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Credit Funds INSIGHT

Spotlight: A SEA CHANGE IN NON-BANK LENDING

ALSO IN THIS ISSUE:

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An overview of this issue

The highly anticipated revised German Insurance Ordinance was passed on 25 February 2015, prompting us to put the spotlight on insurance in our previous issue. On 12 May 2015, the German Federal Financial Supervisory Authority announced significant changes to loan origination by investment funds, which arguably represents a sea change in the perception of "direct lending" and "direct lending funds" by regulators in Europe. However, this positive change has been marred by the European Central Bank's report on "shadow banking", which was published in October 2015 and which described traditional funds as "shadow banks", prompting us to focus in this edition on "non-bank lending". For this issue, we have interviewed one of the largest and most active direct lenders in the direct lending space, Intermediate Capital Group (ICG), to obtain the asset fund management's view on "shadow banking".

We hope that you find Credit Funds *INSIGHT* useful and enjoy reading our latest issue. We welcome your feedback and do let us know if there are any topics that you would like us to cover in future editions by emailing **claire.malkoun@ashurst.com**.

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Dagmar Kent Kershaw (photo courtesy of ICG)

INDUSTRY FOCUS ON ICG

Direct lending emerging from the shadows?

by Diala Minott and Adam Farrell

Dagmar Kent Kershaw offers her views on why it is inaccurate to categorise investment firms like ICG as "shadow banks".

In October 2015, the European Central Bank published a report describing traditional funds as "shadow banks", causing concern among the asset management industry who have long complained that the term should not be applied to their investment business. The Investment Association (the UK trade body for asset managers) said: "*Investment is not banking and investment funds should not be equated with shadow banking*". The European Fund and Asset Management Association (EFAMA) echoed this by stating that it "*does not agree with using the term 'shadow banking' to designate investment management activities*".

Earlier this year, Christophe Evain, Managing Director and CEO of Intermediate Capital Group (ICG), also made clear his dissatisfaction with the label "shadow banks". "*Perceptions are important. The term 'shadow banking' suggests there is something negative or derogatory about what we do,*" said Evain.

Terminology

The unease over terminology has prompted asset managers to lobby various regulators privately to explain why the debt fund industry should not be treated as shadow banking.

We recently met with Dagmar Kent Kershaw, Head of Credit Fund Management at ICG, to discuss this issue.

"*The term 'shadow banking' is an emotive one,*" says Kershaw. "*Back in 2008, shadow banking was used to describe vehicles which were inherently unstable, such as structured investment vehicles, which borrow short to lend long. This contrasts with the long-term way direct lending funds raise capital, which is inherently stable.*" Kershaw explains that "*we cannot lend out something that we don't have so we can't overextend ourselves. If we make a loan to a company, that is not going to be affected because another part of our institution has blown itself up*".

What you need to know

- **Direct lending investment funds believe the label "shadow banking" is misleading.**
- **Government bodies and central banks continue to include investment funds when discussing "shadow banking".**

Institutional private debt is relatively new in Europe and Kershaw argues that the use of the shadow banking term shows the relative "immaturity" of the European financing markets compared to the US. There has been an active US private placement market for many years and as Kershaw puts it: "*No one looks at the US and says 'Ah, that's shadow banking'*".

Gabriela Diezhandino, Director of Public Policy at EFAMA, provides another reason why investment firms should not be covered under the "shadow bank" definition since the asset management companies and the funds they manage "*are subject to a very exhaustive and robust regulatory framework*", unlike "*entities acting in the shadows*". This is certainly true of funds complying with the implementation of the Alternative Investment Fund Managers Directive (AIFMD), which has in many respects led to certain jurisdictions easing their banking monopoly restrictions as long as managers are AIFMD-compliant (Germany being one such country).

Indeed, Kershaw points out that while "*most central banks recognise that there is a shortage of mid-market capital, it is schizophrenic that one government body says we should make more capital available and give capital to direct lenders whilst on the other hand you have other government bodies down the road saying 'we are not sure about this shadow banking'*".

Investment firms like ICG can be far more flexible than the banks. According to Kershaw, post-2008, "*what banks can and can't do is formulaic, very rules-based now, and they do not have the flexibility when it comes to the provision of capital*". This flexibility has been aided by the easing of direct lending regulation in some jurisdictions and the hope is that 2016 will bring more harmonisation in regulation between countries. "*There is a reason our compliance team is five times the size it was in 2008,*" says Kershaw.

So what term should be used? "Market-based lending" has been used in some circles but this remains a somewhat broad label encompassing crowd-based funding, including the relatively nascent peer-to-peer lending industry. "Alternative lending" begs the question of what it is an alternative to. Kershaw prefers "private debt" or "non-bank lending".

The year ahead

2016 looks to be another strong year for the private debt sector. As for its make-up, the expectation is that there will be some direct lender consolidation. "*Our expectation is that there will be consolidation. There are a handful of large players who can set terms and offer value to borrowers. But there are a large group of smaller direct lenders who are in competition and are price takers,*" says Kershaw.

Whatever the year ahead brings, let's hope the private debt industry can cast off its shadows.

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GERMANY

Seminal changes to loan originating funds

by Tobias Krug and Alexandra Heitmann

On 12 May, the German Federal Financial Supervisory Authority *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin) announced significant changes to its administrative practice with regard to loan origination, as well as to restructuring and the extension (*Prolongation*) of loans by investment funds (ref. WA 41-Wp 2100 – 2015/0001).

Given the increasing focus within Europe on alternatives to bank-based credit, the growth of funds originating and investing in loans is one of the most consistent trends in the EU fund industry with assets under management multiplying fivefold in the last two years, albeit from a low base. Loan origination funds, which look to source loan assets for their investment portfolio by directly originating loans (rather than investing via loan participation or assignment), are a key component of this trend.

The new administrative practice

Having changed its administrative practice significantly, BaFin now understands loan origination as well as loan restructuring, i.e. changes to the conditions of a loan after its acquisition, as part of the collective asset management of funds, which is generally excluded from triggering banking licence requirements under German law (section 32 of the German Banking Act (*Kreditwesengesetz*, KWG)). Consequently, loan origination and loan restructuring, which was deemed inadmissible for investment funds in the past, will now generally be viewed as permissible investment activity for certain funds with qualified investors.

Previous administrative practice

Due to the fact that BaFin previously took the view that loan origination by, or for account of, investment funds were generally not permitted (see section 93, para. 4 of the German Capital Investment Act (*Kapitalanlagegesetzbuch*, KAGB)), investment funds were only allowed to invest into loans originated by a fronting bank. Also, the restructuring of an acquired loan by an investment fund was very limited.

What you need to know

- **Loan origination will be permissible for closed-ended special AIFs (i.e. funds with professional and semi-professional investors only).**
- **Loan restructuring will be permissible for AIFs which are allowed to invest into loan receivables subject to appropriate risk management.**
- **Third country AIFs will be allowed to originate loans to German borrowers after passing a distribution notification for their managed AIFs (*Vertriebsanzeigeverfahren*). For EU AIFs, the origination is deemed part of the collective portfolio management and will also be allowed.**

Legal basis of the change in BaFin's practice

BaFin's change of view was based on a revised interpretation of section 93, para. 4 of the KAGB in light of conformity with European provisions. While loan originating and restructuring is not permissible for UCITS (undertakings for the collective investment in transferable securities) according to Directive 2009/65/EU (as amended by Directive 2014/91/EU), the AIFM Directive 2011/61/EU does not generally contradict the permissibility of these activities by AIFs. Moreover, the permissibility of loan origination by, or for account of, AIFs is generally foreseen in recent European legislation (such as the EU Regulation no. 345/2013 on European venture capital funds (EuVECA Regulation), the EU Regulation no. 346/2013 on European social entrepreneurship (EuSEF Regulation) and the EU Regulation no. 760/2015 on European Long-Term Investment Funds (ELTIF Regulation). BaFin is now in line with the European supervisory authority (ESMA) which already deems loan originating AIFs as permissible.

