



Investing in Less Liquid Assets – Key Considerations

Productive Finance Working Group

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Executive Summary

UK workplace Defined Contribution (DC) pension schemes are an increasingly important vehicle for saving for retirement. Ten years since the launch of automatic enrolment in 2012, there are 18 million active savers in UK workplace DC schemes¹. Over this period, their assets have increased from around £200bn to over £500bn, and are expected to double to £1tn by 2030.

As UK DC schemes have developed and grown in size, the range of investment opportunities available to these schemes has increased significantly. And this is likely to increase still further in the years to come. For example, UK DC schemes currently invest relatively little in less liquid assets, compared to UK Defined Benefit (DB) pension schemes and DC schemes in other countries, such as Australia. This reflects several factors, one of which is the important focus of the UK DC pensions industry – across the entire supply chain – on keeping costs low. Investing in less liquid assets tends to be more expensive and they may take some time to generate value; some of them may fail to do so. However, some UK DC schemes are now starting to consider whether and how allocating to less liquid assets as part of a diversified portfolio within a default arrangement could improve member outcomes. This can be for a variety of reasons including improving the potential risk-adjusted return on member savings, net of costs and charges, reducing risk through greater portfolio diversification and assisting net zero transition and sustainability objectives.

These considerations could be particularly pertinent in the context of relatively slow economic growth by historic standards, demographic trends and growing concerns around adequacy of savings for retirement. While investment in less liquid assets by itself cannot ensure adequate savings in retirement, it could help close the gap. For example, estimates suggest that a 22 year-old new entrant to a default DC scheme with a 5% allocation to venture capital / growth equity could achieve a 7-12% increase in total retirement savings².

Reflecting the importance of this issue, the Productive Finance Working Group was established to develop practical solutions to the barriers to investment in less liquid assets. The Group has identified the barriers faced by the DC pension schemes as the main areas of focus. In 2021 the Group published a report³, setting out the key issues and recommendations for industry and the official sector that could create an environment in which DC schemes and other investors could benefit from investment in long-term, less liquid assets, where appropriate. One of the Group's early deliverables was also to consider what is required to ensure the Long Term Asset Fund (LTAF) – a new FCA-authorized fund structure for investment in less liquid assets – is operationally, commercially and legally viable, alongside other existing structures.

In response to the recommendations in that report, the Group has been taking concrete steps to remove barriers and raise awareness of the key considerations around investment in less liquid assets and to give decision makers the necessary tools to consider investing in such assets, when in members' interests. To facilitate this, the Group has produced this series of guides for trustees, employers and other key DC scheme decision makers,

There are 18 million active savers in UK workplace DC schemes¹.



covering key issues around investment in less liquid assets within default arrangements, including:

- **Value for money:** To help shift the focus from minimising cost to a more holistic value assessment, this guide outlines a process for assessing value for members from investing in less liquid assets and provides case studies on how that could work in practice for different types of DC schemes.
- **Performance fees:** To help DC schemes select, negotiate and co-create performance fee structures that could meet their members' needs, the guide sets out key principles and maps them to specific features of performance fees to highlight their implications for DC schemes.
- **Liquidity management:** To support robust liquidity management and give DC scheme decision makers the necessary tools, the guide outlines how DC schemes can meet the liquidity needs of their members, while investing in less liquid assets, by managing liquidity at two levels – the DC scheme and underlying fund levels.

1. See *Corporate Strategy Pensions Future* | The Pensions Regulator

2. See *Oliver Wyman BBB The future of defined contribution pensions.*

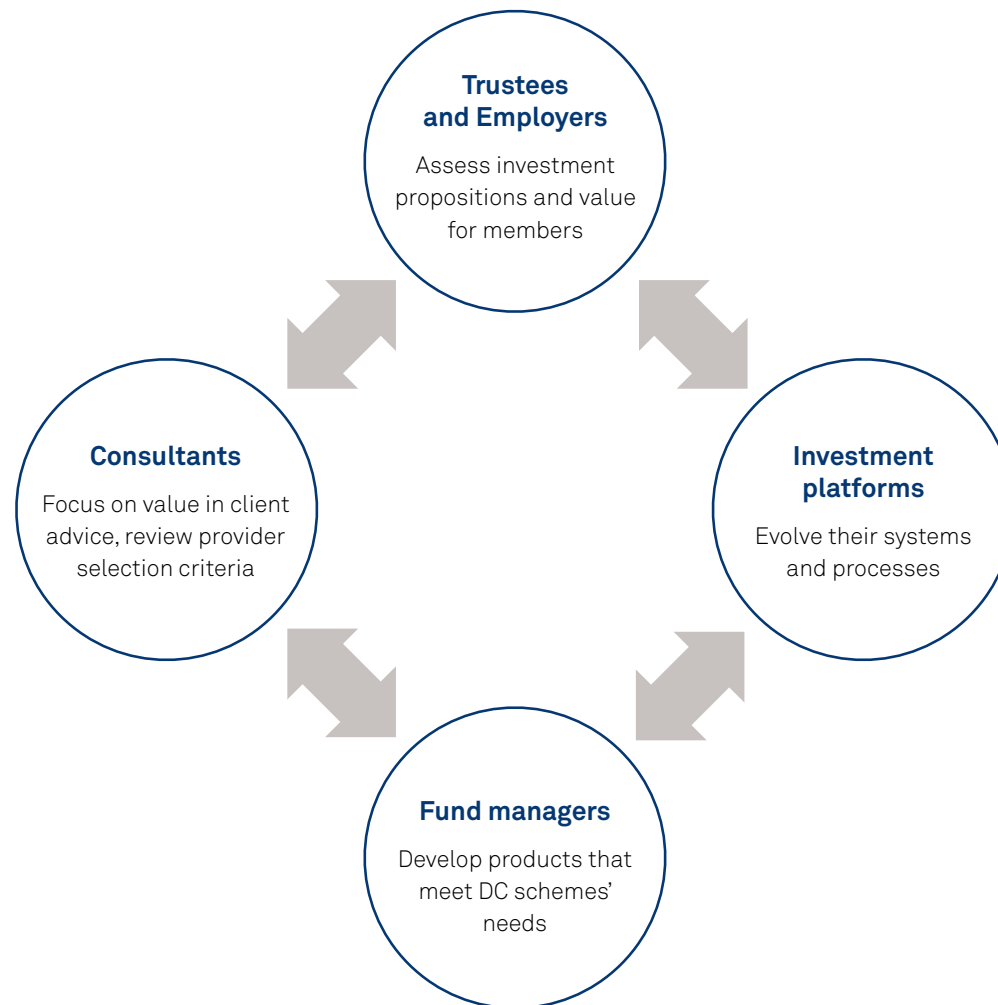
3. See *A Roadmap for Increasing Productive Finance Investment* | Productive Finance Working Group September 2021

- **Fund structures for less liquid assets:** To help DC schemes select a route for investing in less liquid assets that meets their specific needs, the guide provides an overview of the key features and considerations around the fund structures potentially available to UK DC schemes.
- **Legal guide to the Long Term Asset Fund (LTAF):** To help DC scheme decision makers become more familiar with the LTAF as a new fund structure, the guide highlights the key features of the LTAF, including its legal structure and a summary of the key terms. The Group has also been producing model constitutional documents for the LTAF, beginning with the version for an ICVC, published alongside the LTAF legal guide. The other versions, for an ACS and AUT, are currently being finalised and will be published soon.
- **Due diligence:** To facilitate high standards around investment in less liquid assets, this guide highlights the key considerations around due diligence on the investment managers and products.

To support implementation in practice, investment and employee-benefit consultants have [published a joint commitment](#) to shift the focus from cost to value when advising DC decision-makers, and an accompanying list of considerations for consultants on how to incorporate less liquid assets successfully in client solutions, when appropriate. Consultants have also issued [a call to action](#) for DC investment platforms to evolve their processes and systems to support investment in less liquid assets, and will engage with platforms, as appropriate, to set out the business case for such investment.

Implementing and embedding the solutions outlined in these guides in practice will require actions from across the entire ecosystem involving employers, trustees, consultants, platforms and fund managers, as summarised in Figure 1.

Figure 1:



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How to use these guides

The purpose of these guides is to raise awareness of the key considerations around investment in less liquid assets. These materials are not intended as a promotion of these asset classes, any specific investment propositions or their features. Each pension scheme, considering investment in these assets, should make their own assessment of whether such investment meets their members' needs, and seek appropriate advice as needed. Any examples provided in the guides are illustrative only and not meant to set any particular standard or benchmark.

The guides are aimed at a broad audience, with a varying degree of expertise in investment in less liquid assets.

Therefore, these guides cover both the first principles (which might be more helpful for those at the early stages of considering less liquid assets) and some of the more technical issues (to help assist those further forward in this journey).

There are different ways to read these guides. Each of them focuses on solutions to a specific issue, identified as a real or perceived barrier in the Working Group's 2021 *report*, and could therefore be read on its own as an introduction to each of these topics. In practice, these issues are interrelated and a decision to invest in less liquid assets is an iterative process, involving three steps – making the case, designing solutions, and implementing and operationalising them. From that perspective, the value for money guide could be particularly helpful at the first of those steps, the guides on performance fees, liquidity management and fund structures at the second step, and the LTAF legal guide and due diligence at the third step.

These guides have been produced by industry for industry. Therefore, they do not constitute regulatory guidance. The regulatory environment continues to evolve. LTAF rules came into force in November 2021, and at the time of writing, the official sector has been taking forward a series of policy initiatives. Among them are: the work on performance fees and disclose-or-explain requirements for exposures to less liquid assets by the Department for Work and Pensions (DWP); the value for money framework by the FCA, The Pensions' Regulator (TPR) and DWP; and the FCA's work on the appropriate distribution of LTAFs to retail clients, valuations and unit pricing for LTAFs.

We hope you find these guides useful and welcome feedback. The trade body members of the Working Group have planned a series of actions to continue raising awareness of the key considerations around investment in less liquid assets and disseminate the findings from these guides, including through teach-ins for broader industry, conferences, publications in trade media, and other channels.



Guide to Value for Money and Less Liquid Assets

Summary

This guide is aimed at trustees, employers and other DC schemes decision makers (collectively referred to as “decision-makers”), considering investing in less liquid assets as part of a default arrangement. Assessing the value of such investments requires a careful assessment of less liquid investment opportunities, which is not straightforward, as it requires comparing certain cost structures and potential future returns that are uncertain. This is one of many factors that currently makes some schemes emphasise marginal differences in costs and choose not to invest in less liquid assets, even if they may deliver a better net risk adjusted return over the long term.

Meaningful comparisons of value require transparent, robust and consistent metrics, and the FCA-TPR-DWP value for money framework – once implemented – will help facilitate this by prescribing metrics and enabling comparisons of value between pension schemes.

To support the shift from the current focus on costs at many levels of the DC pension scheme ecosystem to a more holistic assessment of value (of which cost is a part), this guide aims to raise awareness of the key considerations for assessing value for members from investing in less liquid assets specifically.

Assessing value from less liquid assets

This guide outlines a process for evaluating less liquid assets and their value, defined as risk adjusted returns net of costs and charges. This process involves answering three key questions:

1. How could adding less liquid assets to a default arrangement improve member outcomes?

This step considers a high-level case for less liquid assets, focusing on whether they might improve risk adjusted returns net of charges and / or achieve broader sustainability goals such as, for example, net zero transition. In some cases these benefits will be complementary.

2. What is the magnitude of the impact on member outcomes?

This step looks at how to measure the value from introducing less liquid assets, depending on a scheme's or provider's investment objectives, set in step 1 above. This step highlights the importance of sufficiently long-time horizons, the need for both forward- and backward-looking metrics when considering an investment and means of benchmarking less liquid asset fund performance.

3. What are risks and governance considerations?

Adding less liquid assets to a default arrangement poses additional risks and requires strong governance. This step summarises the key risks decision-makers should be aware of, and governance considerations for managing these risks effectively.

Case studies: Making a shift from cost to value

This guide also provides several case studies that unpack how decision-makers might consider further integrating value into decision making depending on the type of the DC pension scheme. The process and key considerations will vary across Master Trusts, contract-based schemes overseen by Independent Governance Committees and single-employer schemes.

In scheme or provider selection, a greater weight could be put on the quality as well as the cost of the investment strategy as part of the decision making process. Also, in-house provision could set more stretching objectives for the evolution of default funds that could, potentially, include less liquid assets, when in members' interests.

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Introduction

As UK DC schemes have developed and grown in size in recent years, the range of investment opportunities available to these schemes has increased significantly. This is likely to increase still further in the years to come. For example, UK DC schemes currently invest relatively little in less liquid assets, compared to UK Defined Benefit (DB) pension schemes and DC schemes in other countries, such as Australia. This reflects several factors, one of which is the important focus of the UK DC pensions industry – across the entire supply chain – on keeping costs low. Investing in less liquid assets tends to be more expensive and they may take some time to generate value; some of them may fail to do so. However, some UK DC schemes are now starting to consider whether and how allocating to less liquid assets as part of a diversified portfolio within a default arrangement could improve member outcomes.

There is a balance to be struck between focusing on cost and focusing on value in UK workplace pensions. Pension decision makers are encouraged to focus on both by the regulatory framework. Trustees are mindful of their statutory and common law obligations when they invest, and of the charge cap which exists to ensure savers are not overcharged. However, trustees also act within a market context that has come to focus overly on charges, which limits trustees' freedom of action when they use their investment powers. It would be hard in practice to bring a workplace pension scheme to market with a meaningful allocation to less liquid assets if that leads to a higher price to members – even if it might result in potentially higher net returns.

The charge cap was introduced for important member protection reasons. The 2013 Office of Fair Trading report on the workplace pension market was critical of the cost and value of the products provided to savers. Regulatory action to contain cost was a pragmatic response to that criticism and the current focus on charges by decision makers an understandable market reaction. But the regulatory environment continues to evolve. For example, at the time of writing the FCA, TPR and DWP are working on the value for money framework, that once implemented will help facilitate comparisons of value across pension schemes.

As the market and regulation continue to evolve, decision makers need to consider where they strike the balance between a focus on cost and value. Too often, charges are taken as a proxy for value with scheme selection decisions turning on a handful of basis points. This could suggest that the balance may not be struck in the right place. To help shift the focus from minimising cost to a more holistic value assessment, this guide seeks to provide a framework to help decision makers consider the key issues in respect of value and less liquid assets.

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1. Assessing value from less liquid assets

This section outlines a process for assessing the value offered by less liquid assets. We aim to make it as accessible as possible for decision-makers and their advisers by breaking the process into three component questions, considered in more detail below:

- How could adding less liquid assets to a default arrangement improve member outcomes?
- What is the magnitude of the impact on member outcomes?
- What are the risks and governance considerations?

How could adding less liquid assets to a default arrangement improve member outcomes?

The aim of a workplace DC pension scheme is to provide an income in retirement. Members need a vehicle to grow their savings during their working life and to then use these savings later to support their retirement needs. When considering whether any investment offers value for members the first step is to identify whether there is potential scope to improve member outcomes.

Trustees should consider all potential investments on their individual merits, within the context of the implementation of default arrangements. Just like investments in liquid assets, less liquid assets offer an array of opportunities with different investment characteristics and risks that need to be considered in the portfolio construction and manager selection process. The following table summarises the key potential benefits of investing in less liquid assets. In some cases, these benefits will complement each other:

Overall purpose	Why might less liquid assets be valuable?
To improve retirement outcomes for members	<ul style="list-style-type: none"> • Access to an illiquidity premium may deliver higher risk adjusted returns net of costs and charges (see Box 1). • Improve diversification with less liquid assets offering different return drivers and access to different markets, which can aid risk reduction. • Potential to access inflation linked cash flows to offer members some purchasing power protection.
To deliver on sustainability priorities	<ul style="list-style-type: none"> • Less liquid assets may offer the ability to access longer-term projects and investments with longer-term sustainability objectives. • Enable Environmental, Social and Governance areas of focus to be specifically targeted. • Help with delivering portfolio net zero alignment, including management of transition and physical risks.

Box 1 **Why may an illiquidity premium exist?**

An illiquidity premium is a measure of the additional return that may be received in return for investing in assets that cannot easily be converted to cash. While the existence of an illiquidity premium is debated, there are reasons to believe that it could exist in some circumstances. These include:

- Private companies are potentially able to take a longer term view than public companies, given public markets' emphasis on and reaction to short term results. This means that private companies are potentially able to invest in projects and R&D with a longer payoff period that could appear unattractive to a public company.
- Private companies, that have strong links to private market asset managers, typically enjoy higher levels of governance due to private manager representation (with wider market experience) and can also enjoy access to further capital in difficult market conditions or for growth opportunities from their existing relationships.

While there is some evidence of an illiquidity premium, it is, however, difficult to measure for several reasons:

- Isolating liquidity risk from other systemic risks is challenging.
- Illiquidity premium varies with the asset class and complexity of the deal.
- There are significant positive and negative outliers in terms of returns.
- Liquidity risk is not constant and increases in times of market stress.

There is a range of estimates of illiquidity premium. For example, analysis from the Pensions Policy Institute suggests that the 'illiquidity premium' has varied between a 1%-7% increase in returns over the long term. Recent empirical estimates by Oliver Wyman and the British Business Bank suggest that a 22 year-old new entrant to a default DC scheme with a 5% allocation to VC/growth equity (GE) could achieve a 7%-12% increase in total retirement savings. This potentially makes less liquid assets attractive to DC schemes, should they have the capacity to invest³.

3. <https://www.british-business-bank.co.uk/wp-content/uploads/2019/09/Oliver-Wyman-British-Business-Bank-The-Future-of-Defined-Contribution-Pensions.pdf>

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What is the magnitude of the impact on member outcomes?

Once decision-makers have established the reasons why they might want to allocate to less liquid assets within a default arrangement, they would need to consider the potential materiality of such a decision on member outcomes. The choice of metrics would vary with the objectives, determined in the previous step. As with all things in investing, there is no single metric that can predict with certainty the quantum of value provided to members after allowing for costs and charges. Decision-makers have to rely on metrics and qualitative judgement that might allow them to understand better the value that might be provided by any given investment.

This could be done using the following metrics:

Example purpose	Example assessment(s) of impact (not exhaustive)
<p>Improve retirement outcomes</p>	<ul style="list-style-type: none"> • Expected impact on member long-term net investment returns • Performance relative to appropriate hurdle rates e.g. inflation, or relative to listed markets • Stochastic modelling of potential member retirement outcomes
<p>Reduce risk to the default arrangement as a whole e.g. through improved diversification</p>	<ul style="list-style-type: none"> • Portfolio volatility, measured with a sufficiently long time horizon • Expected performance of the overall portfolio in different economic environments
<p>Access wider opportunities to make progress towards climate-related targets and goals</p>	<ul style="list-style-type: none"> • Impact on appropriate climate metrics (e.g. carbon footprint or forward-looking metrics of alignment with net zero goals)
<p>Access to wider opportunities to deliver a positive, intentional and measurable social or environmental impact</p>	<ul style="list-style-type: none"> • Assessment of specific impacts that may be offered per £1m of investment depending on the particular impact(s) being targeted

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There are a number of important considerations around measuring risk adjusted returns after costs and charges.

First, it is crucial that appropriate consideration is given to time horizons. Trustees already set out their views on the appropriate time horizon for their investments in their Statements of Investment Principles, with the period often regarded as multi-decade. It's therefore important that performance is measured over sufficiently long time periods. This is especially important for investment in less liquid assets where the underlying investment term can

vary between a few years to more than a decade depending on the particular asset class and opportunity. Currently in the DC market performance of investment strategies is usually measured and compared over a quarter, 1, 3 and 5 years. In general, appraising returns after costs and charges over time periods of less than 5 years is not likely to be appropriate when considering the value provided from less liquid assets.

Second, consideration should also be given to appropriate measures of long-term success. Unlike liquid assets,

where there are readily available and industry standard benchmarks and comparators to measure performance, there are relatively few natural comparators to assess performance from less liquid assets. This is not a barrier, but a feature to be aware of. For example, trustees may wish to consider a performance hurdle above inflation, performance relative to liquid markets or a more absolute measure of performance.

