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SPOTLIGHT Credit Funds

Direct Lending
A Mature Market?

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In this issue

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Direct Lending
A Mature Market?

Private debt has erupted onto the scene with senior loans, mezzanine financing, infrastructure debt and even distressed debt recently gaining a large following as investors hunt for better returns and longer term relationships in the current low interest rate environment.

Data from Preqin reveals that nearly two-thirds of credit funds that closed in the first quarter of 2017 exceeded their target fund raising levels. 80 funds raised USD39.1 billion in capital in the second quarter of 2017. All the signs point to private debt continuing to grow as an asset class with increasing competition for deals. It is now a crowded market and arguably a more mature one.

The signs of a maturing market are here:

Changing regulatory landscape

Recent changes in the banking monopoly rules in traditionally conservative jurisdictions such as France, Germany and Italy are a sure sign that regulators are getting more comfortable with the protections that AIFMD (the Alternative Investment Fund Managers Directive) has afforded investors since its implementation. In this edition, Dr. Christopher Wolff and Fritz Kleweta examine the recent bank monopoly changes in Germany while Hubert Blanc Jouvan explores the significant bank monopoly changes in France. Eriprando Guerritore gives his view on the recent changes in direct lending in Italy.

Growth in unregulated structures

The recent changes in the regulatory landscape have had an interesting side effect – the rapid growth of unregulated funds. In this edition, Sophie Laguesse of Elvinger Hoss Prussen examines the growth of one such type of fund which was launched in the wake of AIFMD—the Luxembourg RAIF (Reserved Alternative Investment Fund).

Introduction: Direct Lending – A Mature Market?

A more sophisticated investor base

Investors in debt funds are primarily sophisticated pension schemes and insurers who are now familiar with the protections afforded to them through AIFMD and are now not only wanting to deploy large amounts of capital in short periods of time, but are also actively requesting managers leverage their mandates within careful parameters—something that was not common, even 18 months ago. Katherine Rainwood and Thomas Rao explore the popularity of fund financing.

Funds are getting bigger

There is a growing gap between the large asset managers and the smaller more bespoke asset managers, as managers try to stand out from the crowd. The big players are dominating the larger opportunities and are often oversubscribed. With new entrants piling into the private debt market, managers are having to find their niche either through a specific sector or geographical focus. The success of these funds depends on managers' access to deal flow and their ability to deploy quickly. Accordingly, co-investment opportunities are on the rise as managers try to line up investors to help with larger allocations in order to beat the competition for the assets. We provide a refresher on the basic legal fundamentals of co-investment vehicles especially in light of regulators such as ESMA (European Securities and Markets Authority) and the FCA (Financial Conduct Authority) providing helpful guidelines for managers in structuring their co-investment vehicles.

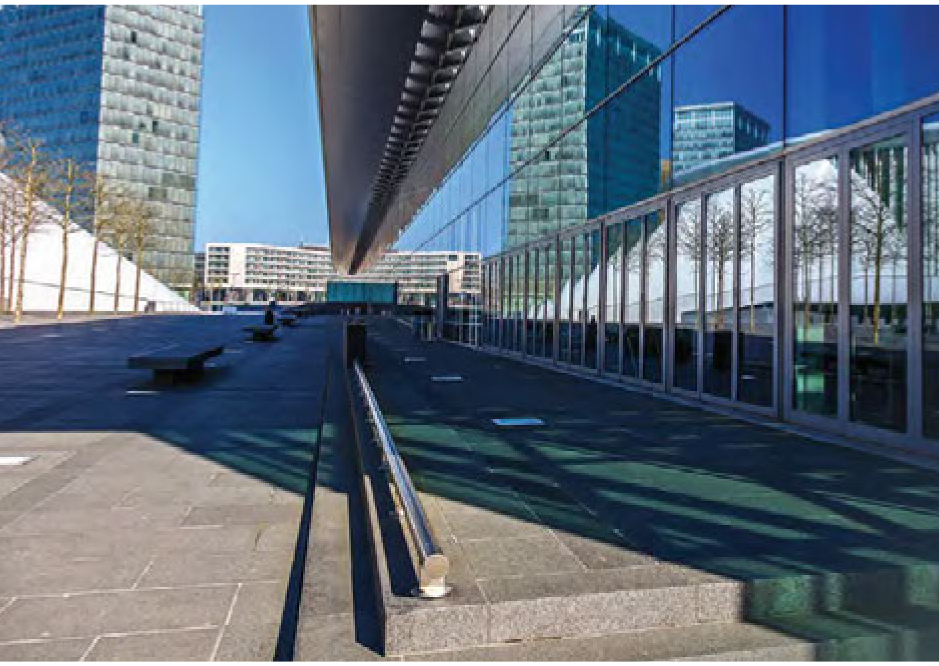
Key investor protection regulations finally being implemented

Solvency II reporting has been a key feature of 2017 for investors providing them with both transparency on the underlying portfolio and favourable regulatory capital treatment. Managers are familiar with delivering those reports, and now MiFID II has finally been implemented, investors benefit from greater transparency and a prohibition on inducements. Diala Minott and Nikki Johnstone explore the impact on fund managers of the long-awaited MiFID II, and Diala Minott and Sophie Wood discuss the effect of the forthcoming EU General Data Protection Regulation (GDPR) on credit funds.

Retail money

Perhaps the most telling factor of a maturing direct lending market is when managers feel ready to market their funds to the public. As direct lending managers tentatively move into this space, Christian Parker and Edward Scott discuss the newly enforced Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation which aims to help investors to better understand and compare the key features, risk, rewards and costs of different PRIIPs, through access to short Key Information Documents (KIDs) which are required to be produced for any fund marketing to investors that are not professional investors and the various pitfalls to consider.

We hope you enjoy this first edition!



Luxembourg

18 Months Of The RAIF – The Verdict

By Sophie Laguesse
of Elvinger Hoss Prussen

Legislation published on 23 July 2016 introduced the European direct lending market to a new Luxembourg investment fund regime—the Reserved Alternative Investment Fund (RAIF). 18 months later, there are now over 280 RAIFs in existence—and for good reason. So what's the attraction?

Key points

- RAIF legislation replicates the familiar regulatory landscape of SIFs[1] and SICARs[2] (including their tax advantages) but with considerable improvements.
- The crucial RAIF advantages come through structural flexibility, a lack of CSSF supervision and generous tax treatment.

Introduction

When the RAIF first came out 18 months ago, there was a certain nervousness amongst managers to test this new fund product. However, fast forward 18 months and there are well over 280 RAIFs in existence.

So what is the RAIF?

The RAIF is a Luxembourg alternative investment fund ("AIF") which must be managed by an authorised alternative investment fund manager ("AIFM") established in Europe.

What are the advantages?

1. Time to market

The RAIF is regulated under Alternative Investment Fund Managers Directive (AIFMD[3]) but *not* supervised by the Luxembourg regulator (i.e. the CSSF). Accordingly, there is no requirement for the CSSF's approval for the creation, launch or even termination of the RAIF, and similarly no approval is required to amend the documentation of the RAIF. The operations and activities of the RAIF are at no point under the ongoing supervision of the CSSF or any supervisory authority (other than through its AIFM).

The RAIF is therefore a very attractive product from a time-to-market perspective and this is what largely explains the success of the RAIF over the last 18 months.

2. No compromise in terms of protection of the investors

Investors in a RAIF enjoy all the protections granted to investors under AIFMD. This product is designed for institutional, professional and sophisticated investors who are capable of performing their own review of the fund's structure and documentation and for which the costs of, and sometimes delay caused by, a second layer of protection via a regulator supervision is not justified.

Interestingly, following the trend started by Luxembourg with the RAIF, many jurisdictions have recently changed their insurance code and banking monopoly rules to also remove the need for local regulator oversight as long as the investment fund is AIFMD compliant.

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1 SIFs refers to specialised investment funds being a type of Luxembourg regulated funds governed by Luxembourg law of 13 February 2007.
2 SICARs refers to investment company in risk capital being another type of Luxembourg regulated funds governed by Luxembourg law of 15 June 2004.
3 AIFMD refers to Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers.

3. Flexibility in terms of structuring

The RAIF enjoys all the structuring flexibility from which Luxembourg funds benefit (both CSSF approved funds and CSSF supervised funds).

The RAIF can be set-up as (i) a common fund (FCP), or (ii) an investment company with variable capital (i.e. SICAV) or fixed capital (i.e. SICAF) in the form of:

- a public limited liability company (SA), a corporate partnership limited by shares (SCA) or a private limited liability company (S.à r.l) which are treated as tax opaque for Luxembourg tax purposes; or
- a common limited partnership (SCS) or a special limited partnership (SCSp) which are treated as tax transparent for Luxembourg tax purposes.

Among the corporate forms available for establishing a RAIF, the SCSp is the most popular.

The key characteristic that distinguishes the SCSp from the other corporate forms is that it has no legal personality. It is very similar in structure to an Anglo-Saxon Limited Partnership and therefore offers a great deal of flexibility around key issues such as economics and control. Moreover, much of the know-how and technology used in English or Jersey limited partnership agreements can be adopted as a starting point for drafting of the limited partnership agreement of a RAIF.

