EUROPEAN LONG-TERM INVESTMENT FUNDS (ELTIF)

Avocats
2, rue Peternelchen I Immeuble C2 I L-2370 Howald I Luxembourg
T. +352 26025-1 I F. +352 26025-999
mail@bsp.lu I www.bsp.lu

On December 9th 2015 Regulation (EU) 2015/760 of the European Parliament and the Council of 29 April 2015 on European long-term investment funds (the "Regulation") became directly applicable in each Member State of the European Union. The Regulation creates a new investment fund framework - the European Long-Term Investment Fund ("ELTIF"). ELTIFs are designed to provide finance of lasting duration to various infrastructure projects, unlisted companies, or listed small and medium-sized enterprises (SMEs) that issue equity or debt instruments. The idea is that long-term finance may be able to strengthen the economy of the European Union, in accordance with the Europe 2020 strategy, making it less exposed to systemic risks.

A. Fundamental purpose of the Regulation

The Regulation establishes a new kind of long-investment fund for professional/institutional and retail investors enabling them to invest in long-term infrastructure projects. The existence of ELTIFs should boost the finance available to companies in search of long-term capital for projects relating to energy, transport but also social housing, schools and hospitals.

The Regulation aims to introduce uniform rules across the EU for such vehicles. Harmonising the national laws of Member States relating to such vehicles should ensure the proper functioning of the internal market and a high level of investor protection. This uniformity is important as regards the composition of the portfolio as an ELTIF should guarantee to those seeking to generate regular income, the maintenance of a diversified portfolio of investment assets suitable for maintaining a regular cash-flow.

B. Benefits of ELTIFs

The aim of the ELTIF is to provide a steady income stream for pension administrators, insurance companies, foundations, municipalities and other entities that face regular and recurrent liabilities and are looking for long-term returns within well-regulated structures and for individual investors that rely on the regular cash flow that an ELTIF can produce. They can also offer good opportunities for capital appreciation over time for those investors not receiving a steady income stream.

Further, financing for projects such as transport infrastructure, sustainable energy generation or distribution, social infrastructure (housing, hospitals), the roll-out of the new technologies and systems that reduce use of resources and energy, or the further growth of SMEs can be rare. ELTIFs can play a crucial role in this respect and also mobilise capital by attracting third-country investors.

ELTIFs can provide long term capital to unlisted undertakings which are looking for private financing through equity stakes or loans which are by their nature long-term investments. Furthermore, they may provide valuable alternative sources of funding to listed SMEs facing significant obstacles in acquiring long-term financing.

C. Rules Applicable to ELTIFs

1. Conditions for Authorisation

Only an EU AIF as defined in Directive 2011/61/EU on alternative investment fund managers (the "AIFMD") shall be eligible to become an ELTIF[1] and only if it is managed by an EU AIFM that has been authorised in accordance with the AIFMD[2]. An internally managed ELTIF is possible provided that the ELTIF must also apply for authorisation as an internally managed AIF under AIFMD[3].

2. Eligible Investment Assets

An ELTIF shall invest only in eligible investment assets and assets that are eligible for a UCITS pursuant to Directive 2009/65/EC[4].

To ensure the integrity of ELTIFs, an ELTIF is prohibited from engaging in certain financial transactions[5] such as:

- short selling,
- taking direct or indirect exposure to commodities,
- entering into securities lending, securities borrowing, repurchase 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,
- using financial derivative instruments, except where the use of such instruments solely serves the purpose of hedging the risks inherent to other investments of the ELTIF[6].

An ELTIF shall invest at least 70 % of its capital in **eligible investment assets**[7]. This limit must be reached by the date set out in the rules or instruments of incorporation which can be no later than five years after the date of authorisation of the ELTIF or half the life of the ELTIF, whichever is the earlier[8].

Eligible investment assets[9] include participations such as:

- equity or quasi-equity instruments and debt instruments in qualifying portfolio undertakings;
- loans granted by the ELTIF to qualifying portfolio undertakings;
- participations in other ELTIFs, EuVECAs, and EuSEFs only if they have not themselves invested more than 10 % of their capital in other ELTIFs;
- direct or indirect holdings of real assets with a value of at least EUR 10 000 000. A real asset means an asset that has value due to its substance and properties and may provide returns, including infrastructure and other assets that give rise to economic or social benefit, such as education, counselling, research and development, and including commercial property or housing only where they are integral to, or an ancillary element of, a long-term investment project that contributes to

[1] Art. 3(2)
[2] Art. 5(2)
[3] Art. 5(5)
[4] Art. 9(1)
[5] Art. 9(2)

