ISSUE 7
NOVEMBER 2016

Credit Funds INSIGHT

Spotlight:

REGULATION: ALL CHANGE ACROSS EUROPE

ALSO IN THIS ISSUE:

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An overview of this issue

There has never been such intense scrutiny of fund managers by European regulatory and tax authorities. While much attention has naturally been devoted to the impact of Brexit on managers with UK operations, this issue considers the changes that are taking place across the whole of Europe. These changes are far-reaching and will impact future fundraising for all international fund sponsors.

We are delighted to include guest articles from Dean Kennedy, Vice President and Jason Sheller, Director at Deutsche Bank, who consider the current state of the alternative investment market, and from Sean M. Tuffy, Senior Vice President at Brown Brothers Harriman, who sets out his views on the future of AIFMD passporting for UK fund managers.

Elsewhere we consider developments including the recent helpful clarification of the extent to which "pre-marketing" is permitted in France, the changing face of direct lending in Italy and, of course, the question of how Brexit will affect UK fund managers. The one thing that is certain when it comes to fund regulation is that change is here to stay.

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 fundsinsight@ashurst.com.

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BREXIT

The impact of Brexit on CLO transactions

The complexity and the operational difficulty inherent in the EU risk retention rules has been compounded by uncertainty as to the future status of UK-based CLO managers due to Brexit.

UK-based CLO managers have for some time been able to comply with the risk retention requirements under Capital Requirements Regulation (CRR) as the "sponsor" of the securitisation. In order to qualify as a sponsor under CRR, managers need to be authorised by their national supervisor to conduct certain specific investment services under the Markets in Financial Instruments Directive (MiFID).

While the UK is still part of the EU, Financial Conduct Authority authorisation will continue to be valid for retention purposes and UK-based CLO managers will continue to be classified as a sponsor if their authorisation includes the relevant activities. However, there is a risk that this authorisation could fall away in a Brexit scenario where the UK does not remain in the EEA and no equivalence regime is agreed. In that case, existing transactions using a UK-authorised sponsor as the retaining party will cease to comply with the CRR retention requirements on the effective date of the UK's withdrawal from the EU.

It has become clear very quickly that most investors in new CLO issuance are not willing to accept the risks of non-compliance. It seems that investors will only invest in new CLOs if a suitable alternative plan is built into the transaction to deal with the situation.

A first option is to establish a subsidiary as a "sponsor" entity in another EEA jurisdiction which meets the definition in CRR and is the named collateral manager for new CLOs. Managers will need to consider whether the substance of such an arrangement is within the CRR retention rules, and also the taxation, employment and corporate governance implications of moving management of the CLO to an EU subsidiary. Furthermore, it will generally take six to nine months in most jurisdictions to obtain the necessary MiFID authorisation. This means that although many managers see this as the longer term solution, a different arrangement is required in the immediate term for new issue CLOs. Indeed, since the referendum, several UK-based managers have started work on this option and are considering Luxembourg and Ireland as possible jurisdictions.

The delay inherent in the above option could be mitigated by the inclusion of provision in the CLO documentation allowing the UK manager to remain as the sponsor for the short to medium term while the UK remains in the EEA, but move operations after Brexit to another authorised affiliate entity within the EEA. However, it has never been clear from the risk retention rules or from discussions with the EBA whether the transaction would remain compliant in these circumstances. As a result, this option is unlikely to provide investors with any additional comfort.

A third option is to use the originator/manager structure, in which the manager originates a portion of the portfolio and assumes the credit and market risk of the assets for a "seasoning" period. Typically, this is achieved by the manager acquiring assets during the warehouse period and holding them for approximately 15 business days before on-selling the assets to the CLO issuer.

Unlike the sponsor route, the use of an originator/manager does not depend on the manager having a MiFID authorisation and therefore insulates the transaction from a Brexit scenario that does not include EEA membership or equivalence.

This approach has a degree of a track record, in that it has been used by the majority of US-based CLO managers seeking to comply with EU retention rules in order to sell their CLOs to EU investors. It has also been used on several European transactions. These transactions should continue to satisfy the current EU risk retention requirements after the effective date of the UK's withdrawal from the EU. In addition, UK managers that have used the sponsor structure in the past should be able to use the same entity as an originator for future CLOs without any further regulatory approvals being required.

It appears that post-Brexit this option has attracted early favour from the market. Several of the European CLO transactions that have priced since Brexit have been from UK-based managers that have historically relied on the sponsor route but have now opted for the originator/manager structure. In addition, at least one post-Brexit US CLO transaction that achieved compliance with the European risk retention rules via the sponsor route (by employing a sub-advisor structure) has switched to the originator/manager structure, in line with most other US CLOs.

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UNITED KINGDOM

Yes, Brexit means the UK will lose access to the AIFMD passport

by Sean M. Tuffy, Brown Brothers Harriman

Although the outcome of the Brexit negotiations remains uncertain, there's less doubt that it will affect access to the AIFMD passport.

Following the UK referendum on Brexit what will happen to the AIFMD passport used for alternative funds, such as hedge funds, private equity and private debt funds? Unfortunately for the denizens of Mayfair, it is clear that Brexit will cause the UK to lose access to the AIFMD passport.

Contrary to UCITS regulations, AIFMD directly regulates alternative asset managers and indirectly regulates alternative funds. As a result, there are specific provisions in the AIFMD that apply to EU and non-EU AIFMs (Alternative Investment Fund Managers). This means that when the UK does officially part ways from the EU, UK AIFMs will go from being EU AIFMs to non-EU AIFMs and this change in status has two key consequences.

The first consequence of becoming non-EU AIFMs is that UK managers will have to be regulated by an EU regulator. All non-EU AIFMs must be authorised by the EU regulator from the "Member State of Reference". Under the terms of the AIFMD, the Member State of Reference is the EU country where the manager intends on selling the majority of its AIFs (Alternative Investment Funds). For example, if Germany is the primary market for a manager's funds, then it must get authorisation from BaFin. Of course, in addition to the Member State of Reference, UK asset managers will also continue to be regulated by the FCA. Bottom line: post-Brexit, UK managers selling alternative products in the EU will end up with additional regulatory oversight.

The second consequence of becoming a non-EU AIFM is that UK hedge funds will ultimately lose access to the AIFMD passport as it is only available to EU managers and EU funds. So, even if an UK manager has an EU fund, when it becomes a non-EU AIFM it would lose access to the passport. Without access to the passport, managers will have to rely on various

national private placement regimes to sell their products in the EU.

In order to get access to the AIFMD passport as a non-EU AIFM, the UK would need to be granted an "equivalence" ruling from the EU Commission, Council and Parliament. On the face of it, this should be pretty straightforward since the UK has already transposed the AIFMD into UK law. Assuming there is no post-Brexit regulatory bonfire (and Brown Brothers Harriman are already on the record as being dubious of this idea), it would be hard to argue the UK did not have an equivalent regulatory environment. However, as we have seen, extending the AIFMD passport is not as easy as it seems. At the moment, a non-EU country has yet to be granted access to the AIFMD passport. Depending on how the divorce proceedings go between the UK and EU, it is not hard to envision the EU dragging its feet on granting AIFMD equivalence to the UK.

