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Ten Things You Should Know About the Democratisation of Private Assets

OPPORTUNITY

1 Why democratise now?

Interest in private assets (including private equity, real estate, infrastructure, private credit and other unlisted/illiquid assets) is not new.

In the aftermath of the 2008 global financial crisis, investors seeking diversification and enhanced returns looked to increase their allocation to private assets. That demand has continued to grow, right through to the present day - according to Preqin, assets under management in "alternative assets" reached $10.3 trillion in 2019 among institutional investors globally and were forecast to hit $14tn by mid-2023.

This growth has, though, been concentrated in the hands of a relatively narrow - albeit extremely financially significant - group of investors, the traditional "institutional" cohort. For other investors and especially, retail investors (whether directly or indirectly through their defined contribution pensions schemes), there are significant barriers to entry into the world of private assets. Importantly, exposure to private assets is limited by regulation which has sought to "protect" investors from the complexity and (in particular) illiquidity often involved with private assets. Similarly, fund of fund and pension fund investors considering investing in private assets have also found limited options as a result of "permitted links" and other investment rules.

More recently, however, the UK government has taken a greater interest in seeking to widen access to private assets. This is driven partly by industry demand, but also as part of the UK government's drive to find additional capital for nationally-significant assets – for example infrastructure and SME finance - from the private sector. This new capital will supplement or supplant (at least in part) reliance on the public sector finances.

This trend is not restricted to the UK but is part of something global. We have seen the EU try to increase investment in infrastructure and other "long term" assets with the introduction (and recent suggested reform) of the European Long-Term Investment Fund (**ELTIF**) regime. There have also been significant developments in the US and Italy. Most recently, of course, the COVID-19 pandemic and its enormous economic impact have again re-focussed minds on the need to boost public sector stimulus with prudent private sector participation.

Whilst widening access to private assets has certainly been gaining momentum globally, there have been several events which have seemingly confirmed regulators' fears over recent years. In particular, liquidity issues have been in the spotlight, with retail investment funds caught up in the market turmoil around the Brexit referendum and COVID-19, leading to a number of property funds being suspended. In addition, in the UK, the collapse of Woodford's Equity Income Fund (**WEIF**) has raised concerns about the ability of investment funds to provide access to private assets whilst offering daily dealing.

Although these high-profile issues have undoubtedly added to regulators' concerns - already at high sensitivity – around illiquidity and its risks for retail and so caused some delay to the push for wider access to private assets, the need for new sources of investment capital remains unarguable. In particular, the

	likely need for enhanced stimulus spending on infrastructure and other projects to aid the post-COVID recovery will lead to a renewed focus on this area.
2	**Where is the demand for democratisation?** Increased demand for access to private assets is coming from a range of sources. First, pension funds are facing reduced investment returns at the time of increased life expectancy, placing strain on the pension fund system. In the face of this problem, pension funds have started to invest in long-term assets and to move away from their previous reliance on stocks and bonds. The government has also recognised in recent years that pension funds need the ability to invest in long-term assets and has encouraged investment by pension funds in that direction. Pension fund managers, however, need to be given a range of alternative ways to invest in long-term assets, in order to provide greater incentive to rebalance their portfolios. In addition, those investors holding their pension portfolios in self-invested personal pensions (**SIPPs**) are also seeking higher returns. The fund management industry's proposals in relation to the Long-Term Asset Fund and Professional Investor Fund (see Section 8 below) are specifically envisaged to assist personal pensions to invest in long-term assets. Second, as with pension funds, retail investors (and, in particular, HNW and "mass affluent") also face a difficult search for returns in what is a consistent low interest rate environment. Whilst their personal time-horizons may render some private asset sub-classes unsuitable, it is thought highly likely that there will be demand from at least some of the retail sector for direct access to funds giving sensible commingled exposure to longer-term assets that offer higher returns than traditional long-term savings products, assuming this can be done without an unacceptable increase in risk. Similarly, but perhaps for less sophisticated/wealthy or more risk-averse investors, it is anticipated that there will be demand for private assets funds-of-funds. By spreading risk across multiple funds creating a more diversified portfolio (and assuming management costs can be kept to a reasonable level) demand from another cohort of investors could be served. As well as these direct sources of demand, another important driver of democratisation is government pressure to bring additional private capital to bear to promote economic growth, as well as to enhance public infrastructure. In the UK, government and regulators have been looking to increase access to long-term assets for some time. HM Treasury's Patient Capital Review was announced by the then Prime Minister, Theresa May, in November 2016 and identified barriers to access to long-term finance for growing firms. The terms of reference for that the review were to: o consider the availability of long-term finance for growing innovative firms looking to scale up, o identify root causes affecting the availability of long-term finance for growing innovative firms, including barriers that investors may face in providing long-term finance, o review international best practices to inform recommendations for the UK market to consider the role of market practice and market norms in facilitating investment in long-term finance, and o assess what changes in government policy, if any, are needed to support the expansion of long-term capital for growing innovative firms. The review identified that "retail" appetite for patient capital is being stifled by regulation. While the Patient Capital Review has already resulted in several significant developments (such as the launch of British Patient Capital as a "patient capital investment vehicle" for the UK – a project with which we were proud to be involved), other changes which could drive genuine democratisation have been slower to come forward. Nevertheless, the FCA has been supportive of industry initiatives which may assist in delivering