Measured volatility will be dependent on the frequency of pricing, which for less liquid assets is likely to be less

Box 2 Different approaches to assessing value

UK DC schemes are subject to two regimes governing value for members. This is in addition to other common law and statutory requirements, like those around investment, that relate to value.

Schemes with assets of more than £100m must assess charges and, insofar as they are able to do so, transaction costs and assess whether these represent value for members. TPR's guidance suggests that, at a minimum, schemes should consider scheme management and governance, administration, investment governance and communications within the scope of their value for members assessment.

For occupational pension schemes that are regulated by TPR, from 31 December 2021, schemes with assets of under £100m ('Smaller Schemes'), that have been in existence for more than three years, have been subject to

different requirements. For their first scheme year ending after 31 December 2021, these schemes will be required to undertake a more detailed annual value for members assessment and report on it in their chair's statement. Schemes that are winding up or decide to wind up before that chair statement is due are exempt. Smaller schemes must benchmark administration and governance against seven metrics and benchmark both costs and charges and investment performance against three comparator schemes.

Rules for contract based schemes are different. Workplace contract based schemes must establish either an Independent Governance Committee (IGC) or a Governance Advisory Arrangement (GAA). Under current FCA rules, IGCs and GAAs are required to assess prescribed aspects of VFM in reaching their assessments of VFM. These include, broadly, the design of the default investment strategy, whether the firm regularly reviews net investment performance and has taken action to make any necessary changes, core financial transactions, communications,

and costs and charges. It is for the IGC to determine how the assessment is conducted. Under the rules, IGCs must also compare their provider's offerings with other similar propositions on the market as part of the VFM assessment.

This guide considers value from investment in less liquid assets as synonymous with a good outcome from saving in a pension scheme. This is something that is easier to judge and compare in retrospect than on a forward-looking basis.

The FCA, TPR and DWP are currently working to develop proposals for a broader and holistic value for money assessment framework, that aims to promote consistent assessments and support a shift in focus from cost to value. This framework would prescribe metrics for each of the three key elements of VFM, be assessed on a forward-looking basis: investment performance, customer service and scheme oversight, and costs and charges. These together determine whether the provider is delivering a good outcome for the pension saver.

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frequent (e.g. quarterly) and based on pricing using an approved valuation methodology rather than daily published prices. This can lead to smoothing of experience and dampening of reported volatility meaning comparing risk with listed assets using volatility as a measure may not always be appropriate. Decision-makers should consider what risk means to members in the context of investments in less liquid assets. For example, decision-makers may regard risk in terms of liquidity, or sustained underperformance relative to longer-term hurdles. Scenario analysis may be a valuable tool in exploring the potential impact of different economic stresses on long-term performance for the overall portfolio, as discussed in more detail in the liquidity management guide.

Finally, as with all investment decisions, the past may not be the best guide for future performance. It's therefore important that trustees consider both backward and forward looking metrics before investing.

What are the risks and governance considerations?

Allocating to less liquid assets can bring potential benefits as outlined earlier in this guide, however these potential benefits need to be considered alongside risks and governance considerations.

Risks

Investing in less liquid assets carries some risks and governance considerations that are unique to less liquid assets. For example, liquidity management and risks related to fair valuation of the assets would require more thought compared to public markets, where there are more

established governance and transparency requirements. These are all solvable problems but one of the keys to success is considering these issues at the outset, and developing plans to address. Other guides produced by the Productive Finance Working Group, e.g. on [liquidity management](#), [performance fees](#) and [due diligence](#), provide useful information for decision-makers on how to mitigate those risks.

Governance

It is important to ensure that a strong governance framework is in place, to help manage risks from investment in less liquid assets and protect DC schemes members' interests. The ongoing governance requirements of any investment in less liquid assets should be considered at the outset of an investment, with documented objectives and ongoing reporting standards in order to enable effective decision making. Investments in less liquid assets could also require wider data analysis or a different governance frequency than for public market investments, though it is not always the case.

The extent of the governance time commitment and budget requirement will depend on the investment vehicle used. For example, some default arrangements may invest directly in individual companies or infrastructure projects. This option is only likely to be possible for decision-makers with the ability directly to govern the investments they have made, or where they are able to source this expertise externally. Others may choose to invest through less liquid fund structures, such as Long-Term Asset Funds (LTAFs) when they launch. These types of less liquid fund structures will likely require some additional specialist skills to decide on whether to allocate to the vehicle as part of the overall

asset allocation and to govern the investment on an ongoing basis. Others may choose to invest through a pooled fund that has a less liquid component. Where LTAFs are used as part of a fund of funds structure distributed through a life platform, governance standards may look to be extended in a proportionate way, focused on the areas of increased risk and complexity.

As part of the initial planning process, decision-makers should consider the specific governance requirements that might be needed when investing in less liquid assets via their preferred implementation route. Some example questions decision-makers may want to ask themselves include:

- Do we have the appropriate skills and experience, along with our investment advisers, to be making an investment in less liquid assets? If not, do we need to invest in our skills and expertise, to improve our member outcomes or appoint specialist advisers or adopt a new investment governance structure?
- What are the time and resource implications of making a less liquid investment from both an initial and ongoing perspective?
- How do the expected member benefits outlined in the previous section correspond to the change in governance required?
- What are the governance opportunity costs of investing in less liquid assets? Could the trustee instead use available bandwidth to improve member outcomes, engagement or sustainability goals in other ways?

2. Making a shift from cost to value

A range of stakeholders have roles to play in making a shift in emphasis from cost to value across the supply chain and recognising that it may be possible to ‘pay more to get better member outcomes’. What is required to implement this shift in practice would vary depending on the type of DC scheme and key decision makers.

For example, trustees act in the interests of their members, given their fiduciary duty and statutory obligations. In practice, this currently often means focusing on keeping costs low, especially when it comes to some asset classes, e.g. less liquid ones, that tend to be more expensive, carry different risks and take some time to generate value. This is often a result of the market context in which decision makers operate, where scheme selection turns strongly on charge levels. Indeed, in the case of less liquid assets, a key challenge for decision-makers is how to ensure they act in the interests of members, while facing this tension between the certainty of cost and uncertainty of future return.

Assessing whether a particular investment approach could improve their net member outcomes relative to another requires taking the time to understand the less liquid investment propositions and whether they could be valuable additions to the overall investment strategy for the default arrangements within DC schemes.

For employers selecting a pension provider for their employees, shifting the focus to value means selecting approaches that are expected to deliver good retirement outcomes, which also will not necessarily correspond to the cheapest option.

Pension providers, consultants and advisors have a key role to play in ensuring the impact of different approaches on long-term member outcomes is appropriately understood by the decision-makers. This includes the impact of inclusion of less liquid assets, for which there are opportunities to enhance outcomes.

Key to implementing a shift in emphasis from cost to value is recognition of member time horizons, which are generally very long (more than 20 years) and may continue well beyond their retirement age. A long-term mindset can support greater appreciation of different potential sources of long-term returns, and opportunities to contribute to a more sustainable world through investment in climate solutions, or those opportunities addressing social needs.

The examples on the following pages are intended to demonstrate how a shift in emphasis from cost to value may be implemented in a number of ‘real life’ scenarios through engaging with their existing providers or through reviewing the market for alternatives that better meet the scheme’s objectives. The examples are intended to cover a wide spectrum of possible scenarios: scheme selection (example 1), ongoing oversight of an incumbent provider (example 2) and trustee decision making around less liquid assets (example 3). In each scenario, there is a range of ways that less liquid assets might be incorporated, within a simplified spectrum of the options discussed in the previous section.

Example 1 – Trustees aiming to improve outcomes for their members

- Number of members: 10,000 to 100,000
- Assets built up in current DC arrangement: £500m+
- Sustainability goals: The trustees have established long-term climate-related goals and interim targets in line with best practices

In this example, the trustees are responsible for governing the pension arrangement. Up until around five years ago, the arrangement used the incumbent provider's default solution. After receiving advice from their investment consultant, the trustees identified several ways to improve outcomes for members. This was achieved by changing the asset allocation, which still uses off the shelf funds.

The trustees rely on a combination of knowledge and experience, consultant advice and information from the pension provider to inform investment decisions. They have recently focused on climate-related and wider sustainability matters. Now, their consultant is advising them to increase the level of alignment between assets and the climate transition, and to consider climate-related and wider impact solutions in future.

The trustees have agreed the following priority areas to support the next review of their investment strategy:

- Deliver better long-term retirement outcomes with an explicit target for employees after charges, with ability to access their pension savings.
- Consider whether their service providers are materially restricting the trustees in meeting any of the above objectives and, if so, consider a review of the market for alternatives.

In this scenario, the trustees may wish to continue changing their investment strategy on a bespoke basis, or work jointly with their pension provider or other strategic partners to make progress against their priorities.

When considering ways to improve retirement outcomes for their members, the trustees should consider a wide opportunity set, including less liquid assets and off-the-shelf provider offerings. The trustees should expect their pension provider to share details of new developments, and potential impact on long-term retirement outcomes.

Costs and charges should not be a sole driver of investment decisions. For example, the trustees may wish to ask their consultant to illustrate the impact of including less liquid assets on long-term retirement outcomes. The trustees should be aware of the limitations that are driven from platforms, asking advisers for their ideas in an unconstrained investment framework. If this assessment suggests less liquid assets could enhance their members' retirement outcomes, the trustees should proceed to the next stage of planning implementation approaches and looking at the governance implications.

The trustees may find that some progress can be made in the short term, and fuller progress may take a number of years to achieve.

In this scenario, the trustees, with support from their advisers, may be expected to:

- Review their own governance structure and expertise (internally and externally) to assess whether they have the capacity and appetite to invest in less liquid assets, potentially as part of their review of Statement of Investment Principles (SIP).

- Be prepared to increase charges for members if an allocation to less liquid assets increases the chance of improving retirement outcomes for their members, recognising long term allocations to less liquids will take time to build;
- Work with their existing pension provider or other potential strategic partners to meet their priority areas;
- Test the ongoing suitability of their investment approach with the wider market, having a clear understanding of their platform's impact on their investment strategy, given the likelihood for continuous development and the opportunity to learn from this;
- Be prepared formally to review the provider market and select a new long-term pension provider if the current approach limits the ability for the trustees to implement their preferred investment strategy.

In this scenario, the trustees are continually exploring ways to enhance outcomes for their members, and consider a wide investment opportunity set to achieve this.

Example 2 – An employer seeking a new off-the-shelf pension solution

- Number of employees: Up to 5,000
- Assets built up in current DC arrangement: Below £100m

In this example, the employer relies on the provider to deliver good outcomes for their employees. The current provider delivers a low-cost solution for employees, as charges have historically been a key factor in provider selection.

The employer should look to establish clear objectives at outset, potentially with the aid of an adviser. These may include:

- Deliver good long-term retirement outcomes for employees after charges, with ability to access their pension savings.
- Level and quality of employee support.
- Cost sensitive plans to transition from the old to new pension arrangement.
- Alignment with the employer's sustainability goals, including e.g. their path to net zero.

In practice very few employers actually articulate an objective to minimise costs as much as possible, to the exclusion of all other factors. Typically most employers see reducing costs as a way to improve retirement outcomes. Emphasis on the goal of expected retirement outcomes rather than a single factor of level of charges is likely to provide the best framework to improve member outcomes.

The employer may wish to work with an expert advisor or pensions consultant to support their requests for and evaluation of proposals from pension providers. The advisor/consultant should ensure that delivering good overall outcomes net of costs gain focus, rather than the absolute level of costs and charges. In the scenario where an employer seeks advice from a consultant on the best provider for their scheme, the employer's objectives should feature strongly in the framework of the adviser's recommendation, where it should be made clear how each potential provider's solution performs against these objectives. It may be beneficial for providers to illustrate more than one proposal, for example with higher and lower charges, to illustrate the potential impact on member outcomes.

In this example, some pension providers propose solutions incorporating meaningful allocations to less liquid assets, but with higher charges. The proposals include evidence to support a view that the less liquid assets will add value and more than justify the increase in charges, both in terms of financial outcomes and alignment with the employer's sustainability goals. These are supported by plans to facilitate liquidity.

The other proposals are based on a replication of the employer's current offering, with similar or lower levels of charges than are currently paid. Some, but not all, of these providers have demonstrated a degree of alignment with the employer's sustainability goals. All non-investment services and offerings are assessed to offer similar value from respective proposals. The investment approach is therefore likely to be a deciding factor.

In this scenario, the employer may be expected to:

- Receive an evaluation from their adviser which emphasises the employers' objectives and provides clarity on the differences in the propositions in meeting those objectives.
- Discount proposals demonstrating little/no alignment with their sustainability objectives, given they do not align with one of the employer's core objectives;
- Challenge some of the lower cost proposals on what member outcome their investment strategy is targeting. Evaluate, with the aid of advisers, whether solutions with exposure to less liquid assets, which are likely to be higher cost, are also likely to provide better expected outcomes for members (given the core employer objective of improved outcomes net of charges, rather than cost).
- Form a short list of providers and select the provider based on the solution that is most likely to meet the objectives set.

The value of this process is derived from objectives that need to be established at the outset together with principles that must be followed through to the final provider selection decision.

[return to previous location](#) 

Example 3 – Governance committee overseeing an existing pension provider

- Number of members: more than 5,000
- Assets built up in current DC arrangement: more than £100m

In this example, the employer has already selected a pension provider for their workforce and rather than creating significant disruption in the pension provision, has decided to engage with their provider to make improvements. They place a significant level of reliance on the provider to deliver good outcomes for their employees, but in line with good practice have established a committee to oversee this.

The committee, as part of a strategic review of pension provision with their adviser, has negotiated better terms with their provider reflecting their longstanding relationship and expected growth in the size of assets in the DC arrangement.

The governance committee has a regular process to identify the priority areas that will contribute to good long-term outcomes for their members, focusing on the following objectives:

- Deliver better long-term retirement outcomes with an explicit target for employees after charges, with ability to access their pension savings
- Plans to evolve the investment approach to enhance outcomes due to growing scale, and access to greater diversification

The first can be supported by benchmarking and value assessments, against other market participants. These should be on a net of costs and charges basis, and ideally with impact on retirement outcomes. The employer may wish to work with an expert advisor or pensions consultant to support the market comparisons.

The pension provider should be expected to share plans for evolution of their investment approach, including consideration of the role of less liquid assets. Plans should set out the anticipated impact on long-term retirement outcomes and plans for enabling liquidity. It may be beneficial for the pension provider to put forward more than one approach, so the impact of different levels of costs and charges can be evaluated.

In this scenario, the employer, with support from their advisor/consultant, may be expected to:

- Challenge their pension provider on an ongoing basis on priority areas that can influence long-term retirement outcomes;
- Test the ongoing suitability of their pension offering with the wider market, given the likelihood for continuous development;
- Be prepared to review the provider market and select a new long-term pension provider if progress falls short of providers' promises and the employer / governance committee's priorities.

In this scenario, the governance committee is using their resources to challenge their pension provider in areas that can lead to improved outcomes for their members. It retains the right to change provider in future if outcomes could be improved using a different approach.



Guide to Performance Fees in Less Liquid Asset Funds

Summary

This guide provides a high-level overview of the key considerations around performance fees. It has been written for trustees and other key UK Defined Contribution (DC) scheme decision-makers considering investing in less liquid assets as part of their default arrangements, as well as for investment managers looking to understand the needs of UK DC schemes.

The aim of the guide is to help explain and demystify the key considerations of UK DC schemes considering investing in a fund(s) containing performance fees, to highlight the different types available and to suggest some principles for DC schemes on how to incorporate these. The guide does not attempt to advocate nor discourage trustees from using funds with performance fees.

Performance fees and similar such arrangements are a common feature in many less liquid investment fund products, and in some asset classes they are almost universal. Such fees are generally payable when the investment returns of the fund exceed pre-determined thresholds or benchmarks.

There are a range of views as to the degree to which performance fees are in the interests of savers. However, institutional investors, including DB and certain overseas DC pension schemes, commonly invest in products that use such fee arrangements (such as performance fees or profit-sharing arrangements like carried interest; referred to in this guide as “performance fees” for ease).

While the use of performance fees will not be appropriate in all circumstances, a properly structured performance fee that reflects the specific requirements of DC pension schemes could be appropriate by supporting value creation (a ‘net benefit’) for members and helping to align interests of investors and investment managers. It is therefore important to assess each investment proposition to decide if the fee arrangements including any performance fees are in members’ interests.

Our engagement with DC pension schemes suggests that there are three key principles that guide their assessment of any performance fee structures. These involve:

- Ensuring the triggering and use of performance fees is linked to added value being created for DC members
- Ensuring performance fees are attributed as fairly as possible between different DC scheme members
- Having the ability to implement operationally within a DC context

This guide sets out some of the key considerations around structuring performance fees to align with these principles, although noting that it is not possible to cover every permutation of possible performance fee structures.

There may be trade-offs between these principles, and the guide illustrates where such trade-offs could occur for some common features of performance fee structures; these are summarized in [Annex II](#) of this guide. It is important in all cases to ask questions to fully understand the potential impact of the performance fee on members. Some suggestions have been highlighted in section four of the guide.

There are solutions that aim to accommodate the needs of UK DC schemes considering investing in less liquid assets with attaching performance fees, and this guide sets out one such approach. It is expected that the market will continue to innovate and develop other solutions as it evolves and new products such as when the LTAF are launched. Developing and negotiating such fee structures will require creativity and compromise across the market.

This guide should be read in conjunction with the latest rules and regulations regarding performance fees, noting that these are likely to evolve over time. One important consultation undertaken by the government late 2021 proposed changes to the regulatory charge cap that applies to default funds, aimed at ensuring DC schemes are able to access a broader range of illiquid asset classes while providing appropriate accompanying mechanisms to ensure member interests remain protected.

1. What are performance fees?

The fees applicable to investing in less liquid assets can have two components. The first, which is almost always present, is a fixed management fee that is linked to the value of invested or committed capital. The second element which may be present is a performance fee that is paid for performance typically once an identifiable figure or benchmark has been exceeded (such as receiving 20% of performance above an 8% threshold). The focus of this guide is the performance fee element which covers different types of arrangements such as profit-sharing arrangements.

Performance fees are a common feature in many less liquid asset fund products, although they are not universal. Where used, the terms and features of performance fees can vary significantly across the range of less liquid asset funds, reflecting the differences in asset classes and investment strategies, but consistent features commonly include:

- They all award a portion of the net profits or returns to the manager.
- They are usually payable when returns exceed a set threshold or benchmark such as a 'hurdle', 'preferred return' or a 'high watermark'.
- The mechanisms (including the proportion of performance the manager receives) and timeframes over which the performance fee is measured and paid out is agreed before an investor invests in a fund.

There is a wide-ranging debate in the DC market regarding the role of performance fees within an investment fund with strong advocates on both sides of the debate. Regardless of these views, it is generally recognised that they have become standard for many less liquid asset funds. However, this does not mean that investors need to invest in funds that use performance fees. It is important to assess

each investment proposition on its own terms. Using expertise, experience and scale to negotiate alternative structures to typical fund vehicles may be possible in some cases, and simply choosing another investment remains an option. Therefore, it is important to assess each investment proposition on its own terms, to decide if the fee arrangements weighted against expected investment outcomes are in investors' interests.

2. Key principles for performance fees from a DC perspective

Historically there have been few examples of investments with performance fees used by UK DC schemes. This is mainly due to concerns about compliance with the DC charge cap as well as the operational challenges associated with members joining and leaving default arrangements at different times.

While the features of performance fees used in different situations will be driven by such factors as the nature of the underlying investments and market norms, it is important to ensure that performance fees, where used by DC schemes, can work effectively in their context and meet DC scheme members' needs. To help achieve that, the guide presents three key principles that DC schemes and managers may wish to consider during discussions about investments that involve performance fee structures.

– Ensuring the triggering and use of performance fees is linked to value being provided to DC members. Trustees and employers are rightly focused on delivering good outcomes for DC pension scheme members. Performance fees potentially increase the costs being paid by members and it is therefore crucial to ensure that these higher fees are only paid when members earn demonstrably better net returns.

