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EU Long-term Investment Funds: new product added to the Luxembourg alternative funds toolbox

Within the framework of the Europe 2020 Strategy to put the EU back on the path to a "smart, sustainable and inclusive economy", supporting long-term investments was identified as a key element to reach such objective.

In this context, in June 2013, the EU Commission (Commission) submitted a proposal for a regulation on EU Long-term Investment Funds (ELTIF Regulation) to boost long-term investment in the EU economy through the introduction of a new type of collective investment vehicle designed to provide private capital for the financing of long-term projects such as infrastructure, private equity or real estate projects.

A provisional agreement on ELTIF Regulation was reached in trialogue in November 2014 (*i.e.* by representatives of the European Parliament, the Council of the EU and the Commission) and the text was finally adopted by the European Parliament during its plenary session of 10 March 2015.

The Council of the EU, which had already confirmed its agreement with the European Parliament in December 2014, has now endorsed the regulation at its meeting of 20 April 2015 without further discussion.

The ELTIF Regulation shall enter into force 20 days after its publication in the Official Journal of the European Union which is expected in May-June 2015. It shall apply six months after its entry into force. The European Securities and Markets Authority (ESMA) shall elaborate and submit draft regulatory technical standards to the Commission within three months after the entry into force of the ELTIF Regulation.

As Alain Lamassoure, Parliament rapporteur for the ELTIF Regulation, has emphasised, this "efficient new tool" will not only give a major boost to financing long-term investment, but will also help to build the capital market union.

The ELTIF Regulation complements the European venture capital funds (EuVECA) and the European social entrepreneurship funds (EuSEF) regulations which have been applicable in all Member States since July 2013.

The design of the ELTIF regime is based on the following core features:

- Specific product rules covering eligible assets and their diversification (*i.e.:* an ELTIF must invest at least 70% of its capital in clearly-defined categories of eligible assets, while trading in assets other than long-term investment is only permitted up to a maximum threshold of 30% of its capital).
- AIFMD requirements applicable regarding authorisation, marketing, cross-border distribution.
- Prospectus directive and the PRIIPs regulation rules (PRIIPs rules applying when targeting retail investors).
- Retail investors' access to ELTIFs.
- Entry ticket required (*i.e.* minimum amount invested is not less than 10,000 euros).
- Alignment between the ELTIFs investment horizon and the redemption expectations of investors.
- ELTIFs' framework has the potential to encourage pension funds and insurers to invest in ELTIFs.

This newsflash will provide you with an overview of the key elements of ELTIFs.

What is an ELTIF?

ELTIFs have been designed to be offered to both retail and professional investors across Europe. Although qualifying as an alternative investment fund (AIF), ELTIFs may be considered to be a hybrid framework between the alternative investment fund managers (AIFM) and UCITS regimes which aims at facilitating cross-border distribution through a European passport allowing fund managers to distribute their products on a pan-European basis. The ELTIF Regulation is closely linked to the AIFMD regime in the sense that an ELTIF is an EU AIF managed by an EU AIFM authorised under the AIFMD.

Eligible investments

An ELTIF is only permitted to invest at least 70% of its capital in the following eligible investment assets:

- Equity or quasi-equity instruments which have been issued:
  - by a qualifying portfolio undertaking (*re. qualifying portfolio undertakings, please see below*) and acquired by the ELTIF from the qualifying portfolio undertaking or from a third party via the secondary market;
  - by a qualifying portfolio undertaking in exchange for an equity instrument previously acquired by the ELTIF from the qualifying portfolio undertaking or from a third party via the secondary market;
  - by an undertaking of which the qualifying portfolio undertaking is a majority-owned subsidiary in exchange for an equity or quasi-equity instrument acquired in accordance with one of the two points mentioned above by the ELTIF from the qualifying portfolio undertaking or from a third party via the secondary market.
- Debt instruments issued by a qualifying portfolio undertaking.
- Loans granted to a qualifying portfolio undertaking with a maturity not exceeding the life of the ELTIF.
- Units or shares of one or more other ELTIFs, EuVECAs and EuSEFs, provided that such ELTIFs, EuVECAs and EuSEFs have not themselves invested more than 10% of their capital in ELTIFs.

