2021 Capital Markets Union package: review of the ELTIF Regulation

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Background

The European long-term investment fund regulation (the **ELTIF Regulation**) [1] was introduced in 2015 in order to support large debt and equity investments in non-listed European businesses and decrease the small and medium-sized enterprises finance gap. It is an addition to the European legislative package, composed of the European venture capital funds (**EuVECA**) and the European social entrepreneurship funds (**EuSEF**) regulations, which have been applicable since 2013.

The ELTIF qualifies as an alternative investment fund (**AIF**) that allows professional and retail investors across the European Union (**EU**) to invest in companies and projects that need long-term, stable capital.

Since the entry into force of the ELTIF Regulation, it has been observed that ELTIFs did not succeed as expected (with only 57 registered ELTIFs as of 14 December 2021). On 10 October 2020, the European Commission (the **EC**) launched a consultation on the review of the ELTIF Regulation. On 3 February 2021, the European Securities and Markets Authority (the **ESMA**) published a letter for the attention of the EC, highlighting issues and areas of improvement applicable to the ELTIF Regulation. These suggestions notably included:

- eligible assets and investments
- portfolio composition and diversification
- authorisation process of ELTIFs

Adoption of a legislative proposal to amend the ELTIF Regulation

As anticipated, the EC adopted a package of legislative proposals with an aim to deliver on several main commitments of the 2020 Capital Markets Union (**CMU**) action plan, covering, amongst others, a proposal to review the ELTIF Regulation on 25 November 2021 (the **Proposal**).

The EC also published (i) a report on the functioning of the ELTIF framework, (ii) an impact assessment, (iii) an executive summary of the impact assessment, and (iv) a factsheet on the Proposal

Rationale and objectives behind the Proposal

Amendments to the ELTIF Regulation are expected to increase the uptake of ELTIFs across the EU, accelerating the reception and improving their attractiveness for investment managers and targeted investors as a fund choice for long-term investments in the real economy. It would support, in turn, the constant development of the CMU "which also aims to facilitate EU companies' access to more stable, sustainable and diverse long-term financing". [2]

The Proposal is also in line with the ambition described in the European Green Deal and specifically in the sustainable finance strategy, addressing sustainability goals and climate neutrality objectives for stakeholders having a role in the long-term financing strategies. Furthermore, the EC highlights that the initiative is an occasion to ensure that the investment strategies and reporting activities of the ELTIF are aligned with the EU's climate and environmental goals.

Main elements of the Proposal

In essence, the Proposal offers amendments to the ELTIF Regulation which envisage the below:

An enlargement of the scope of eligible assets and investments and a reduction of some limitations to allow more flexibility for fund managers

As an example, the Proposal mentions a simplification of the definition of "real assets" in order to include any asset which has an intrinsic value due to its substance and properties, allowing a larger base of eligible assets to ELTIFs, including social, communication, environment, energy or transport infrastructure, as well as education, health, welfare support or industrial facilities or installations. The Proposal would lower the minimum threshold for investments in real assets to €1,000,000, and it would no longer be a requirement for real assets to be owned directly or through "indirect holding via qualifying portfolio undertakings".

Under the context of the extension of the scope of eligible assets, the Proposal mentions that ELTIFs may also invest in:

- undertakings for the collective investment in transferable securities (**UCITS**) and EU AIFs managed by EU alternative investment fund managers (**AIFMs**) in addition to ELTIFs, EuVECAs and EuSEFs; however, these UCITS and EU AIFs should also invest in eligible investments and have not themselves invested more than 10% of their capital in any other collective investment undertaking

- simple, transparent and standardised securitisations (up to an aggregate of 20% of the value of the ELTIF)
- listed qualified portfolio undertakings, maximum capitalisation of which is to be increased from €500,000,000 to €1 billion
- minority co-investments by ELTIFs in investment opportunities which could attract more modest promotors of investment projects

In order to take advantage of the expertise of the ELTIF managers and for diversification benefits, the Proposal foresees the possibility for ELTIFs to invest all or almost all of their assets into the diversified portfolio of a master ELTIF, allowing them to pool their assets and make use of master-feeder structures.

