In focus

ZOOMING IN ON THE FEATURES AND EFFECTS OF THE ELTIF FRAMEWORK

Interview with Dr. Julia Backmann, LL.M. Vice President (legal) at BVI

Dr. Julia Backmann, LL.M. Vice President (legal) at BVI, the German Fund and Asset Management Association. In this capacity, she deals with all kinds of relevant legislation on EU and national level in particular relating to corporate law and corporate governance issues as well as closed-ended funds and fund distribution rules. Before joining BVI in 2012, Dr. Backmann worked at an international law firm. She is attorney at law (Frankfurt bar) and is regularly invited to speak at international conferences.

In April 2015, the European legislators adopted a new investment fund framework designed for investors who want to put money into companies and projects for the long term. The regulation on these private "European Long-Term Investment Funds" (ELTIFs) aims at increasing the pool of capital available for long-term investment, such as infrastructure and small and medium-sized businesses in the EU economy by creating a new form of fund vehicle.

We conducted an interview with Dr. Julia Backmann—Vice President of the legal department at the German Investment Funds Association BVI—on the current status of the ELTIF regulation. The ELTIF regulation has entered into force on 9 December 2015. The European Supervisory Authority ESMA consulted implementing measures (known as Regulatory Technical Standards—RTS) in early autumn 2015. These RTS will determine some of the final circumstances under which the new funds will operate.

1. What do you believe are the drivers for setting up the ELTIF framework?
Julia Backmann:
The main driver behind the ELTIF regulation is to create a win-win situation for both the European governments and the market participants. While reliable sources of long-term financing, such as infrastructure, are needed throughout Europe, and public budgets are tight, institutional investors are striving for stable returns. In times of low interest rates, pension providers and insurance companies as well as private investors have a growing appetite for long-term investments in infrastructure or other tangible assets such as real estate.

2. What are the main features of the ELTIF framework compared with other products?
Julia Backmann:
Although the ELTIF is often understood as an infrastructure fund, ELTIF-eligible assets comprise much more. An ELTIF may also invest directly or indirectly in real assets as well as so-called Qualified Portfolio Undertakings (QPU), in particular companies (unlisted or small and medium-sized listed companies with a market capitalization of up to €500 million). In addition, ELTIFs may also grant loans to such QPUs.

The rules on portfolio composition, investment limits, lifetime of the ELTIF and redemption rights, as well as the requirements for distribution are quite detailed. Throughout the legislative process, BVI has continuously raised its concerns that the rules might not allow for enough flexibility to create a product that the market will accept. For instance, it is unclear whether an ELTIF manager will be able to find the minimum required five typical ELTIF assets with more or less the same lifetime to cover at least 70 percent of the ELTIF capital.

Whether ELTIFs are going to be feasible in practice remains to be seen and with the regulatory discussions still ongoing, it is far too early to say at the moment. This is particularly true when comparing ELTIFs with existing products; the introduction of an EU passport for retail distribution of ELTIFs could, to a certain extent, close the gap between UCITS offering retail investment opportunities in securities markets and alternative investment funds (AIFs), which provide for an EU passport for professional investors. To become a market success, the framework therefore needs to address the interests and needs of retail and professional investors.

The European Supervisory Authority ESMA consulted implementing measures (known as Regulatory Technical Standards—RTS) in early autumn 2015

3. What are the characteristics of an ELTIF fund (Open/closed or something in between)? If ELTIFs are to be opened to retail investors, how is it possible to align the liquidity of the vehicle and its assets with the liquidity expectations of the retail investor?

Julia Backmann:

ELTIFs are designed to be closed-ended funds; however, in the event that certain preconditions are met, redemption rights are allowed. The ELTIF must invest a minimum of 70 percent in typical ELTIF assets (real assets and QPUs) including loans granted to QPUs but may invest up to 30 percent in typical UCITS assets.
The redemption rights have to be limited to the amount equaling these liquid assets. Redemptions are only allowed after half of the ELTIF's life has passed, at the latest after five years. The redemption rights have to be defined by the ELTIF's fund rules. Furthermore, the ELTIF manager has to provide for an appropriate liquidity management system as well as a redemption policy.
I believe that these rules allow ELTIF managers to be able to align the liquidity with the redemption rights provided for investors.

