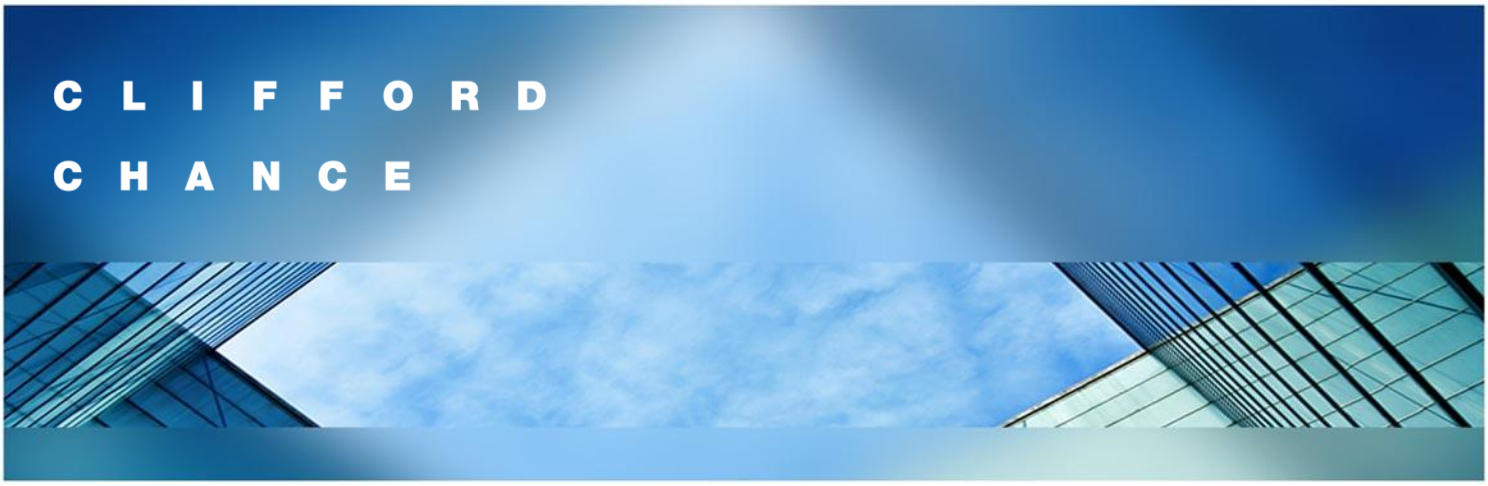

ELTIF2: A NEW DAWN?

On 15 February 2023, the European Parliament adopted the amending regulation to the ELTIF Regulation ("**ELTIF2**") on which the EU Council and the European Parliament had reached provisional agreement on 7 December 2022. These EU bodies believe that ELTIF2 will finally unlock untapped potential to mobilise capital for the financing of long-term projects (encompassing private equity, private debt, loans, infrastructure and real assets) by making such funds more attractive for asset managers and easier for retail investors, while ensuring strong investor protection.

Key issues

- Wider definition of eligible investment assets
- Possibility to invest in FinTechs (subject to conditions)
- Possibility to invest in simple, transparent and standardised securitisations
- Revised eligibility of funds-of-funds strategies
- Significant reduction in terms of investment limits and restrictions
- Improved distribution mechanisms and rules
- New regime for ELTIFs reserved to professional investors

WHAT IS ELTIF?

European long-term investment funds ("**ELTIFs**") are the only type of funds dedicated to long-term investments that can be distributed on a cross-border basis within the EU to both professional and retail investors. The ELTIF regulatory framework sets out detailed fund rules on eligible assets and investments, diversification and portfolio composition, leverage limits and marketing.

WHY ELTIF2?

Since the adoption of the first regulation in 2015 ("**ELTIF1**") only a few ELTIFs have been launched due to significant constraints in the distribution process (demand-side) and stringent rules on portfolio composition (supply-side). The ELTIF industry is nowadays relatively small and concentrated in a handful of member states. According to the EU co-legislators, there is an untapped potential[1] to channel more capital towards long-term projects and ELTIFs remain ideally placed to help finance inter alia the green and digital transitions.

