Investor protection

Retail AIFs – heterogeneity across the EU

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This article provides an overview of the EU market for Alternative Investment Funds (AIFs) sold to retail investors. It presents the first EU-wide analysis of the structure of the retail AIF market, drawing from data collected as the result of the reporting obligation set out in the Directive on Alternative Investment Fund Managers (AIFMD). Overall, the size of AIFs sold to retail investors accounted for 18% of the AIF market in terms of net asset value (NAV) in 2017. Potential risks related to liquidity transformation and liquidity mismatch are analysed. 2017 data suggest no significant signs of liquidity mismatch for AIFs held exclusively by retail clients. The article also describes the heterogeneity across the EU regarding the distribution of retail AIFs which falls under national law.

Introduction

The global financial crisis highlighted the need for further oversight and transparency to ensure the resilience of the financial system. At the global level, the G20 Summit and the FSB developed a programme to improve global monitoring and regulation of both the banking and the non-banking systems (FSB, 2012), including investment funds.

In the EU, investment funds are regulated under three main fund regimes:

— Undertakings for the Collective Investment of Transferable Securities (UCITS) regime;

— Directive on Alternative Investment Fund Managers (AIFMD) regime which regulates fund investment managers managing alternative investment funds (AIFs) within EU; [57]

— National private placement regimes (NPPR), which regulate the sale of non-EU funds in the EU and enable member jurisdictions to impose national requirements on any sale within national borders.

This article focuses on AIFs sold to retail investors in the context of AIFMD and the marketing of AIFs to retail investors. The article provides the EU regulatory background and gives an overview of the EU retail AIF market.

Background

AIFs

Alternative investment vehicles have gained popularity over the past few years. The low interest rate environment has led several asset classes, especially bonds, to generate insufficient returns for investors. Investors, particularly those who must meet return targets, were therefore encouraged to rely increasingly on alternative assets (ECB (2017)). Indeed, alternative products are characterised by a risk-return profile that is fundamentally different from more traditional forms of investments. Alternative assets can offer potentially high returns, with a higher level of risks than other asset classes.

Regarding investor composition, institutional investors are the largest investors in the alternative market (WEF (2015)). However, a series of changes (such as demographics and pension reforms) are fostering further participation of retail investors in the alternative market. (so-called “retailisation”).

Against this background, regulators and supervisors are keen to ensure access to returns and diversification associated with these products, considering more efficient allocation of capital and increased access to capital markets. At the same time, however, they should guarantee investor protection by providing investors with an adequate degree of transparency and information, as well as additional regulatory and supervisory action if needed.

AIFs under AIFMD

AIFs under AIFMD include a very wide range of investments products and funds, excluding funds authorised under the UCITS Directive. The definition covers not only hedge funds, but also other types of funds, such as private equity funds, real estate, some funds of funds (e.g., funds of hedge funds) and structures that cannot be

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[57] Directive 2011/61/EU of the European Parliament and of the Council.

regulated under the UCITS regime due to liquidity or portfolio concentration restrictions.

The lack of transparency in the market of non-UCITS investment funds underlines the necessity to introduce an EU-level legislation to regulate managers of AIFs. Although many asset managers were authorised to manage their portfolio and invest under MiFID, several regulatory activities were implemented at the national level. Therefore, the pre-crisis regulatory and supervisory framework for AIFs was not harmonized.

The AIFMD came in as the first form of EU-level legislation aiming to provide an internal market and a harmonised regulatory and supervisory framework for the activities within the EU of all Alternative Investment Fund Managers (AIFMs), regardless of whether they have their registered office in a Member State (EU AIFMs) or a third country (non-EU AIFMs). The Directive deals with the authorisation, ongoing operations and transparency of AIFMs. [58] The AIFMD explicitly requires the NCA of the Member State in which the manager is domiciled to authorise the AIFM to manage or promote a fund. Upon authorisation, AIFMs may access the EU passport for cross-border management of AIFs or cross-border sale of AIF units to professional investors.

The EU passport is not valid under the following requirements:

- Article 36: the AIFM is domiciled in the EU and markets a non-EU AIF in the EU.
- Article 42: the AIFM is not domiciled in the EU, but the AIF is marketed in the EU, regardless of its domicile.

