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ELTIF - A New Retail Fund that will Benefit from the AIFMD Passport

by **David Williams**

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An ELTIF is a new type of collective investment vehicle that will allow retail investors to put money into companies and projects that need long-term capital.

Regulation (EU) 2015/760 on European long-term investment funds (ELTIFs) (the Regulation) aims to increase the capital available for long-term investment in the EU economy through this new form of fund vehicle. It is targeted at investment fund managers who want to offer long-term investment opportunities to institutional and private investors across Europe using the AIFMD passport.

The Regulation was published in the Official Journal of the EU on 19 May 2015 and it will apply from 9 December 2015.

In previous articles we have reviewed a number of measures implemented by both the Central Bank of Ireland (Central Bank) and the European Commission that aim to alleviate what has been termed the ‘funding gap’, that has developed as a consequence of the 2008 crisis whereby banks can no longer act as financial intermediaries that help channel capital toward large infrastructure projects. To try to fill this gap, the Central Bank and the European Commission have each tried to (and must) find ways to enable such project finance to be raised directly from capital markets. The ELTIF is the latest in a range of fund initiatives at EU level to address the funding gap and it follows ‘hot-on-the-heels’ of the EU Regulations on European Social Entrepreneurship Funds (EuSEF) and European Venture Capital Funds (EuVECA).

The ELTIF is designed to be available to all types of investors across Europe subject to certain requirements set out in EU law. These requirements include the types of long-term assets and projects that the ELTIFs are allowed to invest in, for example infrastructure, transport and sustainable energy projects; how ELTIFs have to spread their money to reduce risks; and the information ELTIFs have to provide to investors. Any ELTIF manager would also have to comply with all of the requirements of the Alternative Investment Fund Managers Directive (Directive 2011/61/EU of 8 June 2011) (AIFMD) (together with Commission Delegated Regulation (EU) No. 231/2013 of 19 December 2012) to provide adequate protection for its investors, in exchange for which they benefit from the EU marketing passport and the ability to sell to retail investors.

If ELTIFs develop as a brand, similar to the success of the UCITS brand which is recognised worldwide, there could be increased marketing opportunities available to ELTIFs. Under the Regulation, the European Securities and Market Authority is mandated to maintain a publicly available register of all authorised ELTIFs and their managers. In addition, the Regulation identifies the European Investment Bank as a potential investor in ELTIFs.

Who can offer an ELTIF?

Only EU managers who are authorised under the AIFMD can offer an ELTIF. The AIFMD puts in place a stringent set of rules for anyone managing Alternative Investment Funds (AIFs). They also include requirements on depositaries, valuation, mechanisms to deal with conflicts of interest and disclosure of information to investors. As an ELTIF is an AIF and not a UCITS fund, its manager must be authorised under the AIFMD. The intention behind the ELTIF Regulation is to enable EU-authorised AIFMs to market EU AIFs which they manage as ELTIFs to both professional and retail investors (as defined under MiFID) across the EU. Authorised managers will be able to make use of an EU-wide passport, subject to a notification procedure established under the AIFMD.

Who can invest in an ELTIF?

ELTIFs are open for investments from both professional investors and retail investors. Professional Investors, for the purpose of ELTIFs, are those investors who can be considered to be professional clients, or who may, on request, be treated as a professional client in accordance with Annex II to Directive 2014/65/EU (the same definition as is used in AIFMD). Retail investors are investors who are not professional investors.

There are some requirements imposed on AIFMs marketing ELTIFs to retail investors including:

1. Assessing the suitability of the ELTIF for the retail investor by obtaining information in relation to:

1.1 the retail investor's knowledge and experience in the investment field relevant to the ELTIF;

1.2 the retail investor's financial situation, including that investor's ability to bear losses; and

1.3 the retail investor's investment objectives, including that investor's time horizon,providing retail investors with a key investor information document that summarises the key points in the ELTIF's prospectus and provides certain information in relation to risk assessment and fee levels.

2. Ensuring where the financial instrument portfolio of a potential retail investor is less than EUR 500,000, having performed the suitability test referred to in point 1 above and having provided appropriate investment advice, on the basis of the information submitted by the potential retail investor, that the potential retail investor does not invest an aggregate amount exceeding 10% of that investor's financial instrument portfolio in ELTIFs.