The principle here is to ensure that any additional value provided by the investment to members outweighs the costs when paying performance fees. Critical to this is ensuring that there are clear links between the costs and charges and the superior returns received by members.

To implement this principle in practice, it is important to ensure a good valuation mechanism is in place (e.g., appropriate frequency, independent valuation and

robust governance structure). It is also important to be able to measure performance fees and their impact on value, or net benefit, for members in a transparent, rigorous, and consistent way. *Annex I* sets out some practical suggestions on how to do that across different structures, using both ex-ante (estimated before investing) and ex-post (calculated after investing) measures.

– Ensuring performance fees are attributed as fairly as possible between different DC scheme members.

As different DC members will invest and divest from investments at different times, it is likely that the experience (and achieved performance of each member) may vary quite markedly from member to member. Performance fees complicate this consideration further, and trustees may be concerned that some members could bear costs but not benefit from any extra performance. Ensuring that any performance fees and returns relating to an investment are borne proportionately across different members is critical.

The principle here is to ensure, as far as possible, that the DC members who receive the strong performance that generates and triggers the performance fee are also the same members that pay for it. As noted, one of the realities of DC schemes is that members come in and out at different times, and these timing issues can lead to members paying more or less in performance fees than is justified by the performance they have experienced, especially as investing in less liquid assets takes time to generate performance. It is particularly important to ensure that those members who do not receive the improved performance are not required to pay additional fees due to the performance fee structure.

– Having the ability to implement operationally within a DC context. Any performance fee structure will need to be incorporated into an existing investment and administration architecture, including member reporting, that has been set up largely to accommodate the prevailing DC investment vehicles of today. Given that performance fees are likely to be new for most DC schemes, it is important to think about how performance fees may be introduced into existing structures. It is also important to ensure that DC schemes are able to provide transparent and clear reporting on costs and charges to their members.

The principle here is to ensure that the performance fee solution being looked at is deliverable. Being able to plug new structures into existing operational infrastructure should assist in both scale and ensuring accuracy (ultimately helping to build confidence) and therefore it may be desirable to keep complexity to a minimum.

These principles are not absolutes; each represents a spectrum of potential outcomes for members and DC schemes. Further, to a certain extent these principles may compete, and therefore trade-offs may be required. Similarly, many existing performance fee structures are not designed to accommodate the DC-specific issues that these principles are looking to address. Given this, finding structures that allow for DC investment into funds that have performance fees may require creativity and compromise across the wider market.

These principles could provide a basis for a helpful practical approach for trustees, who would need to agree and consider how to weight or prioritise these three principles; identify the key performance fees features that could meet their scheme's needs and then use this understanding to select, negotiate and / or co-create a holistic approach to fees to meet their schemes' needs.

3. The key components of performance fee structures

The following section looks at the key elements of performance fee structures, providing an explanation of them and how they work.

Here, the guide aims to bring these principles to life within a DC context by looking at some of the common features of performance fees. The guide then identifies some of the considerations DC decision makers and investment managers may consider when mapping a specific aspect of a performance fee to the principles. For each feature a few examples of common considerations around performance fees have been provided and then mapped to the three key principles above. It is important to highlight that this is not intended to be an exhaustive list of example terms, nor is the guide looking to provide advice about what may be right for individual schemes. In particular, where the fund itself invests in underlying funds or sub-funds – a fund of funds type approach – there may be multiple instances or more than one type of performance fee features and as such, this may require additional consideration not covered in this guide.

The guide includes a ‘rating’ system as noted to the right for specific examples as a means of highlighting the intensity of focus that may be required to develop a specific feature that meets each of the three key principles. This enables us to illustrate how these principles may be used when considering the features of specific performance fee structure, as well as highlighting some of the potential trade-offs that may be associated with addressing these principles.

A summary of all of the key elements highlighted can be found in [Annex II](#).

Legend



Minimal time/effort is required to address this requirement, as there are fewer complexities associated with addressing this requirement within the example.



Moderate time/effort is required to address this requirement, as there are some complexities associated with addressing this requirement within the example.



Significant time/effort is required to address this requirement, as there are greater complexities associated with addressing this requirement within the example.

Performance fee structures typically display the following features.

Split between base fees and performance fees:

A common question is how the compensation paid to the manager should be split between a fixed fee and performance fee. It is not possible to have a ‘one-size-fits-all’ split, and the focus needs to be on ensuring the structure and balance of the fees are designed to maximise the net benefit delivered to members.

A preferred approach will vary depending on a number of factors, including the nature of the returns expected from the investment. For example, in areas where trustees are largely looking to generate returns from the assets, fees predominantly focused on a fixed element might be more appropriate. In some cases, performance fees could reflect bad alignment, as they might incentivise greater risk taking by the manager than is appropriate for the strategy. On the flipside, for those decision makers investing in strategies where extra performance could be incentivised and generated through the manager’s skill a performance-related fee may be more effective.

From a DC perspective, the focus needs to be on ensuring the structure and balance of the fees is designed to maximise the value delivered to members. Theoretically, a fund only charging performance fees could be good for DC members, but this is likely to cause practical challenges (e.g. maintaining manager commitment during periods of poor performance) and possible misalignment from a manager perspective (i.e. what does it do to a manager’s timeframes and risk appetite etc.). However, it could be argued that the base fee should be lower if there is a performance related element in addition to the base fee.

Hurdle rates:

A hurdle rate is typically considered as the level of return that a fund must exceed in order for the manager to be entitled to a performance fee.










- The basis of the performance fee will depend on the nature of the assets. For some strategies, where the manager is trying to deliver capital growth, the performance fee is more likely to be based on some measure of total return (capital and income). For strategies designed to pay investors an income, the performance fee might be based on delivering a yield figure.
- The actual level of required returns that triggers an entitlement to performance fees can be set as a “hurdle” or a “preferred return”. These mechanisms both ensure that investors receive a certain level of return before the fund manager is entitled to receive any performance fee.
- In a “hurdle” model, investors will receive the benefits of all the performance up to a certain rate, with the manager only then receiving performance remuneration for gains over and above the “hard” hurdle.

- Alternatively, a ‘catch up’ mechanism seeks to provide investors and managers with an equal overall rate of return, assuming the investors have first received the “preferred return”. This is achieved by splitting the sharing of profits between fund manager and investors into phases. Initially, investors receive further proceeds until they have received a “preferred return” (at the specified rate), similar to a “hurdle” model. If returns exceed the “hurdle” rate, then in the next phase profits go to the manager (either wholly or in some agreed proportion shared with investors) until the manager has “caught up” with the investors (i.e. the fund manager and investors have respectively received amounts that match the agreed ultimate sharing ratio). After that, any further performance remuneration is earned in the agreed ultimate sharing ratio.

How might this work from a DC perspective? Preferred returns would seem more difficult to operate while ensuring fairness for investors, as members will leave and join at different points. Hurdle rates could offer a helpful control mechanism to make sure members receive fair value. However, this is not a perfect solution and setting the right hurdle rate is important to ensure value for members.

Action: ask to see examples of how the proposed fee arrangement would work in practice. One way of doing this is using historical market performance, or alternatively using different levels of expected returns. In particular, it is expected that there will be need to pay close attention to total net returns in any performance fee calculation, having due regard of capital risks in the case of income-targeting products.

Examples of this principle

	Performance fees only triggered by added value	Fairness between different members	Ability to implement operationally
Setting a preferred return with catch-up			
Setting the hurdle rate at a pre-agree return target			
Setting the hurdle rate linked to a relevant index (e.g. listed equities for private equity)			

** Catch-up may mean that certain investors will pay a higher performance fee than others, depending on when they enter the investment and where it sits versus the hurdle. This makes it more complicated to ensure fairness across different members.*

Measurement period and payment:

Another key feature of performance fees relates to the period over which performance fees are measured and paid to managers. In particular, should performance fees be paid out when assets are realised or is it appropriate to pay the fees on valuation?













- Funds featuring performance fees will have a reference period over which performance is measured and in relation to which performance fees accrue. This varies but could be the period between two consecutive valuation points (which itself will vary in length between different asset classes) on either a discreet or rolling period. While this can vary materially for different structures, in the example of a Long Term Asset Fund (LTAF) which is required to be valued at least monthly, the performance during each month would be accrued into the monthly valuation and be reflected in the Net Asset Value (NAV).
- The accrual of performance fees, which is a methodology used to calculate member fees during a reference period, is separate to the actual payment of performance fees, which happens at the moment of “crystallisation” (or “vesting” in a closed-ended context). The frequency of crystallisation will vary for different funds and may be linked to the expected holding period of underlying investments. Crystallisation may take place monthly, quarterly or (most likely) annually. Some managers expect to hold assets for multiple years and crystallisation often occurs when individual assets are realised, which may or may not align with fund valuations.

- On crystallisation a final net amount combining the previous accrued amounts for the period is calculated and paid to the manager (although settlement may be delayed, or payment may be made in the form of units in the fund). Once paid it is often the case that subsequent under-performance does not necessarily need to result in the repayment of any performance fee that has been paid for prior periods.

How might this work from a DC perspective? Value for money principles would suggest that performance fees should be calculated over longer periods, noting that different investment strategies have different value creation cycles and objectives. However, to ensure fairness between members/investors, the use of an accrual mechanism could help by better linking the additional fee to members who have enjoyed the better performance. Such an accrual mechanism should be sufficiently frequent and aligned to when members can enter/exit an investment. Further, basing performance fees on unit price movements would more likely reflect the member experience while paying the performance fees in units to the investment manager, if practicable and preferable, could support impact alignment and assist in retention.

Action: Discuss each of these areas with your manager to explore whether the fund and its performance fee meets your requirements. In particular, be clear on how and when any lumpy performance fee would be paid by members i.e. would this be accrued or would there be key payments such as catch-ups or a final performance fee on return of capital.

Examples of this principle

	Performance fees only triggered by added value	Fairness between different members	Ability to implement operationally
Performance fee accrual at every valuation point, with performance fee triggered when assets are realised			
No accrual of performance fee, with performance fee triggered when assets are realised			
Payment of the performance fee in the form of units in the fund (subject to the same redemption terms as investors)			
Payment of the performance fee in the form of cash			

Member protection features:










Some performance fees have specific features aimed at controlling costs. Often these features are designed to provide greater protections to investors, but naturally involve greater complexity in how the performance fee is administered. Some examples of additional features include:

- **High watermarks:** A protection mechanism for investors to ensure the manager only receives performance fees for new performance. This is a commonly used method of ensuring that the manager only receives performance fees for new performance – and not for performance improvements that merely recoup earlier losses – is by using a “high watermark”. Under this model, a high watermark, i.e. the peak value of a fund, is set initially at zero, but then reset on an ongoing basis. The manager then only earns any further performance fees on amounts by which the fund’s value exceeds the previous high watermark. This model may be used in conjunction with an external hurdle or relative to a benchmark such as an index in which case the high watermark will need to be adjusted to reflect changes in the hurdle.
- **Caps on fees:** where a maximum amount of performance fee that may be paid to the manager is set to provide a clear limit on how high the fee may be, which can help ensure alignment with the DC scheme’s risk tolerance.
- **Clawback from the manager:** a provision that allows for trustees to receive back from managers performance fees previously paid (i.e. clawback) in the case that the manager subsequently underperforms in future time periods.

How would this work from a DC perspective? The use of ‘high watermarks’ is a potentially important tool for reducing the potential asymmetry of performance fees, but how they are administered to ensure fairness is important. Caps on performance fees can provide trustees with certainty on the total amount that could potentially be charged by the manager and it could be argued that it will also more closely align manager behaviours with trustee risk tolerance. Conversely, it could be argued that performance fees that cap performance might impede incentives. Manager clawback does provide an element of protection to trustees through allowing them to receive money back from the manager, however, within a DC context this is difficult to administer and requires additional thought on how to ensure fairness across scheme members.

Action: High watermarks are likely to be a key element to any performance fee structure. However, take time to understand your managers approach to the setting of the high watermark, and consider both the positive and negative considerations of this approach. Adding additional elements to a performance fee calculation increases the complexity. Consider whether these offer valuable benefits for you and your scheme members.

Examples of this principle

	Performance fees only triggered by added value	Fairness between different members	Ability to implement operationally
High watermark is used to control where performance fees are payable (i.e. extra fees are only paid above previous high)			
Performance fees are capped to control investors costs (e.g. a private equity manager receives a performance fee above an agreed rate but capped out at a higher rate)			
Manager clawback is introduced (i.e. a mechanism whereby where a fund manager provides material underperformance after receiving a performance fee will need to compensate investors)			

An illustrative example of applying these principles in practice

DC schemes looking to apply the principles identified in this guide may need to make trade-offs when determining the most appropriate fee structure. This hypothetical example, provided for illustrative purposes only, shows how they might apply for DC Schemes using an open-ended structure like the LTAF to invest in private equity.

- **Split between performance and management fee:** In our hypothetical example, the fund manager is an established firm with significant levels of asset under management, seeking investor commitments to create a large illiquid assets fund. Due to economies of scale and for its own commercial reasons, the fund manager believes it can operate the fund with a lower than usual base fee of 1% per annum but with a higher than usual performance fee of 30%.

Given the specifics of the manager, the greater proportion of fees being paid through the performance element represent greater alignment of costs to better performance.

- **Performance Hurdle:** As a strategy that is looking to improve member value by delivering better relative performance, the performance hurdle is based on outperforming a stated equity market. The performance fee therefore is based on performance above a pre-agreed proxy hurdle rate or equity benchmark, and as this product is aimed at DC schemes, it does not include any catch-up provisions.

Given a likely alternative is to invest this allocation into listed equities, value generated for the DC investor through this investment can (crudely) be viewed as the performance generated by the investment above either a) a representative equity index or b) a flat figure designed to act as a proxy for listed equity performance. Catch up components may be more difficult to implement in a DC context given the principle of ensuring fairness.

- **High watermark:** Performance fees are only accrued for new positive performance beyond the previous high point of performance.

This ensures performance fees are only payable when value has been created for the DC scheme.

- **Frequency of performance calculation:** The performance fee is accrued at every valuation point to reflect any outperformance relative to equities from time to time and this feeds through to member units. However, the accrual is only crystallized when the underlying assets in the portfolio are realised.

Accruing performance at every valuation point (where appropriate) helps ensure fairness across members. By only crystallizing the performance fee when the underlying assets are realized, this provides the DC investor with confidence that the performance fee is only paid to the manager when true value is realised.

- **Crystallization method:** The accrual is crystallized and is converted to units in the fund for the benefit of the manager's account with some sort of agreed holding period. These units have the same liquidity features as other units held by DC schemes and members.

By paying the performance fee into the fund, it ensures the manager's alignment to the positive performance of the fund beyond the payment of the performance fee. It also ensures that the manager's ultimate realisation of its performance fee is subject to the same terms and conditions (including redemption procedures) as the DC investor.

This is just one hypothetical example of a fee structure that might be used in DC schemes, to meet their members' needs. We hope this guide will support DC scheme trustees, their investment consultants and managers to collaborate to create structures that are appropriate for their needs, maximise the potential value creation for the members and fairness among them, while looking to reflect the principles discussed above.

Annex I: Measuring the impact of performance fees on value for members

One of the key considerations for DC schemes is to ensure that performance fees are only paid when associated investment adds value for the scheme members. Implementing this principle in practice requires an ability to assess the impact of performance fees on value associated with those investments in a transparent, rigorous, and consistent way. When looking at the introduction of a performance fee, it is important to recognise, as noted above, that different managers may implement materially different fee structures across the funds that they manage based on a variety of factors such as their business objectives, their track record and broader market dynamics (among others). And there are also varying components of fee structures. As such, comparability is therefore an area which should require attention.

In general, there are two ways to measure the impact of performance fees on net returns – ex ante (a forward looking estimate at various levels of gross performance) and ex post (a backward looking actual net benefit generated).

Expected net returns (known as ex-ante)

The estimation of fees is inherently assumption driven. Across the market, there is a variety of approaches used to address the performance fee challenge. Best-in-class fee modelling includes a number of features:

- include all the fees; i.e. look at both the base management fee and any performance elements of the fee.
- reflect the optionality of performance fees; good manager performance means that a higher fee is paid, while poor performance generally does not result in lower fees being paid. This leads to most best-in-class processes using stochastic modelling approaches that look at multiple scenarios.
- reflect the time taken for capital to be drawn down and invested in private market investments.

The best ex-ante estimation of fees involves both robust and consistent assumptions and the use of scenario analysis.

It may be appropriate to ask a manager to model the impact of fees on net returns using assumptions that DC decision makers believe are appropriate. While the manager will often have their own assumptions for the various elements that are important for measuring the fees (and there is often no harm in analysing those as they offer the manager's best estimate), in many cases the expectations of the investor and the manager may differ. In particular, having your own assumptions that are modelled consistently across different managers is particularly important when you are looking to make meaningful comparisons between different managers.

There is a wide range of assumptions that DC schemes may want to consider; those below are some that could be viewed as the most impactful in the various areas.

Hedge funds	Private credit	Private equity/ Venture Capital	Real assets
Beta of the portfolio to equity markets	Time taken to invest	Time taken to invest	Time taken to invest
Level of volatility of returns	Expected hold period	Expected hold period	Expected hold period
	Expected level of re-investment	Expected level of re-investment	Split between income and capital growth

DC decision makers may want to look to calculate the overall fee load at different levels of gross performance (as examples, maybe 0-10%p.a., 15%p.a., and 20%p.a.) and plot these as the total net return expected at these various points. The key benefit to this approach is to frame the total fees paid in the context of the net benefit to the DC member. While the fees are likely to be higher the better the performance, with well-structured fees this obviously comes with significant value delivered to the member.

Interrogating historical net returns (known as ex-post)

The ex-post approach to performance fees compares actual fees paid versus actual outcomes received. However, investors might want to go beyond this basic calculation and consider how effective the fee has been in actually rewarding the investment manager for delivering net benefit to DC scheme members. To undertake this type of analysis it is important to identify those areas where the manager has added value, versus where they have been positively or negatively impacted by factors beyond their control, such as market movements, impacting the investments held.

The specifics will be relevant to the fund investment made, but as an example two things to consider in determining true alpha are:

- Is the 'alpha' generated 'true net benefit', or is it just simply market timing based on the method of calculation? In some cases, you will actually be looking to invest into a manager whose skill it is to time the market, but in any case DC schemes should be aware that the entry and exit point of investments can have a big impact on the reported return from an individual manager.

Given that DC decision makers may be replacing listed equities or debt instruments when making investments in less liquid assets, a public market equivalent analysis (where the same cashflows into the private markets investment are assumed to be invested into a comparator public investment) can show whether the manager created additional value for the investor, as opposed to holding the alternative listed investment over the same period.

- Is 'alpha' just the result of the manager taking on more risk, through leverage or holding riskier investments? Ultimately the risk in an investment is borne by the DC investor, so enjoying a higher return simply through taking on more risk is arguably not a net benefit to members.































By adjusting for these types of elements (among others), a better picture of the true 'alpha' can be calculated, and the amount of performance fee paid can be compared against this true 'alpha' amount.

This type of analysis may help in two ways:


- to review the previous track record of a manager in a more robust way with more of a focus on the true net benefit added through that investment's lifecycle.
- to frame the investment decision that you are making today. It is often said that in investments, what gets measured gets managed. By committing to think about fees and net benefit in this way in advance of making an investment, DC decision makers can increase their chances of investing into managers and structures that offer fee structures that align with delivering a true alpha figure.


