EU Regulation

LONG-TERM INVESTMENT FUNDS (ELTIF)

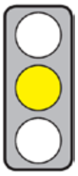
cep**Policy Brief** No. 2013-51 of 09 December 2013

Centrum für Europäische Politik

KEY ISSUES

Objective of the Regulation: More capital, including that from retail investors, should be channelled into long-term investment projects.

Parties affected: Professional and retail investors, alternative investment funds (AIFs) and their managers (AIFMs), qualified portfolio undertakings.



Pro: (1) Harmonised fund rules for ELTIFs reduce information deficits for investors and increase investor confidence.

(2) The ability to lend to qualified portfolio undertakings is appropriate in view of the restrictive rules.

Contra: (1) The redemption ban on ELTIF shares reduces the attractiveness of ELTIFs, especially for retail investors.

(2) A strict application of the matching maturities principle reduces the profitability of ELTIFs: It reduces the ability of ELTIFs to sell long-term investments and thus realise profit-taking even prior to maturity. It also makes borrowing more expensive for ELTIFs.

CONTENT

Title

Proposal COM(2013) 462 of 26 June 2013 for a **Regulation** of the European Parliament and of the Council **on Long-term Investment Funds (ELTIF)**

Brief Summary

- **Context and objectives**
  – The EU has harmonised rules for funds wishing to call themselves "Alternative Investment Funds" (AIFs) or "UCITS Investment Funds".
    - "Alternative Investment Funds" primarily manage monies from professional investors; these include, in particular, private equity funds, hedge funds, commodity and property funds. [AIFM Directive 2011/61/EU, see cep**PolicyBrief**].
    - "UCITS investment funds" invest monies from retail investors in securities and other liquid financial assets [UCITS-Directive 2009/65/EC, see cep**PolicyBrief**]; these include, in particular, the traditional investment funds.
  – There are, however, no corresponding rules on long-term orientated investment funds at European level - or in some Member States. According to the Commission, this prevents capital investment in long-term assets (Explanatory Memorandum page 2 and 3, Impact Assessment page 13).
  – The Commission therefore wants to create a new category of alternative investment funds (AIF): AIFs are permitted to call themselves "European Long-term Investment Funds" (ELTIF) if they comply with the provisions of this Regulation (Art. 6 (1), Explanatory Memorandum page 1).
  – The aim is to channel "patient" capital from both professional and retail investors particularly into infrastructure projects, property and non-listed companies. As a result, investments will be less dependent on bank financing. (Explanatory Memorandum page 1 and 3, see also cep**PolicyBrief** on the Green Paper Long-term Financing)

- **Authorisation of ELTIFs and their fund managers**
  – Authorisation as an ELTIF can only be granted to those AIFs which (Art. 3(1))
    - are authorised or registered in the EU or have their registered or main office in the EU and
    - comply with the provisions of this Regulation.
  – Authorisation as an ELTIF takes place by way of the competent authority in the home Member State of the AIF (hereinafter: ELTIF authority). Authorisation is valid in all EU states ("EU Passport") (Art. 3 (1) and (2), subparagraph 2).
  – Only fund managers authorised under the AIFM Directive ("AIF Managers") can manage and market ELTIFs. For this they require an additional authorisation from the ELTIF authority. (Art. 4 (2))

- **Investment policy of ELTIFs**
  – An ELTIF must invest at least 70% of the acquired capital in long-term "eligible investment assets". Those are (Art. 8 (1), Art. 9, Art. 12 (1), Explanatory Memorandum page 11)
    - direct holdings of real assets such as ships, real estate or aircraft with up-front capital expenditure of at least EUR 10 million,
    - shares in other ELTIFs, EU Venture Capital Funds (EuVECAs) and European Social Entrepreneurship Funds (EuSEFs) provided these have not themselves invested more than 10% of their capital in ELTIFs,

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- equity or quasi-equity instruments and debt instruments issued by a "qualifying portfolio undertaking" as well as loans granted by the ELTIF to these "qualifying portfolio undertakings"; "qualifying portfolio undertakings" are all undertakings apart from AIFs, UCITS investment funds, banks, securities investment firms, insurance undertakings and listed companies (Art. 10).

– An ELTIF can invest a maximum of 30% of the acquired capital in "liquid investment assets". These are liquid assets in which UCITS investment funds usually invest (Art. 8 (1)), particularly shares, money-market instruments - i.e. securities which can be traded on the money market such as treasury bonds and short-term bonds - UCITS shares and deposits with a maximum term to maturity of twelve months (Art. 50 (1) UCITS Directive).
– The rates of 70% and 30% apply (Art. 15 (1) a))
  - from the date specified in the fund rules or ELTIF instruments of incorporation, but
  - no later than six years after authorisation of the ELTIF.
– An ELTIF cannot (Art. 8 (2), Art. 12 (4)):
  - use derivatives unless they serve the purpose of hedging the duration and exchange risks inherent to other investments of the ELTIF,
  - sell assets which it does not own at the time of sale ("short-selling"),
  - sell securities that it has to repurchase at a later date ("repurchase agreements") - reverse repurchase agreements are allowed -,
  - lend or borrow securities that it has to redeem or return at a later date ("securities lending agreements" and "securities borrowing agreements"),
  - take direct or indirect exposure to commodities.