AIFs sold to retail investors: AIFMD regime

The AIFM marketing passport does not extend to the category of retail investors. Nevertheless, the Directive allows AIFMs to market units or shares of AIFs that they manage to retail investors, in their territory, irrespective of whether such AIFs are marketed on a domestic or cross-border basis or whether they are EU or non-EU AIFs. In this instance, Member States may impose stricter requirements than those applicable to AIFs marketed to professional investors.[59]

In other words, besides not directly regulating the products (i.e. the funds), the AIFMD does not cover the marketing of AIFs to retail investors; it only covers marketing to professional investors as defined in MiFID. This is a national prerogative implying a certain degree of heterogeneity and therefore limitations in data availability in terms of Union law. Some examples of different EU national regimes are reported below. We refer to the largest industries in terms of NAV in 2017, according to what has been reported by national jurisdictions to ESMA, within the AIFMD umbrella.

In the UK, restrictions on an AIFM marketing an AIF specify, among other things, that the AIFMD marketing passport cannot be accessed by non-UK managers selling AIFs that are not domiciled in either the UK or the EEA. Such funds are subject to the national private placement provisions in respect of their marketing. Besides general marketing provisions, there are certain cases with specific provisions when marketing is directed to retail investors. [60] Whenever a fund is marketed to a retail client, the EEA AIFM may not sell an AIF unless the FCA has received, from the manager's home state regulator, a notice allowing the marketing of the AIF in relation to the Financial Services and Market Act[61] or it has approved the marketing and not revoked or suspended that approval[62].

Focusing on regulatory fees for AIFs, the variation that exists across jurisdictions should be noted. EEA AIFMs passporting in the UK are required to pay periodic fees in relation to their activities. Charges are based on gross income and funds under management. A discount on fees is allowed according to the fee-block under which the AIFM falls and to the responsibilities that the Member State and the FCA share in it. [63]

In Germany, the marketing of EU AIFs and foreign AIFs, by an EU or foreign AIFM, to retail investors is subject, by law, to certain criteria. These criteria include the following: the AIF and the AIFM being subject to effective public supervision for the protection of investors in the countries in which the AIF and AIFM have their joint registered offices; a satisfying cooperation between BaFin and the foreign supervisory authority of the home countries of the AIF and the AIFM; compliance of the AIFM and its management of AIF with AIFMD; details on, among others, compliance function, depositary, paying agent and asset value; minimum content in fund rules, the articles of association or the company agreement, among others open/closed-

[58] Directive 2014/65/EU of the European Parliament and of the Council.

[59] See Article 43 (1) of Directive 2011/61/EU of the European Parliament and of the Council.

[60] See Regulation 49 of PERG 8.37.2 (1) and (2) of the FCA handbook.

[61] FCA, Financial Services and Markets Act 2000.

[62] See Regulation 54 of Fund 3.12.1 of the FCA Handbook, "Marketing in the home Member State of the AIFM": https://www.handbook.fca.org.uk/handbook/FUND/3/12.html?date=2018-10-01#DES351

[63] See the FCA Handbook.

end fund thresholds; and fees and charges.[64] Further requirements are imposed for foreign AIFs that are being managed by a foreign AIFM. If the notified foreign AIF is managed by a foreign company, BaFin and the supervisory authority of the third country must reach a suitable agreement about their cooperation. The bilateral agreement between the home country and Germany includes, among others, provisions to avoid double taxation and must ensure effective exchange of information on tax matters.[65] Concerning fees and charges, BaFin charges a fee for each EU sub-fund notified (EUR 2,520 until 31 December 2017 and ,as of 1 January 2018, EUR 1,545), plus an annual fee for each EU sub-fund.[66]

In France, all marketing to retail clients is subject to a preliminary authorisation procedure.[67] Marketing with a passport is possible only when the AIF is established in the EU and the manager is domiciled in France. The applicable regime varies according to the domicile of both the fund and the manager. France does not charge an application fee for outward or inward AIFMD passport authorisations. However, the AMF requires AIFMs passporting into France to pay annual fees based on the amount of AuM wherever localised and notified at a specific date. Passporting of a foreign AIF is subject to the payment of an AMF fee of EUR 2,000 per AIF upfront and per-year.[68]

