Revolutionizing alternative investment: unleashing tokenized ELTIF 2.0

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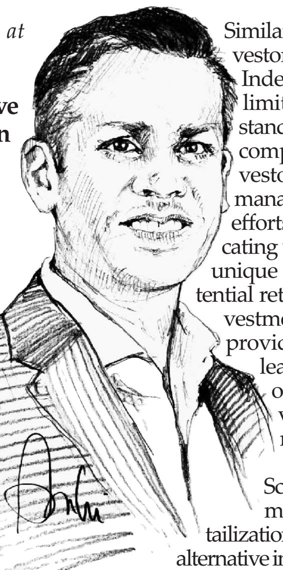

Over the past few years, alternative investment managers have been showing a growing interest in the concept of retailization[1]. Traditionally, alternative investments have been primarily available to institutional investors and high-net-worth individuals due to their complexity, high minimum investment requirements, and regulatory restrictions. However, managers are recognizing the potential benefits of making these investment opportunities more accessible to retail investors. Indubitably, several elements raise their interest when it comes to retailization.

By making alternative investments available to retail investors, managers can tap into a larger investor base, potentially increasing their assets under management and revenue streams. Also, alternative investments, such as, private equity or real estate, have historically offered diversification benefits to institutional investors. Retail investors may seek similar diversification benefits and access to potentially higher returns by including alternative investments in their portfolios.

In addition, Retailization can be made more accessible thanks to the actions of regulatory authorities in some jurisdictions, such as Luxembourg, where they have been making efforts to promote retail investor access to alternative investments by loosening certain restrictions or introducing new regulatory frameworks.

Finally, in an environment of low interest rates and relatively lower returns from traditional asset classes, retail investors are increasingly seeking alternative investments that offer the potential for higher yields or non-correlated returns. This last factor is less relevant when considering the successive interest hikes from the U.S. Federal Reserve and the European Central Bank. However, it still needs to be taken into account, as alternative investment strategies offer fairly higher returns than traditional low risk assets for a level of risk that is not necessarily significantly higher, due to the diversification offered within a typical fund vehicle.

Unpacking the challenges of Retailization

Nonetheless, it's important to note that retailizing alternative investments can present challenges. Some common pitfalls can be observed such as regulatory complexity for instance. Alternative asset managers typically operate in a highly regulated environment, and expanding into retail markets introduces additional regulatory complexities and limitations. Compliance with various rules and regulations specific to retail investors, such as suitability requirements and marketing restrictions, can be challenging and require substantial resources.

Similarly, opening access to retail investors requires investor education. Indeed, retail investors may have limited knowledge and understanding of alternative investments compared to institutional investors. Alternative investment managers need to invest significant efforts in educating and communicating with retail investors about the unique characteristics, risks, and potential returns associated with their investment strategies. Failure to provide adequate education can lead to unrealistic expectations or misalignment between investors' goals and the investment's actual outcomes.

Scale and liquidity constraints must also be considered. Retailization can increase the demand for alternative investment products, potentially necessitating larger-scale investments. Managing a large number of retail investors could pose challenges in maintaining the desired investment strategies, particularly in strategies where liquidity or capacity constraints exist. It may require adjustments to investment processes, risk management, and portfolio construction, potentially affecting performance or introducing new risks.

Retail investors could bring some performance pressure as well as they often have shorter investment horizons and may react more emotionally to short-term market fluctuations. Managers accustomed to dealing with institutional investors may face challenges in managing the performance expectations of retail investors and the associated pressures to generate consistent and attractive returns. This can lead to a conflict between meeting short-term demands and maintaining long-term investment discipline.

Another element to take into account is that, dealing with retail investors directly might be a challenge when it comes to fees. Institutional investors typically have a higher tolerance for higher fees, given the potential for outsized returns and customized services. Retail investors, on the other hand, are generally more fee-sensitive and seek lower-cost investment options. Alternative asset managers entering the retail market may need to adjust their fee structures to be more competitive, potentially affecting profitability.

Targeting retail investors can also present challenges for distribution. Indeed, effectively reaching and distributing investment products to retail investors requires building or leveraging distribution and sales channels, such as financial advisors, online platforms, or direct marketing. Developing and maintaining relationships with these channels can be time-consuming and resource-intensive, particularly for alternative asset managers who may have had limited exposure to the retail distribution landscape.

