ELTIF 2.0: A step towards true democratisation of European private funds

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Background

The original ELTIF Regulation[1] (**ELTIF Regulation**) entered into force on 19 May 2015 with the objective of raising and channeling capital towards European long-term investments in the real economy, in line with the European Union (EU) wider objective of smart, sustainable and inclusive growth. The ELTIF framework initially received considerable attention, particularly as it allows ELTIFs to be marketed to retail investors by way of an EEA-wide passporting regime. However, it has become clear that the original ELTIF Regulation has not achieved the desired success. As of January 2023, only 84 ELTIFs have been registered in the entire European Economic Area (EEA) (48 in Luxembourg, 21 in France, 13 in Italy and 2 in Spain) with only a single digit figure in billion under management. This is an extremely low number for a vehicle that was destined to re-stimulate the European economy post-Euro crisis.

After a public consultation, on 25 November 2021, the European Commission (**Commission**) published its proposal for a revised ELTIF Regulation (**ELTIF 2.0**) to address what were perceived as the main shortcomings of the original ELTIF Regulation.

Following informal negotiations between representatives of the European Council (Council), the Commission and European Parliament (**Parliament**), on 7 December 2022, the Council published a note indicating that it would adopt the current text of the proposed revision of the ELTIF Regulation agreed between the Council and the Parliament in October 2022, provided that Parliament agreed to adopt the same text. The text of the overall compromise package is included as an annex to the Council's note. The next step is for the Council and the Parliament (plenary session) to formally adopt the revised ELTIF Regulation.

This reform process has been met with enthusiasm in the funds' industry as it is hoped that the ELTIF 2.0 is the missing piece in the European funds' toolbox for true retailisation of private funds.

What are the main changes of ELTIF 2.0 compared to the original ELTIF Regulation?

Below is a non-exhaustive summary of the main changes:

1. Eligible investments

Eligible assets under ELTIF 2.0 are greatly improved compared to the ELTIF Regulation. **The definition of "real assets" has been modified and the threshold to qualify as a "real asset" has been removed under ELTIF 2.0.** Furthermore, the market capitalisation threshold, portfolio composition requirements, asset diversification limits and concentration risks have been modified to enlarge

1 Regulation (EU) 2015/760 on European long term investment funds

the scope of eligible assets for an ELTIF. This is also true for the (limited) possibility of an ELTIF to invest into financial undertakings, master-feeder structures or securitisations. Importantly for non-EU managers who may be attracted to the ELTIF, the geographical limitations on non-EU assets that some regulators applied in relation to the ELTIF Regulation has been modified allowing for a much wider geography of the potential underlying assets in an ELTIF structure. ELTIF 2.0 further clarifies that minority co-investments will be possible (which was often seen as a major obstacle by industry participants). ELTIFs can potentially be set up as fund-of-fund structures - something the fund industry also strongly lobbied for. From an 'eligibility of investments' perspective, ELTIF 2.0 is a major improvement compared to the ELTIF Regulation.

2. Retail investors

One of the most far-reaching and innovative amendments under ELTIF 2.0 is to differentiate between ELTIFs that target either professional only or ELTIFs that target retail investors. Stricter investment limitations, borrowing restrictions and concentration limits all apply to ELTIFs that are targeting retail investors. The suitability assessment for retail investors to invest into an ELTIF has been modified - removing the minimum invest limit and the 10% limitation, potentially making the new ELTIF a true retail product without any minimum investment amount. Greater access for retail investors is however coupled with some additional protection mechanisms (both via obligatory risk warnings and explicit investor consent requirements under certain circumstances).

3. Manager authorisation

The double-layer of authorisation (both at ELTIF and ELTIF manager level) will be replaced by a system whereby solely the ELTIF needs to be authorised. The AIFM[2] will not need a specific authorisation to manage ELTIFs. This is intended to increase cross-border activity in the ELTIF market.

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4. Redemptions / Liquidity window

The explanatory paragraphs and the ELTIF Regulation itself clearly stipulate that the European legislator intends the ELTIF 2.0 to remain fundamentally a closed-ended fund product. However, there are possibilities to create semi-liquid structures under the ELTIF 2.0 framework – these will be subject to a lock-up period equivalent to the ramp-up period of the relevant fund regarding its risk diversification limits and certain liquidity management tools to ensure the fair and equal treatment of investors. It will be interesting to see how the European Securities and Markets Authority will exercise its power to provide for further rules on redemptions via the issuance of draft regulatory technical standards.

