EU proposals for a long-term investment fund

Implications for real estate

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European Commission jumps the gun?

On 26 June 2013, the European Commission published proposals for a Regulation on European Long-term Investment Funds (“ELTIFs”). The main purpose is to create a cross-border fund vehicle to increase the amount of non-bank finance available for companies in the European Union requiring access to long-term capital for the purposes of projects relating to infrastructure, housing and real estate.

The timing of the announcement was perhaps slightly surprising. The Commission published a Green Paper on the long-term financing of the European economy on 25th March with a three month consultation to follow running to 25th June. Publishing a detailed regulatory proposal the day after the consultation period ended made it rather obvious that the Commission had decided on the answer in advance. The good news for the real estate industry is that the fund proposal includes real estate as a qualifying asset. The original green paper did not mention real estate. INREV submitted a detailed and well-argued case for the inclusion of real estate at the end of the consultation period. Although the Commission proposal must have been drafted prior to receipt of the INREV submission, it will be a relief to the real estate industry that it reflects the key point made by INREV - that real estate is an important long-term investment asset for the European economy.

What's it all about?

The regulation will introduce a European passport for a closed-ended vehicle for long-term investment in infrastructure and real estate (European Long-term Investment Funds or "ELTIFs") on similar lines to the existing UCITs regime. For institutional investors, it should in theory make little difference as passporting will be available under the EU Alternative Investment Fund Managers' Directive (AIFMD) and all ELTIFs will fall within the AIFMD. Even for institutional investors, the new regulatory regime may stimulate the development of new types of longer-term closed-ended funds for which there would appear to be appetite in the market.

The main distinction between AIFMD and the ELTIF regime is that ELTIFs will be open to retail investors (although this does raise some timing questions, see "Not in front of the KIDs").

The ELTIF regime is a broad regulatory regime rather than a specific vehicle. It can therefore take any legal form, except that an ELTIF marketed to retail investors cannot be in the form of a partnership.

The ELTIF can make equity or debt investments in unlisted companies and invest in direct holdings of individual real estate assets that require up-front capital expenditure of at least EUR 10 million.

What's it all about?

The proposals contain diversification rules that mean that no more than 10% of the fund can be invested in any single unlisted company or real estate asset. There is flexibility in the opening and closing years of the fund. At least 70% of the fund's capital needs to be invested in long-term assets, with the balance in liquid assets.

The lifespan of the fund has to be appropriate for the lifespan of the underlying assets. The European Securities and Markets Authority (ESMA) has been passed the challenge of developing draft regulatory technical standards specifying the circumstances in which the life of an ELTIF is sufficient in length to cover the life-cycle of each of the individual assets of the ELTIF.

There are gearing restrictions, the wording of which is somewhat ambiguous. In particular, the proposed regulations specify that borrowing is permitted if

i) it represents no more than 30% of the capital of the ELTIF;

ii) it does not encumber the assets held in the portfolio of the ELTIF.

Not in front of the KIDs

The draft regulatory proposal allows the marketing of ELTIFs to retail investors. However, article 21.1 of the proposed regulation requires that for retail investors, a Key Information Document (KID) needs to be provided. The European Commission introduced a proposal for KIDs for packaged retail investment products (PRIPs) a year ago on 3rd July 2012. This aims to improve transparency by ensuring that retail investors receive a standard document. In the words of the European Commission:

"KIDs are short, plainly-worded documents – no more than a few pages long – that will provide investors with answers to the key questions they have about the features, risks, and costs of investment products.

They are designed for the retail investor rather than the professional. They will help the retail investor make a more informed decision on whether an investment is right for them.

So the investor can better compare investment products, every KID will follow the same structure. They will answer a standard set of questions, such as: What is the investment? Can I lose money? What are the risks and what might I get back? What are the costs?

Not in front of the KIDs

Information that is vital for comparing different investments – on how risky the investment is, on whether it has guarantees and what these are, on the costs of the investment – will be carefully selected and presented so as to make comparisons as easy and as accurate as possible."

Admirable in sentiment, difficult in detail, the KID proposal is bogged down in EU process. On May 28th, the EU Council Presidency published a draft compromise proposal that suggests many significant changes to the original Commission proposal.

As things stand, a slow resolution by the EU of the KID provisions is potentially an impediment to the timely introduction of, at a minimum, the retail element of the ELTIF.

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The fund, AIFMD and authorisation

The funds will be regulated under the Alternative Investment Fund Managers' Directive (AIFMD). Only EU Alternative Investment Funds (AIFs) can be ELTIFs and each one needs to be managed by an AIFM.