In Luxembourg, the focus is on foreign AIFs marketed to retail investors. Prior to marketing its units or shares to retail investors, any foreign AIF must have obtained authorisation for such marketing by the Commission de Surveillance du Secteur Financier (CSSF). The authorisation request must include all of the relevant information about the AIF. Furthermore, a foreign AIF is authorised to market its units in Luxembourg if it calculates the redemption prices of its shares at least once a month and it demonstrates sufficient risk spreading. Investment restrictions of foreign AIFs are applied if risk-spreading criteria on securities borrowings, use of derivatives, and real estate assets are not fulfilled. [69] For fees, the CSSF charges a fee for each non-LU AIF marketed in Luxembourg. AIFs with single investment portfolios are charged a lump sum of EUR 2,650, while for multiple compartments funds the fee amounts to EUR 5,000. The same annual flat fee is charged for EEA AIFs, while passport notification does not involve any application fee. Again, considering the largest markets, they all report different regimes in terms of applied charges for passporting, products and entities subject to such fees highlighting a significant heterogeneity across the EU.

AIFs sold to retail investors: PRIIPs regime

The examples above demonstrate a lack of harmonisation across EU countries in terms of AIF marketing to retail investors. This is likely to introduce a degree of heterogeneity not only on the functioning of retail AIF markets themselves, but also on the degree of information and transparency at a retail investor level. Adequate data on the performance and costs of retail AIFs are also not available on a consistent basis, implying investor protection risks.

In that context, rules related to the Packaged Retail and Insurance-based Investment Products (PRIIPs) aim at improving transparency. The aim is to establish uniform rules on the transparency that PRIIPs offer to retail investors[70] in the EEA and, from January 2018, on AIFs made available to retail investors in the EU/EEA.[71]

The product manufacturer (i.e. the manager) must produce a Key Information Document (KID) for the product (i.e. the AIF), publish it on its website and provide it to a retail investor in good time prior to the investment. The content of the

64 Section 317 (2) of the German Capital Investment Code (Kapitalanlagegesetzbuch – KAGB).

65 The above-mentioned rules also apply to feeder AIFs. However, further requirements pursuant to section 317 (3) of the German Capital Investment Code (Kapitalanlagegesetzbuch – KAGB) have to be met. In accordance with Article 4(1) (m) of AIFMD, a feeder AIF is an AIF that invests at least 85% of the assets in units or shares of another AIF (the master AIF), invests at least 85% of its assets in two or more AIFs if those AIFs (the 'master AIFs') have identical investment strategies, or otherwise has an exposure of at least 85% of its assets to such a master AIF.

66 Wherever the AIFM is notified (EU or non-EU) charges are identical.

67 AMF Instruction, Procedure for marketing unit or shares of AIFs – DOC-2014-03. Reference texts: Articles 421-A, 421-1, 421-13, 421-13-1, 421-14 and 421-27 of the AMF General Regulation.

68 Article 22 and Article 24 of AMF Instruction, 'Procedure for marketing unit or shares of AIFs' – DOC-2014-03. Article L621-5-3 4 and D621-27-4 Code Monétaire and Financier.

69 CSSF Regulation No. 15/03.

70 A "retail investor" should be equal to "retail client" as in stated in Article 4(1) of MiFID (Directive 2014/65/EU).

71 Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents (KID) for PRIIPs. There is a transitional period applying for UCITS: a KID (in the PRIIPs sense) does not have to be published until January 2020. Until then, a UCITS can refer to its own key investor information document.

KID is set out in the PRIIPs regulatory technical standards.[72]

AIFMD brings access to new reporting data

The reporting obligations established by the AIFMD and the Implementing Regulation provide a standard data collection framework and ultimately improve transparency to NCAs. These obligations together with PRIIPs requirements should ultimately enable NCAs and ESMA to have a complete overview of the AIF and AIFM markets, develop a comprehensive analysis of gross and net performances, and thus better monitor the risks in the EU financial system. This in turns will increase information flows, improve transparency and enhance investor protection. At present, data collected for the end of 2017 cover around 78% of the AIFMs marketing their products in the EU.