	the aims of the Patient Capital Review, and changes are expected in the next few years to widen access to long-term assets.
PROBLEM	
3	**The Problem of Liquidity Mismatch.** One of the core difficulties perceived by regulators in allowing broader access to private assets is the "liquidity mismatch" between those assets and the perceived requirements of the non-institutional investing universe. Institutional investors are perceived to have (and often do manifest) long-term time horizons. They are certainly well able to invest for the longer term. On the other hand, retail investors are seen (seemingly of necessity and without much in the way of differentiation between different classes of "retail" investor) to work to shorter horizons, requiring the ability to redeem investments at short notice (often daily – see Section 4, "The Cult of Daily Liquidity" below). This desire for ready liquidity does not fit well with private or long-term assets which (as the name suggests) take much longer to sell (in order to fund redemption requests). This so-called "liquidity mismatch" has received a great deal of attention in the context of daily dealing funds that hold a small proportion of their portfolios in illiquid assets, with Mark Carney, the former Governor of the Bank of England, famously referring to such funds as being "built on a lie". Long-term assets are inherently illiquid because (i) they are typically not traded on an organised market; (ii) there is no usually market maker or centralised system for price discovery; (iii) it is difficult for buyers to identify sellers due to the imbalance between supply and demand; (iv) they are complex to value and require transactional information and modelling; and/or (v) they can be physical assets which are bought and sold in their entirety, such as property or infrastructure. Due to these factors, fund managers are unable to buy, sell or value such assets quickly to meet short- (or indeed long-) notice redemption requests. If we accept that broader, "democratic" categories of investors require liquidity, then this mismatch represents a very significant problem. It is simply not possible, for instance, for a real estate asset to be liquidated rapidly – at least, not without destroying value. A manager could of course hold cash against demands for investor liquidity but that is destructive of returns and also self-defeating – investors are seeking access to private assets, not to significant cash holdings. Accordingly, investors seeking access to private assets may have to give up daily dealing. This has been perceived as a barrier, as some non-institutional, and especially retail, investors tend to have strong preferences for the perceived simplicity of daily dealing funds. However, it would be a mistake to regard the non-institutional investor universe as monolithic – there are certainly investors for whom illiquidity holds no fear. Likewise, the private assets world is broad and while many of the assets are "long term" to at least some degree, many are no longer-term than some fixed term savings products. Finally, *primary* liquidity (by redemption) is not the only solution for investors who do require liquidity (though other types of liquidity often come with a cost). Given this diverse universe of investors, investments and structures, and in the context of a long-term diminution in returns from more liquid assets, it must be possible to develop a range of products which offer appropriate exposure to appropriate investors. The challenge is in terms of investor and, crucially, regulatory perception. Can regulators embrace this opportunity and make the rule changes necessary to permit those solutions to flourish?