4. Umbrella structure – Platform use

The RAIF can be compartmentalised into an umbrella structure with several sub-funds. Previously only fully CSSF regulated funds could have the benefit of being compartmentalised, leaving managers who didn't want the expense of being fully regulated with the only option of having several funds being set up which were expensive and burdensome to operate.

Each sub-fund's assets and liabilities are segregated under Luxembourg law, providing sufficient comfort to investors.

Accordingly managers have started to use RAIFs to house all their fund strategies under one roof including:

- feeder funds;
- single investor mandates;
- pooled funds;
- funds of one;
- successor funds;
- parallel funds; and
- co-investment vehicles.

This platform strategy allows managers to negotiate consistent fund terms for the entire umbrella structure ensuring that there is uniformity on fundamental terms such as removal for cause or indemnification rights.

RAIFs set-up as an umbrella structure can have a separate prospectus and an annual report per sub-fund which ensures the confidentiality of the terms of each sub-fund.

5. Removal right

A RAIF set-up as a limited partnership (SCA, SCS or SCSp) can only have one AIFM and one general partner, so limited partners in any one sub-fund cannot remove the general partner without the limited partners in every sub-fund voting for its removal. This establishes the manager as the named manager ("white labelled manager") of the umbrella vehicle that cannot be replaced by its competitor. Investors are increasingly comfortable with alternative exit rights for these umbrella structures including:

- appointing a liquidator to liquidate the relevant sub-fund;
- transferring all the assets to another vehicle of the limited partner's choice; or
- redeeming the limited partner's interest or shares.

6. Suitable for all types of investment strategies

The RAIF can be used to implement any type of investment strategy, including direct lending strategies. RAIFs[4] need to comply with certain risk diversification rules applied on a compartment-by-compartment basis and may only place up to and including 30% of their assets in a single investment.

RAIFs are allowed to have different assets in their funds mixing assets such as ABS and other bonds with direct lending assets unlike other jurisdictions and this has allowed managers to progress to the next level of fund—a mixed asset platform. With the current low interest rate environment this has been a huge attraction since high yielding assets can be mixed with direct lending assets in the same subfund. Already several managers are preparing to launch their multi-asset platforms of 2018.

7. Management solution for non-EU managers

The RAIF can also be a suitable investment vehicle for non-EU managers as the requirement that the RAIF must be managed by an authorised EU AIFM can be satisfied by the use of a third party AIFM for the RAIF which then delegates the portfolio management of the RAIF to the non-EU manager. Many US managers have used this route.

8. Benefit from the EU Passport

The RAIF benefits from the passport granted by AIFMD for the marketing to professional investors in the EU since it must be managed by an EU AIFM.

9. Tax

RAIFs enjoy the same generous tax benefits under Luxembourg law as funds that are fully regulated by the CSSF including:

- (For RAIFs which do not invest in risk capital) an annual subscription tax of only 0.01% of its net assets;
- (For RAIFs which only invest in risk capital) income derived from risk capital being fully tax exempted;
- For all RAIFs:
  - No withholding tax on distributions to investors;
  - VAT exemption for management fees;
  - Access to a network of tax treaties subject to certain conditions which vary depending on the legal forms or regime adopted by the RAIF.

Conclusion

The RAIF is a vehicle of choice for debt fund managers and investors looking to combine contractual freedom and short time to market together with both the protection of the AIFMD framework and the RAIF Law and the marketability of an investment vehicle benefiting from the EU passport.

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4 Unless they invest in securities representing risk capital.

Germany

Take-Off For Direct Lending AIFs

By Dr. Christopher Wolff and Fritz Kleweta

There has been steady growth in direct lending in Germany over the last few years, both in terms of the number of transactions made and in terms of total volume. In light of the UCITS V Directive, the German legislature has finally decided to pass the UCITS-V Implementation Act, allowing certain types of AIFs to become active in direct lending.

Key points

- Close-ended special AIFs may now originate loans if they comply with certain requirements.
- There are no new German requirements for EU AIFs / EU AIFMs to originate loans into Germany.
- AIFs authorised for loan acquisition are now also entitled to restructure acquired loans.

Introduction

In the past decade, strict regulations for banks in terms of liquidity and capital requirements, and a historically low-interest rate environment—as well as various other factors—have considerably reduced the number of loans originated by banks within the EU. The resulting shortage in financing options, particularly for small- to medium-size enterprises (SMEs) and sub-prime borrowers in general, led direct lending to become an attractive means of finance.

In Germany, the majority of transactions funded through direct lending have lately been in the field of leveraged buyouts (LBOs) or refinancing.

Legal Framework in Germany

As there is still no pan-European framework for loan origination by Alternative Investment Funds (AIFs), the requirements are still governed by the respective EU Member State laws. The origination of loans in Germany generally requires lenders to obtain a banking license from the German regulator, the Federal Financial Supervisory Authority ("Bafin"). Obtaining a banking license and maintaining compliance with the requirements of the German Banking Act ("KWG") is onerous and expensive. In March 2016, the German legislature passed the UCITS-V Implementation Act (*OGAW-Umsetzungsgesetz*), which implemented certain exemptions from this principle into the German Capital Investment Act ("KAGB").

1. Loan Origination by closed-ended special AIFs

Following these enactments, closed-ended special AIFs (Geschlossener Spezial-AIF) may now originate loans, if they meet amongst other things, the following main requirements:

- the debt incurred by the AIF may not exceed 30% of the aggregate capital contributions and uncalled committed capital ("Investment Capital");
- only (semi-) professional investors may invest in the fund with a minimum stake of EUR 200,000;
- loans may not be granted to consumers within the meaning of section 13 of the German Civil Code (*Bürgerliches Gesetzbuch*); and
- the loan amount in case of a single borrower shall not exceed 20% of the Investment Capital.

In Germany, different regulations will apply to German, EU and non-EU entities. In particular, German Alternative Investment Fund Managers (AIFMs) managing AIFs that engage in loan origination and/or the acquisition of (shareholder-) loans need to comply with certain onerous risk management requirements which also apply to loan originating banks. Also, additional reporting obligations need to be observed in case of loans exceeding an amount of EUR 1,000,000. Further details are described in the Regulations regarding Minimum Requirements for Risk Management of Capital Investment Entities (*KAMaRisk*).

There is uncertainty if the UCITS-V Implementation Act also enables a special purpose lending vehicle to lend into Germany. The respective provisions solely mention AIFs or AIFMs and as a result, it has to be assumed that the exemptions from the banking license requirement apply to AIFs and AIFMs only. Bafin has not yet clarified this point.

2. EU AIFs / EU AIFMs and Non-EU AIFs / Non-EU AIFMs

The UCITS-V Implementation Act does not provide any specific requirements for EU AIFs / EU AIFMs in order to be allowed to originate loans into Germany; rather, these EU AIFs / EU AIFMs are subject to their home state legislation. Also, participations in the EU AIF may be distributed in Germany following the notification process pursuant to the KAGB.

Third-country AIFs will only be entitled to grant loans to a borrower in Germany if the AIF is registered for marketing to semi-professional or retail investors in Germany and if the relevant AIFM complies with the Alternative Investment Fund Manager Directive or if it is an EU AIFM.

3. Restructuring of Loans

The UCITS-V Implementation Act made important legislative changes to the restructuring of loans. In the past, there was a risk that Bafin would consider the modification of loan conditions post-origination (e.g. interest rate adjustments) as loan origination within the meaning of the KWG, thus requiring a banking license. This administrative practice has become obsolete with the UCITS-V Implementation Act (*OGAW-Umsetzungsgesetz*). Therefore, AIFs which are authorised for loan acquisition are now also entitled to restructure acquired loans.

4. Shareholder Loans

Shareholder loans originated by closed-ended special AIFs are exempted from the aforementioned restrictions and may—if certain requirements are met—comprise up to 50% of the Investment Capital.

Market Reaction and Forecast

The number of German direct lending AIFs is still modest compared to other jurisdictions, such as the UK. So far, mainly large capital management companies and bank- / insurance-affiliated capital management companies have set up direct lending funds in Germany. Compared to other EU jurisdictions, the hurdles (particularly risk management requirements) in Germany are still relatively high, which is why credit funds are often set up in less regulated jurisdictions such as Luxembourg or Ireland. EU AIFs can then be distributed with little effort via the notification procedure in Germany, so that there is no urgent need to set them up in Germany. Nonetheless, it can be said that the new legislation is certainly a step in the right direction and the changes support the view from the European Securities and Markets Authority (ESMA), that a consistent framework on loan origination by funds should be implemented across Europe.

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Italy

Freedom For Loan Originating Funds

By Eriprando Guerritore

Many new business opportunities may arise from the opening of the Italian lending market to new qualified lenders of a non-banking nature—such as EU alternative investment funds—following recent developments granting new players the right to lend into Italy.

