AIFMD AND ELTIF REVIEWS

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ELTIF and AIFMD reviews: the challenge to meet investors' needs

The 2015 Action Plan on Building a Capital Markets Union was aimed at strengthening the link between savings and growth, with the ultimate goal of promoting a truly single capital market across the EU. The results, however, fell short of expectations, making it crucial that we get the new CMU action plan on track, decisively focusing on a "CMU for people and businesses".

Efficient, stable and participated capital markets provide more options and better returns for savers and investors and offer businesses additional funding choices. This will be decisive for the competitiveness of the EU 27 block and our strategic global agenda.

But the context and the market itself have been through rapid and deep transformations. The pandemic crisis, Brexit, digitalization and ESG, together with the CMU Action Plan, impose policy and regulatory updated responses making the right tools available to achieve the intended results and requiring measures and contributions of varied nature, sectors and wills.

The asset management sector surely plays a critical role in this process.

The new CMU plan includes an innovative proposal that could evolve to banks directing SMEs to providers of alternative funding. Although posing relevant challenges, bridging banking and non-banking financing should be incentivized, as it creates awareness and opportunities to a wider financing market, with benefits for all parties. For countries with lower levels of financial literacy and high levels of corporate indebtedness this could be particularly beneficial, allowing smaller companies to get more visibility on alternative equity funding.

Funds need flexible solutions, while granting proper protection to investors and financial stability.

The European long-term investment funds (ELTIFs) and Alternative Investment Fund Managers Directive (AIFMD) reviews, among other measures, should become important pieces of this project. But in both cases, the major challenge is to ensure that the revised frameworks provide flexible solutions for investors and businesses, while ensuring adequate protection for retail investors and financial stability.

The revised ELTIFs regime should design these funds as a true alternative for both retail and professional investors, to accelerate their uptake by investors and channel long-term financing to companies and infrastructure projects, in particular those contributing to the objective of smart, sustainable and inclusive growth.

Despite a strong consensus around its success, the AIFMD requires reflection both on the macroprudential and the investors' perspectives, particularly in the areas of reporting, delegation, risk management, supervision coordination and convergence and proportionality. The new framework must make AIFs resilient to other crises and avoid them spreading or amplifying risks throughout the financial system.

But above all, we need an efficient and coordinated supervisory response, in order to ensure proper risk management and avoid future crises that would be detrimental to investors' interests, for the funds' industry and the society in general. This concern is also extensive to UCITs and particularly to MMFs. Regulatory changes need to be complemented by harmonised and effective supervision to foster more investment and sustainable growth. This also requires asset managers, investment advisers and distributors understanding investors' needs and risk profiles and offering transparent, comparable and suitably designed and marketed products, that offer the expected returns.

Taken together, the envisaged enhancements should indeed increase investment, return and trust in the asset management sector, offering a relevant contribution to our desired Union. Building the CMU is an ambitious, yet not an easy goal to achieve. But capital markets and asset management cannot ignore the call to participate in the European economic recovery.

A consistent, persistent and cohesive contribution from EU 27 asset management to the new CMU is critical to returning to long-term growth, to finance the green and digital transition and to a more inclusive and resilient society.

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Asset Management: a year of review

The year 2021 is a significant year for the EU asset management sector as the European Commission prepares its proposals on the reviews of the AIFMD and the ELTIF frameworks. While this work is still ongoing, a number of policy areas have been identified from the public consultations aimed at further facilitating EU AIF market integration and enhancing prudential tools where necessary while supporting the overall achievement of the Capital Markets Union.

The AIFMD Review

Since its adoption almost a decade ago, the AIFMD has contributed to the development of the Single Market for Alternative Investment Funds, established an effective supervisory regime, improved transparency for investors and regulators, the monitoring of market developments and has set out new tools for market oversight.

In June 2020, the Commission published a report for the EU co-legislators on the functioning of the AIFMD, providing an assessment of the experience of industry and regulators in applying the AIFMD. The report concluded that the framework was generally functioning as intended but that it could benefit from some targeted improvements and clarifications to improve its implementation and efficiency of operation.

In terms of the feedback to the public consultation some early issues have been identified that will be subject to further analysis including the lack of a depositary passport, the availability and use of liquidity management tools, reviewing data reporting requirements, the differential treatment of custodians of AIF assets and the fragmented market for loan originating funds.

At the same time, we must bear in mind that the AIFMD is still a relatively new framework, particularly compared to UCITS. While ensuring adequate levels of investor protection will remain our key priority, we must also support the further development of the EU AIF market and provide investors with access to a wide range of investment opportunities while ensuring a level playing field for EU managers and their overall competitiveness.

