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Investment Management Alert

Paving the Toll Road—Making ELTIFs a Suitable Alternative for Institutional and Retail Investors

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The EU is in the process of assessing the introduction of new European Long-Term Investment Funds (ELTIFs) intended to fuel capital formation for energy and infrastructure fund vehicles. Continuing negotiations on recently published and competing proposals to the EC's ELTIF Ordinance, however, suggest that the launch of ELTIFs may be delayed beyond 2015.

ELTIFs: Background

The European Commission (EC) proposed an ELTIF Ordinance on June 26, 2013 designed for institutional and retail investors to put money into infrastructure companies and projects. The basic ELTIF idea had been initially discussed during the UCITS VI consultation launched by the EC almost a year earlier, and the idea was seen, in part, as a way to address criticism that financial markets favor short-term speculative investments. The G20 and the World Bank, among others, also were launching similar initiatives to boost long-term investments.

Examples of infrastructure projects eligible for ELTIFs are listed in the following table, and the Ordinance would also permit investments in related unlisted growth companies, real estate and other real assets. The private and (potentially) closed-ended ELTIFs would also be able to grant loans to their portfolio companies and qualify for a EU retail distribution passport. It was, and still is, not entirely clear, however, which investments are considered to be "long-term" by the EC. In addition to the EC proposal, which was amended in March 2014, there is also a Council of the EU compromise proposal, and both are discussed in detail in the remainder of the alert.

TABLE 1 | Eligible Infrastructure Projects

ELIGIBLE INFRASTRUCTURE PROJECTS	EXAMPLES
Public Building Infrastructure	Schools Hospitals Prisons
Social Infrastructure	Social Housing
Transport Infrastructure	Roads Mass Transit Systems Airports
Energy Infrastructure	Energy Grids Climate Adaption and Mitigation Projects Power Plants Pipelines
Water Management Infrastructure	Water Supply Systems Sewage Systems Irrigation Systems
Communication Infrastructure	Networks
Waste Management Infrastructure	Recycling or Collection Systems

ELTIF—The Basics According to the Amended EC Proposal

On March 10, 2014, the Economic and Monetary Affairs Committee of the European Parliament (ECON) voted amendments on the EC proposal. A respective report has been published on March 25, 2014.

The authorization procedure has been simplified in that an EU AIFM can refer to its AIFMD application files and authorization within the ELTIF application. The ELTIF and the EU AIFM shall be informed within two months from the date of submission of a complete application whether authorization of the ELTIF has been granted. The future ELTIF manager should document a specific expertise in the management of long-term investments. The ELTIF remains a "classified AIF." In addition, non-EU AIFs will not be eligible for marketing as ELTIFs.

Eligible investments should include listed SMEs of up to €1 billion market capitalization. Eligible investments must still make up 70 percent or more of the ELTIF's portfolio. The general rule is that eligible assets are real assets with a value of over €10 million.

TABLE 2 | Eligible ELTIF Assets

ELIGIBLE ELTIF ASSETS	NON-ELIGIBLE ASSETS
Equity or Quasi-Equity Instruments and Debt Instruments issued by Qualifying Portfolio Undertaking[1]	Short-Selling of Assets
Loans granted by the ELTIF to a Qualifying Portfolio Undertaking	Commodities (unlike UCITS)
Direct Holdings of Real Assets that require Up-Front Capital Expenditure of at least €10 million	Securities Lending or Borrowing Agreements
Units or Shares of other ELTIFs, EuVECAs or EuSEFs ("Fund-of-Fund ELTIF")	Repurchase Agreements
	Financial Derivatives other than for Hedging Purposes (unlike UCITS)
	Financial Undertakings (i.e., Credit Institutions, MiFID Investment Firms, Insurance Companies and Financial Holding Companies)

An ELTIF shall not invest more than 10 percent of its capital in: (i) assets issued by a single Qualifying Portfolio Undertaking; (ii) directly or indirectly in an individual infrastructure; (iii) in Units or Shares of any ELTIF, EuVECA or EuSEF; and (iv) no more than five percent of its capital in assets referred to in Article 8(1)(b) where those assets have been issued by any single body. In addition, an ELTIF may acquire no more than 25 percent of the units or shares of a single ELTIF, EuVECA or EuSEF.