BaFin's requirements for AIFs granting loans

Based on the assumption that the KAGB will be amended in the short term in light of investor protection so as to provide regulations for loan originating funds as well as to avoid systemic issues arising in relation to "shadow banks" (*Schattenbanken*), BaFin strongly advises that all respective fund managers adhere to the following recommendations:

- loan origination should be restricted to closed-ended special AIFs;
- loans may not be granted to consumers and to such persons where the granting of loans would lead to a conflict of interest;
- the use of leverage should be strictly limited and simultaneous borrowing from the general public and granting of loans by funds is not permissible, as this would cause conflicts with the rules of the Capital Requirements Regulation 575/2013/EU (CRR/CRD IV);
- risk diversification and management in accordance with the BaFin circular 10/2012 in relation to Minimum Requirements for Risk Management (MaRisk BA), dated 15 August 2014, must be in place as far as it applies to the origination of loans; and
- a liquidity reserve must be held (although it was difficult to see why a closed-ended fund which is fully funded by equity commitments would need to maintain a liquidity reserve).

Draft law by the Federal Ministry of Finance

A draft law for the implementation of UCITS V (EU Directive 2014/91/EU), published by the Federal Ministry of Finance (*Referentenentwurf des Bundesministeriums der Finanzen*) on 16 July 2015, triggers certain amendments of the KWG and the KAGB in order to implement the administrative changes in relation to loan origination as well as to restructuring and the extension of loans by investment funds set out by BaFin in its interpretation. Requirements and benchmarks set out in the BaFin circular will be provided by law, if the draft law is passed.

Changes to German regulatory provisions proposed by the Federal Ministry of Finance

The draft law includes a proposal regarding the statutory legitimation of loan origination by certain investment funds. According to the draft law, section 93, para. 4 of the KAGB, currently stating that capital management companies may neither grant money loans nor enter into obligations under a contract of surety or guarantee for the collective account of the investors, will be replaced by an amended section 20, para. 8 and para. 9 of the KAGB, according to which loan originating is not permissible for UCITS but will ultimately be permissible for German closed-ended special AIFs (i.e. German funds with only professional or semi-professional investors) and funds subject to the EuVECA Regulation, the EuSEF Regulation and the ELTIF Regulation. The enumeration in section 20 of the KAGB will be exhaustive. However, loan restructuring will not be deemed to be loan origination within the meaning of the KAGB and will therefore be permissible for all AIFs which, under the KAGB, are not subject to product rules (or virtually to no product rules).

Implementation of BaFin's requirements

In accordance with BaFin's requirements for funds granting loans (see above), the draft law increases the scope of application in relation to loan origination to German closed-ended special AIFs and funds with permission under EU Regulations. Furthermore, the Federal Ministry of Finance follows BaFin's recommendations in its proposal in relation to the use of leverage, risk diversity and liquidity management. The use of leverage will be limited to an amount of up to 30 per cent of the aggregate contributed capital of the fund in total, and simultaneous borrowing from the general public and granting of loans by funds is not permissible. The granting of loans to a single borrower is restricted to an amount of up to 20 per cent of the aggregate contributed capital. Special AIFs granting loans or investing in unsecuritised loans (*unverbriefter Darlehensforderung*) have to ensure an appropriate liquidity management (in particular

for the repayment of any borrowings on behalf of, or for account of, the AIF), and the Federal Ministry of Finance will have the power to specify, by way of regulation, requirements for an appropriate liquidity management. The Federal Ministry of Finance will also be entitled to delegate this power to BaFin. All limitations in relation to use of leverage, risk diversity and liquidity management are subject to further limitation standards, possibly implemented at the EU level.

New limits for investments of open-ended special AIFs

The law, if implemented as set out in the draft, limits the investment possibilities in unsecuritised loans (*unverbriefter Darlehensforderung*) of open-ended special AIFs with fixed investment guidelines on the secondary market of up to 50 per cent of the AIFs' net asset value which is criticised by the Federal Association of Investment and Asset Management (*Bundesverband Investment und Asset Management e.V.*) and currently under serious discussion.

Implications for non-German funds

While BaFin makes no reference to non-German funds in its publication, the draft law by the Federal Ministry of Finance clarifies implications on EU funds and third country funds. The draft law proposes to amend the KWG to the extent that both German management companies (*Kapitalverwaltungsgesellschaft*), EU funds and third country funds (which may be qualified as loan grantors) are excluded from the requirements of a banking licence in relation to loan originating and loan restructuring.

EU funds and management companies of EU funds acting under this exception are subject to the same requirements as set out for a German fund (as described above). Third country funds and management companies of third country funds will most likely need to comply with the same requirements as German funds and also pass a distribution notification process with regard to the managed AIF that will originate loans.

Conclusion

In principle, the new administrative practice is a very important and welcome change, providing clarity to the market. However, given that BaFin and the Federal Ministry of Finance have stipulated some relatively problematic requirements, such as the need to comply with specific risk-management requirements, it remains to be seen if these requirements will be implemented in German law and enforced in a sensible manner. If not, non-German funds in particular may continue to rely on the passive lending exception or investing via purchasing bonds.

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FRANCE

The new special limited partnership regime

by Hubert Blanc-Jouvan and Priscilla van den Perre

A new investment vehicle offers investors a structure similar to the Anglo-Saxon and Luxembourg limited partnerships as well as an attractive tax regime.

The new investment vehicle, the *société de libre partenariat* (SLP), was introduced by Law No. 2015-990 of 6 August 2015 on growth and activity (the Law).

Existing corporate form

The legal regime of the SLP is based on the existing French company's legal form – *Société en Commandite Simple*.

This form is, however, new to the French asset management industry: before the Law came into force, French investment vehicles could only take one of the following forms:

- a fund, *fonds commun de placement*, which does not have legal personality; or
- a company having legal personality, organised as a *société anonyme* or a *société par actions simplifiée*.

The SLP will co-exist alongside both these existing forms of French investment vehicle.

SLP also considered as AIF

The SLP will be considered as an AIF and, specifically, as a *fonds professionel spécialisé* – a type of French AIF with very flexible investment rules.

Management and categories of partners

The manager is in charge of the general management of the company and is responsible for any legislative or regulatory infringements, breach of by-laws and any other infringements committed in the course of his management functions. The manager can be freely appointed, in accordance with the provisions of the by-laws, and can also

What you need to know

- **The characteristics of the SLP are similar to those of the Anglo-Saxon and Luxembourg limited partnerships.**
- **Credit funds established as French specialised professional funds (*fonds professionel spécialisés*) could take the form of an SLP.**
- **The SLP benefits from the same French tax treatment as applies to French common funds open to professional investors (*fonds professionnel de capital investissement*) (previously called *fonds commun de placement à risque (FCPR) à procédure allégée*).**

be a general partner (*Associé Commandité*) or limited partner (*Associé Commanditaire*). The full portfolio management of the SLP can be delegated to a third party licensed by the French *Autorité des marchés financiers* (AMF) as an AIFM. In these circumstances, the manager's responsibilities are not diminished.

The general partner may be any natural or legal person designated by the by-laws who has the status of business person (*commerçant*) under French law and holds an indefinite and solidary liability for the debts of the SLP.

Limited partners must belong to one of the following categories:

- specific institutional investors;
- the manager of the SLP, the portfolio management company (if the SLP delegates its portfolio management), the general partner of the SLP, any undertaking providing management-related services investing directly or indirectly in the SLP, including its directors, employees, and any natural or legal person acting on behalf of such undertaking; or
- an investor whose initial subscription or acquisition amount is at least equal to €100,000.

The responsibility of a limited partner for the debts of the SLP is limited to the amount of its investment. The SLP must appoint a custodian, which is a regulated entity.

Notification to the regulator

The creation of the SLP must be notified to the AMF. The detailed provisions of such notification are yet to be published but it is expected that the AMF will exercise certain controls after such notification.

Investment policy

The SLP's investment policy is defined in its by-laws, and regulatory constraints are very limited. Limited partners may be offered the right to participate, to a certain degree, in the investment decision-making process. Before the Law came into force, this was forbidden – only asset

management companies were allowed to make investment/divestment decisions.

Credit funds should be able to benefit from the new SLP form when they are established as *fonds professionels spécialisés*.

