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Trends and Developments

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Amendments to the ELTIF Regulation: A New Attractiveness for ELTIFs?

The European Long Term Investment Fund (ELTIF) was created by Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds (the "Regulation"), which has been applicable since 9 December 2015. It was conceived as a hybrid product, applying the rules arising from the Alternative Investment Fund Managers Directive (AIFMD) to the management of funds, and rules similar to the ones arising from the Directive on Undertakings for Collective Investment in Transferable Securities (the "UCITS Directive") for what relates to investments restrictions, diversification and concentration rules. The co-existence of those two regimes is intended to allow the ELTIF to be an alternative investment fund (AIF) open to retail investors

The rationale underpinning the creation of the ELTIF was twofold:

- the creation of a new tool that could participate in financing the European real economy and certain particular projects or entities, for which bank financing can sometimes be scarce, such as infrastructure projects, financing of unlisted companies and small and medium enterprises; and
- this alternative source of financing was aimed at offering access to retail investors to an investment product that could offer better returns than UCITS, which were, at the time, the sole harmonised investment funds available to retail investors within the European Union.

Despite those good intentions, a little less than five years after the beginning of the application of the Regulation, the European Securities Market Authority (ESMA) and the European Commission (the "Commission") both came to the same conclusion that the ELTIF framework had not achieved its goals. As a matter of fact, in June 2020 only 17 ELTIFs were authorised across the European Union, domiciled in only four jurisdictions. This number increased to 57 in October 2020 (mainly due to national considerations such as tax incentives) and still represented a relatively small amount of assets under management (AUM) and a minor portion of the total AUM of European AIFs.

In the explanatory notes accompanying its proposal for amendment of the Regulation, the Commission noted that "the advantages of ELTIFs are diminished by the restrictive funds rules and barriers to entry for retail investors, the combined effect of which reduce the utility, effectiveness and attractiveness of the ELTIF legal framework for managers and investors. These restrictions are the key drivers of the ELTIFs' failure to scale up significantly and reach their full potential to channel investments to the real economy."

Availing itself of the possibility offered by the Regulation in the context of its review, the Commission presented, on 25 November 2021, a proposal for a Regulation of the European Parliament and of the Council amending the Regulation (the "Proposal"). The Proposal suggests amending the Regulation with regards to certain aspects identified by the Commission as key to accelerating the acceptance and improving the attractiveness of ELTIFs as a "go to" fund structure for long-term investments.

Will the revisions included in the Proposal be sufficient to allow the ELTIF to eventually take off? The Proposal intends to remedy the current barriers to ELTIF success by addressing the main criticisms made of the Regulation in (i) providing greater flexibility in the ELTIFs' management while (ii) striking a balance between institutional and retail investor's needs.

Greater flexibility in the management of ELTIF

The main part of the industry criticism of the current ELTIF framework relates to the limited scope of eligible investment assets and its restrictive rules, which are not in line with the standard practice of alternative investment fund managers (AIFMs). The Proposal broadens the scope of eligible investment assets and aligns the management of the ELTIFs with the standards applicable to other AIFs.

A broader scope of eligible investment assets

I) Decrease of the 70% threshold

First, the Proposal intends to decrease the investment threshold in eligible investment assets from at least 70% of the ELTIF's assets to 60%.

II) Removal of the European location requirement

It also proposes to remove the requirement that investment projects be located within the EU. This amendment follows a recommendation made by ESMA in February 2021, which stressed that clarification was needed in relation to the location of the projects, as recital 4 of the Regulation mentions that investments in projects located outside of the EU should not be prevented while no reference to third-country assets was included in the body of the Regulation and thus uncertainty remained in this area. With this revision, AIFMs will no longer be required to invest in projects located within the EU, which will broaden the scope of ELTIF's target investments.

III) Real assets

The Commission also focused on enlarging the scope of the "real asset" investment possibility by substantially simplifying the definition of "real asset" to mean "an asset that has an intrinsic value due to its substance and properties". With this new definition, an asset will no longer have to be "integral to, or an ancillary element of, a long-term investment project that contributes to the Union objective of smart, sustainable and inclusive growth" to be eligible as a real asset. This revised definition will allow investments in assets that do not necessarily provide cash flows or investment returns or cannot be easily quantified.