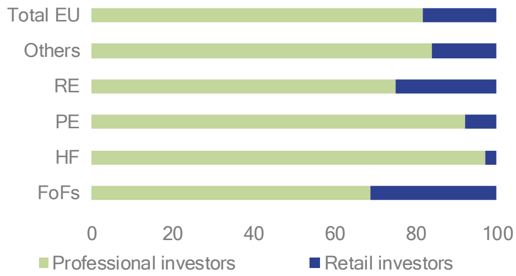
Not all of the data currently reported, however, show an adequate level of quality. Together with the high degree of diversity and complexity in the AIF industry, the quality of relevant information poses challenges from an analytical perspective. ESMA, together with NCAs is currently working on improving the coverage and quality of AIFMD data. From an AIFMD perspective, work is still ongoing trying to ameliorate data quality, but data to be collected from PRIIPs are not yet available.

As already specified in ESMA TRV No.1 2018,[73] the AIFMD reporting obligation represents an unprecedented EU-wide harmonised framework for data collection in the AIF industry and is a first step toward increasing market convergence and integration.

EU retail AIF market: >10,000 funds

The overall EU AIF market size in terms of NAV is around EUR 4.8tn as of end-2017, namely 94% of NAV as reported by the European Fund and Asset Management Association (EFAMA) for the EU AIFs (EUR 5.09tn). V.1 provides a picture of the EU AIF market by AIF types: funds of funds, hedge funds, private equity, real estate and a residual category labelled “others”, distinguishing between retail and institutional investors.

V.1
AIF NAV by type of client
Retail investors focusing on funds of funds and real estate



Note: NAV of AIFs by type of client reported, end of 2017 under the AIFMD, in %. FoFs = fund of funds; HF = hedge funds; PE = private equity; RE = real estate.
Sources: National Competent Authorities, ESMA

The largest share of the market, as expected, is covered by institutional investors. This may be traced back to two forces. Retail investors have focused more on UCITS, as the UCITS Directive was originally developed for retail investors, to increase transparency and reduce risks. Secondly, the AIFMD regulates professional clients whereas retail marketing is left to national regulation. As Member States introduce requirements for AIFs to be marketed to retail investors, we can observe the presence of retail investors in the AIF segment. As of end 2017, 10,179 of the 26,085 AIFs (39% in terms of number of funds) had retail clients among their investors. In terms of NAV, retail clients account for 18% of the market. The investment of retail investors into AIFs is higher for funds of funds (FoFs) and real estate funds (RE), where retail investors account for 31% and 25% of the NAV respectively, while the retail share for hedge funds is around 3%.[74] RE is an asset class that is assuming increasing importance among UCITS mainly investing in alternative assets. Regarding FoFs (Brown et al., 2003), they reduce risks specific to hedge fund and the lack of transparency. FoFs, while also holding shares in hedge funds, provide investors with higher diversification and so probably attract more retail investors. However, as already pointed out by Brown et al., FoFs potential charge high fees , with an incentive fee component that may, in some cases, exceed the realised return on the fund. Furthermore, it must also be highlighted that, typically, FoFs pass on to the investor all of the fees charged by the constituent funds as after-fee returns.[75]

[72] Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing Regulation (EU) No 1286/2014 on KID for PRIIPs.

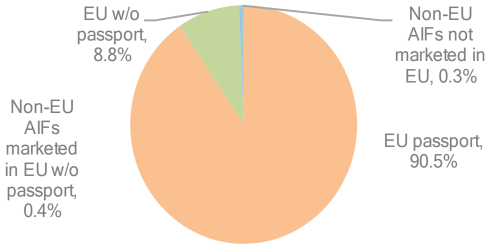
[73] Data relates to data available according to AIFMD reporting at the end of October 2018.

[74] ESMA (2018) reports 35% (FoFs) and 27% (RE) for all investors professional and retail for 2016.

[75] Brown et al., (2003), note, the following: “the more diversified the fund is, the greater the likelihood that the investor will incur an incentive fee regardless of overall fund performance. In fact, there is a significant probability that the incentive fee will be so large that it absorbs all of the annual fund return. […] and diversification does not increase the fee burden as an informed investor would face the same fees if they diversified on their own account. The problem arises because investors lack information necessary to hedge incentive fees charged by the underlying hedge funds and passed on to the investor through the FOF in the form of after-fee returns.”

Focusing on the retail segment, the majority of the assets of AIFs sold to retail investors, 91% (V.2) benefits from the passporting regime, i.e. can be sold across the EU. Similarly, this is the case for professional investors, where AIFs totalling 73% of NAV benefit from the passporting regime.