2021 is a significant year for the EU asset management sector.

The ELTIF Review

Since the introduction of the ELTIF framework, the uptake of the ELTIFs has remained relatively modest. Only four Member States have domestic ELTIFs with only 28 funds launched to date and the total asset base remains below EUR 2 billion.

Based on the High-Level Forum on the CMU report of 2020 and stakeholder feedback to the ELTIF public consultation the Commission services have undertaken a focused review of the ELTIF framework. The aim is to introduce targeted improvements to the ELTIF regime given its potential to play an important role in providing capital investment to the real economy and supporting long-term sustainable economic development. While the review is still ongoing, the following policy themes are particularly noteworthy:

- Reducing barriers to investments and finding a balanced approach to the marketing and distribution of ELTIFs to retail investors while improving the attractiveness and usability of the ELTIF regime for the professional investors. These potential amendments need to be assessed in the broader context of the risk-benefit analysis of increased retail investor participation, higher uptake in ELTIFs and applicable investor-protection safeguards;
- Broadening the scope of eligible investment assets and strategies to include structures such as fund of funds or other indirect investments that support the ELTIF label and its objective of long-term sustainable growth;
- Reviewing the portfolio composition, diversification requirements and the concentration limits in a manner that would introduce more flexibility for managers and provide appropriate diversification;
- Amending the redemption policies and the frequency, liquidity management tools and life cycle of ELTIFs in a manner that does not compromise the integrity of the funds, protects the interests of the investors and facilitates the execution of the investment strategies pursued by the managers.

These policy considerations mainly pursue the twofold objective of promoting the ELTIF market by broadening access to these investments and facilitating a broader range of investment strategies while ensuring the necessary levels of investor protection.

The Commission is aiming for Q4 2021 to submit its AIFMD and ELTIF proposals to the co-legislators.

NATASHA CAZENAVE

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Revamp ELTIF to direct more long-term financing towards European companies?

The persistence of low interest rates and the necessity to finance a quick economic recovery has reignited the debate around the ability for retail investors to access riskier investments than those currently offered through UCITS funds.

The AMF supports the democratisation of investments in private markets, provided that a sufficiently protective framework is in place. Yet, striking a balance between retail access and retail protection is not an easy task. Alternative investment funds (AIFs) differ considerably in nature, risk profile, and authorisation and regulatory requirements, thus making the creation of an EU one-size-fits-all regime for retail AIFs hazardous. Instead, the AMF considers that the ELTIF is the right vehicle to foster retail participation in AIFs.

The forthcoming review is the opportunity to consider broadening the scope of the eligible portfolio assets for such funds and recalibrating some of the features of the current framework in order to make it more attractive and facilitate the access of retail investors to private markets.

AMF advocates for ELTIFs to offer certain features and safeguards when they target retail investors.

At a time of an unprecedented pandemic crisis, the ELTIF review may bring many benefits to the overall EU economy: investors would gain from a more diversified pool of assets with potentially higher returns and savings could be channelled more efficiently towards the financing of non-listed companies and small and medium enterprises.

Nevertheless, apart from the inherent investment risk from investing in non-listed or small businesses, ELTIFs display certain characteristics – namely the intrinsic illiquidity of their portfolio assets and their restricted redemption policy – which need to be carefully assessed and calibrated.

According to IOSCO's 2018 recommendations on liquidity management, funds should offer a redemption policy consistent with the liquidity profile of their underlying assets to avoid the so-called liquidity mismatch. Another challenge to consider is the difficulty of valuing non-listed assets in the absence of a secondary market that supports the price discovery process.

In order to address such risks and adequately protect investors, the AMF advocates for ELTIFs to offer certain features and safeguards when they target retail investors. Importantly, their closed-ended nature should be maintained. Nevertheless, to take into account the fact that retail investors may need to access their savings before an ELTIF reaches maturity, liquidity could be organised through the development of a secondary market for example. Another possibility would be to foresee occasional and limited liquidity windows. In any event, the distribution of ELTIFs to retail investors should be conditional on the performance of suitability assessments and the provision of investment advice.

Investing in non-liquid assets demands a long-term investment horizon, certain risk tolerance and capacity to bear losses that not all retail investors are able to withstand. This is a major difference with most UCITS funds available to retail investors. It is essential that retail investors understand this distinction in order to adjust their investment expectations, accordingly.

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Delegation rules under the AIFMD: need for clarification, adjustment or complete revamp based on the supervisory experience of national regulators?