While losing access to the AIFMD may not seem significant now, sooner or later not having access to the AIMFD passport will become an issue for UK managers. In 2018 the EU is going to look at abolishing private placement altogether. When this becomes the case, UK managers are going to have to make some decisions. If it appears that the UK is on course for an ugly breakup from the EU, then firms may want to consider establishing a presence in the EU. This would involve setting up a new AIFM entity in an EU country to ensure that UK managers would continue to have access to the passport. However, it is still unclear how much substance the EU member state would require of the AIFM and how much activity could remain in the UK.

For the time being, there is no immediate action that needs to be taken. Until the exit negotiations are completed, the UK hedge fund managers will continue to be EU AIFMs and have access to the passport. However, there's little harm in planning for a world where they won't have access to the AIFMD passport.

Visit the BBH regulatory blog www.OntheRegs.com for more insights on developments that are impacting asset managers.

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MARKETING FUNDS IN FRANCE

New regulatory guidance from the AMF

by Hubert Blanc-Jouvan and Maxime Samson

The *Autorité des marchés financiers* updated in July 2016 its guide to UCITS and AIF marketing regimes in France, to provide additional guidance on various situations which should not trigger the application of marketing rules in France.

Background

In June 2014, the French *Autorité des marchés financiers* ("AMF") published the first version of a guide designed to detail the conditions applicable to the marketing of collective investment schemes qualifying as an undertaking for collective investment in transferable securities (UCITS) or alternative investment fund (AIF) within the meaning of Directive 2011/61/EU on alternative investment fund managers (AIFMD).

What does "marketing" mean?

AIFMD defines marketing as a "*direct or indirect offering or placement at the initiative of the AIFM or on behalf of*

What you need to know

- **The AMF published a guide which is designed to detail the conditions applicable to the marketing of funds in France.**
- **This guide has been recently updated to introduce the concept of "pre-marketing" which should not be considered as an act of marketing.**
- **Further clarification has also been provided by the AMF on various other cases which would not constitute marketing in France.**

the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union". In its guide, the AMF expresses the view that an "offering" or "placement" of units or shares of an AIF should include the presentation of such products by different means (e.g. advertising, solicitation, advice) with a view to encouraging an investor to subscribe to or purchase them, and that this definition of marketing should equally apply to funds qualifying as a UCITS .

The guide also provides guidance on circumstances which do not amount to marketing of funds in France, and therefore do not trigger the application of marketing rules.

The first version of the guide provided that the purchase, sale or subscription of units or shares of a UCITS or AIF in response to a client's unsolicited request to invest in a specifically designated UCITS or AIF (the so-called "reverse enquiry" exemption) should not constitute marketing. In the same way, the guide also provided that the purchase, sale or subscription of units or shares of a UCITS or AIF by an asset manager acting under the terms of a portfolio management agreement or as manager of an investment fund should not constitute marketing either.

As part of its ongoing work to improve the distribution of French investment funds abroad and to make it easier to launch new investment funds in France, the AMF published a revised version of its guide on 4 July 2016, which extends the scope of the situations which would not constitute marketing of a UCITS or AIF in France.

Introduction of the pre-marketing concept

The AMF recognised that in practice, prior to the launch of an investment fund, professionals may need to communicate with potential investors in order to gauge their appetite for a product, and that considering such communications as marketing which would trigger the application of marketing rules at this stage of the development of a product was not appropriate.

Accordingly, the AMF introduced the concept of pre-marketing, which does not trigger the application of marketing rules in France.

Management companies or third parties acting on their behalf will consequently be able to contact up to a maximum of 50 investors to assess their interest prior to the launch of a UCITS or AIF without being considered as marketing such UCITS or AIF, provided that (i) investors are professional investors or non-professional investors whose initial subscription amount would be at least EUR 100,000 and that (ii) investors are not given a subscription form and/or documentation containing definitive information on the fund's characteristics which would enable them to subscribe or undertake to subscribe for units or shares of the relevant fund. However, the guide provides that any subsequent investment in the relevant fund by such investors should not be considered as being made in response to a client's unsolicited request within the meaning of the "reverse enquiry" exemption mentioned above, and could therefore constitute marketing in France.

The introduction of such a pre-marketing concept in France might be welcomed, but it is uncertain whether this will fully satisfy certain third countries' fund managers which would like to rely on a broader concept of "pre-marketing".

Other situations which do not constitute marketing

The AMF further clarified other situations that would not trigger the application of marketing rules in France. These situations include:

- the purchase, sale or subscription of (A) units or shares of a UCITS or AIF in the context of a management company's compensation policy or by or on behalf of the management company's management team, its senior management or the management company itself, or (B) carried interest shares;
- OTC secondary trades between investors, when these trades are not organised by the management company or a third party;
- the participation by a management company in conferences or the organisation of meetings with investors giving them information on market trends and developments and on the activities of the management company, provided that (i) these conferences and meetings are reserved for professional investors and (ii) the investors are not asked to invest in a specific product and there is no communication on a UCITS or AIF whose units or shares may be subscribed by investors; and
- a management company responding to a request for proposal from a professional investor which is a legal entity and wants to set up a fund.


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DIRECT LENDING ACTIVITY IN ITALY

Recent developments could open new opportunities for lending into Italy

by Fabio Balza and Paul Miller

EU alternative investment funds can now potentially lend to Italian borrowers without application of Italian withholding tax on interest payments.

Historically foreign funds have not been allowed to lend to Italian borrowers for regulatory reasons. From a tax perspective such lenders suffered Italian withholding taxes on interest payments. For these reasons the so-called opaque “IBLOR” or “Italian bank as lender of record” structures were put in place whereby the loan was granted by an Italian bank (the lender of record) which was financed through collateral posted by foreign funds.

The funds guaranteed the borrower’s obligations to the Italian bank under the loan and posted cash deposits as collateral. The intended tax regime of opaque “IBLOR” structures was that no withholding tax was applicable on the interest payments made to the Italian banks (or Italian branch of a foreign bank) nor on the interest and guarantee fees due from such Italian banks/branch to the funds. The

What you need to know

- **Historically foreign funds have not lent to Italian borrowers for regulatory and tax reasons.**
- **EU alternative investment funds can now potentially grant loans to Italian enterprises without Italian withholding tax on interest payments. There are still issues for CLOs and non-EU funds.**
- **Funds that are not allowed to lend into Italy could consider structuring their funding operations using bonds, benefiting from a withholding tax exemption on the interest.**

Italian tax authorities challenged opaque "IBLOR" structures as tax abusive schemes giving rise to tax litigation and tax settlement proceedings. More recently (from June 2014) the Italian government and the Italian parliament have started to introduce measures aimed at easing the granting of funding to Italian enterprises, also allowing certain types of foreign credit funds to lend directly into Italy.

