

Luxembourg, 28 June 2019

Response to ESMA consultation on draft regulatory standards under Article 25 of the ELTIF Regulation

Introduction

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depository banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

We thank ESMA for the opportunity to participate in this consultation on ELTIF cost disclosures in the fund prospectus.

We support the submission of the European Fund and Asset Management Association (EFAMA).

Response to the consultation

General comments:

Before addressing the specific questions raised by ESMA, we would like to express some general views applicable to the consultation as a whole (rather than to the following individual questions).

As a general approach, we clearly support the attempt to facilitate retail investors' understanding of financial products by harmonising rules around disclosures of information regarding costs and charges. Indeed, we are convinced that seeing comparable disclosure standards in the different disclosure documents may help retail investors in getting a better understanding for investment products generally, and thus to increase their financial literacy and making them feel more comfortable when investing in financial products.

However, as the consultation paper rightly states, the PRIIPs framework has revealed to be problematic in several ways. For various reasons that are currently being analysed, the PRIIPs framework has failed to achieve its objective to provide retail investors with a practicable, understandable document that adequately reflects the features of the underlying product. This failure applies also and in particular to the PRIIPs cost disclosures. The financial industry has raised concerns in relation to the PRIIPs Regulation and its RTS, and the original timeline for the PRIIPs review had to be rescheduled, among other things, for this reason.

We are of the view that it should be avoided to repeat known errors by expanding the PRIIPs cost disclosures to the prospectuses of ELTIFs. Therefore, we strongly advocate to wait for the outcome of the PRIIPs RTS revision before addressing the cost disclosure and calculation rules applicable to ELTIFs.

Furthermore, the currently proposed rules for ELTIFs will have as a consequence that retail investors would be provided with different disclosures / documents (prospectus, KID and periodic reports) indicating different costs because of different factors of calculation. We fear that instead of rendering the ELTIF more transparent, this may create considerable confusion and effect the credibility and attractiveness of the ELTIF for investors.

Q1 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?

Answer:

As a starting point, we do agree that the abovementioned pieces of legislation and regulatory material may serve as a source of inspiration for the purpose of the RTS on Article 25(3) of the ELTIF Regulation. We would however like to stress that regulatory guidelines on the UCITS KIID are tailored to the needs of an investment product in liquid assets only, with a normally daily trading and easily available market prices. In contrary to UCITS, ELTIFs are by definition investment funds aimed at illiquid investments attracting patient capital where investors cannot step out and where the valuation may vary considerably over time. The investment activity, trading behaviour and cost structures in an ELTIF differ very substantially from those of a UCITS. Therefore, we believe that the UCITS KIID is of limited help to define an adequate cost disclosure framework for ELTIFs.

RTS under PRIIPs represent a compromise because they are meant to cover all kinds of packaged retail and insurance-based investment products including illiquid / private market products. However, as we outlined in our general comments above, the cost disclosures and calculation rules under the PRIIPs Regulation and related RTS turned out to be imperfect in practice, in particular with respect to the calculation of transaction costs. Therefore, we think it is absolutely crucial that ESMA waits for the PRIIPs review to be completed before adopting RTS on ELTIF cost disclosures. It makes little sense and does not increase the stability and credibility of the product ELTIF to adopt now the PRIIPs rules as they stand for the ELTIF prospectus, and to change them again where needed shortly after adoption.

Finally, for the sake of clarity for investors who receive in addition to the prospectus a PRIIPs KID as well as information on the costs of a product as required by the MiFID, we recommend that ESMA considers the whole range of documentation / calculation rules to ensure a consistent approach.

Q2 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 PRIIPs level 2 framework on cost disclosure with the level 1 framework on cost disclosure under the ELTIF Regulation (or the other way round)?

Answer:

See answer to question 1. We generally see merit in aligning the level 1 framework on cost disclosure under the ELTIF Regulation with the PRIIPs level 2 framework on cost disclosure, however we believe that the errors committed in the current PRIIPs framework should not be repeated and hence it would be advisable to wait for the outcome of the current PRIIPs review before imposing the same standards for ELTIF prospectuses.

We disagree with the proposal included in paragraph 21. We would like to remind that each retail investor investing in an ELTIF receives as well a PRIIPs KID. Therefore, we see no need to also include the RIY in the prospectus. Also, the divergence mentioned in the consultation paper would in our view lead to investor confusion.

Q3 Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree that the types of costs mentioned in the present paragraph are annual costs that could be expressed as a percentage of the capital?

Answer:

We agree that the fees mentioned in b) are annual costs that can be disclosed on an annual basis.

However, as regards a), we disagree with the approach, for several reasons:

- Management fees and performance fees are usually not incurred at the same level each year during the lifetime of an ELTIF. Management agreements often provide that fees are calculated on total commitments during the investment period, and on NAV during the remainder of the lifetime. It would be confusing for investors to explain this switch with relating fee levels while at the same time inserting cost disclosures on an annualised average basis which deviates from the management agreement and which does not properly reflect the basis for calculation. Retail investors (more than professional investors) should receive understandable information; the abovementioned distinction would be very difficult to understand, and it would not be easy to explain it to them.
- Secondly, performance-related remuneration is often expressed by way of a waterfall / carry. Already, a carry / promote that is structured as a dividend should not be regarded as a cost / remuneration, because it is not structured as a fee. Furthermore, and independently from the structuring as fee or dividend, a carry is generally not incurred every year and depends on the (non-)performance of the assets. It seems almost impossible to anticipate the likely annualised average amount of carry over the entire lifetime of an ELTIF. Even where a carry is granted, clawback clauses would typically retroactively reduce the carry. From a retail investor perspective it is already difficult to understand a carry model when it is well explained, however, this becomes almost impossible if one wishes to explain this with an average annualised carry figure.
- Finally, just to be complete, there are different waterfall models and carry models, which from a retail investor literacy angle make annual average calculations and cost disclosures even more complex and unverifiable.
- Providing annual average performance fee figures will in our view result in a situation where an

investor which tries to track the information received in the ELTIF prospectus will be unable to find the corresponding figures in the annual report which; this will make the product appear non-transparent, contrary to the intention pursued.