- Direct holdings or indirect holdings via qualifying portfolio undertakings of individual real assets with a value of at least EUR 10 million or its equivalent in the currency, and at the time, in which the expenditure is incurred. Real assets are defined in the ELTIF Regulation as assets that have value, by virtue of their substance and properties, and may provide returns. Furthermore, the recitals of the ELTIF Regulation provide for various examples of 'real assets' including infrastructure, intellectual property, equipment, aircraft, immovable property.

In addition, up to 30% of an ELTIF's assets may be invested in UCITS eligible assets.

Qualifying portfolio undertaking

A qualifying portfolio undertaking is defined as a portfolio undertaking other than a collective investment undertaking that, at the time of an investment by an ELTIF meets the following criteria:

- It is not a financial undertaking.
- It is not a portfolio undertaking admitted to trading on a regulated market or a multilateral trading facility as defined in MiFID unless it has a market capitalisation of no more than EUR 500 million.
  By allowing traded portfolio undertakings to have a market capitalisation of no more than EUR 500 million, the ELTIF Regulation has specifically addressed the difficulties encountered by listed small and medium-sized enterprises in accessing long-term financing, given that ELTIFs may provide a valuable alternative source of funding.
- It is established in an EU Member State or in a third country provided that the third country is not identified as a high-risk and non-cooperative jurisdiction by the Financial Action Task Force, and that such third country has signed a cooperation agreement with the home Member State of the ELTIF's manager and with all other Member States where the ELTIF is intended to be marketed in order to comply with Article 26 of the OECD Model Tax Convention on Income and on Capital and to ensure effective exchange of information in tax matters.

Diversification requirements

As mentioned above, an ELTIF shall invest at least 70% of its capital in eligible investment assets. This limit applies as from the date specified in the ELTIF rules or instruments of incorporation for a period which may not exceed 5 years or half of the life of the ELTIF, whichever is earlier, after its authorisation in order to allow for sufficient managerial flexibility to build up the ELTIF portfolio. Such time limit may be extended by an additional year under exceptional circumstances.

In addition to portfolio composition, diversification rules regarding ELTIFs' investments have been introduced by the ELTIF Regulation in order to limit risk-taking by ELTIFs. Accordingly, an ELTIF shall not invest more than 10% of its capital in instruments issued by or loans granted to any single qualifying portfolio undertaking or in a single real asset, provided that such limits may be raised to 20% in case the aggregate value of such assets in which it invests more than 10% of its capital does not exceed 40% of the value of its capital.

It shall also not invest more than 10 % of its capital in units or shares of any single ELTIF, EuVECA or EuSEF, provided that the aggregate value of units or shares of ELTIFs, EuVECAs and EuSEFs in an ELTIF portfolio shall not exceed 20% of the value of its capital.

Furthermore, the aggregate risk exposure to a counterparty of the ELTIF stemming from over-the-counter (OTC) derivate transactions, repurchase or reverse repurchase agreements shall not exceed 5% of its capital.

Lastly, no more than 5% of its capital may be invested in UCITS eligible assets issued by a single body provided that under certain conditions this 5% limit may be raised to 25%.

In case of infringement of the diversification requirements and when the contravention is beyond the control of the ELTIF manager, the ELTIF manager shall, within an appropriate time period, take the necessary measures to rectify the position, taking due account of the interests of investors in the ELTIF.

Diversification requirements shall cease to apply once the ELTIF starts to sell assets in order to redeem investors' shares after the end of the life of the ELTIF and may be suspended for a maximum of 12 months if the ELTIF raises additional capital or reduces its existing capital.

Concentration limits

An ELTIF may not acquire more than 25% of the units or shares of a single ELTIF, EuVECA or EuSEF.