Under article 26 of Decree 600/1973 interest payments made by Italian borrowers to foreign lenders (not acting through an Italian permanent establishment) are subject to a 26 per cent withholding tax (such rate of tax may be reduced under tax treaties). There are exceptions to this rule, one being applicable to foreign lenders that are EU banks, EU insurance companies and institutional investors established in the so called white list countries. White list countries include all EU countries, as well as the US, Japan, China, Brazil and, since August this year, the Cayman Islands, Jersey, Guernsey, Switzerland, and several others. Leaving aside EU banks and insurance companies, which are not the particular focus of this article, the exemption from the interest withholding tax (the WHT Exemption) is applicable to institutional investors if all of the following conditions are met:

- ***the borrower is an "enterprise"*** – an ordinary commercial company would qualify as such. However, it is unclear whether borrowers that are investment funds would qualify as enterprises for these purposes (prevailing opinion is that borrowers that are investment funds do not qualify for the WHT Exemption);
- ***the financing is medium long term*** – i.e. it has a maturity longer than 18 months and one day;
- ***the lender is an institutional investor, established in a white list country and subject to regulatory supervision in the country of establishment (this being the Regulated Institutional Investor Requirement)*** – institutional investors (regardless of whether they are liable to tax or not) are "those entities which, regardless of their legal or tax status (...), have as their principal activity that of managing investments on their own account or on behalf of third parties, such as insurance companies, investment companies, investment funds, SICAV (Open-end investment companies) and pension funds" (see Decree 12 12 2001). According to rulings of the Italian tax authorities (though not specifically issued for the purposes of the WHT Exemption) an entity is deemed to be subject to regulatory supervision if either the entity itself or the asset manager is subject to supervision and such supervision amounts to an initial authorisation and to ongoing controls by the relevant regulator. This latter interpretation has been recently confirmed by the Italian tax authorities in a private (not available to the public) ruling (the 2016 Private Ruling) dealing with a French FCT (fond commun de titrisation) that purchased a loan receivable on the secondary market from an EU bank. In the 2016 Private Ruling the Italian tax authorities acknowledge that, even if the fund itself is not subject to regulatory supervision, but the asset manager is subject

to regulatory supervision, the Regulated Institutional Investor Requirement (for the purposes of the WHT Exemption) would be met; and

- ***the lender is fully compliant with Legislative Decree 1 September 1993, n. 385*** – i.e., the Italian law governing lending activities towards the public in Italy (this being the Reserved Activity Requirement). This condition has been introduced in the text of article 26 of Decree 600/1973 in tandem with the enactment of new rules governing direct lending in Italy by EU alternative investment funds (as defined under the AIFMD) (the AIFs). The rationale for these changes in law, as stated in the government explanatory notes (to article 17 of Decree 18/2006) is to grant the WHT Exemption to foreign, EU credit funds (EU AIFs) subject to the same conditions as applicable to Italian credit funds (Italian AIFs). Indeed, EU AIFs are permitted to grant loans directly to Italian borrowers (other than private consumers), if the relevant EU AIF meets the following conditions: (i) it is authorised, in its home EU country, to directly invest in loans, including loans funded with its assets; (ii) it is a closed-ended investment scheme having structural features similar to Italian AIFs investing in loans; (iii) in its home EU country it is subject to regulatory supervision on risk limits and allocation, including on maximum leverage corresponding to those applicable to Italian AIFs investing in loans. Furthermore managers of EU AIFs planning to lend in Italy must notify their intention to the Bank of Italy and may commence such activity only upon expiry of a 60-day period from such notification (in such period of time, the Bank of Italy may decide to forbid such activity). These conditions from (i) to (iii), including the obligation to notify the Bank of Italy are referred to as the "AIF Conditions". It is unclear whether the AIF Conditions would only be required if the AIF were to directly lend in Italy, i.e., to originate and grant the loan, or also if the AIF were to purchase on the secondary market a loan originated by a bank.

Application to Funds

Turning then to the application of those rules to common fund structures, they don't help non-EU Funds. That is because the newly enacted legislation on direct lending only refers to EU alternative investment funds, with the consequence that the WHT Exemption is not applicable to non-EU funds (because the Reserved Activity requirement would not be met) even if they are established in white list countries (other than EU countries).

AIFs which, in principle, could qualify for the WHT Exemption are, for example, Luxembourg FCP, SICAV, SICAF RAIF, Irish QUIAIF, French FCT, etc. (assuming that the AIF Conditions are met). A doubt may be raised (as no circular or public rulings have been issued yet by the Italian tax authorities on the matter) where the AIF is established as a partnership, since Italian AIFs cannot be formed with such a legal form. The fact that the AIFM Directive covers AIFs established as partnerships should take the direction of also allowing partnerships that are EU AIFs to benefit from the WHT Exemption. Conversely, as CLOs generally do not fall within AIFMD, they do not meet the Reserved Activity Requirement, nor the Regulated Investor Requirement and, hence, the WHT Exemption would not be available to them.

In a recent private ruling the Italian tax authorities considered the case of a French *fond commun de titrisation* (the FCT) buying a portion of a facility from a branch of an EU bank. The ruling acknowledges that the fund itself is not subject to regulatory supervision, while the asset manager is subject to regulatory supervision. The tax authorities concluded that the WHT Exemption should be applicable to interest payments made by the Italian borrower to the FCT.

In any event, in case of doubt as to the proper qualification of the lender, for WHT purposes, the lender or the borrower can apply for an advance ruling in order to request the opinion of the Italian tax authorities.

Alternative Bond Structures

If the relevant fund cannot lend directly into Italy (for example because the relevant credit fund is not established in the EU), bonds could be an alternative funding structure, as follows:

- The borrower, instead of borrowing a loan, issues bonds listed on a regulated EU Market or an EU multilateral trading facility, and the relevant fund subscribes for such bonds. No withholding tax will be applicable in Italy on the interest on the bonds if the holder/relevant fund is an institutional investor established in a white list country. In this case, the exemption is applicable even if the institutional investor is not subject to regulatory supervision, provided that it has skills and expertise in financial instruments and it has not been created to hold the investments for a limited number of investors established in non-white list countries; or
- The borrower borrows a loan from an Italian securitisation vehicle which obtains the funding by issuing bonds to the relevant fund. This scheme requires, inter alia, that a bank or other financial intermediary makes the creditworthiness analysis and retains a minimum 5 per cent investment in the bonds under the skin-in-the-game rules. No withholding tax is applicable on the interest from the borrower to the securitisation vehicle and no withholding tax is applicable on the interest on the bonds on the same basis as above, i.e. the holder/relevant fund is an institutional investor established in a white list country.

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ALTERNATIVES

A transaction banking view

By Dean Kennedy and Jason Sheller, Deutsche Bank

Deutsche Bank specialises in outsourcing for alternative investment funds, providing fund & loan administration, custody, regulatory reporting and middle-office solutions to private equity, real estate, infrastructure and agricultural fund managers, as well as hedge funds and funds of funds. In this article, Dean Kennedy and Jason Sheller of Deutsche Bank provide a snapshot of observations on current trends in the alternatives market and the ways in which, as an institution, Deutsche Bank has adapted to this evolving market.

Current trends

With lending still below the levels seen for deals completed pre-financial crisis, large sophisticated institutional investors who require long-term capital fund structures and fixed income exposure in their portfolios are now a significant segment, as they weigh up the benefits of pursuing illiquid products for a higher yield.

This trend has meant that "alternative funds" continue to become more institutional, as investors are demanding independent fund administration, increased transparency and overall better and more frequent reporting.

> *"Alternative asset fund managers are now managing approximately US$7.5tn globally, up US$500bn from last year"*
>
> **Preqin**

Investors' desire for alternative investments coupled with the shift towards covenant-lite terms, and dependency on credit rating agencies, have unlocked and boosted the market for alternative debt, particularly in Europe where the concept has gained significant momentum.

