European Securities and Markets Authority

Final Report

Draft regulatory technical standards under Article 25 of the ELTIF Regulation

10 December 2019 | ESMA34-46-91

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1 Executive Summary

Reasons for publication

Article 25(3) of Regulation (EU) 2015/760 ("ELTIF Regulation") provides that ESMA shall develop draft regulatory technical standards (RTS) to determine the costs disclosure requirements applicable to ELTIF managers.

On 28 March 2019, ESMA published a Consultation Paper (CP)[1] on draft regulatory technical standards under Article 25 of the ELTIF Regulation to gather input from stakeholders[2].

The consultation closed on 29 June 2019.

This final report provides an overview of the feedback received though the responses to the CP and details the next steps of ESMA's work with respect to the way ESMA intends to achieve its mandate.

This final report does not contain the final proposal of ESMA for the draft RTS to determine the costs disclosure requirements applicable to ELTIF managers because these RTS depend to a large extent on the cost section of the PRIIPs KID, which is currently being revised in the context of the review of the PRIIPs level 2 (PRIIPs Delegated Regulation 2017/653)[3].

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Section 2 is an introductory section providing background information regarding ESMA's mandate and the elements that were taken into consideration in ESMA's decision to postpone the publication of the draft RTS under Article 25 of the ELTIF Regulation.

Section 3 provides the Feedback Statement for the aforementioned consultation which closed on 29 June 2019.

Next Steps

Based on the outcome of the review of the abovementioned requirements on cost disclosure of the PRIIPs KID included in the PRIIPs Delegated Act (Commission Delegated Regulation (EU) 2017/653), ESMA will assess the most appropriate way to finalize the draft RTS under Article 25 of the ELTIF Regulation and will in particular assess the need for another round of consultation on revised proposals on these RTS that would be based on these revised PRIIPs RTS.

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[1] *https://www.esma.europa.eu/sites/default/files/library/esma-34-46-89_-_cpcost_on_eltif_rts_3.pdf*

[2] *This consultation followed a first consultation paper published on 30 July 2015 on the same topic: https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1239.pdf*

[3] *https://www.esma.europa.eu/sites/default/files/library/jc-2019-63_consultation_paper_amendments_priips_kid.pdf*

2 Introduction

1. In accordance with Article 25(3) of the ELTIF Regulation, ESMA shall develop draft RTS to determine the costs disclosure requirements applicable to ELTIF managers. The ELTIF Regulation also specifies that "*When developing these draft regulatory technical standards, ESMA shall take into account the regulatory technical standards referred to in points (a) and (c) of Article 8(5) of Regulation (EU) No 1286/2014)*", acknowledging the fact that it was necessary to wait for the finalization of the PRIIPs RTS before the work to develop these RTS could be carried on.

2. The corresponding PRIIPs Delegated Regulation[4] was published in the Official Journal of the EU dated 12 April 2017 and was expected to be revised by the end of 2019, as indicated in the February final report following a Joint Committee consultation paper concerning amendments to the PRIIPs KID[5]. Following discussions with the European Commission regarding the possibility to test proposals on consumers and the timing of such an exercise, as well as regarding the timing of potential legislative proposals to address the requirements that would apply to UCITS from 1 January 2022 onwards[6], the ESAs now intend to submit their final proposals of revised PRIIPs RTS to the European Commission around the end of the first quarter of 2020. These would then be subject to the endorsement by the European Commission, following which the European Parliament and Council would be given the opportunity to express any objections to the amending regulatory technical standards as adopted by the European Commission.

3. The new regulatory framework put in place in the context of the PRIIPs Regulation includes revised cost disclosure requirements. The review of the rules associated with Article 5 of the PRIIPs Delegated Regulation aims to address the methodology to identify and calculate the costs of PRIIPs and how these should be presented in the section of the KID 'What are the costs?'. The ESAs may propose potential significant

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[4] *Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents.* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0653&from=EN

[5] https://eiopa.europa.eu/Publications/Reports/2019-02-08%20Final_Report_PRIIPs_KID_targeted_amendments%20%28JC%202019%206.2%29.pdf

[6] *In the context of the finalization of the Cross-Border distribution of collective investment funds Regulation, co-legislators have indeed decided to extend the period during which UCITS funds benefit from an exemption to produce a PRIIPs KID until 31 December 2021, and this was reflected in the corresponding amendment to the PRIIPs Regulation, as explained in the above statement by the European Parliament:* http://www.europarl.europa.eu/RegData/etudes/ATAG/2019/629832/IPOL_ATA(2019)629832_EN.pdf

amendments to the Cost Tables currently included in the PRIIPs KID. This includes aiming to improve the compatibility with MiFID II disclosure requirements as well as possibly requiring more specific details or descriptions of the main cost types to be disclosed, and modifying the nature of the cost indicator to be used to aggregate costs. While the cost indicator that is currently used in the PRIIPs RTS is a RIY (reduction in yield), it is envisaged in the context of the review of the PRIIPs level 2 to replace in certain cases and for certain types of costs this RIY with other types of cost indicators and/or with absolute costs figures expressed in EUR (and not in %).