As with the AIFMD, the regulation does not specify any particular legal form for the fund, other than that it cannot be a partnership if the fund is marketed to retail investors. ELTIFs must be closed-ended funds with a fixed life specified in advance. Investors are not permitted to redeem their investments before the end of the life of the fund. Detailed provisions on fund duration and winding up are discussed later.

The application for authorisation as an ELTIF shall include the following:

(a) the fund rules or instruments of incorporation;

(b) information on the identity of the manager;

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(c) information on the identity of the depositary;

(d) a description of the information to be made available to investors;

(e) any other information or document requested by the competent authority of the ELTIF to verify compliance with the requirements of this Regulation.

The application for managing the ELTIF shall include the following:

(a) the written agreement with the depositary;

(b) information on delegation arrangements regarding portfolio and risk management and administration with regard to the ELTIF;

(c) information about the investment strategies, the risk profile and other characteristics of AIFs that the AIFM is authorised to manage.

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Suitable investment assets

At least 70% of an ELTIF's investments must be in eligible investment assets. The balance of up to 30% being invested in more liquid assets, defined as permitted investment assets for a UCITs fund. Eligible investment assets for an ELTIF are:

(a) equity or quasi-equity instruments which have been:

(i) issued by a qualifying portfolio undertaking and acquired directly by the ELTIF from the qualifying portfolio undertaking;

(ii) issued by a qualifying portfolio undertaking in exchange for an equity instrument previously acquired directly by the ELTIF from the qualifying portfolio undertaking;

(iii) issued by an undertaking of which the qualifying portfolio undertaking is a majority-owned subsidiary, in exchange for an equity instrument acquired in accordance with points (i) or (ii) by the ELTIF from the qualifying portfolio undertaking;

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(b) debt instruments issued by a qualifying portfolio undertaking;

(c) loans granted by the ELTIF to a qualifying portfolio undertaking;

(d) units or shares of one or several other ELTIFs, European Venture Capital Funds (EuVECAs) and European Social Entrepreneurship Funds (EuSEFs) provided that those ELTIFs, EuVECAs and EuSEFs have not themselves invested more than 10% of their capital in ELTIFs;

(e) direct holdings of individual real assets that require up-front capital expenditure of at least EUR 10 million or its equivalent in the currency, and at the time, in which the expenditure is incurred.

For these purposes "qualifying portfolio undertakings" are generally unlisted EU entities other than collective investment schemes and financial institutions. In some restricted circumstances, non-EU entities may also qualify.

An ELTIF shall not invest in an eligible investment asset in which the manager has or takes a direct or indirect interest, other than by holding units or shares of the ELTIF it manages.

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There are concentration limits. An ELTIF cannot invest more than:

(a) 10% of its capital in assets issued by any single qualifying portfolio undertaking;

(b) 10% of its capital in an individual real asset;

(c) 10% of its capital in units or shares of any single ELTIF, EuVECA or EuSEF;

(d) 5% of its capital liquid assets (i.e. the up to 30% that is not eligible assets) where those assets have been issued by any single body.

The regulations include other detailed provisions, particularly in respect of investments in EuVECA and EuSEFs. 1. The investment limits shall:

(a) apply by the date specified in the ELTIF rules or instruments of incorporation, where this date shall take account of the peculiarities and characteristics of the assets to be invested by the ELTIF and shall not be later than five years after the authorisation of the ELTIF. In exceptional circumstances, the competent authority of the ELTIF, upon submission of a duly justified investment plan, may approve an extension of this time limit by no more than one additional year;

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(b) cease to apply once the ELTIF starts to sell assets in accordance with its redemption policy;

(c) be temporarily suspended where the ELTIF raises additional capital, so long as such a suspension lasts no longer than 12 months.

Gearing

The ability of an ELTIF to borrow will be very restricted. No distinction is made between those with and without retail investors. The wording of the borrowing restrictions us slightly ambiguous. According to the proposed regulation, an ELTIF may borrow cash provided that such borrowing fulfils all of the following conditions:

(a) it represents no more than 30% of the capital of the ELTIF;

(b) it serves the purpose of acquiring a participation in eligible investment assets;

(c) it is contracted in the same currency as the assets to be acquired with the borrowed cash;

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(d) it does not hinder the realisation of any asset held in the portfolio of the ELTIF;

(e) it does not encumber the assets held in the portfolio of the ELTIF.