The new business opportunities relate to:

- Burdensome regulatory pressures on banks based on "Basel III" framework rules;
- Funding of lending transactions not available for bank lending due, for example, to short timelines for loan structuring and execution, and the complexity and risk involved in deals;
- Flexibility of direct lending terms compared to the equivalent terms for bank lending;
- Cooperation between banks and alternative lenders granting sourcing rights—together with relevant fees—to banks and lending rights to alternative lenders only so that any "cooperated lending transactions" will be safe harbored from banks' regulatory prudential capital requirements under Basel III, allowing banks to save material amounts of regulatory capital.

Key points

- Italian insurance companies, Italian securitisation vehicles, Italian alternative investment funds and EU alternative investment funds may lend into Italy following the new measures on direct lending.
- Italian securitisation vehicles may lend into Italy to borrowers other than consumers and micro enterprises.
- Italian alternative investment funds may lend into Italy to borrowers other than consumers.
- Non-Italian EU alternative investment funds may lend into Italy on a freedom to provide services basis or via the formation of an Italian branch.

The new rules rationale

As a general rule, direct lending qualifies as any form of lending carried out by non-banking entities.

Prior to the enactment of the new measures, the Italian banking license regime was quite burdensome compared to that of other EU Member States since the license applied to all forms of lending transaction—irrespective of the kind of borrower involved. For example, lending transactions carried out for the benefit of professional investors fell within the scope of the banking license regime even though they were carried out for the benefit of professional borrowers only.

Following the enactment of the Basel III framework, EU banks have faced material regulatory pressures that strongly jeopardise their lending capacity. In a nutshell, based on the framework, EU banks must set aside a certain amount of capital for each loan they grant. The capital amount to be set aside is calculated based on the main features of the loan (e.g. a secured loan will require a lower capital amount than an unsecured loan).

The impact that the Basel III framework had on Italy was significant because of the huge amount of non-performing loans affecting the Italian lending market. Italian banks had to review their lending policies by reducing the amount of liquidity available to the market and therefore access to bank credit became more burdensome for Italian borrowers.

The lending notion

Granting finance, in any form, *vis-à-vis* the public, qualifies as a lending activity and therefore one must obtain a banking / financial license prior to starting any lending activity in Italy.

The following activities qualify as granting finance in Italy provided they are carried out *vis-à-vis* the public: i) purchase of receivables in exchange for consideration; ii) financial leasing; iii) consumer financing; iv) real estate financing; v) loan on pledge; and vi) guarantee provisions (collateral).

Granting finance is carried out *vis-à-vis* the public, provided it is executed for the benefit of a number of third parties (other than the lender's group entities) and on a professional (entrepreneurial) basis.

New Qualified Lenders of a non-banking nature

Italian insurance companies, Italian securitisation vehicles, Italian alternative investment funds and EU alternative investment funds may lend into Italy following the new measures on direct lending[1].

1. Italian Securitisation Vehicles

Italian securitisation vehicles[2] may lend to borrowers other than consumers and micro enterprises to the extent that:

i) The borrower is identified by a licensed bank or a financial intermediary;

ii) The licensed bank or the financial intermediary identifying the borrower retains a "significant interest" in the financing transaction for the entire life of the loan (so called "net retention"); and

iii) The notes issued to fund the financings to be granted by the securitisation vehicle must be addressed to "qualified investors" only such as banks, financial institutions and pension schemes.

2. Italian Alternative Investment Funds

Italian investment funds carrying out lending activities qualify as alternative investment funds pursuant to Directive 2011/61/EU of 8 June 2011 on alternative investment funds managers (the "AIFMD") as implemented into Italy.

Italian alternative investment funds may lend into Italy provided:

- Lending is carried out *vis-à-vis* borrowers other than consumers;
- They are formed as closed-ended alternative investment funds.

3. EU Alternative Investment Funds

Non-Italian EU alternative investment funds may lend into Italy on a freedom to provide services basis or via the formation of an Italian branch, provided that:

i) They are licensed to lend in their home EU Member State and they are licensed in advance by the Bank of Italy[3];

ii) They are formed as closed-ended alternative investment funds and their functioning scheme is similar to Italian alternative investment funds with a particular emphasis on participation terms;

iii) Their home EU Member State provisions on risk spread and containment, including leverage issues, are equal to the ones provided under Italian laws for Italian alternative investment funds executing direct lending transactions.

Since alternative investment funds lending into Italy fall within the AIFMD scope, non-Italian EU licensed alternative investment fund managers may passport their AIFMD license into Italy—on a freedom to provide services basis or via the establishment of a branch—to form, manage and fundraise Italian alternative investment funds lending into Italy.

Final remarks

The Italian legal, regulatory and tax framework on direct lending is complete. Thus, investors and borrowers may finally enjoy a wide range of alternative lending options in addition to traditional bank lending.

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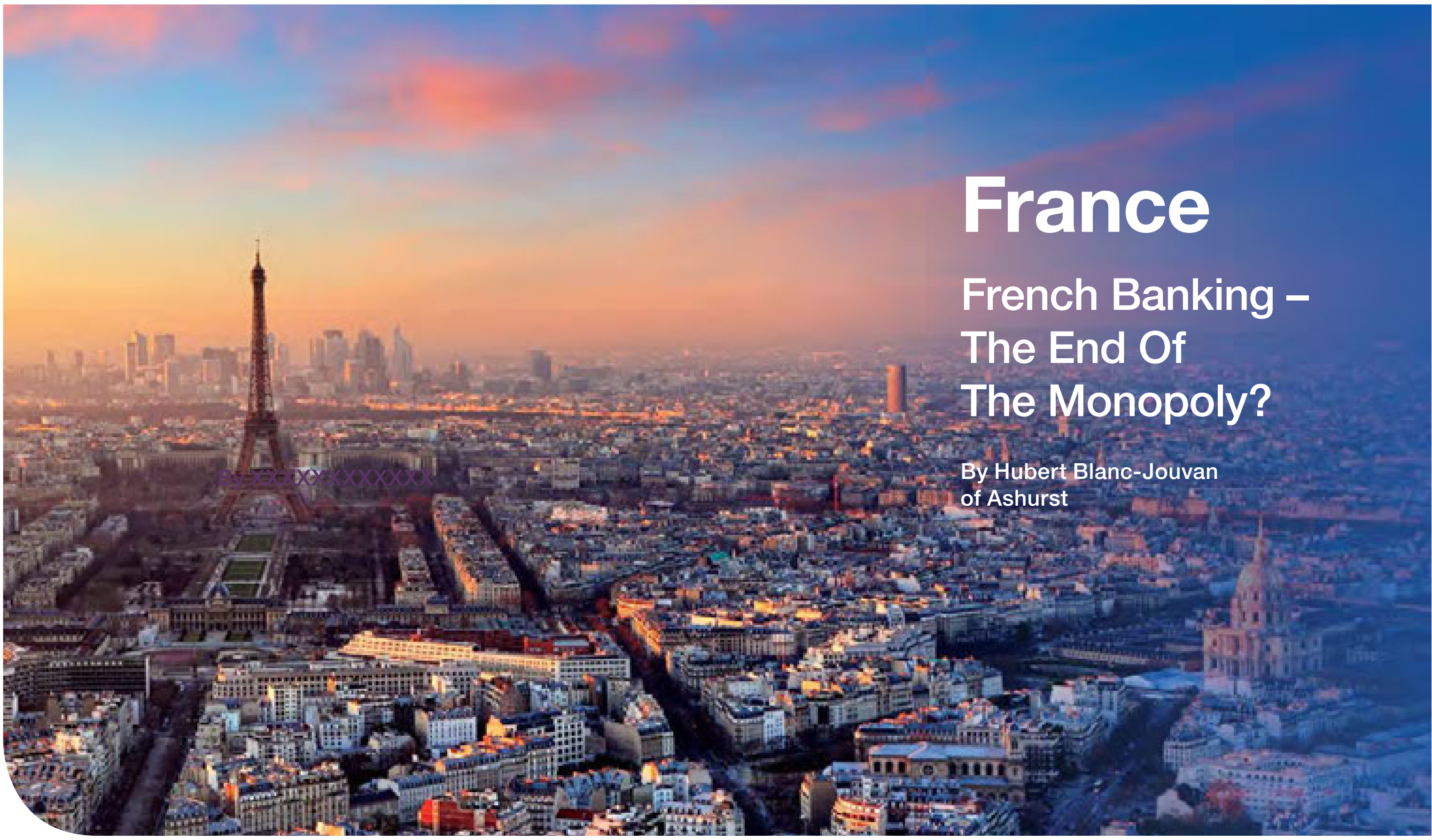
1 This paper will not focus on the Italian insurance company scenario.
2 *I.e.* any vehicle formed pursuant to Law 30 April 1999 n. 130 (so called "Italian securitisation law").
3 The Bank of Italy acts in its capacity as Italian national competent authority on direct lending.



France

French Banking – The End Of The Monopoly?

By Hubert Blanc-Jouvan of Ashurst

Strong regulatory pressures on the European banking sector in recent years have bolstered the importance of the alternative funding market, especially in France. The most recent changes to the French securitisation and debt funds regime, introduced 3 January 2018, have only reinforced this trend.

