

Your Guide to European Long-Term Investment Funds (ELTIFs)

A legal update from Dechert's Financial Services Practice

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Strengthening the European economy through sustainable growth and boosting long-term investment is currently at the forefront of the European Union's ("EU") economic agenda. This focus on sustainable growth is the key driver behind a new European fund regime, the European long-term investment fund ("ELTIF"). The aim of the ELTIF is to increase the pool of capital available for long-term investment in Europe and in particular for infrastructure projects, small and medium sized enterprises, research and development and education.

The ELTIF regime was established pursuant to the regulation on European long-term investment funds (Regulation (EU) 2015/760) (the "Regulations"), which was published in the Official Journal of the EU on 19 May 2015. It has been possible to launch an ELTIF since 9 December 2015, but what exactly is it? Who can establish an ELTIF? How can it be structured? To whom can it be sold? What constitutes a "long-term" investment and are any limitations imposed on promoters using an ELTIF?

This OnPoint aims to address these questions and serve as your introductory guide to understanding an ELTIF.

Eligible Investments

The defining feature of an ELTIF as a fund product is the asset classes in which it can invest. In line with the overriding policy objective, ELTIFs must focus on alternative investments that fall within a defined category of asset classes whose successful development requires a long-term commitment from investors.

What can an ELTIF invest in?

The Regulations prescribe that an ELTIF must invest at least 70% of its assets in "eligible investment assets". However, in order to provide a degree of liquidity, ELTIFs are also permitted to invest up to 30% of their capital in assets in which a UCITS fund may invest.

What are eligible investment assets?

Equity or Quasi-equity¹ Instruments	<ul style="list-style-type: none"> • Issued by a qualifying portfolio undertaking and acquired either directly or from a third party via the secondary market. • Issued by the qualifying portfolio undertaking's parent company (where such parent has majority ownership) and acquired either directly or from a third party via the secondary market.
Debt Instruments	<ul style="list-style-type: none"> • Issued by a qualifying portfolio undertaking (secondaries not permitted).

¹ Quasi-equity means any type of financing instrument where the return on the instrument is linked to the profit or loss of the qualifying portfolio undertaking and where the repayment of the instrument in the event of default is not fully secured.

Loan Origination	<ul style="list-style-type: none"> Granted to a portfolio undertaking with a maturity no longer than the life of the ELTIF.
Other ELTIFs, EuVECA² and EuSEFs³	<ul style="list-style-type: none"> Units or shares of other ELTIFs, EuVECA²s or EuSEFs³ provided such ELTIFs, EuVECA²s or EuSEFs³ have not themselves invested more than 10% of their capital in ELTIFs (single issuer limit of 25%).

What is a qualifying portfolio undertaking?

A qualifying portfolio undertaking is an eligible issuer or borrower that is:

1. not another fund;
2. not a financial undertaking (i.e. a credit institution, MiFID investment firm, AIFM, insurance company or financial holding company), unless the financial institution itself exclusively finances qualifying portfolio undertakings or real assets;
3. not admitted to trading on a regulated market, or is admitted to trading on a regulated market but with a market capitalisation of no more than €500,000,000; and
4. established in a member state of the EU ("Member State"), or a third country, provided that third country (i) is not a high-risk and non-cooperative jurisdiction identified by the Financial Action Task Force; and (ii) has signed an agreement with the ELTIF manager's Member State and each Member State into which the interests in the ELTIF are intended to be marketed in order to ensure compliance with the tax information exchange standard laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital.

If an undertaking in which the ELTIF has already invested ceases to comply with (3) above, the ELTIF's investment can continue to be classified as an investment in a qualifying portfolio undertaking for three further years.

What are real assets?

The Regulations define a real asset as any 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 benefits. Real assets should yield a predictable cash flow, and the recitals to the Regulations include examples such as energy, transport and communication infrastructure, as well as education, health, welfare support and industrial facilities.

² A European Venture Capital Fund established pursuant to Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds.

³ A European Social Entrepreneurship Fund established pursuant to Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds.

What are the diversification requirements?

Maximum exposure as percentage of capital	Investment
5%	<ul style="list-style-type: none"> UCITS eligible securities from a single issuer (increasing to 25% when issued by a Member State credit institution subject to supervision designed to protect bond-holders).
10%	<ul style="list-style-type: none"> Instruments issued by, or loans granted to, a single qualifying portfolio undertaking. In a single real asset (whether invested directly or indirectly). Units or shares of a single ELTIF, EuVECA or EuSEF.
20%	<ul style="list-style-type: none"> Aggregate value of units or shares in other ELTIFs, EuVECAs or EuSEFs. Instruments issued by/loans granted to a single qualifying portfolio undertaking, or direct/indirect investment in a single real asset, provided that the total aggregate value of the assets held by the ELTIF in qualifying portfolio undertakings and 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.
25%	<ul style="list-style-type: none"> UCITS eligible securities from a single issuer 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.

Investments in UCITS eligible assets are subject to the diversification requirements in the UCITS Directive.