Finally, expanding into the retail market brings increased visibility and exposure to a broader investor base. Any negative events, scandals, or underperformance can quickly spread and tarnish the brand and reputation of the asset manager. Managing the increased risk of reputational damage becomes crucial when catering to retail investors.

European Long Term Investment Fund (ELTIF) 2.0 and the enhanced possibilities to attract individual investors

To successfully navigate these pitfalls, alternative asset managers need to carefully consider their operational capabilities, resources, regulatory compliance, investor education initiatives, and distribution strategies. Some existing investment products, such as Real Estate Investment Trusts (REITs) or exchange-traded funds (ETFs) package alternative strategies in a more accessible and regulated format. Earlier this year, a brand new vehicle has been released at EU level and has seen a promising start in Luxembourg, the European Long Term Investment Fund 2.0 (ELTIF 2.0). The ELTIF 2.0 is nothing less than a revamp of the previous EU ELTIF regime. Beyond the broadened scope of eligible assets, the reduction in thresholds for investments (increase of maximum market capitalization from €500 million to €1,5 billion, more flexible rules applicable for diversification and concentration), the ELTIF 2.0, coupled with tokenization can be a real game changer for alternative asset managers.

Indeed, the ELTIF 2.0 removes a certain number of barriers for retail investors. Notably, it removes the "entry ticket" requirement set at €10,000 and the 10% exposure threshold for retail investors whose financial portfolio are below €500,000. Finally, the new ELTIF 2.0 regime abolishes the requirement for ELTIF managers and distributors to provide "appropriate investment advice" when marketing ELTIF to retail investors. With all these features, the ELTIF 2.0 could be a powerful tool to attract massive amount of liquidity from retail investors to the alternative world.

Tokenization, the future of fund distribution

In the context of Retailization, blockchain technology can play a significant facilitating role through tokenization of asset, like in the case at hand, tokenization of the fund units. In a nutshell, tokenization is the process consisting in digitalizing tangible and intangible assets and transforming them into a token leveraging on the blockchain technology. In the context of, a tokenized ELTIF 2.0, blockchain and tokenization would bring significant benefits both for the asset manager and the retail investors.

Indeed, this can help managers to enhance liquidity at fund level in various aspects by unlocking the full potential of the ELTIF 2.0 features such as "matching mechanism". It addresses some of the complexities triggered by retail investors such as liquidity needs to redeem fund units when, e.g. investors decides to exit the fund. Instead of forcing the fund to sell assets (or adjust the strategy of the fund accordingly), security tokens issued by the fund to its investors could be exchanged freely with other investors (existing or new) on dedicated exchange platforms, creating a new means of liquidity exits without impacting the fund. In that sense, tokenization can create secondary markets for traditionally illiquid assets.

Investors who wish to exit their positions before the asset reaches maturity can potentially trade their tokens on secondary exchanges, providing increased liquidity and flexibility for retail investors. Additionally, tokenization could broaden the potential investor base for the fund as more people would be able to subscribe/acquire tokens. Digital tokens can be easily traded across borders, enabling broader access to alternative assets for retail investors worldwide. This opens up new markets and opportunities for asset managers to reach a more diverse investor base. Tokenization has the potential to unlock liquidity in traditionally illiquid assets such as alternative investments funds.

Tokenization could also help improving the distribution of funds and notably those targeting retail investors. Indeed, rather than using traditional distribution channels, tokenization can help deploy more innovative and user-friendly ways to market products to this very specific category of investors. In addition, it can prove to be a perfect on-ramp strategy for alternative investment managers who are not necessarily familiar with fund distribution targeting retail investors which usually require very specific distribution channels and intermediaries.

Another benefit of utilizing blockchain technology for tokenization lies with the fact that it can provide a transparent and auditable record of transactions, which can assist with regulatory compliance. The use of smart contracts can help automate compliance procedures, such as investor accreditation or KYC/AML checks, reducing administrative burdens. Furthermore, blockchain-based tokenization offers a decentralized and transparent ledger, allowing investors to view ownership, transaction history, and other essential data in real-time. This transparency can build trust with retail investors, as they can monitor their investments' performance and verify the asset's authenticity.

Last but not least, tokenization can potentially reduce operational costs associated with managing and distributing investments. With automation enabled by smart contracts, administrative overhead may be minimized. Additionally, tokenization could eliminate the need for intermediaries in some cases, leading to more direct and cost-effective investment opportunities.