The review of the AIFMD, enshrined in the Directive itself aims to complete the work of the CMU, of which the AIFMD is one of the founding pillars. Its primary purpose is hence to introduce legislative proposals designed to tackle hurdles for completing the Single Market for AIFs, with an emphasis on the experience acquired in applying the AIFM, its impact on investors, AIFs and AIFMs.

The AIFMD seeks to achieve a coherent approach of supervisory authorities to the risks of the financial system, to provide a high-level investor protection and also to facilitate AIFM market integration. The current AIFMD provides for rules on delegation, further specified by Article 82 of its Delegated Regulation 2013/231. This article includes a series of parameters for the delegation of AIFM functions to third-parties, including provisions on when the AIFM would be considered to be a "letter-box" entity. This regime was further complemented by a July 2017 non-binding ESMA Brexit Opinion in the area of investment management.

This opinion focuses on technical aspects of delegation arrangements such as the due diligence to be applied by an IFM (e.g. operational risk management policies and procedures), a focus on supervisory aspects as well as clarifications on the substance requirements (human and technical resources) as well as expertise on the selection of potential delegates and the effective monitoring of those.

Considering the purpose of the AIFMD and the aim of the review of the AIFMD, the experience of NCAs in applying the AIFMD has not evidenced any specific deficiencies relating to the delegation framework that would need to be addressed. To the contrary, experience has not evidenced any issues linked to delegation of investment management functions or to the current delegation regime. Further, an ESMA "Supervisory Coordination Network" has operated between 2017-20 where all EU NCAs had been requested to present Brexit related cases of fund managers and MiFID firms, focusing on delegation and substance aspects.

Experience of NCAs in applying the AIFMD has not evidenced specific deficiencies in the current rules that would require or justify a complete revamp.

The SCN discussions have shown that delegation rules work effectively, and only a very small number of cases revealed issues which were usually related to an inadequate application of the AIFMD rules rather than problems in relation to the AIFMD delegation regime itself.

If nevertheless the view is taken that substance should be given to the existing AIFMD delegation rules, those could cover specific aspects of the existing framework such as provisions on the control of the delegates, the requirement for a specific delegation policy addressing specifically initial and on-going controls (e.g. on the basis of the EBA guidelines on outsourcing).

Further controlling measures could include an ongoing review of the organizational set-up of the delegate as well as other aspects in accordance with a risk-based approach and potentially more specific provisions on exchanges between NCAs directly involved in the delegation of AIFM core functions.

VERENA ROSS

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Enhancing the AIFMD framework in the forthcoming review

The AIFMD has provided a solid framework for alternative investment funds in Europe. It gave a basis for consistent supervision of alternative managers in the EU, thus reassuring investors in Europe and the world that alternative investment funds are grounded in a credible regulatory framework.

Since its creation in 2011, ESMA and the national competent authorities have exchanged practical experiences in supervising firms in accordance with the AIFMD rules.

We have noticed many areas of the framework that should evolve in the current review. In addition, the recent COVID-19 related stresses highlighted some areas that could be further improved.

The current AIFMD framework requires changes covering areas such as reporting, availability of liquidity management tools and leverage. There is also merit in greater harmonisation of the UCITS and AIFMD frameworks in many areas.

The current AIFMD framework requires changes covering areas such as reporting, availability of liquidity management tools and leverage.

More broadly, it is time to create a true Single Rulebook for investment management by making greater use of directly applicable regulations rather than directives which need to be individually transposed by the different Member States. Many key regulatory matters covered by the AIFM and UCITS Directives are left to national discretion which adds to regulatory complexity and risk of regulatory arbitrage for investors, market participants and authorities.

One area that we believe deserves specific attention is that of delegation and substance. These rules deserve to be updated, both in the area of the AIFMD and UCITS.

In many cases, AIFMs and UCITS management companies delegate to a large extent the collective portfolio management functions to third parties and only perform some control functions internally (notably risk management functions). In particular, portfolio management functions are often largely, or even entirely, delegated to third parties within or outside of the group of the AIFM or UCITS management company.

We recognise that such extensive use of delegation arrangements can increase efficiencies and ensure access to external expertise, taking into account the global nature of financial markets. However, we also see that they may increase operational and supervisory risks.

Therefore, ESMA believes the extent of delegation should be clarified to avoid the risk of letterbox entities. Consideration should be given to specifying and complementing the existing broad qualitative criteria to clarify which core functions should always be retained by the licensed entity.

THOMAS SCHINDLER

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Should retail investors consider investing in AIFs and ELTIFs?

The success of the UCITS brand and the establishment of UCITS as the default investment fund for retail investors in Europe has created a strong focus on the most liquid assets classes.

