EFAMA

European Fund and Asset Management Association

POSITION PAPER

Brussels, 23 February 2022

EFAMA POSITION PAPER ON THE EUROPEAN COMMISSION'S DRAFT PROPOSAL ON ELTIF

What is needed to make ELTIF 2.0 successful?

EXECUTIVE SUMMARY

EFAMA strongly supports the Commission's draft proposal amending the ELTIF Regulation where it addresses some of the major obstacles that have undermined the attractiveness of the ELTIF product since inception. The revised legal framework has the potential to transform ELTIF into a product of choice for a larger (retail) investor audience, all while serving the purposes of the Capital Markets Union (CMU). However, some important adjustments remain to be made for the ELTIF regime to reach its full potential as a competitive long-term investment option.

- The ELTIF draft proposal successfully removes **the unnecessary barriers that have limited retail investors' access to long-term investment opportunities,** while **preserving a sound investor protection framework** that prevents retail investors from being exposed to excessive risks. To strike the right balance between flexible product rules and investor protection, the draft proposal:

    - Removes the minimum investment amounts (i.e. the EUR 10.000 entry ticket and 10% aggregate threshold), while introducing an important alignment to the suitability test as defined by Article 25 of MiFID II. Such changes eliminate unjustified barriers that have prevented retail investors from having access to ELTIFs and overcomplicated the distribution process while ensuring legal certainty by providing a level playing field for distributors when applying the suitability test to a potential retail client; and

    - Safeguards important investor protection requirements that ensure that retail investors are exposed to a safe product. More specifically, a retail audience benefits from detailed and complete information via the AIFMD transparency requirements, including a prospectus, a KID, as well as periodical reports. Greater certainty for distributors at the point of sale is ensured by the cross-reference to the established suitability test under Article 25 of MiFID II, as complemented by the possibility for investors to withdraw from the investment agreement, redeem or transfer their units/shares, or raise complaints should they have concerns about actions taken by the ELTIF manager.

- The European Commission's draft proposal promises **to improve ELTIF's attractiveness** by:

    - Broadening the scope of the current eligible asset universe, thus allowing for more diverse investment opportunities, including fund-of-funds investment strategies, real assets, financial assets, increasing the minimum capitalisation (up to EUR 1 billion) for qualified portfolio undertakings to be investable, and lowering the restrictions on real asset holdings to EUR 1 million;

    - Reducing the threshold of eligible investment assets to 60% of the ELTIF capital, thus enabling managers to opt for slightly more liquid portfolios (to meet retail clients' possible liquidity preferences);

    - Removing the unnecessary barriers to retail investors while cross-referencing the suitability test requirement under MiFID II (Article 25); and

    - Adopting adequate diversification and concentration limits which improve the liquidity profile of the ELTIF's underlying portfolio and promote the flexibility of asset managers when executing their investment strategies, while also increasing the threshold for borrowing cash.

- For a **successful take-up of ELTIF in the future, its chances would increase** if the following aspects were considered:

    - Further clarifications (to also assist the future work of ESMA) are needed regarding the operational complexities for the proposed "Liquidity Window Mechanism", intended to allow investors to redeem their units during the life of an ELTIF;

    - To not materially alter the portfolio composition and investment strategies of existing ELTIFs, as well as on legal certainty grounds, it is crucial to include a grandfathering clause to prevent the new regime from becoming retroactive;

    - Securitisations as eligible investment assets remain limited to those conforming to the EU STS regime, thereby excluding a broader universe of national/non-EU ones. This may limit investment opportunities, as well as the diversification of the ELTIF's portfolio;

    - The attractiveness of the ELTIF product would benefit from a further increase of the UCITS-eligible asset to 50% of the ELTIF's capital so as to facilitate the management and offer of a slightly more liquid version of an ELTIF product to better meet retail investors' liquidity premium, and;

    - Even though the Commission has a limited scope to influence the tax treatment of ELTIF, we nevertheless believe that tax considerations should be addressed, as tax neutrality and tax incentives have proven to be an important obstacle in the take-up of the ELTIF product compared to other investment vehicles.