French banking monopoly

France is known as being one of the rare European jurisdictions to limit the exercise of banking transactions to licensed credit institutions. The "French banking monopoly" is large in scope and includes, in particular, loan origination and the purchase of receivables which are not yet due, in each case, if made on a "habitual" basis and for consideration.

It is frequently the source of difficulties in cross-border transactions in which credit is sought to be extended to French borrowers by institutions which do not hold a French banking license and which are not entitled to take advantage of EU "passport" rights. For decades, market participants had to rely on limited exemptions applicable to funding generally (such as intra-group funding or bond issues) or to French eligible purchasers of unmatured receivables (such as *organismes de titrisation*, the French securitisation vehicles). Needless to say, off-shore structures were sometimes sought by market participants.

In recent years, the unsatisfied needs of liquidity of small businesses, coupled with the increasing development of shadow banking, have led the French authorities to create new silos of exemptions to the French banking monopoly, such as allowing certain French investment funds to originate loans.

Recent changes have been introduced by ordinance no. 2017-1432 of 4 October 2017 (the "2017 Ordinance"),

Key points

- Non-French eligible investors in the financial industry are now allowed to purchase, from a French entity, professional receivables which are not yet due without the French banking monopoly being infringed.
- Non-French ELTIFs are, as a matter of French law, allowed to grant loans to French borrowers.
- The 2017 Ordinance reshapes the French legal securitisation framework and gives birth to the term "organismes de financement", a global denomination for French securitisation vehicles, which comprises two distinct vehicles: organismes de titrisation, which already existed, and the new organismes de financement spécialisés. Both vehicles are allowed to grant loans (subject to the conditions applicable to each of them) while only organismes de financement spécialisés can be labelled ELTIF.
financement spécialisés can be labelled ELTIF.

enacted pursuant to article 117 I of law no. 2016-1691 of 9 December 2016 promoting transparency, anti-corruption and economic modernisation (the "Sapin II Law"), applicable as of 3 January 2018.

New eligible purchasers of professional receivables

The purchase of matured receivables does not fall under the ambit of the French banking monopoly. But the highest courts in both administrative and civil matter have decided that the purchase of unmatured receivables does.

The Sapin II Law authorised the Government to open to certain non-French investors in the financial sector the acquisition of unmatured professional receivables from French credit institutions or financing companies. The new exemption to the French banking monopoly is provided by article 2 I. of the 2017 Ordinance.

The reform is expected to ease and boost the secondary loan market for French assets. This said, the French banking monopoly continues to prevent the eligible non-French investors (save those non-French funds labelled ELTIF), described below, to provide direct lending facilities to French borrowers.

The new exemption will only apply if all of the following criteria are met:

- the receivable results from a credit transaction entered into by a French credit institution, a French *société de financement*, a French undertaking for collective investment in transferable securities (*organisme de placement collectif en valeurs mobilières*, "OPCVM"), or an eligible French alternative investment fund ("AIF");
- the debtor of the purchased receivable is not an individual (*personne physique*) acting for non-professional purposes, failing which the acquisition of the receivable will be null and void;
- the receivable is acquired by way of assignment or transfer;
- the purchaser of the receivable is a non-French entity or institution whose purpose or activity is similar to those of any of the following entities or institutions:
    - credit institutions and *sociétés de financement;*
    - collective schemes mentioned in article L. 214-1 I of the French Financial and Monetary Code ("CMF"), namely:
        - undertakings for collective investment in transferable securities licensed pursuant to 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);
        - AIFs under directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers;
        - other collective investments;
    - pension institutions and pension funds (*organismes de retraite et fonds de pension*);
    - French securitisation vehicles (*organismes de titrisation*);
    - entities which are listed at the top of article L. 511-6 of the CMF which are allowed by law to carry out banking transactions (subject to the specific rules applicable to them):
        - companies regulated by the French Insurance Code and reinsurance companies;
        - investment firms, electronic payment issuers and payment institutions;
        - undertakings for collective investment in transferable securities (OPCVM);
        - AIFs referred to in paragraphs 1 (*fonds d'investissement à vocation générale*), 2 (*fonds de capital investissement*), 3 (*organismes de placement collectif immobilier-OPCI*) and 6 (*fonds de fonds alternatifs*) of sub-section 2, and sub-sections 3 (*fonds ouverts à des*

France: French Banking – The End Of The Monopoly?

investisseurs professionnels which include *organismes professionnels de placement collectif immobilier*, *fonds professionnels spécialisés-FPS*, *fonds professionnels de capital investissement-FPCI*), 4 (*fonds d'épargne salariale*) and 5 (*organismes de financement*), of Section 2, Chapter IV, Title I, Book II of the CMF;

- institutions and services listed in article L. 518-1 of the CMF;
- provident institutions (*institutions de prévoyance*) regulated by Title III Book IX of the French Social Security Code and licensed entities regulated by Book II of the French Mutuality Code;
- bodies that collect the employers' contribution to building efforts for transactions under the French Building and Housing Code.

The ability of non-French ELTIFs to grant loans to French borrowers

Although there were arguments that non-French ELTIF funds should be able to originate and grant loans in France subject to legal and regulatory provisions applicable to them, the legal analysis was unclear and has been clarified by the 2017 Ordinance.

Article 2 I. of the 2017 Ordinance adds a new exemption in article L.511-6 of the CMF so that the French banking monopoly does not apply to AIFs which are authorized to use the ELTIF label pursuant to Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds (subject to the specific provisions applicable to them).

Other changes resulting from the 2017 Ordinance relate to securitisation vehicles

Although law no. 2015-1786, dated 29 December 2015 (the "2015 Law"), amended the French legal regime applicable to professional specialised funds (*fonds professionnels spécialisés*), professional private equity funds (*fonds professionnels de capital investissement*) and securitisation vehicles (*organismes de titrisation* ("OT")) to allow these types of AIFs to grant loans (provided that they have been authorised by the French Autorité des Marchés Financiers to use the ELTIF label), the securitisation legal framework was not completed accordingly.

Completion has been achieved by the 2017 Ordinance. In addition to French OTs, a new category of French vehicles called *organismes de financement spécialisés* ("OFS") is created. Both OTs and OFSs are *organismes de financement* (French securitisation vehicles) and are allowed to grant loans (subject to the conditions applicable to each of them, to be further defined by implementation decrees) but only OFS can be labelled ELTIF.

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Fund Finance: A Guide For Borrowers

Leverage And Variation Margin Loans Making A Debut

by Thomas Rao and Katherine Rainwood

As the market for lenders has become more competitive and performance data on credit funds more developed, investors are growing in confidence and are increasingly requesting leverage facilities in addition to their subscription line facilities. With this in mind, we examine the key terms in this rapidly changing area.

Key points

- Funds should expect extensive negotiations about the security package.
- Lenders are starting to offer hybrid facilities combining a leverage facility and variation margin facility to help funds comply with EMIR.
- Funds with a European or U.S. strategy hoping to expand into the other market should take time to compare terms from U.S. and European leverage facility providers, as the markets start to diverge in their approach.

Funds in both the regulated and unregulated space have employed subscription—or seasoning—line facilities since the growth of the credit fund market in the 1990s. Subscription line facilities provide short-term financing allowing funds to bridge the commitments of their investors. Popular with investors, these facilities have allowed funds to smooth out capital calls and make it administratively easier for both investors and the fund. Subscription line facilities are generally not intended to change the internal rate of return over the life of the facility but instead are usually used to ramp-up assets during the investment or ramp-up period of the fund. Some funds bridge the purchase of the entire initial portfolio, and call on investors in one go, avoiding the need to engage equalisation mechanics.

Leverage facilities allow funds to access liquidity even after the investment period has ended and there are no uncalled commitments. Leverage facilities are also known as asset-backed facilities, or, if both upstream and downstream security is taken, hybrid facilities.

Leverage facilities are normally term facilities but can also be structured with a term of 2-3 years with the option to extend the term by one or two year "revolving" extensions.

Some lenders will require the facility to be structured as a securitisation and note purchase facility so they can take advantage of lower regulatory capital requirements driven by their Basel II internal ratings-based approach and provide better financing terms. Other lenders require the opposite and will structure the facility as a loan facility.

Security: banks seek a triple layer of protection

Leverage facilities, unlike subscription or bridge facilities, look to the credit of the underlying assets. The eligibility criteria of the asset portfolio and diversity score ratios are usually set-out in the facility agreement and are negotiated extensively, often at the term sheet stage. Funds should take care when negotiating the key covenants such as the definition of obligor, the obligor group and LTV ratio grid.

Security will be given to lenders over the primary source

Fund Finance: Leverage And Variation Margin Loans Making A Debut

of repayment of the facility: the eligible assets of the underlying loan portfolio. In addition to security over the underlying assets which is normally enforceable on an enforcement event, some lenders require security over the asset holding company (the "Asset HoldCo") and, in the case of hybrid facilities, over the uncalled commitments of investors or limited partners in the fund. Some lenders also require a guarantee by the fund in relation to payment defaults by the borrowing entity, usually the Asset HoldCo.