4. In order to best meet the requirements of Article 25(3) of the ELTIF Regulation, that explicitly requires to take into account the cost section of the PRIIPs RTS when developing these ELTIF RTS, and in order to ensure consistency between the different EU regulatory frameworks and avoid a possible repeated sequencing of changes within the ELTIF framework, ESMA is of the view that it is needed to wait for the final outcome of the Joint Committee’s work on the amendments to the PRIIPs KID before finalizing the draft RTS under Article 25 of the ELTIF Regulation.

5. Based on the outcome of the review of the abovementioned requirements on cost disclosure of the PRIIPs KID included in the PRIIPs Delegated Act, ESMA will assess the most appropriate way to finalize the draft RTS under Article 25(3) of the ELTIF Regulation and will in particular assess the need for another round of consultation on revised proposals that would be based on these revised PRIIPs RTS.

3 Feedback on the consultation

1. ESMA received 9 responses to the consultation paper (CP) on ESMA's draft RTS under Article 25(3) of the ELTIF Regulation. The respondents were asset managers and asset manager associations.

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?

2. Respondents unanimously agreed that the abovementioned pieces of legislation and regulatory material are relevant for the purpose of these RTS. Two respondents were of the view that the MiFID II ex-ante and ex-post cost disclosures and AIFMD investor disclosures would also be of relevance for that purpose.

3. Several respondents stressed that the investment activity, trading behaviour and cost structures in an ELTIF differ very substantially from the those of a UCITS since ELTIFs are per se funds aimed at illiquid investments, attracting patient capital where investors cannot step out and where the valuation may vary considerably over time. Those respondents supported that the UCITS KIID should be of limited help to define an adequate cost disclosure framework for ELTIFs.

4. A few respondents invited ESMA to wait for PRIIPs review to be completed before moving further with these RTS. Not doing so would entail the risk of having to revise the implementing rules shortly after their adoption.

5. Finally, respondents highlighted the need to ensure consistency between the whole range of documentation and calculation rules.

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)?

6. Most respondents agreed with the abovementioned assumptions and with ESMA’s overall approach. These respondents supported the alignment in principle in the understanding of relevant cost elements with PRIIPs framework. Nonetheless, several concerns were expressed in the responses.

7. Firstly, they deemed the methodology for calculating transaction costs inappropriate and unsuitable. In this regard, respondents explained that their key concern was the PRIIPS "arrival price" methodology which systematically leads to erroneous and misleading transaction costs – especially for real assets. Several respondents suggested that 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. Here again, respondents urged ESMA to wait for PRIIPs review since the transaction cost methodology might be revised.

8. Secondly, one respondent argued that there is no reference to carried interest in the Article 25 of the ELTIF Regulation and that therefore, it should not be included within the cost section. According to this respondent, referring to carried interest as a cost would have counter-productive effects but if ESMA was to do so, it should at least carefully ensure that carried interest's specific features are acknowledged and addressed in order to ensure that investors do not get a distorted picture of the costs that they will face.

9. In addition to that, almost all respondents expressly disagreed with the proposal included in paragraph 21is a right basis for the ELTIF's overall cost indicator.

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?

10. Whilst several respondents agreed that the types of cost mentioned are annual costs that could be expressed as a percentage of capital, a significant amount of concerns were expressed in relation to the new cost disclosure framework.

11. Only two respondents expressly disagreed with the inclusion of management and performance fees as such. From their perspective, these fees are usually not incurred at the same level each year during the ELTIF lifetime. It would be confusing for investors to implement cost disclosures on an annualised average basis which deviates from the management agreement and which does not properly reflect the basis for calculation. Secondly, with regards to performance fees, respondents pointed out again that carried interest should not be calculated on annual basis and as a percentage of capital. According to them, calculating carried interest as such would not give to the investors an appropriate overview of what the actual cost of investing in an ELTIF is.