Prohibited investments

According to the ELTIF Regulation, an ELTIF is not permitted to:

- engage in short-selling;
- take direct or indirect exposure to commodities or any other means or instruments that would give an exposure to them;
- enter into securities lending, securities borrowing, repurchase transactions or any other agreement which has an equivalent economic effect;
- use financial derivative instruments other than for hedging risks inherent to other investments of the ELTIF.

Borrowings restrictions

Borrowings are strictly restricted. An ELTIF may only borrow cash if the following five cumulative conditions are met:

- It is limited to 30 % of the capital[1] of the ELTIF.
- It is limited to the purpose of acquiring eligible investment assets. In order to address concerns related to shadow banking activities, the cash borrowed from the ELTIF should not be used for granting loans to qualifying portfolio undertakings.
- Borrowings must be expressed in the same currency as the asset to be acquired.
- Borrowings must have a maturity not exceeding the life of the ELTIF.
- The ELTIF's assets encumbered are not more than 30% of its capital.

The ELTIF manager shall specify in the prospectus of the ELTIF whether or not it intends to borrow cash as part of its investment strategy.

[1] With respect to ELTIFs, "capital" means aggregate capital contributions and uncalled committed capital calculated on the basis of amounts investible after deduction of all fees, charges and expenses which are directly or indirectly borne by investors.

Such borrowing restriction coupled with the strict investment eligibility criteria and the prohibition to enter into securities lending agreements, securities borrowing agreements and repurchase agreements raises the issue of the extent of the ELTIF's capacity to use leverage in the context of the implementation of its investment strategy, especially when the ELTIF invests through complex corporate or financial structures. Indeed most of the investment strategies pursued by private equity, real estate and infrastructure fund managers imply the use of third party finance at some level of the structure.

It remains to be seen whether the ELTIF regime will be further clarified to reflect the approach followed under the AIFMD, where the leverage that exists at the level of portfolio investments is not always taken into account in terms of limitations, when the AIF does not have to bear potential losses beyond its investment in the relevant company or issuer.

Redemptions

Due to the illiquid nature of the portfolio of ELTIFs, investors shall in principle not be permitted to request the redemption of their units or shares. Redemptions shall only be possible as of the day following the date defining the end of life of the ELTIF which must be clearly indicated in the ELTIF rules or instruments of incorporation.

In order to incentivize investors, in particular retail investors, who might not be willing to lock-up their capital for a long period of time, an ELTIF should be able to offer under certain conditions early redemption rights to its investors. The ELTIF rules or instruments for incorporation may allow early redemptions provided that the following cumulative conditions are fulfilled:

- Redemptions are not granted before the date on which the diversification requirements start to apply (*as set out above*).
- The manager of the ELTIF is able to demonstrate that an appropriate liquidity management system and effective procedures for monitoring the liquidity risk of the ELTIF are in place.
- The ELTIF manager has set out a defined redemption policy, which clearly indicates the periods of time in which investors may request redemptions.
- The redemption policy of the ELTIF ensures that the overall amount of redemptions within any given period is limited to a percentage of the UCITS eligible assets held by the ELTIF.
- The redemption policy of the ELTIF ensures that investors are treated fairly and redemptions are granted on a pro rata basis if the total requests for redemption within any given period of time exceed the percentage of the UCITS eligible assets held by the ELTIF.

The ELTIF shall not prevent the units or shares from being admitted to trading on a regulated market or multilateral trading facility nor prevent investors from freely transferring their shares or units to third parties.

Distributions

To offset the strict early redemption facilities of ELTIFs, the ELTIF Regulation has provided for the possibility of ensuring steady income to investors in ELTIFs. To that end, ELTIFs shall have the right to make distributions of proceeds (regular proceeds that the assets are producing and the capital appreciation realised after the disposal of an asset) but only to the extent that such income is not required for future investments. An ELTIF may reduce its capital on a *pro rata* basis in the event of the disposal of an asset, provided that the early disposal is duly considered to be in the investors' interest. All other proceeds are to be distributed when the ELTIF is liquidated after the end of its term.