> *"European direct lending fundraising surpassed North America for the first time in 2015, up 42 per cent from the previous year and up 400 per cent from 2012."*
> **Preqin**

Positively, as highlighted at the recent Annual Loan Market Association (LMA) conference in London, issuance of private debt is up over 50 per cent year on year. Taking these trends into account, alongside legislative changes in Europe allowing alternative credit funds to invest directly in assets, the seemingly positive outlook establishes direct lending as an asset class in its own right.

Direct lending

Access to and availability of sizeable credit through the conventional routes was waning, stunting the growth of small to medium sized enterprises (SMEs) and stifling the mid-market buyout sector. This market, traditionally dominated by lending institutions, has opened to private equity firms and corporate entities as an alternative source of funding.

In response to this trend, Deutsche Bank has evolved its direct lending services by combining the bank's award-winning private equity fund administration service with its expertise in loan administration into a single solution to simplify operations and deliver flexible reporting to originators, investors and borrowers. The solution allows direct lenders to seamlessly monitor loan performance, rate changes, repayments and fee disbursements directly through a customisable online reporting platform.

> *"Recent analysis and surveys reveal the private debt market will continue to grow, particularly over the next 12 months, with the majority of investors satisfied with performance and expecting to increase their allocations to this space in the coming year"*

Private placements

Given reduced investor appetite for public bonds and bank debt, European mid-market companies have looked to the private placement (PP) market for financing, while investors are turning to private debt structures. Investment in these structures has increased by approximately 78 per cent (source: LMA) year on year, including both large and small revenue companies.

The question is: will we now see a more harmonised PP marketplace in Europe? The UK, German and French PP markets are well established. Given the UK government's progress on abolishing withholding tax, and the access to standardised documentation and other guidance being made available to parties, could we see a true pan-European PP market in the near future?

Deutsche Bank has supported the PP market for many years, particularly US and UK PPs and German Schuldschein. We are now seeing the use of new PP templates created by the LMA in practice, not just for mid-market funding, but also in the infrastructure space.

There has been significant institutional investment in European infrastructure over the last 18 months, with many deals being funded by a single institution or a small club of non-traditional investors. This shows the large amount of capital available to this asset class.

> *"Interestingly, 44 per cent of respondents at this year's LMA conference believe such a market will emerge in two to five years' time."*
>
> ***LMA***

Infrastructure

The revival of the European project bond market a few years ago has seen a number of the investment arms of the larger insurance companies, and other asset managers, commit to investing directly in infrastructure across Europe. Some of the deals closed in the past 12 months have been arranged by such managers with no bank involvement in the structuring, arranging and distribution of the debt.

The long dated nature of infrastructure debt clearly supports the requirements of these institutions to match their long-term liabilities. What was a space supported heavily by the monoline insurers pre-crisis, is now seeing various capital markets solutions funding infrastructure and energy projects, without the need for bank funding or insurance wraps.

This trend has led Deutsche Bank to focus on this space and enhance its Corporate Trust product offering in project and infrastructure finance by creating a bespoke Project Agency role. Although the role is new for the project bond space, the service itself has been on offer to borrowers and investors in the loan market for some time. With numerous financial structures and instruments now available, roads, bridges, offshore wind and solar assets are being financed by non-traditional investors. These are complex assets which we would normally expect traditional bank lenders to finance, particularly during the riskier construction phase of Greenfield projects.

Regulation

Alternative funds across the board are experiencing much more regulatory pressure than ever before. The introduction of regulations such as Basel III and Solvency II, both requiring deleveraging of assets, improved capital adequacy and a boost in bank balance sheet, has led to significant changes in how funds need to operate. As reported recently by Deloitte Research, over €300bn of loan portfolio sales have been completed since 2013.

With AIFMD and FATCA, our clients have more compliance requirements than previously, so again the "build or outsource?" decision beckons, and some look to outsource to administrators with specialist dedicated teams and the right technology to help them comply.

Investor requirements

In this changing global environment additional investor requirements and queries seems to be going up at an exponential rate. Funds clients continue to require greater transparency based on their particular needs and situations. As the lending fund space continues to attract a lot of attention, this attention comes with added scrutiny. Third party providers and their experience is the key to being able to deliver what investors need. This includes availability of short term liquidity solutions.

As such, Deutsche Bank has expanded its support to the asset/investment management and debt fund community with a new liquidity solution through a committed repo facility.

Deutsche Bank has developed a one-stop shop service for investors looking to incorporate direct lending into their overall fund strategy. In addition, those funds can outsource their accounting, the management of their capital calls and distribution, cash management, the preparation of financial statements, audit coordination, SPV administration and ultimately reporting to their investors to a third party such as us.

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ALTERNATIVES

Opening access to alternatives

by Steven Haywood

The digital marketplace is facilitating ways for individuals to access alternatives. Here we consider the issues involved and the potential for sponsors of this.

Traditionally access to large alternatives funds has more been the preserve of institutions and wealthy family offices. This is in part because of the high barriers to entry in terms of ticket size (typically several million), but also because the bespoke nature of the fund terms means that investors may need to turn to external legal and investment advisers to assist, for which they will need a budget.

Breaking down barriers

Breaking down these barriers is possible through the aggregation of smaller ticket size investors e.g. HNWIs who might each invest £100,000 into a feeder vehicle, which then itself becomes an investor into the fund that the HNWI might not otherwise be able to invest in themselves directly. In the past it has mainly been the wealth management divisions of the banks that have offered this type of service to their clients, usually working in conjunction with sponsors wishing to raise a fund. In return for a reserved portion of a fund's target size, the bank will market the fund to its clients and establish a dedicated feeder vehicle, be it a limited partnership or a corporate, which the bank's clients will become investors in and then that vehicle itself will become an investor in the target fund. The bank may take various fees from its clients over the lifetime of the investment (and the dedicated feeder vehicle assists with this as the economics of such arrangements can be applied at the feeder level without disturbing the economics of the target fund).

The concept of aggregation is therefore not a new one, but what may be considered different is one of the ways it is now being brought to market. Whereas before the kind of arrangements described above would have been marketed to HNWIs through direct conversations between the individual and their financial adviser at their bank we are now seeing developing in the market the overlay of technology in facilitating access more generally. Digital marketplaces for funds are again not new – online fund supermarkets have been around for some time – but the point is that these platforms generally only provide investors access to traditional "retail" funds, as opposed to what would be considered "non-retail" alternative asset classes, such as private equity. Now we are starting to see the aggregation concept for these "non-retail" alternatives appear in a new digitised form as investors can go online and seek out these opportunities themselves.

Why is this happening and growing in popularity now? It's difficult to say, but there certainly seems to be momentum and a number of providers are emerging in the market. It could be that poor or negative returns on cash on deposit and, for example in the UK, stamp duty intervention in the housing market is pushing these kind of investors into these new ways of investing.

Possibilities and issues

The possibilities for sponsors (in particular for first time managers who don't have legacy funds with the resultant legacy investor base to tap for new fund raises) of such online platforms are potentially significant. Whereas before a sponsor may have needed to team up with a bank (and often with the balance of power with the bank) in order to tap the individual investor market, now it can attract these investors directly, either itself or through a platform provider. This provides sponsors with access to sources of investor capital that they may not have been able to access before and also potentially raises awareness of the sponsor in the marketplace to the target investment base for its fund.