4	**The Cult of Daily Liquidity** The retail investment environment in the UK (and elsewhere) is built on the presumption of long-term investing. The notion that "buy and hold" is preferable to trying to second guess the ups and downs of the stock market (and to incur costs in doing so). Conversely, though, (at least in the UK market) there has been a historic reliance on intermediaries such as IFAs and private wealth platforms who typically advise their clients into the most liquid, often daily-dealing, products in the expectation that this will enable them to sell out (or re-allocate between funds) easily, presumably when the market (or performance) turns. Similarly, even with the rise of fund supermarkets and other platform models where no advice is offered, it seems (anecdotally) to be the case that funds which deal less frequently find it difficult to get air-time on those platforms which usually default to a daily-dealing model. As a result, supermarkets and platforms seem to both meet and to feed a demand for immediate liquidity. Given that it is often preferable to "ride out" periodic blips in performance and take a long-term view, this focus on liquidity - at the expense of broader access to illiquid asset types – seems odd. The ability to exit all assets immediately may well not be the right approach for a retail client taking a five- or ten-year view of their investments (or longer for retirement provision) – or, at least, not for the entirety of their portfolio. This oddity can be seen as the "cult" of daily liquidity. Managers and product designers are arguably caught in a "feedback loop" – incentivised to design funds to meet a demand that is, to some extent, artificial, created not by the end investor but by the intermediary chain or the dealing platforms that drive the industry operationally. There is a strong argument that the UK retail investment market has an unhealthy reliance on daily-dealing products, fed not by objective analysis but rather by habit and advice focussed on too narrow an approach (driven of course by a lack of a greater diversity of available products for advisers to choose). This is, then, to some extent a "chicken and egg" problem. Until advisers and supermarkets/platforms have access to alternative products, they will not be able to present those to investors and so generate demand – but until there is demand (and, crucially, regulatory freedom to create these products) there is nothing for investors to buy. This will not change over-night, of course, but the "cult" can perhaps start to be addressed in (at least) two ways. First, it would be beneficial to broaden the horizons of the investor base to create demand for suitable, longer-term investment products aligned to match retail investor time horizons (a mismatch of its own!) This applies to both end investors and to the intermediary chain and platform community, whose "one-size fits all" approach is, arguably, not best suited to the (actual, rather than perceived) requirements of their clients. Second, and perhaps of paramount importance, is that regulators should adjust their rules, carefully and with clear regard to suitability, to create space away from the "cult" to allow the development of products with much greater flexibility around liquidity. In its recent Call for Input: "The Consumer Investments Market", the FCA has taken forward one of its key priorities for the next one to three years from its Business Plan 2020/21 – that of "Enabling effective consumer investment decisions". Not surprisingly, perhaps, the FCA's focus is on the "overwhelming majority of retail investors" who are (in its view) "best served by readily-understood, well-diversified and low-cost investments" and on those who do not seek investment advice because it is too costly and for whom a form of simplified guidance may be appropriate.

	The Call for Input does not, however, address the possible need for retail access to longer-term products where, with appropriate advice, this would align with the investment horizon of the investor. Despite having a section on "Making the mass market work well", the Call for Input does not address the dominance of daily-dealing funds in the retail intermediary market. Equally, while it has a section on "higher risk investments" and "choice for those who can afford loss" the Call for Input focuses on speculative illiquid investments such as "mini-bonds" (suggesting a way forward which might include better information on the risks involved in such investments in "prospectus-like" disclosure). You could argue that, instead of focussing on the more speculative end of the market, allowing broader access to non-speculative (and, indeed, relatively low risk, compared with many liquid products) less liquid investment products might be a prudent extension of the consumer investment market. The Call for Input does, however, ask "Have we prioritised the right issues and questions? Are there other things you think we should be looking at?" The FCA is asking for feedback by **15 December 2020**.
5	**Woodford - a case study in illiquidity?** A name that crops up repeatedly in the FCA's work on liquidity mismatches is that of Neil Woodford. Mr Woodford needs little introduction - a 'star' equity fund manager with a reputation earning him a place on the panel of industry experts for HM Treasury's Patient Capital Review in 2017. Mr Woodford ran the LF Woodford Equity Income Fund (**WEIF**) which, as a UCITS scheme, could be marketed to retail investors and which was daily dealing. Crucially, though, WEIF had a history of investing in less liquid assets, including unlisted holdings within the so-called "trash bucket" of 10% of the portfolio which is permitted to be invested in "unapproved securities". A period of success was followed by prolonged underperformance, including a 24% loss in the two years from June 2017 to June 2019. Despite high outflows from the fund in May 2019 (an average of £9m a day), WEIF played down fears about its liquidity. In the end, though, a request by Kent County Council to redeem its entire investment of £260m proved the final straw – WEIF simply did not have (and could not easily obtain) cash to meet its redemption obligations. On 3 June 2019, it suspended dealing and in October 2019, Link Fund Solutions, the WEIF's ACD, determined that it was in the best interest of investors that the fund should be liquidated. This saga unsurprisingly caused alarm bells to ring at the FCA (and, indeed, across the wider investment world). Put simply, this sort of collapse should not happen with UCITS. In the FCA's view, the WEIF saga was evidence of some important problems. Specifically, that: o liquidity considerations are not confined to open-ended funds with exposure to property or other immovables but can affect UCITS where these have holdings of less liquid assets. o many retail investors simply were not aware of (or did not fully appreciate) the liquidity risk to which they were exposed and the impact this could have if they wanted to withdraw from the fund. o a single large investor seeking to redeem a large investment in an open-ended fund can have significant consequences for both that investor and other investors remaining in the fund. o the investment limitations under the UCITS rules (that are intended to place limits on investment in less liquid assets) may not be as effective as they could be. It would be wrong to claim either that WEIF triggered the FCA's recent scrutiny of liquidity mismatches and long-term investment by open-ended funds (its initial discussion paper came out in January 2017, a good two years before the problems with the WEIF became apparent) or that it has been the regulator's only cause for concern in this area. As the FCA points out in CP20/15, both the 2008 financial crisis and the EU referendum result in 2016 caused several property funds to temporarily suspend dealing. More

