STAY CURRENT
A Client Alert from Paul Hastings

PAUL HASTINGS

February 2012

Loan Funds in Europe: UCITS and AIFMD in 2012

BY CHRISTIAN PARKER, JONATHAN SHENKMAN & KARINA BIELKOWICZ

There is a peculiarity in the funds world that has meant that the European loan fund[1] has long been the poor relation by comparison with more traditional bond and share funds and that disparity is likely to get worse as the AIFM Directive[2] comes into force across Europe. That peculiarity has been embedded since the 1980s in the way that the UCITS Directive[3] has made it possible for the retail market to be accessible directly to funds that are invested in credit investments that are similar to loans (high yield bonds and asset backed securities) and (since UCITS III in 2003) indirectly to hedge fund and other "alternative" strategies (such as commodities) that are only available through the use of derivatives (the Newcits phenomenon[4]).

Historically, commercial lending was the preserve of the banks but that began to change quite significantly in the late 90s and accelerated in the 00s, driven to a significant degree by the rise of the CLO and simultaneously, but to a lesser degree, by the rise of the loan fund. Banks, damaged by the Lehman crisis and now further at risk by virtue of the sovereign debt crises, do not appear to be that well-placed to ramp up their lending. New regulation has made the issuance of (tranched) CLOs difficult[5] and the AIFM Directive is likely to significantly raise the costs of loan funds that are set up by way of European specialist funds (whether Luxembourg SIFs, Irish QIFs, UK QISs etc) or in fact any fund sold in Europe. Not that one should necessarily expect a reasoned approach from a politician or regulator, but it is worth noting that the added difficulties and costs associated with European loan funds come at a time when industry (and politicians) are crying out for loans.[6] Notwithstanding this paradox, the political/regulatory environment for non-bank lending is likely to get worse as the regulators ramp up their analysis of how to regulate the pejoritatively titled shadow banking system.[7]

UCITS

Attempts have been made to bring loans into the "eligible assets"[8] category of the UCITS Directive (most recently by lobbying from the Association of Financial Markets in Europe (AFME)). The AFME put out a paper in February 2010 as part of the UCITS IV consultation which quoted managing director Gilbey Strub as saying that "Widening the UCITS definition of "eligible assets" to include loans is the single most significant measure policymakers could take to improve funding channels for UK companies." The sentiment was certainly right. However, ESMA appears to have taken little notice and, so long as UCITS requires its funds to have ready liquidity (i.e., redemptions twice a month and on no more than ten days' notice), the UCITS regime is unlikely to welcome an asset class where average settlement is over 40 days.

Like other asset classes that are nominally forbidden by the UCITS Directive, loan funds can, however, be set up under the UCITS framework through the use of tailored indices and derivatives (i.e., as a Newcits fund) but historically this route has not been used to any significant degree. This is probably

because the costs associated with setting up a UCITS fund targeting investment returns of maybe 8 – 10% per annum cannot afford the basic UCITS administrative cost, the cost of a liquidity facility, plus the additional structuring costs associated with the traditional Newcits structural device, namely a bespoke index and a total return swap (that could reach 2 – 3%). These costs are then enhanced by the investment manager's own fees.

There will be managers that do persist with UCITS-compliant loan funds, however; a potentially significant number of high-yield bond fund managers will seek to hold some level of loan exposure in a UCITS wrapper and so can potentially proportionally minimise the costs referred to above. The key developments of 2011 in the UCITS environment, the implementation of the so-called "UCITS IV", will have kept their administrators and service providers busy primarily in preparing for the "Key Information Document" or "KID." The other changes in UCITS IV were targeted at efficiency and convenience: for example, the ability to have intra-EU master/feeder structures and the enhanced notification procedures will undoubtedly improve retail accessibility but should have little significance for funds that are targeting professional and institutional investors.[9]

Despite the implementation of UCITS IV in 2011, the next iteration (unsurprisingly "UCITS V") is likely to follow reasonably soon. The draft UCITS V Directive was scheduled to have been published in 2011, but has been pushed back into 2012. This will have a significant impact on all types of UCITS funds if only by virtue of its likely adoption of the depositary liability requirements that are being adopted under the AIFM Directive and the associated costs (about which see below).

