



EUROPEAN LONG-TERM INVESTMENT FUNDS: INVESTMENTS IN THE ENERGY INFRASTRUCTURE OF THE REGION AND IN OTHER LONG-TERM PROJECTS THROUGH CYPRUS

1. Introduction

The increasing public discourse, including political and diplomatic mobility, as to energy exploitation in the Mediterranean and subsequent energy distribution, also includes the construction of the necessary energy infrastructure projects. The proximity of Cyprus to the recently discovered sources of energy in the Mediterranean, renders Cyprus a potential candidate for the construction of energy infrastructure projects. At the same time Cyprus is also an international shipping centre, involved in financing the construction of vessels. However, the significant length and cost of such projects (energy infrastructure and shipping finance) automatically raise the question of their smooth and viable financing. Recently adopted European Union Law in the form of a Regulation, undertakes to provide a financing tool for such and other projects of long-term nature by introducing the 'European Long-Term Investment Funds'. This way, a legal framework tailored to the needs of long-term investments is established, which interacts with the current local investment funds framework, adds value to Cyprus' physical proximity to possible long-term projects and allows for Paneuropean fundraising possibilities from both professional¹ and retail investors. 'European Long-Term Investment Funds' are also eligible applicants for financing from the European Investment Bank, whereby the relevant application is assessed by priority.

The present memo undertakes to provide a brief overview of this new legal framework and of its interaction with the investment funds legal framework currently applicable in Cyprus. The aim is to facilitate, through Cyprus, the financing of long-term projects in Cyprus, the European Union and in third countries.

2. The concept behind the EU Regulation on 'European Long-Term Investment Funds' and its interaction with Cypriot investment funds legislation

The European Union (EU) Regulation 2015/760 (**Regulation**), which has introduced the 'European Long-Term Investment Funds' (**ELTIFs**) shall apply from 9 December 2015 to investment funds that wish to subject themselves to the Regulation's rules. Those investment funds may market themselves as investment vehicles tailored to the needs of long-term investments such as transport infrastructure, intellectual property, equipment, machinery, vessels, aircrafts, energy infrastructure, schools and social housing. An investment fund complying with the Regulation may bear the designation 'ELTIF', which indicates its appropriateness for long-term investments due to the applying 'product rules'. Long-term investments have the characteristics of:

- Being illiquid;
- Having, in principle, a duration usually exceeding 10 years (which exceeds the maximum duration for e.g. private equity funds); and
- Offering a predictable return on the course of time.

¹ Professional investors correspond to 'professional clients', within the meaning of the EU Markets in Financial Instruments Directive (**MiFID**) transposed by Law 144 of 2007 on Investment Services and Activities and Regulated Markets as amended.

This latter characteristic, i.e. the predictable return on the course of time, differentiates long-term investments, within the meaning of the Regulation, from other illiquid assets, such as manuscripts, works of art, watches and other assets known as 'passion assets'. Another illiquid asset that does not qualify as a long-term asset, within the meaning of the Regulation, is property, when used for purely commercial purposes without any economic or social benefit. The reason is that the objective of the Regulation is not to promote purely speculative investments but rather to promote investments in real economy with social or economic benefit.

According to the applicable provisions of the Regulation, only EU alternative investment funds (**AIFs**) managed by an EU alternative investment fund manager, within the meaning of the EU Alternative Investment Fund Managers Directive (**AIFMD**), (**AIFM**) may qualify for the ELTIF status. Thus, an ELTIF is from a Cypriot perspective an AIF licensed under Law 131 of 2014 on AIFs as amended (**AIF Law**) which:

- Has appointed an AIFM, licensed either under Law 56 of 2013 on AIFMs transposing the AIFMD (**AIFM Law**) or under the relevant legislation of another EU member state (**MS**), as its external manager or is itself licensed as an AIFM (if self-managed)²;
- Is an AIF under Part II of the AIF Law (retail AIFs and professional and/or well-informed investor AIFs), having regard to the requirement for being managed by an AIFM; and
- Is additionally authorised by the Cyprus Securities and Exchange Commission (**CySEC**) as an ELTIF³.

In respect of the above, this practically means that when setting-up in Cyprus an investment fund for long-term investments, two regulatory approvals are required: One for the licensing of the investment fund as an AIF under Part II of the AIF Law and a second one, regarding the authorisation of that AIF as an ELTIF (**AIF-ELTIF**). Within the context of the AIF-ELTIF authorisation procedure, the AIFM to be appointed as manager of the AIF-ELTIF will have to satisfy CySEC that its scope of authorisation covers the investment strategies to be pursued by the AIF-ELTIF in question. Where the external AIFM to be appointed is not CySEC authorised, then CySEC may request from that AIFM's competent supervisory authority an attestation, as to whether the investment strategy of the AIF-ELTIF is covered by that EU AIFM's scope of authorisation. Where the AIF-ELTIF in question will be internally managed, then it must simultaneously apply for authorisation under the AIFM Law as well. The authorisation procedure of an AIF-ELTIF also involves the approval of the entity to be appointed as depositary of the AIF-ELTIF and information on delegation arrangements. Thus, an AIF-ELTIF must comply with the AIF Law, the Regulation and, as applicable, with the AIFM Law/AIFMD. CySEC's decision on an AIF-ELTIF authorisation shall be taken within two months for externally managed and within three months for internally managed AIFs respectively.