ELTIF2 is intended to overcome a number of supply-side and demand-side limitations making ELTIFs more attractive and easier to invest in.

WHAT KEY CHANGES DOES ELTIF2 MAKE?

Eligible Investment Assets

The definition of eligible investment assets has been profoundly revisited and ultimately widened.

[1] According to a survey conducted by Scope Fund Analysis GmbH in 2022, "*A total of EUR 6.8trn had been invested in alternative investment funds (AIFs) in Europe at the end of 2020. The estimated ELTIF market volume of EUR 7.2bn to EUR 7.7bn is still only a tiny share (0.11%) of the total closed-ended investment market, but it highlights their growth potential*".

In particular:

- limits and restrictions previously applicable to investments located in third countries have been streamlined on the understanding that many of these long-term assets may benefit the real economy of the EU;
- real assets – assets having 'an intrinsic value due to their substance and properties' – will form a more flexible and attractive category of eligible investment assets. The definition of real assets has been simplified accordingly, thus being made open to case-by-case assessment by ELTIF managers;
- the existing prohibition on investing in financial undertakings has been amended with a view to allowing ELTIFs to invest in innovative new financial undertakings (such as FinTechs) in the first five years of their activity;
- simple, transparent and standardised (STS) securitisations have now been included amongst eligible investment assets;
- the eligibility of funds-of-funds strategies for ELTIF managers has been expanded and will now include undertakings for collective investment in transferable securities (UCITS) and EU alternative investment funds (EU AIFs) managed by EU AIF managers, provided however that these collective investment undertakings also invest in eligible investment assets and have not themselves invested more than 10 % of their capital in any other collective investment undertaking;
- ELTIFs will also be allowed to make use of master-feeder structures.

Investment Restrictions and Limits

The existing set of restrictions and limits applicable to ELTIFs have proven to be too burdensome, difficult to comply with and costly in terms of transactional costs and capital allocation. ELTIF2 is now expected to allow ELTIF managers to be more efficient in terms of liquidity management and to pursue more concentrated investment strategies.

In particular:

- ELTIFs will no longer be required to invest at least 70% of their capital in eligible investment assets. The new (lower) threshold (55%) will enable ELTIF managers to better manage liquidity in order to accommodate semi-open-ended structures;
- the existing requirement that each individual real asset needs to have a value of at least EUR 10 million has been removed – thus deleting any minimum value – with a view to boosting more effective investments in real assets;
- the maximum market capitalisation of listed qualifying undertakings in which ELTIFs can invest has been increased from EUR 500 million to EUR 1.5 billion to widen the range of available investment targets and provide ELTIFs with a better liquidity profile;
- ELTIFs that can be marketed to retail investors will be permitted to borrow cash amounting to up to 50% (as opposed to the previous 30%) of the net asset value of the ELTIF;

- the existing diversification requirements for ELTIFs' exposures to single qualifying portfolio undertakings, single real assets, collective investment undertakings and certain other eligible investment assets and financial instruments have been adjusted. Amongst other things, the previous 10% threshold to invest ELTIFs' capital, respectively, in instruments issued by, or loans granted to, any single qualifying portfolio undertaking, in a single real asset has been doubled (20%);
- the aggregate risk exposure threshold to a counterparty of the ELTIF stemming from OTC derivative transactions, repurchase agreements, or reverse repurchase agreements is now 10% (as opposed to the previous 5%) of the value of the ELTIF's capital;
- ELTIFs may now invest up to the 20% (as opposed to the previous 10%) of their capital in a single collective investment undertaking provided that they do not acquire more than 30% of interests of that single collective investment undertaking (as opposed to the previous 25%) (this latter limit not being applicable to feeder ELTIFs investing in their master ELTIFs).

Distribution

Distribution of ELTIFs has encountered a number of different obstacles stemming from stricter requirements than those applicable to any other complex financial products and limitations applied at the level of each single retail investor. ELTIF2 finally removes these unnecessary impediments, better coordinating this new framework with other pieces of EU legislation (including MiFID2[2]).

Also, ELTIF2 has reassessed and loosened certain investor protection safeguards, which were considered either not in line with established market practices or disproportionate and detrimental to the successful implementation of ELTIFs' investment strategies and to the interests of investors.

