

This argument should have no traction whatsoever. Taking an informed regulatory decision to restrict access to the LTAF does not 'force' retail investors to do anything. It achieves the FCA's statutory obligation to protect consumers.

Limiting LTAF distribution does not prevent consumers from accessing other products that may secure them a suitable risk-adjusted return. The market already offers a huge range of collective investments with a wide range of assets, including illiquid assets. The LTAF is not the only option. As the Investment Association put it

"our view is that the LTAF will provide an additional route for the investment of long-term capital alongside more established vehicles, notably closed-ended, listed investment companies."[40]

The notion that the FCA's current position is actively disadvantaging retail investors has no credibility. When weighed against the evident risks of wider retail disclosure, identifying LTAFs as NMPIs delivers the regulator's statutory duty to ensure consumer protection while also allowing access to a wide range of established investment products that can meet the market's needs.

LTAFs will not make productive finance investments

Supporters of wider LTAF distribution claim this will benefit the economy by allowing more funds to launch that will invest directly into UK businesses. While this is astute political positioning, it is not a realistic view of how LTAFs will invest.

LTAFs are likely to invest much of their capital overseas. Insofar as they do buy assets in the UK, they are expected to purchase existing (secondary) assets. This will mean the money they invest will go to investors already holding the assets rather than providing finance to a trading company.

The claim that LTAFs will provide productive finance (that is, invest into businesses to increase their productive capacity) relies on a view that a proportion of total investment will be allocated directly into UK businesses. This is unconvincing. LTAFs will not provide 'productive' finance because they are not suitable for this purpose.

Productive finance investment opportunities are complicated to identify, negotiate, and transact. This type of investment requires permanent capital, where investments are only realised when they mature, in accordance with the investment case. This investment approach is incompatible with a fund structure that may have to rely on the fund operator selling assets to meet redemptions.

The British Venture Capital Association explained the problem, saying

"It is difficult to square an open-ended fund model with a PE/VC [private equity/venture capital] *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."*[41]

The claim that LTAFs will deliver greater investment into long-term productive assets does not bear scrutiny. Even if it did, it does not override the FCA's statutory duty to ensure adequate consumer protection.


Caution
Mind your head

Recommendations

Wait and see

Allowing wider retail distribution of the LTAF before any have been launched would mean the FCA not achieving its statutory duty to protect consumers.

There is no material advantage to consumers in allowing early retail distribution. Far more likely is that LTAFs will incorporate liquidity mismatches, which will cause financial harm. The FCA will only be able to gauge the risks of liquidity mismatches, and if they can be mitigated, after the first cohort of LTAFs has been launched and shown how they operate in good and poor markets. This will provide data, evidence of the robustness of the LTAF structure, and the quality of the manufacturers' governance processes. Also, as the rules stand, LTAFs are not sufficiently regulated to make them suitable for a wider retail market.

- The AIC **recommends** that no changes be made to the distribution of the LTAF at this time.
- The AIC **recommends** that the FCA reviews the performance of LTAFs five years after the first cohort of LTAFs have been launched, which will allow time to demonstrate how they operate in good and poor market conditions.

Liquidity classification

The AIC **recommends** that the period after the launch of the first LTAFs and subsequent review of retail distribution should be used to develop a consistent and realistic classification of the liquidity of funds' assets. This would respond to a need previously identified by the FCA and the Bank.[42]

Establish a two-tier approach

Before allowing LTAFs to be marketed to a wider retail market, the AIC **recommends** that the FCA introduce a two-tier LTAF regime:

- One tier of LTAFs would retain the current rulebook and retain NMPI status.
- The other tier of LTAFs would include additional consumer protections (as set out below) to make them suitable for wider retail distribution (as a Restricted Mass Market Investments (RMMI). Wider distribution would then be allowed if the FCA concludes that market experience of the LTAF justifies such an approach.

