AFG ANSWER TO THE CONSULTATION PAPER 34-46-89

DRAFT REGULATORY TECHNICAL STANDARDS UNDER ARTICLE 25 OF THE ELTIF REGULATION

The Association Française de la Gestion financière¹ (AFG) is grateful for the opportunity to answer to the European Security and Market Authority consultation on the Draft regulatory technical standards under Article 25 of the ELTIF Regulation.

Introduction

AFG largely supports ESMA’s proposals. However, the currently prescribed PRIIPs (arrival price) transaction cost methodology is unsuitable ELTIFs that are – by design – invested in illiquid assets. In terms of timing, ESMA should align the adoption of the RTS on the ELTIF cost disclosures with the conclusion of the currently ongoing PRIIPs review. This will avoid the industry having to implement rules that will need to be revised shortly afterwards.

1. Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree that the abovementioned pieces of legislation and regulatory material are relevant for the purpose of the RTS on Article 25(3) of the ELTIF Regulation? Which other pieces of legislation and regulatory material do you consider relevant for that purpose?

¹ The French Asset Management Association (Association Française de la Gestion financière, AFG) is the professional organisation representing the French asset management industry. The French asset management sector is the largest in continental Europe: 630 asset management companies employ directly and indirectly 85,000 people and invest on behalf of their clients up to 4,000 billion euros in bonds, shares and other assets. About 50 % of French asset managers market their funds on a cross-border basis, and more than 30 % of the assets managed by our members are issued by corporates or states of the Euro zone (excluding France), which makes our industry a key source of funding for the European economy. AFG is an active member of EFAMA and PensionsEurope.
In addition to the four pieces of legislation and regulatory materials, the MiFID II ex-ante and ex-post cost disclosures and AIFMD investor disclosures (Art. 23) are also of relevance. Going beyond the targeted nature of this consultation, we would encourage ESMA to do its part in achieving a common approach to cost disclosures in the future. This would be in the great interest of investors instead of the current “piece meal” approach regarding the UCITS KIID Regulation, the PRIIPs Regulation, the ELTIF Regulation, MiFID II and the PEPP Regulation.

In terms of timing, ESMA may wish to wait for the conclusion of the ongoing PRIIPs review before adopting RTS on the ELTIF cost disclosures. This will avoid implementing rules that will need to be revised shortly thereafter.

2. Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree with the abovementioned assumptions? In particular, do you agree with the proposal included in paragraph 21 above? With respect to the overall cost indicator, would you see merit in aligning the level 1 framework on cost disclosure under the ELTIF Regulation with the PRIIPs level 2 framework on cost disclosure?

In response to ESMA’s questions, we would like to make four comments:

(1) List of one-off and ongoing costs is okay for ELTIFs

We agree with ESMA’s overall assessment to take into account, where possible, the general cost disclosures introduced by the PRIIPs Regulation. Nevertheless, we stress that the basis for further work on ELTIFs vis-à-vis PRIIPs should be limited to the list of one-off and ongoing costs as laid out in points 1 to 5 of Annex VI of the PRIIPs Delegated Regulation. It should also be clarified what is meant by the “different costs borne directly or indirectly by the investors”. It is not clear if one-off costs borne by the retail investors that are not deducted from the assets of ELTIF should also be included in the cost disclosures and for the purpose of the calculation of the overall ratio of the costs to the capital of ELTIF. Paragraph 21 of the consultation states “ESMA is also of the view that the costs listed in Article 25(1) are the costs borne by the ELTIF (the fund, taken as a whole), as opposed to the fees paid by a specific investor investing in this ELTIF”.

(2) Current PRIIPs “arrival price” unsuitable for ELTIFs

ESMA should not prescribe inappropriate and unsuitable transaction cost methodologies for ELTIFs as currently required in points 7-24 of Annex VI of the PRIIPs delegated Regulation. Article 1(3) of the draft regulatory technical standards (Annex V) needs to be redrafted in order not to make reference to points 19b and 20 of Annex VI of the PRIIPs Delegated Regulation as the “arrival price” methodology is unsuitable for ELTIFs.