The SLP should benefit from a fairly secure regime which provides, in particular, that common bankruptcy rules stemming from the French Commercial Code (*Code de commerce*) should not apply to the SLP.

Tax regime

From a French tax standpoint, the SLP will be treated as the existing *fonds professionel de capital investissement*.

The SLP will not be subject to any French taxation on income and gains derived from its investments.

Non-French investors will be subject to French income tax under conditions similar to those which apply in the case of a direct ownership of the underlying investments, except that French taxation will be triggered only upon distribution by the SLP. Non-French investors will not be subject to any French taxation on income and gains derived from investments made by the SLP outside of France. Gains derived from French investments should also generally not be taxable in France. French source dividend will in principle be subject to a withholding tax in France when on-distributed by the SLP (save for tax treaty exemption) and French source interest will generally be free of any withholding tax.

French investors will be taxable under the same conditions as if they had invested in a *fonds professionel de capital investissement*. Therefore, they will be entitled to opt for a favourable tax regime provided that certain conditions are met and, in particular, that the SLP complies with certain investment quotas.

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EUROPEAN RISK RETENTION

Proposed rules and their application to levered funds

by Cameron Saylor

Increasingly, credit fund managers have sought to enhance investor returns by injecting leverage into their structures. This can be done in a number of ways, but in all cases credit fund managers need to consider if the leverage creates a securitisation for the purposes of the EU risk retention requirements. Absent careful structuring, there is a risk that a levered credit fund could be considered a securitisation and thus be caught by the EU risk retention requirements.

While the rules around what is considered a securitisation have been stable for some time (although market practice has evolved), the rules of who can, and should, retain the risk and in what form have been the subject of considerable change over recent years. These, and the sanctions for non-compliance, are changing again.

The Securitisation Regulation

At the end of August, a draft proposal from the EU Commission for a new European framework regulation for simple, transparent and standardised (STS) securitisation (the Securitisation Regulation) was leaked to the *Financial Times*. A second version was leaked in mid-September and the official version of the Securitisation Regulation was published for consultation at the end of the same month, as part of the Commission's action plan for a Capital Markets Union. It is expected that the Securitisation Regulation will come into force in the second half of 2016 and will apply to all securitisations (as defined in the regulation) entered into after such time (although it should be noted that the draft grandfathering provisions are not entirely clear).

While the Securitisation Regulation proposes criteria to define so-called "STS securitisations" (which will benefit from lower regulatory capital requirements), it is not anticipated, nor in most cases would it be desirable, to classify a credit fund as an STS securitisation. However, the proposed

What you need to know

- **New obligation creates direct legal requirement for managers to retain.**
- **Structuring leverage should be considered in light of the new harsher sanctions.**
- **It is expected that the regulation will come into force in the second half of 2016.**

Securitisation Regulation also proposes important changes to the EU risk retention rules which could be relevant to a credit fund.

The Securitisation Regulation retains the due diligence and risk retention obligations imposed on investors under the current regime. In a similar way to the current regime, investors will be required to verify that one of the originator, sponsor or original lender retains five per cent.

New direct approach to risk retention

The draft, however, also introduces a new direct approach to risk retention, under which "*the originator, sponsor or the original lender of a securitisation shall retain on an ongoing basis a material net economic interest in the securitisation of not less than five per cent*". Effectively, in the context of a levered credit fund that is considered a securitisation, this places an obligation on the credit fund manager to ensure the deal is risk retention compliant.

This change of emphasis from the "indirect approach", which requires investors to diligence the transaction, to the "direct approach", which creates a strict legal obligation on a party to actually retain, needs to be considered in light of the proposed sanctions for failure to comply.

Sanctions for non-compliance

Where an originator, sponsor or original lender has failed to meet its risk retention obligations under the direct approach, the Commission has proposed that individual Member States impose their own enforcement rules. Notably, this is "*without prejudice to the right for Member States to provide for and impose criminal sanctions*".

There are proposed minimum requirements for such sanctions, which include public censure, a ban on employees, and administrative fines of between €5m and ten per cent of total annual group turnover of the entity in question. The proposed regulation also provides that sanctions for failure under the direct approach be extendable to "members of the management body" of a non-compliant entity and to other individuals who, under national law, are responsible for any infringement. This amounts to board-level sanction.

These proposed sanctions (including the possibility of criminal liability) are significantly harsher than those applicable to investors under the current and the new regime. As a result, when the new Securitisation Regulation comes into force, it will be more important than ever for credit fund managers to carefully consider the structure of any leverage injected into their credit funds.

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US CLO RISK RETENTION

One year of development, one year to go!

by Eric Bothwell

One year ago, the US CLO market received final word on the risk retention framework that will dictate the path of our market on an ongoing basis.

While the market has previously adapted to regulatory and accounting change adopted in reaction to significant market events (e.g. Asian and Russian crises, Long-Term Capital, Enron, Internet Bubble), the risk retention rules will likely have the most significant ongoing impact on this market since its inception. This impact has begun to be evidenced directly on the face of deals through structural adaptation, but overall has the potential to have broader ripple effects on the economic attractiveness of this market to underwriters, managers and investors, and therefore the ongoing mix of market participants.

Over the course of the last year, many smart people have spent a lot of time thinking about what these rules mean, how broad-reaching they are, and how our market should respond. While the manager community is perhaps foremost in directly being affected by the rules, they and their counsels have been joined by underwriters and their counsels, accountants, lenders and third party investors in taking the first steps toward the new look for our market. That combined effort has made great strides in the last year toward potential solutions but, perhaps not surprisingly for change of this magnitude, there are a range of opinions as to what will be required for compliance.

Impact on managers

Perhaps the most progress has been made by managers with pre-existing deep pockets and with operating models that already include a higher degree of capital commitment and more active involvement in asset origination and accumulation. Many of these managers have found that the five per cent base risk retention requirement is already satisfied in their transactions, or can be easily adapted to through a modestly larger commitment of capital to which they already have access. Interestingly though, many of these managers have been slow to broadly claim compliance with risk retention even though their outstanding transactions

comply, or could comply, with minor changes. Given the lack of consensus in the market on certain aspects of compliance, there seems to be a reluctance by people to be the "first ones into the pool". The visibility and scrutiny that first movers might receive from both the market and the regulatory community is something many would perhaps wish to have their competitors face first. Hopefully, as we move toward the December 2016 deadline for compliance we will see some of the more prominent managers in the market abandon this "game of chicken" and take a leading role in guiding the market forward.

The segment of the manager market without pre-existing access to larger amounts of capital will face the most material changes. These managers' business models have been built around minimal co-investment in the transactions and a more traditional agency-type manager role. If these managers wish to continue to be a part of this market they have no choice but to look for partners. Risk retention rules can be satisfied by purchase of either a vertical or horizontal strip in the related CLO. Which of these options a manager pursues will dictate the type of partner to be identified and the relationship with that partner.

Horizontal strip retention

Retention of a horizontal strip will most often be structured as a purchase of a large portion of the CLO equity. In that situation, the partner to be identified will be joining the manager as an equity partner in risk retention, and the risk-return profile offered to potential partners will look very similar to CLO equity. The investment, though, will be structured as a direct investment in a manager vehicle or as a joint investment with the manager in a manager subsidiary. As a result, the investment will not have the liquidity, clarity of valuation and control of a direct investment in CLO equity. In exchange for accepting those features, potential equity capital partners are requiring a participation in the management fee earned by the manager or some other economic incentive to participate. Also, as an equity co-investment, in addition to the economics, these partnerships raise questions regarding control issues and voting rights in either the manager vehicle or subsidiary. For managers with simpler business models, these control issues and voting rights are perhaps more easily resolved, but managers with more developed businesses and/or multiple lines of business will find it more difficult to balance their interests with the interests of these potential partners.

Vertical strip retention

Retention of a vertical strip has the potential to eliminate or minimize the need for equity partner capital and instead can be structured with a financing partner. In this structure the manager (and perhaps an equity partner) take a subordinated position in the retained interest while obtaining financing on a senior portion of the retained interest. A common proposed example is a 20 per cent subordinated position coupled with 80 per cent senior financing. From a risk perspective, market participants will likely look at that senior risk as Aa2/AA area risk on a rough-pass-through basis from the underlying CLO. Providers of this financing will likely index the cost of providing this financing to the underlying CLO financing, although, not unlike the equity partnership discussed above, they will add a premium to that related CLO financing cost to compensate them for the specialized nature of financing the risk retention.