ELTIF 2.0 also includes a new matching provision for the secondary trading of shares/units of an ELTIF – the relevance and impact of such mechanism remains to be seen.

2 **Alternative Investment Fund Manager** per Alternative Investment Fund Managers Directive (2011/61/EU) (**AIFMD**)

5. Borrowing

ELTIF 2.0 increases the borrowing limits for an ELTIF (from 30% to 50% for retail ELTIFs, and to 100% for ELTIFs solely marketed to professional investors). ELTIF managers will also be able to pledge all the assets of the relevant ELTIF - previously this was limited to 30%. This amendment is expected to substantially facilitate the ability of ELTIFs to enter into loan arrangements with banks and other providers of debt capital.

6. Equal treatment

ELTIF 2.0 specifies that all retail investors benefit from equal treatment, with no preferential treatment or specific economic benefit granted to individual investors or groups of investors within the same class or classes. The aim being to create greater legal security for carried interest structures or other differentiations that may otherwise occur between classes.

7. Conflict-of-interest and co-investments

Under ELTIF 2.0, co-investments by the ELTIF manager and its affiliates will be allowed provided that any conflicts of interest arising from such co-investment are properly dealt with and disclosed. Co-investment is a common feature in other fund structures to ensure 'alignment of interest' so this amendment will align the ELTIF 2.0 with other private asset vehicles.

ELTIF 2.0 is not perfect...

Notwithstanding the positive sentiments around the ELTIF 2.0, there has been some criticism. For example, the redemption limitations during the ELTIF's term may be perceived as an obstacle for retail investors who may not want to lock in their liquidity for a substantial amount of time. ELTIF 2.0 could have arguably broadened its appeal with regards to master-feeder structures. Creating a double layer of ELTIFs (where both the feeder and the master need to qualify as ELTIFs), is seen by some as unduly burdensome and restrictive without adding obvious investor protection.

A different source of criticism relates to the overlap ELTIF 2.0 with the on-going AIFMD review. Proposals for reform of the ELTIF Regulation were launched on the same day that the Commission set out its proposals to make significant amendments to the AIFMD. From a loan origination perspective, in certain countries, ELTIFs are the only fund vehicles that are permitted to originate loans alongside banks or other licensed professionals.

The reform of AIFMD as regards the 'loan originating funds' and the potential possibility to passport the 'loan originating' activity by the AIFMs across the EEA could reduce the attractiveness of the ELTIF vehicle, even following its reform.

What's next?

It is expected that the legislative procedure will be finalised by early March 2023 resulting in the formal entry into force of the ELTIF 2.0 around that time. Based on previous experience, it is likely that the final approved text would be published in the Official Journal of the EU at the end of March or early April 2023, with its provisions entering into effect nine months thereafter (expected January/February 2024).

Notably, ELTIF 2.0 includes 'grandfathering' for existing ELTIFs. Under ELTIF 2.0, an existing ELTIF that complies with the ELTIF Regulation will be deemed compliant (i.e. grandfathered) for five years following the date of application of ELTIF 2.0. However, ELTIFs that are authorised under the current ELTIF Regulation, but that wish to make use of the terms of the new ELTIF 2.0 rules, can simply notify their national competent authority of their wish to do so.

Conclusion

ELTIF 2.0 is currently attracting a lot of interest from industry participants as it fits well with the political desire to unlock large amounts of savings from private individuals for much-needed European infrastructure and other long-term projects. ELTIF 2.0 also provides retail investors with an opportunity to invest in assets other than stock markets or UCITS funds thereby increasing diversification and risk spreading, while also maintaining certain safeguards and specific investor protections.

In terms of jurisdiction, Luxembourg seems well placed to benefit from ELTIF 2.0 given its global recognition as a tried-and-tested investment fund location and its favourable local legal framework which will allow for different ELTIF structures with different investor horizons (from full retail to high-net-worth individuals/semi-professional to professional).

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