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Annex II: Features of performance fees and how they relate to principles of DC investing

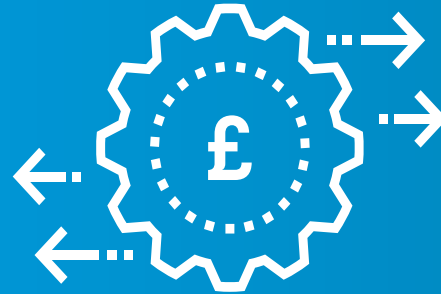
Feature	Type	Principles to consider in a DC context		
		Performance fees only triggered by added value	Fairness between different members	Ability to implement operationally
Basis	Setting a preferred return with catch-up			
	Setting the hurdle rate at a pre-agree return target			
	Setting the hurdle rate linked to a relevant index (e.g. listed equities for private equity)			
Calculation	Performance fee accrual at every valuation point, with performance fee triggered when assets are realised			
	No accrual of performance fee, with performance fee triggered when assets are realised			
Payment	Payment of the performance fee in the form of units in the fund (subject to the same redemption terms as investors)			
	Payment of the performance fee in the form of cash			
Control	High watermark is used to control where performance fees are payable (i.e. extra fees are only paid above previous high)			
	Performance fees are capped to control investor costs (e.g. a manager receives a performance fee above an agreed rate but capped out at a higher rate)			
	Manager clawback is introduced (i.e. a mechanism whereby where a fund manager provides material underperformance after receiving a performance fee will need to compensate investors)			

Legend:

 Minimal time/effort is required to address this requirement, as there are fewer complexities associated with addressing this requirement within the example.

 Moderate time/effort is required to address this requirement, as there are some complexities associated with addressing this requirement within the example.

 Significant time/effort is required to address this requirement, as there are greater complexities associated with addressing this requirement within the example.



Guide to Liquidity Management

Summary

Increased investment in less liquid assets highlights the importance of robust liquidity management, given that many of these assets cannot be bought and sold daily. Many DC schemes have found a way to meet the liquidity needs of their members, while investing in less liquid assets, and the Productive Finance Working Group report concluded that a broader range of DC schemes could find a way of doing that too.

This guide highlights the key considerations around liquidity management accompanying investment in less liquid assets within DC schemes' default arrangements. The guide is aimed at DC trustees and other key decision makers (collectively referred to below as “decision makers”) considering investing in less liquid assets, as well as the asset managers seeking to develop products that could meet the needs of DC schemes and their members.

DC schemes can meet the liquidity needs of their members, while investing in less liquid assets, by managing liquidity at two levels – at the DC scheme and underlying fund levels. Liquidity is likely to be managed primarily at the DC scheme level, but it is also important for DC scheme decision makers to understand the key features of the fund-level liquidity management.

Liquidity management at DC scheme level

DC schemes can meet the liquidity needs of their members, while investing in less liquid assets as part of a diversified portfolio within their default arrangement, by understanding expected future cashflows. For the foreseeable future, default arrangements are likely to have strong, predictable cashflows and significant holdings of liquid assets.

Decision makers could take comfort around investment in less liquid assets by determining their risk appetite for these assets and by drawing on the results of scenario analysis and stress testing of liquidity events. They should also ensure that appropriate risk mitigation and governance frameworks are in place. This guide describes ways of implementing a liquidity management framework as well as practical steps such as an appropriate approach to cash flow projections and stress testing / scenario analysis.

Liquidity management at the underlying fund level

DC decision makers will also need to work with fund managers to understand the liquidity profile of the underlying investments, as well as the structure of the fund itself.

This guide considers key questions that DC decision makers will need to ask their fund manager. In particular, the impact of different fund structures on the ability of the scheme to access liquidity, and the range of liquidity tools used by managers. Where DC decision makers choose to invest in open-ended funds they will also need to ensure they understand the alignment between the liquidity of the underlying assets and the liquidity of the fund vehicle. For these fund structures, fund managers would need to set a minimum notice period in a way that ensures such alignment.

1. What is liquidity management for DC pension schemes?

DC pension schemes that decide to invest in less liquid assets will face liquidity considerations at member, scheme and fund levels, as highlighted in the Productive Finance Working Group [report](#). There are both regulatory and policy requirements for DC schemes to ensure liquidity events are achieved within certain time frames. The UK DC pension system needs liquidity to accommodate a number of member and scheme events such as:

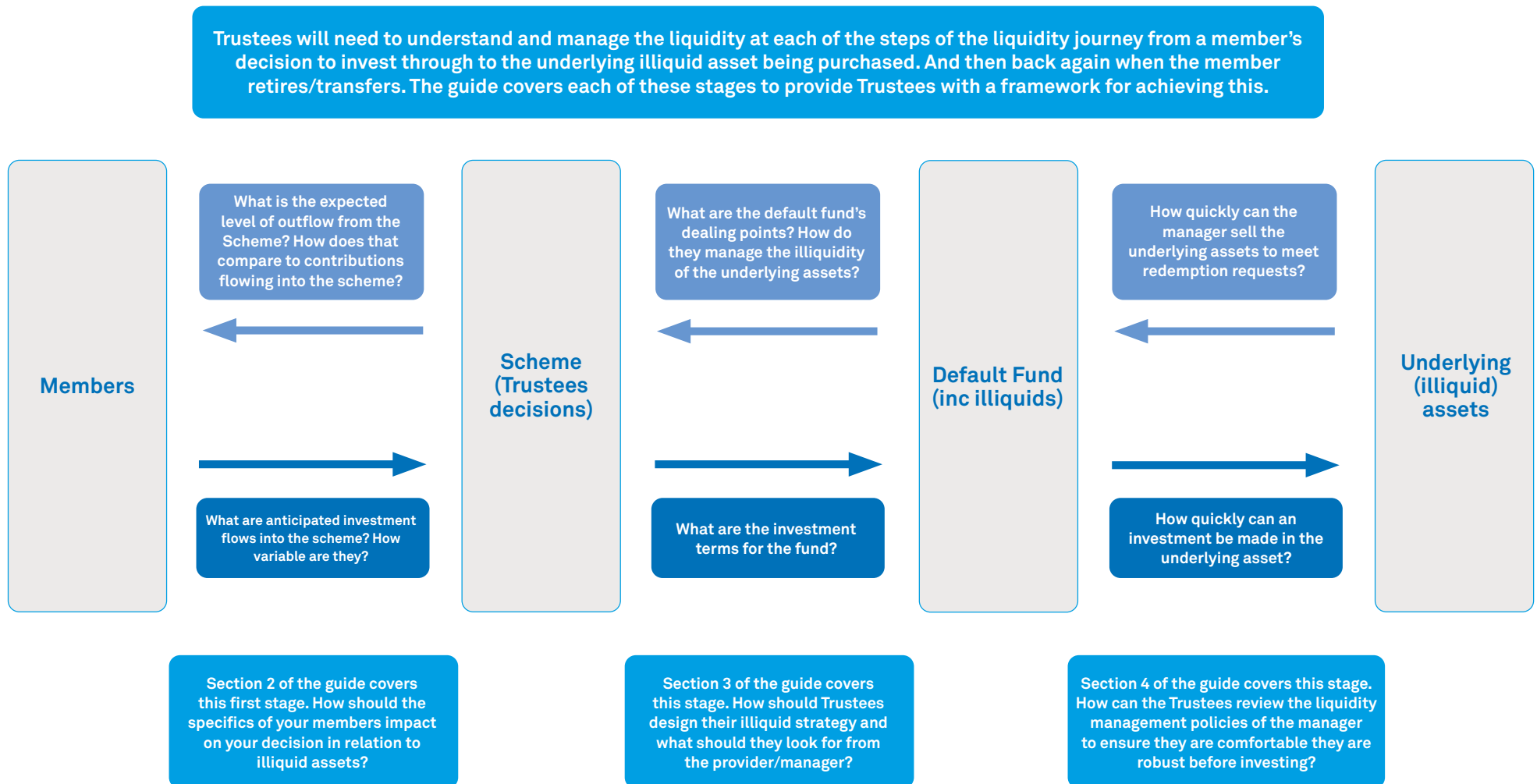
- Investment of contributions
- Individual member and whole scheme transfers in and out
- Provision of retirement and death benefits
- Member switches between funds
- Lifestyle switching and rebalancing
- Replacement of investment manager
- In multi-employer schemes, the transfer away of an employer's mandate

What is liquidity management for less liquid assets?

Investment in less liquid assets, appropriately managed, could benefit investors, through higher risk adjusted returns and diversification, as highlighted in the value for money guide by the Productive Finance Working Group. Buying and selling such assets can be a lengthy process, which generally would not be an issue for DC schemes' members given their long investment horizons – but it does mean that DC schemes need to have appropriate frameworks in place to manage this.

The process of establishing a framework to manage the DC scheme's liquidity obligations in the context of its' investment strategy and the assets that comprise it is known as liquidity management. Increasing the level of less liquid assets in the scheme, without addressing the “daily dealing” expectations of the scheme, creates the possibility of a ‘liquidity mismatch’. This is where the scheme's need for liquidity does not align with the time it takes to generate the liquidity (either through sales or investment income). This guide endeavours to cut through the complexity and outline an approach that can help DC decision makers get comfortable that these issues are surmountable in a way that helps protect against the risks of liquidity mismatch.

Figure 1: Liquidity management framework for DC pension schemes investing in less liquid assets



2. Liquidity management at DC scheme level

It is possible for DC schemes investing in less liquid assets to meet the liquidity needs of their members, by understanding expected future cash flows, provided:

- those investments are part of a broader diversified portfolio within a default arrangement;
- schemes determine their risk appetite for illiquid assets and take practical steps to manage liquidity; and
- assets are held within appropriate fund structures to meet the needs of the scheme.

This section considers the first two of these considerations, while Section 3 focuses on the last one.

Holding an appropriate proportion of less liquid assets within a diversified portfolio

The greater the portion of less liquid assets in the scheme's default arrangement, the more challenging the daily dealing is to maintain, because an increasing portion of the scheme's portfolio comprises assets that take longer to sell. As a result, it takes longer for the scheme to generate the cash needed to meet its liquidity needs. However, in a diversified portfolio of size, an individual member transaction is unlikely to cause a problem because the size of the transaction required for the individual member's illiquid holding is likely to be small relative to the scheme's assets and potentially manageable at "parent fund" level, if applicable to the scheme.

The Productive Finance Working Group's engagement with the UK DC market has shown that schemes are considering long-term allocations to less liquid assets of between 5-20%⁴ of the DC default arrangements. These levels of allocation are only possible if appropriate governance procedures are in place and should be determined on a scheme by scheme basis.

Holding less liquid assets within a portfolio requires trustees and pension managers to consider how they intend to generate cash to meet liquidity needs. Assuming the proceeds from the sale of less liquid assets will take time to be realised there are two other options to meet liquidity needs in the short term:

- **From new contributions:** where DC schemes are expected to be cashflow positive for some time to come, new contributions can be used to provide liquidity to those members who require it. For DC schemes, where contributions are negligible compared with existing assets, this route to generating liquidity may be less of an option.
- **From selling liquid assets in the portfolio:** with a high allocation to liquid assets, cash can be generated by selling part of the liquid allocation. Depending on the size of any redemption this can have implications for a scheme's Strategic Asset Allocation (SAA) at various points along the glidepath, which may require re-balancing as a result, with the scheme needing to manage any concentration risk that arises.

If less liquid exposure is held in a liquid investment structure the liquidity needs could be met by selling some or all of the exposure. Some structures, notably listed investment companies, provide liquidity in the investment vehicle itself. This offers the possibility that some (or all) of the shares in the investment can be sold on the stock market, as required over a short period of time despite the underlying holdings being illiquid. Whilst trading in these shares could address the liquidity needs, consideration has to be given to other issues like discounts and premiums, and the need for a long-term strategy for disposing of listed investment company securities without impacting materially the price.

4. Note this is not a recommendation nor an endorsement for appropriate levels of less liquid allocations, which will be based on specifics of each scheme.

Determining appetite for illiquidity risk

Once DC decision makers have concluded that an allocation to less liquid assets is appropriate for a DC default fund, a key task is then to examine and quantify the limiting factors, in order to answer the question: How much could they theoretically allocate to less liquid assets given the liquidity profile, governance resources and risk appetite of the scheme?

Where a scheme chooses to run its own default structure, it will need to establish and regularly review a sense of its own liquidity requirements, or its capacity for illiquidity risk. The key factors to consider are:

- **Scheme size** limits the ability to allocate to less liquid assets through a number of mechanisms, including lack of economies of scale and size of governance budget. The smaller the scheme the less governance resources and economies of scale it will have, which will influence the ways it can access less liquid assets.
- **Expected future cashflows**, in particular a scheme's long and short-term cash flow profile should be considered relative to the scheme's asset scale, how the relationship between flows and assets is likely to develop in the future, and the potential liquidity needs of the scheme membership.
- **Operational sophistication and flexibility of investment platforms to accommodate less liquid assets** will make or break a scheme's ambition to invest in less liquid assets irrespective of their scale and cash flow profile. If platforms are unable to offer funds that are investing in less liquid assets this could curtail schemes' abilities to access these investment opportunities.

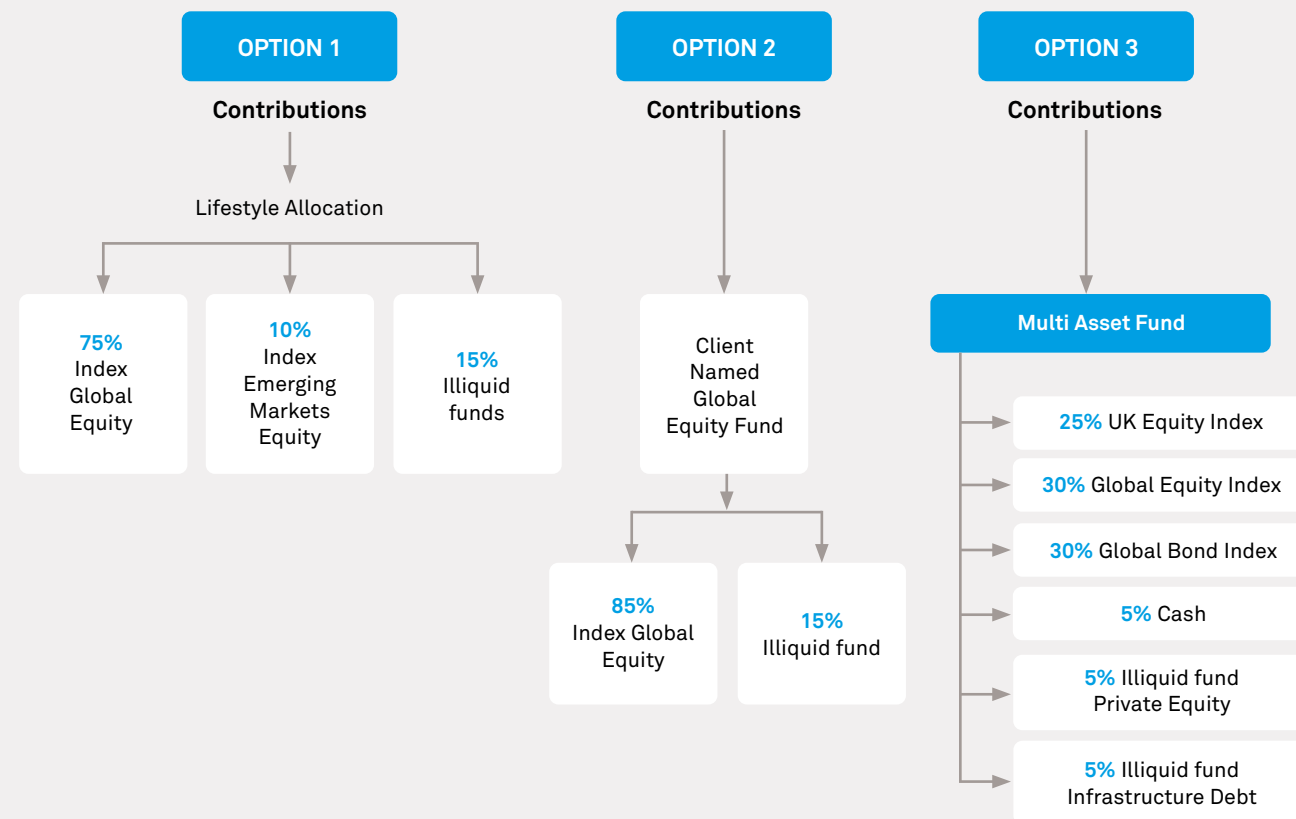
- **Liquidity in the vehicle used to purchase illiquid exposure:** different investment vehicles that can be used to gain exposure to less liquid assets will have their own liquidity profile.
- **Scenario analysis and stress testing** can help crystallise the concept of illiquidity risk. It is important to perform integrated scenario analysis for liquidity events at both scheme level (e.g. a sudden mass of transfers out) and market level (e.g. a sudden decline in public markets). The liquidity profile of the overall portfolio can 'drift' from a strategic asset allocation between liquid and less liquid assets, requiring portfolio rebalancing to ensure schemes stay within the agreed risk appetite for investing in less liquid assets. Approaches to rebalancing could differ for less liquid funds, compared to liquid assets, as set out in Section 5 of the Productive Finance Working Group [report](#).
- **Scheme covenant** is a new and developing concept for many DC schemes, which indicates where a scheme sponsor signs up to a long-term commitment to running the scheme on behalf of end members. Such a commitment is vital to realising long term value from less liquid assets. Decision makers should be mindful when considering an allocation to less liquid assets of the potential for future consolidation, and the impact that any limiting liquidity issues like lock-in periods within their scheme's arrangement might have.

Box 1 Structuring a fund that holds less liquid assets within a default strategy

There are three possible ways to structure a fund (listed or unlisted) that holds less liquid assets within the default:

- **Held directly as one of a number of funds that comprise a default strategy** (e.g. alongside a global equity or diversified growth fund). This would result in direct DC member exposure to a fund holding less liquid assets as part of a diversified default strategy.
- **A single fund providing exposure to a broadly defined asset class** (e.g. global equity) which then invests in an less liquid fund alongside other funds (e.g. an equity index fund alongside a private equity fund). This results in indirect member exposure to the fund holding less liquid assets.
- **A multi-asset fund that invests in a less liquid fund alongside a number of funds in a fund-of-fund structure** – member exposure to the fund holding less liquid assets is also indirect.

Figure 2: Options to structure less liquid assets in DC pension scheme



(Option 1) A direct holding will expose the member directly to the illiquidity of the fund holding less liquid assets with the knock-on effect that daily dealing will generally not be possible in respect of that element of the allocation, other than where there is an ability to match units between members moving in and out of the fund. This approach will require the full use of the governance framework to ensure liquidity mismatch risk is managed.

(Options 2 & 3) Where the less liquid element of the portfolio is held alongside liquid investments as part of a diversified portfolio, a manager is required to ensure the high-level fund maintains its Strategic Asset Allocation and adheres to its stated investment objectives and risks.

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Practical steps DC pension schemes can take to include less liquid assets

DC schemes that decide to invest in less liquid assets can take several practical steps to help them determine their preferred approach to gaining exposure to these assets and then to manage liquidity on an ongoing basis. These steps involve an approach to cash flow projections and stress testing / scenario analysis.

Building a **forecast of expected cashflow** for the scheme membership based on the above characteristics can help maintain a stable portfolio with exposure to less liquid assets. This will deal with liquidity risks proactively, thereby also accommodating notice periods, where relevant. Depending on the investment structure used by the scheme, it is important to consider the liquidity risks and forecast cashflow for members at different points in their retirement journey on a cohort basis, because the portfolio liquidity profile and the membership's liquidity needs are unlikely to be consistent as they approach retirement.

A strong forecast of cashflows is also helpful for negotiating fees with less liquid fund managers who benefit from reduced distribution costs associated with raising capital, where DC offers reliable cashflow.

While forecasting cashflow helps to deal with liquidity risks in normal market conditions before they are allowed to compound, **scenario analysis and stress testing** are vital to ensuring the robustness of the strategy in exceptional circumstances and should be considered on an ongoing basis. Potential scenarios to consider are:

- **Public market shock**, resulting in a distorted portfolio and disruption of portfolio's ability to re-balance – Testing portfolio robustness through historical market conditions e.g. COVID market shock, financial crash can help to design the portfolio to be robust in market downturns.
- **Impact of significant membership increase or decrease** – i.e. merger / de-merger or gain / loss of large scheme from a DC Master Trust or Provider Default.
- **Suspension of a less liquid asset class based on valuation challenges** – e.g. Property markets through Brexit, covid. Suspensions can vary in length, depending on the asset class and the circumstances.
- **A sudden reduction or stop of contributions**, potentially driven by a pause of automatic enrolment, a mass redundancy event or a loss of large scheme from a DC Master Trust.
- **Change in small or deferred pot regulation** driving significant liquidity event for smaller pot or deferred members.
- **Scheme maturity** – at what point do schemes stop being cash-flow positive?