What you need to know

- **Five per cent risk retention required of CLO managers as the "securitizer", effective December 2016.**
- **Horizontal and vertical strip options for compliance available, each presenting unique issues and costs.**
- **Compliance potentially brings additional capital into the sector as equity partnership funding or financing.**

Through either of these approaches, managers should be able to meet their risk-retention requirements, but at a cost. Common proposed structures in the market today have managers obtaining a combination of equity partnership and financing for anywhere from 50 per cent to 80 per cent or even 90 per cent of their risk retention. In fact, theoretical basis exists for structuring as much as 96 per cent of a manager's risk retention through equity partners and financing, although many participants believe that taking that aggressive an approach is likely to be rejected by the market overall and/or to attract the type of regulatory scrutiny that managers do not want.

Cost of compliance

Whatever the percentage of third party involvement, the key for the manager becomes the net cost, either through sharing of management fee with equity partners or through excess financing spread of that involvement. Reduced net management fee or reduced income on the retained interest directly affects a manager's bottom line and will reduce the profitability of existing management franchises, as well as create barriers to entry for new market entrants. Whether managers are able to dictate revised economic terms with other market participants in order to "share the pain" of compliance remains to be seen.

An interesting year ahead

We have made a lot of progress in the last year, but the upcoming year will be an eventful one as managers find their partners, if necessary, and take formal steps toward compliance. While the core underlying concepts of retention will be present in all approaches, exactly how those concepts will be implemented will be a customized solution fitting each manager. This is a time of change in the US CLO market, but the market has matured in many ways over the last 20 years and the changes we will go through over the next year to fully implement risk retention are just further evolution to which the market will adapt.

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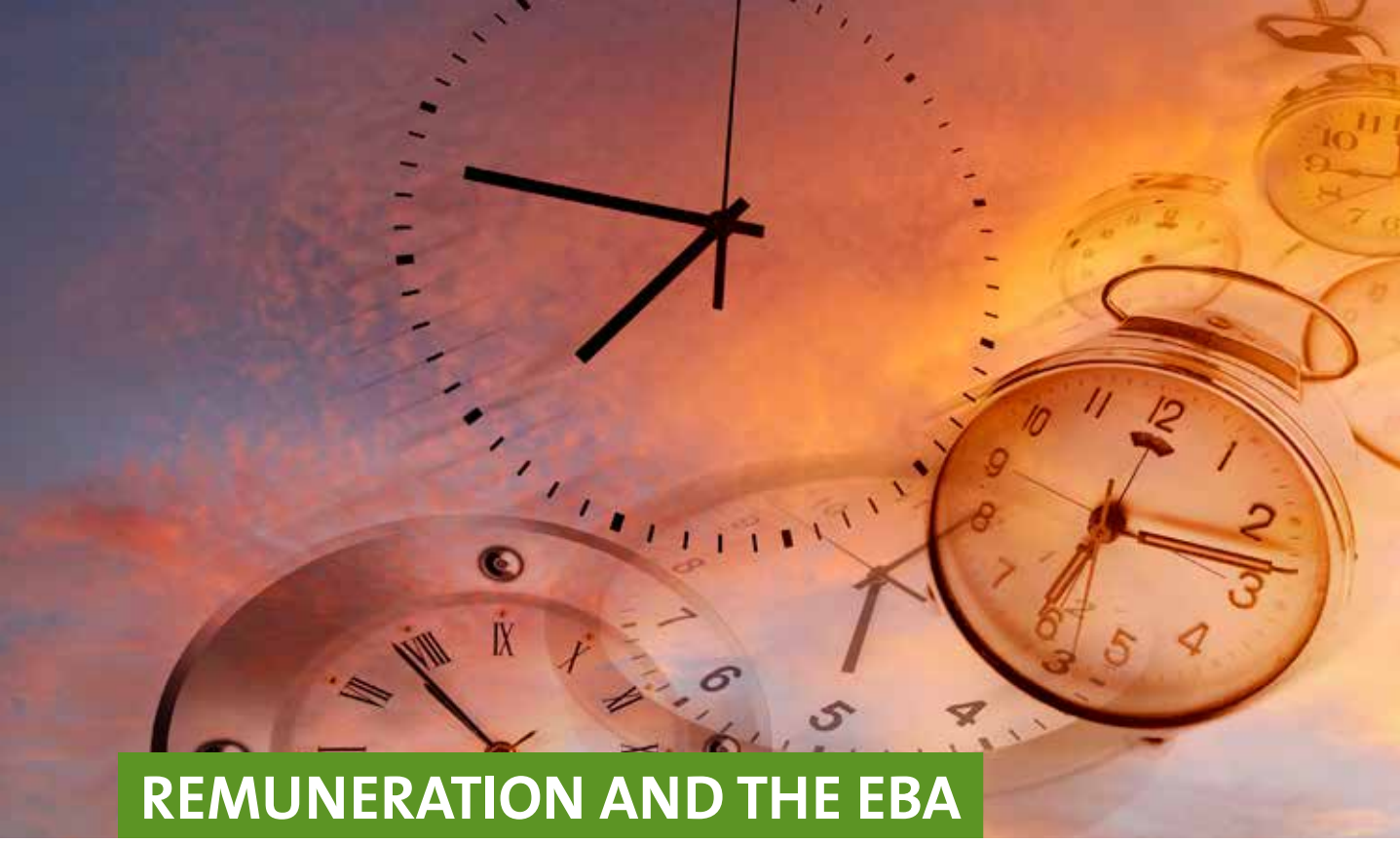


REMUNERATION AND THE EBA

The wait is almost over

by James Perry

If it seems quite a long time since the European Banking Authority (EBA) published its consultation paper on the guidelines for "sound remuneration policies" (4 March to be precise), well, it is, given the importance of the subject for credit managers and others in the industry.

To refresh readers' memories, the EBA's proposals in March of this year threatened the concept of proportionality and would lead (if issued without material change) to a major overhaul of the current remuneration rules. The market is expecting some feedback from the EBA during this calendar quarter (indeed, we may be summarising the new position in our next edition!). In the meantime, we set out below the issues at stake and the possible implications for the industry.

Background

In the UK, rules intended to combat "unsound remuneration practices" (or, more bluntly, excessive bonuses) in financial institutions following the global crisis have been with us for around five years. At the EU level, regulation was originally introduced by the Capital Requirements Directive III on 1 January 2011 (CRD III), a European directive that includes rules in relation to certain firms' prudential and remuneration requirements. CRD III was supported by detailed guidelines produced by the EBA in its former, non-statutory guise as the Committee of European Banking Supervisors (CEBS).

It was this CRD III package and the CEBS guidelines which introduced the important concept of proportionality: namely, that institutions should apply the remuneration rules in a manner and to the extent that is appropriate to the institutions' size and internal organisation.

The idea was that rules on pay should be applied to match the scope and scale of institutions' businesses and risk appetites: the rules were not meant to be "one size fits all". This was important because, in the EU, these rules didn't just catch (deposit-taking) banks; they also caught "investment firms" regulated under the Markets in Financial Instruments Directive (MiFID), including a random assortment of agency brokers, asset managers, proprietary traders, corporate financiers and so on.

In particular, the CEBS guidelines confirmed that it was possible to "neutralise" (i.e. not to comply with) certain rules if, in essence, your business model did not warrant it. These rules (which could be neutralised) included:

- the requirements for 40 per cent to 60 per cent of bonuses to be deferred over a period of at least three to five years;
- for at least 50 per cent of bonuses to be paid in shares or other suitable instruments; and
- that awards should be subject to "performance adjustment" ("malus" for vested awards and "clawback" of vested or paid amounts).

Then, on 1 January 2014, the new Capital Requirements Directive – CRD IV – came into force, which introduced the "bonus cap" ("variable" pay being limited to the amount of "fixed" pay, or twice the amount of fixed pay if shareholders agree) and a remarkably broad definition of a "material risk-taker". Still, though, the proportionality principle was present to ensure a sensible outcome.

