European Long-Term Investment Funds: An uncertain future for the 'UCITS of the alternatives industry'

Introduced in April 2015, the European Long-Term Investment Fund regime has been consistently underutilised and has arguably failed in its aim to facilitate the flow of (retail) capital into sustainable long term investments in the real economy. The European Commission is currently in the process of reviewing the ELTIF regime and this presents managers of alternative focussed closed ended funds with an opportunity to help create a revised pan-European framework to facilitate access to sophisticated non-institutional capital.

Introduction

Access to retail capital by managers of alternative focussed closed ended funds ("Managers") remains a challenge. In North America, the drive for access to such capital continues to accelerate, with the SEC consulting on this topic, the introduction during 2020 of changes to broaden the scope of the 'accredited investor' definition and various Managers establishing dedicated retail programmes with multiple billions of dollars already under management.

In Europe, access by Managers to retail capital has always been difficult. Following the introduction of the Alternative Investment Fund Managers Directive ("AIFMD") in 2013 and its disjointed implementation across the EU, cross border distribution of Alternative Investments Funds ("AIFs") has become increasingly cumbersome, with the use of the Markets in Financial Instruments Directive ("MiFID") 'professional investor' definition further hindering access by Managers to a range of sophisticated non-institutional investors.

Notwithstanding this, a number of options have remained open to Managers seeking European retail capital. Managers have been able to establish listed investment trusts with illiquid focussed strategies (including both real assets and private equity), which offer liquidity through the stock market, and, other regulated products such as Non-UCITS Retail Schemes and Qualified Investor Schemes are also available. On the UCITS side, retail investors are able to gain very limited illiquid asset exposure where full redemption rights are guaranteed through liquid and illiquid portfolio mixes and for the more sophisticated retail investor, self-directed investment has become a reality through platforms such as Moonfare and Palico.

Despite these developments, market access remains moderate with only a small percentage of non-institutional investors being able to invest into alternative focussed closed ended funds.

ELTIFs: the 'UCITS of the alternatives industry'

In response to this issue, and in line with the European Commission's wider sustainable finance goals, the European Long Term Investment Fund ("ELTIF") was launched in April 2015. The purpose of the ELTIF regime was to facilitate the flow of capital into long term investments in the real economy (such as social and infrastructure projects, real estate and SMEs) in line with its objectives of ensuring smart, sustainable and inclusive growth.

In practice the ELTIF regime acts as a 'UCITS style' wrapper for Managers and AIFs established under AIFMD. In return for compliance with prescribed investment restrictions and investor protection measures, an AIFMD regulated Manager is able to market an ELTIF to retail investors (technically through a pan European marketing passport).

At a high level, to qualify as an ELTIF, the relevant AIF must:

(a) be managed by an authorised Alternative Investment Fund Manager ("AIFM");

(b) invest at least 70% of its capital in eligible assets and investments;

(c) follow strict rules on use of leverage and derivatives; and

(d) not engage in short selling.

In general, ELTIFs do not offer investor redemption rights before the end of their fixed term although Managers may exercise some discretion here.

An underutilised regime

Since inception, there have only been in the region of 30 ELTIFs established with AuM of <€2Bn and of this number only around 20 have actually been marketed on a cross border basis. In order to understand why the ELTIF regime is underutilised, it is first necessary to understand some key points associated with the regime:

(a) **Investment restrictions:** ELTIFs must invest in line with a range of pre-set investment restrictions which, for an EU investment product that is both focussed on delivering sustainable investment in the real economy and which in theory can be made available to retail investors, is to be expected. It is important to note, however, that the investment restrictions apply irrespective of whether retail capital is being raised and are relatively prescriptive, so when looking at the cost/benefit analysis of establishing an ELTIF, Managers may well determine that they are simply too restrictive.

70% of an ELTIF's capital must be invested in 'eligible investment assets', which broadly speaking covers predominately EU based unlisted or listed (small cap;<€500m) businesses, real assets of at least €10m at the point of acquisition, other ELTIFs, EuVECAs and EuSEFs and UCITS/eligible UCITS assets.

Although this bucket is relatively broad, it is more restrictive than would be typical for a non-ELTIF AIF and further diversification and concentration limits (e.g. no more than 10% of an ELTIFs capital can be invested in a single portfolio undertaking/real asset (with option to extend to 20% with further restrictions)) are applicable.