There are of course a number of marketing issues which need to be considered. The promotion of non-mainstream pooled investments to ordinary retail clients who are neither sophisticated investors nor high net worth individuals is currently prohibited in the UK by the FCA. Consequently, sponsors seeking to access sources of funding from individuals need to ensure that they market to them in accordance with the exemptions available under COBS 4.12.4 – the certified HNW investor, certified sophisticated investor and self-certified investor exemptions likely being the most useful. It is also worth noting that an ordinary retail investor may opt to be treated as an elective professional client if they meet the relevant criteria and if so the exemption to allow promotion to non-retail clients may also be available.

Though investors may be electing-up to be considered as non-retail investors, what protections should these platforms

offer? What needs to be disclosed to investors, how is this done and do the investors truly understand what it is they are investing in? Careful thought needs to be given to these issues and at a minimum a wrapper to the target fund's offering memorandum is likely to be required containing relevant disclosures.

Thinking about the detail

The terms of the aggregating vehicle and especially what happens in the case of one of their fellow aggregated investors defaulting is important. For example, under the terms of the target fund would the whole aggregating vehicle be defaulted and if so does everyone in the aggregating vehicle suffer the punitive default provisions that closed-ended alternative asset funds generally contain? A side letter in place with the

target fund agreeing to "look through" treatment in the event of default may be a solution if the target fund agrees to this. Alternatively, drawdowns may be managed to mitigate this risk, for example investors in the aggregating vehicle being fully drawn at the level of the aggregating vehicle on day one and the funds held within the platform until called by the target fund. This then does raise the question of how those funds are held and the consequent drag on the performance of an investment made into the aggregating vehicle. It may also be beneficial to match the terms of the aggregating vehicle as closely as possible to that of the target fund e.g. stating in the constitutional documents of the aggregating vehicle that the terms of the target fund apply mutatis mutandis (other than where they specifically need to be different as a result of tailoring for the aggregating vehicle).

The regulatory position of the platform, its manager and the investors is crucial, as well as ensuring the risks are properly explained to investors. Disclosure is essential, the digital platforms need to be designed with this in mind and the aggregating vehicle needs to be carefully considered, both in respect of its structure and its terms to ensure the product works as a whole.

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TAX: FRENCH TAX TREATIES

Foreign exempt entities not eligible for tax treaties

by Nadine Gelli and Priscilla van den Perre

The French Supreme Court rules for the first time that entities exempt from tax in their country of residence cannot benefit from the provisions of tax treaties concluded between their country of residence and France.

French Supreme Court decision

The two cases submitted to the French Supreme Court (Conseil d'Etat) involved pension funds, established respectively in Spain and Germany, having received French source dividends which were subject to a 25 per cent withholding tax in France. These pension funds claimed the benefit of the reduced rate of withholding tax on dividends provided for under the relevant tax treaties concluded between France and their country of residence. The French tax authorities refused to apply the reduced rates on the grounds that such pension funds were not entitled to the benefit of these treaties as they were not subject to tax on these dividends in their country of residence.

The lower courts and the courts of appeal found in favour of the funds. The French tax authorities, however, appealed before the French Supreme Court, providing first opportunity for it to determine whether an entity not effectively subject to tax in its country of residence could be

regarded as a "resident" for the purpose of tax treaties.

The relevant tax treaties, concluded between France and respectively Germany and Spain, provide that a "*resident of a Contracting State means any person, who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature*".

In decisions rendered on 9 November 2015, the French Supreme Court indicated that tax treaties must be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of their purpose, which is mainly to avoid double taxation. The conclusion of the Supreme Court is that persons or entities which are tax exempt in a given State by reason of their legal status or their activity are not liable to tax within the meaning of tax treaties and can thus not be considered as "residents". On this basis, the Supreme Court refused to grant the benefit of the reduced treaty withholding tax rate to the pension funds.

These decisions have been widely criticised by tax practitioners. Another reading was available, according to which residents are those which are covered by local tax laws, even if not effectively subjected to tax because they benefit from a specific exemption or a nil rate of tax. This reading is in particular supported by the Spanish version of the tax treaty between France and Spain and is the one taken by the Spanish tax authorities which consider that, given their specific purpose, Spanish pension funds are liable to tax although they benefit from a nil rate and thus entitled to treaty benefits. Certificates of residence attesting that pension funds are entitled to the benefits of the treaty between France and Spain are systematically delivered by the Spanish tax authorities. Unfortunately, this is not the reading which the French Supreme Court chose to take.

The situation may evolve further, as the OECD is considering changing the Model Tax Convention to ensure pension funds are considered as residents of the country in which they are constituted. In the meantime, the position expressed by the French Supreme Court has practical consequences which need to be taken into account.

Practical consequences

Although these cases relate to the tax treaties concluded by France with Germany and Spain, the ruling of the Supreme Court should be considered as establishing a general principle applicable to all tax treaties concluded by France which contain a similar definition of "resident". This definition being the one currently used in the OECD

model, it is usually included in recent tax treaties signed by France, although some of them contain specific provisions allowing nevertheless certain exempt entities to benefit from all or some of their provisions (e.g. UCITs in the tax treaty concluded with Spain or Germany). There are also still some old tax treaties, such as the one between France and Luxembourg, which do not require that the persons be liable to tax in order to qualify as residents.

French paying agents are likely to be very reluctant to apply on French source income the reduced rate of withholding tax provided by tax treaties absent any written confirmation by the foreign beneficiaries of their tax status. The French tax authorities have informally indicated that they may amend the procedural formalities necessary to claim the benefit of the tax treaty provisions as a result of this decision.

Implications for non-French funds investing in France

This decision will affect the French withholding tax treatment of French source payments made to non-French funds.

The impact will be limited for debt funds since interest payments are exempt from withholding tax in France under French domestic law as long as lenders are not acting from or receiving payments in a non-cooperative jurisdiction. The treatment of fees paid to these funds may however need to be reviewed. If they cannot qualify as interest, they may attract French withholding tax applicable to "*fees paid in consideration of any type of service used in France*" at the rate of 33.33 per cent if they are not paid to a fund which can benefit from a tax treaty.

The impact could be more significant for funds investing in French equity, since withholding tax generally applies on dividend payments and capital gains derived from substantial shareholdings or shares in real estate companies.

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GERMANY

Brexit – the potential effects on licence requirements

by Detmar Loff and Jasper Lembke

If the United Kingdom becomes a third country in terms of UCITS, AIFMD, MiFID II and other European provisions, UK entities will have to deal with several issues in Germany – two of them are (i) licence requirements and (ii) the impact on German institutional investors wishing to invest into UK funds.

Market access and licence requirements

If the UK decides not to become an EEA member in the context of Brexit, depending on the "way out", UK firms might have to deal with the consequences of becoming third-country firms in terms of the above Directives. Various EU Directives – for the purpose of this article UCITSD, AIFMD, MiFID and MiFID II/MiFIR as well as CRD IV are taken into consideration – have different protection mechanisms and regulation principles including licence requirements for third-country firms.