A BALANCED PROPOSAL THAT ENSURES A SOLID INVESTOR PROTECTION FRAMEWORK

I. Removal of unnecessary barriers for retail investors

EFAMA strongly welcomes the European Commission's intentions to remove most barriers of the current ELTIF framework that have prevented retail investors from benefiting from long-term investment opportunities while helping the financing of the EU real economy. As such, we believe that the changes proposed by the revised Article 30 of the draft proposal meet this objective as they delete the obligations related to the initial minimum investment amount of EUR 10 000 and of the 10% threshold of an investor's aggregate financial instrument portfolio (for those retail investors whose portfolio does not exceed EUR 500 000). Such changes would *de facto* align the revised ELTIF framework with some of the more successful national regulatory frameworks that have attracted mass retail savings without minimum investment thresholds.

According to the experience of most managers with an interest in the ELTIF structure, retail investors usually invest an amount below the €10 000 threshold when choosing long-term investment products. Moreover, we question on what basis the aggregate threshold has been set at 10% of the investor's financial portfolio. Such threshold is particularly cumbersome as ELTIF distributors in most EU jurisdictions do not have a consolidated overview of an individual's holdings of financial instruments since the retail audience typically invests in financial instruments through different types of wrappers (e.g. insurance or pension products) or through direct accounts. Where one of the the *raisons d'etre* of ELTIF is to encourage retail investors to partially invest some of their wealth in alternative investment fund products, we believe the existing restrictions are artificial and, unless removed, will continue to hamper both investor appetite and distributors' willingness to market the product.

II. Stronger suitability test requirement by referencing MiFID II

EFAMA supports the changes suggested under the revised Article 30 of the draft proposal as we believe that the requirements of the suitability test are strengthened by a clear reference to Article 25 of the MiFID II. Such provision ensures that managers, but above all distributors, can more practically rely on a familiar method for onboarding new clients and, in the interest of legal certainty, would also not be obliged to apply a separate but largely overlapping investor distribution regime stemming from the existing Regulation (EU) 2015/760 (ELTIF).

As part of the amendments included under the revised Article 30, the draft proposal has deleted the reference to "*appropriate investment advice*". Although we understand that the rationale behind such requirements was to ensure that investors received adequate information before committing their savings to long-term investments, practitioners have noted that such obligation has acted as a constraint in the marketing of ELTIF to retail investors. The lack of clarity of what an "appropriate investment advice" means, as there is no definition under Regulation (EU) 2015/760, combined with the absence of a cross-reference to MiFID II, which already contains a definition of "investment advice"[1], has created confusion for managers and distributors thereby undermining legal certainty. Moreover, we fear that the inclusion of investment advice within the ELTIF structure would lead to a situation where ELTIF products would be subject to stricter requirements than other complex financial products. Consequently, the deletion of such provision would increase the attractiveness of the ELTIF product for the retail audience and ensure a higher degree of harmonisation through the reference to MiFID II. Therefore, we believe that the suitability test included in

[1] According to Article 4, paragraph 4 of Directive (EU) 2014/65, 'investment advice' means the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments;

the revised ELTIF draft, among other provisions that we list below, is sufficient to guarantee that the revised framework does not expose retail investors to unnecessary risks when investing in an ELTIF product.

It is also worth noting that Article 25 of MiFID II establishes that the suitability test is required only for two investment services: investment advice or portfolio management. However, the wording of the proposed Article 30 of the ELTIF Regulation refers only to units or shares of an ELTIF *to be marketed* to retail investors. As such, we consider that Article 30 of the revised ELTIF Regulation should instead refer to investment advice upon the subscription offer of units or shares of ELTIFs to investors.