EBA position

If the rain clouds were already gathering over remuneration (following the UK's failed European challenge to the bonus cap), the EBA consultation appeared to herald the storm for many financial businesses. This is because the EBA has decided, after careful deliberation, to eviscerate the proportionality principle. Worse still, the Commission fully agrees with the EBA analysis – there must be no exceptions or exemptions.

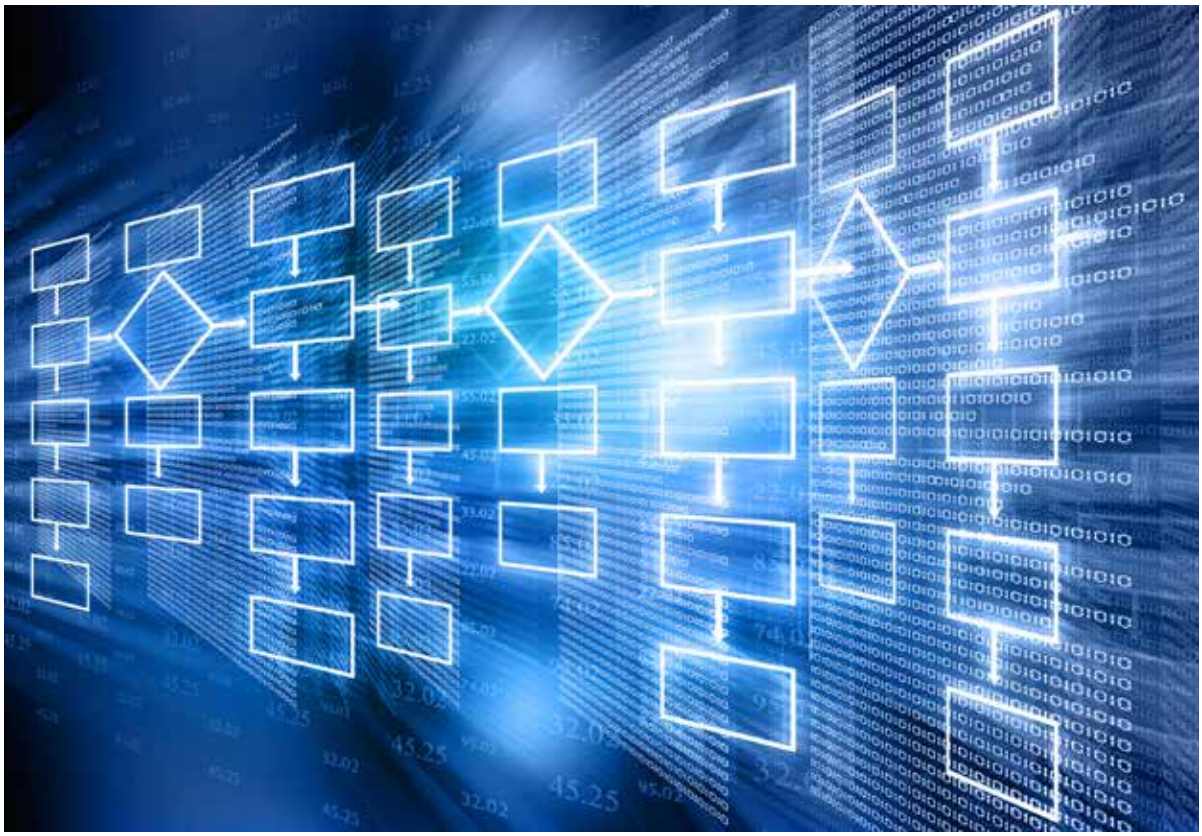
There are further concerns for banking groups, in that the EBA seems to envisage even more consumer-facing individuals being drawn into the net (seemingly in order to catch some sales and marketing teams, for example) and that the requirements for consolidation groups (including overseas and non-banking subsidiaries) may become even more difficult. Banks and trade associations have attempted to clarify this position during the consultation.

What's going on here?

The proportionality principle is not new, so why has the EBA (and the Commission) suddenly decided it is unlawful? We suspect that it is related to how governments and regulators globally remain concerned with systemic risk outside of mainstream banking groups, i.e. the so-called "shadow banking" sector.

Shadow banking is a difficult term to pin down, but broadly refers to credit intermediation (i.e. the lending of money) by certain non-deposit-taking entities (such as hedge funds) that are not subject to equivalent regulation to mainstream banking groups. If there are shadow banking risks lurking within the European investment industry, the EBA may think that stronger regulation of pay is one obvious way of exposing and combating it.

If this is the EBA's target, it has used a sledgehammer to crack (an admittedly nebulous) nut. The main problem (and there are several) is that the EBA's proposals would capture businesses that pose little or no systemic risk at all. Credit fund and CLO managers, for example, do not carry material risks on their balance sheets, nor do they create financial risk of systemic importance. Put simply, the EBA's proposals catch many irrelevant and innocent victims, and will cause significant commercial damage.



What will businesses do?

If the EBA does not change its stance, it is possible that some business models will cease to be viable, and that others will have no obvious route to compliance. Firms will undoubtedly consider a number of possibilities such as (and much will depend on the type and nature of business conducted):

- moving particular business lines or services into different entities so as to minimise the number of CRD IV-regulated firms a group has;
- discontinue a service or business line which would otherwise bring a firm into CRD IV scope – proprietary trading and custody, for example. This route is currently not available to credit managers which act as "sponsors" of CLO transactions, however; and/or
- US or Asian banking groups may decide to move entities, businesses or people out of a European sub-group or entity.

Of course, there will be others and much depends on the facts. Another moving part is whether the Financial Conduct Authority (FCA) will choose to follow a similar path in its remuneration code for those investment firms which fall outside CRD IV. If the FCA decides to maintain the status quo, that may offer a solution for some firms. If the FCA does not, then this will prove a further headache for the industry. It is interesting to note in this regard that the FCA chose to confirm its existing remuneration code (in SYSC 19A), including its proportionality guidance, after the EBA published its consultation paper. It is no secret that this reflects the FCA's (and the Prudential Regulation Authority's) disagreement with the EBA's view and approach.

What you need to know

- **The EBA's draft guidelines for remuneration have threatened to undermine the "proportionality" principle for credit managers and others.**
- **Structural changes in the industry may occur if the guidelines are implemented as proposed.**
- **The position will become clearer when the EBA publishes feedback and confirms its position (probably Q4).**

What next?

We continue to wait – but not for long. We hope to be able to report better news shortly.

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UK GOVERNMENT

Promoting P2P lending through changes in tax

by Nicholas Gardner and Paul Miller

The UK Government has recognised the growth of the peer-to-peer (P2P) industry through several announcements made over recent months, particularly in the Summer Budget, setting out plans for changes to the taxation of P2P lending.

In issue 4 of Credit Funds *INSIGHT*, the exponential growth of the P2P lending industry was highlighted. This has been recognised by the Government through several announcements made over recent months, particularly in the Summer Budget, setting out plans for changes to the taxation of P2P lending. The Government's objective is to encourage the growth of the P2P sector and, in doing so, improve competition in the banking sector, providing savers and investors with an increased choice of investments, and individuals and small enterprises with another potential source of capital.

Withholding tax consultation

HMRC has consulted on a new withholding tax regime for UK P2P lending.[1] HMRC accepts that the current rules (which apply to interest other than that paid by banks or building societies on deposits) are difficult for P2P platforms to apply, and cause confusion for prospective lenders and borrowers.

Under the current system of interest withholding tax, the treatment of the interest depends on the identity of the borrower, and the identity and location of the lender. Borrowers and/or P2P platforms may be obliged to pay interest gross to some lenders, and net of withholding tax to others. This is also confusing from a lender's perspective, as they may be receiving both gross and net interest on loans made through the P2P platform. Furthermore, the P2P platform may have confidentiality agreements with borrowers which prevent it disclosing the identity of the borrower to the lender and/or vice versa.

The proposals being considered are whether the obligation to deduct tax should be placed on the platforms, and whether the applicability of withholding on a P2P loan should depend only on the status of the lender.

