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By **Jérôme Wigny,**
Partner, Elvinger Hoss Prussen

And **Jérôme Mausen,**
Senior Associate,
Elvinger Hoss Prussen

Retailisation of Private Assets: The Luxembourg Part II Fund

Both the US Securities and Exchange Commission[1] and the European Commission have in recent years explored ways to facilitate access by retail investors to private assets. Higher returns and lower volatility compared to public markets are among the main arguments for private investors to seek alternatives to the traditional stock market and to mutual investment funds. Financial advisers are also keen on diversifying their clients' portfolio allocations.

Success in the United States

Large US sponsors have been able to tap into this market by launching open-ended, NAV subscription-based funds alongside their traditional closed-ended, commitment-based funds designed for professional investors. These open-ended funds usually offer redemption rights of up to 2% per month or 5% per quarter. In the US, they are mainly structured as real estate investment trusts (REITs) or business development companies (BDCs) for private debt.

1 Expanding Retail Access to Private Markets, Small Business Capital Formation Advisory Committee, https://www.sec.gov/spotlight/sbcfac/expanding-retail-access-to-private-markets-finley.pdf

The current trend in Europe

The same US sponsors now seek to replicate these structures through European vehicles, designed to be sold through private wealth channels to non-US investors. Considering its cross-border fund distribution expertise, Luxembourg was well positioned to host these initiatives. More surprisingly, the vehicle of choice has been determined to be an old type of vehicle, supervised by the CSSF.

Why Part II Funds?

Undertakings for collective investment subject to Part II of the UCI Law[2] ("Part II Funds") are subject to a robust regulatory framework but offer sufficient flexibility to replicate the main characteristics of their US equivalents.
Part II Funds mirroring US structures have already been approved for real estate, private debt and private equity, with infrastructure soon to be approved as well.
A key advantage of Part II Funds is that they are available to all types of investors. Considering the illiquidity of the underlying asset classes, the CSSF however requires a minimum investment of around EUR 25.000 to warrant a certain level of sophistication from retail investors. This remains a clear advantage over other types of vehicles and in particular reserved alternative investment funds ("RAIFs") or specialised investment funds ("SIFs"), which are only available to well-informed investors (i.e. minimum EUR 125.000 investment for non-professional investors).

2 Luxembourg law of 17 December 2010 relating to undertakings for collective investment

Part II Funds, being AIFs and falling under AIFMD, benefit from the European passport for distribution to professional investors. They may however be marketed to retail investors in Luxembourg and, subject to certain local restrictions, to retail or semi-retail investors in most European jurisdictions, either directly or through a local supervised feeder fund. Marketing to retail investors outside the European Union is also possible under local private placement regimes.

Sale through intermediaries

The issue of securities based on the Part II Fund's net asset value, without any need for subscription commitments, enables intermediaries to aggregate orders and act as nominees. It facilitates the distribution of the fund by banking institutions offering it to their private clients on an international basis.

> **"Considering the illiquid nature of the underlying assets, particular attention should be brought to ensuring that the portfolio composition enables the fund to deliver the required liquidity to meet shareholders' redemption rights."**

Structuring

Part II Funds can be set up under a contractual form (fonds commun de placement) and a corporate form (currently only the société anomyme). Each Part II Fund may also be set up as an umbrella structure i.e. with one or multiple subfunds. The master/feeder regime set out in the AIFMD is also available to Part II Funds investing at least 85% of their assets in units or shares of another AIF.[3]

Certain considerations when marketing to retail investors

While the ESMA Performance Fee Guidelines do not apply to open-ended venture capital or private equity AIFs marketed to retail investors, certain Part II Funds which are marketed to retail investors may fall under the requirements of the ESMA Guidelines on Performance Fees[4].

Liquidity

Considering the illiquid nature of the underlying assets, particular attention should be brought to ensuring that the portfolio composition enables the fund to deliver the required liquidity to meet shareholders' redemption rights. The warehousing of certain assets in order for the fund to quickly have an adequate portfolio seems to make a difference.

3 Article 1 (42) and (43) of the Luxembourg Law of 12 July 2013 on alternative asset fund managers (the "AIFM Law")
4 The Guidelines apply to UCITS management companies and to AIFMs of AIFs allowed by Member States to market their units to retail investors in their territory in accordance with Article 43 of the AIFM Directive, except for closed-ended AIFs and open-ended AIFs that are EuVECAs1 (or other types of venture capital AIFs), EuSEFs2 , private equity AIFs or real estate AIFs Guidelines On performance fees in UCITS and certain types of AIFs, 05/11/2020 | ESMA34-39-992 EN

Alternative to Part II Funds

The European Long Term Investment Fund ("ELTIF") offers a better marketing passport than the AIFMD one, as it gives access to retail investors across Europe. The ELTIF being in essence a label and a regulation which applies on top of existing rules, it is possible to structure an ELTIF as a Part II Fund but other fund regimes are possible, in particular RAIFs and SIFs.

ELTIFs face a number of constraints. At least 70% of their assets need to be invested in eligible assets (i.e. equity and quasi-equity, debt instruments, loans and real assets with at least 10 million euros asset size). This is currently more stringent than the Part II Fund limits (i.e. 20% diversification requirement, subject to derogations). Borrowing for ELTIFs is limited to 30% of net assets whereas existing Part II Funds may borrow in excess of 60% in certain circumstances. ELTIFs are not allowed to invest in derivative instruments for investment purposes and they are currently not permitted to invest in other undertakings for collective investment, except in other ELTIFs, EuVECAs or EuSEFs.

Additional flexibility will be brought in the course of next year through a revised ELTIF regime, adopting the same 20% diversification rule as for Part II Funds and lowering the current requirement of 60% to be invested in real assets. The revised definition of real assets[5] will include asset such as infrastructure, intellectual property, real assets and attached rights (i.e water rights, minerals, etc) and provide for a decreased reduced asset size of EUR 1 million. ELTIFs may in the future take advantage of the master-feeder and funds of funds regimes.

The ELTIF however largely remains a closed-ended fund although the new regime proposes to open ELTIFs to the secondary market by offering redemptions to investors against subscriptions from new or existing investors[6].

The European Commission also proposes to remove "unjustified barriers preventing retail investors from having access to ELTIFs"[7] by no longer requiring a EUR 10.000 entry ticket and removing the maximum 10% exposure limit.

European asset managers, not using US vehicles as precedents, seem more open to tailoring a product to the ELTIF regulation and certain US sponsors are starting to follow that path as well.
The momentum however seems on the side of the Part II Funds, considering the weight of US managers. ●

5 any assets that have intrinsic value due to their substance and properties
6 Michel Storck, Isabelle Riassetto, Fonds européens d'investissement à long terms, Revue de droit bancaire et financier, N°1, janvier-février 2022, page 48
7 Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) 2015/760 as regards the scope of eligible assets and investments, the portfolio composition and diversification requirements, the borrowing of cash and other fund rules and as regards requirements pertaining to the authorisation, investment policies and operating conditions of European long-term, COM(2021) 722 final 2021/0377 (COD) investment funds