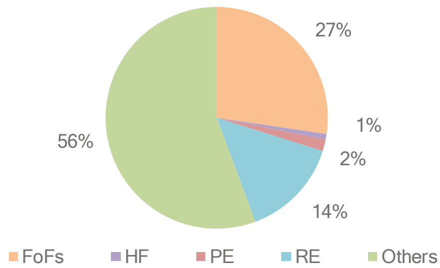
V.2
AIFMD passport by NAV of retail investors AIFs
Large use of passporting regime



Note: NAV of retail AIFs by manager's access to AIFMD passport, end 2017, %. Authorised EU AIFMs access AIFMD passport or market non-EU AIFs to professional investors w/o passport, sub-threshold managers are registered only in national jurisdictions w/o passporting rights.
Sources: National Competent Authorities, ESMA

Looking at the types of AIFs that retail investors invest in, "Other Funds" account for the largest share at 56%, followed by FoFs and RE (V.3). The Others category consists of fixed income funds, equity funds, infrastructure funds, commodity funds and other funds.[76]

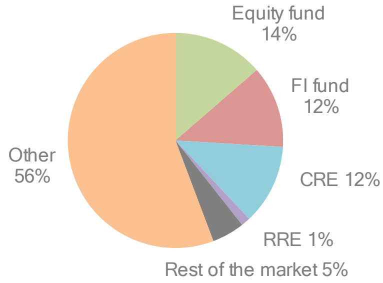
V.3
Retail investor NAV by AIF type
High concentration in "Other", FoFs and RE



Note: Share of NAV of AIF by type, retail clients, end 2017, in %. Reporting according to AIFMD. AIFs managed by authorised and registered managers.
Sources: National Competent Authorities, ESMA

Therefore, we also look at the structure of the retail AIF market according to the strategy classification. According to a previous study focusing on all clients, fixed income held the largest share of NAV in 2016 (ESMA (2018)). Focusing on retail clients, the largest share, in 2017, was the category "Other" with 56% (V.4), which includes FoFs and is in line with what has previously been shown. In the RE there is also a prevalence towards CRE (commercial real estate) which could give rise to prudential risks (ESMA (2018)).

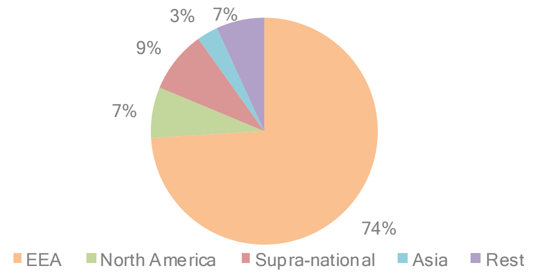
V.4
Retail investors NAV by AIF strategy
Five dominant investment strategies



Note: Share of NAV by investment strategy, end of 2017 retail clients, reporte under AIFMD, in %. FI = Fixed income; CRE = Commercial real estate; RRE Residential real estate.

Looking at the regional investment focus (V.5), according to the data reported by EU-domiciled AIFMs on behalf of their funds, EEA is the dominant investment region for funds with a 100% retail client participation, with 74% of assets domiciled in the EU.

V.5
NAV by regional investment focus
Retail AIF: Europe as key investment area



Note: NAV of AIFs by regional investment focus, retail clients, end of 2017, in %, reporting according to the AIFMD. AIFs managed by authorised and registered AIFMs. Sources: National Competent Authorities, ESMA.

Liquidity risks: elevated, but no systematic mismatches

Liquidity risk is one of the most prominent risks in the fund industry. Funds performing liquidity transformation allow investors to redeem their shares on a daily or weekly basis while investing in illiquid assets. Liquidity risk can be amplified by the use of leverage, exposing investors to potentially large losses. Redemption rights and liquidity mismatches are therefore crucial for clients and especially retail clients, which potentially have a lower degree of information and flexibility than professional investors. Therefore, one of the main features of UCITS products relates to portfolio diversification and eligibility criteria to certain types of assets.