Introduce additional consumer protections

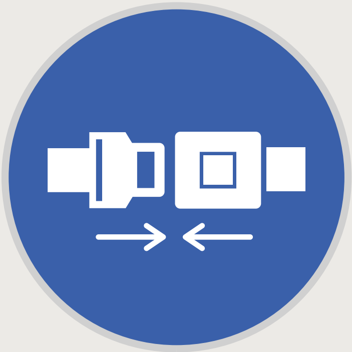
The current proposals to amend the LTAF rules (which will: require operators to engage with investors when changes to an LTAF are proposed; mandate additional investor disclosures in the event of a suspension; and create new obligations in relation to investor meetings) are necessary, but not sufficient to protect retail consumers.

To achieve standards sufficient to allow LTAFs to be distributed as RMMIs, the AIC **recommends** rules be introduced as set out below.

Redemption arrangements

LTAFs will cause consumer harm if they allow some investors (most likely institutions) to exhaust available liquidity at the expense of those remaining. Certain liquidity management tools will disproportionately disadvantage retail investors when they are used. To address this, the AIC **recommends** that any LTAF marketed to a wider range of retail investors should:

- be required to set notice periods long enough to allow the operator to dispose of holdings from the least liquid portion of the portfolio in a single redemption event, in good or poor market conditions. This will prevent liquidity concentration and give investors a realistic view of notice periods.
- not be able to use deferrals as a liquidity management tool except in stressed market conditions. Deferrals should not be a planned mechanism for managing redemptions used, for example, because of persistent or a high-net redemptions. They should not be deployed.
- be banned from using borrowing to meet redemptions. Borrowing to meet redemptions increases the costs to investors without addressing structural liquidity shortfalls. Indeed, there is a strong argument that an LTAF with retail distribution should not be allowed borrowing for any purpose.
- not be allowed to impose 'lock-in' periods on retail investors that are longer than the standard notice period. The industry has argued[43] that some LTAFs may require 'ramp-up' periods of 24 months, or even up to five years, during which an LTAF operator may not wish to permit redemptions. Lock-ins of this duration are not appropriate for a wider retail market and should be explicitly banned for LTAFs sold to retail investors.



The AIC **recommends** that before wider retail distribution of the LTAF is allowed, the FCA should publish guidance on the LTAF rules, including a discussion of how LTAF operators should set notice periods to achieve the expectation that redemptions will be met from the sale of a *"representative sample"* of the investment portfolio.

Enhance governance

Given the additional vulnerabilities of retail investors, the AIC **recommends** that enhanced governance obligations be imposed where LTAFs are distributed to retail investors.

The AIC **recommends** that LTAF operators make an annual statement confirming that the product design of an LTAF and its continued distribution to retail investments is consistent with its consumer duty.

Suspension requirements

Other authorised retail schemes (non-UCITS retail schemes (NURS)) holding inherently illiquid assets must be suspended if their independent valuer expresses material uncertainty about the value of assets making up 20% or more of the portfolio[44]. The FCA has explained why the material uncertainty clause is required as follows

"Open-ended funds must be priced correctly to ensure that investors are treated fairly and can have confidence in the product. If there is material uncertainty about the valuation of a significant proportion of the assets in an open-ended fund, that uncertainty will be reflected in the unit price of the fund. That creates the potential for investors to be treated unfairly. In essence, the uncertainty in the value of the underlying assets may mean an investor exiting the fund receives a unit price significantly lower or higher than its underlying value. Those investors who remain invested in the fund might then see the value of their investments go up or down once it became clearer to the market the underlying value of the assets in the fund, relative to the price paid to those who exited."[45]

The LTAF rules do not include any reference to material uncertainty[46]. The manager of an LTAF is required to suspend dealing in the fund only if there are exceptional circumstances that make a suspension necessary in the interests of investors. This is a far lower standard than is applied to other retail schemes. Retail investors should not be exposed to an LTAF that does not offer this consumer protection.

No convincing justification has been given for not including 'material uncertainty' provisions for LTAFs.

One argument is that a material uncertainty clause is not required because the rule for funds holding immovables (property) cite RICS valuation global standards (the Red Book). As the LTAF can hold assets not covered by the Red Book, the clause is not appropriate. This argument is not credible.

Were an LTAF to hold property it could arbitrage the rules on material uncertainty which the FCA has otherwise concluded are necessary to protect investors.

The omission of a material uncertainty rule for the LTAF undermines the regulatory requirement for operators to have sufficient confidence in the value of the assets, which ensures that they fairly price the units in the fund.