Licence requirement topics

UCITS Directive

The question of third-country regulations is not a focus of the UCITS Directive. This is because a fund that is not domiciled within the EEA, cannot be (or become) a UCITS-fund. Rather, investment funds domiciled outside the EEA are AIFs even if operated/managed like a UCITS.

What you need to know

- **If the UK becomes a third country, financially regulated UK firms must deal with different regulatory licensing regimes.**
- **Post Brexit the EU-Passport may no longer be available and depending on the service provided and product offered, the UK firm may be required to establish a branch or comply with individual market access rules of the different member states.**
- **Future investments by German pension funds and other investors subject to the German Investment Ordinance into a UK AIF may require some more structuring (e.g. a wrapper) to be attractive.**

Since no requirements exist at EU level, each member state may define its own ways of accessing its market.

In Germany, the access is, in accordance with the Directive itself, focused on German and EU UCITS (as set out in section 294 of the German Capital Investment Code (Kapitalanlagegesetzbuch – "KAGB")).

Only section 296 KAGB deals with third-country providers of "UCITS": BaFin, the German Financial Supervisory Authority, may agree with the competent bodies of third countries that the provisions of sections 310 and 311 of the German Capital Investment Code (inbound) and sections 312 and 313 of the German Capital Investment Code (outbound) apply for the marketing of comparable investment funds, i.e. essentially the same regulations as for EU UCITS and/or the notification of German UCITS for marketing in the EU. Since these third-country investment funds are, from a legal perspective, not UCITS due to being located in a third country, these investment funds are referred to as foreign AIFs, with the special feature, that, in order to provide for comparability, the product-related rules of the Directive as well as the marketing rules have to be met (section 296, para. 3 KAGB).

For example, Germany has entered into an agreement with Switzerland stipulating that Swiss securities funds may (similar to UCITS) be marketed in Germany by means of a simple notification process. Conversely, a corresponding notification process for Switzerland is implemented for German UCITS. Such an agreement might be used as an example for a potentially similar agreement between the UK and Germany – which in our view should be even easier to achieve as long as the UK adheres to the UCITS provisions.

AIFM Directive (the AIFMO)

Unlike the UCITS Directive, the AIFMD provides for a differentiated and more harmonised third-country access right: however, it is subject to a staggered implementation over time.

As far as it concerns EU-based management companies of AIFs (EU AIFMs), it is intended that upon compliance with the access requirements in a member state, they may market AIFs, which are managed by them and have their registered seat in the EU (EU-AIF), in any other member state to professional clients following implementation of the notification procedure. Currently, this AIFM passport only applies to EU AIFMs managing and marketing an EU AIF.

Third-country AIFMs may only market their foreign AIFs in a member state if this member state allows the possibility of doing so within the framework of a private placement regime or another access procedure. A third-country AIFM is obliged to obtain such approval for each member state and/or review exemptions.

In the future, a non-EU AIFM may be allowed to market AIFs managed by it by applying the AIFM passport, article 67, section 1 AIFMD. A prerequisite for this is, among others, a positive opinion from ESMA on the respective third country, the compliance with the regulations provided for by the AIFMD as well as the adoption of a delegated act by the Commission. Assuming the UK will go on adhering to AIFMD-like provisions, in our view UK AIFMs and their AIFs will most likely be able to benefit from the AIFMD-third-country passport regime once implemented.

The regulation, article 67, section 1 AIFMD, and access regime is reflected in the KAGB. Marketing to professional (and semi-professional) investors is also based on the procedure following advice and delegated acts from ESMA (section 295, para. 2 and 3 of the German Capital Investment Code). Special German regulations apply to marketing to private clients, i.e. similar rules must be applied by the foreign AIF as German AIFM/AIF have to comply with.

MiFID and MiFID II (including MiFIR)

Under the current MiFID, the possibility for third-country companies to gain access to the EU market is not harmonised. Each member state may adopt its own rules.

A third-country company establishing a branch in one EU member state and obtaining authorisation to provide investment services there, may not adopt the MiFID passport to provide its services in other EU member states. The only possibility for the companies to overcome this access barrier is (i) to establish branches in the respective member state and separately obtain authorisation for providing investment services or (ii) to establish fully MiFID licensed subsidiaries which may use the EU passport. Other possibilities are (iii) the application of reverse solicitation or (iv) any national exemption possibilities.

The status quo outlined above will be amended by MiFID II: while a registration procedure in accordance with article 46 MiFIR will be required for third-country companies to provide services cross-border to at least per se professional clients (subject to staggered implementation and grandfathering provisions), the member states may, as far as it concerns other categories of clients, i.e. opt-up clients and retail clients, require that the third-country company establishes a branch (article 39 of MiFID II). In more detail:

- In accordance with article 46 MiFIR, a third-country company wanting to provide cross-border investment services to eligible counterparties and per se professional clients must be registered with ESMA. In this context, the member states may not impose further requirements on the registered third-country companies. In this way, the MiFIR procedure establishes a European harmonised set of rules and regulations for addressing at least per se professional clients. Separately, the possibility of reverse solicitation remains unaffected.

  However, a so-called equivalence decision regarding the third country from which the company originates is required (structurally similar to that under AIFMD) – (voluntary) compliance with the MiFID II/MiFIR regulations only by the company itself without respective national regimes in the third country does not suffice.

  Pursuant to article 47 MiFIR, third-country companies may, in compliance with the national regulations, continue providing investment services in the member states for up to three years following adoption of a decision in connection with the respective third country.

It must be taken into account that this procedure refers only to investment services. Credit or deposit business as well as other banking services which are not investment services may not be carried out or provided in the EEA through this procedure. To this end, national law continues to apply which effectively prevents a harmonised overall approach.

- If the third-country company wishes to address retail clients or opt-up professional clients, articles 39 et seqq. MiFID II will apply. Pursuant to these articles, it is at the discretion of the respective member state to specify whether establishing a branch in the member state is required or not. Alternatively, the previous national regime may be maintained (or, if applicable, a further developed regime). MiFID II does not provide for a harmonised system in this regard.

  The possibilities of reverse solicitation remain unaffected in this context.

Currently, the Germany Securities Trading Act deals only marginally with the obligations of third-country companies regarding the cross-border provision of investment services to clients in Germany. The core standard is section 31 para. 10 of the German Securities Trading Act, defining the applicable conduct of business rules in a cross-border context.

The authorisation for providing investment services is, however, governed by the licence requirements of the German Banking Act (Kreditwesengesetz – "KWG") allowing for exemptions in accordance with section 2 KWG.

With regard to such an exemption, BaFin differentiates between certain categories of clients, whereby differentiation is not made between professional clients and retail clients in accordance with MiFID, but between institutional and private clients. It should be noted that not each professional client within the meaning of MiFID/MiFID II is at the same time "an institutional client".

The German legislator will probably opt not to apply the requirement of a branch under MiFID II (at least according to the draft bill). Other EU member states also seem reluctant to opt for this requirement. In Spain, the Netherlands and France on the other hand there seem to be tendencies towards endorsing an obligation for establishing a branch.

CRD IV

CRD IV does not contain many direct rules for access to the EU market by third-country market participants. In this respect, the licence requirement topic for banking services remains with the individual member state.

The German authorisation requirement for banking services is subject to KWG rules, cf. above.