recently, it explains "*almost all UK authorised funds that invest in property have suspended dealings because of valuation uncertainty in the light of the uncertain economic impact of the current coronavirus pandemic*".

The Woodford saga is often used as an example of why illiquidity is "bad" – at least for the retail sector for whom UCITS are meant to be "safe". UCITS investors should have the confidence that they will be able to redeem their investment without problem. However, WEIF is unusual and not a case study in the perils of liquidity *per se*.

Rather, WEIF highlights issues with investor education, adviser diligence, "celebrity" managers and – arguably – complacency. It was assumed that UCITS status conferred protection on the retail investor and reliance was placed on that "brand" rather than on proper scrutiny of what was happening with the fund as its portfolio composition moved. Although the FCA's work to date has tended to concentrate on other fund types – especially NURS – there are clearly lessons to be learned in the context of UCITS.

On that basis, with Woodford being an example of how illiquidity *can* cause issues where other factors pertain, the door remains open for greater diversity in the retail sector. The travails of the WEIF investors are not a good argument against properly described, sensibly constituted and appropriately targeted longer term, illiquid investment products allowing access to private assets. Indeed, such access can clearly be beneficial to investors who are otherwise offered a limited product range, always featuring liquidity but possibly at a higher cost.

The key issue remaining, then, is how to grant the right access to the right investors – how to square the circle of allowing retail investors access to private assets but with adequate protections?

SOLUTIONS?

6 The market approach: A switch to secondary liquidity?

As we have seen, one of the main concerns in broadening out access to illiquid, private assets is that these cannot be quickly converted into cash without an immediate loss in value. This means that investors are unable to redeem their interests within sort timeframes (ideally daily) and, if one accepts membership of the cult of daily liquidity, that is an unacceptable bar to retail participation in such assets.

However, liquidity need not be primary. Secondary liquidity, via properly functioning markets, would allow investors seeking an exit to dispose of their interests quickly and at a market price.

Investors can, of course, already access illiquid assets through listed investment trusts. These issue shares by way of IPO (and then possibly secondary offers/a placing programme) which trade in the secondary market. Funds are, therefore, not forced to trade their underlying portfolios to meet investor demand.

Investment trusts are a long-standing feature of the retail investment landscape in the UK, the first having been launched in 1868. There have been numerous developments (not all positive, it must be acknowledged) in the investment trust world over the intervening period but we now have a host of listed vehicles, based either in the UK or (commonly) the Channel Islands and covering an extremely broad range of underlying asset classes – many of which are fundamentally illiquid.

For those investors concerned about the presence of regulation, as well as regulation of the management of the fund vehicle, there is also the benefit of regulation imposed by the relevant exchange and the rules governing the publication of a prospectus. Listed funds do, of course, present issues in terms of valuations (and, indeed, disparities between market and net asset values) but, even so, these funds offer a tried and tested route for broad access to illiquid, private assets.