Given the transaction costs associated with trading less liquid assets, it is important for decision makers to be comfortable with the level of less liquid exposure and to develop a view on their tolerance toward certain liquidity risk events, so that excessive trading does not erode value for the investor.

3. Liquidity management at the underlying fund level

While DC schemes investing in less liquid assets as part of their default arrangements will manage liquidity primarily at the DC scheme level, it is important for DC decision makers to understand the key features of the fund-level liquidity management and ensure they have governance and operational procedures in place to invest in these type of funds. This section therefore considers five key questions that DC pension schemes should ask fund managers when deciding to allocate to less liquid assets.

Q1 How does the fund structure affect the liquidity profile for DC schemes?

Investing in less liquid asset is in many ways no different to a DC scheme's investment in listed assets and will be done via a fund structure with a fund manager. However, there will be a number of legal differences in that fund structure, and the ability to speedily invest/disinvest from that fund will be different. In the UK there are three main fund types DC schemes could use:

- **Unlisted closed-ended e.g. limited partnership** – typically these fund types are structured without redemption rights. Investors will typically hold their interest in the fund until maturity. There is a secondary market but this is carried out through private negotiations between buyers and sellers and often involves a discount to current valuations.
- **Listed closed-ended e.g. listed investment company** – vehicles that are closed-ended and listed on a public exchange. As investors own listed shares in these companies, they have the ability to trade daily, assuming there are willing buyers, but this could be at a discount to the NAV of the underlying holdings.

- **Open-ended funds e.g. Long Term Asset Fund** – an open-ended fund structure typically maintains liquidity for investors through offering liquidity windows and, in some cases, notice periods.

The [guide to the fund structures to access less liquid assets](#), produced by the Productive Finance Working Group, considers these and other common fund structures in more detail.

Q2 How do DC schemes assess if fund managers aligned fund liquidity with the liquidity of the underlying assets for an open-ended fund such as the LTAF?

While LTAFs are open-ended funds, they incorporate several features such as minimum notice and redemption periods which affect the liquidity profile of the fund. These features are designed to help align the structure of the less liquid fund with the nature of the underlying assets and investment strategy. This alignment is meant to protect the interests of the end investors, including DC schemes members. Therefore, DC schemes' decision makers should ask fund managers to demonstrate what they have done to ensure such alignment in practice.

The following good practice is worth keeping in mind when considering how a manager ensures alignment between fund liquidity and liquidity of underlying assets.

- There is no “one size fits all” way of structuring the liquidity management of a less liquid fund. The approach will depend on the assets, the investment strategy and the profile and needs of investors.

- A less liquid fund's liquidity policies should prevent liquidity mismatches by aligning the redemption policy of the fund with the liquidity profile of the underlying assets and investment strategy.
- To determine the appropriate length of a notice period, fund managers typically categorise assets within the fund into 'buckets' based on the time taken to sell the assets. This will then be aggregated at a portfolio level. The FCA expects fund managers of LTAFs to set notice periods based on a typical time to sell a representative sample of this portfolio. This is designed to ensure that the portfolio's future cashflows are able to be matched against the notice periods agreed in the fund design, and does not mean that a manager is required to necessarily sell underlying assets to fund redemption requests. The fund manager will continually assess the portfolio's liquidity position. Box 2 sets out key considerations around the times to liquidate less liquid assets.

The FCA LTAF rules require a minimum notice period of at least 90 days. This is an absolute floor, and the FCA expects that many LTAFs would have notice periods significantly longer than that. Fund managers are required to align the redemption policy with the liquidity of the underlying assets and demonstrate it during the fund authorisation process and on an ongoing basis. The less liquid the target assets, the longer the notice period is likely to be. The amount an investor will receive is calculated after the end of the notice period.

Box 2 – Notice period and time to liquidate less liquid assets

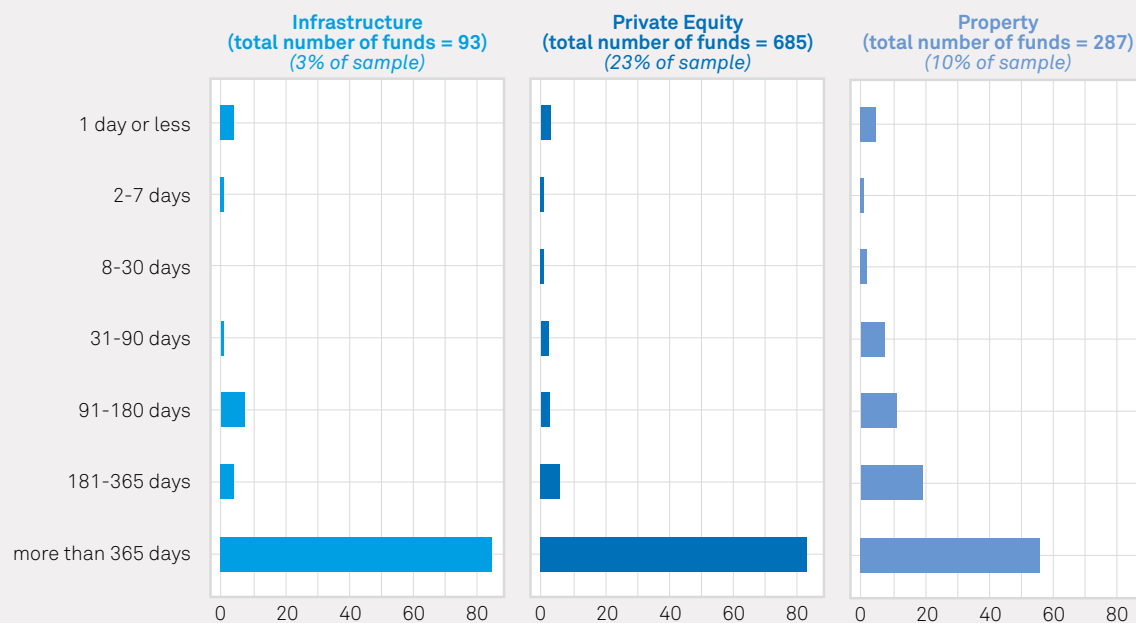
The length of time an unlisted asset takes to sell, and hence an appropriate notice period, will vary from asset to asset. The time to sell depends on a number of factors including, for example:

- Asset class
- Idiosyncratic nature of individual asset being sold
- Type of exposure to underlying holdings held either directly or through a fund interest
- Market conditions
- Asset size
- Region

FCA analysis of regulatory data submitted under AIFMD⁵ indicates that, for a reporting subset of UK-domiciled alternative investment funds, managers estimate that the vast majority of assets invested in infrastructure, private equity and property could take over 365 days to be liquidated. (Figure 3). This data has limitations and does not speak to actual liquidity of the underlying assets but underlines that investors need to be prepared to be committed for an extensive period when investing in such asset classes.

Compared to investing in public companies, transacting in less liquid assets such as infrastructure projects or private equity requires significant resource and time, so regular transactions in such assets are best avoided. The process of selling less liquid assets involves several stages. After the decision is taken to dispose of an asset there is an initial phase of legal and tax structuring. Following this preparatory work, there is typically a longer period of bidding and due-diligence undertaken by prospective buyers. Once the seller and buyer agree in principle, there is often a period of finalising terms of the sale before the transaction is concluded.

Figure 3: Average time to liquidate less liquid assets, per asset class



Source: FCA analysis of AIFMD data as of 2020.

Therefore, where less liquid assets are held in a fund, they are unlikely to be sold quickly to meet the scheme's obligations. Simply accepting a lower price for the assets to get a quick sale should not be relied on as the plan of action, and would generally not be a desirable outcome and most likely be unfair to other investors.

When a fund manager designs the liquidity features of a fund investing in less liquid assets, it is required to avoid

liquidity mismatch by ensuring the redemption policy of the fund is consistent with the investment strategy and the liquidity profile of the underlying assets. Setting the notice period at a fund level, fund managers will typically consider the profile of the portfolio as a whole rather than a single asset, and draw on all the factors discussed above.

⁵ The Alternative Investment Fund Managers Directive (AIFMD) is a European Union (EU) regulation that applies to alternative investments such as unlisted assets. The directive sets standards for marketing around raising private capital, remuneration policies, risk monitoring and reporting, as well as overall accountability.

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Q3 What is the impact of Liquidity Management Tools on DC schemes?

Fund managers of less liquid funds are also able to use a range of liquidity management tools. These tools are designed to protect investors' interests and help manage liquidity for DC schemes. To optimise the use of these tools DC decision makers will need to consider the potential impact of different tools on the functioning of the scheme – these considerations are outlined in the table below.

Liquidity Management Tool	Description of tool	Considerations for DC schemes
Notice periods	The time an investor must wait after their redemption request has been lodged before they can receive a cash payment representing the value of their investment. When set appropriately, the notice periods can help safeguard investors from misaligning of liquidity between funds and the underlying assets.	Schemes need to ensure they operationally meet deadlines for dealing cut-offs otherwise they would need to wait for the next dealing opportunity. Schemes will require a forward-looking process to assess in advance future cashflows that might be needed and consider the length of the notice period.
Subscription & redemption frequency	This may limit the availability of purchasing an interest in the fund or how often liquidity is made available to investors. Similar to the notice periods, the tool aims to align liquidity of the fund with that of its assets.	Similar to notice periods, the operational and cashflow monitoring process will be required by DC schemes to incorporate non-daily dealing funds. If subscription frequency is infrequent there may be a need to build up cash to invest in the fund periodically, or the DC scheme will need to plan to liquidate other assets to meet planned subscriptions. In such cases, DC schemes will need to consider the balance between minimising cash drag and having the cash necessary to meet any subscription commitments.
Lock-in periods	Pre-determined periods after the initial investment, during which redemptions are prevented.	DC schemes will need to consider the implications for stress testing and rebalancing where capital is locked in for an initial period, as well the impact of lock-in periods on allocations of expected future cashflow from a scheme.
Investors level gating	A type of gating sometimes referred to as a 'deferred redemption' where there is a pre-determined limitation on the amount an individual investor can either invest or redeem at one time.	In stressed environments this can present challenges for DC schemes. To ensure this is effectively managed, a range of gating scenarios should be considered as part of stress testing and scenario analysis.

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Liquidity Management Tool	Description of tool	Considerations for DC schemes
Fund level gating	A type of gating sometimes referred to as a 'limited redemption' where there is a pre-determined limitation of the aggregate amount that all investors in a given fund can redeem.	<p>This will need contingency planning for schemes as it will be hard to know when other investors will also want to draw on a fund's liquidity – but the fund manager is likely to engage with investors during this period.</p> <p>Regular informal dialogue with the fund manager about DC schemes' upcoming liquidity needs (both in terms of potential new investment and potential redemption requests) should help more efficient management of liquidity in the portfolio.</p>
In-specie redemptions	Involving an investor receiving one or more underlying assets rather than cash. This approach is not typically taken for less liquid assets but fund managers do have experience of pricing of private assets for the purposes of such transfers.	<p>An in-specie redemption will require a high level of oversight from DC decision makers. DC Decision makers would need to understand with the managers the circumstances when an in-specie payment could be made and assess its likelihood. It is unlikely that the vast majority of DC schemes would be set up operationally to receive such a payment.</p> <p>For multi-employer schemes this could create governance issues but for single-employer schemes, that have identified a vehicle to house the assets, there may be wider scope to use this tool.</p>
Side pockets	Where illiquid or hard-to-value positions from the main pool of assets in a fund are segregated until such time as they are realised or are no longer difficult to price.	<p>Side pockets can be a useful way to isolate certain investments (e.g. those subject to sanctions or unique circumstances) from the main pool of assets, when it is in the best interests of all investors to do so, and ensure that only current investors in that asset are affected rather than any new investors in the fund.</p> <p>DC pension scheme investors should engage in dialogue with the fund manager to understand the types of scenarios which may justify the use of side-pockets and the routes to liquidity.</p>
Suspension	The tool of last resort, where all dealing is stopped in the fund, subject to further notice.	DC schemes must have contingency plans in place to ensure the impact on their cashflows and valuations are minimally impacted. More detailed considerations are outlined in Q4.

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DC decision makers should be aware that fund managers are responsible for ensuring the most appropriate tool is used and must consider fairness to all investors and conduct when implementing tools. When used, the liquidity arrangements should prevent ‘first mover’ advantages, whereby one investor may gain an advantage over others by seeking an early exit from the fund. This will ensure fairness and reduce structural weaknesses within the less liquid fund.

Q4 What should DC decision makers consider when contingency planning for fund suspensions?

Where an open-ended pooled fund is suspended, typically due to exceptional broader market conditions, no subscriptions or redemptions can be requested or completed. No new investments can be made into the fund. Typically, there is a requirement that a suspension be lifted as soon as possible. In practice, the length of suspension will depend on the event that created the need for suspension. For example, a number of UK Property funds suspended following the EU referendum in 2016 and many re-opened after six months.

Suspensions are often seen as a last resort, as withdrawing redemption rights can be perceived as unfair to investors. DC decision makers should ensure their stress testing considers this event, ensuring there is sufficient liquidity in the wider portfolio as well as operational procedures in place.

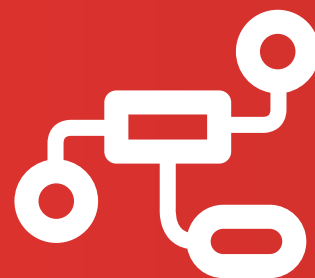
DC scheme operators will consider the past market conditions and the possible impact of downturns on the scheme’s investment strategy and liquidity when designing these procedures. This ‘stress testing’ should enable the DC scheme to continue to operate through foreseeably good and poor markets despite a suspension. DC decision makers should note that the risks of redemptions causing suspensions may be much lower where an appropriate range of liquidity management tools (see Question 3 above) is employed.

Q5 How is liquidity management disclosed to DC pension schemes?

Fund managers manage liquidity in different ways. Whilst the FCA rules require certain standards to be upheld liquidity management is carried out at the discretion of the fund manager. Due to the diversity of less liquid assets and funds, approaches will vary between fund managers and between funds pursuing different investment strategies and investor outcomes.

When trying to understand the liquidity management arrangements applied to a less liquid pooled fund, and whether they are acceptable given the risk appetite and operational needs of investors such as DC pension schemes, the fund prospectus will provide key information. It will specify which liquidity management tools are available and whether they are used on an ex-ante or ex-post basis i.e. whether they are in place from the start of the fund or can be activated by the fund manager during the life of the fund. It may also explain the circumstances in which they may be used and the potential impact on investors.

Where an authorised fund has been in operation for a year or more, investors may also review disclosures made in the annual report. The authorised fund manager must set out its assessment of how the liquidity management arrangements have performed and any issues that may have arisen.



Guide to the Fund Structures to Access Less Liquid Assets

Summary

There are several routes through which UK Defined Contribution (DC) pension schemes could access less liquid assets. This guide sets out the key features of these routes, with an aim to present the options available to trustees, employers and other key decision-makers (henceforth ‘decision-maker’) who are interested in accessing less liquid assets for their schemes, so they can make informed decisions with their consultants on which options might be suitable for their schemes.

The main routes set out in the guide are as follows:

1. Closed-ended funds:

- Listed Investment Companies – traded on stock exchanges and can hold a wide range of assets.
- Limited Partnership Funds – operate over a fixed period intended to align with the investment cycle of less liquid assets.

2. Open-ended funds:

- Long Term Asset Funds – authorised funds with limited redemption terms and notice periods to align liquidity of the fund with that of the underlying assets.
- Professional Open-ended Investment Funds – lightly-authorised or non-authorised funds with flexible investment rules and no prescribed dealing terms.
- Unit-linked Life Policies – insurance-based contracts that can be linked to less liquid assets or funds.

3. Non-funds:

- Segregated Mandates – bespoke investment management arrangements that can be used for less liquid investment strategies.

Not all of these structures will be available to all DC schemes. While some platforms can already accommodate investment in these structures, others still need to evolve their systems and processes to be able to do so. Some structures also face restrictions under the ‘permitted links’ rules for unit-linked life policies. Going forward, the availability of some structures to DC schemes will, therefore, depend on more DC platforms evolving their systems and processes, and the ability of DC schemes to invest off platform or outside of the permitted links universe.

To choose an appropriate investment structure, decision-makers need to consider the key strengths and operational and regulatory challenges of different options, as well as any constraints in their scheme rules, constitutions or mandates that may prevent them investing in some of the structures.

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Structures Overview

This table summarises the key features of each structure potentially available for UK DC schemes. It also highlights the key considerations that could be relevant from the DC schemes' perspective, such as eligible asset classes, approach to valuations and redemption policy. The rest of this guide considers each of the structures in more detail.

Type of structure	How it works	Key Considerations for DC schemes
1. Closed-ended funds		
These are structures that have a limited number of shares or capital allocation that is mostly fixed during their lifetime.		
Listed Investment Companies (ICs)	<ul style="list-style-type: none"> • Company structure, with shares traded on a stock exchange. • Governed by an independent board, which appoints and oversees the asset manager. • Capital is fixed – investors either buy through initial offers/placings or in secondary trading on stock market. • Evergreen structure, i.e. operates on a continual basis with no defined end/maturity point. 	<ul style="list-style-type: none"> • Can invest in a wide range of assets and use borrowing as part of investment strategy. • Share price set by market and is affected by the volume of share dealing, so can differ to the value of the assets in portfolio. • Investors able to enter and exit the IC during exchange open hours (where trading permits). • Underlying assets do not need to be bought and sold when investors buy or sell shares in the IC. • Constant pricing can result in increased volatility compared to other structures.
Closed-ended limited partnership funds (LPs)	<ul style="list-style-type: none"> • The investment manager operates the fund as a partnership through a General Partner. • Investors are Limited Partners. • Closed-ended, raises capital commitments from investors at the start (commitment period), and usually operates for a specified time period. • Governance structures are bespoke to each vehicle, but must follow the Alternative Investment Fund Manager's Directive (AIFMD) requirements. 	<ul style="list-style-type: none"> • Can invest in a wide range of assets – no prescribed regulatory restrictions. • Valuations are infrequent, quarterly to annual, though estimated valuations may be available. • Investors "commit" to an agreed level of capital during the initial phase of the partnership/fund, which must be paid when called by the general partner during the investment phase. • Investors must maintain the ability to meet calls on committed capital at short notice (typically within 10 days). • LPs do not usually permit redemptions during the investment cycle, but interests (including the obligations for outstanding commitments) can sometimes be sold/transferred to other investors on informal secondary markets (typically subject to consent of the GP/fund manager).

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Type of structure	How it works	Key Considerations for DC schemes
2. Open-ended funds These are structures which can increase or decrease the number of shares in issue to meet investor demand for investing or withdrawing.		
Long Term Asset Fund (LTAF)	<ul style="list-style-type: none"> • FCA authorised • Can be an authorised contractual scheme (ACS), authorised unit trust (AUT) or an investment company with variable capital (ICVC/OEIC). • Can be evergreen structure or have a fixed life. • Governance set by regulation: Board of the LTAF manager performs annual assessment of value, liquidity management, conflicts of interest and due diligence processes. 	<ul style="list-style-type: none"> • Flexible investment powers but must invest at least 50% in less liquid assets. • Prices based on valuation of assets in portfolio. Valuations available at least monthly, investors may be able to request more frequent valuations but these will likely be estimates only. • Low redemption frequencies (monthly or less frequent), and longer notice periods ahead of redemption (90 days or more) allow the LTAF manager to align fund liquidity with that of the underlying assets. • Investors are not able to quickly get access to their money and must plan selling investments in advance.
Professional Open-ended Investment Funds	<ul style="list-style-type: none"> • Non-authorised or lightly authorised funds not generally available to retail investors. • Include UK or overseas structures, e.g. QIS (UK), RAIF (Luxembourg), QIAIF (Ireland), JPUT (Channel Islands). • Can be evergreen structure or have a fixed life. • Can be a corporate, contractual or partnership structure. • Governance structures can vary but most require a board. • Manager must follow AIFMD standards. 	<ul style="list-style-type: none"> • Can invest in a wide range of assets and use borrowing. • Redemption terms set by the manager – can range from daily to having limited redemption terms and long notice periods subject to underlying asset class. • Fewer investor protections than authorised funds and ICs, though may have a depositary on the fund for this purpose.
Unit-linked Life Policies	<ul style="list-style-type: none"> • Insurance contract, split into units, with insurer linked to the value of specified investments. • Backed by/exposed to insurer's balance sheet. • Capital can expand or contract depending on demand. • Evergreen structure. • No specific governance requirements at unit-linked policy level, but industry good practice used. 	<ul style="list-style-type: none"> • Must invest in accordance with the FCA's permitted links rules, which leads to some limitations on what can be invested. • Prices based on those of linked funds where available, otherwise insurer's valuation policy. • Subscription and redemption terms set by insurer, dependent on underlying assets (historically daily).