Alternatives for accessing the market

Reverse solicitation

In principle, every EU–Directive provides for the possibility of reverse solicitation. Reverse solicitation occurs if a European client contacts a third-country firm on its own initiative and requests service. In practice, this possibility of accessing the

market is still sometimes strongly used, even though past experience has repeatedly shown that a substantial business model should not be based on this principle.

Wrappers for investment structures

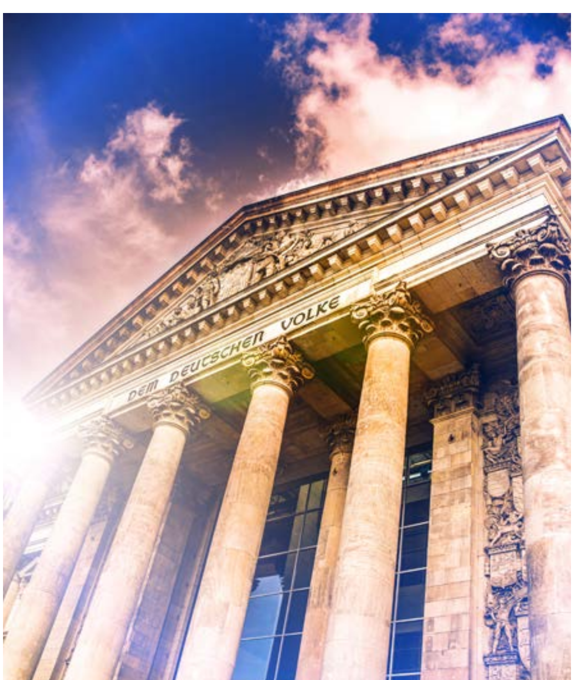
Wrappers are frequently applied, especially in the area of fund investments, e.g. in the form of a fund-linked note. This has the advantage that instead of complex marketing in accordance with AIFMD or the national marketing regime for investment funds, which is even more extensive for private clients, the Prospectus Directive with its generous exemptions and its private placement regime typically applies to the note.

Parallel vehicles for investment structures

The launching of European vehicles parallel to the original foreign investment structure is becoming increasingly noticeable. Both European investment vehicles and foreign investment structures make investments in accordance with the same investment rules, typically even in the same asset. European investment vehicles (and/or their EU management companies) may make comprehensive use of the advantages for EU providers, e.g. they may apply the European marketing passport. Such parallel structures, however, are expensive and only worthwhile in case of investments with greater volumes.

Possibilities for exemption

Most national supervisory regimes provide for possibilities for exemption for the provision of services in the EU. Especially when providing a service to (per se) professional clients, the need for supervision is often not emphasised strongly enough and an exemption is, to the extent required by law, granted.



German investor considerations

Besides these licence-related topics, one should also bear in mind the applicable restrictions on the investors' side, in particular insurance companies (Solvency II) and investors which are subject to the German Investment Ordinance (Anlageverordnung – "AnlV") such as pension funds, when investing into UK AIF and other UK investment structures.

Solvency II

German and other EU investors subject to Solvency II may be faced with a higher capital stressing pursuant to article 168 para. 6 lit. c) of the Commission Delegated Regulation (EU) 2015/35 in case they invest into non-EU-AIF. Whereas AIFs established in the EU which are closed ended and not using leverage benefit from a preferential capital treatment, such preferential treatment is only available for non-EU AIFMs if they have opted (and are able to opt subject to the staggered implementation set out above) for the passport under the regime for non-EU AIFMs.

Investment Ordinance

For investments in private equity funds, becoming a third-country firm should not have much effect as the allocation under the so-called private equity quota of the AnlV only requires that AIF and AIFM have their seat in an OECD country (which is and will continue to be the case for the UK); the further criteria that the AIFM is subject to supervision which is equivalent to the one which EU AIFMs have to comply with should be achievable.

With respect to indirect investments into real estate, debt and other asset classes, the AnlV provides that any such AIF would only qualify under the specific asset class quota (i.e. "real estate quota", "alternative investment quota") if the AIF and the AIFM have their seat in the EEA. If the rules of the AnlV remain unchanged until the departure of the UK, it will be difficult (subject to some structuring or wrappers) or impossible for German investors, which have to comply with the AnlV, to invest into UK AIFs.

In the past , BaFin and the AnlV very often provided some relief by grandfathering provisions, i.e. investments correctly made under a former version of the AnlV can remain unchanged and the new AnlV only applies for new investments. It remains to be seen whether such a grandfathering can also be implemented in the event of the invested asset, e.g. the UK AIF, changing its status into that of a third-country AIF.

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FUNDS

Reserved Alternative Investment Fund ('RAIF'): A new Luxembourg regulated fund with no direct supervision

by Nick Goddard and Marianna Tothova

A new type of investment fund has been launched in Luxembourg, the RAIF, which provides the protections and flexibilities typical of a Luxembourg regulated fund but free of CSSF supervision, representing a new way of bringing funds quickly to market.

The long awaited law introducing a new type of Luxembourg regulated fund: the reserved alternative investment fund ("*fonds d'investissement alternatif réservé*" or "*RAIF*") was published on 28 July 2016. The RAIF regime is a new regulatory regime in Luxembourg which replicates the regulatory regimes of the "*fonds d'investissement spécialisé*" or "*SIF*" and of the "*société d'investissement en capital à risque*" or "*SICAR*" (including their tax advantages) but with considerable efficiencies and improvements.

As with a SIF and a SICAR, the RAIF regime takes the form of a regulatory wrapper around a Luxembourg fund vehicle, which may be a company (typically an SA or an SCA, including an investment company with variable capital or "SICAV"), a limited partnership (an SCS or SCSp), or a contractual arrangement (an FCP).

Comparison with other regulated fund structures in Luxembourg: RAIF vs SIF/SICAR

No direct supervision by the CSSF

A RAIF will qualify as a regulated fund, however, unlike other regulated funds in Luxembourg, RAIFs will not be supervised by the Commission de Surveillance du Secteur Financier ("CSSF").

What you need to know

- **The RAIF is a new type of regulated Luxembourg fund which is not supervised by the CSSF.**
- **A RAIF may be set up with compartments, with variable capital (e.g. as a SICAV) and/or as a limited partnership.**
- **Unregulated Luxembourg funds (usually set up as limited partnerships) remain an attractive structuring option for fund promoters.**

This is the key advantage of the RAIF regime compared to the SIF and SICAR. Instead, a RAIF will have its regulatory compliance supervised by its alternative investment fund manager ("AIFM"). All RAIFs will qualify as alternative investment funds ("AIFs") under the Alternative Investment Fund Managers Directive ("AIFMD") and will be required to appoint a fully authorised external AIFM, established in Luxembourg or in another EU country (or in a non-EU country if the AIFMD passport is extended to non-EU countries). In common with other Luxembourg AIFs, each RAIF will also need to appoint a Luxembourg domiciled depositary, administrator and auditor.

The role of the CSSF (or another regulator) is restricted to the supervision of the AIFM appointed by the RAIF (i.e. an indirect supervisory role). Accordingly, the CSSF will have no direct involvement with the fund vehicle. This means that, unlike a SIF or a SICAR, the CSSF will not need to approve the constitutional or marketing documents of a RAIF prior to its launch; nor will it need to approve amendments to a RAIF's constitutional or marketing documents during the life of a RAIF. It will be, principally, the responsibility of the AIFM of the RAIF to ensure the compliance of the RAIF with the AIFMD.