In addition, the Proposal lowers the minimum threshold for investment directly in real assets from EUR10 million to EUR1 million.

It is expected that these revisions will broaden the scope of real asset investment strategies that AIFMs can pursue by providing them with access to large portfolios irrespective of the value of the individual real assets forming these large portfolios and the opportunity to build more diversified portfolios with consequently fewer risks.

IV) New eligible assets

The Proposal also proposes to authorise ELTIFs to invest in UCITS and other EU AIFs (in addition to other ELTIFs, European venture capital funds (EuVECAs) and European social entrepreneurship funds (EUSEFs)) provided that those funds (i) invest in eligible investments and (ii) have not themselves invested more than 10% of their assets in any other collective investment undertaking (CIU). The 10% limit will now apply in relation to any other CIU and not only in relation to ELTIFs, as is currently the case. This revision echoes a suggestion made by ESMA to broaden the scope of the eligible investment funds to UCITS and EU AIFs having (i) the same or similar assets as the ELTIFs and (ii) similar investment restrictions as ELTIFs (eg, those on eligible assets, diversification and leverage limits) in order to allow ELTIFs to pursue "fund of funds" investment strategies and to give ELTIFs access to broader underlying projects. It is to be noted that the European Parliament has proposed to change this limit to 20% of the net asset value.

Further to the aim of extending the possibility to ELTIFs of pursuing fund of funds investment strategies, the Proposal also authorises ELTIFs to be structured as master-feeders and to disregard the investment rules regarding CIU. With this revision, a feeder ELTIF can invest permanently at least 85% of its assets in another master ELTIF. This possibility would only be available when the master fund is an ELTIF.

Under the Proposal, ELTIFs would be authorised to invest in certain types of simple, transparent and standardised securitisations that comply with the Securitisation Regulation (EU) 2017/2402. The underlying exposures of such securitisations would correspond to one of the following to be eligible:

- residential loans and leases that are either secured by one or more mortgages on residential immovable property or that are fully guaranteed by an eligible protection provider (ie, a residential mortgage-backed security);
- commercial loans that are secured by one or more mortgages on commercial immovable property;
- corporate loans (including loans granted to small and medium enterprises); and

- trade receivables or other underlying exposures that the originator considers to form a distinct asset type, provided that the proceeds from securitising these trade receivables or other underlying exposures are used for financing or refinancing long-term investments.

V) Removal of the majority owned subsidiary requirement

It is also proposed to remove the "majority owned subsidiary" eligibility requirement, so that ELTIFs can now invest in equity or quasi-equity instruments issued by undertakings in which a qualifying portfolio undertaking (QPU) holds a capital participation (and not solely a majority participation). This will ensure that ELTIFs can make minority co-investments in investment opportunities.

VI) Increase of the maximum market capitalisation

Finally, ELTIFs will be authorised to invest in QPUs with a maximum market capitalisation of EUR1 billion instead of EUR500 million. The

Proposal also clarifies that this amount applies solely at the time of the initial investment.

Alignment of the management of ELTIFs with the standard applicable to other AIFs
I) Co-investment possibility

The Proposal intends to remove the restriction for AIFMs to invest in a dedicated project alongside an ELTIF they manage. This prohibition is currently criticised by the industry and ESMA as being unjustified considering the AIFMD does not include such a general restriction and that it is rather standard for AIFMs to co-invest with the AIFs they manage. Under the Proposal, AIFMs, their affiliated entities and their staff will be authorised to co-invest with the ELTIF, provided that they put in place organisational and administrative arrangements to identify, prevent, manage and monitor conflicts of interest and that such conflicts of interest are adequately disclosed, which replicates the provisions of the AIFMD in relation to the management of conflicts of interest.

II) Use of borrowing

The rules surrounding the recourse to borrowing are also less restrictive and are aligned with the AIFMD framework. In particular, ELTIFs are authorised to borrow for the following purposes:

- making investments – this language replaces the current “investing in eligible investments assets” and allows greater flexibility; or
- providing liquidity, including paying costs and expenses.