Another strong concern we have is that the proposed text calculates the costs based on “capital” as defined in the ELTIF Regulation. By definition the amount of “capital” cannot be foreseen at the time when the prospectus is drafted, i.e. before the first closing. Unlike in a professional investor environment *retail* capital raising is highly uncertain and can take a considerable amount of time – from experience with retail ELTIFs months or even up to years. Therefore, the capital (i.e. the sum of drawn and undrawn commitments) is not a reliable basis for a realistic and transparent cost disclosure.

In this context, we strongly disagree with the proposed article 1 (18) of the RTS suggesting that as long as the capital is not known, calculations should be made on the basis of the defined minimum volume of an ELTIF. Taking as a reference the lowest conceivable volume below which an ELTIF is not viable does in our view not result in realistic cost calculations – but it will instead be misleading and render the ELTIF unattractive for investors. Indeed, certain costs factors are fixed or have a minimum charge rate which, when calculated based on the lowest viable basis, will result in unrealistically high cost factors. It should in our view not be the purpose of a disclosure requirement to reflect the worst case scenario (of an ELTIF being hardly viable), but a realistic / likely one.

Q4 Taking into account the new cost disclosure framework introduced by the PRIIPs Regulation, do you agree that the types of costs 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?

Answer:

We agree that establishment costs are one-off. However, we disagree with the qualification of distribution costs as one-off costs. Indeed, in certain scenarios – and this is the case very frequently in a retail set-up – distribution costs are incurred on an ongoing basis. The reason is that the role of a distribution agent in such retail products often involves not only marketing / placement costs in the traditional sense, where we could agree that these costs are often one-off / fixed. In practice, however, distribution agents acting for retail products often include ongoing client relationship costs, such as serving as a point of contact for questions, e.g. on regular investment reports or annual reports, information about the NAV, on subscription and redemption possibilities etc. In the specific environment of the ELTIF, the ELTIF Regulation explicitly requires that for retail investors local facilities be established where investors can obtain information, documents, etc. Distributors often act as both distributor and local facility in a given distribution country, thereby providing an ongoing service to the ELTIF and the retail investors. Therefore, we disagree that distribution costs are considered as one-off costs.

Q5 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?

Answer:

No, we believe that this should be consistent with the PRIIPs approach and we would welcome further refinement of the PRIIPs cost calculations, for example, for closed-ended funds the possibility to amortise transaction costs for illiquid investments over the expected life of the product.

As stated above we consider the qualification as particularly problematic in a retail environment where certain costs such as transaction / acquisition costs will not be annually incurred, however, an average annual cost factor will nonetheless be calculated. For such costs, retail investors will be given a cost figure in the Private Placement Memorandum which will never appear in the same manner in any annual report. We fear that the average annualised cost disclosure in the offering memorandum of ELTIFs will lead to more confusion than transparency.

As per our general comment at the beginning, we strongly believe the issues that were discovered in the PRIIPs framework should be addressed first, before any ultimate conclusions are drawn or legislation is adopted for the ELTIF prospectus.

Q6 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?

Answer:

ALFI understands that the proposal by ESMA is not to require / impose the identical format as used in the PRIIPs KID for the ELTIF full prospectus. We understand that the proposal is to allow a certain flexibility in the format / length / details of the disclosures in the prospectus compared to the KID since these two documents do not have the same purpose and are not subject to the same constraints (notably the length of the KID).

ALFI welcomes this approach. Indeed, retail investors investing in an ELTIF always also receive a KID, which will allow investors to easily compare products. At the same time, as the prospectus may use a more descriptive format, they will receive a potentially more detailed cost disclosure in the prospectus, which may include additional explanations, possibly examples, and generally more tailored information.

This flexible approach should also be considered for AIFs investing in private assets and presenting characteristics similar to ELTIFs.

Q7 Given that the RTS enter into force after the date of application of the ELTIF Regulation and authorisations 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?

Answer:

ALFI definitely supports the proposal to foresee grandfathering provisions for existing ELTIFs.

For ELTIFs that are still in the fund raising process there should be a reasonable timeframe allowing them to consider and adapt to the new disclosure requirements.

We believe that an indefinite grandfathering should be granted for ELTIFs which are closed for new subscriptions and are not marketed anymore. Indeed, such ELTIFs will likely not update their prospectuses anymore, because no new investors will enter into these funds. We cannot see the need for these products to incur considerable fees by amending their prospectuses with new cost disclosures, where all investors receive annual and possibly quarterly or semi-annual reporting indicating the actually incurred costs.

Q8 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?

Answer:

For the introduction of PRIIPs, the ESAs estimated a one-off costs figure of EUR 171 million for non-UCITS PRIIPs, and ongoing costs of around EUR 14 million per year. If ESMA decides to diverge from PRIIPs, it can expect a similar cost. This cost would be borne by ELTIF investors. Therefore, we strongly advocate use of the evolving PRIIPs approach.

ALFI strongly advocates to wait until the PRIIPs framework is adapted, and only then to continue the work on the ELTIF cost disclosure.