The cash-borrowing threshold has been increased from 30 percent to 40 percent of the capital[2] and durations shall be aligned with the ELTIF lifetime. It still remains to be seen whether the prohibition of a number of typical complex financing agreements used within private infrastructure projects is acceptable for both potential ELTIF sponsors and investors.

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1 Such Qualifying Portfolio Undertaking may also be established in a country outside the EU provided: (i) that the third country is not identified as a high-risk and non-cooperative jurisdiction by the Financial Action Task Force (FATF) and (ii) that the third country has signed different cooperation agreements to ensure compliance with Article 26 of the OECD Model Tax Convention on Income and on Capital and ensures effective exchange of information in tax matters.

2 Defined as Aggregate Capital Contributions and Uncalled Committed Capital calculated on the Basis of Amounts investible after the Deduction of all Fees, Charges and Expenses which are directly or indirectly borne by Investors.

A distinction was made between professional ELTIFs (to be marketed to professional and semi-professional investors with a minimum investment of €100,000) and retail ELTIFs. Investors in retail ELTIFs shall have the right to ask for redemption of their shares or interests before the end of the ELTIF lifetime (if any). Irrespective of this, the ELTIF rules may foresee a regular redemption right. This redemption by both retail and (semi-)professional investors was to take place: (i) whenever the life of the ELTIF is halfway and (ii) relate to a maximum of 20 percent of the total amount of the fund. The initial idea of the EC was not to grant any redemption rights to encourage long-term investments. There were, however, market concerns whether the lifetime concept was appropriate at least for retail investors.

ELTIFs are subject to a prospectus requirement and retails ELTIFs are to issue a Key Information Document (KID) in accordance with PRIPS Regulation.

MEP Position

The 2009-14 five-year European Parliament (EP) term ended in mid-April, and the Members of the European Parliament (MEPs) had to vote on a high number of remaining items during the last plenary session in Strasbourg. In addition, they settled on the EP's position ahead of further negotiations of various subject matters in the next term.

On April 17, 2014, MEPs adopted their position on the amended EC proposal that would create ELTIFs to increase funding for infrastructure, energy or construction. The proposal is still being discussed by EU member states, who are expected to negotiate a final agreement with the next EP following elections in May 2014. It remains to be seen whether the first ELTIFs are to be set up in 2015.

Under the adopted draft, 60 percent out of the 70 percent of eligible assets have to be invested in Qualifying Portfolio Undertakings.

The ELTIF lifetime should have been coordinated with the specific needs of investors—and not only be modeled after a theoretical lifespan of the underlying assets.

Although the EP has acknowledged the need for redemption rights, there was still no mandatory redemption right included in the amended Ordinance proposal. Redemption rights should be left to the discretion of the ELTIF manager.

The Council Compromise Proposal—Beware of the Retail Investor?

On April 25, 2014, the Council of the EU published a compromise proposal on the EC proposal. Publication of the compromise proposal follows MEPs' adoption of certain amendments to the ELTIF regulation and includes some surprises:

- The distinction between professional and retail ELTIFs is no longer to be found and the redemption options in Article 16 of the current draft have been completely eliminated. As the ELTIF structure was created with the retail investor as a source of infrastructure funding in mind, the inclusion at least of annual redemption rights should be one of the elements of retail ELTIFs to be further added to the final ELTIF Ordinance.
- Secondary markets, as addressed in Article 17 of the current draft, are no suitable alternative taking into account their limited liquidity and "haircut" prices for interests of initial investors. ELTIFs need to meet international standards in terms of marketability to address both institutional and retail investors, even more so as Article 24 of the current draft now provides that the ELTIF may have any legal form.

Other questions have to be addressed, too: In case of marketing to retail investors, Article 23 of the current draft asks the ELTIF to put in place "facilities" available for making subscriptions in each member state but only refers to draft regulatory technical standards with regard to further definitions of such "facilities."

Apparently, there is still a way to go on the road to the final ELTIF Ordinance.

In the meantime, please do not hesitate to discuss any related questions with us.

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