Even with limited redemption rights, ELTIFs can enhance investors' portfolios. Germany has a long history of closed-ended funds marketed to retail investors. Until the AIFMD implementation, such funds often provided for special termination rights for retail investors, e.g., in the case of unemployment. Such special termination rights would address retail investors' needs to disinvest in case of unexpected events.
The liquid assets should generally be sufficient to allow for such redemption rights.

4. Do you believe that there are significant concerns as to potential "mis-buying" on the part of retail investors? What are the additional safeguards if ELTIFs are marketed to retail investors? How will the MiFID II requirements affect the marketing of ELTIFs to retail investors?

Julia Backmann:

No, I do not think there are significant concerns regarding "mis-buying". Generally, regulation has increased investor protection since the financial crisis. In addition, the ELTIF regulation provides for a number of additional safeguards for retail investors. The ELTIF regulation requires disclosure, in the form of a PRIIPs KID e.g., and specific cost disclosure within the prospectus. Furthermore, the ELTIF manager has to set up an internal procedure to assess whether the ELTIF is suitable for marketing to retail investors (similar to the product governance requirements according to MiFID II). Moreover, retail investors who have accumulated a portfolio (composed of cash deposits and financial instruments) that does not exceed €500,000 may only invest up to 10 percent of their portfolio but need to invest a minimum of €10,000 in the new product.

Furthermore, the ELTIF regulation allows ELTIFs to only be sold to retail investors if the investor receives investment advice and therefore the suitability of the ELTIF has been tested, even in the case of direct distribution. In this regard, the MiFID requirements regarding investment advice apply and ELTIF interests cannot be distributed by execution only or advice-free. Furthermore, ELTIFs are likely to be considered as complex. Regardless of whether all AIFs will be considered complex products, as suggested by ESMA under MiFID implementing rules, all products that have a fixed investment term of a number of years with exit barriers are considered complex. This will apply also to ELTIFs unless a liquid secondary market can be established.

5. Is the ELTIF a nice-to-have or a must-have regulatory framework? What support can be given to ELTIFs to encourage their take up?

Julia Backmann:

To be a "must-have", a product has to give the specific type of investor and the relevant manager an advantage over the use of other products. Professional investors already benefit from an AIF EU passport without any regulation of the product on a European level. Depending on the national requirements for the AIF as a professional product, they can therefore generally set up the equivalent of an ELTIF. In many cases, they would not have to comply with the restrictions on investment limits, duration requirements, etc.

ELTIFs currently offer two advantages as a product for professional investors compared with the common AIF:

- An AIF may grant loans to unlisted companies as well as to listed companies with a market capitalization of up to €500 million. Depending on national restrictions for AIFs to grant loans, this might be an advantage also compared with AIFs for professional investors.
- For retail AIFs, no EU passport regime (except for EuVECAs and EuSEFs) exists. The ELTIF framework provides a passport for retail AIFs, which invest in real assets for example. However, there are many additional safeguards for distribution of an ELTIF to retail investors. Some of these safeguards are open to interpretation and might hence impose an increased liability risk to the manager.

In addition, the European Commission proposed some amendments to the Solvency II regime to enable insurance companies to benefit from lower capital charges for ELTIF investments. However, institutional investors already have access to invest in infrastructure today.

Therefore, some see the ELTIF regulation as being more legally restrictive for the institutions than alternative infrastructure products. I believe that the advantages provided by the current regime are more likely to create a "nice-to-have" rather than a "must-have" product.

6. We have noticed that there is a lot of interest outside Europe for ELTIFs, reflecting an interest in viable, unitized vehicles for investing in infrastructure by facilitating cross-border fundraising in the EU. Why do you think this is the case?

Julia Backmann:

This is true, there seems to be an interest in ELTIFs outside Europe, for example in the Asian market. This might be based on specific national requirements. Another explanation is the general success of UCITS outside Europe. Like UCITS and unlike AIFs, the ELTIF is a product regulated on a European level and could be considered to be comparable with UCITS in terms of supervision and product regulation, which allows investment in real assets.