Prospectus and PRIIPs Rules

Before an ELTIF can be marketed in the EU, a prospectus complying with the requirements of the Prospectus Directive must be published. In addition, the prospectus must contain specific information including:

- a statement setting out how the ELTIF's investment objectives and strategy for achieving these objectives qualify the fund as long-term in nature;
- a prominent indication of the categories of assets in which the ELTIF is authorised to invest.

In addition to the prospectus requirement, a key information document (KID) in accordance with regulation of packaged retail and insurance-based investment products (the so-called PRIIPs regulation) must also be published before the shares or units of an ELTIF are marketed to retail investors. Such KID shall include specific risk warnings about the illiquid nature of the ELTIF.

Specific Requirements for Retail Investors

In order to reconcile opposing interests resulting from lack of liquidity and the possibility of having retail investors, a certain number of increased protection requirements will apply to ELTIFs when targeting retail investors.

For the definition of a retail investor, the ELTIF Regulation refers to MiFID[2].

Before any marketing or distribution of an ELTIF to retail investors, an ELTIF manager should assess the retail investor's knowledge as well as the suitability of the ELTIF.

The ELTIF manager shall put in place and apply a specific internal process to assess whether the ELTIF is suitable for marketing to retail investors, taking into account at least the lifecycle and the intended investment strategy of the ELTIF. The ELTIF manager shall also make available to any distributor all appropriate information on the ELTIF that is marketed to retail investors.

Moreover, when directly offering or placing an ELTIF to retail investors, the ELTIF manager shall obtain the necessary information regarding the retail investor's knowledge and experience in the investment field relevant to the ELTIF, his financial situation including his ability to bear losses, and his investment objectives including his time horizon so as to enable the ELTIF manager to recommend the ELTIF only if it is suitable for the retail investor.

Where the lifecycle of an ELTIF that is offered or placed to retail investors exceeds 10 years, the ELTIF manager or distributor shall issue a clear written warning that this product may not be suitable for retail investors unable to sustain such a long term and illiquid commitment.

Retail investors shall be provided with appropriate investment advice from the ELTIF manager or the distributor.

In addition, the ELTIF regime expressly provides that, in the case of marketing to retail investors, where the financial instrument portfolio of a potential retail investor does not exceed EUR 500,000, the manager of the ELTIF or any distributor shall ensure that the potential retail investor does not invest an aggregate amount exceeding 10% of his financial instrument portfolio in ELTIFs provided that the initial minimum amount invested in one or more ELTIFs is EUR 10,000.

The ELTIF manager shall establish appropriate procedures and arrangements to deal with retail investor complaints, which allow retail investors to file complaints in the official language or one of the official languages of their Member State.

[2] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

In case of marketing to retail investors, all investors must benefit from equal treatment and no preferential treatment or specific economic benefits shall be granted to individual investors or groups of investors. Retail investors may also, during the subscription period and at least two weeks after the subscription of units or shares of the ELTIF, cancel their subscription and have the money returned without penalty.

Finally, it is worth bearing in mind that specific rules apply to the depositary of an ELTIF marketed to retail investors.

Outlook

Although the industry has welcomed the initiative of the Commission to introduce such new product, some key players have raised practical concerns linked in particular to the hybrid nature of ELTIFs (e.g. the 10% investment restriction for retail investors in certain circumstances, the minimum amount of the initial investment or the very restricted early redemption rights). Furthermore, the industry criticises the lack of flexibility of the ELTIF Regulation due to an accumulation of rules (i.e.: AIMFD, Prospectus Directive, MiFID and PRIIPs in addition to the ELTIF's product rules). However, this new product may be a success if the European regulator adjusts the regulatory requirements for insurers and pension funds as they could be key players in the ELTIFs success.

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