CLIFFORD CHANCE

Briefing note

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# The European Long-Term Investment Fund Regulation

A new type of European fund is expected to come into force in mid-2015, targeted at institutional and retail investors seeking long-term investments in illiquid assets such as infrastructure projects.

The European Long-Term Investment Fund Regulation is one of a series of measures proposed by the European Commission to boost growth in Europe and to increase the amount of non-bank funding available to companies investing in the real economy. The new regulation creates a legislative framework for EU funds which will only invest in businesses that need long-term capital, thereby complementing UCITS which focuses on liquid securities. It is hoped that European Long-Term Investment Funds - or ELTIFs - will prove attractive to investors seeking steady, long-term returns, such as smaller pension funds and insurance companies.

## Key issues

- ELTIFs likely to be launched in 2015
- Regulated fund for long-term investments
- Intended to boost non-bank funding for companies and projects requiring long-term capital
- Open to professional and retail investors
- Authorised EU AIFMs can elect to offer ELTIFs
- EU passport available
- Only permitted to invest in specified assets
- ELTIFs have a defined life (specified in the prospectus) during which there are no (or limited) redemption rights
- Secondary trading permitted
- Investor protection through transparency and marketing requirements

## The ELTIF Framework

The ELTIF framework is, in some ways, a 'hybrid' between the existing institutional AIF product and the retail UCITS and PRIIPS products. The new regulation builds upon the Alternative Investment Fund Managers Directive (AIFMD) - by definition, ELTIFs are EU[1] AIFs, managed by authorised EU AIFMs in accordance with the AIFMD and, like AIFs, can take different legal forms.

However, an EU AIFM that decides to offer ELTIFs will also have to be approved to manage an ELTIF, and comply with the detailed requirements set out in the ELTIF Regulation, in addition to AIFMD requirements. The requirements are extensive, particularly if the funds are to be marketed to retail investors, and to some extent reflect requirements in the UCITS and PRIIPS regimes (for example, the requirement to have a depositary that complies with UCITS V and to produce a Key Information Document (KID). However, some managers may decide that complying with the new regime is worthwhile given the benefit of the EU cross-border passport, allowing them to

[1] EEA managers are also within the scope of the Regulation, in a similar way to UCITS and AIFs.

offer ELTIFs to institutional and retail investors across the EU. In addition, as ELTIFs are a regulated product, they may prove attractive to third country investors, in a similar way to UCITS funds which have been popular to investors outside the EU, notably in Asia.

The key provisions of the ELTIF Regulation are summarised in the Table below.

**How would the ELTIF rules work?**

Only EU managers authorised as AIFMs under the AIFMD can offer ELTIFs. To qualify as an ELTIF, a fund must be an EU AIF and can only invest in certain types of assets, such as unlisted companies and real assets that need long-term capital. At least 70% of the money in the fund has to be invested in these assets – 'eligible investment assets' - although ELTIFs will have up to five years in which to reach this target. The remaining 30% of the money in the fund can be held in other assets that would be eligible for a UCITS fund. The ELTIF rules or instruments of incorporation must specify a date marking the end of the life of the fund, hence the ELTIF would run for a specified period of time, during which investors will, in principle, not have the right to get their money back. This has to be made clear to investors in the prospectus, which must be prepared in compliance with the Prospectus Directive and contain the information required under article 23 of the AIFMD (if not already covered under the Prospectus Directive). In order to alleviate investor protection concerns, there are limits on short selling, leverage and the use of derivatives is limited to the hedging of risks inherent to its own investment.

**Retail investors**

ELTIFs are designed for both institutional and retail investors, in the hope that the broader investor base will allow more capital to be raised for European businesses. However, a consequence of this is that ELTIFs will be subject to a number of additional requirements designed to protect retail investors. For example, a manager of an ELTIF is permitted to offer or place units or shares in the ELTIF to retail investors if it is authorised to provide the 'MiFID activities' specified in article 6(4)(a) and b(i) of the AIFMD (management of portfolios of investments on a discretionary, client by client basis and the provision of investment advice) but must also comply with the additional marketing requirements in the ELTIF Regulation.

If an ELTIF is marketed to retail investors, it would be a Packaged Retail Investment Product (PRIP) and so subject to the requirement to have a key information document or KID explaining its features and its risks. The KID will be a two or three page document that will set out in plain language what the most important feature of the PRIP is and what its risks are. For an ELTIF, one of the most important risks that will be clearly explained will be that any investment is locked away for the lifetime of the ELTIF.

