ELTIF 2.0 in Luxembourg: Should you?

By Dr. Marcel BARTNIK (picture), Partner & Olivier AMREIN, Counsel, Bonn & Schmitt

The European long-term investment fund ("ELTIF") is a fund regime that was initially introduced in 2015 by the EU Regulation 2015/760. It was intended to fill the gap that existed between the retail world of UCITS and alternative investment funds ("AIFs") in the sense that, under certain conditions, it allowed retail investors to invest into certain types of alternative assets – and to market such fund in the EU by way of a passport similar to the UCITS and AIFMD passport.

While that was a good idea in theory and also greeted with some enthusiasm at first, the provisions of the initial ELTIF regime revealed themselves to be so restrictive that it was entirely unattractive to fund promoters and ended in a complete failure: 6 years into its existence, only EUR 2.4bn of assets under management (as of October 2021) were allocated to such product, making it insignificant in terms of market share. As of January 2023, 84 ELTIFs have been established – by way of comparison, over 2000 RAIFs have been set up in Luxembourg since 2016.

In order to make it more practicable for the industry, the ELTIF Regulation was recently amended and substantially rewritten. Such new rules are therefore often referred to as "ELTIF 2.0". This raises a few questions – such as whether most of the initial shortcomings have been addressed, for which type of investors the ELTIF really is an appropriate vehicle, and lastly whether Luxembourg is an attractive jurisdiction to establish an ELTIF.

A larger investment universe

One criticism leveled at the initial ELTIF regime was the rigidity of its investment universe that resulted in a significant part of alternative assets not being eligible for an ELTIF's portfolio. That has been changed by substantially simplifying the definition of the term "real assets" that an ELTIF can invest into. It now includes "any asset that has an intrinsic value due to its substance and properties", which should cover most alternative asset classes and only excludes, pursuant to the preamble, exotic assets such as works of art or jewellery.

Also of interest is the possibility for ELTIFs to directly grant loans to target companies, for as long as the maturity of the loan does not exceed the term of the ELTIF; this appears to be in line with the increasing interest in debt funds that has been observed over the past years.

It has also been explicitly specified that an ELTIF can invest into FinTech assets and certain standardised securitisations, and into green bonds issued under the EU legislation. Also, there is no minimum size of the target investment any longer, which was formerly set at 10 mio. EUR and consequently made it difficult to fund venture capital projects or smaller start-up firms. Furthermore, target companies (called "qualifying portfolio undertakings") that are listed on a stock exchange can now be larger and have a market capitalisation of up to 1.5bn EUR (instead of 500 mio. EUR).

Another major obstacle was removed by allowing target assets to also reside outside the EU. Such restriction had previously excluded ELTIFs from investing in huge markets such as the U.S. and pursuing global investment strategies. The only conditions for investing outside the EU are that the relevant targets are not in a jurisdiction that is considered as high risk for money laundering or as uncooperative for tax purposes.

Additional strategies now possible

Other improvements in terms of flexibility include the possibility to pursue fund-of-fund strategies, such as investing into other alternative investment funds (AIFs) or UCITS. Some conditions still remain: The target funds have to be managed by an AIFM or management company in the EU, have to invest into eligible investments from the ELTIF's perspective, and must not pursue a fund-of-fund strategy themselves with a 10% limit to their own target funds.

The new regime also allows to establish ELTIFs using master/feeder structures, and for EU AIFMs and their staff to co-invest in the ELTIF's target companies subject to complying with conflict of interest rules. Both are important elements in structuring fund products in the alternative asset segment, and frequently employed for the benefit of investors.

More flexibility in risk diversification rules

One fundamental improvement resides in the fact that henceforth, the percentage of assets that are a compulsory component of the portfolio of an ELTIF in order for it to qualify as such has been reduced from 70% to 55% of its capital. That means in particular that a significant portion of liquid assets can be held by an ELTIF, which should make it easier to manage its liquidity, or to react to adverse market developments.

The pure risk diversification rules that were largely unworkable in practice have also been relaxed. Pursuant to the new regime, an ELTIF may have as few as 5 different target investments (down from 10 previously), with consequently a maximum of 20% of its capital invested in a single target.

The option to use external financing for investment purposes has also been made more appealing: ELTIFs can now borrow for an amount of up to 50% of their net asset value if they are sold to retail investors, and even up to 100% if marketed to professional investors – a marked increase from previously 30%. Similar to the rules for AIFs, credit lines that are entirely covered by outstanding commitments are disregarded for this calculation. Finally, all of the assets can now be pledged as security for such financing, where previously this was limited to 30% of its capital.

Simplified distribution to investors

A hurdle that contributed to ELTIF's failure so far is that the previous regime made its distribution to retail investors burdensome and complicated. It had to be ensured that investors did not invest more than 10% of their financial assets into an ELTIF, they had to invest at least EUR 10.000 and instead of using MiFID II rules for the suitability assessment, the former regulation set out its own regime. All of these rules which proved entirely unsuited in practice have now been abolished. Together with the removal of the requirement to have local facilities available to investors, the alignment with MiFID II in particular should decrease the compliance effort required to reach retail investors.

Which type of investors is targeted by ELTIF?

It appears obvious that ELTIFs do not primarily target institutional investors. They can benefit from much more flexible alternative investment fund regimes such as RAIFs or unregulated partnerships. These do not have any restrictions in terms of eligible assets or leverage, some even forgo any risk diversification requirements and they can also be marketed to professional investors with the AIFMD passport.

How about retail investors then? The major unique selling point of the ELTIF is doubtless the possibility to distribute it to retail investors by using a EU passport and simple notification procedure. Since the publication of the new regime, the terms of a "democratisation" or "retailisation" of private assets are touted frequently. Some doubts are, however, in order.

Asset classes that are typically associated with this category such as private equity, venture capital, infrastructure, private debt or real estate are more complex by an order of magnitude than most assets typically sold to retail investors through UCITS. They require significant sophistication, knowledge and experience that only few non-professional investors will possess. It appears therefore far more likely that ELTIF is not an instrument to mass-market private assets, but to make it available to sophisticated and experienced investors such as high net worth individuals or family offices that could not previously qualify as professional investors under MiFID II and therefore easily access existing AIFs.

Should you establish your ELTIF in Luxembourg?

Out of the 84 existing ELTIFs, 48 are set up in Luxembourg, and it is reasonable to expect this proportion to increase further to the benefit of the Grand Duchy. There are several reasons for this. One aspect is that Luxembourg has a long-standing experience with retail funds investing into private assets. The so-called part II funds that can do just that (albeit without a EU passport) have existed for several decades, making the local regulator CSSF very experienced in assessing the suitability of a given product for its purpose.

Another consideration is that, as the ELTIF regime is added on top of any existing fund product regime, the large and diversified Luxembourg investment fund toolbox can be employed for the structuring of each product. In particular the RAIF or the unregulated partnership structures appear attractive in this context, as the regulator will not, during its approval process, review the entire documentation but only the ELTIF specific aspects with a potential benefit in time to market. The same benefits also apply to the existence of the service provider infrastructure or the experience with cross-border distribution where Luxembourg is without doubt a class leader.

When to start?

The new rules entered into force on 9 April 2023 but in theory only apply 9 months later, on 10 January 2024. However, the new regime can, at least in Luxembourg, be used immediately: The CSSF has already signaled their willingness to apply it as of now and to systematically agree to the opt-in possibility provided for in the new regulation, avoiding the 9 months transitional period. To answer the question: Now could be a good time!