The manager of an ELTIF will have an “appropriate period of time” to rectify the ELTIF’s positions where it infringes the above diversification requirements due to circumstances beyond the manager’s control.

Are there any prohibited activities?

An ELTIF is prohibited from undertaking any of the following activities:

- ▶ Short selling.
- ▶ Taking direct or indirect exposure to commodities.

- ▶ Entering into securities lending, securities borrowing and repurchase transactions (or any other agreement which has similar economic effect) if more than 10% of the ELTIF's assets are affected.
- ▶ Having aggregate exposure to over the counter derivatives or reverse/repurchase transactions of greater than 5%.
- ▶ Using derivatives (other than for efficient portfolio management).

Regulatory technical standards ("RTS") should be published by ESMA over this summer for consideration by the European Commission. The RTS will address the circumstances in which the use of financial derivative instruments solely serves the purpose of hedging the risks inherent to investments. The European Security and Markets Authority ("ESMA"), in its consultation paper on the draft RTS issued on 31 July 2015 (ESMA/2015/1239), proposed a definition of hedging based on the definitions of hedging provided in IFRS Standard 9, the CESR guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS.

Structural Considerations

Who is eligible to manage an ELTIF?

An ELTIF is an AIF and therefore must be managed by an authorised AIFM (each as defined under the Alternative Investment Fund Managers Directive (Directive 2011/61/EU)) that is authorised to manage AIFs that follow investment strategies of the type covered by the ELTIF regime. While there is not a separate regime for ELTIF managers, an EU AIFM seeking to manage an ELTIF must be authorised to do so by the competent authority in the Member State where the ELTIF is established. A UCITS management company may not manage an ELTIF (unless it is also authorised as an AIFM).

Where should an ELTIF be established?

An ELTIF and the AIFM managing the ELTIF must both be established in a Member State. In contrast to the rules under AIFMD, a third-country AIFM may not manage an ELTIF. An ELTIF can be internally managed, but a self-managed ELTIF must also be authorised as an AIFM.

In deciding where to establish the ELTIF, consideration should be given to whether a particular jurisdiction will provide the ELTIF with access to the assets in the jurisdictions that it is targeting and whether pursuing its proposed strategy in that jurisdiction (including through any trading subsidiaries) will be tax efficient for the ELTIF's end investors. Loan origination in particular is restricted in a number of jurisdictions in Europe, with certain countries requiring a banking license.

Can an ELTIF be open-ended or closed-ended?

An ELTIF must be closed-ended, but can provide for liquidity before the end of the life of the ELTIF from a stated date, being the date by which the ELTIF must reach the 70% investment target. That date can be no later than the earlier of (i) five years into the term, or (ii) half the life, of the ELTIF. Certain conditions must also be fulfilled, including: (i) establishing a liquidity management system; (ii) setting out a defined redemption policy; and (iii) limiting the amount of redemptions in a given period to a specified percentage of liquid assets.

Managers should note that where such liquidity is provided, if redemption requests are not satisfied within one year from the date they were made, investors may require the ELTIF to be wound down.

Is the term of the ELTIF restricted?

An ELTIF must specify the date on which its term will come to an end. The term may be temporarily extended. While no fixed minimum is prescribed, the term of the ELTIF must be long enough to cover the life cycle of each of its assets and be consistent with the long-term nature of the ELTIF. The draft RTS suggest that the term of the fund should be set by reference to the individual asset within the ELTIF portfolio which has the longest life-cycle. The ELTIF must be 70% invested in eligible investments within such period as set out in the fund terms, which can be no longer than five years or half the life of the ELTIF (whichever is earlier).

What is the approval process for establishing an ELTIF?

An authorised EU AIFM must make an application to the competent authority of the Member State where the proposed ELTIF is to be established. While the specifics of the process may differ from Member State to Member State, the application process will include the filing of: (i) the ELTIF's constitutional documents; (ii) information regarding the AIFM and its operating history; (iii) information on the depositary; and (iv) a description of the information to be made available to investors.

Where the proposed ELTIF is to be managed internally, an AIFM application must be made at the same time as the fund applies for approval as an ELTIF.

Marketing an ELTIF***To whom can an ELTIF be marketed?***

While one of the core purposes in establishing the ELTIF regime was to provide institutional investors with access to long-term investment, an ELTIF is able to market both to professional investors and retail investors.

Is there an ELTIF passport?

ELTIFs can avail of the marketing passport available to EU AIFs under AIFMD. However, unlike AIFMD, the marketing passport can be used for marketing both to professional and retail investors.

Do additional requirements apply when marketing to retail investors?

When an ELTIF will be marketed to retail investors it must comply with additional requirements. These include the following:

- ▶ The AIFM must establish facilities in each Member State where the ELTIF proposes to market for making subscriptions, making payments to investors and repurchasing or redeeming units/shares. The draft RTS proposals indicate that an approach similar to that for UCITS is likely to be followed.
- ▶ The AIFM must be authorised to provide investment advice to retail clients in accordance with MiFID.
- ▶ The AIFM must establish and apply a specific internal process for the assessment of the suitability for investment in the ELTIF by retail investors.
- ▶ The AIFM must assess a retail investor's suitability before directly offering or placing units or shares of the ELTIF with a retail investor.
- ▶ The AIFM must provide the retail investor with "appropriate investment advice" when marketing the ELTIF.