	Whilst the investment trust and broader "listed closed-end" sector is long-established, it's also dynamic and expanding. The recent launch of the International Property Securities Exchange (**IPSX**), now offers investors a dedicated platform for real estate investment, with its "prime" market offering the possibility of such access to the retail public. We are proud to be UK legal advisers to the issuer under the first anticipated admission to IPSX, Mailbox REIT plc, and hope that many other real estate opportunities will come to this exciting new market in future. Secondary liquidity does not necessarily entail listing/trading on the public markets. While this does offer the broadest and most liquid market (likely most appropriate for the direct retail sector), it may be possible to provide suitable liquidity for more sophisticated/institutional investors by way of *private* secondary liquidity. Institutional secondaries are well established even if, perhaps, far from commoditised. It is conceivable that hybrid funds structures and manager-led secondary processes could give sufficient assurance as to liquidity (though perhaps far from guaranteed) to enable at least a slight broadening of the investor universe.
7	**A more fundamental approach: The need for regulatory change** While secondary liquidity may offer some opportunities for democratisation, it's highly unlikely that this will offer a universal solution across all asset classes for all investors. The use of secondary markets is costly and can be cumbersome, with issues around "discount management" and other factors limiting its use. Something more fundamental is required. At present, the "cult" of liquidity – daily or otherwise – is applied by regulators (and certain areas of the intermediary market) as a "broad brush" tool, effectively limiting access of a swathe of non-institutional investors to a swathe of investment products and asset classes. This restriction prevents investors with longer-term time horizons from accessing opportunities for enhanced returns and diversification and inhibits the success of public policy goals to drive private capital into desirable sectors such as SME finance and infrastructure. Worse still, a regulatory framework that prohibits the development of products designed to reflect the return profile of inherently illiquid products, when paired with market desire to access those asset classes, results in the development of products which are perpetually at risk from liquidity mismatch. Either the measures necessary to preserve liquidity will inhibit the achievement of investment objectives (through over-preservation of cash/near cash) or the liquidity which is promised may prove illusory, particularly in extreme market conditions. The solution lies in a more sophisticated and contextual approach from regulators, reflected in sensitive product development and promotion by the asset management industry and appropriate advice and management decisions from intermediaries. If the industry is able to escape a broad-brush reliance on liquidity as a (virtually) universal requirement for retail (direct or indirect) suitability, then the objectives of all may be satisfied. While all industry participants have a role to play, change must originate with the regulators. The primary restrictions preventing broader access are regulatory. If these can be reformed, product development and intermediation will be given room to breathe. Regulation must however be careful and considered. It must recognise that not all investors share the same degree of sophistication, risk attitude or time-horizon. Likewise, intermediated and direct channels will require separate consideration, as will the position for direct retail investors versus pension funds. What might be suitable for a pension fund trustee with a complex, long term liability position will not necessarily suit a member of the "mass affluent" individual community.

	We are now seeing active steps by regulators on a global basis to address these issues, and some of these steps are considered below. It is to be hoped that these steps are the beginning of a more ambitious programme to allow the growth of a more sophisticated universe of investment products.
8	**Regulatory Change in the UK** There are two UK-specific proposals for regulatory change in this area – the PIF and the LTAF: **A. The Professional Investor Fund (PIF)** The Investment Association (**IA**) has been working with the Association of Real Estate Funds (**AREF**) on its proposal for a new form of onshore (UK) fund for professional investors, including pension funds - the Professional Investor Fund. The PIF is a development of the PAIF regime, an attempt (albeit largely unsuccessful) to develop a UK-based, onshore property fund. Tax issues on seeding played a large role in the lack of take-up of the PAIF vehicle but it is hoped that the PIF, if properly considered, will not suffer from similar issues. The PIF is intended to be a contractually based investment vehicle, working within a regulatory framework based on the existing Authorised Contractual Scheme (**ACS**) infrastructure, provided that the PIF will *not* be an authorised fund. It will however be an AIF, with an AIFM and a depositary. It will also be an unregulated collective investment scheme (and subject to the NMPI regime accordingly). In terms of liquidity, it could be closed-ended or a hybrid structure. Importantly, the IA and AREF have sought to address detailed tax issues from the start. The PIF will not be a legal person and will be tax transparent. Also, it is hoped that the PIF will benefit from an absence of SDLT on transfers of units, and would be more attractive if SDLT seeding relief, which would allow conversions of existing structures to give critical mass (although the focus will be on new funds, rather than conversion from e.g. JPUT/GPUT structures). In terms of access, the PIF will be available to these investors currently able to access ACS. Direct investment will be available to investors contributing £1m or more or those who are professional investors. Importantly, it should be possible to achieve broader access via feeder funds. It is also proposed to amend UK rules on financial promotion to allow promotion of PIFs to HNW and sophisticated investors. How will this affect access to private assets? We will have to wait to see the final proposals, but it appears that the PIF could offer a good solution for certain categories of investors, especially institutional and highest-end "retail" UK institutional investors who wish to invest in long-term assets, particularly around real estate and infrastructure. Creating an onshore product which offers a viable solution for a certain sector of the investor universe focused around specific asset classes is a good example of precisely the approach that is required – tailored solutions offering suitable access to illiquid, private assets. **B. The Long-Term Asset Fund (LTAF)** Of broader potential application than the PIF is the "Long Term Asset Fund" – the LTAF. In DP18/10, the FCA looked at what factors were holding back investment in patient capital through authorised fund vehicles. The most substantive response to that DP came from the IA, which put forward suggestions for a new type of authorised fund expressly designed to invest in long-term assets. This would require the FCA to adapt the existing NURS structure. An LTAF would, among other things: o be an **authorised retail fund**, with a target market most likely to be DC pension schemes, professional investors and private wealth/discretionary portfolio managers.