On enforcement, the lender's first line of defence would be to enforce their security over the Asset HoldCo and its bank accounts. This means the lender would become the sole beneficiary of all payments made to the Asset HoldCo by the underlying obligors (or assets in the case of private equity or other funds.)

Funds should make sure that they isolate the cashflows through the bank accounts pledged to the lenders and that unrelated expenses and payments do not flow through those bank accounts.

Common Negotiating Difficulties

A significant portion of the time and cost involved in establishing leverage facilities will be spent on negotiating the scope of the security package. Umbrella or compartmentalised fund structures can give rise to particular difficulties. Tension exists between lenders seeking security over a clean bankruptcy remote asset holding vehicle, and the investors and fund's desire to ensure the legal segregation of each compartment is protected. Second, as leverage facilities are normally introduced after the fund has been established, investment managers need to be mindful of the constitutional documents of the fund which normally contain borrowing limits and controls in relation to guarantees and related forms of security. Amending these provisions can be costly and for regulated funds, can involve time-consuming discussions with the regulator. Typically, investment managers gain time and cost efficiencies if the team negotiating the leverage facility are the same team who establish the fund and understand the nuances of the structure and legal limits of the security package.

Intercreditor issues are becoming an increasing feature of leverage financings. These discussions can become centre stage in three primary situations: (a) when the lender is offering a hybrid structure in exchange for better pricing terms; (b) if a subscription line is already in place and the leverage loan provider requires second-ranking security over the uncalled commitments; and (c) if hedging has taken place at the level of the Asset HoldCo borrower—which is increasingly commonplace as hedging at this level usually provides the fund with more comfort from a BEPS perspective (and may fall outside the European Market Infrastructure Regulation (EMIR)).

Limits on Leverage: not all leverage is created equal

Funds and investors need to be mindful of the limits on leverage which may be imposed on their fund. Leverage limits arise under most fund constitutional documents; in Europe under AIFMD; and, in the U.S., guidance on leverage limits was issued by the U.S. federal bank regulatory agencies which apply to federally regulated financial institutions, but which guidelines have influenced the market. By the end of 2017, the European Central Bank followed suit, issuing guidance in relation to leverage limits which, broadly, restricts post-financing leverage to a debt:EBITDA ratio of 4.0. The private-equity fund group ILPA (the Institutional Limited Partners Association), also

produced guidance on best practices for limited and general partners in relation to subscription and leverage facilities in 2017 which is starting to have some limited influence in the fund leverage market. The definition of "leverage" in some regulations is wide enough to catch certain subscription line facilities. Funds need to evaluate carefully how they use their subscription line facilities in practice and whether they can exclude these facilities from their leverage limit calculations.

Developments in the Market

1. Where America leads, Europe will follow?

Despite predicted interest rate rises in the U.S., the macro-economic environment will likely continue to mean that the pricing of leverage and subscription line facilities will be attractive for funds. The subscription line market in the U.S. is more developed and advanced than the European market. In particular, one interesting U.S. trend not currently seen in Europe is the increased frequency in lines advancing against the unfunded commitments of lower-rated investors (so-called "designated investors") typically at a 65% rate as opposed to the traditional 90% rate for included investors.

2. Combined Leverage and EMIR funding lines: the next frontier

Certain banks are enhancing their subscription line or leverage facility offerings to help funds meet their obligations under EMIR. Specifically, those lenders are permitting the use of the facilities to accommodate margin calls related to hedging on a net basis as part of the same subscription line or leverage facility. For U.S. funds who have historically raised funds in USD but are now moving into European strategies in EUR, or for European funds looking to expand into the U.S., these combined facilities could represent an operational and cost saving. The obvious restriction caused by these facilities is that the fund must agree to face one entity as both their hedge counterparty and facility lender. A further restriction is that funds who are considering establishing an aggregator entity (a "HedgeCo") to manage their hedging requirements across various funds and their exposure to EMIR, would need to be joined as a party to the combined facility, which can increase the complexity of negotiation and underlying documentation. Despite the complexities raised by a combined leverage or subscription line and variation margin facility, we expect to see an increase in lender offerings in this space as a combined facility can provide funds with a real benefit in managing their margin calls.

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Co-Investments 101

What Every Manager Should Know

By Diala Minott

Co-investments are on the rise and funds are increasingly becoming more creative in the vehicles that they offer investors seeking co-investment rights. In this article we examine the vehicles on offer and the considerations that ought to be taken into account.

What is a co-investment?

Co-investment is the practice whereby an investor invests in the same underlying asset as that of an asset manager's own funds.

Why do managers offer co-investment rights?

There are many reasons for managers to offer co-investment rights and these typically include:

- Enabling the manager to manage its exposure on the underlying loan by spreading the risk between the main fund and the co-investors
- Offering investors potentially higher returns through the ability to co-invest
- Allowing investors to obtain direct deal access to build-up their expertise and knowledge
- Providing the ability for the asset manager to build stronger and deeper relationships with existing or potential investors
- Allowing the manager to fund investments which would not be possible to complete without the contribution of the co-investors, either due to lack of sufficient funding, certain investment restrictions (incl. diversification) at the main fund level, or potential investor redemptions at main fund level
- Attracting new investors by exposing them to loan relationships they would not otherwise see

What sort of co-investment rights are there?

Funds will often offer their investor the right to co-invest alongside the main fund and this helps fund managers source more investors for their funds but also allows them to cater for larger deal sizes, syndicating them out over a period of time.

Key points

- Co-investments are on the rise. Managers should properly consider certain key factors in structuring co-investment vehicles before establishing the vehicle.
- Sharing of any broken deal costs should be disclosed in the Prospectus.
- Co-investment vehicles can either be regulated or unregulated vehicles.

The following are the typical scenarios we see:

- The co-investment vehicle dedicated to one single investor;
- The co-investment vehicle dedicated to a limited number of investors of the main fund that obtain co-investment rights via their side letter;
- The co-investment vehicle that is a carry co-investment vehicle dedicated to employees and staff of the main fund's manager;
- The co-investment vehicle that is a vehicle whose investment policy is to co-invest with one or several main funds in opportunities that will be proposed to the co-investment vehicle and which the co-investment vehicle can either accept or reject.

An investor with co-investment rights can either be:

(a) an investor in the main fund with a right to co-invest in the same assets as the main fund through its co-investment vehicle investing alongside the main fund; or

(b) an investor that is not in the main fund but has a mandate to invest in any funds of the asset manager.

Why is it important to distinguish co-investment vehicles from Parallel/Successor Funds?

It is important to distinguish them from parallel funds in order to avoid any potential conflicts of interest concerns. Parallel funds are specifically set up to follow the same investment policy of the main fund with the main fund investors' consent and have been set up to address investors' specific tax, legal or regulatory requirements. Therefore, co-investments need to be structured in such a way so as to protect the interests of the main fund investors versus the interests of the co-investor(s). While these interests should typically be fully aligned, this is not necessarily the case at the outset, which is why co-investment vehicles tend not follow the investment policy of the main fund mitigating against this perceived conflict of interest or misalignment of interest.

What is the role of the conflict of interest policy and fair allocation policy in respect of co-investments?

Fair Allocation Policy

It is important that the fund investors do not feel that a co-investment vehicle that has been set up is competing with the main fund for allocations in the underlying assets. Instead the co-investment vehicle is typically allocated the "overflow" from a main fund allocation so that if the main fund cannot commit to the full loan size it can then offer the "excess" to its co-investors. There is then often a discussion about which co-investment vehicles have priority over the main fund or other co-investment vehicles. Typically asset managers have a fair allocation policy that will deal with this and the norm is for the allocation to be done on a *pro rata* basis between the main fund and its co-investment vehicles.

Conflicts of Interest Policy

The concern here is that if a co-investment vehicle behaves like a parallel or indeed a successor fund then investors in the main fund could argue that such a conflict has not been adequately disclosed and for successor funds in particular there are typically certain criteria that need to be achieved before a successor fund can be launched which will likely not be satisfied with co-investment vehicles as they are usually launched during the fund raising process.

What about liquidations if there are positions held by the main fund and the co-investment vehicle?

Managers consider issues such as whether, if the co-investment vehicle wishes to divest itself of a loan ahead of the main fund, this divestment might be prejudicial to the main fund. This may be difficult to manage with bespoke direct lending loans. Often investors don't want to be tied to the valuation and/or timing of the main fund investors but divesting early may impact the main fund investors. The fair allocation policy and conflicts of interest policy may help the manager to address these issues.

So what are the structuring options available?

There are a variety of vehicles that can be used to offer co-investment rights and these depend on whether the manager is trying to avoid AIFMD or trying to fall within AIFMD and accordingly these include:

Compartmentalised Lux SV (non AIFMD complaint)

If a co-investment vehicle is within the scope of the AIFMD, approval and ongoing authorisation is required from the home state regulator which can be costly and time consuming, so in many cases managers are typically trying to use non-AIFMD compliant structures like a Luxembourg securitisation vehicle which is easy to run and can be compartmentalised to serve any number of funds.

Compartmentalised AIFMD compliant structures i.e. RAIFs

Managers use already existing structures such as a RAIF to house their co-investment vehicles allowing them to offer investors an already established up and running platform which help speed up fund term negotiations.