In particular:

- ELTIF managers or distributors no longer have to provide investment advice when marketing ELTIFs to retail investors;
- retail investors are no longer subject to any initial minimum investment (i.e. EUR 10 000 minimum investment) or limitation on aggregate investments (i.e., maximum 10% of a retail investor's financial instrument portfolio invested in ELTIFs);
- the requirement to set up local facilities (infrastructures for making subscriptions, making payments to investors, repurchasing or redeeming interests and the making available of information by ELTIF managers) has been removed – consistently with the new CBDF framework[3] - thus removing additional costs and friction to the cross-border marketing of ELTIFs.
- it has been specified that provisions on conflicts of interest shall not prevent ELTIF managers (or entities belonging to the group) from co-investing in an ELTIF or co-investing with an ELTIF in the same target asset;

[2] Directive 2014/65/EU.
[3] Directive (EU) 2019/1160 and Regulation (EU) 2019/1156.

- investors' right to request the early winding down of an ELTIF where a redemption request has not been satisfied has been removed.

ELTIFs AND PROFESSIONAL INVESTORS

The existing rules are almost identical for both professional and retail investors. Managers have been reluctant to offer tailored ELTIFs to professional investors, also in light of the administrative burden, the associated costs and mindful of the possibility to offer alternative – more viable and substantially similar – structures (such as in the form of reserved AIFs). To lighten these burdens ELTIF2 has introduced a set of provisions intended to create a simplified regime for ELTIFs reserved to professional investors.

In particular:

- with reference to diversification and composition of portfolios, ELTIFs will no longer be required to comply with concentration requirements (towards single issuers; borrowers, real assets and collective investment undertakings) and maximum aggregate values and risk exposure when respectively investing in STS and in OTC derivative transactions, repurchase agreements, or reverse repurchase agreements;
- ELTIFs will be permitted to borrow cash amounting to up to 100% (as opposed to the previous 30% threshold and the 50% threshold applicable to ELTIFs open to retail investors) of the net asset value of the ELTIF.

SNAPSHOT FROM CERTAIN EU MEMBER STATES

France

In France, about 20 ELTIFs or compartments of ELTIFs have been authorised by the French *Autorité des marchés financiers* (based on the ELTIF Register in early January 2023).

A number of vehicles, such as professional specialised funds (*fonds professionnels spécialisés* or FPS), including those set up as French limited partnerships (*sociétés de libre partenariat* or SLP), professional private equity investment funds (*fonds professionnels de capital investissement* or FPCI) and specialized financing vehicles (*organismes de financement spécialisés* or OFS) have been identified as having the most compatible characteristics with the requirements of the EU regulation on ELTIF.

The subscription and purchase of units or shares of these French funds are in principle reserved for professional investors or investors whose initial subscription is at least EUR 100,000, except for such AIFs which have been authorised as ELTIF. In this case, retail investors may invest in accordance with the conditions provided for in ELTIF provisions.

In accordance with the ELTIF regulation, such AIFs have also been authorised to grant loans, as a derogation from the French banking monopoly requirements.

Accordingly, certain French rules should be revised in order to align them with the new ELTIF provisions which have been adopted.

In this respect, special attention should be paid to the harmonization of the applicable rules to ELTIFs, in particular regarding liquidity management for certain ELTIFs which would be partially open (i.e. ELTIFs which provide for the possibility of redemptions during their life).

Germany

Although Germany is one of the main markets in the EU when distributing share or units in ELTIFs (29 ELTIFs as of January 2023), no single ELTIF has so far been established in Germany.

One reason might be that Germany already has a well-established and sustainably grown funds market for retail investors – also creating access to illiquid real assets such as real estate or infrastructure. In addition, closed-ended (long term) investments funds are well accepted by professional and retail investors. It is expected that German manages will now leverage from this existing expertise market under the new ELTIF regime.

So far, however, the ELTIF regime has never been tested for German domiciled ELTIFs and there are some uncertainties with regard to the interaction between ELTIF2 and the German Capital Investment Act (which does currently e.g. not explicitly provide for an outgoing ELTIF passport to retail investors).