12. Three respondents noted that the understanding of "other costs" for ELTIFs and for other funds investing in real assets was not clear at all. In this context, they invited ESMA to seize the opportunity offered by these RTS to clarify:

a. The treatment of operating costs relating to real assets. According to these respondents, these costs are not specific to the management of investment funds and thus should not be relevant to the purpose of recurring cost calculation.

b. Interest payments for debt financing of real assets are an intrinsic part of this investment strategy and should therefore not be seen as a cost.

13. One respondent also strongly opposed the inclusion of “professional service costs”. It was of the view that term is unclear and the inclusion of such costs would be irrelevant to ELTIFS.

14. Finally, another concern was expressed regarding the use of “capital” as a basis to compute the costs. A respondent noted that by definition, the amount of capital cannot be foreseen at the time when the prospectus is drafted. It would not be a reliable basis for a realistic and transparent cost disclosure. This respondent also disagreed with the proposed article 1 (18) of the RTS stating that as long as the capital is not known calculations should be made on the basis of the defined minimum volume of an ELTIF.

Q4: 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?

15. A vast majority of respondents agreed that both the costs of setting up the ELTIF and distribution costs 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. While sharing other respondents’ view on the costs of setting up an ELTIF, one respondent was of the view that distribution costs cannot be qualified as one-off costs since in certain (frequent) scenarios, these costs are incurred on an ongoing basis.

16. Two respondents also invited ESMA to clarify that the initial calculation of the costs will be based on the business forecast due to the lack of financial statements. One respondent also suggested adding some flexibility in relation to umbrella ELTIF structures where a portion of the setting up costs might be spread over multiple sub-funds. In such a scenario, these costs might be subject to change over the life of the relevant fund.

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?

17. Most respondents agreed 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. Still, among those who agreed, three respondents specified that further consideration may be needed for investments into other ELTIFs.

18. Only two respondents firmly disagreed that the types of costs mentioned in paragraph 27 could be considered fixed costs in the case of an ELTIF. One of them was of the view that the qualification is particularly problematic in a retail environment where certain costs such as transaction/acquisition costs will not be annually incurred. The other respondent noted that ELTIFs, like private equity funds, have significant transaction costs as part of their nature and it should be reflected as such.

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?

19. The respondents almost unanimously supported ESMA's approach and agreed that the PRIIPs presentation format cannot be used for ELTIF as it relies on the RIY methodology, and that the CESR's UCITS KID template should be used as a basis instead. Most respondents shared ESMA's view that given the highly individualised nature of ELTIF, the presentation should not be further standardised in the RTS. They saw merit in adopting a flexible approach.

20. However, two respondents noted that the currently proposed presentation of costs does not take into sufficient consideration the different cost levels in case of multiple share classes in an ELTIF. They invited ESMA to clarify that the presentation format may be extended by adding tailor-made columns in case it is intended to issue multiple share classes having different features in an ELTIF.

21. One respondent, who was of the view that the CESR's template for the KID is a good basis, noted that it however fails to take into account models that are used beyond the UCITS world (e.g. private equity carried interest model).

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?

22. The respondents unanimously saw a need for specific transitional/grandfathering provisions for the proposed RTS. They deemed necessary to ensure legal certainty for ELTIF managers and investors.

23. Since the cost elements and their calculation are supposed to rely to a great extent on PRIIPs standards, a significant number of respondents invited ESMA to align the entry

into force date of the RTS with the date of application of the revised PRIIPs standards in order to avoid unnecessary consecutive modifications of ELTIF prospectuses and confusions among potential ELTIF investors.

24. Regarding the update of the prospectus, two respondents invited ESMA to reconsider the Art. 1 (15) of the draft RTS. This article states that "the overall ratio shall be calculated once a year" and implies that the prospectus needs to be updated annually. But according to these respondents, such a requirement is not envisaged by ELTIF Regulation.

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?

25. Respondents generally supported a greater harmonization in relation to the ELTIF cost disclosures and agree that it is a good practice for ESMA to have regard to a variety of cost-based legislative and regulatory material in creating RTS.

26. One respondent pointed out that the proposed clarifications would significantly enhance comparability of cost disclosures and would have a positive effect on the general quality of cost information under PRIIPs and MiFID II.

27. Another respondent warned ESMA against the risk that any divergence from the PRIIPs framework would entail. Indeed, this respondent noted that if ESMA was to diverge from PRIIPs, the cost to be borne by ELTIF investors would be similar to the one implied by the introduction of PRIIPs (one-off costs of EUR 171M and ongoing costs of EUR 14M, according to ESAs' estimate).