1 See "Deduction of income tax from interest: peer-to-peer lending", HMRC consultation document, published on the gov.uk website, July 2015.

What you need to know

- **Withholding tax rules for P2P loans will be simplified.**
- **The ISA rules will be amended to create a new type of ISA for P2P loans.**
- **Individual investors in P2P loans will be able to benefit from a new P2P bad debt relief.**

In relation to the first question, the aim is to simplify the process without constraining the P2P market by not allowing any flexibility as to who deducts the tax. The consultation document envisages a potential way round this, being that interest could be deducted either by the platform themselves or another intermediary who undertakes payment services on their behalf.

In relation to the second question, it is intended that income tax would be deducted at source if the lender is an individual or is based overseas.

An alternative to the introduction of a new withholding tax regime for the P2P sector would be to abolish the deduction of tax at source completely – this would arguably achieve the simplest result. This prospect is currently being explored (among other options) by a separate consultation on the deduction of tax at source from interest other than that paid by banks and building societies which will apply to P2P arrangements.[2] A decision to abolish withholding tax on such interest would render the P2P consultation obsolete, as all interest would be paid gross.

P2P ISA investments

The Summer Budget also announced the introduction of the new Innovative Finance ISA. This followed a consultation held at the end of last year, and confirms the Government's intention to allow P2P loans to be held in an ISA from 6 April 2016, to achieve its objective of increasing the choice of investments available to ISA investors and encouraging the growth of the P2P sector.

The rationale behind the creation of a third type of ISA is to "*send a clear signal to consumers that peer-to-peer loans are different to more traditional forms of investment*"[3] – a fact that is highlighted by the restrictions on withdrawal and transfer due to the lack of guarantee that all P2P platforms will have an active secondary market. With most of the larger P2P platforms offering a secondary market, this is unlikely to prevent investors taking advantage of this welcome opportunity to enjoy tax savings on a new type of investment which generally offers a higher return than banks' traditional

products, and we would expect this to result in further growth in the P2P lending sector.

Other conclusions reached include the Government proceeding with its proposal to make advising on P2P loans a regulated activity, although investors will not be protected by the Financial Services Compensation Scheme. Also, P2P platforms that become ISA managers will not be required to legally own or co-own loans held within the ISAs they manage. This should provide additional flexibility for structuring these arrangements.

The ISA eligibility of P2P loans accompanies the announcement that, from 1 July 2015, it is generally sufficient for the relevant bonds or shares to be held in an ISA to be admitted to trading (even if unlisted) on a "recognised stock exchange" within the European Economic Area. Previously, where a group has not had its shares listed, its unlisted bonds were not ISA-eligible.

A separate consultation on whether to include crowd-funded debt securities and equity investments as ISA-qualifying investments is also underway. The ISA regime is perceived to be relatively low risk and limited to regularly traded assets. One wonders whether extra safeguards

2 See "Deduction of income tax from savings income: implementation of the Personal Savings Allowance", HMRC consultation document, published on the gov.uk website, July 2015.

3 See "ISA qualifying investments: response to the consultation on including peer-to-peer loans", HM Treasury report, published on the gov.uk website, July 2015.

might be appropriate for crowd funding or whether the existing tax relief regimes, such as the Seed Enterprise Investment Scheme relief, better promote such investments in a context where investors would be aware of the level of investment risk.

Bad debt relief

A new measure was announced in last year's Autumn Statement providing for bad debt relief when lending through P2P platforms. More information on this was released in the March Budget. This relief provides that if a P2P loan is not repaid, the loss suffered by an individual lender of that loan can be set against the pre-tax income that individual receives on other P2P loans (but not against non-P2P income).

It is intended that the relief will be available when a loan has been determined to be a "bad debt" (HMRC is currently in discussions with P2P platforms on that definition) and either formal recovery procedures have been commenced or the debt has been released by the lender.

Some established P2P platforms operate a "safeguard" or "provision" fund to mitigate the risk of their participating lenders losing their money. In the event a borrower misses a payment, investors are repaid out of the fund, ensuring there is no delay in receiving interest due. For P2P platforms operating a compensatory mechanism such as this, losses are actually suffered by the platforms rather than the individual lenders and this relief is unlikely to be available for the P2P platform.

Conclusion

The Government has clearly embraced P2P lending as an important source of capital and these measures should promote an upsurge in the amounts invested in P2P loans and in investment in equity crowd-sourcing structures.

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AIFMD

Annoyingly Inconsistent Frankly Maddening Directive?

by Jake Green

In issue 4 of Credit Funds *INSIGHT*, our (slightly tongue-in-cheek) article titled "AIFMD: Absolutely Insufferably Fundamentally Materially Defective?" was intended to highlight how difficult it has been for the funds industry, and indeed us poor practitioners, to adhere to all of the requirements of the AIFMD.

Following our article (but, alas, not as a result of it), ESMA published in July both its "advice" and "opinion" in relation to the application of the AIFMD passport to non-EU AIFMs and AIFs, and an "opinion" on the functioning of the existing passport and the national private placement regimes. The key points from these documents are summarised in our briefing "ESMA AIFMD advice and opinion on NPPR and passporting regimes", available on ashurst.com.

However, it is also useful to look at our previous "complaints" relating to the AIFMD and to consider whether they stand up to scrutiny following the evidence detailed by ESMA in its recent publications (they do) and to discuss whether things have got any easier (they haven't).

The ESMA "advice"

The advice paper considers the AIFMD provisions which allow for the extension of the marketing passport to non-European AIFMs and European AIFMs managing non-European AIFs.

In its advice, ESMA has stated that Jersey, Guernsey and Switzerland are equivalent and are therefore approved jurisdictions, meaning that European managers with funds domiciled in those jurisdictions can utilise the marketing passport for such funds. It also means that AIFMs set up in those jurisdictions may apply to the "relevant EU member state regulator" (which depends on detailed criteria) for full authorisation under, and be subject to full compliance with, the AIFMD, and may then market those non-EU AIFs throughout the EU on the basis of the AIFMD marketing passport.

Perhaps the most interesting points to come out of the paper are not the identities of the countries that have been "approved", rather those countries that are currently not approved and the reasons given for this. For example, one of the "reasons" (and it is easy to be sceptical in relation to this) why ESMA noted that the US should not be deemed equivalent was in relation to the regulatory structure in the US regarding "investor complaints". ESMA points out that the mechanism created by the SEC to resolve investor complaints "cannot force a firm to resolve the complaint". Highlighting this issue seems somewhat bizarre in the context of AIFMD which is, for all intents and purposes, a "professional" investor directed directive, and it should be noted that in the UK (as an example) there is no formal regulatory process in relation to professional investor complaints either. It also strikes us as an anomaly that there appears to be no evidence put forward indicating that an EU national competent authority (a regulator) has refused a fully completed national private placement application from a US manager. Therefore, it seems somewhat odd to suggest that the US cannot be viewed as an approved jurisdiction vis-à-vis a passport. Clearly, there are political reasons for this decision, particularly those related to "equivalence" (in the regulatory context) that extend far beyond the AIFMD. In summary, we are therefore left with nearly 200 pages of somewhat contrived information leading to results that most might view as being pre-determined.

The *timing* aspects of the extension to the AIFMD passport are also interesting. Within three months of receiving "positive" advice (i.e. in relation to the countries detailed above) and an opinion from ESMA, the Commission should adopt a Delegated Act specifying the date on which the legislative provisions in the AIFMD will become applicable, whereupon the AIFMD passport would then be extended to non-EU AIFs and non-EU AIFMs. Given that ESMA has only provided such advice in relation to Guernsey, Jersey and Switzerland, it is not clear as to whether the Commission will adopt its Delegated Act and "activate" the passport for AIFMs and AIFs from those three countries within three months of the advice and opinion (i.e. around November 2015) or wait until more countries have been assessed positively by ESMA. If the Commission takes on board ESMA's suggestion and waits until a sufficient number of non-EU countries have been positively assessed, then the Delegated Act may not come into being until 2016.

