

European Long Term Investment Funds - ELTIFs

Updated May 2015

The publication of the Regulation for ELTIFs on 19 May 2015 in the EU Official Journal will result in ELTIFs being introduced under the AIFMD as a new fund label for long term investment funds but ones which will have a passport for promotion of retail investors. The logic as to how UCITS and AIFMD sit alongside each other, with AIFMD being for managers of alternative investment funds offered to professional investors, is put into question. Nonetheless, it is encouraging that the European Commission is open to widening the offering of the range of investment funds. Indeed, in its flagship initiative for Building a Capital Markets Union published in February, it sees early progress resulting from supporting the take up of new ELTIFs to channel investment into infrastructure and other long term projects.

What is their purpose?

Article 1 of the Regulation is to state that the objective of the Regulation is to raise and channel capital towards European long term investments in the real economy, in line with the European Union's objectives of smart, sustainable and inclusive growth.

It is perceived that there is a gap in the market place under the European Directive system whereby investments should be offered not just to professional investors but also to smaller investors including retail savers. All UCITS funds are truly open ended – there must be arrangements for issue and redemption of units/shares subject to limited scope for suspension of dealings in exceptional circumstances. The object of ELTIFs will though be to allow investors to put money into companies and projects that need long term capital. They mention for example infrastructure projects. In this they are seeing the funds as being able to increase the amount of non-bank finance available for companies investing in the real economy of the European Union. To facilitate this there needs to be a lock-in period where the investors do not have redemption rights for their units/shares.

Qualifying portfolio undertakings

The objective is to encourage investment in unlisted companies which need long term capital, real assets that need long term capital to develop them, European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF).

The Regulation will include a definition of a qualifying portfolio undertaking which refers to unlisted undertakings established in a Member State, which should encourage EU investment. The Regulation does though also go on to allow an ELTIF to invest not only in an undertaking established in the Member State, but also an undertaking established in a third country provided the third country is not in a high risk and non-co-operative jurisdiction identified by the Financial Action Task Force and has signed an agreement with the home Member State of the manager of the ELTIF and of the other member state in which units or shares of the ELTIF are intended to be marketed to ensure that the third country fully complies with the standards noted down in Article 26 of the OECD Model Tax Convention on income and on capital and ensures an effective exchange of information in tax matters including any multinational tax agreement. Also the previously made proposal that at

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least 60% of its capital must be in securities issued by eligible portfolio undertakings established in the EU has been removed from the finalised text of the Regulation. Consequently, it would appear that a qualifying portfolio undertaking is quite widely defined and so one of the Commission's expressed aims of encouraging investment in the real economy of the European Union might not necessarily be achieved.

Investment constraints

The idea is that at least 70% of the money is invested in the assets explained above.

There are both diversification and concentration provisions included in the Regulation so, to this extent, the approach does follow that in the UCITS Directive which looks at the funds and gives them precise parameters. In addition to the point mentioned above about the 70% being invested in eligible investment assets:

- No more than 10% should be invested in any single real asset (5% in assets referred to in Article 50(1) of Directive 2009/65/EC which by derogation may be raised to 25% where bonds are issued by a credit institution which has its registered office in a Member State and is subject by law to a special public supervision designed to protect bond holders and which meet the criteria set out in Article 12 of the Regulation). The 10% limit is raised to 20% provided the aggregate value of the assets held by the ELTIF in qualifying portfolio undertakings and in individual real assets in which it invests more than 10% does not exceed 40% of the value of its capital.
- No more than 10% should be invested in instruments issued by, or loans granted to, any single qualifying portfolio undertaking.
- The maximum to be invested in EuVECA's and EuSEFs is 20%.
- Aggregate risk exposure to a counterparty stemming from OTC derivative contracts or reverse repo agreements is 5%.

For those of you familiar with the UCITS constraints therefore, the approach on some of these investment parameters – or at least their derivation – is very clear and based on a specific approach.

An ELTIF shall not:

- short sell any assets;
- take direct or indirect exposure to commodities including via derivatives, certificates representing them, indices based on them or any other means or instrument that would give an exposure to them;
- enter into securities lending, securities borrowing and repo transactions or any other agreement which has an equivalent economic effect and poses similar risks if thereby more than 10% of the assets of the ELTIF are affected; or
- use financial derivative instruments except where it solely serves the purpose of hedging risks inherent to other investments of the ELTIF.

