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# Retailisation of Private Funds – Is the Revised ELTIF Regulation the Solution?


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## Background

The European Parliament and Council approved a new regulation revising the existing regulation on European long-term investment funds (the "ELTIF Regulation") on 15 February 2023. The previous iteration of the ELTIF Regulation, initially adopted on 29 April 2015, was widely viewed as an unsuccessful attempt to attract investment in infrastructure projects and other long-term assets in the European Union.

Prescriptive requirements around eligible assets and treatment of retail investors may have muted interest under the old regime. Despite attractive features such as access to a retail marketing passport across the European Union, fewer than 90 ELTIFs had been registered as of December 2022, with combined assets under management in the single-figure billions. ELTIFs were also concentrated in a small number of jurisdictions, with almost all funds registered in one of Luxembourg, France or Italy. As the recitals to the new regulation put it, the regime has 'not scaled up as expected'.

Following Brexit, the United Kingdom had already moved on from its inherited version of the ELTIF Regulation, introducing the Long Term Asset Fund ("LTAF") regime in 2021. The Financial Conduct Authority (the "FCA") announced that it had authorised the first LTAF on 9 March 2023. The LTAF regime similarly focuses on providing capital for long-term investments, although an LTAF is an open-ended product and its investor base is limited to professional investors, high net worth investors and sophisticated investors, with a focus on investments by defined contribution pension schemes. However, the FCA has recently consulted on widening retail access to LTAFs.

Like the United Kingdom's LTAF regime, the new ELTIF Regulation focuses on providing opportunities to a wide range of investor types to invest in illiquid assets which support economic growth in the relevant jurisdictions and the transition to a low-carbon economy (or 'a path towards smart, sustainable and inclusive growth').

The new regime is expected to apply starting in Q1 2024. This note sets out some of the key changes which may drive a greater demand for ELTIFs in the European Union, bringing benefits to managers, investors and the wider economy, with a focus on the potential to increase retail appetite.

## Eligible Investment Assets

The pool of eligible investment assets in which an ELTIF can invest has been expanded in a number of ways:

- **Geography.** The new ELTIF Regulation acknowledges that benefits can accrue to the European Union's economy from investment in assets located outside of the European Union. In particular, infrastructure such as subsea fibre-optic cables, liquified natural gas terminals and renewal energy installations are identified as assets which could provide benefits while located in third countries. The new ELTIF Regulation explicitly states that there is no restriction on ELTIFs holding a majority of their investments in non-EU assets. However, entities will only be 'qualifying portfolio undertakings' (and therefore eligible investment assets for an ELTIF) if they are located either in the European Union or in a third country which is neither a high-risk jurisdiction for money laundering purposes nor listed as a non-cooperative jurisdiction for tax purposes.

- **Real Assets.** The previous definition of real assets was detailed and ultimately required an asset to contribute to the European Union's objective of 'smart, sustainable and inclusive growth'. While this objective remains in the background of the new ELTIF Regulation, the definition has been simplified to 'an asset that has an intrinsic value due to its substance and properties'. Crucially, the minimum value of EUR 10 million has been lifted, making it easier to invest in a wider range of real assets and providing access to capital for smaller infrastructure projects.

- **Qualifying Portfolio Undertakings.** ELTIFs may invest in equity or quasi-equity instruments in ‘qualifying portfolio undertakings’. The key changes here are to allow investment in certain types of financial undertakings which previously would not have been permitted (the new aim being to promote investment in fintech) and to raise the market capitalisation limit for undertakings listed on regulated markets from EUR 500 million to EUR 1.5 billion.

- **Fund of Funds.** In addition to investing in units of other ELTIFs, EuVECAs and EuSEFs (as allowed under the existing regime), ELTIFs may now pursue a broader fund-of-funds approach by investing in UCITS and EU AIFs, subject to requirements on the underlying investments of those funds.

- **Other Assets.** Simple securitisations and EU ‘Green Bonds’ (to be issued under further proposed regulation) have been added to the scope of eligible investment assets.

In addition to expanding the types of assets available to ELTIFs, the new ELTIF Regulation provides greater flexibility by modifying increasing the liquidity pocket available to managers (the requirement that eligible investment assets form 70% of the portfolio has been reduced to 55%) and increasing the diversification threshold from 10% to 20% exposure to a single asset, reducing the number of investments that an ELTIF must make to comply with the regulation. These rules previously combined to require an ELTIF to make seven separate investments in order to comply with the ELTIF regulations. The new limits allow for the flexibility to pursue a more concentrated strategy while still qualifying as an ELTIF.

## Retail Investors

ELTIF managers are still required to conduct suitability assessments of retail investors and take certain additional steps in order to meet the needs of retail investors. For example, managers must provide written alerts when marketing an ELTIF with a term of more than 10 years.