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Type of structure	How it works	Key Considerations for DC schemes
3. Non funds		
Segregated Mandates	<ul style="list-style-type: none"> • Bespoke investment management service for specific portfolio. • Investor must have separate arrangements with a custodian for holding the investments where required, or recording ownership of non-custodial assets (e.g. real estate.) • Mandate set by agreement between the investor and investment manager. • Investment manager may have external administrator for accounting of such segregated mandates. • May be established as a “fund of one”. 	<ul style="list-style-type: none"> • Can invest in any assets that the investor is allowed to hold. • Investment terms can be negotiated by investor, allowing the investor to have greater control over deployment of capital. • Arrangements for valuation and pricing to be agreed with investment manager. • No standard dealing terms – investments and withdrawals arranged with investment manager. • Requires scale to be efficient and limited pooling benefits.

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1. Closed-ended funds

Closed-ended funds are structures that, following an initial capital raise, have a fixed level of capital for their duration with no ability for investors to redeem their investment as a right. Some types of closed-ended funds can raise additional capital after the initial capital raise through placings or reduce capital in issue through share buy backs.

While a number of closed-ended fund options exist throughout the world, we cover two of the structures most likely to be relevant to decision makers of UK DC schemes: Listed Investment Companies and Limited Partnerships.

Listed Investment Companies

Investment companies include investment trusts, Real Estate Investment Trusts (REITs) that invest in real estate, and Venture Capital Trusts (VCTs) that are retail focussed and provide exposure to growth capital investments. Investment companies are listed on public stock markets, usually the London Stock Exchange.

Similar to open-ended funds, investment companies purchase a portfolio of assets. Less liquid assets, such as private equity and debt, property, infrastructure (including renewable infrastructure) and other emerging asset classes (such as music royalties) are among the assets that may be held.

How the vehicle works

An investment company is governed by a board of directors and company law. The board has legal duties to make sure that all shareholders are treated fairly and to ensure that the company is run in the long-term interests of the shareholders as a whole. The board customarily appoints an external asset manager to make the day-to-day investment decisions in accordance with the company's investment strategy. The directors negotiate terms with the manager and can even change the manager if there are fundamental issues with the delivery of the strategy, such as poor performance, although replacing the asset manager is a rare occurrence.

The share capital of the company is fixed, meaning the size of the investment portfolio does not change when investors buy and sell shares in the secondary market. There is no need to hold cash or sell assets to pay for redemptions by investors (as investors trade their shares on the stock market when market liquidity persists). This means investment companies can be fully invested in less liquid assets, which can be held for the long-term, being sold solely according to the judgement of the manager.

How to invest/access the vehicle

Following the admission of the company's shares to a stock market, investors buy and sell shares in the investment company through a stockbroker or investment platform. Shares are traded throughout the day, and so investor liquidity is based on the number of shares traded, potentially providing investors with daily liquidity even when the underlying assets are inherently less liquid. For companies that trade frequently and in appropriate scale, an investor can manage their position on a day-to-

day basis, adding small investments or re-allocating as required. Shares in different investment companies can be purchased to gain exposure to a blended range of assets and different investment managers.

Where an investment company is launched, investors can subscribe for shares. Information about the company is provided via a prospectus, which sets out the intention for the company, what it will invest in and the risks.

Valuation/pricing

The share price, which may change during the day, is set by the market according to prevailing demand and information available on the company.

The company makes regular announcements about the value of the assets. Quarterly announcements are usual for less liquid assets such as property or private equity, although the frequency will depend on the company. The assets are valued in accordance with policies set by the board (and may involve the use of an independent valuer when the assets are not traded on a stock market). Strict rules protect investors against market abuse. The market operates within an internationally recognised regulatory framework.

Shares are bought and sold at prices determined by the market. These prices can be more (a premium) or less (a discount) than the net asset value (NAV) per share. The market price of an investment company share incorporates factors, such as changing economic conditions and market sentiment. Investors should be mindful that, due to market dynamics, a rapid sale of large holdings may have a negative impact on exit price.

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Scope for negotiation of investment terms

Most companies will only have one share class, ordinary shares. All investors buying shares in the same class (usually ordinary shares) invest on the same terms. They share equally in the costs of running the company.

Investors vote on issues such as the appointment of directors and any material change to the investment strategy of the company. As holders of listed equity, investors can engage with the board to express their views on the running of the company similar to holdings in other listed equities.

Restrictions and any obligations imposed on investment/commitment

Share trading is undertaken on the stock market, without the intervention of the company. There are no entry or exit charges levied by the company. There are no contractual lock-in or notice periods for investors (that is, periods when investors are prevented from selling their shares). The company has no capacity to defer trading.

Where underlying stocks possess sufficient liquidity, UK stock markets offer access to trading during market opening hours.

Further resources

<https://www.theaic.co.uk/>

Limited partnership funds

A limited partnership is a fund that uses a partnership structure to pool capital from a group of investors to make and manage a portfolio of investments on their behalf. These are usually set up for a time-limited period intended to be in line with the expected life-span of which the manager will look to hold the underlying investments, though this period can often be extended.

How the vehicle works

Investors in funds using LPs as the fund vehicle become limited partners. Their liabilities for the debts and obligations of the fund are limited to the amount of capital they commit to the fund, as long as they remain passive investors and do not become involved in the management of the fund. Conversely, the fund manager controls the general partner, which has (i) responsibility for the management of the fund and (ii) unlimited liability for the fund's debts and obligations. The fund manager is subject to the requirements of the AIFMD, which requires the manager to be authorised by a regulator such as the FCA if the assets it manages are over a certain size, or to register with the regulator if these are below that. The fund manager is required to have in place governance procedures to ensure risk management and portfolio management is performed separately, conflicts of interests are appropriately managed, and appropriate arrangements are in place to ensure the ownership of the assets is attributed to the fund and its investors.

How to invest/access the vehicle

Investors negotiate terms and agreed commitments to advance capital to the fund on the demand of the general partner during the fund's fixed life, up to a fixed maximum amount known as the investor's "commitment". The general partner draws down investors' commitments in tranches at relatively short notice (usually 10 days), mostly during the first half of the fund's life (the "investment period") to cover the acquisition cost of fund investments or general costs. The circumstances in which the general partner may draw down further commitments from investors after the investment period, during the second half of the fund's life, are limited and typically are linked to events that are foreseen at the time of the primary investment.

Valuation/pricing

The fund manager will typically carry out valuations of the fund's assets in accordance with market 'best practice' (e.g. International Private Equity Valuation Guidelines) and provide these to investors periodically according to the terms of the fund, e.g. quarterly. Where an investor sells its interest (including undrawn commitments) in the fund to another investor, this is referred to as a secondary trade (or the secondary market) and the amount at which the transfer takes place is a bilateral trade on terms agreed between the two parties.

Scope for negotiation of investment terms

There are few legal or regulatory restrictions on the terms of closed-ended limited partnership funds, as they are not subject to general company law (although as noted, they are subject to laws governing limited partnerships and the AIFMD) and are typically only available to professional or sophisticated investors. Investors and managers are therefore relatively free to agree investment and redemption terms between themselves. In reality, market forces tend to keep terms around certain points, although these points can shift over time to reflect market dynamics, and may depart from market standards where any party in a particular case has greater bargaining power. There is some scope for individual investors in a fund to negotiate different terms to other investors, for example in “side letter” arrangements. However, a fund manager’s legal duty to treat all the investors in a fund fairly may limit the extent to which these arrangements can alter the terms that a manager is able to negotiate with any individual investor.

Many LPs have advisory committees, where a panel of investors in the fund can give views on the strategy being employed by the general partner and on any conflicts of interest issues, although these are generally not empowered to make investment decisions themselves

Restrictions and any obligations imposed on investment/commitment

Investors’ main obligation is to provide capital on demand within the prescribed draw down notice period, and they should ensure that they are aware of the amounts they have committed and maintain enough liquid assets. Investors may also be subject to other requirements, for example to return distributed capital in certain circumstances, provide information required for the fund to comply with its legal, regulatory or tax obligations and give consent to certain proposed actions to the extent they are reasonable.

It is not usually possible to redeem investments in part or in full until the LP reaches the end of its investment life-span – redemption opportunities from the LP itself are either infrequent or not permitted (although as noted below under Professional Open-ended Funds, limited partnerships can also be structured as open-ended funds, though this is uncommon in many asset classes). There can be scope to sell/transfer interests in the LP to another party on the secondary market subject to the general partner’s approval, where the investor will receive an agreed level of compensation for their interests in the LP and transfer their interests and any outstanding (undrawn commitment) to the other party (who becomes the new limited partner).

Further resources

<https://www.bvca.co.uk/>

2. Open-ended funds

Open-ended investment funds are structures which can increase or decrease the number of shares in issue to meet investor demand for investing new capital in the fund or withdrawing their capital from the fund.

Although a range of open-ended structures exist throughout the world, we cover three types most likely to be relevant to decision makers of UK DC schemes: Long Term Asset Funds (LTAF), Professional Open-ended Investment Funds and Unit-linked Life Policies. Some funds structured as Non UCITS Retail Schemes operating as Funds of Alternative Investment Funds (NURS-FAIFs) that invest in less liquid assets are also available to DC schemes, but the LTAF structure is expected to be more widely used for the assets going forward.

Long Term Asset Fund (LTAF)

The LTAF is a new form of FCA-authorized open-ended investment fund. It is open for investment by professional and sophisticated retail investors but was designed with the default arrangements of defined contribution (DC) pension schemes largely in mind.

How the vehicle works

An LTAF is a UK authorised investment fund and can be structured as, an authorised unit trust (AUT), an authorised contractual scheme (ACS), or an investment company with variable capital (ICVC), also known as an OEIC.

LTAFs can invest across a broad range of asset classes including venture capital, private equity, infrastructure, private debt and real estate, and may also invest in other funds that invest in these assets. An LTAF can also

participate in, or originate, loans (other than loans to natural persons and to certain related parties of the LTAF). The LTAF manager must ensure that the fund aims to provide a 'prudent spread of risk' (PSOR).

The governing body of the LTAF manager is required to satisfy itself that the LTAF is being managed in the best interests of its investors. The governing body is also required to carry out an annual assessment of value of the LTAF (which requires the governing body of the LTAF manager to consider whether costs paid by investors are justified in the context of the value delivered), along with an annual assessment of the operation of the LTAF in respect of valuation, due diligence, conflicts of interest and liquidity management.

The LTAF must also appoint an independent depositary, which is responsible for the custody of the LTAF's assets and overseeing key operations of the LTAF's manager in respect of the LTAF.

How to invest/access the vehicle

Each investor will subscribe for units in the LTAF in the amount set out in the investor's application form. The Prospectus will set out the dealing frequency for the LTAF and any rules governing further investor subscriptions.

LTAFs may operate on either i) a subscription basis, where the investor fully pays the subscription amount at the point they submit their application form for the LTAF; or ii) commitment basis, where the investor commits to invest a specified amount in the LTAF, but only pays when the manager asks for some or all of their committed capital to pay for investments / costs as they occur.

Valuation/pricing

The FCA rules require that the valuation be carried out by either an external valuer; or by the LTAF manager if it possesses 'the knowledge, skills and experience' necessary to carry out a proper and independent valuation of the assets the LTAF holds.

Valuations of the assets are expected to be carried out according to the valuation policy set out in the prospectus which will also include the frequency of publication of the net asset value and share price of the LTAF (which must be at least monthly); the role of each party involved in the valuation process; the valuation procedure for different asset types that the LTAF may hold; and procedures to follow where there is uncertainty as to the value of certain assets.

Scope for negotiation of investment terms

The investment manager is tasked with investing the LTAF's assets according to the investment objective; policy and strategy as specified in the prospectus. Investors do not have any control over the day-to-day management of the LTAF, although if they are dissatisfied with the management of the LTAF, they can (if there is sufficient number of investors) convene an extraordinary general meeting to remove the manager.

LTAFs can offer more than one unit class, with different management fees. These are usually linked to minimum investment levels, so investors able to commit to a higher level of investment may be able to access a unit class with a lower fee. Investors may also be able to negotiate a partial rebate of the management fee with the manager, based on the amount of investment they expect to commit.

However, the terms of one unit class cannot materially prejudice investors in other unit classes, e.g. an investor in one unit class cannot have preferential voting rights over investors in other unit classes.

Restrictions and any obligations imposed on investment/commitment

While LTAFs are open-ended funds, FCA rules provide that redemptions cannot be more frequent than monthly and require a minimum of 90 days' notice before investors can redeem their investment. Redemptions may be less frequent and notice periods may be longer where the fund invests in more illiquid assets. Investors seeking to redeem their capital may also be subject to other redemption restrictions to support management of the LTAF portfolio and with a view to ensuring all investors (whether looking to redeem or remain in the LTAF) are not disadvantaged. Such restrictions might include lock-in periods, side pockets, investor or fund level gates, and potentially suspension.

The liability of each investor is limited to the amount contributed to the capital of the LTAF by such investor.

Further resources

See the [Legal Guide to the Long-Term Asset Fund \(LTAF\)](#) by the Productive Finance Working Group. This covers the legal structures and rules that apply to the LTAF in more detail.

[PLSA: Long Term Asset Funds \(LTAF\) Made Simple](#)

Professional Open-Ended Investment Funds

Professional open-ended investment funds are typically only made available to institutional investors and, in some cases, to individual investors who have a high net worth or are highly knowledgeable investors (e.g. financial professionals). Typically, these funds tend to be subject to lighter regulation than retail funds – in particular, fewer rules on investment restrictions apply, meaning they have the scope and flexibility to invest in a broad range of asset classes and employ diverse investment strategies, including those using illiquid investments. As they are subject to fewer investor protection requirements, they typically cannot be widely marketed to retail investors. A professional fund can be set up to manage a mandate for a single institutional investor, which is known as a “fund of one” (see “Segregated Mandates”).

In the UK, there are professional fund regimes, i.e. Qualified Investor Schemes (QIS), which are authorised by the FCA, and unauthorised unit trusts (UUTs), which are not FCA authorised. However, most European professional funds are domiciled in other countries, particularly Luxembourg, Ireland and the Channel Islands. Examples include the Reserved Alternative Investment Fund (RAIF) in Luxembourg, the Qualifying Investor Alternative Investment Fund (QIAIF) in Ireland, and the Jersey Property Unit Trust (JPUT). Professional funds established in the UK and EU are subject to the AIFMD, a framework that sets out minimum standards and requirements that all alternative investment fund managers (AIFMs) must follow, and equivalent regimes in each region.

How the vehicle works

Professional funds can take the form of corporate, (e.g. open-ended investment companies), trust based (unit trusts) or contractual structures (e.g. limited partnerships), depending on the legal structures available in the country in which the fund is established. Usually these are open-ended, although some (such as the Luxembourg RAIF and Irish QIAIF) can also be established as closed-ended funds.

Managers of professional funds are normally fully authorised AIFMs. These must have appropriate governance structures in place – in particular, risk management must be separated from portfolio management, the AIFM must act in the interests of investors and manage conflicts of interest appropriately, and must appoint a depositary to oversee the activities of the AIFM, monitor cash flows in and out of the AIF, and hold assets in safekeeping or ensure assets are properly registered.

How to invest/access the vehicle

The terms of investment will vary considerably and will be set out in the scheme offering document (e.g. prospectus). Some professional funds offer regular subscription opportunities, others offer only periodic subscriptions, and some only allow subscriptions at the point they are launched. Some professional funds also offer the opportunity for existing shares to be bought from redeeming investors on secondary markets, through exchanges or matching services, although this is relatively rare.

Valuation/pricing information

Professional funds are usually required to be valued at least quarterly, although they can choose to value more frequently. These are subject to the valuation requirements in the AIFMD, which oblige the valuation to be carried out independently of the team that is managing the investments. At a minimum, valuations will be made available in annual reports, although managers may choose to publish valuations and prices more frequently. The valuation policy, frequency and method for publishing prices will be set out in the scheme offering document.

Scope for negotiation of investment terms

There is scope for some professional funds to offer preferential terms for some investor groups, and therefore there may be some scope for negotiation. Terms can vary by factors such as charges, hedging overlays, such as, for currency) and (less commonly) relative voting rights, which can have different minimum investment terms.

There is not usually scope for the investor to influence the investment strategy, unless the fund is being set up specifically for the investor (e.g. as a “fund of one”). Some professional funds have advisory committees, where a panel of investors in the fund can give views on the strategy being employed by the manager and on any conflicts of interest issues, although these are generally not empowered to make investment decisions themselves.

Restrictions and any obligations imposed on investment/commitment

Professional funds are only available to investors who meet the requirements of professional investors, or who have opted-up to professional status, and in some cases to sophisticated and high net worth investors. The investment and commitment terms will be set out in the scheme offering document. Investors do not usually have any additional liabilities beyond their investment or commitment, although this depends on the structure used and the terms that apply to the fund. The manager is obliged to disclose any potential risks that investors in the fund will be exposed to, including the potential for additional liabilities if these apply, in the scheme offering document.

Unit-linked Life Policies

How the vehicle works

A unit-linked fund, also known as a unitised insurance fund or insured fund, is a type of collective investment that is linked to an insurance contract issued by a life insurance company. Here the policyholder owns the contract with the insurance firm, the value of which is linked to the value of the assets (often funds). Upon a transfer or crystallisation, the insurance firm is obliged to pay out the value of the contract calculated by reference to the value of the underlying funds.

The total value of assets held by a unit linked fund is split up into units of equal price. As such the unit price determines how many units the investor receives when investing in a unit linked fund and in turn how much cash will be paid when the units are sold.

Unit-linked funds can include external fund links and blend two or more underlying funds for diversification. The FCA permitted links regime (set out in [COBS 21.3](#)) determines which asset classes and underlying funds unit-linked policies can invest in, applying some restrictions on less liquid assets.

In particular, there is a 35% cap on illiquid holdings by a unit-linked policy, unless it is investing in an LTAF, in which case the cap does not apply, although the provider does have obligations to ensure the ongoing suitability and appropriateness of the investment strategy, including the liquidity strategy, for investors. For now, unit-linked policies investing in an LTAF are limited to doing so only as part of a DC default arrangement.

Unit-linked funds are regulated at the firm level and protected by the capital reserves of the insurer, which are subject to strict rules under Solvency II. Unit-linked fund providers are subject to firm-level and product governance requirements. While there are currently no specific rules which prescribe particular governance practices at the level of individual unit-linked funds, the [ABI guide](#) to good practice for unit-linked funds does provide some additional practical guidance for providers.

How to invest/access the vehicle

Unit-linked funds can be accessed by retail investors and decision makers on behalf of their members' DC pensions. A policyholder or scheme buys an insurance contract with an insurer, the insurer creates a unit-linked fund which invests in one or several funds, which in turn is invested in multiple underlying assets. A small selection of investment platforms offer unit-linked funds to retail customers.

Valuation/pricing information

The majority of unit-linked funds have historically been priced daily and allow daily dealing (business days). This is not likely to be the case in the context of funds that invest in less liquid assets or other less liquids fund, e.g. the LTAF, which will have flexibility in its notice period and dealing terms to allow it the ability to offer terms that are appropriate to the liquidity of the underlying assets. A daily price feed may still be required for these funds to allow them to fit into a daily dealing architecture, even though actual dealing opportunities will be less frequent.