The IA anticipates limited interest from retail investors wishing to invest direct or on an execution-only basis – even so, it feels that an LTAF should be capable of being marketed to retail investors, where the fund manager considers this to be appropriate.

- have **investment and borrowing powers** which would allow:
  - up to 100% of the fund's net asset value (**NAV**) to be invested in unauthorised collective investment schemes
  - direct investment in limited partnerships
  - up to 100% of NAV to be held in unlisted securities and
  - a wider range of derivatives to be held for hedging purposes.

  Giving an LTAF these powers would mean an amendment to the current investment powers of a NURS.
- have flexible dealing frequencies, from daily up to two years.
- have a **range of liquidity management tools** – these would include the use of notice periods for redemptions (to allow the manager sufficient time to sell underlying assets) as well as permitting deferred and limited redemptions.
  - an LTAF's manager would need to make use of a **valuation model** which considers a range of economic information relating to both the asset and the wider market.
  - if an LTAF's **redemption opportunities** are to be less frequent than they currently are for authorised funds, investors might be required to receive advice and/or face limits as to how much of their assets they can invest.

Whilst there is expected to be interest in the LTAF by retail investors, attracting the investments from retail investors is only part of the answer. Professional investors are also looking for greater access to long-term assets, and the IA is therefore also supporting a proposal for a Professional Investor Fund for professional investors.

It's fair to say, the FCA's response was fairly lukewarm - 'more work is required before we consider consulting on changes to our rules'. No doubt, this was influenced in part by WEIF cropping up between DP18/10 and FS20/2 being published – something which is understandable but to some extent misconceived, as explained above.

In CP20/15, the FCA expanded (slightly) on its initial reaction:

> "[W]e identified areas where we encouraged further work on the balance between expanding the types of assets that funds invest in and investor protection. We understand the IA is currently developing the proposal further, including the need to balance any expansion in the types of assets that authorised funds can invest in with appropriate levels of investor protection.
>
> While we are not making specific proposals at this time, we welcome views on whether there are further steps the FCA should take to accommodate such structures within the regulatory framework."

These are small, but important steps towards a regulatory acknowledgement that change is necessary.

The LTAF should fill a gap for certain investors who are seeking better returns, such as for investment through personal pensions. So long as there is confidence that the final form of LTAF provides sufficient safety, the LTAF may very well be part of the solution to the democratisation of private assets conundrum.

The IA continues to work on its proposals for the LTAF, so the final form remains unknown. However, the IA has sought to work closely with the FCA and, therefore, the FCA and HM Treasury are expected to be supportive of the final form that the IA proposes.

9

Regulatory Change in the EU – in pursuit of ELTIFs?

The European Long-Term Investment Fund (**ELTIF**) Regulation was to contribute to the EU's real economy by providing "finance of lasting duration" to infrastructure projects, unlisted companies or listed SMEs.

In turn, this would provide a steady income stream for pension administrators, insurance companies and other entities that "are seeking long-term returns within well-regulated structures" while at the same time offering "good opportunities for capital appreciation over time for those investors not receiving a steady income stream".

ELTIFs sit within the overall AIFMD regime – which is probably both a strength and a weakness. While it certainly opens up opportunities, the degree of regulation that ELTIFs are subject to has clearly stifled their development.

To take one example, managers of ELTIFs have the advantage that they can make use of a marketing passport to reach all categories of investor across the EU. However, access to what might be thought of as 'real' retail is significantly limited by the Regulation's restriction that an investor's initial investment must be a minimum of EUR 10,000.

In addition, ELTIFs are bound by a battery of rules and restrictions (on authorisation, investment policies, and operating conditions) as well as by various disclosure obligations, all designed to protect investors (with an additional layer of regulation biting where the ELTIF is marketed to retail investors).

By way of example:

- only an EU AIF can be authorised as an ELTIF and only an authorised EU AIFM can manage it
- in the case of a retail investor, the ELTIF manager must undertake a suitability test and provide the investor with "appropriate investment advice"
- there are strict rules as to 'eligible investment assets' and 'qualifying portfolio undertakings'
- at least 70% of the ELTIF's capital must be invested in eligible investment assets
- an ELTIF cannot:
  - short sell
  - take direct or indirect exposure to commodities, including via derivatives or indices or
  - enter into securities lending securities borrowing and repo transactions which affect more than 10% of the ELTIF's assets.