The other item to look forward to in 2012 in connection with UCITS funds is the ongoing debate associated with the division of UCITS funds into "complex" and "non-complex" under MIFID II.[10] In summary, if adopted, this development will create a two-tier UCITS distribution regime whereby any kind of UCITS fund that is "structured" or "swap-based" will be unavailable to the European retail market on an "execution only" basis.

AIFM Directive

Much has been written about the AIFM Directive, for which the founding intention was to create a comprehensive and effective regulatory and supervisory framework for alternative investment fund managers and to allow a simplified selling structure within the EU. Although some larger well-established managers may see the AIFM Directive as an attractive barrier to entry to potential smaller competitors, there is no evidence of institutional investors supporting this Directive, not least because the institutional market sees it as adding cost to their investments without any clear regulatory value. That said, the Directive is due for implementation in Summer 2013 and, although more detail will be developed through Level 2 and Level 3 implementation, it is now possible to see the issues that should concern those involved in "alternative investment funds" and, specifically, loan fund managers.

The main aspects of the AIFM Directive that will be relevant to a specialist loan (or any other) fund manager will include the requirement to be specifically authorized as an AIF manager (the AIFM), together with certain remuneration and capital requirements for the AIFM. Beyond the regulation of the AIFM, the Directive is an indirect way to regulate the "alternative" funds (or AIFs) that are managed by the AIFMs, with regulatory oversight ranging from substantial reporting requirements to an ability of the regulator to control the AIF's leverage.

However, the most eye-catching aspects of this Directive are the marketing and depositary-related requirements.

Marketing of AIFs

The intention behind the marketing restrictions imposed by way of the AIFM Directive is essentially good, namely to provide a passport for the distribution of AIFs in Europe. In practical terms, however, the arrangements are complicated and transitory in the sense that most managers, seeking to access the institutional market, will rely on the stipulation that they can continue until at least 2018 to use the EU private placement regimes (that have served well enough in the past).

Depositaries and Depositary Liability under the AIFM Directive

Under the AIFM Directive, subject to some very limited restrictions, each AIF must appoint a "depositary" whose roles can be simplistically divided into two main strands, firstly to provide a custody function and, secondly, a compliance function. The compliance obligation derives from the UCITS Directive and boils down to an obligation to oversee the AIF's cash management and its compliance with its own constitution and certain regulatory requirements involving, for example, delegation.

The custody function requires the depositary firstly to maintain certain financial instruments in custody and, secondly, to verify ownership of other assets and to keep accurate records. A distinction is drawn here between these two tasks for liability reasons (about which more below). The important point here is that the custody function applies to all financial instruments registered or held in an account directly or indirectly in the depositary's name and therefore, while catching cash, bonds and other securities, would appear to exclude loans held in the AIF's (or its nominee's) name. This would mean that an AIFM Directive-compliant depositary to a loan fund is likely to have custodial responsibilities that are limited to any cash and securities but will have relatively extensive compliance oversight obligations.

The most controversial issue in the depositary-related aspects of the AIFM Directive is depositary liability. Under the Directive, the standards of liability for its custodial safe-keeping are divided. In summary, custodial liability for cash and securities is "strict": where a financial instrument is held directly by the depositary (i.e. for cash and securities), the depositary will be liable to return the relevant financial instrument in all events save where it can show that the loss of the relevant instrument was beyond its reasonable control and the consequences of which were unavoidable despite all reasonable efforts to the contrary. On the other hand, the liability level for loans (and other non-financial instruments) is limited to the depositary's intentional or negligent failure.

The increased liability associated with being a depositary for an AIFM Directive-compliant AIF has one important practical implication, namely cost. In an AIMA sponsored report,[11] the added liability associated with the appointment of depositaries to AIFs was reported to be likely to add on an ongoing basis between 1 and 1.5% per annum.

It is our view that this number could be exaggerated for mainstream credit funds (where bonds are held in Euroclear, Clearstream and/or DTC) and that this kind of level of increased cost is only really likely to be seen where non-standard clearing systems and the extensive use of sub-custodians is required. For loan funds, the reduced liability for the custody of loans (when compared with bonds) is likely to mean that although the cost of a depositary will likely be increased by the Directive, it should be possible for credit managers to negotiate that added cost to a more reasonable level.

Is There Any Alternative to the UCITS or AIF for A Loan Fund Manager?

We briefly touch on the future of CLOs above that, while being a delivery mechanism for loan investment, are clearly different to standard open-ended loan funds as being both "closed-ended" and

tranched. The new "skin-in-the-game" requirements associated with an investment in any kind of tranched securitization have made anything other than traditional balance sheet CLOs both difficult and expensive.