Scope for negotiation of investment terms

As with other open-ended fund vehicles, pricing is often quite bespoke to the scheme, with a larger pool of assets generally allowing for greater bargaining power.

Restrictions and any obligations imposed on investment/commitment

Some unit-linked funds have an exit charge, payable if a policy is surrendered early, e.g. before retirement apart from critical illness or death. However, this is not very common.

Most unit-linked fund providers will allow savers to switch between funds. Depending on providers, most customers switching funds will not spend time out of the market because of the nature of the contracts.

Further resources:

ABI guide to good practice for unit linked funds:

<https://www.abi.org.uk/globalassets/files/publications/public/conduct/abi-guide-to-good-practice-for-unit-linked-funds-2019.pdf>

3. Non funds

Segregated Mandates

Segregated mandates are widely used by institutional investors such as Defined Benefit (DB) schemes. Traditionally, they have not been used as much by Defined Contribution (DC) schemes, which have tended to favour open and closed ended pooled investment vehicles. Segregated mandates offer significant flexibility in terms of setting up the investment offering but, as they do not benefit from pooling, these are likely to be an option only for larger DC schemes. Segregated mandates are also often formed as “funds of one” by investment managers using a fund structure devoted to the management of a substantial mandate from a single (usually institutional) investor (see Professional Open-ended Funds). This can allow the investor to retain a high degree of control over the mandate while reducing the governance burden, including the need to make appropriate custody or registration of ownership arrangements.

How the vehicle works

A segregated mandate is an investment service rather than an investment vehicle. The investments are managed by an investment manager for an individual investor (e.g. a pension scheme) under a bespoke arrangement for a specific investment portfolio.

The investment manager will not hold the investments themselves, only manage these for the investor. The investor will need to make separate arrangements for holding the investments. This may include setting up a “fund of one” in conjunction with the investment manager.

The investment mix in the segregated mandate can consist of direct investments by the investment manager, or a series of, open or closed-ended funds selected by the investment manager.

How to invest/access the vehicle

An investment mandate will be entered into by an agreement with an investment manager. This will detail the arrangements for the service, the portfolio to be managed, the investment restrictions, the fees to be paid to the investment manager and the arrangements for payment, etc. As noted, separate provision must be made for custody arrangements.

Valuation/pricing

Arrangements for valuation and pricing will need to be considered by the investor, depending on their requirements and obligations. If the mandate is invested in funds, the fund operators will usually provide valuations periodically which can be used by the investor. The investment manager will usually be willing to provide valuations for direct investments within the mandate. To ensure confidence in the valuation, the investor may want to consider ensuring arrangements are in place for an independent valuation of the assets held in the mandate.

Scope for negotiation of investment terms

As segregated mandates are bespoke arrangements, there is significant scope to negotiate these, subject to agreement of the commercial terms with the investment manager

Restrictions and any obligations imposed on investment/commitment

There are few restrictions in what can be offered within a segregated mandate, and the investment terms can be agreed between the investor and the investment manager. For pension schemes, any broader investment restrictions on the scheme, including any specific environmental, social or governance (ESG) or sustainability requirements will need to be taken into consideration when negotiating the investment mandate. The mandate will also be limited by the services that the investment manager is willing to offer, and any investment restrictions that the scheme operates under.

The terms of investment will be set out in the investment management agreement for the mandate – there will not necessarily be standard dealing points as for an investment fund. The investor will however need to understand the length of time the investment manager will need to sell investments within the mandate to meet any withdrawal requests.

Further resources

Further information is provided by most investment managers offering investment services for segregated mandates on their webpages for institutional investors.



Legal Guide to the Long-Term Asset Fund (LTAF)

Summary

This guide is aimed at trustees, employers and other Defined Contribution (DC) pension scheme decision makers (collectively referred to here as “decision makers”), considering investing in less liquid assets through the long-term asset fund (LTAF). The guide provides a brief overview of the key features of the LTAF, including considerations around the LTAF’s legal structure and a summary of some of the key terms to look out for when considering an investment in an LTAF.

The LTAF covers a potentially wide spectrum of asset classes and with such broad parameters there could be significant divergence between funds in areas that will be important to investors. This guide aims to help decision makers to become more familiar with the parameters and to arm them with sufficient information to be able to dive deeper into the specific terms that apply to a particular LTAF in which an investment is being considered. Key features of the LTAF include the following:

- a new form of FCA-authorized investment fund.
- “open-ended” meaning investors can realise their investment by selling (or redeeming) their shares or units with the fund itself although the frequency of redemptions may vary between funds.
- invests across a very broad range of asset classes including venture capital, private equity, infrastructure, private debt and real estate.
- provides a high degree of governance and liquidity management (including the alignment of fund liquidity with the liquidity of the underlying assets) which should provide a degree of comfort to investors to invest in less liquid assets
- open for investment by professional and sophisticated retail investors but was designed with the default arrangements of DC pension schemes in mind although the FCA has consulted on extending access to the LTAF including for other categories of retail investors.

The Group has also been producing model constitutional documents for the LTAF, beginning with the version for an ICVC, published alongside the LTAF legal guide. The other versions, for an ACS and AUT, are currently being finalised and will be published soon.

1. Legal Structure of the LTAF

Introduction – What is an LTAF?

The LTAF is a UK authorised open-ended fund, designed to complement other investment vehicles that are available offering exposure to less liquid asset classes (such as closed-ended funds, limited partnerships, and offshore professional open-ended funds). LTAFs must invest mainly (i.e. no less than 50% of their assets) in long-term, less liquid assets such as venture capital, private equity, private credit, real estate and infrastructure.

While LTAFs are open-ended funds, FCA rules require that redemptions cannot be more frequent than monthly and require a minimum of 90 days' notice before investors can redeem their investment. In practice, redemptions may be less frequent and notice periods may be longer where the fund invests in more illiquid assets. Investors seeking to redeem their capital may also be subject to other liquidity management tools that the LTAF manager may use to support efficient management of the LTAF portfolio and to ensure that investors (whether looking to redeem or remain in the LTAF) are not disadvantaged. Such tools might include lock-in periods, side pockets, investor or fund level gates, and, as a last resort in extreme scenarios, potentially suspension. For more information about these tools and what they mean for DC schemes, see the Productive Finance Working Group's [Guide to Liquidity Management](#).

LTAFs can currently be invested in by professional investors, including the default arrangements of defined contribution (DC) pension schemes (Default Funds), and by sophisticated retail investors. The FCA *consulted* in August 2022 on whether to expand the distribution of the LTAF to self-select DC pension schemes and a wider range of retail investors. As a result, some of the detail on FCA regulations below may be subject to change in early 2023.

Legal Structure

The LTAF can be structured as any of:

- an authorised unit trust (AUT),
- an authorised contractual scheme (ACS), which has two variations and can take the form of either a co-ownership scheme or a limited partnership scheme, or
- an investment company with variable capital (ICVC).

Key Parties

As an FCA-authorised fund structure, the LTAF provides a high degree of governance and aims to provide additional levels of protection to investors through a combination of product-level rules and the regulation of the key parties involved in managing the fund and holding its assets.

The LTAF Manager

As a potential investor in the LTAF, decision makers will need to know who is responsible for managing the fund and what level of regulatory oversight and governance applies to them.

The LTAF manager must be a full-scope UK AIFM (meaning an alternative investment fund manager established in the UK with permission to carry on the regulated activity of managing an alternative investment fund) and is referred to in the FCA rules as an “authorised fund manager” (AFM).

The LTAF manager will likely be either part of an institutional asset management group or a specialist provider of services as a third-party AFM in each case with resources and expertise in the strategy or asset class in question. The primary role of the LTAF manager is to manage the fund in accordance with applicable FCA rules and as set out in

the instrument constituting the LTAF (Instrument) and the prospectus of the LTAF (Prospectus), and to carry out those functions required to ensure compliance with applicable FCA rules.

In particular, the FCA rules require that:

- a senior manager at the LTAF manager has responsibility for overseeing that the LTAF is managed in the best interests of investors;
- the LTAF manager carries out an annual assessment of value of the LTAF (which is an obligation that applies for all UK authorised funds) which is designed to focus on whether the payments that are charged to the fund (including the charges of service providers) are justified in the context of the overall value delivered to investors;
- the LTAF manager also carries out an annual assessment of how the LTAF is being managed in accordance with investors' best interests (this requires the LTAF manager to assess and report on at least four additional aspects of the operation of the LTAF: valuation, due diligence, conflicts of interest and liquidity management);
- the governing body of the LTAF manager must include at least two independent people or, if the governing body comprises more than 8 individuals, at least one quarter of that body must be independent. FCA rules include guidance on the meaning of “independent” for these purposes; and
- the members of the governing body of the LTAF manager must also (a) possess the collective knowledge, skills and experience to be able to understand the activities of the manager and the risks involved, (b) commit sufficient time to properly perform their functions and (c) act with honesty, integrity and independence of mind.

Depositary

Equally important to a potential investor is knowing how the assets of the fund are held and by whom. The LTAF's depositary (Depositary) is responsible for the safekeeping of the LTAF's assets. The Depositary must be authorised by the FCA to act as depositary of an authorised AIF and must be independent of the LTAF and the LTAF manager. In addition to safekeeping the LTAF's assets, the Depositary has additional duties of oversight including:

- to take reasonable care to ensure the LTAF is managed in accordance with the LTAF's investment objectives, policy and strategy,
- to take reasonable care to ensure the LTAF is managed in accordance with the FCA rules on valuation, pricing and dealing, and
- where an external valuer is not appointed, to determine that the LTAF manager has the resources and procedures to carry out a valuation of the assets of the LTAF.

Legal Documents

The principal documents required include:

- an Instrument constituting the LTAF (depending on the legal structure, this may be an instrument of incorporation, a deed, or a partnership agreement).
- a Prospectus containing information regarding various aspects of the LTAF as set out in the FCA rules. The Prospectus must be kept up to date and must be revised

immediately if there is any materially significant change in the information set out in it.

- a contract between the LTAF and its manager (for an LTAF that is an ICVC)
- a contract between the LTAF (or the LTAF manager) and its depositary
- a PRIIPs KID (if the LTAF is made available to retail investors).

Investment and Borrowing Powers

Although the investment powers of an LTAF are relatively broad to support its ability to invest across a wide range of less liquid assets, some key rules apply:

- the LTAF manager must ensure that the fund aims to provide a 'prudent spread of risk' (PSOR) – a concept that is not defined in the FCA rules but which must be given its "ordinary natural meaning" in the context of the fund in question.
- an LTAF may invest in other funds, (called "second schemes") including UK regulated collective investment schemes and, with certain additional requirements, in unregulated schemes.
- an LTAF may invest as a feeder fund into another fund to which it is dedicated (called a "qualifying master LTAF" in the FCA rules and which must meet certain criteria and operate on the principle of PSOR but which does not itself need to be an LTAF or indeed an authorised fund at all).

- an LTAF can participate in, or originate, loans (other than loans to natural persons and to certain related parties of the LTAF).
- an LTAF may borrow up to 30% of the Net Asset Value (NAV) of the fund.

Investment in a unit-linked or "wrapped" LTAF by Default DC pension schemes

An important route for investment by UK DC pension schemes is to invest via a life insurance platform. In this case, the schemes become subject to the "permitted links" regulations that aim to offer consumer protection to the end retail client by controlling the types of exposures that a life wrapper can take. This includes limiting investment in less liquid assets to 35% at the level of individual funds.

Amendments to the permitted links rules, however, now allow a Default Fund in an insurance wrapper to invest in an LTAF subject to certain conditions being met⁶, as the LTAF is a type of 'conditional permitted link' in its own right under the FCA rules. Also, the rules now exclude a wrapped LTAF (meaning a unit-linked fund which includes an investment in an LTAF) from the calculation of the 35% limit on illiquid assets where the underlying investor is part of a Default Fund. Proposals for the broadening of the distribution of LTAFs beyond Default Funds were the subject of consultation by the FCA in [CP 22/14](#).

6. The conditions are that: (a) the nature of the LTAF does not prevent a policyholder from exercising any of their rights under the DC pension scheme policy within the contract timeframe, and (b) the investment risks of the LTAF are suitable and appropriate given the circumstances of the policyholder, the expected maturity period of the policy, and the purpose for which the policy is held. Note: The insurer must also assess on an ongoing basis the total exposure of the Default Fund to conditional permitted long-term asset funds and other investments of similar risk profile, and information requirements must also be met under which certain information will be given to policyholders about the fund, its risk profile and investment strategy.

2. Summary of Key Terms

Provision	Description
Fund Structure	
Constitution	<p>An LTAF is a UK authorised investment fund. It can be established as:</p> <ul style="list-style-type: none"> • an ICVC; • an AUT, or • an ACS. <p>Full details of the constitution of the LTAF are set out in the Instrument and the Prospectus.</p>
Duration / Term	An LTAF may either have a fixed or unlimited duration/term. This will be set out in the Prospectus.
Amendments to an LTAF	<p>Decision makers will want to know how the terms of their investment might be changed after they invest. FCA rules provide that amendments may be made to an LTAF during the life of the fund. If a change is proposed that would reasonably be considered to be 'fundamental' then that requires investor approval by extraordinary resolution (meaning at least 75% of those voting must approve the change).</p> <p>Where the change is not fundamental but is instead merely 'significant', reasonable notice must be given to investors.</p> <p>Finally, where the change is neither 'fundamental' nor 'significant' but is, merely "notifiable", the rules require that investors be informed in an appropriate manner dependent on the nature of the changes.</p> <p>When assessing the materiality of an amendment for these purposes, LTAF managers must consider the impact of the change on the fund based on the nature of the LTAF and on the investor profile. The FCA provides guidance on what constitutes the different categories of materiality for these purposes.</p> <p>In addition to the above, the FCA is also required to approve any change to the Instrument and any change to the Prospectus that, if made, would be considered to be 'significant'.</p>
Fund Currency and FX	The LTAF's base currency will be specified in the Prospectus. The Prospectus may permit the LTAF manager to enter into foreign exchange hedging arrangements, and an LTAF may have unit classes of a different currency to the base currency of the LTAF.

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Provision	Description
Investment Powers and Restrictions	
Investment objectives, policy, and strategy	<p>Decision makers will want to know in advance what the fund will invest in and what its aims and objectives are so that they can allocate the investment internally in terms of the risk and exposure profile of the plan as a whole. These will be set out in the Prospectus, which will also include any investment restrictions and the procedures by which the LTAF manager may change the investment objectives, strategy or policy. The FCA rules require that an LTAF must invest 'mainly' in long-term illiquid assets, and FCA guidance states that their expectation is for at least 50% of the LTAF's investments to be comprised of such assets. The LTAF is required to invest only in the following asset classes under the FCA rules:</p> <ul style="list-style-type: none"> • 'specified investments' (deposits, electronic money, contracts of insurance, shares, debentures, government and public securities, warrants, certificates representing certain securities, units in collective investment schemes, rights in an AIF, stakeholder and personal pension schemes, options, futures, contracts for differences, underwriting or membership of a Lloyd's syndicate, and rights or interests to the aforementioned investments); • interests in a loan (subject to certain restrictions); • interests in land or buildings (subject to certain restrictions); • precious metals; and • commodity contracts traded on a recognised investment exchange. <p>LTAFs are required to provide a prudent spread of risk, taking into account the investment objectives, policy and strategy of the LTAF. This may include whether the investments provide sufficient diversification of exposure and the spread of any other risks arising (such as market risk, credit risk, liquidity risk and counterparty risk).</p>
Investment Allocation	<p>The LTAF manager will have an allocation policy which sets out the process by which it allocates investment opportunities between the LTAF and its other mandates.</p>
Borrowings	<p>LTAFs may borrow up to 30% of the NAV of the fund under FCA rules but, within that limit the permitted level for any particular LTAF will be specified in the Prospectus. There are no restrictions on the purposes for which borrowing may be entered into and so borrowing can be used to support liquidity management, for the efficient management of the portfolio and to increase returns.</p>
ESG policy	<p>Any environmental, social and governance (ESG) policy of the LTAF will be set out in the Prospectus. While long term assets can play an important role in how investors meet their ESG goals, there are no additional ESG requirements on LTAFs beyond those required generally for other UK authorised investment funds.</p>

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Provision	Description
Investment Basis	
Subscriptions	<p>Each investor will decide how much they wish to invest in the fund and will subscribe for units in the LTAF in the amount set out in the investor's application form. The Prospectus will set out the dealing frequency for the LTAF and any rules governing further investor subscriptions.</p> <p>LTAFs may operate on either a subscription or a commitment basis:</p> <ul style="list-style-type: none"> • On a subscription basis, an investor fully pays the subscription amount at the time they submit their application form for the LTAF manager to make investments and to fund expenses and liabilities. • On a commitment basis, the investor commits to invest a specified amount in the LTAF. As the LTAF manager sources the assets and builds the portfolio, some or all of the committed capital will then be drawn down by the LTAF from investors as required for investments to be made and to fund expenses and liabilities. Decision makers will want to know the important details of any advance commitments and these may be documented either by way of a separate agreement or "side letter" between the investor and the fund or the process may be hard-wired in the fund documents themselves. In either case, decision makers will need to understand and agree any notice periods for such 'drawdowns' and any other relevant terms, including what happens if an investor defaults on their commitment and how any shortfalls might be covered.
Redemptions	<p>Investors will want to know how and when they can get their money back if they decide to realise (or "redeem") their investment. The redemption process for the LTAF will be set out in the Prospectus.</p> <p>While LTAFs are open-ended funds, FCA rules provide that, in order to allow alignment between fund liquidity and asset liquidity, redemptions cannot be more frequent than monthly, although funds with less liquid strategies are likely to operate with less frequent redemptions than this. An LTAF manager is required to align the redemption policy with the liquidity of the underlying assets and demonstrate that during the fund authorisation process and on an ongoing basis. This is an important feature of the LTAF as a properly aligned fund will allow investors to understand the liquidity profile of their investment and to accommodate it within their own liquidity management requirements.</p> <p>The FCA rules also provide that a minimum notice period of at least 90 days (where a notice period is the time an investor must wait after their redemption request has been lodged before they can receive a cash payment representing the value of their investment), although this is an absolute minimum, and the FCA expects that many LTAFs will have notice periods significantly longer than that.</p> <p>The FCA expects LTAF managers to set notice periods based on a typical time to sell a representative sample of the portfolio. This is designed to ensure that the portfolio's future cashflows can be matched against the notice periods agreed in the fund design and does not mean that a manager is necessarily required to sell down underlying assets to fund redemption requests.</p> <p>The redemption price will be determined on the dealing day following the end of the notice period. Subject to any discretion reserved to the LTAF manager and set out in the Prospectus, a redemption request is irrevocable once submitted.</p> <p>Investors seeking to redeem their capital may also be subject to other redemption restrictions to support efficient management of the LTAF's portfolio and ensure fair treatment for all investors (whether looking to redeem or remain in the LTAF). Such restrictions might include lock-in periods, side pockets, investor or fund level gates, as well as extended notice periods and potentially suspension of dealing. These will be set out in the Prospectus.</p> <p>The Productive Finance Working Group's Guide to Liquidity Management provides an overview of the different liquidity considerations for investors in illiquid assets and information on liquidity management tools that may be employed by LTAF managers.</p>

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Provision	Description
Valuation and Reporting	
Valuer	<p>Valuation of the type of less liquid assets that an LTAF can invest in can be a challenge as there is less information available on which to base an accurate assessment of what an asset is worth. Decision makers will need to be confident that the valuation function is being carried out by someone who is appropriately skilled. The FCA rules require that the valuation be carried out by either:</p> <ul style="list-style-type: none"> • an external valuer; or • the LTAF manager, if it possesses the knowledge, skills and experience necessary to carry out a proper and independent valuation of the assets the LTAF holds. The LTAF manager may appoint a delegate to value assets that are not immovables and an ‘appropriate valuer’ and ‘standing independent valuer’ to value certain immovable assets (land and buildings).
Valuation policy	<p>Units must be priced on a forward pricing basis. The valuation policy of an LTAF will be set out in the Instrument and Prospectus, and is likely to include:</p> <ul style="list-style-type: none"> • the frequency of publication of the NAV of the LTAF (FCA rules require that the NAV must be published at least monthly and on each dealing day of the LTAF, but LTAF managers may choose to publish the NAV more frequently for information purposes to align with the liquidity of the underlying assets); • the role of each party involved in the valuation process; • the valuation procedure for different asset types that the LTAF may hold; and • procedures to follow where there is uncertainty as to the value of certain assets.
Reporting	<p>The LTAF manager must publish, in relation to the fund:</p> <ul style="list-style-type: none"> • an annual report, not more than four months after the end of each relevant annual accounting period; • a half-yearly report, not more than two months after the end of each relevant half-yearly accounting period; and • a quarterly report, not more than 20 business days after the end of each relevant quarterly reporting period. <p>These reports must be provided free of charge on request to any investor or potential investor.</p> <p>Where investors require information not typically included in these reports, this will need to be requested separately from the LTAF manager.</p>

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Provision	Description
Fees and Expenses	
Management Fee	Investors will pay a management fee (Management Fee) to the LTAF manager usually as an annual fee calculated as a percentage of assets under management in the fund although the fee may be accrued and paid in more frequent instalments during the year on the basis set out in the Prospectus.
Performance Fee	<p>The LTAF may be structured on such terms that investors pay a performance fee to the LTAF manager. The details of any performance fee and how this will be charged to the investor will be set out in the Prospectus.</p> <p>The structure and amount of any performance fee will be tailored to reflect the investment strategy of the LTAF. The Productive Finance Working Group has produced a Guide to Performance Fees in Less Liquid Asset Funds that provides investors with information on Performance Fees and the mechanisms that may be used to ensure an alignment of interest between investors and LTAF managers.</p>
Fund Expenses	<p>Expenses that may be charged directly to the LTAF will be set out in the Prospectus. This will cover:</p> <ul style="list-style-type: none"> • costs and expenses incurred in connection with the formation of the LTAF and when such costs are payable; • costs and expenses, direct or indirect, relating to the business and operation of the LTAF (i.e. other than the remuneration and day-to-day expenses of the LTAF manager such as the costs of their employees, office accommodation and other overheads) which will usually be borne by the LTAF manager out of the Management Fee) and when such costs are payable; • details of the fees payable by the LTAF to service providers, such as the Depositary, fund administrator, auditor, legal and other professional advisers; and • how any transaction fees (charges to investee companies and typically retained by the LTAF manager) are accounted for when calculating the Management Fee.