3. Requiring an initial minimum investment amount in one or more ELTIFs of EUR 10, 000.

4. Where the life of an ELTIF exceeds ten years, providing a written warning that the ELTIF may not be suitable for retail investors that are unable to sustain a long-term and illiquid investment.

5. Ensuring that retail investors have no further liability or additional commitment to the ELTIF other than the original capital commitment.

Eligible investments for an ELTIF

The Regulations provide that an ELTIF must generally invest 70% of its capital in "eligible investment assets", which are defined as:

1. Equity or quasi-equity instruments that have been:

1.1 issued by a qualifying portfolio undertaking and acquired directly by the ELTIF from the qualifying portfolio undertaking (see below) or from a third party through the secondary market;

1.2 issued 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 through the secondary market; or

1.3 issued by an undertaking of which the qualifying portfolio undertaking is a majority-owned subsidiary, in exchange for an equity instrument acquired in accordance with points 1.1 or 1.2 above by the ELTIF from the qualifying portfolio undertaking or from a third party through the secondary market.

2. Debt instruments issued by a qualifying portfolio undertaking;

3. loans granted by the ELTIF to a qualifying portfolio undertaking with a maturity no longer than the life of the ELTIF;

4. units or shares of one or several other ELTIFs, EuVECAs and EuSEFs, provided that those ELTIFs,

EuVECAs and EuSEFs have not themselves invested more than 10% of their capital in ELTIFs; and

5. 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.

A qualifying portfolio undertaking referred to above is a portfolio undertaking other than a collective investment undertaking that fulfils the following requirements:

1. It is not a financial undertaking (i.e. it is not a credit institution, a MiFID investment firm, an insurance undertaking, a financial holding company, a mixed-activity holding company as defined in the Capital Requirements Directive, a UCITS management company or an AIFM).

2. It is an undertaking which:

2.1 is not admitted to trading on a regulated market or on a multilateral trading facility; or

2.2 is admitted to trading on a regulated market or on a multilateral trading facility and at the same time has a market capitalisation of no more than EUR 500 million.

3. It is established in a Member State, or in a third country provided that the third country:

3.1 is not a high-risk and non-cooperative jurisdiction identified by the Financial Action Task Force; and

3.1 it has signed an agreement with the home Member State of the manager of the ELTIF and with every other Member State in which the units or shares of the ELTIF are intended to be marketed to ensure that the third country fully complies with the standards laid 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 multilateral tax agreements.

By way of derogation from point 1 above, a qualifying portfolio undertaking may be a financial undertaking that exclusively finances qualifying portfolio undertakings or real assets referred to in above.

ELTIFs are not permitted to invest in assets in which the manager takes a direct/indirect interest, although ELTIFs are permitted to invest in other ELTIFs, EuVECAs and EuSEFs managed by the manager and in which the manager holds units or shares.

ELTIFs may also invest in assets that are eligible assets pursuant to the UCITS Directive (2009/65/EC).

Safeguarding the assets of an ELTIF

When an ELTIF is marketed to retail investors, the depositary of the ELTIF may be one of the eligible entities set out in the UCITS Directive and should comply with the "no discharge of liability" rule, and the rules around reuse of assets set out in the UCITS Directive.

Portfolio composition and diversification

As the purpose of an ELTIF is to invest in long term investments, it is logical that they would be expected to invest at least 70% of their capital in the eligible investments listed above. However, the application of this requirement may be deferred to a date that is five years or half the life of the ELTIF (whichever is the earlier) after the date of authorisation of the ELTIF in order to enable it to ramp up its investment in long term investments as sourcing and closing such investments can take a significant amount of time. In exceptional circumstances, the competent authority of the ELTIF may approve an extension of this time limit by an additional twelve months.

An ELTIF may not short sell, invest directly or indirectly in commodities or invest more than 10% of its capital in securities lending, securities borrowing, repurchase agreements or reverse repurchase agreements. The aggregate risk exposure of an ELTIF to a repo counterparty shall not exceed 5% of its capital.