The current material uncertainty rule could be adapted for the LTAF to remove the reference to the Red Book and instead establish a broader principle that the manager must suspend the LTAF if there is a material uncertainty over 20% or more of the value of the assets. The rule need not refer to a specific valuation methodology to achieve this outcome.

It has also been said that longer notice periods make it unnecessary to impose a requirement to suspend trading of an LTAF if there is a material uncertainty of asset values. The AIC does not agree. If there is material uncertainty at the dealing point (whatever its frequency) then investors (particularly retail investors) must be protected by fair pricing of the units. After all, the assets held by LTAFs may be particularly vulnerable to valuation uncertainty, given their idiosyncratic nature, which increases the risk of consumer harm.

The omission of a material uncertainty clause is a major deficiency in the LTAF regulation, which makes LTAFs fundamentally unsuited to wider retail distribution. The AIC **recommends** that LTAF operators should be required to suspend dealing if there is material uncertainty in relation to the valuation of assets.

Enhanced risk warnings

Longer notice periods, and the potential for deferrals, justify an additional risk warning for LTAFs distributed for retail investors to explain their possible impact.

The AIC **recommends** including an additional warning, which states: *"After you ask to redeem your investment its value may fall. The amount you get back will be determined at the end of the notice period."*

Cooling-off period

The omission of a cooling-off period for LTAFs is unjustified. The reason given by the FCA for the omission is the LTAF's governance arrangements and *"further investor protections that we are carrying over from other authorised retail funds".*[47] Presumably this is a reference to providing updates where dealing is suspended; requiring engagement with investors about changes to the LTAF, the conduct of investor meetings; and restrictions on payments and charges to retail investors. These changes should be made to LTAFs intended for retail distribution. However, they do not justify omitting a cooling-off period for LTAFs.

The additional consumer protections proposed by the FCA affect the continuing operation of the LTAF. They do not have any impact on a consumer's investment decision. Cooling-off periods protect investors from intemperate decisions. They do not compromise appropriate distribution of products. As the FCA has explained

"A cooling-off period should not negatively affect those consumers for whom the investment is appropriate, as they can still proceed after a short wait. However, it adds a slight pause to the process and helps those consumers for whom the investment may not be appropriate to reflect on whether they still want to proceed."[48]

The FCA notes that daily-dealing funds do not have cooling-off periods.[49] This does not provide a justification for omitting them for LTAFs. The opposite is true. An impetuous decision to invest in a daily-dealing fund can be reversed very quickly. Daily dealing limits the exposure of an investor that has made a poor decision. A similar, poorly thought through decision to invest in an LTAF cannot be reversed so easily. LTAFs will not offer dealing more than once a month.

The investor will then be subject to a notice period of at least 90 days. During this period their investment will be exposed to investment risk and fund charges. The requirement for an appropriateness test for self-directed investors is not sufficient protection. Even if it were, then the FCA's previous analysis of cooling-off periods (set out above) would still apply.

Removing the cooling-off period for LTAFs reduces consumer protection on a novel product and creates risks for retail consumers. The AIC **recommends** that a 24-hour cooling-off period be introduced for any LTAF distributed to retail consumers.

Limit distribution to advised clients

If the measures recommended above are not taken, then the risk of consumer harm is acute.

To limit the financial damage to consumers if the recommendations above are not adopted, the AIC **recommends** that, as a minimum, retail purchasers must receive independent financial advice before purchasing an LTAF.

Investors taking advice are more likely to incorporate any LTAF holdings into their investment portfolio in a way that mitigates the worst possible outcomes. Advised investments are more likely to be compatible with their financial needs.

Objections to imposing a requirement to take advice before buying an LTAF fail to recognise the inherent risks in LTAFs, including their capacity to incorporate liquidity mismatches and inadequate standards of consumer protection. They ignore the consumer biases that increase the risks of inappropriate purchases of LTAFs.

To be clear, requiring advice for LTAFs is sub-optimal in comparison with waiting to see if LTAFs can be suitable for a wider retail market and ensuring adequate consumer protection standards. This is because LTAFs are expected to incorporate liquidity mismatches and because, in the absence of market experience, it will be difficult for advisors to take an informed view on how LTAFs may operate in good and poor market conditions.