► **Additional rules on diversification and concentration**
– An ELTIF must spread its investment capital among both long-term and liquid investment assets. The following maximum rates apply in this regard:
  - a maximum of 10% in a single qualifying portfolio undertaking or a real asset (Art. 12 (2) a) and b)); this may be increased to 20% provided that the value of the assets in qualifying portfolio undertakings and in real assets in which it invests more than 10% of its capital does not exceed 40% of its capital (Art. 12 (5)),
  - a maximum of 10% in a single ELTIF, EuVECA or EuSEF,
  - a maximum aggregate value of 20% in ELTIFs, EuvECAs and EuSEFs,
  - a maximum of 5% in "other investments" of a single issuer and
  - a maximum aggregate value of 5% in over the counter (OTC) derivative transactions or reverse repurchase agreements with a single counter-party.
– An ELTIF may (Art. 13)
  - hold a maximum of 25% of the shares in an ELTIF, EuVECA, EuSEF or UCITS,
  - hold a maximum of 10% of the non-voting shares, bonds and money-market instruments of one issuer,
  - not acquire any shares with voting rights insofar as it would thereby gain "significant" influence.

► **Restrictions on borrowing**
An ELTIF may take out loans insofar as they (Art. 14)
– do not exceed 30% of the invested capital,
– serve the purpose of acquiring a participation in "eligible investment assets",
– are contracted in the same currency as the assets to be acquired with the loan,
– do not encumber the assets such as by way of a mortgage.

► **Distribution of income**
An ELTIF "may" regularly distribute income to investors. The distribution policy must be indicated in the fund rules or instruments of incorporation. (Art. 20 (1) and (3))

► **Life of ELTIFs, and the redemption, trading and issue of ELTIF shares**
– An ELTIF always has a fixed life (Art. 16 (1) subparagraph 2).
– The life of the ELTIF must "be sufficient in length" to "cover" the life-cycle of each asset in the portfolio (Art. 16 (2)). The details are defined by the European Securities and Markets Authority (ESMA) in the form of technical standards (Art. 16 (6)).
– The investor cannot require redemption of ELTIF shares prior to the end of life of the shares (Art. 16 (1), subparagraph 1). The investor may, however, sell the ELTIF shares at any time on the secondary market (Art. 17).
– An ELTIF may issue new shares but can only issue them below the value of the fund's assets ("net asset value") if they have already been offered to existing investors at this lower price (Art. 18).

► **Transparency**
– Prior to marketing the ELTIF, the ELTIF fund managers must publish a prospectus containing, inter alia, details of the investment and its risks. Where it markets the ELTIF to retail investors – in which case the ELTIF is deemed to be an "Investment Product for Retail Investors" within the meaning of the PRIPS Regulation (COM(2012) 352; see cep**PolicyBrief**) –, it must also publish a key information document. (Art. 21 (1), Recital 35)

– Both documents must notify investors of (Art. 21 (4), Art. 22 (1), (3) and (4))
  - the "illiquid and long-term nature" of the investment,
  - the end of life date,
  - any intended marketing to retail investors,
  - the fact that the investment cannot be redeemed before the end of its life,
  - the frequency and timing of income payments,
  - the "direct and indirect" costs of an ELTIF; ESMA will develop technical standards on definitions, calculation methodologies and presentation formats of the costs.

  The documents must "clearly advise" investors that only part of their investment capital should be invested in an ELTIF (Art. 21 (4) f)).

Statement on Subsidiarity by the Commission

According to the Commission, national regulation entails the risk of different investment products all being sold under the same name but with different characteristics, creating investor confusion.

Policy Context

One of the twelve key objectives set out in the Single Market Act II [COM(2012) 573] is to boost long-term investment in the real economy. In the Green Paper "Long-term Financing of the European Economy" [COM(2013) 150, see cep**PolicyBrief**] measures to support long-term investment were called for and draft legislation on ELTIF announced. There is already EU legislation on Alternative Investment Funds [AIFM Directive (2011/61/EU), see cep**PolicyBrief**] and UCITS investment funds [UCITS Directive (2009/65/EC), see cep**PolicyBrief**]. In addition, there is legislation on EU venture capital funds [Regulation (EU) No. 345/2013] and on EU social entrepreneurship funds [Regulation (EU) No. 346/2013]. The planned PRIPs Regulation [COM(2012) 352, see cep**PolicyBrief**] requires providers of investment products – and thereby also ELTIFs – to publish key information documents. The planned MiFID-II Directive [COM(2011) 656, see cep**PolicyBrief**] contains provisions on the sale of these products – e.g. rules on commissions.

Legislative Procedure

26 June 2013	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market
Leading Committee of the EP:	Economic and Monetary Affairs, Rapporteur: Rodi Kratsa-Tsagaropoulou (EPP Group, GR)
Leading Federal Ministry:	Ministry of Finance
Leading Committee of the BT:	Finance
Decision mode in the Council:	Qualified majority (Adoption by a majority of the Member States and with 260 of 352 votes; Germany: 29 votes)

Formalities

Legal competence:	Art. 114 TFEU
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

As with UCITS investment funds, EU-wide legislation on funds permitted to be sold as ELTIFs reduces information deficits for investors and thus increases investor confidence.