The portfolio composition and diversification rules should be applied on the earlier of five years or half the lifetime of the ELTIF after authorisation, although the relevant regulator can upon submission of a duly justified investment plan approve an extension by no more than one additional year. These rules cease to apply once the ELTIF starts to sell investments in order to redeem investors after the end of the life of the ELTIF. They may be temporarily suspended where the ELTIF raises additional capital or reduces its additional capital for a period of no longer than 12 months.

Where there is a breach of a diversification requirement and the contravention is beyond the control of the ELTIF manager, the ELTIF manager must, in an appropriate time period, take measures as are necessary to rectify the position taking due account of the interests of investors of the ELTIF. Usefully some late amendments to the wording in the Regulation recognise the difficulties in achieving rectification in a fund which has illiquid investments.

To constrain concentration, an ELTIF may acquire no more than 25% of the units or shares of a single ELTIF, EuVECA or EuSEF, and further the concentration limits in the UCITS Directive in Article 56(2) will apply to any assets referred to in Article 50(1) of the UCITS Directive.

Borrowing powers

An ELTIF may borrow cash provided the borrowing:

- represents no more than 30% of the capital of the ELTIF (note the late reduction of this to 30% from

- 40%);
- serves a purpose of investing in eligible investment assets except for loans granted to a qualifying portfolio undertaking (with the majority no longer than the life of the ELTIF) provided that the holdings in cash or cash equivalents of the ELTIF are not sufficient to acquire the participation in eligible investment assets;
- is contracted in the same currency as the assets to be acquired with the borrowed cash;
- has a maturity no longer than the life of the ELTIF; and
- encumbers the assets that represent no more than 30% of the capital of the ELTIF.

There may therefore be limited leverage of up to only 30% for the purpose of acquiring participation in eligible investment assets and provided it does not encumber the assets in the portfolio (and so is not secured).

Lock-in period

In order to fit with the long term purpose, there will be a lock-in period during which investors will not be able to ask for redemption of their units or shares which will be "the end of life of the ELTIF". This specific date is to be stated in the rules or instrument of incorporation and disclosed to investors. In a sense it could be viewed very much like a closed ended private equity fund proposition.

Article 16 of the finalised Regulation provides only a limited derogation from the lock-in provision where certain conditions are fulfilled, which link with the typical concerns regarding liquidity management arrangements, fair treatment of investors and clear disclosure of the defined redemption policy.

The aim is that the "life of the ELTIF" shall be sufficient in length to cover the lifecycle of each of the individual assets of the ELTIF measured according to the illiquidity profile and economic lifecycle of the asset and the stated investment objective of the ELTIF. As is increasingly the case, the intention is that ESMA will develop regulatory technical standards (RTS) specifying the circumstances in which the life of an ELTIF is sufficient in length to cover the lifecycle of each of the individual assets of the ELTIF.

Role of AIFMs

Having explained above that the approach on some provisions are derived from UCITS, it is only managers who are authorised under the AIFMD which can offer an ELTIF. As an ELTIF is not a UCITS it inevitably will be an AIF and so its manager (whether external or internal) must be authorised under the AIFMD.

Promoting ELTIFs

The distinction between promoting regulated collective investment schemes which are available to all investors including retail investors and promoting unregulated collective investment schemes which are now subject to an even more restricted list of categories of potential investors in the UK has always been clear, even if the categories have latterly been more narrowly defined and the increasing restrictions on promotion have become a bone of contention. We are always particularly conscious of the constraints on availability of funds in the UK. With the introduction of AIFMD, we now have to cope with a new divide of whether the marketing passports will be available and whether the funds can be made available to retail investors in particular Member States.

An ELTIF will however introduce yet a third dilemma. They will sit under AIFMD and will build on the cross border provisions in AIFMD adding to the European passport for marketing to professional investors, but also adds a European passport for marketing to retail investors across the EU with regard to ELTIFs. This is subject to compliance with the strict ELTIF rules limiting investments and assets that may create a conflict of interest, transparency rules required in publication of a key investor document and specific marketing conditions. In the Frequently Asked Questions document released by the European Commission it is indicated that an ELTIF will be regarded as a packaged retail investment product (PRIIP) and so be subject to the requirement of a key information document explaining the features and risks; and they also make reference to the MiFID provisions for investment products so that in practice they indicate that an ELTIF will have to assess its suitability in relation to the financial needs of the person to whom they are offering it.