Consultation questions

Q1: Do you have any comments on our assessment of the effects of our proposals?

The AIC disagrees with the FCA's assessment of the effect of its proposals. Allowing untested LTAFs, incorporating inadequate investor protections, to be distributed to a wider retail market is expected to be a source of consumer harm.

The proposals create unacceptable risks to retail consumers. These investors are more vulnerable to the expected flaws in the design of LTAFs. These flaws are expected to include liquidity mismatches.

Widening distribution of the LTAF at an early stage of the market's development will make it more difficult to resolve any problems that arise later on, compounding the consumer protection issues arising over the long term.

Widening distribution of the LTAF risks undermining long-term confidence in the LTAF, the asset classes held and in the UK's asset management sector. This creates reputational risks for the FCA and is likely to undermine consumer confidence in regulatory standards.

The proposals will not create benefits for the wider economy by providing finance for productive investment. LTAFs are unsuited to direct investment in UK businesses. Most of the investment will be in secondary (existing assets) and/or outside the UK.

The consultation paper's proposals for adjusting the LTAF rules do not address these risks. They do not provide the basis for changing the NMPI status of LTAFs.

Q2: 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.

The AIC has no comments on this question.

Q3: Do you agree that the LTAF should be recategorised as a RMMI (as per PS 22/10), from its previous category as NMPI, thus broadening retail access to include restricted investors?

No. Notwithstanding that the current proposals are open to consultation, it is a matter of concern that the FCA has revised its view on the categorisation of LTAFs without any evidence to justify this change of position.

The current consultation states

"We do not think NMMI is the appropriate category for the LTAF because it is not proportionate for an FCA authorised fund that has to adhere to strict requirements to be categorised in the same way as unauthorised funds." [50]

The basis for this conclusion has not been set out. Less than a year ago the FCA concluded

"We think that proceeding with the introduction of the LTAF as an NMPI remains an appropriate first step. This will mean that LTAFs may initially be marketed to professional investors, such as DC pension schemes, and certified sophisticated retail investors." [51]

This was a prudent decision. It delivers on the FCA's statutory objectives to retail consumers. It was based on an evaluation of the risks of retail distribution following a consultation. As the FCA noted in its original invitation for views

"LTAFs will, by their nature, invest in higher risk assets. There could be significant differences in the risk and return profile from fund to fund. Different LTAFs might take very different risks or offer different return profiles. Some risks, such as the inability to sell assets at the time when an investor wants to, will be common to most LTAFs. But private investments often involve more complicated risks than listed investments. Retail investors may not understand the risks they are taking or may see unexpected risks crystallise. These risks might make an LTAF unsuitable for broad distribution to retail investors. Investments in assets which retail investors are less familiar with, for example, infrastructure, could pose other, more esoteric, risks." [52]

This analysis remains compelling. The FCA kept an open mind to widening retail distribution within a restricted distribution framework (such as a 10% limit of investable assets). Yet it had intended to evaluate this option after gaining experience of LTAFs being distributed as NMPIs. There has been no experience gained as no LTAFs have been launched.

In the absence of any evidence that the consumer risks have been mitigated, the primary reason for reviewing LTAF distribution seems to be demand from commercial providers. This does not provide a regulatory justification for changing the current approach. The AIC **recommends** that the FCA should not widen the distribution of LTAFs at this time.

The AIC **recommends** that the FCA should review the retail distribution of LTAFs once their characteristics are better understood, the structure has been tested in good and poor economic conditions, and the risks to retail consumers have been evaluated.

The AIC **recommends** that LTAFs should only be eligible for wider retail distribution where they incorporate sufficient investor protections. Additional protections required include:

- excluding liquidity management arrangements likely to harm retail consumers;
- imposing additional governance requirements;
- implementing additional risk warnings and a 'cooling-off period' and,
- requiring LTAFs to suspend where there is material uncertainty in the value of 20% of the assets.

A full discussion of additional consumer protections required is set out above (see page 34 – 39).

Q4: Do you agree with the wording of the proposed LTAF risk warning and risk summary? Please explain your answer and suggest alternative drafting if appropriate.

