EU Investment Fund Standards Offer Welcome Clarity

By **Zac Mellor-Clark and Nishkaam Paul** (July 31, 2024)

On July 19, the European Commission published its eagerly anticipated final draft regulatory technical standards supplementing Regulation 2015/760, as amended.[1]

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The publication of the final draft standards brings some much-needed clarity on the mandatory liquidity features of an open-ended European long-term investment fund, or ELTIF, which permits redemptions by investors prior to the end of its term or life.

Amendments to the ELTIF regulation made earlier this year, the ELTIF 2.0, granted managers greater flexibility with respect to open-ended ELTIFs, but prior drafts of these regulatory technical standards caused some consternation within the market as the prescriptive requirements therein undermined this flexibility.

In this article, we will explore some interesting aspects of the draft standards, with a particular focus on an ELTIF's mandatory liquidity features. This will be of particular interest to managers active in the European semiliquid fund space.

Background

By way of introduction or refresher, an ELTIF is a form of EU regulatory designation available to EU-domiciled alternative investment funds managed by EU-domiciled managers. The ELTIF regulation establishes a framework intended to provide investors with the opportunity to make long-term investments in companies and projects that require long-term capital.

The ELTIF designation enables such EU-domiciled alternative investment funds to be marketed to retail investors across the EU pursuant to an ELTIF marketing passport. By contrast, pursuant to the EU Alternative Investment Fund Managers Directive, unregulated EU-domiciled alternative investment funds may only be marketed under a passport to professional investors.

Managers of unregulated EU-domiciled alternative investment funds looking to market to retail investors are instead reliant on national private placement regimes for retail marketing, where such retail marketing is permitted at all, which in certain cases requires local authorization, limits marketing to certain types of retail investor (e.g., "semiprofessional investors") and imposes additional compliance burdens.

As a trade-off for the retail marketing passport, there is a significant amount of product regulation to contend with. ELTIFs or managers of ELTIFs are subject to relatively restrictive investment eligibility criteria, concentration limits, borrowing restrictions, transparency requirements, distribution requirements and operating conditions, among other things.

As originally enacted in 2015, the ELTIF regulation made it difficult to establish an open-ended ELTIF. However, in January, ELTIF 2.0 entered into force, bringing with it a number of targeted improvements to the regime that were intended to improve its usability. One of

those improvements was to make changes to the conditions around redemptions.

ELTIF 2.0 provided the European Securities and Markets Authority, or ESMA, with a mandate to develop regulatory technical standards building on those conditions. The regulatory technical standards are required, among other things, to establish the criteria to determine an ELTIF's minimum holding period, requirements to be fulfilled by an ELTIF in relation to its redemption policy and liquidity management tools, and criteria to assess the percentage of the liquid assets of an ELTIF to which redemptions must be limited.

After a protracted and politically charged process, which saw the European Commission publicly invite ESMA to revise its initial December 2023 draft — the ESMA draft regulatory technical standards — and adopt a more proportionate approach, the commission's final draft standards have now been published. We now enter a three-month period during which these standards will be scrutinized by the European Parliament and European Council.

For completeness, the regulatory technical standards also:

- Provide guidance around the rule that ELTIFs may only use derivatives that serve the purpose of hedging risks;
- Prescribe the circumstances in which the life of an ELTIF is to be considered compatible with the life cycles of each of its individual assets, as required pursuant to the ELTIF regulation;
- Set out various requirements relating to an ELTIF's ability to match transfer requests of exiting investors and potential investors, to facilitate secondary trading;
- Establish criteria for the valuation of assets to be divested following the end-of-life date of an ELTIF; and
- Set out certain definitions, calculation methodologies and presentational formatting requirements that supplement the ELTIF regulation's cost disclosure requirements.

Further detail on these points is outside the scope of this update.

Key Liquidity Features

Minimum Holding Period

While the default position is that ELTIFs must be closed-ended, under ELTIF 2.0, the rules or instruments of incorporation of an ELTIF may provide for the possibility of redemptions

during the life of the ELTIF, provided that certain specified conditions are met.

One of these conditions is that redemptions are not granted before:

- The end of a minimum holding period; or

- The date by which the portfolio composition and diversification requirements apply, i.e., before the end of the ELTIF's ramp-up period.

Regarding the latter limb, the ramp-up period is required to expire no later than the earlier of five years following the date of the authorization as an ELTIF, or half the life of the ELTIF.

In the case of an open-ended ELTIF simulating an evergreen fund by having a very long term, e.g. 99 years, we would typically expect the ramp-up period to last one or more years.

During the development of the regulatory technical standards, there was a tussle between the commission and ESMA about whether the establishment of a minimum holding period should be viewed as mandatory.

The commission prevailed, and it is clear from the commission's final draft standards that an ELTIF does not have to establish a minimum holding period.

To the extent it chooses to do so, the manager must calibrate such period by reference to specified factors and justify it to the relevant competent authority on request.

However, as explained, if the manager does not establish a minimum holding period, it will not be able to grant redemptions before the end of the ramp-up period.