III. The draft proposal preserves a sound investor protection framework

It has been argued that the deletion of the requirements related to the minimum investment amounts for retail investors and the removal of the obligation to provide "appropriate investment advice" could compromise the safety of the ELTIF product and therefore undermine investor protection. Keeping in mind that the rationale behind ELTIF is to provide retail investors with the opportunity to benefit from alternative investment products, we believe that the draft proposal strikes the right balance between flexible product rules and a sound investor protection framework.

A thorough analysis of the draft proposal shows that the proposed framework preserves those essential requirements that enable retail investors to engage with and invest in ELTIF products without being exposed to unnecessary risks.

Retail investors can:

✓ **Count on complete and detailed information**

Retail investors benefit from sound transparency requirements established by the draft proposal, which allow them to make an informed decision and be fully aware of all potential risks involved, especially those proper of investments in less liquid assets.

Besides complying with the *transparency requirements* established by the AIFMD, asset managers are required to publish a *prospectus* that includes the necessary information to enable investors to make an informed assessment of the proposed investments.

In addition, when ELTIF is marketed to retail investors, managers are required to provide those investors with the *Key Information Document* based on the PRIIPs Regulation. Moreover, Recital 41 of the ELTIF Regulation establishes that any marketing documents should explicitly *draw attention to the risk profile* of the ELTIF.

Finally, Article 19 of the Regulation indicates that an ELTIF shall publish *periodic reports* containing the market value of its listed units or shares along with the net asset value per unit or share;

✓ **Withdraw from the agreement**

The Regulation grants retail investors a period of consideration of two weeks after they subscribe to units or shares of an ELTIF. Retail investors can cancel their subscription within this time frame and have the money returned without incurring any penalty;

✓ **Redeem or transfer their shares or units**

Although the ELTIF Regulation establishes a general rule based on which investors cannot redeem from their units or shares before the end of the ELTIF's life, based on certain conditions laid down

by Article 18 of the Regulation, investors can redeem during the life of an ELTIF, or freely transfer their units or shares to third parties other than the manager of the ELTIF (Article 19);

- ✓ **Benefit from a manager's internal assessment process**

  Article 27 of Regulation (EU) 2015/760 establishes that a manager which markets ELTIF to retail investors shall develop and apply a specific internal process to assess that ELTIF before it is marketed or distributed to retail investors. Therefore, the ELTIF manager has to evaluate whether the ELTIF is suitable for marketing to the retail investor by at least considering the life of the ELTIF and the intended investment strategy of the product;

- ✓ **Raise complaints**

  Article 30 of the Regulation guarantees that retail clients can take advantage of the possibility to file complaints in their official language, or in one of the official languages of their Member State, should they have any concern about the actions taken by the ELTIF manager; and

- ✓ **Benefit from legal certainty stemming from the cross-reference to MiFID II and IDD**

  As already explained, the cross-reference to Article 25 of MiFID II ensures a level playing field on applying the suitability test. It guarantees a consistent and "tried and tested" framework on which managers and distributors can rely when marketing ELTIF to retail investors. The same approach should be followed when investment funds are distributed through insurance channels under the Insurance Distribution Directive (IDD).

LIQUIDITY PROFILE AND REDEMPTION POLICY

I. Investors need an adequate redemption regime

EFAMA notes that the revised Article 18 of the draft proposal has deleted paragraph 4, which enabled investors to request the winding down of an ELTIF if the manager did not satisfy their request for redemption within one year from the date of the request. EFAMA welcomes the amendment proposed by the draft framework, as the decision of one investor to redeem should not affect the remaining investors in the fund. As reiterated by recital 29 of the Regulation, the possibility for an investor or a group of investors to request the winding down of ELTIF can be detrimental for both the successful execution of the ELTIF investment strategy and for those investors who are willing to remain in the fund.