However, the burden of marketing to retail investors and admitting them into an ELTIF has been reduced under the new ELTIF Regulation:

- **Local Facilities.** There is no longer a requirement to put in place local facilities in each European Union Member State in which the ELTIF is marketed to retail investors for making subscriptions, payments to unitholders or redemptions. This relieves managers of a significant compliance cost.

- **Minimum Subscription.** Retail investors with a portfolio of financial instruments of less than EUR 500,000 were subject to a minimum investment amount of EUR 10,000 and a 10% exposure limit to ELTIFs. These requirements no longer apply.

- **Borrowing.** The limit on borrowing for ELTIFs marketed to retail has risen from 30% of NAV to 50%. Borrowing which is fully covered by investors’ capital commitments does not fall within the scope of borrowing for this purpose.

- **Suitability Test.** This has been aligned with the requirements of MiFID II, which simplifies the approach for managers.

However, while the requirements for an ELTIF badge have softened, managers must consider restrictions imposed on an underlying vehicle. For example, while the new ELTIF Regulation does not impose minimum subscription requirements, a local regulator may still impose them on fund vehicles. Similarly, some Luxembourg fund structures may only be marketed to 'well-informed investors', undercutting the prospects to use such a vehicle under the ELTIF regime to access retail investors.

## Professional Investors

While access to capital from retail investors was a key feature of the old regime, it may have contributed to its downfall due to the interaction with the expectations of institutional investors which would still likely have provided the bulk of the capital.

Previously, ELTIFs marketed to retail investors could not grant preferential treatment or specific economic benefits to individual investors or groups of investors. Professional investors may therefore have been reluctant to invest in ELTIFs that were also marketed to retail as their conventional side letter requests would have fallen afoul of this requirement. A tweak to this rule requiring that preferential treatment could not be granted to investors 'within the relevant class' opens the door for differentiation in fund terms between retail and professional or institutional investors.

The new ELTIF Regulation includes further concessions for professional-only ELTIFs, such as allowing leverage of up to 100% NAV and the disapplication of portfolio composition and diversification requirements.

## Redemption and Secondary Market

ELTIFs are designed to be closed-ended, as this suits the long-term horizon of their intended investments. However, there is scope within the ELTIF Regulation to allow redemptions under certain conditions.

A significant previous hurdle for ELTIFs was the risk that a duly made redemption request, if unmet within one year, could serve as a trigger to wind up the entire ELTIF. This risk was a significant disincentive to managers producing a compliant redemption policy. By removing this prospect, the new ELTIF Regulation may encourage limited scope for redemptions, which may in turn increase the pool of retail investors willing to invest.

An interesting new feature of the ELTIF Regulation is the potential introduction of a matching mechanism to match supply and demand for ELTIF interests on the secondary market during the life of the ELTIF. The ELTIF instrument may contain rules for facilitating matching and transfers under specific conditions to allow investors to generate liquidity in what would otherwise be illiquid structures.

While the potential for a secondary market may address some concerns of retail investors around liquidity, it may be that the mechanics for processing transfers are beyond the capabilities of true retail investors.

## Open Questions

It remains to be seen whether the new ELTIF Regulation will succeed where its predecessor failed. Notably, the ELTIF regime attempts to combine access to retail investors with 'long-term investments'. Typically, retail investors are seen as reluctant to part with capital over the same time horizons as institutions and tend to demand greater liquidity in their investments. This is at odds with the focus of the regime on raising capital for infrastructure projects and other illiquid investments. Indeed, in the United Kingdom, the FCA emphasises that LTAFs are designed for investors who 'understand the risks, do not need immediate liquidity and have long-term investment horizons', suggesting a class of investor that does not necessarily reflect a true retail market. While measures exist to mitigate retail investors' concerns in the potential for redemptions and secondary market mechanisms, it may be that the appetite for ELTIFs does not exist among retail investors.

At the other end of the spectrum, there is little reason to pursue authorisation as an ELTIF for a professional-only fund. The major benefit of the ELTIF Regulation is the retail passport; this is not an incentive for managers to accept the restrictions of the regulation if their main source of capital will be professional.

There are gaps too in some of the detail. The market is still awaiting guidelines from the European Securities and Markets Authority on points such as the minimum holding period for investors in ELTIFs, redemption requirements and the matching mechanism. Clarity on these points may help the assessment of whether the new rules are helpful in attracting retail investment.

Nevertheless, the new ELTIF Regulation, with its looser strictures on eligible assets, concentration and diversification, may find new interest from managers looking to raise capital from a mixture of investor types but with a sizable retail component. Managers looking to raise funds in Europe should consider whether their strategy and objective are compatible with the requirements of the ELTIF Regulation. They may be able to take advantage of a tool that the European Union is eager to revitalise.