In addition to the information requirements described above, ELTIFs are investment products that come under the requirements of the Markets in Financial Instruments Directive (MiFID). Therefore, where ELTIFs are marketed to retail investors through a distributor, for example, the distributor will have to comply with the relevant requirements in MiFID2.

**Restrictions on redemptions and secondary trading**

The rationale behind ELTIFs is that capital is committed for the long-term so, in principle, redemption should not be possible before the end of the life of an ELTIF. To protect retail investors, however, the ELTIF Regulation provides for redemption rules that would enable an ELTIF which has enough liquid assets to permit, under certain conditions, the possibility in its rules or instruments of incorporation for redemptions before the end of life of the ELTIF.

Although ELTIFs do not generally offer redemption rights before the end of their life, they can be traded and transferred to another investor, so the secondary market should afford investors the opportunity to sell their units or shares during the life of the fund.

## Next Steps

The EU Parliament and Council have to formally adopt the proposed Regulation. Once adopted, the Regulation will enter into force on the twentieth day following its publication in the Official Journal of the EU, which is expected mid 2015. This being the case, the Regulation will apply six months later, that is the end of 2015 or early 2016.

## European Long-Term Investment Fund Regulation - Key Provisions

***Authorisation and use of designation (articles 3 and 4)***

ELTIFs must be EU AIFs and can only be offered by authorised EU AIFMs which have also been approved to manage ELTIFs

ELTIFs and AIFMs deciding to offer ELTIFs must be authorised by the competent authorities in the home member state of the ELTIF

The ELTIFs and the AIFMs must be informed within two months whether authorisation and approval have been granted. (This extends to three months for internally-managed ELTIFs)

***Eligible Investments (articles 8, 9 and 10)***

An ELTIF is only permitted to invest in:

- "eligible investment assets" (which are distinct from UCITS eligible assets) as set out in the ELTIF Regulation as follows:
  - equity or quasi-equity instruments which have been:
    - (i) issued by a qualifying portfolio undertaking and acquired by the ELTIF from the qualifying portfolio undertaking or from a third party via the secondary market
    - (ii) 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 via the secondary market
    - (iii) 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 (i) or (ii) 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 by the ELTIF to a qualifying portfolio undertaking with a maturity no longer than the life of the ELTIF
  - 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
  - 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
- UCITS eligible assets

A "qualifying portfolio undertaking" is defined as a portfolio undertaking, other than a collective investment undertaking, that fulfils <u>all</u> of the requirements set out in article 10 of the ELTIF Regulation, in summary, that it is not a financial undertaking, it is not admitted to trading on a MIFID regulated market or multilateral trading facility, unless it has a market capitalisation of no more than EUR 500 million, it is established in a Member State, or in a third country that is not a high-risk and non-cooperative jurisdiction identified by the FATF, it has signed an OECD Model Tax Convention 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.

***Prohibited Activities (article 8)***

An ELTIF is not authorised to undertake any of the following activities:

- short-selling of assets
- take a direct or indirect exposure to commodities
- undertake securities lending, securities borrowing and repurchase transactions, or any other agreement which has an equivalent economic effect and poses similar risks, if more than 10% of the assets of the ELTIF are affected
- use financial derivative instruments, except for hedging purposes

***Portfolio composition (article 12)***

An ELTIF is required to invest at least 70% of its capital in eligible investment assets. Compliance with this 70% limit is not required immediately, but is required by a date to be specified in the ELTIF's rules or instruments of incorporation and that date cannot be more than five years or half the life of the ELTIF (whichever is the earlier). In exceptional circumstances, this time limit may be extended by no more than one additional year.

The remaining 30% of the ELTIF capital may be invested in UCITS eligible assets, subject to the diversification and concentration limits as set out below.

***Diversification Requirements (article 12)***

No more than 10% of an ELTIF's capital can be invested in:

- instruments issued by or loans granted to any single qualifying portfolio undertaking
- directly or indirectly in a single real asset

The limit may be raised to 20% if the aggregate value of the assets held by the ELTIF in qualifying portfolio undertakings and in individual real assets does not exceed 40% of the value of its capital.