While developing the regulatory technical standards (RTS) on redemption policy, we encourage ESMA to consider that the fixed maturity of the ELTIF structure has limited its attractiveness, especially when targeted to retail investors. To improve the appeal of ELTIFs to a retail investment audience and in line with the conditions under Article 18 paragraph 2 of the existing Regulation, managers should be allowed to determine appropriate redemption frequencies (i.e. no shorter than monthly, or otherwise quarterly or semi-annually), depending on the nature of the underlying portfolio assets and the individual investor profile. The current rules under AIFMD ensure that the redemption policy of the fund is consistent with its liquidity profile and that different types of liquidity management tools can be used.

II. Optional liquidity mechanism

EFAMA notes that the review of the ELTIF legal framework introduces an optional liquidity window mechanism intending to provide additional (secondary market) liquidity to redeeming ELTIF investors and subscribing investors without impacting the ELTIF's capital. The revised Article 19 requires ESMA to develop draft regulatory technical standards (RTS) on the specific liquidity matching structure.

While we expect more clarity around the exact functioning of such a mechanism from ESMA under its future RTS, we understand that such a mechanism might potentially work in certain circumstances. However, we encourage ESMA to consider that the secondary market needs to be very liquid in order for investors to access liquidity swiftly. Moreover, this mechanism would be more suitable for large funds which could potentially offer such mechanism, as they can count on a larger number of investors looking to redeem/subscribe at one time.

PORTFOLIO COMPOSITION

I. Diversification and concentration limits

EFAMA welcomes the amendments included in the draft proposal regarding diversification and concentration requirements, as they promote the attractiveness of ELTIF by improving the diversification of the ELTIFs' underlying portfolios, while allowing the asset managers greater flexibility when executing their investment strategies, as well as an opportunity to enhance portfolio liquidity in the interest of investors.

The changes proposed under the revised Article 13 establish that an ELTIF shall invest at least 60% of its capital in eligible investment assets, increasing the ELTIF's diversification compared to certain types of domestic AIFs, which are usually more concentrated in the absence of diversification rules. Such benefit of improved diversification could come with an enhanced liquidity profile, where the UCITS-eligible portion of the portfolio could potentially be increased further if the ratio of UCITS-eligible assets to eligible investment ones equals up to 50% of the ELTIF's capital. Given that the current ELTIF structure has not succeeded in attracting retail investors' interest towards alternative investments funds, EFAMA believes that the threshold of UCITS-eligible assets could be increased up to 50% so as to facilitate the management and offer of a slightly more liquid version of an ELTIF product to better meet retail investors' liquidity premium.

EFAMA supports the changes under the revised Article 13, paragraphs 2 and 3 concerning the portfolio composition and diversification requirements, as managers' experience suggests that the 10% exposure limit to instruments issued by, or loans granted to, a single portfolio undertaking is too low. Therefore, the total removal of such requirements for professional investors and the recalibration of the thresholds to 20% of the ELTIF capital for retail investors is welcome.

II. Eligible assets and investments

The draft proposal meets its objective of broadening the scope of the current eligible asset universe by increasing the market capitalisation threshold and lowering the restrictions on real asset holdings.

The revised ELTIF legal framework raises the market capitalisation threshold for listed issuers from EUR 500 million to EUR 1 billion. We support the changes proposed under the revised Article 11, paragraph 1, letter b. The new threshold allows asset managers to include more companies in light of the average capitalisation for companies included in Europe's main "small-cap" indices.

At the same time, we welcome the changes under Article 10 paragraph 1, as the revised provisions allow ELTIFs to invest in real assets if the minimum investment value of such asset is at least EUR 1 million – and not EUR 10 million as established by the current Regulation – while also removing the requirement under which real assets are to be owned directly or via indirect holding via qualifying portfolio undertakings. Evidence suggests that individual real assets of large funds have a value of far less than EUR 10 million. By reducing the threshold, asset managers would have access to a larger portfolio, regardless of the values of the individual real assets included in such portfolio, benefitting diversification and the product's risk profile. Therefore, such changes allow ELTIFs to capture a broader range of potential real assets by including smaller value projects.