[6] ESMA, in their consultation paper on draft regulatory technical standards under the ELTIF Regulation (ESMA 2015/1239) propose criteria for considering whether a financial derivative instrument shall be considered as serving the purpose of hedging.
[7] Art. 13(1)
[8] Art. 17(1)
[9] Art. 10

the Union objective of smart, sustainable and inclusive growth[10];

A **qualifying portfolio undertaking**[11] is a portfolio undertaking, other than a collective investment undertaking, that

(a) Is not a financial undertaking (this includes, banks, investment firms, insurance companies) provided that there is an exception for financial institutions that exclusively finance qualifying portfolio undertakings or real assets;
(b) Is not admitted to trading on a regulated market or on a multi-lateral trading facility or, if so admitted, has a market capitalisation of no more than EUR 500m; and
(c) Is established in an EU Member State or a third country provided that the third country is not high risk, is not a non-cooperative jurisdiction identified by FATF and has signed a tax agreement with the home Member State of the ELTIF manager and with every other Member State in which the units or shares of the ELTIF are to be marketed.

An ELTIF shall not invest in an eligible investment asset in which its manager has or takes a direct or indirect interest, other than by holding units or shares of the ELTIFs, EuSEFs or EuVECAs that it manages[12].

[10] Art. 2(6)
[11] Art. 11
[12] Art. 12

3. Diversification[13] and Concentration[14]

An ELTIF shall invest no more than:

(a) 10% of its capital in instruments issued by, or loans granted to, any single qualifying portfolio undertaking;
(b) 10% of its capital directly or indirectly in a single real asset;
(c) 10% of its capital in units or shares of any single ELTIF, EuVECA or EuSEF;
(d) 5% of its capital in UCITS eligible assets where those assets have been issued by any single body provided that the limit 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 special public supervision designed to protect bond-holders.

By way of derogation from points (a) and (b) above, an ELTIF may raise the limit 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 the capital of the ELTIF.

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 capital of the ELTIF.

The aggregate risk exposure to a counterparty of the ELTIF stemming from OTC derivative transactions, repurchase agreements, or reverse repurchase agreements shall not

[13] Art. 13
[14] Art. 15

exceed 5% of the value of the capital of the ELTIF.

In addition, an ELTIF may acquire no more than 25% of the units or shares of a single ELTIF, EuVECA or EuSEF. The ELTIF is also subject to the concentration limits applicable to a UCITS pursuant to article 56(2) of Directive 2009/65, in respect of the UCITS eligible assets it invests in.

4. Redemptions[15] and Secondary Market[16]

Redemptions to investors are possible from the day following the date of the end of the life of the ELTIF. The illiquid nature of most investments in long-term projects prohibits an ELTIF to offer regular redemptions to its investors. Early redemption rights can however be offered to investors under five cumulative conditions:

- redemptions are not granted before the date specified in the rules or instruments of incorporation of the ELTIF as the date the 70% investment limit applies;
- at the time of authorisation and throughout the life of the ELTIF, the manager of the ELTIF is able to demonstrate to the competent authorities that an appropriate liquidity management system and effective procedures for monitoring the liquidity risk of the ELTIF are in place, which are compatible with the long-term investment strategy of the ELTIF and the proposed redemption policy;
- the manager of the ELTIF sets out a defined redemption policy, which clearly indicates the periods of time during 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 of 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 amount of requests for redemptions within any given period of time exceed the percentage of the UCITS eligible assets of the ELTIF referred to above.

When such a redemption rights regime is in place, those rights and their main features must be predefined in the rules or instruments of incorporation of the ELTIF.

Investors may request the winding down of an ELTIF if their redemption requests have not been satisfied within one year from the date on which they were made.

Investors shall always have the option to be repaid in cash and redemptions in kind are possible if certain conditions are met:

- The rules or instrument of incorporation of the ELTIF so provide;
- The investor asks in writing to be repaid in kind; and
- No specific rules restrict the transfer of those assets.

The rules or instruments of incorporation of an ELTIF shall not prevent units or shares of the ELTIF being admitted to trading on a

[15] Art. 18
[16] Art. 19

regulated market or on a multilateral trading facility, nor shall they prevent investors from freely transferring their units or shares to third parties who wish to purchase them.

5. Borrowing of cash[17]

An ELTIF can borrow cash provided that such borrowing satisfies the five following cumulative conditions:

- it represents no more than 30 % of the value of the capital of the ELTIF;
- it serves the purpose of investing in eligible investment assets, except that it may not be used to grant loans to qualifying portfolio undertakings[18], provided that the holdings in cash or cash equivalents of the ELTIF are not sufficient to make the investment concerned;
- it is contracted in the same currency as the assets to be acquired with the borrowed cash[19];
- it has a maturity no longer than the life of the ELTIF;
- it encumbers assets that represent no more than 30 % of the value of the capital of the ELTIF.