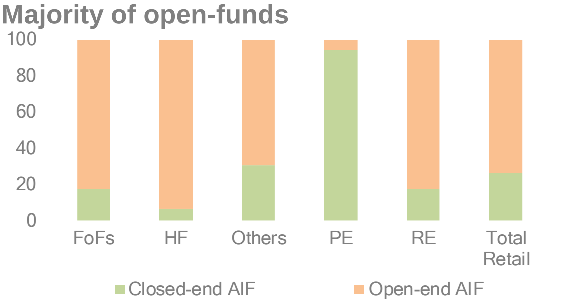
On the AIF side, being alternative implies that these types of products inherently involve a higher degree of risk. Regulators, however, set out specific requirements. Besides, risk management requirements, both the AIFMD and

[76] See Annex IV to Commission Delegated Regulation (EU) No 231/2013 supplementing Directive 2011/16/EU.

the Delegated Regulation No. 231/2013 include provisions to ensure sound liquidity management.[77]

According to the AIFMD sample as reported in 2017, open-ended funds make up the greatest share of NAV, more than 70% of NAV (V.6). The open-ended feature adds to the risk of potential liquidity mismatches. In this respect, the AIFMD requires specific disclosures to NCAs and investors.[78] These include a description of the investment strategy and structure of the AIF as well as information on redemption rights, notice periods, lock-up periods and circumstances in which the normal redemption mechanisms might be suspended.[79]

V.6
Redemption rights to retail investors
Majority of open-funds

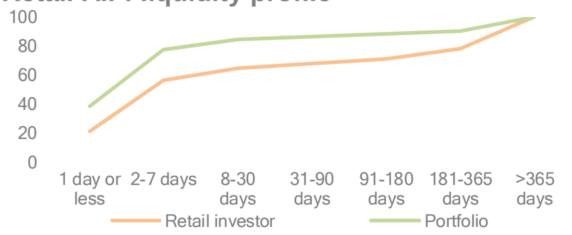


Note: NAV of AIF by redemption rights offered to retail clients, end 2017, %, reporting according to AIFMD. AIFs managed by authorised and registered AIFMs.
Sources: National Competent Authorities, ESMA.

Potential liquidity mismatches may arise from the difference between portfolio and investor liquidity profiles, shown in aggregated terms in V.7. The portfolio liquidity profile refers to the time needed by the fund to liquidate its assets whereas the retail investor profile refers to the shortest period at which the investor itself can redeem the fund.

Overall, as shown in V.7, AIFs with 100% participation of retail clients show no sign of significant liquidity mismatches. The percentage of the fund portfolio that can be liquidated within a specified time period is always higher than potential redemption by investors over the same time frame. The only asset type that presents a different liquidity risk profile is hedge funds with 100% retail client participation. According to reporting, until three months no liquidity mismatches are identified for hedge funds. However, for longer time periods, the percentage of portfolio liquidity is lower than investor liquidity needs.

V.7
Portfolio and investor liquidity
Retail AIF: liquidity profile



Note: AIFs portfolio and investor liquidity profiles, retail investors. The portfolio liquidity profile is determined by the percentage of the fund portfolios that can be liquidated within the period specified on the horizontal axis. The retail investor liquidity profile reflects the shortest period at which the fund could be withdrawn or investors could receive redemption payments.
Sources: National Competent Authorities, ESMA.

Conclusion

This article provides a general overview of the retail AIF market.

The main findings are that:

— professional investors make up the largest proportion of the AIF market;
— as of end 2017, investments by retail investors in AIFs occur in 39% of funds and account for 18% in terms of NAV;
— FoFs and RE funds have the largest share, 31% and 25% respectively;
— 91% of retail AIFs are managed by authorised AIFMs, with significant use of passporting regime;
— 91% of the assets of AIFs sold to retail investors are managed by authorised AIFMs;
— in terms of liquidity risk, overall, AIFs with 100% participation of retail clients show no sign of noteworthy liquidity mismatch. The only asset type that presents a different liquidity risk profile is hedge funds.

[77] Article 16 of Directive 2011/61/EU of the European Parliament and of the Council states that AIFMs shall for each fund managed that is not closed-ended, employ an appropriate liquidity management system. Article 43 of the Delegated Regulation 231/2013 requires that managers demonstrate to the relevant NCAs of their home Member State that an appropriate liquidity management system and effective procedures are in place in relation to the investment strategy, liquidity profile and the redemption policy of the AIF they manage.

[78] See Articles 23 and 24 of Directive 2011/61/EU of the European Parliament and of the Council. Reporting template for regulatory disclosures 2013/1359.

[79] ESMA (2018) reports that half of the open-ended AIFs analysed in the cited paper, including open-ended AIFs that this report refers to, disclose that they require redemption notice to investors. The use of lock-up period is limited.

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