In addition, in the current Regulation's Article 12, it is not clear whether a co-investment in the same asset between the ELTIF and another fund managed by the same management company (which is a very common practice) would be allowed or not. It is also not clear in the current Regulation whether the ELTIF manager can bring "seed money" or "initial capital" to the ELTIF in order to facilitate the development of the fund. We welcome the fact that, based on the revised Article 12, these co-investments and seed money are clearly possible.

III. Scope of eligible securitisation

EFAMA supports the European Commission's actions to expand the scope of eligible asset universe that ELTIF can invest in, as the current limited range of investable assets has proven to be an important barrier to the take-up of the product.

We welcome the clarification provided by the draft proposal, which allows ELTIFs to benefit from investment in securitisation. However, we suggest policymakers do not limit such investment to only simple, transparent and standardised (STS), but to broaden such scope by including all forms of securitisation. While we recognise that the STS is a growing market, our internal analysis clearly shows that STS represents only a limited portion of the overall securitisation market and that such limitation would in general bring little value to an ELTIF fund.

We question the rationale behind the limitation with regards to the aggregate value of STS securitisation set at 20% of the value of the capital of ELTIF. We suppose the threshold aims at ensuring that investors are not exposed to assets that are not in line with the eligible assets under ELTIF. In that case, we believe that the provision of a look through approach would provide full transparency on the assets owned by the fund in any event.

Securitisation has also proven to be an important means by which capital markets can directly finance the real economy. This, combined with the Securitisation Regulation providing a sound regulatory framework to investors, should encourage policymakers to broaden the scope of eligible securitisation and not reduce it to one single label.

III. Fund-of-fund strategies

As part of the provisions aimed at broadening the scope of the eligible asset universe, the revised framework enables ELTIFs to pursue fund-of-fund investment strategies and invest in EU AIFs managed by EU AIFMs. EFAMA welcomes the introduction of more flexible fund rules to facilitate fund-of-funds investments by ELTIFs as these provide the following benefits:

- A swifter exposure to illiquid assets (e.g. real assets);
- A greater diversification of the initial asset pool;
- A lower degree of portfolio volatility; and
- The assurance that managers of the underlying funds have already conducted adequate due diligence on the underlying investment.

However, we note that the revised Article 13 paragraph 3 limits ELTIF's investment in other funds to 40% of ELTIF's capital. Such threshold should be removed for ELTIFs to benefit from fund-of-fund strategies fully. It is worth noting that the look-through approach would provide full transparency on the assets owned by the underlying fund.

Finally, while we understand that the restrictions on the use of fund-of-fund structures seek to protect retail investors from high fees on their investments, we would like to highlight that ELTIF already aligns the disclosure of fees to investors with the requirements laid down in MiFID II and PRIIPs.

IV. Borrowing of cash

EFAMA supports the Commission's amendments concerning the borrowing of cash as they address the difficulties that asset managers currently face regarding the restrictions on borrowing and the limits stemming from the obligation of the borrowing currency to be the same as the asset to be acquired with the borrowed cash.

The flexibility provided in term of leverage levels - which now are set at 50% for retail ELTIFs and 100 % for professional ELTIFs - allow the managers to opt for a degree of leverage that is consistent with the investment strategy, the nature of the underlying assets and with investors' tailored needs.

Moreover, the removal of the condition that allows borrowing only in the same currency as the assets which will be acquired with the borrowed cash enables ELTIFs to borrow at more convenient rates in other currencies, provided that foreign currency exposures are adequately hedged.

However, we note that the proposal does not introduce provisions that would temporarily allow derogations from the restrictions - notably at the beginning of the investment period - which would help provide ELTIF managers with additional capital in the fund's ramp-up phase.

ADDITIONAL FUND RULES

I. Authorisation and ELTIF register

We support the revised provisions which facilitate the authorisation of the ELTIF and streamline the separation of those provisions that address the authorisation of the ELTIF and the one of the AIF manager (AIFMD).