At the same time, ELTIFs fill an existing gap: The existing European categories of funds are either aimed primarily at professional investors (AIFM Directive 2011/61/EU, see cep**PolicyBrief**) or only permit investments in short-term investment assets (UCITS Directive 2009/65/ EC, see cep**PolicyBrief**). **A European category of long-term funds which is also available to private investors has, until now, been lacking.**

The introduction of an EU passport facilitating the Europe-wide sale of ELTIFs is consistent with a harmonised EU fund type. The EU passport reduces selling costs and increases cross-border competition.

By allowing ELTIFs to lend to "qualified portfolio undertakings", the Commission is creating a type of "shadow bank": ELTIFs can carry out activities similar to banks but do not have to fulfil the rules applicable to banks. This contradicts the Commission's desire for stricter regulation of shadow banks [Green Paper COM (2012) 102, see cep**PolicyBrief**]. **Permitting the granting of loans to "qualified portfolio undertakings" is** however **justifiable because the regulations on diversification and concentration, the redemption ban on ELTIF**

shares during the lifetime of the ELTIF and the restrictions on their own borrowing, in particular, will prevent serious credit risks - such as liquidity and maturity risks. Being restricted to qualified portfolio companies, and thus to stakeholders who are not part of the finance sector, means the danger of new systemic risks for the financial markets is reduced.
The blanket ban on the use of derivatives to safeguard against risks arising from an investment **prevents ELTIFs from being able to hedge, for instance, their property exposure to falling house prices. Far from contributing to the desired protection of investors** this may, in fact, increase the risk of investing in an ELTIF.
The upper limit of 30% for borrowing is too generalised because the use of third-party capital does not always result in a high investment risk. In fact, it can also be used to finance low-risk participations or for issuing loans with a low default risk. In addition, the provision whereby ELTIF assets cannot be encumbered by taking out a loan, further restricts the ability of ELTIFs to borrow because lenders generally require securities.
Whether ELTIFs will actually be successful remains to be seen. It is true that fixed lifetimes and the strict ban on the redemption of invested funds prior to end of their life, do reduce the risks involved in lending by ELTIFs (see above). They also both increase the financing and planning security for ELTIF fund managers and for qualified portfolio undertakings in which ELTIFs invest. However, these requirements also have disadvantages:
Firstly: **The redemption ban reduces** - as the Commission also admits - **the attractiveness of ELTIFs, especially for retail investors** who often shy away from a long-term commitment. The extent to which this will be counteracted by the option to sell ELTIF shares during their life-time on secondary markets will depend on the liquidity of these markets.
Secondly: **A strict application of the matching maturities principle** - the life-time of the ELTIF cannot be shorter than the life-cycle of the longest-lived asset in the portfolio - **reduces the profitability and thus the attractiveness of the ELTIF** for two reasons. **On the one hand, it reduces the ability** of the ELTIF **to sell long-term investments and thus realise profit-taking even prior to maturity of the ELTIF** because, following the sale, the ELTIF would be forced to reinvest the funds released for the ELTIF's exact residual maturity period and in compliance with the diversification rules. This reduces the chance of finding high-yielding investment assets. **On the other hand, it increases the cost of borrowing** because, effectively forcing the ELTIF to hold on to assets until the fund matures, increases the risk of only being able to achieve an unfavourable price. This in turn increases the default risk for potential lenders and thus the interest payable by the ELTIF so that the profitability of the ELTIF falls. Thus, when it comes to defining the matching maturities principle in more concrete terms, ESMA will be faced with a conflict of objective in not just one but two respects.

Legal Assessment

Legislative competence

Art. 114 TFEU (Single Market) is the applicable legislative basis.

Subsidiarity

Unproblematic.

Proportionality

Unproblematic.

Other compatibility with EU law

Unproblematic.

Impact on German law

As of July 2013, the Capital Investment Code (KAGB) now provides the first single set of rules for all investment funds and their fund managers. ELTIFs will probably also be incorporated into the KAGB.

Conclusion

EU-wide legislation on funds that are to be permitted to be sold as ELTIFs reduces information deficits for investors and thus increases investor confidence. At the same time, ELTIFs fill an existing gap: A European category of long-term funds which is also available to private investors has, until now, been lacking.
The ability to lend to qualified portfolio undertakings is appropriate in view of the rules on diversification and concentration, the redemption ban and the restrictions on borrowing. The blanket ban on the use of derivatives prevents ELTIFs, for instance, from hedging their property exposure to falling house prices and therefore does not exactly serve the desired purpose of investor protection. The redemption ban reduces the attractiveness of ELTIFs, especially for retail investors. A strict application of the matching maturities principle reduces the profitability of the ELTIF: on the one hand it reduces the ability to sell long-term investments and thus realise profit-taking even prior to maturity of the ELTIF. On the other hand, it increases the cost of borrowing.