So what are the criteria for the co-investment vehicle to be an Alternative Investment Fund (AIF)?

Under Article 4(i) of AIFMD an AIF means:

"**collective investment undertakings**, including investment compartments thereof, which:

(i) raise capital from a number of investors, with a view to investing it in accordance with a defined policy for the benefit of those investors" and

(ii) not otherwise regulated i.e. as a UCITS.

The European Securities and Markets Authority ("ESMA") also helpfully released guidelines ("Guidance") in August 2013 breaking down what is considered an AIF into the following four key elements:

- Collective investment scheme undertaking;
- Raising Capital
- Number of investors
- Defined investment policy

1. "Collective investment undertaking" ("CIU"):

The Guidance states that if all the features below are present, then a CIU is likely to be present:

- The undertaking does not have a general commercial or industrial purpose;

- The undertaking "*pools together capital raised from investors for the purpose of investment with a view to generating a pooled return for those investors*".
- Unitholders of the undertaking as a collective group have no day-to-day discretion or control.

The FCA also provided more helpful guidance, clarifying that:

- General commercial or industrial undertakings are not a CIU on the basis that the primary purpose of the undertaking is to generate a "pooled" return and this should eliminate ordinary commercial businesses such as manufacturing, trading or supply of services so that a supermarket for example is not a CIU; and
- Joint ventures were expressly excluded.

2. "Raises capital"

This is described as the commercial activity of taking direct or indirect steps by an undertaking or a person or entity on its behalf, i.e. if the AIFM procures the transfer or commitment of capital by one or more investors to the undertaking for the purpose of investing in it, in accordance with a defined investment policy, this would amount to the activity of raising capital.

The Guidance given was that:

(i) it was immaterial if:

   (a) the activity takes place once or several times, or ongoing; or

   (b) the transfer or commitment of capital takes place in kind or in cash.

3. "Number of investors"

Guidance was given that if an undertaking is not permitted by its national law, the rules or instruments of incorporation or any other provision or arrangement of binding legal effect, from raising capital from more than one investors, then it would fall outside the AIF definition and so for many single investor mandates, provisions have been built in to prohibit the acceptance of further investors.

Further Guidance was given that feeders/master and funds of funds were caught within the AIF definition.

Helpfully the FCA (unlike other authorities) has said that a limited partnership where there is a single limited partner making a substantive contribution and a general partner making a nominal will not be an AIF as the general partner's nominal investment amounts could be disregarded.

4. "Defined investment policy"

The Guidance sets out that the following factors would *singly or cumulatively* tend to indicate the existence of a defined investment policy:

- The investment policy is determined and fixed at the latest by the time that investors' commitments to the undertaking becomes binding on them;
- It is set out in a document which becomes part of or is referenced in the rules or instruments of incorporation of the undertaking;
- The undertaking or legal person managing the undertaking has an obligation (however arising) to investors, which is legally enforceable by them, to follow the investment policy, including all changes to it; and
- The policy specifies investment guidelines with reference to following criteria:
    - to invest in certain categories of assets or conform to restrictions on asset allocation;
    - to purse certain strategies;
    - to invest in particular geographical regions;
    - to conform to restrictions on leverage;
    - to conform to minimum holding periods; and
    - to conform to other restrictions designed to provide risk diversification.

Accordingly, many single co-investment mandates try not to include any formal portfolio limitations and risk diversification requirements so as to fall outside the AIFMD.

FCA's interpretation of co-investment vehicles

The FCA set out exceptions of what is not considered an AIF. The following vehicles fall outside the definition:

- co-investment vehicles where an investor confers on the investment manager a substantial mandate and the other limited partners are the manager and its employees or carry interest vehicle or family investment vehicle;
- employee participation schemes which include staff carried interest vehicles;
- private equity acquisition vehicles;
- securitisation vehicles as long as its sole purpose is for securitisation and appropriate activities to accomplish that purpose i.e. Lux SVs;
- vehicles for non-business related purposes; and
- real estate investment trusts.

The FCA particularly focused their guidance on two types of co-investment structures and clarified why they would fall outside the AIF scope:

- *Carried Interest Co-investment vehicles* - A carried interest participation of employees of a AIFM structured through one or more carried interest vehicles are out of AIF scope because the employee participation scheme exclusion applies as the carried interest participation allows employees to benefit from the AIF management's success undertaken by their employer. This applies even when the AIFM (alongside employees) invests in the vehicle as well.
- *Single investor mandates* - An institutional investor confers a mandate on an investment manager and structures the mandate through an investment vehicle

(co-investment vehicle) with the only other investors being the manager and its employees or the carried interest vehicle mentioned above is not an AIF. The manager and carried interest vehicle can even make a nominal contribution.

- The FCA views this vehicle as out of AIF scope because even if the manager/employees made a nominal investment (or even more than a nominal investment), the undertaking is viewed as only raising capital from a single external investor.

A word about Broken Deal Costs

Often broken deal costs are shared by the fund and the co-investment vehicle but recent SEC enforcement action (in 2015, the SEC charged Kohlberg Kravis Roberts & Co. L.P. (KKR) with misallocation of broken-deal expenses) has led to the U.S. market being more sensitive about clearly disclosing who bears the brunt of any broken deal costs.

The early stage work putting a deal together may be lost if the deal does not come to actual fruition, leading to broken deal expenses. There is no European market practice on whether the co-investment vehicle should shoulder its fair share of the broken deal costs for an asset it co-invests in alongside the fund.

However looking to the US by comparison, we may see Europe starting to adopt similar trends. In the US there are two ways of dealing with expenses and broken deal fees:

- With respect to "programmatic" co-investments (i.e., an established co-investment vehicle that invests in for example 10% of each deal), it is common for the co-investment vehicle to be "on the hook" for its share of applicable broken deal costs and expenses.
- With respect to "non-programmatic" co-investments (i.e., traditional co-investment opportunities where a specific deal requires additional capital outside of the fund and the manager or prospective investors are contemplating creating a co-investment vehicle), there is no consistent market approach to determine at what point in time a co-invest vehicle should be "on the hook" for a pro rata share of broken deal costs.
- The real key is clear disclosure to both the fund investors and the co-investment vehicles' investors (including, if appropriate, making sure the co-investment vehicle investors are legally on the hook through a commitment letter, cost-sharing agreement, etc. for any expenses that are supposed to be shared).

Conclusion

Managers need to carefully choose the right investment vehicle for their limited partners. Being classified as an AIF in respect of co-investment vehicles clearly results in accrued costs and administrative burdens. On the other hand, there are also some clear advantages. At least now, there are a growing number of vehicles from which asset managers can offer their co-investors.

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GDPR

What Is All The Fuss About?

By Diala Minott and Sophie Wood

The EU General Data Protection Regulation ("GDPR") finally takes effect on 25 May 2018 after a four year legislative development period. It will be directly applicable in each EU member state[1] and is designed to harmonise EU data protection rules.

At a glance

The current EU data protection regime applies to data controllers (i.e. funds and fund managers) that are:

- established in the EU and process personal data in the context of its activities; or
- not based in the EU but use equipment situated in the EU to process personal data.

GDPR will, however, extend the reach of EU data protection law, such that non-EU organisations will fall within its scope if they:

- Process an EU resident's personal data in connection with goods or services offered to that individual; or
- Monitor the behaviour of individuals within the EU.

Non-EU funds and non-EU service providers may therefore be caught by GDPR if they control or process personal data for such purposes and would, as a consequence, need to appoint an EU based representative.

Additionally, any EU fund will likely be within the scope of GDPR for all personal data the entity processes—even if the relevant data subjects are located outside the EU.

Whilst funds, their managers and service providers are not generally considered to be high-risk businesses with regards to data protection compliance, a significant amount of personal data will be processed during the life cycle of a fund. With this in mind, we set out the key considerations for the funds industry.

Key points

Whilst the fundamental principles of data protection regulation remain the same, there are significant changes in the following areas:

- Extra-territorial effect: GDPR will extend the application of EU data protection, potentially requiring overseas funds and managers to comply where they may not have done so previously.
- Liability: data 'processors' as well as data 'controllers' will have direct obligations under GDPR.
- Sanctions: the level of fines that can be imposed for breaches has risen substantially.
- Breach notification requirements.
- Data Protection Officers.

Careful preparation for the implementation of GDPR will be critical for maximising the value of data that a fund holds.

Controllers and Processors

A 'controller' is an entity that determines the purposes and means of the processing of personal data whereas a 'processor' is the entity which processes the data on behalf of the controller. As a result of this distinction, each party to a fund will need to identify whether they are a controller, processor, or joint controller (over the same subset of personal data)[2] for the purposes of GDPR.

In the funds industry, funds are typically considered controllers of personal data of employees and investors[3], whilst fund managers will be controllers of third-party data such as service providers and trade counterparties.

1 EU regulations are binding on their actual wording rather than just the meaning and so Member States will have no discretion when transposing the Directive.
2 If there are joint controllers, firms should clearly signpost all splits in compliance obligations between the two joint controllers in the relevant documentation.
3 Note the latter will likely be a joint controller alongside the relevant fund.