All this leads to greater administrative and management costs. Crucially, market perception is (rightly) that the ELTIF structure currently offers no advantage over traditional institutional-only fund structures. Indeed, there are significant additional costs. So, since ELTIFs offer nothing better – and, indeed, several things less appealing - than traditional structures, very few have been formed. And if there are almost no ELTIFs available in which to invest, investor choice is naturally limited. There is no critical mass.

The extent to which ELTIFs failed to take off is demonstrated by ESMA's ELTIF Register. This shows that, since their introduction in December 2015, only 27 such funds have been registered, in four Member States (France, Luxembourg, Italy and Spain). None at all have been registered in the UK. On top of that, only one of the five Italian ELTIFs has been marketed at all and, of the remaining 22 funds, half are only marketed in a single Member State. Change is clearly required if this is to change.

As is usual with EU financial services legislation, the ELTIF Regulation contained a review clause which mandated the European Commission (the **Commission**) to start a review by June 2019, focusing on (among other things) the extent to which ELTIFs are marketed in Europe; and whether (and how) the list of eligible investments should be updated. However, while a cold, hard look at these – and associated - issues could be the kickstart needed to tackle the inadequacies of the ELTIF regulatory framework as of September 2020, the Commission had published nothing directly related to this review.

	However, there is hope that this will change. In June 2020, the Commission's High Level Forum on the Capital Markets Union (**HLF**) published its final report, 'A New Vision for Europe's Capital Markets'. The report recognises that the EU has been suffering from a "chronic shortage" of financing for the long-term investments necessary for environmental sustainability and that 'targeted' amendments to the ELTIF Regulation's current legal framework – especially if coupled with national tax incentives – should accelerate the take-up by investors, strengthen the ELTIF passport, encourage more participation from retail investors through more flexibility in redemptions or tax incentives and broaden the scope of eligible assets and investments – all while taking investor protection ' into due account'. As a result, the HLF recommended (a) that the Commission put forward a proposal to amend the ELTIF regulatory framework by the end of 2020 (with the aim of finalising new legislation by mid-2022) and (b) that Member States should simplify their tax rules in respect of ELTIFs and/or give them preferential tax treatment. On 16 September 2020 the Commission issued its Inception Impact Assessment flagging its intention to proceed with an initiative of amending the ELTIF framework. A public consultation of the potential amendments is due imminently in October 2020. Whilst this approach to reform of the ELTIF regime is welcome, it will only succeed in generating real change within the European funds market if it addresses head on the issues currently preventing broader access to illiquid assets. It remains to be seen if the Commission will have the courage to do so.
10	**Regulatory Change - Other Examples** **Italy** The Italian regulatory framework provides that investment schemes investing more than 20% in illiquid assets must be closed-end alternative investment funds. These can be either retail or reserved to professional investors (as well as to retail investors that subscribe for an amount of at least EUR 500,000), the main difference between the two categories being that retail funds must be authorised by the Bank of Italy and their management rules must comply with certain strict regulations as regards functioning, governance and investment concentration limits. In practice, retail funds investing in illiquid assets have rarely been set up, with the private equity, private debt, venture capital and real estate industries preferring to only use the reserved fund structure. This mainly because reserved funds grant more flexibility and managers are facilitated in aligning the characteristics of the investment schemes to the international market practice. More recently, though, sentiment seems to be changing and some amendments to the regulatory and tax regime of Italian AIFs are either expected or have already been introduced: • first, a favourable tax regime (the so-called "Alternative PIR") has been introduced in relation to the investment in closed-end funds (including ELTIFs) focused on SMEs by retail clients and pension funds, and • second, a possible reduction of the minimum amount to be invested by retail clients in reserved funds has been proposed in a consultation paper by the Italian Ministry of Finance. These measures are aimed at boosting investments in SMEs through the increase of fundraising opportunities in the retail market. The Alternative PIR (*Piani Individuali di Risparmio* – long-term savings plans) are particularly innovative. Introduced this summer, Alternative PIRs basically comprise a favourable tax regime for Italian tax resident individuals and pension funds looking to invest in portfolios composed of financial instruments issued by Italian and European companies which meet certain requirements.

The Italian Government's explanatory report expressly allows Alternative PIRs to be established with various structures, among which a particular mention is given to alternative investment funds (**AIFs**) and their various closed-end types: Private Equity funds, Private Credit funds and ELTIFs.