No. Longer notice periods, and the potential for deferrals, justify an additional risk warning to highlight the possible impact of these product features.

The AIC **recommends** including an additional warning that states:
"After you seek to redeem your investment its value may fall. The amount you get back will be determined at the end of the notice period."

Q5: Do you agree that when investors buy units in an LTAF, they should not have to comply with the 24-hour cooling-off period?

No. A cooling-off period should be applied. No convincing reason for not adopting a cooling-off period has been given. Removing the cooling-off period reduces consumer protection on a novel product, which raises significant risks for retail consumers. The AIC **recommends** that a 24-hour cooling-off period be introduced for any LTAF distributed to retail consumers.

A full discussion of this issue is set out above (page 38).

Q6: Do you agree that the retail fund rules noted above should be applied to LTAFs with retail investors?

Yes. The AIC **recommends** that these disclosure and other rules should be applied to authorised fund managers managing LTAFs. However, the AIC does not agree that these measures provide sufficient investor protections to extend retail distribution of LTAFs to a wider range of retail investors. Additional protections required include:

- excluding liquidity management arrangements likely to harm retail consumers;
- imposing additional governance requirements;
- implementing additional risk warnings and a 'cooling-off period',
- requiring LTAFs to suspend where there is material uncertainty in the value of 20% of the assets.

A full discussion of additional consumer protections required is set out above (see page 34 – 39).

Q7: Should the LTAF regime have any other additional protections that are already available for mass-market retail fund regimes?

Yes, additional protections are required for any LTAF distributed to a wider retail market. Additional protections required include:

- excluding liquidity management arrangements likely to harm retail consumers;
- imposing additional governance requirements;
- implementing additional risk warnings and a 'cooling-off period' and,
- requiring LTAFs to suspend where there is material uncertainty in the value of 20% of the assets.

A full discussion of additional consumer protections required is set out above (see page 34 – 39).

Q8: Do you agree that the LTAF should require an appropriateness test for all potential retail investors?

If self-directed investment is permitted, the AIC agrees appropriateness tests should be required. However, this is not sufficient to mitigate the risk of serious consumer harm arising for retail investors. Additional protections required include:

- excluding liquidity management arrangements likely to harm retail consumers;
- imposing additional governance requirements;
- implementing additional risk warnings and a 'cooling-off period' and,
- requiring LTAFs to suspend where there is material uncertainty in the value of 20% of the assets.

A full discussion of additional consumer protections required is set out above (see page 34 – 39).

The AIC **recommends** that, if LTAFs are distributed to a wider retail market before additional consumer protections are implemented and the operation of LTAFs has been reviewed in light of market experience, all investors should receive advice (see page 39 for further discussion).

Q9: Do you agree with the proposal to enable a FAIF to invest up to 35% into a single LTAF?

The AIC has no comments on this question.

Q10: Should we apply a limit to the value, as a percentage of the Net Asset Value (NAV), that a FAIF can invest in multiple LTAFs?

The AIC agrees that an upper limit should be applied to the amount a fund of alternative investment funds (FAIF) can invest into LTAFs. The AIC agrees that this should be set at 50%.

Q11: Do you agree that COLL 5.7.9R (1) and (2) should be switched off for FAIFs that invest in units of LTAFs, given the existing detailed LTAF due diligence rules?

The AIC has no comments on this question.

Q12: Do you agree with our proposals to extend distribution of the LTAF beyond defaults in qualifying schemes?

No. The LTAF is an untested product. Allowing distribution beyond defaults in qualifying schemes should only be considered after the operation of LTAFs has been evaluated in good and poor market conditions.

Q13: Do you agree with our proposals to extend distribution of the LTAF more widely where investors in a long-term unit-linked product have appropriate professional support on fund selection as above?

The AIC has no comments on this question.

Q14: Do you agree with our proposal to make rules to give equivalent status to that of LTAFs under the permitted links rules to other illiquid assets where the conditions for securing an appropriate degree of consumer protection can be met?

The AIC has no comments on this question.

Q15: Do you consider there to be any unintended consequences from categorising the LTAF as a non-standard product for SIPPs?

The AIC agrees that LTAFs should be categorised as a non-standard product for Self-invested personal pensions (SIPPs).

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