This timing is important for other related reasons. Three years after the Delegated Act (therefore maybe in 2018 or 2019), ESMA will issue an opinion on the function of the passport for non-EU AIFMs and AIFs, and advice on the (potential) termination of the national private placement provisions. Further, the AIFMD is going to be the subject of a review in 2017. It is therefore possible that around this time the regime, in relation to marketing, may be overhauled (and, indeed, if ESMA is reading and understanding the evidence (see below) that they are receiving, they should).

The ESMA "opinion"

Moving on to the "opinion", where we can really compare our previous thoughts in relation to the AIFMD with the evidence that ESMA has received.

On the face of it, we must have been wrong, given ESMA's high-level statement in relation to the national private placement and passport regimes – which apparently have seen no "major issues" – but ESMA requires longer periods of time to gather more evidence to form a final conclusion.

However, when one scratches beneath the surface, the situation appears somewhat different and below is a summary of some of the issues highlighted by respondents to ESMA's call for feedback. (As a side note, if ESMA views the below as not constituting "major issues", then perhaps this is the litmus test that should be used when a fund manager AIFM considers what constitutes a "material change" for AIFMD purposes.)

The marketing passport

Firstly, we must consider what the intention of the benefits of the passport was meant to be. If a European manager (with a European fund) has a marketing passport, it should simply be able to go into another member state and market its fund. This should involve three simple steps:

i. an application to home state regulator;
ii. the application is sent onward to other relevant regulators; and
iii. marketing begins.

If there are any other steps involved in the process, one must question what the point of the whole thing is. Unfortunately, respondents have "identified" (in the same way that one identifies the proverbial elephant in the room) issues, including:

- differing fees charged by competent authorities;
- definition issues in relation to "professional investors"; and
- importantly, a varying interpretation on what constitutes "marketing" in the various jurisdictions.

This final point should not be underestimated and, indeed, is what we previously referred to as the "chicken and egg" problem that appears in many member states where regulators are of the view that marketing cannot commence until all documents are in final form (which is incredibly difficult to do if one is not allowed to negotiate such documents with investors in the first place).

As an ancillary point, ESMA did pick up the fact that certain regulators had implemented additional national requirements compared to the provisions of the AIFMD (such as requiring a centralising agent through which all payments must be channelled) which we (and others) view as a clear breach of the directive.

In summary, the passport does not completely do what it should but, according to ESMA, this is not a "major issue".

National private placement regime

Unsurprisingly, there were far more issues uncovered in relation to the divergent approaches by competent authorities under their respective national private placement regimes. These relate to many of the issues which we previously identified, such as fee discrepancies, timing problems and general information, and process uncertainties that make the whole process extremely difficult for fund managers to manage (and, for smaller fund managers, almost operate as a barrier to entry).

However, what is more striking, is some of the detail provided by respondents and which seems to sum up the whole process:

- *"Among those surveyed, 52% of respondents believe that AIFMD registration requirements have in fact had a somewhat or very negative impact on European limited partners, due to uneven implementation of the AIFMD and the additional requirements posed by certain national regulators";*
- *"The regulation might make sense if fund managers were addressing retail investors, which is, however, not the case. We feel the regulation is restricting our access to top fund managers rather than providing us with any benefit";*
- *"We do not see any positive impact, only a potential delay in coming to market because of a lack of registration capacity by authorities".*

Indeed, a pie chart is included in ESMA's paper which indicates that only around ten per cent of respondents believe that the AIFMD registration requirements had any positive impact in relation to investor protection.

Lastly, it does appear that the frustrations around the AIFMD are (again, as anticipated) going to increase as managers begin to feel the full effect of the regulator reporting requirements under the AIFMD. There is a lot of evidence that there is duplication in relation to the reporting process which creates additional costs, particularly since many member states have different interpretations as to the detailed requirements necessary to comply with these obligations and different forms and process for doing so.

Concluding thoughts

What this all points to is the inability of fund managers to be able to properly comply with the AIFMD. Put another way, we do not consider that it is possible (certainly in the case of the national private placement regimes) for a fund manager to be able to market a fund in multiple European jurisdictions while complying with the letter of the rules in each jurisdiction simply because it is impossible to line up all the pieces in the same direction. Therefore, an educated, risk-based approach is perhaps the best a manager can hope for. According to ESMA, however, this is not a "major issue"! More interesting is a point that will perhaps impact beyond the fund managers' world – in the regulatory sense, the US is a long way from being deemed "equivalent".

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TECHNICAL SPOTLIGHT

New UK withholding tax exemptions

by Paul Miller and Derwin Jenkinson

HMRC has been consulting on the new UK interest withholding tax exemption for qualifying private placements. This was initially announced in the Autumn Statement 2014 as a means "to help unlock new finance for businesses and infrastructure projects" and some details were contained in the Finance Act 2015.

However, the key remaining details are to be included in secondary legislation, a further draft of which has been doing the rounds. Many of the more restrictive conditions previously included in earlier draft provisions have now helpfully been dropped and the exemption will now be available to all loans meeting the criteria, including those entered into before the exemption comes into effect.

Critically though, it seems increasingly clear that the benefit of the exemption is, in practice, likely to be limited to lenders resident in countries which have double tax treaties with the UK. Perhaps the biggest impact is that many lenders in China, Japan, Korea, Italy and Indonesia will now be able to lend direct to the UK without suffering any withholding. That could open up some new sources of capital.

It is now clear that this new qualifying private placement exemption will not be as seminal a change as had originally been hoped. However, there is a second ongoing consultation which could lead to further relaxation of the UK withholding regime in the Finance Act 2016.

This article deals with the qualifying private placement exemption now that its outline is reasonably clear. Final details will be released by HMRC towards the end of 2015.

Background

Private placements are much more common in the US than has hitherto been the case in Europe.

There is a widely held view that the depth and resilience of the US private placement market helped speed economic recovery, as lenders – other than the traditional banks –

What you need to know

- **Benefits to lenders resident in countries which have double tax treaties with the UK. Many lenders in China, Japan, Korea, Italy and Indonesia are now able to lend direct to the UK without suffering any withholding.**
- **Final details of the qualifying private placement exemption will be released by HMRC towards the end of 2015.**
- **There will be a possible further relaxation of UK WHT rules some time in 2016.**

stepped in to fill the funding gap as banks shrunk their balance sheets. This has led to a well-publicised effort to develop a pan-European private placement market.

A typical private placement involves direct lending by non-bank investors, such as pension funds, insurers and fund managers.

Current withholding tax position

By way of background, the UK generally imposes a 20 per cent withholding on payments of interest by UK incorporated companies (and some foreign companies with a UK connection) on loans or debt securities, but only where the loan or debt is intended to last more than a year.

The UK's quoted Eurobond exemption disapplies withholding tax (WHT) from most listed bonds. However, that quoted Eurobond WHT exemption does not generally apply to private placements of debt securities issued by UK incorporated companies since such issuances are usually, by their very nature, unlisted. Most UK lenders that are either incorporated as a company or are registered as a pension fund with HMRC can avail themselves of a WHT exemption. But the position for non-bank lenders – the category of lenders the new exemption is designed to stimulate – is more difficult where they are incorporated outside the UK.

Even where they cannot use the above exemptions, though, that is not necessarily fatal. That is because those lenders, resident in other jurisdictions that have a UK tax treaty which reduces the WHT to nil, can generally still apply to HMRC for exemption from withholding. Historically, this was a somewhat painful and time-consuming process involving a formal tax treaty clearance application to HMRC. Since 2010, HMRC has offered an alternative, more streamlined, process known as the double tax treaty passport (DTTP). In our view, that works well, though it also takes a little time and paperwork.

"Qualifying private placement exemption"

This new "qualifying private placement exemption" is designed to simplify matters for many such lenders in treaty jurisdictions. It will not assist lenders incorporated in tax havens such as, for example, many hedge funds. This new exemption is an alternative; as a matter of law, lenders can continue to claim treaty relief, or other available exemptions if they prefer, subject to whatever contractual provisions are contained in the underlying debt documentation.

Following an initial consultation, both the primary legislation and the draft regulations impose fewer conditions than the original December drafting. Our thoughts on the currently proposed conditions are set out below.

What are the conditions for the exemption?

Two sets of conditions need to be met. The first set of three conditions was included in the Finance Act 2015 and provides that the WHT exemption is, subject to the further conditions under discussion below, available for:

- interest paid on a security;
  - which represents a loan to which a company is a party as debtor; and
  - which is not listed on a recognised stock exchange.