"I believe that the advantages provided by the current regime are more likely to create a "nice-to-have" rather than a "must-have" product."

7. What support can be given to ELTIFs to encourage their take-up? Does the ELTIF regulation require changes to prevent it from going down a similar path to the EuSEF regulation, which seems to have really failed in its objective to promote the creation of social funds?

Julia Backmann:

We believe that some adaption of the ELTIF regulation would facilitate the success of the product. For instance, the additional safeguard for investors whose portfolio does not exceed the €500,000 mentioned before does impose legal uncertainty and civil liability issues from the viewpoint of the ELTIF manager or the distributor. From a civil law perspective, the ELTIF manager or the distributor may be required to verify and scrutinize any information that the investor provides in this respect. Since any consequences under civil law are hard to predict, I think this is a significant obstacle for taking up the ELTIF as real retail product. It is therefore unclear whether this risk would outweigh the advantages of a cross-border product.

Furthermore, I believe that the ELTIF regulation should provide for some flexibility for institutional investors that do not qualify as professional investors according to MiFID II. This applies in particular to investors considered as semi-professional, such as certain pension providers or foundations.

Finally, for professional investors, the ELTIF adds unnecessary complexity. Nevertheless, for some institutional investors, investments might be easier if the product itself is regulated. This might lighten a due diligence burden if recognized by the regulator of such institutional investors. Whether the proposed amendments to the Solvency II regime will increase the success of the product for insurance undertakings remains to be seen.

8. Investments in real assets require a minimum investment of 10 million. Do you believe that a lower "entry ticket" to a portfolio of infrastructure investments via an ELTIF is a decisive factor in ensuring the success of ELTIFs in the future?

Julia Backmann:

No, I do not believe that market participants consider the "entry ticket" an obstacle. Obstacles for infrastructure investments are the lack of respective projects rather than potential vehicles that could be used for such investments. For instance, open-ended institutional funds in Germany may today purchase loans that finance infrastructure projects. Closed-ended funds may invest in all types of real assets.

9. Can the proposed RTS encourage or discourage the take-up of the ELTIF?

Julia Backmann:

Generally, ESMA's approach shows an interest in finding practicable solutions to facilitate the framework's success. However, according to the ELTIF regulation, the rules delegated to the Commission, which are to be suggested by ESMA, are limited. This limits the additional flexibility ESMA could provide for accordingly. For instance, ESMA has to propose rules regarding lifetime, hedging investments, disinvestment schedule, and facilitations for retail investors. The rules are quite technical and put limits on what ESMA can allow.

10. Do you believe that the current regulation supporting ELTIFs is too multi-purpose? Is the design under a "catch-all" approach covering infrastructure and other purposes too unspecific to answer specific investors' (e.g., pension funds) needs to invest in a specific infrastructure label? Do you think it might be beneficial to leverage the experience of both the EIF and similar entities, and of regulators who have already considered infrastructure funds, to determine if it would be appropriate to define a specific category or status of AIFM to manage infrastructure ELTIFs?

Julia Backmann:

No, I do not believe that the multi-purpose approach is an obstacle for the ELTIF's success. The fact that an ELTIF could be structured in a totally different way, with underlying assets with a varying degree of liquidity, investments in equity and debt instruments and loans as well as real assets, should support the ELTIF's acceptance.

Since the understanding of infrastructure differs, I think it is an advantage that the ELTIF regulation does not try to define infrastructure, thereby narrowing the possible investments. The long-term nature of the fund is rightly not only focused on infrastructure but generally real assets as well as instruments that may be used to finance real assets.

11. In Conclusion: what do you think about the ELTIF regulation?

Julia Backmann:

Overall it's a good idea. It seems to be positive for the market. However, it remains to be seen whether it really is workable or will be in the future.

"I believe that the ELTIF regulation should provide for some flexibility for institutional investors that do not qualify as professional investors according to MiFID II."