ELTIFs are also authorised to contract loans in a currency other than the currency of the investments (which is not the case today) under certain conditions.

It is also intended to increase the current 30% borrowing limit to up to 100% for ELTIFs marketed to professional investors and to 50% for ELTIFs marketed to retail investors.

Following the AIFMD rules on the computation of leverage, the Proposal provides that should the amount borrowed by the ELTIF be fully covered by the total amount of investors’ commitments, those arrangements will not have to be taken into consideration for the purpose of calculating the ELTIF borrowing level.

The 30% encumbrance requirement is removed and it is clarified that the encumbering of assets is permitted where it is sought to implement the borrowing strategy.

III) Procedural amendments

Several amendments of a more procedural nature are also intended to be made to the Regulation, some of which, further align the ELTIF framework with the AIFMD.

First, if the national competent authorities (NCAs) of the ELTIFs and the AIFM differ, the ELTIF NCA will no longer be required to approve the AIFM. In addition, the Proposal clarifies that there is no obligation that the ELTIF be managed by an AIFM having its registered office in the ELTIF’s home member state or that the AIFM pursue or delegate any activities in the ELTIF’s home member state, which is already the case for AIFMs under the AIFMD.

In line with the amendments made to the AIMFD last year by Directive (EU) 2019/1160 with regard to cross-border distribution of collective investment undertakings, the Proposal abolishes the obligation of a local presence in host member states for ELTIFs marketed to retail investors, recognising that the preferred method of contact with investors has shifted from physical meetings to direct interaction via electronic means.

The procedure related to the disposal of the ELTIF assets is also simplified so that the AIFM shall inform the ELTIF NCA about the orderly disposal of the assets one year before the end of the life of the ELTIF and will be required to provide an itemised schedule only upon NCA request.

Finally, the Proposal also removes the double suitability assessment for retail investors and replaces it with the suitability assessment provided under the MIFID directive. This removal is needed in light of (i) the removal of the EUR10,000 minimum initial investment (the "entry ticket") for retail investors and (ii) the 10% limit currently applied to retail investors whose financial instruments portfolio does not exceed EUR500,000. Those requirements have proven to constitute unjustified barriers for retail investors to access ELTIFs and such thresholds have proven, in most instances, to be "burdensome", "dissuasive" and ineffective.

The balance between institutional and retail investors needs

In addition to the proposed amendments to the Regulation to broaden the scope of investment possibilities and strategies for ELTIFs, the Proposal also intends to make a distinction as to how these new rules are applied based on the category of investor, in an attempt to strike a balance between the needs of institutional and retail investors.

Acknowledging one of the recommendations made by ESMA that "ELTIFs should be attractive to retail investors whilst meeting the specific needs of professional investors," the Proposal includes important revisions which intend to provide flexibility for institutional investors while maintaining the protection of retail investors with the aim of increasing its attractiveness in the current economic context.

A flexible regime for institutional investors maintaining the protection of retail investors

I) Increase of the diversification limits and concentration rules and possibility to disregard them for institutional investors

Under the Proposal, all diversification and concentration limits will increase as follows:

- from 10% to 20% for investment in instruments issued by, or loans granted to, any single QPU;
- from 10% to 20% for direct or indirect investment in real assets;
- from 10% to 20% for investments in units or shares of any single investment fund;
- from 5% to 10% for investments in assets referred to in Article 50(1) of the UCITS Directive;
- from 20% to 40% for the limit related to the maximum aggregate value of an ELTIF's investment in one single investment fund; and
- from 25% to 30% for the limit regarding the maximum amount of shares of a single investment fund held by an ELTIF.

In a proposed major revision to the Regulation, all the above listed diversification and concentration limits, will only apply for ELTIFs marketed to retail investors, meaning that those marketed to institutional investors only can disregard them, at least under the ELTIF regime, as limits may apply under national law to the products chosen to create the ELTIF.