Life, purgatory and redemption

As previously mentioned, ELTIFs must be closed-ended funds with a fixed life specified in advance. Investors are not permitted to redeem their investments before the end of the life of the fund. The proposed regulations specify that the ELTIF rules or instruments of incorporation and disclosures to investors shall lay down the procedures for redemption and disposal of assets and state clearly that redemption to investors shall commence on the day following the date defining the end of life of the ELTIF.

The life of the ELTIF shall be sufficient in length to cover the life-cycle of each of the individual assets of the ELTIF, measured according to the illiquidity profile and economic life-cycle of the asset, and the stated investment objective of the ELTIF. Investors may request the winding down of the ELTIF if their redemption requests have not been satisfied within one year after the end of life of the ELTIF.

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Investors shall always have the option to be repaid in cash. Repayment in kind out of the ELTIF's assets shall be possible only where all of the following conditions are met:

(a) the ELTIF rules or instrument of incorporation foresees this possibility, under the condition that all investors receive fair treatment;

(b) the investor asks in writing to be repaid through a share of the assets of the fund;

(c) no specific rules restrict the transfer of those assets.

ESMA shall develop draft regulatory technical standards specifying the circumstances in which the life of an ELTIF is sufficient in length to cover the life-cycle of each of the individual assets of the ELTIF.

Although early redemption is not possible, the regulations anticipate secondary trading. The fund may be listed and the ELTIF rules or instrument of incorporation shall not prevent investors from freely transferring their shares or units to third parties.

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Each ELTIF shall adopt an itemised schedule for the orderly disposal of its assets in order to redeem investors after the end of life of the ELTIF which shall include:

(a) an assessment of the market for potential buyers;

(b) an assessment and comparison of potential sales prices;

(c) a valuation for the assets to be divested;

(d) a precise timeframe for the disposal schedule.

ESMA shall develop draft regulatory technical standards specifying the criteria to be used for the assessments in point (a) and valuation in point (c)

An ELTIF may regularly distribute to investors the income generated by the assets contained in the portfolio. This income shall be composed of:

(a) any income that the assets are regularly producing;

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(b) the capital appreciation realised after the disposal of an asset, but excluding the original capital commitments made.

The income shall not be distributed to the extent that it is required for future commitments of the ELTIF. The ELTIF shall state in its fund rules or instruments of incorporation the distribution policy that it will adopt during the life of the fund.

Transparency

As previously mentioned, ELTIFs will fall within the AIFMD and will therefore need to meet the transparency requirements of that Directive. Also, as again previously mentioned, where the ELTIF is marketed to retail investors, a KID will need to be produced. A prospectus needs to be provided that meets the requirements for closed-ended funds under the Prospectus Directive (Directive 2003/71/EC). The proposed regulation stipulates that the prospectus must include a statement setting out how the ELTIF's investment objectives and strategy for achieving these objectives qualify the fund as long term in nature and a prominent indication of the categories of assets in which the ELTIF is authorised to invest.

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The prospectus, the KID and any other marketing documents shall prominently notify investors about the illiquid nature of the fund and shall clearly:

(a) inform investors about the long-term nature of the ELTIF's investments;

(b) inform investors about the end of life of the ELTIF;

(c) state whether the ELTIF is intended to be marketed to retail investors;

(d) state that investors shall have no right to redeem their investment until the end of the life of the ELTIF;

(e) state the frequency and the timing of any income payments, if any, to the investors during the life of the fund;

(f) advise investors that only a small proportion of their overall investment portfolio should be invested in an ELTIF.

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The proposed regulations also specify disclosure requirements for costs for which ESMA is to develop draft regulatory technical standards to specify the common definitions, calculation methodologies and presentation formats.

Raising additional capital

An ELTIF may offer new issues of shares or units in accordance with its fund rules or instruments of incorporation.

An ELTIF shall not issue new shares or units at a price below its net asset value without a prior offering of those shares or units at that price to existing investors.

Conclusion

For institutional investors, the new proposal should in theory make little difference as what it creates is already covered by the AIFMD. Even for institutional investors, the new regulatory regime may stimulate the development of new types of longer-term closed-ended funds for which there would appear to be appetite in the market. The main distinction between AIFMD and the ELTIF regime is that ELTIFs will be open to retail investors, when the KID regulations are enacted.

There are areas of ambiguity in the proposed regulations that need to be clarified and there are key areas in which ESMA has been delegated the task of determining detailed rules. The provisions in respect of fund duration are likely to be key.

The new regulation has the possibility of being a stimulus to product development particularly if there are initiatives around the secondary trading in fund units to allow long-term investment vehicles with shorter-term liquidity.

For more information

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