Private Assets - a popular revolution?

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The retail investment universe is changing, driven both by direct and indirect investor demand and the public sector need for support from private capital. However, the current "cult of liquidity" and resulting monolithic regulatory regime has created an environment where the necessary democratisation is hard, if not impossible, to achieve. A change in regulatory mindset (which appears now to be beginning to take hold) will hopefully catalyse new developments by fund providers as well as the acceptance of less-liquid products by intermediaries – all of which is necessary if private assets are to find a wider audience.

Investors seeking diversified, enhanced returns have increasingly looked to grow their allocation to "alternative" investments. While traditional 'institutional' investors have led the way, retail investors face significant barriers to entering the world of private assets, with exposure limited by regulation designed to "protect" them from the complexity and, especially, illiquidity of such assets.

Recent events, though, have re-focussed minds. The public sector spending necessary to aid the post COVID-19 recovery must be funded somehow and the need to boost public sector stimulus with private sector capital seems clear. While some regulatory fears remain relevant, the need for new sources of investment capital is unarguable.

Demand for broader access to private assets now comes from several areas.

- **Pension funds**, facing reduced traditional returns coupled with increasing life expectancy, are moving towards longer-term, alternative investments.
- **Funds-of-funds,** which create a more diversified portfolio by spreading risk across multiple funds, and so cater for more risk-averse investors (assuming management costs can be kept reasonable).
- **Direct retail investors who**, facing low interest rates, are increasing demand for exposure to longer-term assets, provided this is not accompanied by an unacceptable increase in risk or out of step with their personal time-horizons.

One of the key issues holding regulators back from allowing wider access to private assets has been the "liquidity mismatch" between those assets and the (perceived) necessity of easy liquidity for the retail universe.

Retail investors are regarded, en masse, as having shorter term horizons, needing the ability to redeem at short (often daily) notice. This primary liquidity requirement does not fit well with less liquid assets, which take time to sell. A real estate asset, say, may not be quickly realisable without

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destroying value. This "liquidity mismatch" has received much attention in the context of daily dealing funds that hold a small proportion of their portfolios in illiquid assets – funds which Mark Carney famously referred to as being "built on a lie".

Likewise, whilst a manager could hold cash against redemption demands, this is inefficient and fundamentally against the wishes of investors seeking access to private assets, not cash holdings.

However, **primary** liquidity by redemption is not the only solution. Investors can already access illiquid assets through listed investment trusts, which offer secondary liquidity.

With management of the fund vehicle regulated and supplemented by the relevant exchange rules, these provide an established route for retail access to private assets.

The "listed closed-end" sector is dynamic - the International Property Securities Exchange (IPSX) offers investors a dedicated platform for real estate investment, with its "prime" market offering the possibility of access to the public.

But secondary liquidity doesn't always mean public markets – one option for more sophisticated investors could lie in private secondaries – or even tokenisation of illiquid fund interests.

Secondary liquidity, though, is not a universal solution. In order to drive real democratisation a more sophisticated approach is required from regulators, recognising that liquidity is not always a prime determinant of retail suitability. Regulatory change combined with sensitive product development and appropriate advice and management decisions from intermediaries offers a more comprehensive answer.

Fortunately, regulators and industry in several countries are taking active steps to address these issues.

UK

Industry has lobbied hard for changes to allow more product innovation with moves ongoing to try to develop a more flexible regime for an onshore alternatives vehicle for the professional investor in the form of aProfessional Investor Fund (PIF) which could offer a solution for the highest end of "retail" and UK institutional investors looking to invest in long-term assets – particularly, real estate and infrastructure.

Of broader retail potential application is the Investment Association's (IA) proposal for a Long-Term Asset Fund, a new type of non-UCITS retail scheme and therefore an FCA authorised fund, expressly designed to invest in long-term assets. The likely target market comprises Defined Contribution pension schemes, professional investors and discretionary portfolio managers but marketable to retail investors, where appropriate. The IA has been working closely with the FCA to develop its proposal and, while the final form remains unknown, the regulator is expected to be supportive.