Final thoughts

For the past 2 to 3 years there have been a lot of excitement in the digital asset space. We clearly see a move from a traditional finance actors towards decentralized finance and especially tokenization. Leading financial institutions have already launched their own tokenization platforms (e.g., the Onyx platform[2]) and be vocal about how bright is the future for tokenization, not only for the alternative funds industry but for the global market[3]. Tokenization represents a great opportunity for asset managers to reach out to a new category of investors by leveraging from the innovation and technology offered by the blockchain and combine with a traditional fund investment vehicle.

1) Retailization refers to the process of adapting alternative investment strategies and structures to meet the needs and preferences of retail investors.
2) https://urlzs.com/4FeaW
3) https://urlzs.com/x7gvr

ESAs Elevate Sustainability Disclosures with Revised SFDR Rules

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The European Supervisory Authorities (ESAs) have published their final report containing the draft proposal for amendments to the Regulatory Technical Standards (RTS) aimed at modifying the existing rules under the Sustainable Finance Disclosure Regulation (SFDR) with regard to sustainability- related information. The main objective is to increase transparency for investors while maintaining a balanced and proportionate approach for financial market participants.

At the heart of this development is a comprehensive impact assessment that examines the policy choices contained in the proposed RTS. Complemented by a comprehensive feedback statement on the responses gathered in the April 2023 consultation document, the report weaves a tale of meticulous scrutiny.

This holistic approach ensures that the amendments not only align with the ESAs' vision, but also address the concerns and aspirations expressed by stakeholders. The impact assessment scrutinises the proposed measures, highlighting the potential costs and benefits. The key issues are the extension of disclosure requirements, alignment with existing policy provisions and mitigation of the risk of greenwashing.

At the same time, a public consultation, to which over 180 people responded, revealed a nuanced landscape of opinion. While the call for greater transparency was unanimous, industry players expressed well-founded concerns about potential administrative burdens.

Feedback played a pivotal role in shaping the ESAs' final proposals. Concerns regarding data availability and quality, the complexity of certain disclosures, the spectre of greenwashing, and challenges associated with machine-readable formats took centre stage. The ESAs have diligently responded, refining their proposals to strike a delicate balance between ambition and practicality.

The preliminary impact assessment provides a compass for evaluating various policy options. The findings outline a strategic approach to extending social Principal Adverse Impact (PAI) indicators, disclosing greenhouse gas (GHG) emission reduction targets, designing Disclosures on Non-Sustainable Holdings (DNSH), simplifying templates, and introducing technical adjustments. Each option is carefully weighed, considering the potential benefits and implementation challenges.

One of the main thrusts of the changes is the expansion of mandatory social indicators. Investment companies will now be required to report on potential negative social impacts, including for example tax evasion, tobacco production, labour rights, the gender gap, the inclusion of people with disabilities in the workplace and wages. Responding to the European Commission's directive, these additions broaden the spectrum of social factors within the existing framework.

In line with the EU's sustainable finance strategy, financial products will now be required to disclose greenhouse gas emission reduction targets for Article 8 and 9 products. This includes detailed information on baseline emissions, intermediate targets and monitoring methods.

The aim is clear: to improve the transparency and comparability of financial products' climate commitments, in order to encourage a better-informed investment landscape. In addition to the mandatory changes, the ESAs have introduced technical adjustments to the periodic and precontractual disclosures templates to improve their usability. Visual presentations of key information, provisions extended to products with multiple investment options, clarified calculation methodologies and mandatory machine-readable information collectively contribute to making the system more user-friendly and analytically accessible.

With the final version of the SFDR now on the table, the baton has passed to the EU legislative process for adoption by the Commission, which is due to carry out a three-month review.

These amendments will be applied independently of the full review of the SFDR announced by the Commission in September 2023, which is due to make far more substantive changes.

Conclusion

The ESAs' amendments elevate sustainability-related disclosures to the next level of sophistication. Expanding vital metrics, mainstreaming climate transparency, simplifying usability, and resolving persistent issues collectively upholds the SFDR's purpose.

However, until the European Commission concludes its evaluation, certainty remains evasive. Ultimately, the amendments represent an incremental yet meaningful step towards operationalising the EU's sustainable finance aspirations.