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Transparency requirements

Article 21 of the Regulation requires that units or shares of an authorised ELTIF shall not be marketed in the EU without prior publication of a Prospectus. This is in addition to the requirement that units or shares shall not be marketed to retail investors without prior publication of a KIID in accordance with the PRIIPs Regulation.

The Prospectus must contain at least the following information:

- how the investment objectives and strategy for achieving those objectives qualify the Fund as long term in nature;
- information to be disclosed by collective investment undertakings of the closed-ended type in accordance with the Prospectus Directive and the Prospectus Regulations;
- information to be disclosed to investors pursuant to Article 23 of AIFMD, if not already covered under the previous point;
- a prominent indication of the categories of assets in which the ELTIF is authorised to invest;
- a prominent indication of the jurisdictions in which the ELTIF is allowed to invest; and
- any other information considered by the relevant regulators to be relevant in order to provide the information necessary for investors to be able to make an informed judgement regarding the investment proposed to them and in particular the risks attached to it.

The Prospectus and other marketing documents must prominently notify investors about the illiquid nature of the ELTIF. The Prospectus and any other marketing documents must clearly:

- inform investors about the long term nature of the ELTIF's investments;
- inform investors about the end of the life of the ELTIF as well as the option to extend the life of the ELTIF, if this is provided, and the relevant conditions;
- state whether the ELTIF is intended to be marketed to retail investors;
- explain the right of investors to redeem their investment and the rules of the ELTIF;
- state the frequency and time of any income payments, if any, during the life of the Fund;

- advise investors that only a small proportion of their overall investment portfolio should be invested in an ELTIF;
- describe the hedging policy of the ELTIF including a prominent indication that financial derivative instruments may only be used for the purpose of hedging risks inherent in other investments of the ELTIF, and an indication of the possible impact of the use of financial derivative instruments on the risk profile of the ELTIF;
- inform investors about the risks related to investing in real assets/infrastructure;
- inform investors regularly, at least once per year, of the jurisdictions in which the ELTIF has invested.

An additional late introduction to the Regulation's text is that the Annual Report of the ELTIF should contain a cash flow statement and information of the geographical location of the assets of the ELTIF, in addition to information on any participation of instruments involving Union budgetary funds and the value of the individual qualifying portfolio undertakings and value of other assets – and the annual report must also now include the value of any derivatives used.

Upon request of a retail investor, the ELTIF manager must also provide supplementary information relating to the quantitative limits that apply in the risk management of the ELTIF, to the methods chosen to this end and to the recent evolution of the main risks and the yields of the instrument categories.

These late amendments reflect the concern that the original drafts of the Regulation were relatively lightweight on the requirements for transparency. The Regulation now contains some familiar elements on disclosure which, taken together with the advice requirement, does strengthen the regulatory approach in connection with retail investment quite some considerable way from the April 2014 draft of the Regulation.

Promoting ELTIFs retail

The more onerous late amendments to the original drafts of the Regulation concern the means of distribution to retail investors, so as to strengthen the protection for retail investors.

Before marketing an ELTIF to retail investors, its manager must establish and apply specific internal processes for the assessment of the ELTIF to see whether it is suitable for marketing to retail investors, taking into account its lifecycle, the intended investment strategy. The manager must make available to any distributor all appropriate information on the ELTIF including information as regards the lifecycle and its investment strategy, as well as on the internal assessment process and jurisdictions in which the ELTIF has invested. A new provision has recently been inserted as Article 28 of the Regulation inserting specific requirements for retail distribution too.