EU

European Long-Term Investment Funds (ELTIFs) were designed to help the EU's real economy by providing "finance of lasting duration" to infrastructure projects, unlisted companies and listed SMEs, thereby generating a steady income stream for entities seeking "long-term returns within well-regulated structures".

While sitting within the AIFMD regime offers advantages for ELTIFs, the level of regulation to which they are subject has stifled their development - since their introduction in 2015, only 22 have been established. Crucially, market perception is that the current ELTIF structure offers no advantage over traditional institutional-only funds.

However, there is hope. As part of the European Commission's review of the ELTIF framework, its High Level Forum notes the EU's "chronic shortage" of financing for long-term investments necessary for environmental sustainability and recommends amendments (including a broader range of eligible investments) to encourage retail participation, while taking investor protection 'into due account'. The Commission is currently consulting on proposals to amend the ELTIF framework and aims to finalise new legislation by mid-2022.

Meanwhile, the German investment funds association, BVI, has proposed a new structure, the European Impact Fund (EIF). EIFs would invest not only in equity and debt instruments issued by

EU SMEs but also in long-term projects via new "European Impact Bonds" - green or social bonds issued by the Commission, tied to individual "impactful" projects. Over time, the scheme could be extended to the private sector, with private enterprises issuing similar bonds.

Though targeted primarily at retail investors, EIFs could also be attractive to institutions. Although the BVI envisages EIFs as part of the UCITS framework (with obvious "democratic" advantages), it is unclear whether they would meet current UCITS liquidity requirements and whether those requirements would be unduly restrictive for truly long-term investment.

Italy

Italian schemes investing more than 20% in illiquid assets must be closed-end AIFs and are usually reserved to professional investors. Although they can also be structured as retail funds, in practice, few such funds have been established since they are subject to strict operational, governance and investment restrictions.

Moves, though, are afoot to amend the regulatory and tax regime for Italian AIFs.

First, a consultation is pending on facilitating investment by retail investors into reserved funds. Second, 2020 saw the introduction of Alternative PIRs (*Piani Individuali di Risparmio*), offering a favourable tax regime for Italian tax resident individuals and pension funds. These can take a variety of forms, including closed-ended AIFs, such as Private Equity funds and ELTIFs.

Returns from Alternative PIRs are exempt from income and inheritance taxes provided (among other things) at least 70% of the portfolio is invested in Italian and European SMEs for at least eight months each year.

Alternative PIRs cannot invest more than 20% of their portfolios in any one issuer while individual investors can only subscribe up to EUR 300,000 per year and in one Alternative PIR at any time, with a five year minimum holding period. (These limits do not apply to pension funds.)

US

While US investment firms are not specifically prohibited from including illiquid assets in defined pension contribution plans, managers have traditionally held back from including access to private equity investments in individual account plans as part of the overall portfolio mix. Regulators have now signalled greater willingness to allow access to products previously limited to institutional investors.

The Department of Labor recently clarified that

- ERISA fiduciary responsibility provisions do not prohibit fiduciaries of 401(k) and other individual account plans from including diversified investment options with private equity exposure, provided various requirements are met; and

- private equity investments that are part of professionally managed, multi-asset class vehicles can be offered to retail investors and form part of a prudent investment mix, provided a proper analysis is conducted by the plan's fiduciaries.

Some, though, have called on the DOL to reconsider, arguing that illiquidity and the lack of standardised performance calculations for private equity funds could be problematic for plan participants.

The SEC, too, has considered increasing retail access to private companies, seeking comments on proposals to amend current restrictions on private equity funds offering interests to retail investors, expanding the definition of "accredited investors" and allowing qualification based on defined measures of professional knowledge, experience or certifications as well as existing income or net worth tests.