No more than 10% of an ELTIF's capital can be invested in units or shares of any <u>single</u> ELTIF, EuVECA or EuSEF, and the aggregate value of these units or shares in an ELTIF portfolio must not exceed 20% of the value of its capital.

No more than 5% of an ELTIF's capital shall be invested in UCITS eligible assets issued by a single body. This 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 bondholders.

The aggregate risk exposure to a counterparty of the ELTIF stemming from OTC derivative transactions, repurchase agreements or reverse repurchase agreements must not exceed 5% of its capital.

***Concentration Limits (article 13)***

An ELTIF may acquire no more than 25% of the units or shares of a single ELTIF, EuVECA or EuSEF.

Up to 30% of an ELTIF's assets <u>may</u> be invested in UCITS eligible assets, provided that an ELTIF shall not acquire more than:

- 10% of the non-voting shares of the same issuer
- 10% of the bonds of the same issuer
- 25% of the units of the same UCITS or other UCI
- 10% of the money market instruments of the same issuer

***Cash Borrowing (article 14)***

Cash borrowing is permitted providing all the following conditions are met:

- it is no more than 30% of the capital of the ELTIF
- it is used to invest in ELTIF eligible investment assets, except for loans, if the holdings in cash or cash equivalents of the ELTIF are not sufficient to acquire the participation in eligible investment assets
- it is the same currency as the assets to be acquired with the borrowed cash
- it must have a maturity no longer than the life of the ELTIF
- it must encumber the assets that represent no more than 30% of the capital of the ELTIF
- there has been appropriate disclosure in the ELTIF prospectus

***Redemption and Secondary Market (articles 16 and 17)***

Due to the illiquid nature of an ELTIF's assets, redemption by investors shall, in principle, only be possible as of the day following the date defining the end of life of the ELTIF, which date must be clearly indicated in the ELTIF rules or instruments of incorporation. The ELTIF rules or instruments of incorporation will also indicate the right (if any) to temporarily extend the life of the ELTIF and the conditions to exercise such right.

To protect retail investors, however, the ELTIF Regulation provides for redemption rules that would enable an ELTIF which has enough liquid assets to organise, under certain conditions, the possibility in its rules or instruments of incorporation for redemptions before the end of life of the ELTIF. In particular, the ELTIF Regulation provides that:

- no redemption will be authorised before the end of the build-up period
- the lifetime of the ELTIF must be consistent with the long-term nature of the ELTIF and shall be sufficient in length to cover the life-cycle of each of the individual assets of the ELTIF
- appropriate liquidity management systems and effective procedures for monitoring the liquidity risk of the ELTIF must be put in place
- the redemption policy must clearly indicate the period of time in which investors may ask for redemption and must ensure a fair treatment of investors
- the investors will have the right to request the winding-down of the ELTIF if their redemption requests have not been satisfied within one year
- the redemption price will be paid in cash or in kind if requested by the investor

Notwithstanding the fact that ELTIFs do not generally offer redemption rights before the end of their life, their rules or instrument of incorporation shall not prevent their units or shares from being admitted to trading on a regulated market or on a multilateral trading facility as defined in MiFID, nor shall they prevent the free transfer of their investors' shares or units to third parties.