The revised Article 3 of the draft proposal requires ESMA to prepare a more granular composition of the ELTIF public register, including additional data fields beyond the name of the authorised ELTIFs, their managers and the competent authorities for the product. More specifically, Article 3, paragraph 3 letter k) requires ESMA to keep "up-to-date links to the ELTIF documentation, including the rules or instruments of incorporation of the ELTIF, the annual reports, the prospectus, and where available, the Key Information Document."

Asset managers are not in favour of sharing any details about the investment strategy and cost structures with third parties (including also competitors) unless these parties will invest in the product. If documents such as the prospectus become publicly available, it could have serious repercussions on investor protection by lowering investment returns. Therefore, prospectus documentation should be streamlined to not disclose the details of the managers' unique market insights, details on the investment strategies, among others. We question if the Commission intended to make this information available to the public, or only to the fund's investors. In the latter case, access to such documentation should be offered through a dedicated investor portal accessible only through personal login details.

Additional considerations not addressed by the EC draft proposal on ELTIF

I. Tax considerations remain unaddressed

While we recognise that the Commission has a limited scope to influence the tax treatment of ELTIFs, we believe it is nevertheless important to highlight that tax barriers within the ELTIF framework continue to hamper the product's success. Tax neutrality and tax incentives, such as zero or reduced tax on distributions and capital gains, play a key role in the ELTIF structure's success. Should these changes not be considered and implemented, ELTIF's attractiveness would suffer because of local competing structures that already offer similar tax rebates.

Moreover, we note that the existing Article 11 paragraph 1 letter c point (ii) of the Regulation – which the European Commission's draft proposal has not amended – prevents ELTIFs from being marketed on a broad EU-wide basis. Such provision indicates that the qualifying portfolio undertaking should be established in a Member State, or in a third country, provided that the third country fully complies with Article 26 of the OECD Model Tax Convention on Income and on Capital, ensuring an effective exchange of information in tax matters, including any multilateral tax agreements. Although the rationale behind such requirement is to prevent ELTIF managers from investing in non-tax compliant jurisdictions, such onerous assessment has significantly reduced the number of Members States in which an ELTIF is allowed to be actively marketed, thus affecting its success. The request for tax information from the Member State where an ELTIF is established should be sufficient to guarantee that the necessary information is disclosed to ensure the correct tax is being declared. We thus believe that removing the portion of this requirement relating to each of the Members States in which the ELTIF is marketed should allow ELTIFs which might invest in third countries to be marketed on a much broader EU-wide basis.

II. Need for grandfathering clause to not harm existing ELTIFs

For those ELTIFs that have been successfully launched, investors would greatly value the inclusion of a grandfathering clause to guarantee that the revised framework will not apply to existing ELTIFs, so as to not materially alter their portfolio composition and investment strategy. For example, if one considers that the scope of eligible securitisation, as included in the proposed revision of the legal framework, mandates that only STS securitisation may qualify as eligible going forward, most existing ELTIFs will not meet this requirement, having invested in non-STS securitisations. Therefore, adopting such a requirement would lead to a situation where part of the portfolio of existing ELTIFs would not align with the new rules. Given the long-term nature of the product, the changes to the underlying assets would require time and are likely to upset the strategy investors have subscribed to, along with the resulting expected returns.

ABOUT EFAMA

EFAMA, the voice of the European investment management industry, represents 28 member associations, 58 corporate members and 24 associate members. At end Q1 2021, total net assets of European investment funds reached EUR 19.6 trillion. These assets were managed by more than 34,600 UCITS (Undertakings for Collective Investments in Transferable Securities) and almost 29,600 AIFs (Alternative Investment Funds). At the end of 2020, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 27 trillion.

More information is available at www.efama.org

Contact

Elona Morina
Regulatory Policy Advisor
Elona.morina@efama.org | +32 2 548 26 53