It is worth noting that:

a. HMRC's clearly stated guidance is that the exemption will be available for debt taking the form of loans, facility agreements, etc., as well as that structured as a note or bond;
b. the exemption applies whether the debt is in bearer or registered form; and
c. in theory, the exemption applies whether the debt is cleared or not or, if cleared, where it is cleared (as long as the debt is not also listed on a recognised stock exchange where the quoted Eurobond exemption might be expected to apply). However, the practicalities of the certification requirements set out below means that the exemption may be less useful for cleared instruments.

Additional conditions in the draft secondary legislation

The draft secondary legislation specifies that the following further conditions must be met:

1. Securities

The securities may not have a term exceeding 50 years

There is no minimum term specified. As noted above, though, where the term is less than a year (i.e. commercial paper), there is generally no UK WHT in any event so the exemption will not generally be relevant for such paper.

The security or the placement as a whole must have a minimum value of £10m

But subject to that, there is no upper limit for the availability of the exemption.

2. Creditor

The creditor will generally be the beneficial owner of the relevant securities. That is straightforward when a lender holds a loan directly or via a nominee and has not sought to reduce its economic exposure through, for example, a sub-participation or hedge. What is less clear to us, under the current drafting, is who the "creditor" is where there is a sub-participation or similar risk transfer mechanism involved.

The debtor reasonably believes that it is not connected with the creditor

This requirement has presumably been included to prevent

intra-group shareholder debt availing itself of this new exemption. That is not surprising given all the historic discussions around shareholder debts structured as quoted Eurobonds.

The "creditor" also needs to certify that it meets the following conditions:

The creditor is "resident" in a "qualifying territory"

This is a key condition regarding the width of this new exemption.

A "qualifying territory" is, broadly, the UK or a territory with which the UK has a double tax treaty with a non-discrimination provision. The fact that the UK does have tax treaties with a number of tax havens – generally to exchange information, etc. – sometimes causes confusion. However, those treaties with tax havens do not generally have a "non-discrimination provision" (effectively a clause providing that the UK will not discriminate against nationals of the tax haven as compared to UK nationals). That is why this exemption will not directly assist lenders incorporated in tax havens (for example, many hedge funds).[1]

The requirement is that the creditor be "resident" in a qualifying territory. In this draft legislation, "resident" means "liable to tax" in that territory. Note that this condition means that such a lender would, subject to what is covered below, often already be able to avail itself of relief under the relevant double tax treaty (assuming the relevant filings were made).

The term "resident" does, perhaps surprisingly, generally

1 There is a (slightly historic) list of the treaties that HMRC considers qualify in the HMRC International Manual at INTM412090, hmrc.gov.uk.

cover a foreign pension fund or charity even if it is tax-exempt in its home jurisdiction.[2]

However, the requirement that the lender be "resident" means that this new exemption will not directly help those private equity, mezzanine or infrastructure funds set up as partnerships, whether established in the UK or elsewhere. Again, that is because to qualify as "resident", the lender effectively needs to be a taxpayer in the relevant jurisdiction. Partnerships are, on the whole, tax transparent and so will generally not qualify. Theoretically, it may be that one could look through to the partners and whether the partners themselves satisfy this condition but the practicalities involved in most investment funds mean that that is of little practical use as drafted.

The current drafting is far more likely to assist where a fund partnership has incorporated a subsidiary entity, such as a taxable Luxembourg company. Indeed, this new exemption could conceivably be very useful, in this context, if work under Action 6 of the OECD Base Erosion and Profit Shifting Plan restricts the ability of such subsidiaries to access treaty relief.

Interestingly, it is not relevant for these purposes whether the treaty actually reduces the rate of UK withholding to nil (as it does under most of the UK treaties) or to, for example, ten per cent (as it does under the current UK treaties with China, Japan, Korea, Italy and Indonesia). Thus, this is a really positive development in terms of attracting inbound investment from those countries as, historically, they would generally have suffered ten per cent withholding if they had originated or acquired loans to UK borrowers which were not in the form of quoted Eurobonds.

2 See INTM162040 on hmrc.gov.uk and the principles in *Weiser -v- Revenue and Customs Commissioners* [2012] SFTD 1381.

This exemption will, where the other conditions are met, remove that cost for them.

The creditor holds the security for genuine commercial reasons and not as part of a tax advantage scheme

This sort of provision is now fairly standard in new UK tax legislation. What will be interesting to understand is its application to some commonly seen arrangements. The creditor will be required to certify that it meets these conditions. The borrower is able to rely on that certification and, absent inappropriate behaviour, should therefore not be at risk if the creditor's certification turns out to have been incorrect. This does place additional burdens on investors, but these will be less onerous than under a full treaty claim, although the difference may be minimal as compared to the filings required where a lender already has a DTTP number.

As with the other UK exemptions, the exemption is looked at on a lender-by-lender basis. It is therefore possible that some lenders will qualify for the exemption and some will not, but the existence of the latter camp does not, of itself, prejudice the availability of the exemption for the former camp.

Outstanding issues

There are a couple of aspects that Ashurst is still discussing with HMRC, in particular, whether the following will be able to benefit from the exemption:

a. UK lenders lending through partnerships; and
b. offshore incorporated borrowers.

The wider HMRC consultation

HMRC is currently undertaking a full review of options in relation to withholding on interest, including considering its abolition. That review was started as a result of the decision to abolish certain withholding on interest paid on bank accounts. While that limited change is only going to apply to bank accounts, it has triggered this wider review of withholding on interest more generally.[3]

It is too soon to tell where that is going to end up, but a number of groups are pushing for further relaxations of the regime, especially for partnerships which cause particular issues at the moment.

Change is not expected, though, under this wider review until mid-2016.

3 See "Deduction of income tax from savings income: implementation of the Personal Savings Allowance", HMRC consultation document, gov.uk website, July 2015.

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WATCH THIS SPACE

What's new?

On 22 October 2015, the French financial markets authority (the *Autorité des Marchés Financiers* or AMF) launched a public consultation on the current legal restriction on French investment funds granting loans.

French investment funds cannot currently grant loans directly to borrowers, despite an exemption from the banking monopoly rule that permits them to purchase fully-funded loan receivables.

This restriction is being reconsidered as a result of the implementation of the European ELTIF Regulation (Regulation (EU) 2015/760 of 29 April 2015 on European long-term investment funds (ELTIF)), which comes into force in December 2015 and allows ELTIFs to grant loans in specific conditions. In France, however, even if an investment fund wanted to structure itself as an ELTIF, it could not benefit from the ELTIF Regulation rules on granting loans, as the French domestic legislation prohibits it (except if, and to the extent one may argue, that EU legislation should prevail over French domestic legislation).

The AMF has launched this consultation to consider changing the domestic rules so that French investment funds could grant loans directly to borrowers which, in turn, would allow them to make full use of the ELTIF regime.

The consultation focuses on the five areas below:

- restrictions on the management company;
- types of funds that can grant loans;
- restrictions on granting loans;
- restrictions on the types of borrower and loans; and
- debt collection.

For further information, please read the full briefing – "AMF consultation on the ability of French funds to grant loans" – available on www.ashurst.com or contact:

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Forthcoming events

Credit*flux* Direct Lending Workshop
9 February 2016, One America Square, London EC3N 2LS (Credit*flux*)

ABS Vegas 2016
28 February – 2 March 2016, ARIA Resort & Casino, 3730 South Las Vegas Boulevard, Las Vegas NV 89158 (SFIG and IMN)

Credit Symposium & Manager Awards
4 May 2016, Landmark Hotel, 222 Marylebone Road, London NW1 6JQ (Credit*flux*)

The 5th Annual Investors' Conference on CLOs & Leveraged Loans
16–17 May 2016, Grand Hyatt New York, Park Avenue at Grand Central Station, New York, NY 10017 (IMN)

The 20th Annual Global ABS
14–16 June 2016, Centre de Convencions Internacional de Barcelona, Plaça de Willy Brandt, 11–14, Barcelona 08019 (AFME/IMN)

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