The PRIIPs “arrival price” methodology captures market movements (also called “slippage” – i.e. the time between the order and its execution) and thus leads to consistently under- or overestimating transaction costs. In 2018, exhaustive evidence\(^2\) was provided on how this methodology provides misleading cost disclosures retail investment funds. ELTIFs are – by design – invested in illiquid assets, which are treated as “other assets” for the purpose of PRIIPs “arrival price” calculation. This would result in ELTIFs having to calculate their transaction costs based on “the previous independent valuation price of the asset, adjusted for market movements, where appropriate, using an appropriate benchmark index”.\(^3\) This provision, however, does not account for the market realities of illiquid instruments. The price of, for example, real estate is subject to bilateral negotiations between the buyer and the seller and is not assessable against any kind of price index.

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\(^2\) Evidence was provided through EFAMA papers, available on request.

\(^3\) Cf para. 19 (a) (i) and (b) (i) of the Delegated Regulation’s Annex VI
More importantly, the price or valuation of the asset itself is not in any way relevant for transaction cost calculations, since there are no implicit costs hidden in the price. All costs associated with transactions in real assets are explicitly charged and, thus, are fully known by the fund and are already disclosed in the fund’s annual report. They include, in particular, notary and brokerage fees and taxes for real estate transfer. **Thus, for the purpose of calculating costs for ELTIFs, the costs of transactions in real assets should be calculated by summing identifiable cost items directly associated with a transaction.**

Last but not least, as the ongoing PRIIPs review may also revise the transaction cost methodology, it may be best to await its conclusion to ensure consistency of cost disclosures. This is in line with our suggestion to question 1. If this is not feasible, ESMA’s technical advice must be flexible enough to allow for sufficient consistency between the ELTIF Regulation and the evolving PRIIPs framework.

(3) The costs related to the acquisition of assets

It should be clarified if – in line with Article 25(1) of the ELTIF Regulation and the references included in Article 1(3) of the draft regulatory standards – only the (estimated) costs of buying assets are of relevance in the cost disclosures (i.e. no (estimated) costs of selling the assets). In addition, for the calculation of the acquisition of assets it should also be explained, if the estimation regards all assets of the ELTIF or whether it should be limited to the eligible investments, as those are the “core business” of the ELTIF. If it is not the latter, then ESMA should not be as prescriptive, as more liquid assets could be eligible.

(4) Distribution costs

It should be clarified if distribution costs are only those direct costs deducted from the assets of ELTIF. In other words, it should be clarified if a specific disclosure is required when distribution costs are paid directly by the asset manager.

(5) Overall cost indicator should be based on UCITS

We agree with ESMA’s suggestion to use the UCITS CESR guidelines as a right basis for the ELTIF’s overall cost indicator and concur that the PRIIPs’ reduction-in-yield indicator should not be used.

(6) Not up to ELTIF manager to explain regulatory divergences

We do not agree with the proposal in paragraph 21, as there is no value for ELTIF managers being required to explain the differences between the ELTIF overall cost ratio and the PRIIPs RIY figures. First, due to the investment restrictions placed on ELTIFs, the number of retail investors investing in ELTIFs will be very low. Second, explanation of these differences would, in reality, involve explaining the different regulatory approaches taken between ELTIFs and PRIIPs. Given the more sophisticated nature of these ELTIF retail investors (“semi-professionals”), we doubt whether these explanations will be of added value. This again highlights the necessity of our call for a common approach to cost disclosures and calculations as expressed previously.

3. Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree that the types of cost mentioned in the present paragraph are annual costs that could be expressed as a percentage of the capital?

Management fees, performance fees and other costs (including administrative, regulatory, depositary, custodial, professional and audit costs) are indeed annual costs that can be expressed as a percentage of the fund’s capital. It should be clarified, though, that it is ex-ante cost disclosure and that ex-post costs are disclosed in the ELTIF’s annual report and accounts.
However, the understanding of “other costs” for ELTIFs and other funds investing in real assets is not sufficiently clear. In the context of PRIIPs disclosures, it is still heavily contested among the industry whether (1) operating costs incurred at the level of the asset and (2) interest payments for debt financing shall be considered cost and thus, included in the summary cost indicator. Since real assets are part of the eligible investments by ELTIFs, we believe that the technical standards under the ELTIF Regulation offer an opportunity for ESMA to clarify these issues, possibly by cooperating and interacting with the ESA’s working groups on the PRIIPs review. In this regard, we urge ESMA to take into account the following:

(1) Treatment of operating costs relating real assets

Non-apportionable operating costs of real assets such as incidental expenses (including payments for water and waste disposal, road cleaning, other cleaning services, energy supply, real estate tax and insurance coverage) and maintenance costs (including maintenance work and inspection performance, renovation and repair measures) are incurred by any person holding real estate or other real assets. They are not specific to the management of investment funds nor related to property management or similar services, and thus should not be relevant for the purpose of recurring cost calculation. By way of comparison, costs incurred in the operations of exchange traded companies are clearly not to be taken into account when calculating recurring cost figures for funds investing in equities or having equities as underlyings. Such operating costs have an impact on the market value of the relevant stocks, but are not included in the cost calculations.