| ***Disposals of assets (article 19)*** |
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| Each ELTIF shall adopt an itemised schedule for the orderly disposal of its assets in order to redeem investors after the end of life of the ELTIF and shall disclose this to the competent authority of the ELTIF at the latest one year before that date. |
| ***Distributions (article 20)*** |
| In order to compensate the lack of early redemption possibilities, the ELTIF Regulation contemplates favouring the provision of steady income to investors. In particular, an ELTIF may regularly distribute to investors the proceeds generated by the assets contained in its portfolio as well as the capital appreciation realised after the disposal of an asset, as long as such income are not required for future commitments of the ELTIF.<br><br>For the avoidance of doubt, an ELTIF may reduce its capital on a *pro rata* basis in the event of a disposal of an asset, provided that the early disposal is duly considered as being in the investors' interest by the ELTIF manager.<br><br>The distribution policy that an ELTIF intend to adopt during its lifetime shall be stated in its fund rules or instruments of incorporation. |
| ***Transparency Requirements (articles 21 and 22)*** |
| The ELTIF Regulation contains various transparency rules where ELTIFs are being advertised to investors. In particular, the prior publication of a prospectus including the constitutive documents attached as an integral part thereof and, in case of marketing to retail investors the publication of a KID pursuant to the PRIIP KID Regulation, will be required before the ELTIF is marketed.<br><br>The prospectus, KID and any other marketing document shall inform the investors about the special nature and risks of the long-term investment into an ELTIF as well as of all the different costs attached to the ELTIF (set-up costs, acquisitions costs, management/performance fees, distribution and other running costs). For the avoidance of doubt, the ELTIF Regulation requires that the prospectus of an ELTIF, which is an AIF, is prepared in accordance with the Prospectus Directive and also contains the information required under article 23 of the AIFMD (if not already covered under the Prospectus Directive).<br><br>Upon request of a retail investor, the ELTIF manager shall 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 yields of the instrument categories.<br><br>Finally, the annual report of an ELTIF will be prepared in accordance with the AIFMD but will, in addition, contain: (i) a cash flow statement; (ii) information on any participation in instruments involving Union budgetary funds (iii) information on the value of the individual qualifying portfolio undertakings and the value of other assets in which the ELTIF is invested, including the value of derivatives used, and (iv) information on the geographical location of the assets of the ELTIF. |
| ***Marketing (articles 23 and 24)*** |
| Investors targeted by ELTIFs can include both professional and retail investors.<br><br>Authorised ELTIFs managed by an authorised ELTIF manager benefit from a passport allowing the ELTIF manager to market the ELTIF's shares or units to professional and retail investors in the EU through a regulator-to-regulator notification procedure in accordance with the AIFMD. In addition to the documentation and information required pursuant to the AIFMD, the notification must also include the prospectus of the ELTIF, its KID (in case of marketing to retail investors) and the information on the facilities available for making subscription, making payment to share-/unitholders, repurchasing or redeeming shares/units and making information available to investors. The notification must also specify whether or not the ELTIF manager intends to market the ELTIF to retail investors.<br><br>Marketing to retail investors is subject to specific additional requirements designed to protect retail investors, including but not limited to:<br><br>▪ The ELTIF manager must be authorised to provide the so-called "MIFID services" under article 6(4) of the AIFMD<br><br>▪ The ELTIF manager or any distributor must ensure that a retail investor with a portfolio of up to EUR 500,000 does not invest an aggregate amount exceeding 10% of his portfolio in ELTIFs, provided that the initial amount invested in one or more ELTIFs is not less than EUR 10,000.<br><br>▪ Facilities must be made available to retail investors for making subscriptions, making payments to unit or shareholders, repurchasing or redeeming units or shares and making available the information that the ELTIF and its managers are required to provide<br><br>▪ An internal process must be established and applied by the ELTIF's manager for the assessment of the ELTIF in order to ensure that it is suitable for marketing to retail investors, taking into account at least the lifecycle of the ELTIF and its intended investment strategy<br><br>▪ The ELTIF manager must make available to any distributor all appropriate information on the ELTIF that is marketed to retail investors, including all information as regards the lifecycle and the investment strategy, as well as information on the internal assessment process and the jurisdictions in which the ELTIF has invested<br><br>▪ When directly offering or placing an ELTIF to retail investors, the manager must obtain the necessary information to enable it to recommend the ELTIF only if it is suitable for the retail investor: knowledge and experience in the investment field relevant to the ELTIF; financial situation including ability to bear losses; and investment objectives including his time horizon<br><br>Where the lifecycle of an ELTIF exceeds ten years, the ELTIF manager or distributor should indicate clearly, and in |

written form, that this product may not be suitable for those retail investors unable to sustain such a long-term and illiquid commitment

- By derogation to the AIFMD, the depositary regime of an ELTIF marketed to retail investors will be aligned with the UCITS V depositary regime
- The ELTIF's rules or instruments of incorporation must provide that all investors benefit from equal treatment and no preferential treatment or specific economic benefits are granted to individual investors or groups of investors
- The ELTIF may have any legal form as long as it does not lead to any further liability for the investor or require any additional commitments on behalf of such investor apart from the original capital commitment is not structured as a partnership
- Retail investors may, during the subscription period and at least two weeks after subscription of units or shares of the ELTIF, cancel their subscription and have the money returned without penalty
- The ELTIF manager must establish appropriate procedures and arrangements to deal with retail investor complaints

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