3. Benefits of the AIF-ELTIF status

As an exchange for the willingness to also comply with the Regulation, an AIF-ELTIF may bear the brand 'ELTIF', which indicates that its structure and operations are tailored to the nature of long-term investments. As an additional exchange, an AIF-ELTIF may market its units/shares across the EU to both professional as well as to retail investors on a 'passport' basis. This means that no marketing approval from the targeted EU MS is required but an electronic (home MS) regulator to (host MS) regulator notification procedure, encompassing marketing to both professional and retail investors. Marketing to retail investors on a 'passport basis' is an advantage

² References to AIFMs hereafter shall also include references to internally managed AIFs, which are also licensed under the AIFM Law, unless relevant distinction is made.

³ An ELTIF is an AIF and CySEC is currently the competent authority for regulation and supervision of AIFs.

not granted to AIFs managed by an AIFM, unless the ELTIF status is obtained. Where retail investors are also targeted, the Regulation then provides for a series of additional safeguards regarding marketing arrangements, documentation and the depositary of the AIF-ELTIF. Furthermore, an AIF-ELTIF is an eligible applicant for financing from the European Investment Bank, whereby the relevant application is assessed by priority. The Regulation prohibits EU MS from adding further requirements in the fields covered by it. An AIF-ELTIF is not restricted to investments within the EU only, but may invest in (FATF and OECD compliant) third countries as well. This way, having regard to Cyprus' location and business links, Cypriot AIF-ELTIFs could serve as fundraising platforms for long-term investments in Russia and in the energy infrastructure projects of the region.

4. Illiquidity of investments and liquidity to investors

Given the illiquid nature of long-term investments, an AIF-ELTIF will be structured in principle as a closed-ended fund, i.e. it will not be providing for the investors' right to request redemption of their participation in the AIF-ELTIF during its life-cycle. As to the units/shares in an ELTIF themselves, these are freely transferable and can be traded on the secondary market, whereas new issues of units/shares are possible, if so provided in the AIF-ELTIF's constitutional documentation. Regarding redemptions after the life-cycle of the AIF-ELTIF, these have to take place in accordance with an itemised asset disposal schedule, which must be disclosed to CySEC one year before the end of the life-cycle of the AIF-ELTIF, the latest. During its life-cycle the AIF-ELTIF may distribute proceeds generated by the AIF-ELTIF's assets or as capital appreciation realised following the disposal of the AIF-ELTIF's assets, provided such proceeds are not required for future commitments of the AIF-ELTIF. However, the Regulation allows AIF-ELTIFs to also choose to operate as open-ended funds, i.e. to provide for investors' redemption right during their life-cycle, following an initial lock-up period. Where a redemption right is granted, the AIF-ELTIF is subject to strict obligations towards its investors. Such strict obligations are for instance the requirement for defined redemption periods, the investors' options to always request redemption in cash, whereas redemptions in kind (if applicable) must comply with prescribed conditions. The investors have the right to request the winding down of the AIF-ELTIF, if the latter fails to satisfy redemption requests, made in accordance with the AIF-ELTIFs redemption policy, within a year.

5. Eligible investments for AIF-ELTIFs

An AIF-ELTIF is allowed to invest mainly in long-term assets, which provide a predictable return. Furthermore, AIF-ELTIFs are conceived to be investing in the real economy and in assets presenting an economic or social benefit, excluding, in principle, speculative investments, short-term investments and liquid investments. The composition of an AIF-ELTIF's portfolio shall therefore consist of at least 70% of eligible investment assets, within the meaning of the Regulation, i.e. of long-term assets. These are in broad terms:

- Real assets, such as equipment, machinery, vessels, aircrafts, infrastructure, schools, which may be directly or indirectly held by the AIF-ELTIF and are of a value of at least EUR 10.000.000. Real assets would also include commercial property or housing, only where they are integral to, or an ancillary element of, a long-term investment project that contributes to the EU's objective of smart, sustainable and inclusive growth;
- Participation and/or financing in EU or (subject to FATF and OECD compliance) non-EU unlisted undertakings or listed undertakings of a certain market capitalisation;
- Units/shares in other ELTIFs and other EU regulated investment funds (EuVECAs and EUSEFs), provided the said vehicles do not themselves invest more than 10% of their capital in ELTIFs.

Investments in the aforesaid eligible investment assets, are subject to diversification and concentration limits laid down in the Regulation.

Eligible investment assets, within the meaning of the Regulation do not comprise commodities or exposure thereto, notwithstanding the means through which such exposure occurs. The reason is that commodities are considered to be liquid and not of long-term. The said restriction on commodities does not prejudice an AIF-ELTIF's right to invest in companies in the infrastructure sector or in companies being related to commodities or in companies whose performance is indirectly linked to the performance of commodities, provided any other eligibility requirements under the Regulation are complied with.