Accordingly, it seems open-ended ELTIFs will need to provide for some form of hard lockup period, whether by reference to a minimum holding period or a ramp-up period or, potentially, by foregoing a ramp-up period entirely in respect of the portfolio composition and diversification requirements.

Note that the application of the criteria specified in the commission's final draft standards for calibrating the minimum holding period is subjective, and it remains to be seen what regulators in individual member states will expect in this regard and how much flexibility will be afforded to managers of ELTIFs in setting short minimum holding periods.

12-Month Minimum Notice Period

One of the most problematic elements of ESMA's initial draft standards was the 12-month minimum notice period it imposed on redemptions, which was inconsistent with market practice in the semiliquid retail funds space.

Derogations were permitted, but only where the minimum notice period was calibrated based on:

- The minimum percentage of liquid assets held by an ELTIF; and

- The maximum percentage of an ELTIF's liquid assets that could be used to satisfy redemption requests.

For redemption notice periods of less than three months, the minimum percentage of liquid assets to be held by the ELTIF was 40%, which was significantly higher than the percentage of liquid assets that semiliquid retail funds in the market would typically hold.

The position under the commission's final draft standards is now more proportionate. To begin with, the default 12-month minimum notice period has fallen away.

There remain, however, complicated rules stipulating the relationship between the minimum redemption notice period, redemption frequency, the minimum percentage of liquid assets to be held by an ELTIF (i.e., the size of the liquidity bucket), and the maximum amount of liquid assets that may be used to meet redemption requests.

As against ESMA's initial draft standards — which prescribed the minimum percentage of liquid assets an ELTIF must hold and the maximum percentage of such assets that would be available to satisfy redemption requests where there was a notice period of less than 12 months — the final draft standards impose mandatory relationships for the purposes of determining the maximum percentage of an ELTIF's assets to which redemptions must be limited.

In order to calibrate such maximum percentage, the manager must adopt one of two methodologies set out in the commission's final draft standards.

Annex I

Annex I establishes mandatory relationships between:

- Redemption frequency; and

- The redemption notice period, including any extensions. For example, under "Option 1: baseline option," ELTIFs with a one-month notice period and a redemption frequency of three months may use up to 27.3% of the ELTIF's liquid assets to satisfy redemption requests. Annex I does not impose any conditions with respect to the minimum percentage of liquid assets an ELTIF may hold.

Annex II

Annex II, instead, establishes mandatory relationships between:

- Redemption frequency; and

- The minimum percentage of liquid assets the ELTIF must hold, instead of the redemption notice period. ELTIFs with a three-month redemption frequency and that hold liquid assets of at least 20% are permitted to use up to 50% of the ELTIF's liquid assets to satisfy redemption requests.

Annex I may prove to be more popular since it does not impose a minimum requirement with respect to the minimum size of an ELTIF's liquidity bucket — and the greater that bucket is, the greater the drag on the ELTIF's returns will be.

However, with reference to the example given in Annex II above, depending on the relevant investment strategy and the fund's other liquidity terms, a 20% liquidity bucket may not be inconsistent with market practice in any case.

Other Redemption Policy Requirements

The commission's final draft standards contain various other rules regarding an ELTIF's redemption policy, including minimum content requirements and qualitative criteria.

Where redemptions are offered more frequently than quarterly, the manager will be required to justify this to the relevant competent authority in light of the features of the specific ELTIF.

Where the notice period for such redemptions is less than three months, as is typically the case in the semiliquid retail funds space, the manager shall be required to notify the competent authority of the reasons for such shorter period and to explain how it is consistent with the individual features of the ELTIF, unless the relevant ELTIF is marketed exclusively to professional investors.

Whereas in ESMA's initial draft standards, the default position was that a manager had to select and implement at least one specified antidilution liquidity management tool, these are now optional.

This amendment reduces overlap with forthcoming amendments to the Alternative Investment Fund Managers Directive, which will require managers of all open-ended EU-domiciled alternative investment funds to employ at least two specified liquidity management techniques.

Conclusion

Publication of the commission's final draft standards will generally be seen as a welcome step by the industry. The initial consensus appears to be that, while the standards are not perfect, the regime should prove viable.

The standards remain subject to scrutiny from the European Parliament and Council, and the politics surrounding the ELTIF regulation should not be underestimated. However, they provide a good indication of the direction of travel, and the hope is that they will be published in the Official Journal in the fourth quarter of 2024 and enter into force the next day.

What will be interesting to see is whether the final regulatory technical standards are perceived as being sufficiently workable to encourage managers in the European semiliquid retail fund space to move away from structuring their funds as undertakings for collective

investment Part II funds, which has been a popular model in recent years.

From an investment and operational perspective, the undertakings for collective investment Part II fund boasts greater flexibility than an ELTIF, but it does not benefit from a retail marketing passport.

Structuring decisions may therefore come down to the domicile and type of retail investors, e.g. high-net-worth investors versus mass retail investors being targeted, and whether they could instead be reached under national private placement regimes.

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[1] https://ec.europa.eu/transparency/documents-register/detail?ref=C(2024)4991&lang=en.