For a retail investor whose portfolio does not exceed €500,000, the manager of the ELTIF or any distributor, after having performed the suitability test and having provided appropriate investment advice, shall, on the basis of the information submitted by the potential retail investor, 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 €10,000. The potential retail investor is expressed to be responsible for providing accurate information on his portfolio. This provision will of course preclude a direct execution only offering of ELTIFs. Indeed one new sentence in Article 30 of the Regulation states: "*The units or shares of an ELTIF may be marketed to retail investors on the condition that retail investors are provided with appropriate investment advice by the manager of the ELTIF or the distributor.*"

Where the ELTIF manager directly offers or places an ELTIF to retail investors, that manager must be authorised to provide the services referred to in Article 6 (4) of AIFMD and perform the suitability test referred to in Article 28(1) of the Regulation. This Article 28(1) requires that, when directly offering or placing an ELTIF to a retail investor, the ELTIF manager shall obtain the necessary information regarding the retail investor's knowledge and experience in the investment field relative to the ELTIFs and that person's financial situation, including his ability to bear losses and his investment objectives including his time horizon. Based on this information, the manager of the ELTIF shall recommend the ELTIF only if it suitable for a particular retail investor. Further, where the life cycle of an ELTIF that is offered or placed exceeds 10 years, the ELTIF manager or distributor must issue a clear written alert that this product may not be suitable for those retail investors unable to sustain such a long term and illiquid

commitment.

This will all require careful documenting of the execution of the respective responsibilities of provider and distributor. Also, it will ensure that not only does the investor receive full information but also receives advice before investing.

Timetable

There has been a consultation since mid 2012 and the Commission has prepared an impact assessment – so at least the proposal is not quite as rushed as for AIFMD.

The publication of the Regulation¹ in the Official Journal on 19 May 2015 means the Regulation will apply from 9 December 2015. The Regulation is directly applicable in all Member States and so there will be no time delay in awaiting individual implementation in Member States.

When the Regulation does come into force, ESMA will be required to produce regulatory technical standards on various issues which would need to be submitted to the Commission for consideration and adoption.

Loss of logic?

It seems curious to try and look at product regulation for UCITS for retail investors and then manager regulation for professional investor funds under AIFMD and then to propose an ELTIF product which is an amalgamation of the two but which would sit under AIFMD. Indeed, in the market place, talk of ELTIFs being "long term UCITS" demonstrates the confusion which is likely to arise.

There is some logic for EuVECAs (European Venture Capital Funds) and EuSEFs (European Social Entrepreneurship Funds), with the minimum investment level of €100,000, which have been available since 22nd July 2013. These are targeted at very different sets of more specialist investors who might wish to be investing in highly risky start-ups. There is also some logic in building on EuVECAs and EuSEF provisions so they can be offered by AIFMs generally: they squarely fit under AIFMD.

¹ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0760&rid=1>

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The risk here for ELTIFs is that, because they seem to be subject to more specific consumer protection rules, they suddenly might appear to dress up what are really private equity fund proposals into something which appears more retail without resolving their core feature, and potential problem: which is that they must be presented within closed ended funds. We might limit the leverage and ban short selling and include some diversification requirements but essentially an ELTIF is still making illiquid investments which are going to be made which are hard to close out.

The Commission's answer on all of this seems to be to require that retail investors receive advice before investing. This though might simply preclude some from investing rather than focusing more on the education of investors so that they can decide whether or not to invest in an illiquid asset.

Likely demand for ELTIFs?

The aim of the Commission is clear: it indicates under the question "How much demand is there for ELTIFs" that an estimated €1,500 - €2,000 billion will be needed to finance infrastructure projects alone in Europe up to 2020 and so there is a need for large scale financing. But, as mentioned above, the investment powers would seem to go wider than Europe. Also the question is whether there is an appetite from potential investors to fund these projects through these sorts of funds.

It is expected that ELTIFs should particularly appeal to investors such as insurance companies or pension funds which need steady income streams or long term capital growth. The Commission's February 2015 Green Paper on Building a Capital Markets Union indeed asks for further views as to what further role the Commission and Member States could play in supporting the take up of ELTIFs, including the possible extension to ELTIFs of advantages currently available for national regimes.

The Commission certainly seems keen to be seen to be supporting the take up of these new ELTIFs to channel investment into infrastructure and other long term projects.

fieldfisher

Contacts



Kirstene Baillie

Partner - Financial Services and Funds

E: kirstene.baillie@fieldfisher.com

T: +44 (0)20 7861 4000



Nicholas Thompsell

Partner - Financial Services and Funds

E: nicholas.thompsell@fieldfisher.com

T: +44 (0)20 7861 4292

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