The management of the AIF-ELTIF also benefits from a "grace period" regarding the observance of the 70% investment limit, in order to be able to conduct the (lengthy) due diligence required for long-term assets. The investment limit of 70% mentioned above, ceases to apply when the AIF-ELTIF starts selling assets, in order to redeem investors' units/shares after the end of the life-cycle of the AIF-ELTIF. It may also be suspended for up to twelve (12) months, where an increase or reduction in the AIF-ELTIF's capital takes place.

Apart from the investment limit of at least 70% in eligible investment assets, within the meaning of the Regulation, an AIF-ELTIF's portfolio may also consist of up to 30% of liquid assets qualifying as eligible investments for Undertakings for Collective Investment in Transferable Securities (**UCITS**) under Law 78 of 2012 on Open-Ended Undertakings for Collective Investments (**UCI Law**). The reason for offering the possibility of having 30% of an AIF-ELTIF's assets invested in liquid financial instruments, is to allow an AIF-ELTIF to satisfy redemption requests, where structured as open-ended; however, no more than the said 30% shall be dedicated to satisfying redemption requests.

As to investment techniques, short selling is banned, whereas the use of financial derivative instruments is only allowed to the extent it serves the purpose of hedging the risks inherent to other eligible investments of the AIF-ELTIF. Securities lending, repos and other economically similar transactions are also allowed only to a certain extent. Borrowing of cash, in order for an AIF-ELTIF to finance its investments is allowed, once again subject to a series of restrictions. An AIF-ELTIF shall further not invest in assets, in which the external AIFM of that AIF-ELTIF takes a direct or indirect interest (e.g. the manager of the real estate AIF-ELTIF also holds an interest in the target asset itself); however where the external AIFM takes the said interest through other AIF-ELTIFs or other EU regulated investment funds being EuVECAs and/or EuSEFs under its management, then the investment is allowed.

6. Marketing rules

As to marketing possibilities and the possible investor base, an AIF-ELTIF can be marketed to professional investors across the EU on a 'passport' basis, because of its AIFM Law/AIFMD compliant management status. The Regulation goes a step further and also allows the marketing of an AIF-ELTIF on a passport basis to retail investors. Both in cases where professional and/or retail investors are targeted, the AIFM Law passporting procedure and certain additional Regulation requirements apply. Furthermore, marketing to retail investors requires the provision of appropriate investment advice to such investors. As a result of this requirement, only external AIFMs, which are also authorised for investment advice pursuant to the provisions of the AIFM Law/AIFMD are allowed to market an AIF-ELTIF directly and not via an external distributor (indirect distribution) to retail investors. Depending on the retail investors' financial standing, a cap is placed on the

amounts retail investors may, in aggregate, invest in AIF-ELTIFs. In addition to protection prior to the investment, the Regulation also grants retail investors a withdrawal right during the subscription period, which lasts up to two weeks following their subscription without any penalty applying.

As to the content of the prospectus of the AIF-ELTIF, the ELTIF Regulation provides that it must include information on the long-term and illiquid nature of the AIF-ELTIF's investments and a prescribed section on costs, in addition to the information that is required under other pieces of applicable legislation. Marketing to retail investors also requires, apart from the publication of the prospectus, the production of a succinct document in plain language, known as 'key information document', in accordance with EU Regulation 1286/2014 on 'Packaged Retail Investment Products'. The Regulation grants retail investors the right to request additional information on the risk management of the AIF-ELTIF. Where an AIF-ELTIF has a life-cycle exceeding 10 years and such AIF also targets retail investor an explicit warning has to be made in this respect.

Regarding an AIF-ELTIF's annual report, it must be principally drafted in accordance with the AIFM Law/AIFMD provisions on an AIF's annual report and must also include certain additional information required under the Regulation.

Prior to initiating marketing to retail investors, the management of the AIF-ELTIF is required to conduct an internal assessment process as to whether the AIF-ELTIF is suitable for marketing to retail investors. The said assessment has to be provided to the external distributor (where applicable) by the AIF-ELTIF's management as part of the required information. Furthermore, the Regulation requires paying agent facilities to be in place in the host MS where the AIF-ELTIF is marketed to retail investors. Finally, where marketing to retail investors takes place, the Regulation introduces derogations from the applicable depositary provisions of the AIFM Law/AIFMD.

7. Conclusion

The Regulation establishes a legal framework, which allows Cypriot AIFs to operate as fundraising platforms for investments in long-term assets in Cyprus, the EU and third countries. The existence of local AIFMs, the reputation of Cyprus as an international shipping centre and the proximity of Cyprus to possible energy infrastructure projects significantly enhance the financing potential of those projects through Cypriot AIF-ELTIFs. At the same time, the Regulation expands the possible investor base of an AIF-ELTIF providing for the marketing of an AIF-ELTIF on a 'passport' basis also to retail investors. It also grants to AIF-ELTIFs the status of an eligible applicant for financing by the European Investment Bank, whereby such application will be assessed by priority.