In order to ensure comparability of cost information to investors, the same approach should apply to funds investing in real assets. If the basis for cost calculation were different e.g. for equity and real estate funds (by including costs incurred at the level of individual assets in the latter case), this would delude prospective investors and create detriments for ELTIFs at the point of sale.

(2) Interest payments for the debt financing of real assets

Financing costs in relation to real estate or other real assets are inherent to any economically viable investment in these asset classes. They are not specific to the management of investment funds and thus should not be taken into account in the recurring cost calculation. Debt financing of real assets serves the purpose of optimizing the return on equity with a view to enhancing investors’ performance. Recurring interest payments at asset level which are an intrinsic part of this investment strategy should thus not be viewed as a cost.

Moreover, a meaningful cost disclosure should enable investors to determine the costs of managing a specific fund as an extra cost in comparison to direct investments in the relevant assets. If fund management costs were to be mingled together with costs inherent to direct investments e.g. in real estate, investors would not be able to make meaningful comparisons of management cost-efficiency across products. On balance, qualifying regular interest payments on asset financing as costs would undermine the economic purpose of debt financing and be detrimental to the comparability of different investment products under a cost perspective.

4. Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree that the types of cost mentioned in paragraph 24 are fixed costs and that an assumption on the duration of the investment is necessary to calculate these costs in the numerator of the overall ratio mentioned in Article 25(2), provided that this overall ratio is a yearly ratio?

Costs for setting up the ELTIF and its distribution costs are one-off costs for which the “life of the ELTIF” is necessary in order to calculate the Article 25(2) ratio. These should also include carried interests.

4 Draft RTS Article 1(16)
Especially for initiators intending to launch their first ELTIF, it would be reassuring to clarify that the initial calculation of the costs will be based on the business forecast due to the lack of financial statements.

5. Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree that the types of costs mentioned in paragraph 27 may be considered as fixed costs in the case of an ELTIF?

In general, we agree that costs relating to the acquisition of the main assets of the ELTIF portfolio should be considered as one-off costs and therefore be amortised over the life of the ELTIF. Further consideration may be needed for investments into other ELTIFs.

6. Do you agree with the views expressed in paragraph 28 on the presentation formats of the costs in the context of the ELTIF cost disclosure?

We agree that the PRIIPs presentation format cannot be used for ELTIF, as it relies on the RIY methodology, and that the CESR’S UCITS KIID template should be used as a basis. Given the highly individualized nature of ELTIFs, we concur that the presentation format should not be standardized.

In addition, the currently proposed presentation of costs does not yet take into sufficient consideration the different cost levels in case of multiple share/unit classes in an ELTIF. We suggest clarifying that the presentation format may be extended by adding tailor-made columns in case it is intended to issue multiple share/unit classes having different features in an ELTIF.

7. Given that the RTS enter into force after the date of application of the ELTIF Regulation and authorizations have been granted between the date of application of the ELTIF Regulation and the date of application of the proposed RTS, do you see a need for specific transitional/grandfathering provisions for the proposed RTS?

We see a need for specific transitional/grandfathering provisions for the proposed RTS in order to ensure legal certainty for ELTIF managers and investors. The general understanding of ELTIF costs and their calculation rely heavily on the PRIIPs framework. Therefore, the entry into force of the proposed RTS should be aligned with the date of application of the revised PRIIPs standards. This will avoid unnecessary repeated revisions of ELTIF prospectus which could confuse (potential) ELTIF investors.

On the topic of updating prospectus, Article 1(15) of the draft RTS states that “the overall ratio shall be calculated once a year”. This could imply that the prospectus should be updated annually. This requirement, however, is not envisaged by ELTIF Regulation and it makes little sense to update the prospectus once the ELTIF is no longer open to new subscriptions. We would therefore ask ESMA to reconsider this Article 1(15).

8. Do you agree with the above-mentioned reasoning in relation to the possible costs and benefits of the option taken by ESMA as regards common definitions, calculation methodologies and presentation formats of costs of ELTIFs? Which other types of costs or benefits would you consider in this context?

No comments.