In detail, financial income and capital gains from an Alternative PIR are exempt from income taxes and inheritance and gift taxes. This tax exemption regime is applicable to long-term savings plans having the following characteristics:

- at least 70% of the Alternative PIR's portfolio must be invested – directly or indirectly – in financial instruments issued by Italian companies and/or Italian branches of EU entities different from those included in the FTSE MIB, FTSE Mid Cap or similar indexes ("Qualified Investments") for no less than eight months of each calendar year;
- Qualified Investments also include financing granted to the abovementioned companies, as well their account and financial receivables;
- the concentration risk in any issuer must not exceed 20% of the amounts invested in the Alternative PIR;
- a maximum annual invested amount of EUR 300,000 and an overall maximum invested amount of EUR 1,500,000 in aggregate (these limits are not applicable to pension funds).

Individual investors can invest in a single Alternative PIR at a time and for a minimum holding period of five years.

US

While US federal laws do not prohibit investment firms from including illiquid assets such as investments in private equity funds in defined pension contribution plans (such as, 401(k) contribution plans), investment management firms have not traditionally included access to private equity investments in individual account plans as part of the overall portfolio mix for fear of litigation. In 2015, a lawsuit was brought by a former employee against Intel Corp. accusing the firm of violating its fiduciary duty by including private equity funds in its company pension plan.

However, recent regulatory guidance issued in the US signals a willingness on the regulators to allow access to investment products that had previously been limited to institutional investors and suggests the possibility of creative solutions when exploring retail investor access to private equity investments, despite the risks and complexities involved.

On 3 June 2020, the Employee Benefit Security Administration of the U.S. Department of Labor (**DOL**) issued an information letter stating the fiduciary responsibility provisions of the Employee Retirement Income Security Act of 1974, as amended (**ERISA**) do not prohibit fiduciaries of 401(k) and other individual account plans from including diversified investment options with private equity exposure if various requirements are met. Under the information letter issued by the DOL, private equity investments that are part of target date funds and other professionally-managed, multi-asset class vehicles may be offered to retail investors and may form part of a prudent investment mix, provided a proper analysis is conducted by the plan's fiduciaries. It does not, however, allow participants to direct investments specifically into private equity.

The U.S. Securities and Exchange Commission (**SEC**) has also explored the possibility of increasing assess for retail investors to private companies and sought proposals on the proposed restrictions for private equity funds to offer their interests to retail investors, e.g. maximum percentage of assets that closed-ended funds may invest in private funds and whether closed-ended funds should be required to diversify their investments across a minimum number of private funds, if they are not restricting their offerings to accredited investors. On 26 August 2020, the SEC re-defined the term "accredited investor" to remove

the requirement that managers of certain high-risk funds only accept capital from investors with assets of $1 million or more. The amendments allow investors to qualify as "accredited investors" based on defined measures of professional knowledge, experience or certifications in addition to the existing tests for income or net worth. The amendments also expand the list of entities that may qualify as "accredited investors", including by allowing any entity that meets an investments test to qualify.

Despite certain regulatory interest as outlined above, advocates for investors have called on the DOL to withdraw its policy statement and argued that the absence of standardised performance calculations for private equity funds and their lack of transparency and illiquidity could become problematic for plan participants, citing the complexity of private equity investments for plan participants and plan sponsors as problems which prevent transparency in such investments.

GERMANY

BVI, the German investment funds association, has recently proposed a new "impact" fund structure, the European Impact Fund. This vehicle will invest in long-term projects via new "European Impact Bonds", as well as equity and debt instruments issued by small- and medium-sized EU companies. Specific mention is made in the proposal to the use of such vehicles to support "an energetic COVID-19 response", and the BVI points to the key question of increasing the availability of "impact investing assets".

The "European Impact Bond" is a central plank of the BVI's new regime.

These are proposed as new green or social bonds issued by the Commission tied to individual "impactful" projects. In time, the scheme could be extended to the private sector, with private enterprises issuing similar bonds. European Investment Funds, then, are funds raised primarily to invest in these new bonds. These funds would be targeted primarily at retail investors but would also be attractive to institutions.

The proposal is that these new funds would be within the UCITS framework, which would carry obvious "democratic" advantages. It is not yet clear, though, how the liquidity requirements applicable to UCITS status would be met, and whether those requirements would be unduly restrictive for truly long-term investment.

Further work is clearly needed, but the aspiration of driving additional capital, particularly from the retail sector, into "impactful" projects on a pan-European basis is admirable, and hopefully this project will develop successfully in due course.

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