A reduction of the obstacles of entry for retail investors while ensuring appropriate levels of investor protection

In this respect, the Proposal intends to create two regimes, one for ELTIFs marketed to retail investors and the other for ELTIFs marketed only to professional investors. Taking into account the lesser need of protection for professional investors, the Proposal suggests the removal of diversification requirements for ELTIFs exclusively marketed to professional investors. The Proposal also suggests amendments to borrowing limits – ELTIFs marketed to retail investors will be able to borrow up to 50% of the value of their capital (currently 30%) and those marketed solely to professional investors would be permitted to leverage up to 100% of the value of its capital. The 30% encumbrance limit (notwithstanding the type of target investors) will be removed, introducing a clarification that borrowing fully secured by investors' capital commitments shall not constitute borrowing. Additional flexibility will be provided through the possibility to borrow in the currency of targeted assets.

It also suggests to amend the scope of conflict of interest provisions in the ELTIF Regulation to allow for an AIFM managing an ELTIF, their affiliated entities that belong to the same group, and their staff, to co-invest together in such an ELTIF. The EC highlights that such co-investments seem necessary for co-investment strategies pursued by AIFMs and in some cases can represent a standard industry practice. Organisational and administrative arrangements have to be put in place to "identify, prevent, manage and monitor conflicts of interest and provided that such conflicts of interest are adequately disclosed", with a view to ensure investor protection and maintaining market integrity safeguards.

The Proposal also contemplates removing (i) the requirement to set up facilities for investors in each EU Member State where an ELTIF is marketed to retail investors and (ii) current suitability requirements (ie suitability tests for retail investors which duplicate the suitability requirements in the Directive 2014/65/EU (**MiFID II Directive**)).

An introduction of an additional liquidity window redemption mechanism which will permit retail investors to exit the fund's investment

As of now, article 18 of the ELTIF Regulation envisages the redemption policies pursuant to which, as a standard, investors may not redeem their shares (or units) before the ELTIF's maturity. Derogations can be included in the constitutive documentation of the fund. However, redemptions before the end of the life of the ELTIF are exceptional subject to strict conditions.

Noted as a limitation for investors by an important number of stakeholders, a call for flexibility permitting an early redemption process during the life of the ELTIF has been recognised as an important tool to contribute to ELTIFs attractiveness among other existing investment vehicles.

In this context, the Proposal aims to amend the ELTIF Regulation to enable managers to include the possibility for an optional liquidity window mechanism, as well as a full or partial matching of transfer requests of shares (or units) by exiting investors with the requests for subscription by new investors, which may help to ensure the adherence of retail investors whom the intrinsic illiquid nature of the ELTIFs may hold back.

Apparent benefits of the Proposal for asset management ecosystem

The Proposal brings a possibility for fund managers to invest, with a regulated product open to professional and retail investors, in a larger pool of eligible assets, through easier and more sophisticated investment structures and strategies.

Even though the proposed changes will not increase the level of investor protection, especially for retail investors, it will help the latter to invest more easily in ELTIFs as part of their overall investment strategy while keeping proper levels of investor protection with the MIFID II suitability test. Under the suggestions of the Proposal, retail investors can further consider long-term investments and meet their savings' needs.

The possibility to set up open-ended ELTIFs, especially with the liquidity window redemption mechanism, may permit ELTIFs investors to exit their investments before the end of the ELTIF's life, which should allow for minimising the impact of the ELTIF value on the investments of the remaining investors.

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[1] Regulation 2015/760 of 29 April 2015 on European long-term investment funds.

[2] Proposal for a Regulation of the European Parliament and of the Council amending

Regulation (EU) 2015/760 as regards the scope of eligible assets and investments, the portfolio composition and diversification requirements, the borrowing of cash and other fund rules and as regards requirements pertaining to the authorisation, investment policies and operating conditions of European long-term investment funds, European Commission, 25 November 2021

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