(b) **Additional retail requirements:** ELTIFs don't need to be distributed to retail investors, but if a Manager is looking purely for institutional capital, there is no obvious reason to opt into the ELTIF regime. Where a Manager wishes to market an ELTIF to retail investors, a number of additional requirements become applicable.

The first such requirement is that the Manager of the ELTIF must have the MiFID top up permissions of portfolio management and investment advice. This may be fine where a third party AIFM is appointed, but, for self-authorised Managers, introduces additional complexity into their regulatory matrix and has a knock on impact on capital requirements that may become increasingly onerous over time. Aside from this inbuilt complexity, when creating or distributing an ELTIF to retail investors certain MiFID requirements are triggered including the product governance (suitability) rules which necessitates the completion of a target market assessment in addition to wider observance of certain MiFID investor protection requirements.

Additional regulatory overlays come through compliance with the Prospectus Directive and the requirement to produce a Key Information Document as part of any offering of ELTIF interests. Further investor protection measures are introduced in connection with complaints handling which needs to be offered in the language of the jurisdiction in which an investor is based and technically the Manager must ensure that facilities are available for making subscriptions (and redemptions) and payments in any Member State in which it markets the ELTIF.

A depositary is always required in connection with ELTIFs but once retail investors are introduced, the depositary has to have the necessary permissions to enable it to act as the depositary of a UCITS. As a result, non-bank depositaries operating under the 'PE exemption' (contained in Article 21(3) of AIFMD; such as Aztec) are unable to act and, when operational issues are considered (e.g. higher investor numbers and associated corporate actions), the administration of the structure is naturally pulled towards a custody bank which may not have the specialist alternative asset class expertise.

The final point of note in connection with the additional retail requirements is that the current minimum subscription levels applicable to retail investors seem to please neither the investors themselves nor interested Managers. For retail investors with an existing portfolio of up to €500,000, the maximum subscription is capped at 10% of that portfolio amount and the minimum subscription amount is €10,000. A €10,000 minimum subscription amount remains high for many retail investors but at the same time is vanishingly small in the context of typical institutional tickets in standard alternative focussed closed ended funds.

(c) **Marketing passport:** In theory the ELTIF regulation should provide authorised Managers with a cross border marketing passport for retail investors, but as a result of divergent implementation across the EU, passporting does not work and is generally subject to individual Member State discretion, so even where the enhanced retail specific requirements are complied with, Managers are left with a distribution issue.

Is retail capital the right pool for managers of alternative focussed closed ended funds?

Aside from the range of factors that become relevant when ELTIFs are marketed to retail investors, the overarching question as to whether retail capital is suitable for alternative asset investment strategies remains. Sentiment within the industry remains largely against the introduction of retail capital with 73% of limited partners against opening illiquid asset focussed investment funds to retail money. ILPA has previously gone on the record against any proposed retail expansion, warning that opening the market up will lead to reduced returns for everyone.

From a Manager perspective, in addition to the investment and regulatory hurdles introduced under the ELTIF regime, the operational issues associated with administering a widely held investment product could also be quite significant. Processing calls and distributions for many hundreds of investors at a time could result in significant additional administrative expenses and, where investor capital is called over time, defaulting investors could become problematic (both in terms of numbers and aggregated value). A misalignment also remains between the traditional AIF fee model, and, the more modest amounts that retail focussed products generally levy, which may leave many retail investors concerned.

The Consultation: hope for the future

The European Commission remains supportive of the ELTIF regime and is currently in the process of reviewing it with a view to identifying and rectifying issues as part of its ongoing consultation process (the “Consultation”). The Consultation represents an opportunity for interested Managers to provide input into the shortcomings of the ELTIF regime in the context of their respective asset classes and to explain in more detail why setting up an ELTIF in its current form, might not be an attractive proposition.

Although the majority of Managers may remain unconvinced of the value of true retail capital or consider that there is already enough retail capital in the alternative focussed closed ended fund space, having an AIFMD wrapper that facilitates cross border distribution of AIFs to otherwise sophisticated but non-institutional retail investors may well prove an attractive proposition, particularly if the existing regime can be improved through proper extension of the retail marketing passport and through dilution of some of the more restrictive 'additional retail requirements' and prescribed investment requirements.

If Managers wish to access retail capital, there will always be a trade-off. Managers may look at the retail landscape and conclude that the benefit is simply not worth the cost, but if a middle ground could be found, the analysis may just shift in favour, making ELTIFs a viable option for facilitating access to the sophisticated non-institutional retail pool as the 'UCITS of the alternatives industry'.

The Consultation remains open for comment until 19 January 2021 and is available here.