II) Borrowing limits and disclosures

As mentioned, ELTIFs' permitted recourse to borrowing is extended and with that the maximum borrowing limit will increase from a current maximum of 30% applicable regardless of the type of investors to (i) a maximum of 50% for retail ELTIFs and (ii) up to 100% for institutional ELTIFs. This revision intends to create different limits to accommodate different needs and realities. While institutional investors are used to high borrowing levels and more ready to bear the risks accompanying high leverage, the situation is different for retail investors. Retail investors would not generally have the same level of knowledge and awareness of the leverage mechanism and its risks. In addition, the consequences of loss for retail investors are different as they usually invest their savings with the perspective of earning a higher return than the one offered by bank deposits, to finance different personal projects, such as retirement, children's education, access to residential ownership, etc. Therefore, limiting the use of borrowing for retail ELTIFs aims at maintaining the protection needed by these investors.

Additional disclosure obligations will apply to retail ELTIFs which will not apply to ELTIFs marketed to institutional investors only. The prospectus of the retail ELTIFs will have to disclose the intention of the fund to make use of borrowing along with a detailed presentation of the borrowing strategy and limits. In particular, the prospectus shall indicate how borrowing will help implement the ELTIF strategy and mitigate borrowing, currency and duration risks

III) Creation of an optional liquidity window

The Proposal encompasses the creation of an optional liquidity window whereby the ELTIF manager may, before the end of the life of the ELTIF, provide for the possibility of full or partial matching of transfer requests by exiting and potential investors. This mechanism is of particular interest for those investors needing liquidity before the end of the life of the fund but unable to redeem their shares due to the closed-ended nature of the fund. The mechanism embeds several limits: exit will only be possible insofar as there will be a subscription request matching the redemption request and the option is one that the AIFM can use and not a right that the shareholders may impose.

The differentiation of the rules based on the category of investors clearly aims at increasing the attractiveness of the ELTIF in the context of the COVID-19 recovery, increased interest rates and recession.

Attractiveness of the ELTIF in the current economic context

The last two years have been marked by unprecedented situations, including the COVID-19 pandemic and the Ukraine war, which are now showing their impact on the global economy.

At the beginning of the COVID-19 pandemic and the first lockdowns, governments implemented a series of economic measures to support their economies, which ended during the last quarter of 2021. Even if it is undeniable that those aids were needed at the time and have substantially helped to mitigate the immediate effect of the pandemic, they have also postponed the real impact of the COVID-19 crisis.

A couple of months after the state aid combatting the COVID-19 pandemic crisis stopped, in February 2022, Russia attacked Ukraine. The war in Ukraine translated into a scarcity of certain goods, sourcing difficulties, sanctions on Russia and an energy crisis impacting the global economy and the financial markets. Interest rates have risen for the first time since 2011 making borrowing more expensive and more difficult to obtain as banks are reluctant to finance.

In this context, alternative sources of financing, such as ELTIFs, appear as an attractive option, meeting the needs of both the company seeking financing and investors. ELTIFs usually offer more financing options than banks, in particular for big projects or projects deemed as too risky for banks and ensure a better return than bank savings. Due to their flexible regime (in particular for institutional ELTIFs) and their simple distribution across the EU to all types of investors, including retail, the ELTIF is certainly becoming a strong product with a large scope of financing possibilities, which can play an important part in economic recovery.

However, the interest and possibility to invest in an ELTIF may not be the same for all types of investors. The ELTIF is a European label which needs to be set up within a local corporate or contractual vehicle capable of accommodating its investment rules and both types of investors. If the lifting of all the investment diversification and concentration rules for institutional investors is likely to provide more options to AIFMs managing institutional ELTIFs, it may not be the case for retail ELTIFs in so far as the AIFM will still have to perform a suitability test for those investors and find a local product that would allow subscription by retail investors.

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It is clear that the Proposal has taken into consideration the main criticisms made of the current ELTIF framework and has addressed them to make this product more attractive. These revisions should now allow the ELTIF to achieve its aim of financing the real economy, which is particularly needed in the current economic context. However, the lack of available products at local level and the maintaining of the suitability test for retail investors might hinder the full potential of the ELTIF and limit its new attractiveness. In addition, there may be further amendments, given that trilogue discussions between the European Commission, Council and Parliament still need to take place in order to agree on a final version of the text.

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