Despite the continuing low interest rate environment prompting investors to explore new avenues, retail investors continue to invest through UCITS and the limited range of strategies available in this structure.

Could EU Alternative Investment Funds (AIFs), including European Long-Term Investment Funds (ELTIFs), provide retail investors with access to investments unavailable in UCITS funds? What sets such alternative funds apart from UCITS and what would make AIFs and ELTIFs suitable and attractive to retail investors? Since AIFMD governs fund managers and not the funds, there are many different types of AIFs and a broad spectrum of fund characteristics. Therefore, a differentiated approach to this question is needed.

A number of AIFs have been set up and function very much like UCITS, geared towards the specific needs of retail investors. Their investment strategies usually permit investment in certain assets or a portfolio weighting just outside the scope of the UCITS requirements, creating the opportunity for retail investors to broaden their investment exposure whilst maintaining liquidity as well as the subscription and redemption features UCITS are known for.

The many different types of AIFs and broad spectrum of fund characteristics require a differentiated approach.

Investing in less liquid assets, the purpose of many AIFs and ELTIFs (which provide long-term financing for infrastructure projects, SMEs and unlisted companies), means that early redemption is usually unavailable, restricted, or only possible at a significant cost for the investor. As such, only retail investors who do not need liquidity should consider investing in such funds. Some AIFs maintain a portion of more liquid assets, often reducing potential performance of the fund. Moreover, the liquid assets portion may not suffice to cover an extreme situation in which all investors seek to redeem.

In practice, many AIFs and most ELTIFs are set up for professional investors only. The combination of large unit sizes and initial investment requirements, capital calls and restrictive redemption make such investment funds less suitable for retail investors. Adaptation of such AIFs for investment by retail investors would not make sense as retail interests would inevitably and irreconcilably collide with those features offered to professional investors.

For a well-informed decision to invest in AIFs and ELTIFs, retail investors need additional information from distributors on all features typical to AIFs but not present in UCITS. Retail investment in less liquid strategies will require more extensive customer due diligence, appropriateness and suitability testing, and a clear understanding of the target market.

More affluent and financially literate retail investors may then find investments in AIFs and ELTIFs an interesting and attractive investment proposition, allowing them to access asset types and investment strategies that enhance and are complementary to more traditional UCITS investments.

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How blockchain technology can kickstart ELTIF investing

The European Long-Term Investment Fund was supposed to throw open the doors of the cloistered kingdom of unlisted companies and real assets to ordinary investors. Six years later, the rush hasn't happened.

This should be a golden era of ELTIF investing for institutional and retail investors alike. The pandemic has prompted governments to tap taxpayer money to keep the economy afloat. Still more is needed to fund innovation and infrastructure to achieve a broad-based recovery and deliver on the climate agenda European governments have promised. At the same time, low interest rates and much easier access to public markets have pushed investors further out on the risk curve.

Yet retail investors have been reluctant so far to dive into ELTIF portfolios. At the end of 2020 assets under management of ELTIF funds across the EU stood at just €1.5 billion.

What's the holdup? A lot has been written about fairly technical details such as the authorisation process, prospectuses and disclosures, and specific details on portfolio composition. Yet in our view, the biggest stumbling block is liquidity.

ELTIF assets are long-term in nature but the lack of modern technology and standardisation increases the liquidity challenges in several ways. First, selling assets requires material legal resources; it can take months for contracts to be finalized, and cross-border transactions present still more challenges.

Likewise, the registration process typically costs €300,000 in legal expenses, compared with roughly €30,000 to €40,000 for a typical European mutual fund.

What's more, each private debt loan is a bilateral contract often spanning 100 or more pages, requiring manual intervention in administration. And ELTIF funds also suffer from a lack of a standardised template for regulatory reporting and communication between manufacturers and distributors.

Blockchain technology can help. It would allow for real-time distribution of everything from the most current asset valuations to legal information needed for an asset transfer.

Blockchain technology can help democratize markets that have traditionally been dominated by the largest firms and wealthiest investors.

Hours and days could turn into fractions of a second. It would also help the EU create and distribute the lingua franca needed to standardise these products and underlying investments across firms and borders.

A blockchain-driven platform for secondary trading might also attract a new cadre of retail investors concerned about liquidity. Private assets are often viewed as an insular world of asymmetric information, and blockchain could help lift the veil.

That would help democratize markets that have traditionally been dominated by the largest firms and wealthiest investors. For retail investors, it could provide access to true alternative investments. For advisors and distributors, it could provide a differentiated value proposition.

Blockchain technology won't turn ELTIFs into the hottest retail investments overnight. But it could help to create buzz for an investment product that, so far, hasn't lived up to its potential.