An ELTIF shall invest no more than:

1. 10% of its capital in instruments issued by or loans granted to any single qualifying portfolio undertaking.

2. 10% of its capital directly or indirectly in a single real asset.

3. 10% of its capital in units or shares of any single ELTIF, EuVECA or EuSEF.

4. The aggregate value of units or shares of ELTIFs, EuVECAs and EuSEFs in an ELTIF portfolio shall not exceed 20% of the value of the ELTIF's capital. In addition, an ELTIF may acquire no more than 25% of the units or shares of a single ELTIF, EuVECA or EuSEF.

5. 5% of its capital in assets which may be invested in by a UCITS, as listed in Article 50(1) of the UCITS Directive, where those assets have been issued by a single issuing body. Companies in the same group for the purposes of consolidated accounts shall be regarded as a single issuing body. The UCITS diversification limits also apply in this context so that an ELTIF may acquire no more than: (i) 10% of the non-voting shares of a single issuing body; (ii) 10% of the debt securities of a single issuing body; or (iii) 10% of the money market instruments of a single issuing body.

An ELTIF may raise the 10% limit referred to in points 1 and 2 above to 20%, provided that 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% of its capital does not exceed 40% of the value of its capital.

An ELTIF may raise the 5% limit referred to in point 5 above to 25% in the case of bonds issued by an EU credit institution.

Borrowing restrictions

An ELTIF may borrow cash provided that it:

1. represents no more than 30% of the capital of the ELTIF;

2. is used to invest in eligible investment assets (other than loans granted to a qualifying portfolio undertaking with a maturity no longer than the life of the ELTIF), provided that the ELTIF's cash or cash equivalent holdings are not sufficient to acquire the participation in eligible investment assets;

3. is in the same currency as the assets to be acquired with it;

4. has a maturity no longer than the life of the ELTIF; and

5. it does not encumber assets making up more than 30% of the ELTIF's capital.

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

Distribution of proceeds and capital

An ELTIF may regularly distribute to investors the proceeds generated by the assets contained in its portfolio, whether that be ongoing income generated by the assets or gains on the disposal of assets.

In the event of a disposal of assets before the end of life of an ELTIF, the capital of the ELTIF may be reduced on a pro-rata basis.

Redemption

Investors in the ELTIF may not redeem their units or shares before the end of life of the ELTIF unless all of the following conditions are fulfilled:

1. The ELTIF has reached the end of the term specified in the ELTIF’s constitutive document.

2. At the time of authorisation and throughout the life of the ELTIF, the manager of the ELTIF has put in place an appropriate liquidity management system, effective procedures for monitoring the liquidity risk of the ELTIF
and a defined redemption policy.

3. The manager of the ELTIF sets out a defined redemption policy, which clearly indicates the periods of time during which investors may request redemptions.

4. The redemption policy of the ELTIF ensures that: (i) the overall amount of redemptions within any given period is limited to a specified percentage of the ELTIF’s assets; and (ii) investors are treated fairly and redemptions are granted on a pro rata basis where necessary.

Where an ELTIF provides for redemptions and investors submit redemption requests in accordance with the ELTIF's redemption policy that are not fulfilled within one year, then that ELTIF may be wound down at the request of the investors.

Trading of ELTIFs on the secondary market

The Regulation provides that the shares or units of an ELTIF may be admitted to trading on a regulated market or multilateral trading facility, thus providing investors with an opportunity to sell their units or shares before the end of life of the ELTIF.

Authorisation as an ELTIF

The ELTIF must apply for authorisation to the Central Bank and in doing so must submit documents including its prospectus, instrument of incorporation, depositary agreement, AIFM agreement and such other agreements and information as is required by the Central Bank.

The ELTIF must comply with the provisions of both the ELTIF Regulation and AIFMD, while its manager must comply with the provisions of AIFMD and will be responsible for ensuring compliance with the Regulation.

Glossary of Acronyms

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Managers
AIFMD	Alternative Investment Fund Managers Directive
ELTIF	European Long-Term Investment Fund
EuSEF	European Social Entrepreneurship Fund
EuVECA	European Venture Capital Fund
MiFID	Markets in Financial Instruments Directive

UCITS	Undertakings for Collective Investment in Transferable Securities

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