This streamlined regulatory approach will make the RAIF a much quicker and more efficient fund to establish than a SIF or a SICAR and should considerably shorten the time necessary to bring a Luxembourg regulated fund to market. It should also mean the ongoing operation and management of a RAIF is more efficient than that of a SIF or a SICAR.

Umbrella/compartmentalised fund

Just like a SIF or a SICAR, a RAIF may be established as an "umbrella fund" comprising a number of separate "compartments" with assets and liabilities that are legally segregated from each other under Luxembourg law. Again, like a SIF or a SICAR structured as an umbrella fund, a RAIF may create new compartments for new funds or mandates from time to time. Many managers are attracted to the efficiency of having as many of their funds and segregated mandates as possible consolidated in one platform and the ease and efficiency with which new compartments may be established in a RAIF makes this more achievable with a RAIF than with a SIF or a SICAR.

Risk diversification

A RAIF will need to comply with certain risk diversification rules. These diversification rules are the same as for a SIF or a SICAR. SIF-like RAIFs, which are allowed to invest in any type of assets, may not generally invest more than 30 per cent of their net assets or commitments in one asset. SICAR-like RAIFs, which voluntarily decide to only invest in what is defined as "risk capital" (meaning broadly investments in view of an asset's launch, development or listing) are not subject to any diversification requirements and may hold just one asset. The diversification rules will apply on a compartment-by-compartment basis for RAIFs established as umbrella funds.

Tax advantages

Provided the RAIF satisfies the relevant risk diversification requirements it will enjoy the same tax treatment as either a SIF or a SICAR depending on the assets it holds. For example, generally a SIF-like RAIF will be tax exempt, save for an annual subscription tax of 0.01 per cent of its net assets (a "*taxe d'abonnement*"). Subject to that, a RAIF which is structured as a limited partnership (an SCS or an SCSp) should be treated as tax transparent for Luxembourg tax purposes. In addition, the Luxembourg VAT exemption on management services will apply in relation to a RAIF in the same way as it applies to SIFs and SICARs.

Comparison with unregulated Luxembourg fund structures

While Luxembourg's funds industry historically focused on the regulated and supervised fund vehicles (such as SIFs), since the implementation of the AIFMD and the introduction of the modernised limited partnership regime into Luxembourg law in 2013, the use of limited partnerships (a common limited partnership or "SCS", with legal personality and a special limited partnership or "SCSp", without legal personality) as unregulated AIFs has become increasingly popular among the promoters targeting professional investors.

The unregulated AIFs remain a structuring option for promoters. In addition, if desired, unregulated AIFs with a fully authorised external AIFM may upscale to a RAIF at any time during their lives. Below we compare and contrast the two regimes.

AIFMD

A RAIF must appoint an external authorised AIFM and will therefore be fully subject to the AIFMD, hence always benefiting from the EU marketing passport.

Unregulated AIFs may also appoint an authorised AIFM and benefit from the EU marketing passport. However, they are not obliged to do so and may still benefit from the sub-threshold AIFMD regime, be internally managed or appoint a registered AIFM (as opposed to an authorised AIFM).

Regulation by law

Unregulated AIFs are governed by the provisions applicable to the chosen legal form under the Luxembourg 1915

Commercial Companies Law[1] and by the AIFMD (full scope or sub-threshold) but otherwise will enjoy full contractual freedom.

RAIFs will be governed by the relevant provisions of the 1915 Commercial Companies Law, the AIFMD (full scope) and their constitutional documents but will also have an additional layer of regulation since they must comply with the RAIF law. The RAIF law imposes certain additional restrictions on the AIF but also grants certain flexibilities which are not available to unregulated AIFs (such as compartments or variable capital).

Umbrella/compartmentalised fund

Unregulated AIFs may not be established with legally segregated compartments.

Therefore if a promoter wishes to establish a compartmentalised platform, with, for example different investment strategies or portfolio managers on each compartment, then the platform must be established as a regulated AIF and the RAIF is the most simple straight-forward regulated fund to establish and operate that is in Luxembourg armoury. An umbrella can provide certain economies of scale for promoters.

Variable capital (SICAV)

Only RAIFs can be set up with variable capital and use the label "SICAV" (a "*société d'investissement à capital variable*" or an investment company with variable capital). A SICAV may issue and redeem its shares without limitation. The shares of a SICAV are issued with no par value and their value (and the SICAV's corporate capital) automatically fluctuates with the value of the SICAV.

An unregulated AIF structured as a limited partnership (as opposed to a corporate) may also achieve similar results through operation of the partnership agreement.

Risk diversification

RAIFs (and each of their compartments) must, by law, follow the risk diversification principle described above (unless they invest in "risk capital", i.e. are SICAR-like), save that it is possible to provide for a ramp up period. It is expected that RAIFs will be required to comply with the risk diversification requirements appropriate to SIFs or SICARs depending on the type of assets in which the RAIF invests.

Unregulated AIFs are under no legal obligation to comply with any risk diversification rules save for those set out in their fund documentation.

Offering document

A RAIF must prepare an offering document which must include certain information prescribed by the RAIF law and the AIFMD. In the case of a multi-compartment RAIF, offering documents may be prepared per compartment or, alternatively, all compartments may be covered by one umbrella offering document.

An unregulated AIF is subject only to the AIFMD disclosure requirements which are listed in the AIFMD.

FCP

A RAIF may adopt a legal form of a fonds commun de placement(an "FCP") which was widely used in the past for investors seeking a tax transparent vehicle and which is still a vehicle of choice for certain investor jurisdictions (e.g. Japan), although it is increasingly being replaced by limited partnerships.

Unregulated AIFs may not take the form of an FCP.

Minimum capital

RAIFs must achieve a minimum capital within a certain timeframe and the RAIF may be subject to winding up if its capital falls beneath its minimum capital.

Unregulated AIFs are required only to comply with the rules applicable to the legal form they have adopted as per the 1915 Commercial Companies Act, e.g. limited partnerships are not subject to any minimum capital requirements.

Subscription tax

RAIFs (unless they invest exclusively in "risk capital", i.e. are SICAR-like) will be subject to annual subscription tax of 0.01 per cent of their net asset values.

Unregulated AIFs are not subject to the subscription tax.

What will RAIFs mean for managers?

The RAIF is a credible and attractive new structuring option to add to the existing options available to managers and investors in Luxembourg. As far as Luxembourg regulated funds are concerned, we believe that the more user-friendly RAIF will replace the SIF and the SICAR regimes and become the go-to vehicle for managers which are structuring their funds to appeal to investors which require (or prefer) regulated funds (e.g. certain European insurance companies and pension funds) and for managers which have the aim of consolidating their funds and mandates within different compartments of the same umbrella fund vehicle.

Notwithstanding the introduction of the RAIF, unregulated AIFs (especially in the form of limited partnerships) remain an attractive structuring option and we anticipate that they will continue to be used widely by promoters targeting investors who do not require a regulated fund vehicle as well as by promoters raising smaller funds who may wish to use the sub-threshold AIFMD regime.


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1 Note that limited partnerships are governed by a very flexible regime with few restrictions.


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