On the other hand, the following are typical examples of where an entity in a fund structure will constitute a processor:

- The Transfer Agent to a fund will use information provided to update the Shareholder Register of the fund. The Transfer Agent should clearly set out what data it processes, where and how it is processed, and by which entity, when assessing its obligations under GDPR.
- Funds may also appoint a Distributor who will collect, process and store personal data.
- Where a fund administrator provides contractual anti-money laundering services to a fund, it will become a processor in respect of personal investor details such as discrete investor accounts and ultimate beneficial owners.

As GDPR now imposes mandatory provisions in relation to processing contracts, any agreement that includes processing arrangements (e.g. service agreements or administration agreements) should be reviewed and updated to ensure these mandatory provisions are incorporated. Each party to a fund will also need to review and map their data flows, to ensure that their data processing activities are clearly defined, and reflected, in these processing agreements. This is particularly important for processors, who risk exposing themselves to liability if they act beyond the scope of the controller's instruction.

Sanctions

GDPR will significantly increase the administrative fines that can be imposed on funds (and their service providers). GDPR adopts a two-tiered approach to administrative fines, which are set at:

- EUR 20,000,000 or 4% global turnover, whichever is higher, for serious breaches; and
- EUR 10,000,000 or 2% global turnover, whichever is higher, for less serious breaches.

It is clear that the potential sanctions expressed in terms of a percentage of global turnover could be extremely large and, whilst the UK Information Commissioner's Office has repeatedly stated that fines will be a last resort, it is important that funds comply with GDPR, especially in relation to those provisions that attract a higher level of fine, if breached.

Data Breaches

GDPR introduces a duty on all organisations that process personal data to report certain types of data breach to the supervisory authority and in some cases, to individuals not later than 72 hours after becoming aware of the breach. A breach must be notified to:

- the supervisory authority where it is likely to result in a risk to the rights and freedoms of individuals; and
- to individuals where the breach is likely to result in a high risk to their rights and freedoms.

As non-compliance can be costly, firstly funds must ensure that they are able to actually identify if and when their data has been attacked and secondly, funds must implement procedures to effectively report and investigate a data breach.

Data Protection Officers

One of the most notable changes of GDPR is the introduction of DPOs: the appointment of a Data Protection Officer (DPO) is required if the processing or controlling of data is a core activity[4] of the controller or the processor. For funds, this is very unlikely to be the case, and furthermore it seems unwise to choose to appoint a DPO voluntarily as they come under an obligation to whistle-blow in the event of a breach and they are expensive—annual salaries can go up to £300,000.

Brexit

The 'Data Protection Bill' was introduced to the UK Parliament in September 2017. The Data Protection Bill seeks to implement GDPR into UK law, with departures only permitted under GDPR. Material changes, if any, to the UK data protection regime will likely be slight and gradual.

Assuming the UK becomes a third country, one important issue that arises is the applicability of cross-border transfer provisions. For example if an Irish fund is transferring data to a UK fund manager, this will require compliance with GDPR international transfer rules.

Next steps

As GDPR will require substantial changes to processes and procedures, data mapping exercises should be undertaken to fully understand the role and obligations of each party to the fund in the processing of personal data. This will provide a useful starting point for establishing a clearly defined compliance programme.

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4 Defined as the key operations designed to achieve the controller's / processor's objectives

MiFID II

The Long Wait Is Over

By Diala Minott and Nikki Johnstone

On 3 January 2018, the second Markets In Financial Instruments Directive and Markets in Financial Instruments Regulation ("MiFID II") came into force. Whilst the most significant impact will be felt by those investment firms whose core activities fall within scope of the MiFID regime, the effect on the funds industry has been to further complicate the patchwork of regulation governing the activities of fund managers as well as their advisers/arrangers.

Whilst many credit fund managers hold authorisation under the EU Alternative Fund Managers Directive ("AIFMD") and thus fall outside the MiFID framework, they will nevertheless be impacted where they have MiFID "top up" permissions and/or due to the fact that some EU member states—including the UK—have opted to "gold-plate" their local implementation of MiFID II such that it applies MiFID II requirements on AIFMs.

Key points

MiFID II repeals and recasts the EU Markets in Financial Instruments Directive ("MiFID I"). As well as expanding the scope of the MiFID regime to cover additional asset classes, trading platforms and third-country firms, MiFID II introduces significant changes in the following areas of relevance to managers of credit funds:

- more explicit restrictions on "inducements", including payments for research.
- changes to the treatment of local authorities and occupational pension schemes under the client categorisation regime.
- additional record-keeping obligations.
- new best execution requirements.

MiFID II and its impact on managers of credit funds

MiFID II came into force on 3 January 2018 (following a one-year extension beyond the original deadline of 3 January 2017) with the objective of addressing the weaknesses in transparency and investor protection which were observed to have exacerbated the effects of the financial crisis. Whilst the UK managed to transpose the myriad requirements of MiFID II into its national laws by the deadline[1], UK managers can take some comfort from recent statements by the Financial Conduct Authority (FCA) that they have "*no intention of taking enforcement action against firms for not meeting all requirements straight away where there is evidence they have taken sufficient steps to meet the new obligations by…3 January 2018*."[2]

The FCA's proposal to gold-plate MiFID II

We have identified some of the key areas affecting UK fund managers whose activities are regulated under the UK implementation of AIFMD. While full scope AIFMs generally fall outside of MiFID II's remit, the FCA has opted to gold-plate certain MiFID II standards to apply them to AIFMs. Additionally, many AIFMs that have elected to have additional "top-up" permissions to perform certain limited MiFID activities will be directly affected by the provisions of MiFID II governing those activities.

Inducements and research

AIFMs who conduct MiFID business such as independent

1 As at 12th January, only 16 of the EU's 28 member states have fully transposed MIFID II into their national laws (https://ec.europa.eu/info/publications/mifid-ii-directive-transposition-status_en),

2 https://www.fca.org.uk/news/speeches/better-view

investment advice or discretionary portfolio management services are prohibited from accepting, retaining or rebating a commission, fees, monetary or non-monetary benefits ("inducements") from third parties in relation to the provision of services to clients. Importantly, this includes payment for investment research.

In an attempt to create efficiency and transparency, the FCA has extended the ban on bundling research and execution costs to AIFMs. The receipt of research by a full scope AIFMs is permitted only if it is paid for either (a) by the fund manager itself or (b) from a separate research payment account ("RPA"), provided that specific conditions have been satisfied. Any inducement considered to be a minor, non-monetary benefit will not be caught by the prohibition (free sample research provided for a limited trial period).

To the extent an AIFM is caught by this extension, it will be reviewing its commission sharing arrangements with third party brokers and clarifying its policies on the receipt of research. Fund managers will need to establish whether it will meet its own research costs or whether it will set up an RPA and ensure that any associated fund documents (e.g. fund offer document) accurately reflects the position that has been taken. Where an RPA will be used, fund managers will need to ensure that the necessary agreements, policies and procedures are established and that these are adequately communicated to clients.

Client categorisation

Firms that provide investment services are required to categorise their clients as "eligible counterparties", "professional clients" or "retail clients". The FCA has confirmed that full scope AIFMs (when conducting AIF business) are not subject to the client categorisation rules apart from when dealing with local authority clients, who will now be classified as retail clients unless they opt-up to become a professional client. The FCA has implemented revised opt-up procedures for local authority clients, which takes into account both a qualitative and quantitative test.

The impact of this change will be felt most by AIFMs for which local authority clients are their most significant investor class as they will need to carefully consider whether their permissions allow them to continue to provide services to local authorities that are not able to opt-up to professional investor status. This is particularly relevant in the context of marketing; the AIFMD marketing passport permits promotion only to professional clients in each member state.

Enhanced record keeping: Telephone recording

The FCA has extended the MiFID II taping requirements to AIFMs, such that telephone conversations and electronic communications that relate to the transactional side of portfolio management activity must be recorded and a copy of electronic communications must be retained. As the telephone taping requirements relate directly to the conclusion of a transaction or the intended conclusion of a transaction, it's unlikely that investor relations calls will be captured.

Some good news: Non-extension of MiFID II Best Execution regime to AIFMs

Full scope AIFMs are already subject to certain best execution requirements derived from AIFMD: for UK AIFMs, these requirements are to be found in COBS 11.2. These require AIFMs to take "*all reasonable steps*" to obtain, when executing orders, the best possible result for its clients. The FCA initially proposed that these rules would be supplemented by the MiFID II best execution regime; this regime would have required AIFMs to (amongst other things) publish an annual report containing data on the top five execution venues where they executed client orders and a summary of the outcomes achieved. However the FCA has now confirmed that, due to practical timing constraints and legal complexity, it will not now apply the MiFID II best execution standards to AIFMs. That said, the FCA did indicate that it will still apply additional aspects of MiFID II best execution requirements to full scope, pending a review of how these are best applied in the context of AIFM activity.