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Provision	Description
Termination	
General	FCA rules set out the circumstances in which an LTAF may be terminated and the procedures for such termination. The Prospectus and Instrument must set out details of these circumstances, including the termination procedures and the rights of investors under such termination. FCA approval is required for the termination of an LTAF, and the termination must be carried out in accordance with the FCA rules.
Investor-led Termination	An LTAF can be terminated by an extraordinary resolution approved by at least 75% of investors (although formal permission to terminate must then be sought from the FCA). Investors can call a meeting in order to propose such a resolution. The process for calling an extraordinary resolution will be set out in the Prospectus and Instrument.
Governance Issues	
The LTAF manager	<p>The FCA rules require that:</p> <ul style="list-style-type: none"> • a senior manager at the LTAF manager has responsibility for overseeing that the LTAF is managed in the best interests of investors • the LTAF manager carries out an annual assessment of value of the LTAF which is designed to focus on whether the payments that are charged to the fund (including the charges of service providers) are justified in the context of the overall value delivered to investors • the LTAF manager also carries out an annual assessment of how the LTAF is being managed in accordance with investors' best interests (this requires the LTAF manager to assess and report on at least four additional aspects of the operation of the LTAF: valuation, due diligence, conflicts of interest and liquidity management) • the governing body of the LTAF manager must include at least two independent people or, if the governing body comprises more than 8 individuals, at least one quarter of that body must be independent. FCA rules include guidance on the meaning of "independent" for these purposes; and • the members of the governing body of the LTAF manager must also (a) possess the collective knowledge, skills and experience to be able to understand the activities of the manager and the risks involved, (b) commit sufficient time to perform their functions properly and (c) act with honesty, integrity and independence of mind.
Conflicts of Interests	The Prospectus will include disclosures to investors on potential conflicts of interests, such as in relation to delegation and transactions for the LTAF carried out with connected persons of the LTAF manager, Depositary or their associates. Such disclosures will include statements about other products which the LTAF manager may have and how conflicts of interests will be managed.

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Provision	Description
Liability and Contractual Issues	
Liability of Investors	The liability of each investor will be limited to the amount contributed to the capital of the LTAF by such investor.
Fair treatment of investors	<p>A description of any preferential treatment that any type of investor (or potential investor) may obtain will either be disclosed in the Prospectus or in a separate disclosure of the LTAF manager. Such preferential treatment will tend to be set out in a side letter to an investor, which may include provision of additional reporting, fee reduction, etc.</p> <p>Within illiquid markets, where buying an asset is more difficult, an LTAF manager may need to bring a number of investors together to be able to buy assets. In some cases the LTAF manager will offer the opportunity to participate in such an acquisition to certain investors in the LTAF. This is called “co-investment” and the Prospectus will likely set out details as to how the LTAF manager would offer any such co-investment opportunities.</p> <p>FCA rules require that the LTAF manager must always ensure fair (but not necessarily equal) treatment of all investors and any preferential arrangements with investors must be consistent with this principle.</p>
Tax Provisions	
Tax Considerations	<p>The tax position of the LTAF and the investors will depend upon a number of factors such as the nature of the LTAF, the tax status of the investors in the LTAF and the nature of the investments to be made by the LTAF, whether directly or indirectly.</p> <p>The Prospectus for the LTAF will include a summary of the expected UK tax position of the LTAF and investors. Investors may wish to obtain their own advice to ensure they understand the tax implications of any investment of the LTAF.</p>
Tax Information and Reporting	<p>LTAF managers will provide periodic disclosures to investors as required by any applicable laws. Investors may request additional reporting where required (e.g. to allow the investor to meet its own tax reporting obligations).</p> <p>LTAF managers may also require investors to provide information to comply with the LTAF’s tax reporting obligations. Such requests may include supporting documentation and self-certifications regarding the investor and, where appropriate, its direct or indirect beneficial owners and/or controlling persons.</p>



Due Diligence Considerations for DC Schemes Investing in Less Liquid Assets

Due Diligence Considerations for DC Schemes Investing in Less Liquid Assets

Due diligence of investment managers and products is a critical step for investors when considering investing in less liquid assets. Careful consideration must be given to choosing the investment manager⁷ and product best suited to deliver the objectives of the Defined Contribution (DC) scheme's investment strategy.

We anticipate trustees, employers and other DC scheme decision makers (collectively referred to as 'decision makers' below) will draw on input from their advisers and, where required, legal professionals, who can assist them through the due diligence process. This document outlines the key due diligence considerations for decision makers looking to invest in less liquid assets. While many of the considerations will be similar to the due diligence for any investment manager appointed or products selected, in some cases the approach may differ for less liquid assets.

The considerations and challenges around investing in less liquid assets make the due diligence of the investment manager and product particularly important. The nature of many investment strategies involving less liquid assets means that there is often a greater role for the investment manager compared to investment in public markets. For example, originating a private loan will require greater investment by the investment manager in deal sourcing capacity, credit underwriting, due diligence, investment monitoring and reporting compared to purchasing a publicly traded corporate bond on a regulated market. It is also particularly important to do due diligence on investment products and underlying assets, to understand the offer and ensure the investment is suitable and appropriate for scheme members.

Below are the key due diligence areas that DC scheme decision makers should seek to understand before making an investment.

Due diligence on the investment manager:

- its background, governance, and culture (including how reward and remuneration is aligned to deliver good client outcomes);

- the investment team's knowledge, skills, expertise and track record in the specific asset classes they will be managing, particularly where specialist expertise is required, e.g. origination capabilities for private credit;
- the nature and effectiveness of the fund manager's controls (including those around conflicts of interest) and risk management processes (e.g. how it manages market, credit, liquidity and operational risk);
- the investment manager's processes for selecting investment partners and / or investments, and their own approach to due diligence;
- essential services and information, such as the provision of price feeds (where available), transparency of reporting, quality of administration, and the service levels for providing these; and
- its policy on environmental, social and governance (ESG) considerations, how this policy is implemented across all asset types, how it will obtain climate and other ESG related data from unlisted and smaller companies (who may not be under the same reporting obligations as listed companies), and what reports it will provide to decision makers, e.g. to satisfy stewardship and TCFD requirements.

7. The investment manager is the entity that manages and makes the day-to-day investment decisions on the investment portfolio, in line with the investment mandate set by the DC scheme decision makers. Where the investment is being made through a fund structure, there may be a different entity that assumes responsibility for managing and operating the fund in accordance with legal and regulatory requirements. We refer to this entity as the fund manager. Where the investment manager and fund manager are different entities, DC scheme decision makers will need to consider performing due diligence on both entities, as their responsibilities will differ.

Due diligence on the investment product:

- Key features and terms of the of the fund, such as, for example:
 - Structure and domicile
 - Investment objective and benchmark
 - Subscription and redemption terms, including settlement periods
 - Minimum and maximum cash allocations
 - Pricing basis and frequency
 - Tax treatment
 - Governance structure
 - Past performance (where available)
 - Number of dominant investors
- net expected returns from investment and their key drivers, including projected returns and assumptions made in estimating them including during stress scenarios, costs and charges (including the manager’s own charges, any performance fees and how they are calculated and payable, and other charges); – for more information, see the guides on [value for money](#) and [performance fees](#) by the Productive Finance Working Group;

- valuation of less liquid assets, including how the fund manager ensures independence of the valuation function, and whether the valuation process uses industry good practice for that asset class;
- liquidity management tools at a fund level, including how has the fund manager aligned liquidity of the fund with that of its assets; for more information, see [liquidity management guide](#) by the Productive Finance Working Group.

In the case of a fund or investment product, much of this information may be found in the application or subscription documents, prospectus, private placement memorandum, constitutional documents of the fund or other offering documents. However, DC scheme decision makers may wish to ask additional questions to clarify any points of uncertainty and, where practicable, consider using independent third-party data providers for verification. Decision makers may also wish to consider seeking references from existing investors of the investment manager or product being selected.



Outputs by Investment and Employee-Benefit Consultants

Commitment Statement from Investment and Employee Benefit Consultants

The importance of delivering long-term value to members in UK defined contribution schemes is an evident focus of trustees, governance bodies and sponsoring companies. This has been long encouraged by regulator guidance since the launch of automatic enrolment in 2012. The aim is to ensure that all members get good value from their pension savings, after allowing for costs and charges.

As defined contribution (DC) pension schemes in the UK have developed and grown in size, the range of investment opportunities available to these schemes has increased significantly. And this is likely to increase still further in the years to come. Schemes are now considering allocating to less liquid assets to improve the potential return earned on member savings, net of costs and charges. While negotiating costs on behalf of members is important, it is key to consider the overall value that the investment strategy delivers to members.

As consultants, we recognise the important part we play in influencing the net member outcome. We are therefore committed to shifting the focus from cost to long-term value for members in our approach to DC consultancy.

In practice, this means committing to:

1. Delivering advice to UK pension schemes based on an assessment of improved net member outcomes rather than solely on an assessment of costs and charges, transparency of which we continue to support. This

recognises the potential for members to pay more and get more if it can deliver better long-term outcomes.

2. Raising awareness of the broadening investment opportunity set available to DC pension schemes and how this can contribute to improved net member outcomes. In particular, we support the use of the triennial review process as the natural point for assessing the suitability of less liquid assets in default investment strategies and a platform's ability to access these investment opportunities.
3. Working with industry participants to aid innovation and the integration of less liquid assets in DC schemes with ultimate member outcomes in mind, including working with trustees, employers, asset managers and platforms. Specifically with respect to the latter, we continue to engage with platforms to understand their ability to accommodate less liquid assets as we commit to platform and provider selection criteria that focusses more on elements that can contribute to net member outcomes (where not done so already) rather than solely the lowest cost solution.

Whilst we acknowledge that consideration of less liquid assets may not be appropriate across all schemes, it is important that consideration is not affected by certain constraints or barriers (perceived or otherwise). We therefore commit to continuing to develop practical

solutions to such barriers and to raise awareness among decision-makers on how to address such barriers.

The above commitment is made as part of the industry-led Productive Finance Working Group. It is made in the context of our legal and fiduciary duties to clients and unless otherwise prohibited by applicable law.

The use of less liquid investments is a newer area of DC investment strategy design and adds different considerations to the risks and opportunities of the strategy. The Productive Finance Working Group has produced a series of guides that could be helpful in understanding these issues and solutions, including a list of considerations from consultants for their industry on the integration of less liquid assets, as well as guides on [value for money](#), [performance fees](#), [liquidity management](#), [fund structures](#), [legal considerations around the Long-Term Asset Fund](#), and [due diligence](#).

Aon

Barnett Waddingham LLP

Hymans Robertson LLP

Isio

Lane Clark & Peacock LLP

Mercer

Redington

Willis Towers Watson

Top 12 Considerations for Consultants Integrating Less Liquid Assets into DC Schemes

This note sets out key principles for consultants on how to integrate successfully less liquid assets into DC schemes, drawing on experience of consultants who have done that in the past. The intention is to share the tips they have learnt with the consultant community at large, to make it easier for more schemes, and members, to benefit from investment in less liquid assets within default strategies.

These principles are aimed at investment advisers, employee-benefit consultants (EBCs), corporate advisers and anyone else who has a remit to advise on DC pension scheme investment arrangements or the selection of a DC pension provider including an assessment of their investment arrangements. The points below can therefore also help trustees, employers and other DC scheme decision makers to know what to expect from their consultants.

Consultants should:

1. Help decision-makers (e.g. trustees, employers, governance committees, providers etc) **set net member outcome objectives** for their schemes as part of any review of investment strategy and consider the extent to which investment in less liquid assets can help improve the ability to achieve those objectives.
2. Review internal **provider selection criteria** to ensure they focus on expected long-term financial value for pension scheme members rather than costs alone.

3. Frame investment strategy advice in terms of the long-term financial **value** that may be offered in return for investing in less liquid assets rather than costs alone. For example, demonstrate the extent to which the addition of less liquid assets to portfolios could: enhance net returns; aid portfolio diversification; bring wider sustainability benefits etc. Refer to the PFWG [Value for Money](#) guide to help set the value context.
4. Ensure that decision-makers are equipped with the available **evidence and insights** to support positive decisions about DC savers' projected future financial outcomes including transparency around the modelling assumptions and data inputs, including cost.
5. Outline the extent to which investing in less liquid assets can help achieve **net zero** transition plans and **ESG** integration objectives.
6. Undertake **scenario analysis** to demonstrate how a scheme's liquidity needs is expected to be met in future (refer to the PFWG [Liquidity Management guide](#)).
7. Assist trustees in setting a **liquidity management policy** in their Statement of Investment Principles that applies at a scheme level. Refer to the PFWG [Liquidity Management guide](#) on how that policy could work in practice with the introduction of less liquid assets.
8. Help decision-makers assess which solution amongst the spectrum of approaches aimed at providing exposure to less liquid assets is commensurate with the **governance** budget they have available. Support DC schemes in establishing a necessary governance structure to manage effectively the risks from less liquid assets.

9. Ensure clear communication to the decision-makers around the **time horizon** associated with investment in less liquid assets and ensure it aligns with the scheme's sponsor's commitment to running the scheme (refer to the 'scheme covenant' in the PFWG [Liquidity Management guide](#) for further information).
10. Seek to add value through fee negotiations with asset managers and providers, leveraging expected cashflows where possible. If a DC scheme selects to pay **performance fees**, ensure they are well-designed to meet its specific needs. The [Performance Fee guide](#) prepared by the PFWG sets out principles and trade-offs to consider in this regard.
11. **Work collaboratively** with asset managers and platforms to ensure suitable funds can be made available to DC schemes, helping to develop solutions (if necessary) as the market evolves. Refer to the [guide on Fund Structures](#) produced by the PFWG.
12. As the market evolves, seek to continually **improve knowledge** – consultants' own and across the supply chain through **relevant communications** – of less liquid investment solutions that could benefit DC schemes' members, drawing on the guides produced by the PFWG amongst other sources.

A Call to Action for Platforms

There is growing interest from investors in less liquid assets, some enquiring about the Long-Term Asset Fund (LTAF) and other structures. It is clear the future will include greater exposure to less liquid assets, but all industry participants have a role to play to get there. With growing client demand and with asset managers building investment solutions expected to increase supply, platforms will need to contribute to ensure the industry provides an effective supply chain.

Based on extensive external engagement in 2021, a report by the Productive Finance Working Group concluded that there are no insurmountable operational barriers to Defined Contribution (DC) scheme investment platforms accommodating less liquid assets. Subsequent engagement in the context of the LTAF rules launch (e.g. through the IA LTAF Implementation Forum) has identified that some platforms are already able to do so, while others would need to evolve their systems and processes to do so. This suggests more work may be required than was originally suggested in the initial report.

As this is a key next step to remove barriers, the consultant community is putting in place this Call to Action for DC investment platforms, **encouraging them to evolve their systems and processes to accommodate investment in less liquid assets** – across all product types (in house and third party), fund structures and types of clients. To support this, the consultant members of the Productive Finance Working Group will engage platforms to set out a business case (e.g. based on collective client demand). And to further assist the platforms in evolving their systems and processes, the Annex below sets out the specific areas of development that the platforms might want to consider, if not already.

We believe the time is right for platforms to make the shift to offer the operational flexibility for less liquid assets, for the following reasons:

- Following the Consultants' public commitment, each consultancy will review their own internal platform and provider selection criteria to ensure they focus on value rather than costs. As part of the assessment process, consultants will view favourably those platforms with the operational flexibility to accommodate a broad range of assets, including less liquid assets.
- A series of guides, produced by the Productive Finance Working Group, helps raise awareness of the key considerations around investment in less liquid assets, including, for example, around [liquidity management](#), [value for money](#), and [performance fees](#). This will make it easier for DC scheme decision makers to invest in less liquid assets, when they choose to.
- The regulatory landscape has been evolving to help remove the barriers to investment in less liquid assets. The LTAF rules have come into force, and the official sector is taking forward work on the proposals for a value for money framework, approaches to performance fees, and disclosure of less liquid asset exposures.

Annex

To support investment in less liquid assets in practice, where this has not already been considered, platforms should consider the following areas of development:

- Develop and review liquidity management policies to cover:
 - Best principles on re-balancing portfolios to ensure desired portfolio is maintained and tolerances for different liquidity frequencies.
 - Liquidity scenarios that the default strategy must be able to weather.
 - Actions in the event portfolio breaches expected target ranges.

- Develop trading best execution policies and controls that enable trading with non-daily dealing, less liquid structures (including notice periods as outlined in LTAF rules).
 - Principles on the most appropriate intermediate asset to invest in over the period between trade instruction having been given to commit to less liquid assets and settlement date.
 - Review out-of-market procedures.
- Review policyholder T&Cs and member risk warnings to ensure effective communication and that they are robust enough to accommodate extreme liquidity scenarios for LTAFs and other less liquid structures (e.g. gating / suspension over a set time period). This will be alongside the work undertaken by other industry stakeholders (e.g. pension providers, trustees etc) to ensure a complete solution for the end investor.
- Develop policies around underlying investments' liquidity interaction with Treating Customers Fairly principles, permitted member behaviours and communicate operational requirements of the LTAF and other structures to the industry to enable asset managers to more effectively create products for the DC industry. This will also be alongside actions by other stakeholders who have responsibilities towards the end investor.
- Ensure there is appropriate expertise, either internally or externally, to research and govern less liquid fund structures, including conducting suitable due diligence on the portfolio and its processes.
 - Consider the structure of ongoing reporting and monitoring as part of governance frameworks (e.g. in meeting conditional permitted link regulations when reporting on non-LTAF less liquid assets).