- ▶ The ELTIF must produce a key investor document.
- ▶ Where the retail investor's portfolio of financial instruments does not exceed €500,000, such investor may not invest an amount exceeding 10% of that investor's portfolio in an ELTIF (but must have an initial investment in ELTIFs of no less than €10,000 in aggregate).
- ▶ The ELTIF will be unable to enter into any side letters with investors.
- ▶ The legal form of the ELTIF must not lead to liability for the retail investor apart from the original capital commitment.

While the requirements for marketing to retail investors may appear burdensome, the mandated assessment of each individual retail investor's circumstances need only be made on the basis of information obtained from the investor. Appropriately drafted subscription documents should, therefore, reduce the burden somewhat in this regard.

Retail investors will also have until the end of the subscription period or at least a two week "cooling off" period from the date that they invest in the ELTIF during which they can cancel their subscription and have their money returned without incurring any penalty.

From 31 December 2016, ELTIFs selling to retail investors will be subject to the EU Regulations on key information documents for packaged retail and insurance-based investment products or PRIIPs (Regulation (EU) No 1286/2014).

Why might investors choose an ELTIF?

While there is little that the ELTIF can do that cannot be achieved through an AIF, an ELTIF may be appealing for investors aiming to achieve a steady flow of income and long-term returns within a well-regulated fund product. For institutional investors such as insurers, ELTIFs should be attractive as they will benefit from better capital treatment than other fund products, as type I equities under Solvency II. In addition, unlike an AIF, ELTIFs can be marketed on a passport basis to retail investors providing a broader category of eligible investors and giving retail investors access to an asset class from which retail investors have historically been barred. While not appropriate for all retail investors, certain high net worth individuals seeking to build a diversified portfolio with a long term investment horizon may find that ELTIFs suit their investment needs.

Can an ELTIF be listed on a regulated market?

The Regulations encourage the listing of ELTIFs by providing that the rules or instruments of incorporation of an ELTIF cannot prevent the ELTIF's units or shares from being admitted to trading on the secondary market. Where an ELTIF is listed, it must publish in its periodical reports the market value of its listed units or shares along with the NAV. The normal initial and ongoing listing requirements would of course also apply.

Other Considerations

Are there any restrictions on distributions?

No, provided that proceeds are not required for future commitments of the ELTIF, income can be distributed. The ELTIF may, subject to it being in the interests of the investors to do so, reduce its capital if an asset is disposed of during the ELTIF's term.

Are there any limitations on borrowing?

ELTIFs may borrow up to 30% of their capital if such borrowings (i) are in the same currency as the assets to be acquired with the funds borrowed and (ii) have a maturity of no longer than the life of the ELTIF, and the ELTIF does not have sufficient cash assets to make the investment concerned. Funds borrowed cannot be used for loan origination.

Are there any disclosure requirements?

As a form of AIF, ELTIFs fall within the scope of the AIFMD disclosure obligations. However, the Regulations go further and stipulate a number of additional disclosures that must be included in an ELTIF's prospectus and annual report.

In addition to complying with Article 23 of AIFMD, the prospectus must include a statement outlining how the ELTIF's investment objective and strategy qualify the fund as long-term in nature and a prominent indication of the categories of assets and jurisdictions in which the ELTIF is authorised/allowed to invest, as well as clearly informing investors about the long-term nature of its investments and the term of the ELTIF.

Furthermore, as well as including the requirements stipulated by Article 22 of AIFMD, the annual report of an ELTIF must contain a cash flow statement, information on any participation involving EU budgetary funds and information on the value of the ELTIF's investments and where such investments are located.

Can the Manager be liable for non-compliance?

The AIFM is responsible for ensuring compliance with the Regulations and liable in accordance with rules under AIFMD for any infringement of the Regulations, as well as for any loss or damage resulting from non-compliance.

Could an ELTIF be affected by the EU's proposed loan origination regime?

On 11 April 2016, ESMA published its opinion on the necessary elements for a harmonised European framework for loan origination by funds. ESMA's opinion focuses on funds that conduct loan origination and therefore certain ELTIFs could find themselves within the scope of any resulting loan origination framework (for further information, please see our OnPoint ['ESMA Lends Support for a Harmonised European Framework for Loan Origination Funds.'](#))

While ESMA's opinion does not expressly cover ELTIFs, ESMA (i) acknowledges that loan origination is possible for an ELTIF and (ii) raises as an option mandatory authorisation under a proposed loan origination regime for AIFMs managing ELTIFs (although views within ESMA diverge on this point).

Commission's Review

No later than June 2019, the European Commission is required to review the implementation of the ELTIF regime.

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