The German regulator (BaFin) is currently elaborating on the authorisation process for a German ELTIF Manager. Most likely, no extension of an existing authorisation as AIFM to explicitly include ELTIF needed, provided that the authorisation covers the targeted investor category (retail / professional), the intended term (open / closed ended) and the underlying investments (such as real estate) of the ELTIF already.

From a German perspective, it will be quite important for the future success of ELTIFs that the national legislator creates the needed legal framework surrounding the ELTIF regulatory framework and that also BaFin in its administrative practice pro-actively supports "home grown ELTIFs".

Italy

Italy is one of the main markets in the EU when it comes to ELTIFs' distribution (approx. 30 ELTIFs offered so far); however only 16 *Italian* ELTIFs have been established since the ELTIF1 legislation was enacted.

Amongst the key drivers supporting distribution, tax incentives have played a very important role. ELTIFs have been successfully structured as PIR-compliant products (PIR (*Piani Individuali di Risparmio* – Individual saving plans) are long-term savings plans giving relief on income and inheritance tax for individuals) thus taking advantage of the associated tax benefits and attracting savings from private investors with small investment tickets.

Local regulators and market practice have not gold-plated on the European framework.

Interestingly, in the face of rigid banking monopoly rules in Italy (non-Italian EU AIFs willing to engage in financing into Italy have to secure an ad-hoc license from the Bank of Italy), certain regulatory filings processed by the Bank of Italy suggest that, in their view, ELTIFs are intrinsically allowed to engage in financing in Italy with no need for any local permit.

Luxembourg

Luxembourg is the clear market leader for ELTIFs. Currently, 48 ELTIFs out of 84 (in total) are domiciled in Luxembourg. Luxembourg ELTIFs are typically established as Part II UCIs, SIFs or RAIFs. These vehicles are well established and known in European market and therefore easy to distribute on a cross-border basis within the EU/EEA. ELTIF2 is expected to further increase the number of Luxembourg based ELTIFs.

Spain

ELTIFs have not been successful in Spain. Since ELTIF1 became into force in Spain only residual vehicles have been incorporated in Spain. The key driver for this is the fact that they do not have any efficient tax treatment, not transparency, and are subject to Spanish corporate income tax. Also, the fact that the Spanish ECR is flexible from an investment strategy perspective and has a very tax efficient treatment for Spanish investors.

On the other hand, Luxembourg ELTIFs have had relative success in Spain to allow marketing to retail investors and we have seen how Spanish debt fund managers have used the ELTIF to market these structures to Spanish retail investors.

With the amendments foreseen in ELTIF2, we expect an increasing number of projects considering the ELTIF as an alternative to other vehicles, that although efficient from a regulatory and tax perspective, cannot be marketed to Spanish retail investors.

UK

The UK 'onshored' the ELTIF Regulation when the UK withdrew from the EU. As a result, it has remained possible to create ELTIFs in the UK post-Brexit. However, due in part to the distribution and portfolio composition constraints referred to earlier in this briefing, the ELTIF did not gain popularity as a fund vehicle in the UK and it remains the case that no UK ELTIFS have been established.

There did, however, remain demand in the UK for a fund vehicle that is tailored to investment in long-term assets. As a result, in 2021 the UK created a new type of fund, the 'Long Term Asset Fund' (LTAF). LTAFs are open-ended, authorised funds with an investment strategy of investing mainly in long-term, illiquid assets. Relevant guidance states that this means LTAFs should invest at least 50% of the value of the scheme property in unlisted securities and other long-term assets such as immovables or other funds that invest in those assets. Currently LTAFs may only be marketed to professional investors and certain sophisticated retail investors. Following a consultation in 2022, it is expected that these rules will be widened in 2023 to permit the LTAF to be marketed to all professional and retail investors.

As a result of the creation of the LTAF regime and continued absence of establishment of UK ELTIFs, the UK government announced in 2022 that it intends to repeal the ELTIF Regulation.

WHAT HAPPENS NEXT?

The new rules will apply nine months after their publication in the Official Journal. A transitional period of approximately five years from the date of application is expected to be granted to existing ELTIFs. Notwithstanding the transitional period, authorised ELTIFs may choose to be subject to ELTIF2 provided that the competent authority of the ELTIF is notified thereof.

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