ALTERNATIVE INVESTMENT FUND DESIGNATION BILL [HL]

EXPLANATORY NOTES

What these notes do

These Explanatory Notes relate to the Alternative Investment Fund Designation Bill [HL] as introduced in the House of Lords on 22 November 2023 (HL Bill 10).

- These Explanatory Notes have been prepared by Baroness Altmann in order to assist the reader of the Bill. They do not form part of the Bill and have not been endorsed by Parliament.
- These Explanatory Notes might best be read alongside the Bill. They are not, and are not intended to be, a comprehensive description of the Bill.

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Policy background

Listed investment companies

1 Listed investment companies are companies that raise money from investors and reinvest that money in accordance with their prospectus policy, for example in shares of other listed companies or directly into critical and productive economy investments such as private equity, real estate, renewable energy and infrastructure. Listed investment companies are required to be closed-ended, which means that once established they do not buy and sell investments to cater for investors coming in or leaving.

2 Listed investment companies are also variously termed closed-ended investment companies, investment trusts, closed-ended investment trusts or funds, venture capital trusts or, in the specialist real estate sector, real estate investment trusts (REITs).

3 Over 350 closed-ended investment companies are listed on the London Stock Exchange premium segment, specialist fund segment and on AIM (London Stock Exchange's market for small and medium size growth companies). They have combined assets exceeding £250bn and provide support for financing schools, hospitals, transport, renewable infrastructure, battery storage, the airline and shipping industries, industrial warehousing, student accommodation, retirement homes, and affordable private rental housing, as well as providing venture and growth capital to United Kingdom firms.

4 Like all other listed companies, they come under the Listing Rules and Companies Act 2006 requirements, including annual and interim reports and audit.

5 Listed investment companies differ from other listed companies in that they make money from investments, rather than from trading in products and services. Sometimes investment and trading companies can have similar models, especially in the real estate sector, but be classified differently. The Financial Conduct Authority looks at which category a company should list under using factors such as number of employees and non-investment expenditure.

6 Shares in listed investment companies are traded on the London Stock Exchange and are therefore liquid even if the underlying investments are illiquid. Investment companies enable investors of all levels of resources and sophistication, including retail, to participate in ownership of sectors which are otherwise difficult to access, such as the assets listed in paragraph 3.

Closed-ended companies

7 Investment company investors can buy and sell shares on the London Stock Exchange just as for any other listed company.

8 The closed-ended structure enables the longer-term horizon for investment which supports the productive economy in particular. Despite that, the buying and selling of exchange listed investment company shares is faster than open-ended fund redemption and does not have the risk of 'gating' (delayed redemption).

Governance of listed investment companies

9 Listed investment companies have a Board of Directors including non-executive directors that oversee running and administration of the company. On behalf of shareholders the Board also monitors the performance of the company, the Investment Adviser and the fees charged.

10 The oversight and control of costs has been a strong focus for the non-executive directors in recent years. The costs incurred in a listed investment company, in addition to corporate costs

such as audit, will vary depending on the nature of the investments. A portfolio of shares of other companies is usually simpler to run than managing a portfolio of real assets so the costs for running real assets will be higher.

Alternative Investment Fund Managers Directive

11 In 2013, in the aftermath of the financial crisis of 2008/9, a new European directive entitled the Alternative Investment Fund Managers Directive (AIFMD) was introduced to regulate 'alternative' investments that were considered to be too lightly regulated before the crisis and to protect EU economies from systemic risk.

12 The Directive was initially conceived as regulating hedge funds. However, due to investments being reinvested rather than used for corporate trading, listed investment companies were caught by the definitions even though they were already highly regulated. Initially this meant some duplication in reporting, but over time being within the AIFMD tipped listed investment companies into additional requirements in other regulations such as the Packaged Retail and Insurance-based Investment Products regulations (PRIIPs) and regulations under the Markets in Financial Instruments Directive (MiFID).

Cost reporting

13 The lack of recognition within the AIFMD of the listed company structure and role of share price as the investment value has now given rise to reporting requirements on costs that do not distinguish between costs already accounted for within share price and costs that are yet to be deducted from value.

14 Due to the lack of recognition of the listed company structure and the market setting of value as the share price, within which process costs have all been accounted for (just as with ordinary or 'trading' listed companies), certain cost reporting requirements relating to deductions from value have been applied in a way that indicates the internal costs of the investment companies are to be deducted again from the share price. Reporting requires the already 'paid' or accounted for costs to be inserted into the Ongoing Charge Figure, effectively double counting the costs and making listed investment companies look expensive to hold either in their own right or when held in Funds.

15 For comparison, listed 'trading' companies are free to hold, i.e. have no Ongoing Charge Figure, in recognition that costs are already accounted for within the share price value.

Effect of the Bill

16 The policy intention of the Bill is to recognise a company's share price as having costs included by removing listed investment companies from the Alternative Investment Fund Managers Regulations 2013), which implement the AIFMD in the United Kingdom and stands at the top of subsequent legislation that gives rise to the cost reporting requirement explained above.

17 The removal of listed investment companies from the Alternative Investment Fund Managers Regulations 2013 also removes unnecessary reporting requirements, recognising that the listing requirements and requirements in Companies Act 2006 already provide substantial transparency.

18 Clauses 2 to 4 make consequential changes to other Regulations.

19 The Financial Conduct Authority already has the ability to make disclosure requirements by way of the Listing Rules.

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