Another fund delivery mechanism, the "GP/LP" closed-ended fund also has its attractions, although it clearly is not open-ended and its drawbacks will also include the fact that such a vehicle, wherever situated and assuming sales into Europe, will also be subject to the AIFM Directive. Similar to the GP/LP structure, there have recently been a number of "permanent capital funds" launched[12] that invest solely in the loan asset class. These are listed, closed–ended funds, typically with discount prevention mechanisms, that also will be subject to the AIFM Directive. Unlike the traditional GL/LP funds however, these vehicles are accessible to the retail market.

For those seeking untranched loan investment on an open-ended basis in a manner that will not bring in the cost and regulatory burden inherent in the UCITS and AIFM Directives, the only mechanism available at this time is the untranched and pooled note programmes. Although relatively lightly used, and only at the top end of the institutional market to date, we expect that these vehicles will be increasingly drawn upon to ensure that more of the investment return generated by the underlying investment pool will be delivered to the investor rather than the service providers.

Summary

In summary, the UCITS Directive purports to make the delivery of loan funds to the European public either impossible or extremely expensive. Meanwhile, the European institutional market's access to all non-UCITS funds (including loan funds) is about to be made significantly more regulatorily intensive and costly by the AIFM Directive — all at a time when the market is seeking the efficient delivery of loans into European industry to promote commercial activity. As a result, and in time-honoured fashion, just as the regulations deliver an apparently all-encompassing and expensive protection to investors, those same investors will seek to find cheaper and lightly-regulated ways to circumvent that same protection.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

London

Karina Bielkowicz
1.44.20.3023.5195
karinabielkowicz@paulhastings.com

Jonathan Shenkman
1.44.20.3023.5131
jonathanshenkman@paulhastings.com

Christian Parker
1.44.20.3023.5161
christianparker@paulhastings.com

San Francisco

Mitchell E. Nichter
1.415.856.7009
mitchellnichter@paulhastings.com

18 Offices Worldwide | Paul Hastings LLP | www.paulhastings.com

Stay*Current* is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2012 Paul Hastings LLP.

IRS Circular 230 Disclosure: As required by U.S. Treasury Regulations governing tax practice, you are hereby advised that any written tax advice contained herein or attached was not written or intended to be used (and cannot be used) by any taxpayer for the purpose of avoiding penalties that may be imposed under the U.S. Internal Revenue Code.

[1] By "European loan fund" in essence we mean loan funds sold in the EU, so including e.g. funds whose portfolios comprise loans sourced globally

[2] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

[3] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

[4] "Newcits" is an unofficial umbrella term coined by the media to describe funds that are compliant with UCITS but that are criticized for "breaching the spirit" by straying into increasingly complex structures that use derivatives and might not be UCITS compliant if structured without derivatives.

[5] Inter alia and in summary, each of the AIFM Directive, Capital Requirements Directive and Solvency II Directives require that AIFs, credit institutions and insurance companies that wish to invest in CLOs have ensured in turn that the "originator" of the CLO has retained a 5% economic risk interest. See e.g. "Retention Requirements for ABS — The New Regulatory Landscape in the U.S. and Europe" – Paul Hastings Stay Current (July 2010).

[6] Ironically, EU fund regulation is making the provision of credit more expensive at the same time that the UK government is engaged in a consultation on "Improving access to non-bank debt" (Department for Business Innovation & Skills – URN 111454)

[7] See e.g. EUROFI paper dated 19 February 2011, FSB background note of 12 April 2011 and IMF Working Paper (WP/11/289) dated December 2011.

[8] Eligible asset criteria under the UCITS regime are strict and restricted to, inter alia, transferable securities, cash and derivatives. Loans are not transferable securities for these purposes.

[9] See e.g. 'The New UCITS IV Directive: Risks and Opportunities,' Paul Hastings Stay Current (June 2009).

[10] See the European Commission's legislative proposals to amend the Markets in Financial Instruments Directive (2004/39/EC), which were published on 20 October 2011 (MIFID II).

[11] See "Alternative Investment Managers Association submission to ESMA dated 13 September 2011."

[12] For example Neuberger Berman's NB Global Floating Rate Income Fund of April 2011 and Alcentra's European Floating Rate Income Fund launched in January 2012.