The intention to borrow cash or not shall be specified by the manager of the ELTIF in the prospectus.

[17] Art. 16
[18] This is to address concerns relating to shadow banking.
[19] To eliminate currency mismatches.

6. Distribution of proceeds and capital[20]

An ELTIF is allowed to distribute regularly to investors the proceeds generated by the assets contained in its portfolio, to the extent that such proceeds are not required for future commitments of the ELTIF. Such distribution may consist in proceeds that the assets are regularly producing and capital appreciation realised after the disposal of an asset. An ELTIF may reduce its capital on a pro rata basis in the event of a disposal of an asset before the end of the life of the ELTIF, provided that such a disposal is considered to be in the investors' interests by the manager of the ELTIF.

7. Transparency requirements[21]

A prospectus shall be published before the marketing of the units or shares of an ELTIF and include all information[22] essential for the investors to make an informed assessment. The essential elements of the prospectus must be kept up to date.

Closed-end funds must disclose information required to be disclosed by such funds pursuant to Directive 2003/71[23] and Regulation 809/2014[24].

[20] Art. 22
[21] Art. 23
[22] Articles 23 to 25.
[23] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (OJ L 345, 31.12.2003, p. 64).
[24] Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of

In addition, marketing to retail investors may not be commenced without prior publication of a key information document in accordance with Regulation 1286/2014[25].

8. Requirements for retail investors[26]

The Regulation sets out specific requirements for retail investors i.e. non-professional investors.

Before marketing the ELTIF, its manager has to establish a specific internal process to assess whether the ELTIF is suitable for marketing to retail investors taking into account at least the life of the ELTIF and the intended investment strategy.

Furthermore, when a manager is directly offering or placing units or shares of an ELTIF to a retail investor, he shall obtain information concerning the retail investor's knowledge and experience in the investment field relevant to it, his financial situation, including his ability to bear losses and his investment objectives, including that investor's time horizon.

If the life of an ELTIF that is offered or placed to retail investors exceeds 10 years, its manager or distributor has to issue a clear written alert that the ELTIF product may not be suitable for retail investors that are unable to sustain such a long-term and illiquid commitment.

Retail investors shall obtain appropriate investment advice from the manager of the ELTIF or the distributor. In case that 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 that investor's financial instrument portfolio in ELTIFs and that the initial minimum amount invested in one or more ELTIFs is EUR 10 000.

The manager of the ELTIF must put in place[27], in each Member State where it intends to market the ELTIF to retail investors, facilities for making subscriptions, making payments, repurchasing or redeeming units and making information available[28].

Moreover, the manager must establish appropriate procedures and arrangements allowing retail investors to file complaints in one of the official languages of their Member State.

Retail investors shall be able to cancel their subscription and have the money returned without penalty, during the subscription period and at least two weeks after the date of their subscription for units or shares of the ELTIF.

The depositary of an ELTIF that is marketed to retail investors is subject to certain specific conditions.

such prospectuses and dissemination of advertisements (OJ L 149, 30.4.2004, p. 1).

[25] Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) (OJ L 352, 9.12.2014, p. 1).

[26] Arts. 27 to 30

[27] Art. 26

[28] ESMA, in their consultation paper on draft regulatory technical standards under the ELTIF Regulation (ESMA 2015/1239) specifies further the types and characteristics of such facilities.

9. Marketing passport[29]

The manager of an ELTIF shall be able to market the units or shares of that ELTIF to professional and retail investors in its home Member State. Such manager shall also be able to market the units or shares of that ELTIF to professional and retail investors in Member States other than the home Member State of the manager upon complying with the same type of notification procedure as is applicable to AIFs pursuant to the AIFMD.

D. Conclusion

The creation of a new investment fund framework has been conceived to make long-term investment easier and to respond to the needs of institutional and private investors, who are willing to invest their money into long-term assets, such as infrastructure projects, to assure them a steady income. This new kind of long-term investment fund will be interesting in particular for pension funds and insurance companies as well as private investors.

On July 31st 2015 the European Securities and Markets Authority (ESMA) issued a consultation paper[30] including draft regulatory technical standards on eligible investments, length of life of the ELTIF, disposal of assets, cost disclosure and facilities available to retail investors. The consultation closed on October 14th 2015 and the responses received will help ESMA in finalising the draft RTS to be submitted to the European Commission for endorsement.

[29] Art. 31
[30] ESMA 2015/1239. Consultation Paper – Draft Regulatory Technical standards under the ELTIF Regulation.

For further information, please contact:

Evelyn Maher, Partner
emaher@bsp.lu
Tel: +352 26025-1