Conclusion

The scale and structure of an AIFM's MiFID II implementation work should reflect the firms' legal structure, size and investment strategy. Identifying processes, systems and documentation that will need to be updated is a considerable job and many asset managers have already been undertaking a gap analysis exercise to fully understand the operational impact of MiFID II. Banks and asset managers have been preparing for MiFID II for a long time and now, finally, the wait is over.

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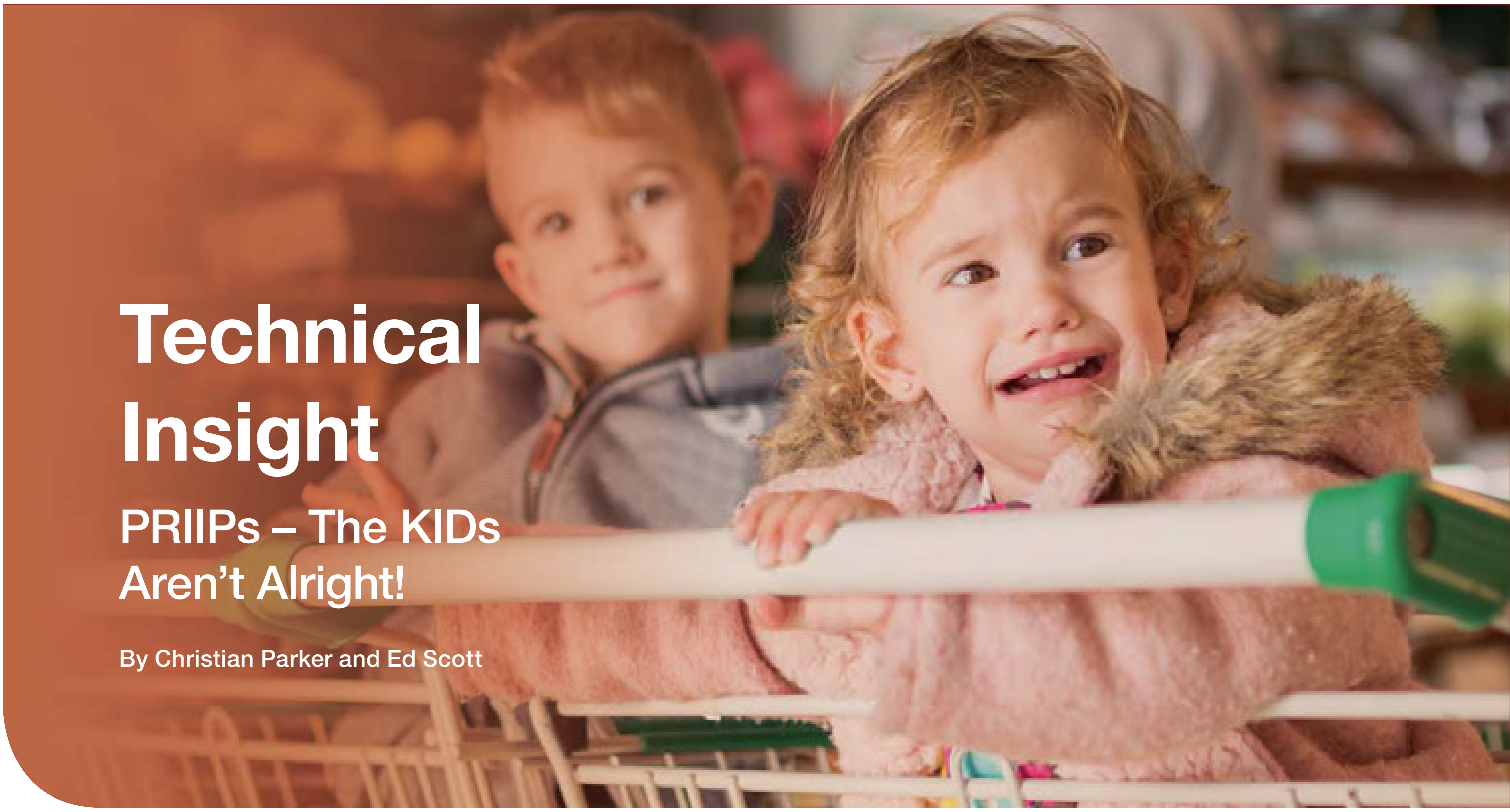

Technical Insight

PRIIPs – The KIDs Aren't Alright!

By Christian Parker and Ed Scott

The investment industry is up in arms about the newly-enforced PRIIPs KIDs that are required to be produced by any fund or quasi-fund that is marketed to or may otherwise be available to persons in the EU that are not "professionals" for the purposes of the MiFID II[1] legislation—what's all the fuss about?

Key points

- PRIIPs KIDs are intended to make life easier for retail investors who want to compare the risks and projected returns of funds, but are having the opposite effect.
- Credit funds investing in similar assets are producing KIDs with dissimilar risk profiles due to a divergence in approach to the credit risk measure calculation.
- The regulatory guidance as to the credit risk measure calculation is confusing and contradictory; this article proposes an interpretation of that guidance.
- The regulators need to act in order to ensure a more unified approach to KID formulation.

The primary focus of the complaints to date has surrounded the fact that the formulae that underlie these documents may result in "serious investor detriment" and that they will "at best confuse…and at worst mislead[2]" prospective investors. That focus has been relentless on the topic of the forward-looking "performance scenarios" and the underlying cost allocations—and these two areas have thrown up some very strange results especially in relation to "performance scenarios" that imply that a fund may even in an "unfavourable" scenario generate positive double digit annual performance returns[3].

Those very strange results in relation to "performance scenarios" have also affected the credit fund industry, which is also struggling with the so-called "summary risk indicator" (or SRI) number. The SRI number is stipulated as risk measured on a scale of 1 to 7 for which there are specific regulations (the "PRIIPs RTS[4]") and an ESMA Q&A[5] that, in theory, make this number a formulaic calculation. However, the interpretation of the rules in relation to those formulae is far from ideal and the guidance ambiguous such that, in KIDs published to date, there are a number of anomalies where funds investing in leveraged CLO equity with investment targets of 12%+ per annum are being held out as significantly less risky than funds investing on a lightly levered basis simply and directly in senior secured loans.

1 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU Text with EEA relevance
2 https://www.efama.org/Publications/Public/PRIPS/EFAMA%20Statement%20on%20PRIIPs%20-%20December%202017.pdf
3 Ibid
4 The PRIIPs RTS are contained within the Commission Delegation Regulation (EU) 2017/653.
5 https://esas-joint-committee.europa.eu/Publications/Technical%20Standards/JC%202017%2049%20%28JC_PRIIPs_QA_3rd%29.pdf

The rules and associated guidelines around the establishment of the SRI number are contained in the Annex II to the PRIIPs RTS. In simple terms the calculation is made by reference to the PRIIP's "market risk measure" (or MRM), that is based on the market risk of the underlying assets and the investment units and, although the MRM has been described by Professor John Kay as reflecting "a triumph of pseudoscience over common sense"[6] is mathematically uncontroversial[7]. Once, however, the MRM (itself on a scale of 1 to 7) is established, in order to reach a final SRI, a "credit risk measure" (or CRM) (also on a 1 to 7 scale) is applied to that MRM: the MRM and the CRM are then combined into a regulatory grid to produce the SRI. The guidance around the CRM calculation is especially ambiguous and appears to have been the subject of different interpretation by different fund managers. It is also worth noting that the published SRIs of PRIIPs holding lightly levered senior secured loan portfolios are, in a number of instances, higher than those of PRIIPs with portfolios of shares of technology companies.

The guidance for how to calculate the CRM is contained in sections 30 and following of Part 2 of Annex II which provides as follows:

- A PRIIP will have credit risk if directly or via its underlying investments it relies on the creditworthiness of a counterparty; this may be direct or indirect and so will apparently include a credit fund whose underlying investments comprise debt obligations (section 30).
- Underlying investments should be assessed on a look through basis (section 33) and, where the PRIIP is also an AIF, the PRIIP shall be "taken to entail no credit risk" (section 34); this would appear to mean that any kind of leverage undertaken by the PRIIP can be disregarded for the purposes of the CRM calculation such that the only relevant CRM test for credit funds will be by reference to their underlying investments.
- Where no underlying investment represents more than 10% of the PRIIP's NAV the analysis of the underlying investments is carried out on a holistic (rather than separate) basis (section 35). Section 35 then receives some "clarification" in the ESMA Q&A (SRI Q2, page 18) which specifies that all individual holdings that are below 10% of the NAV should be given a 0 rating for its "credit quality step" (CQS) (see below).
- Section 36 then states that "underlying investments… shall be assumed for the purposes of the credit risk assessment to carry no credit risk"; we think that this may be mistakenly presented and what this means to say is that "underlying investments [in] exchange traded derivatives or cleared OTC derivatives shall be assumed for the purposes of the credit risk assessment to carry no credit risk". Section 36 also goes on to state that "no credit risk shall be taken to be entailed where an exposure is fully and appropriately collateralised…": some people have interpreted this as referring to the underlying investments being collateralised but the text simply refers to "exposure" which appears only to seek to deal with derivative *exposure* and may not be relevant to secured or collateralised underlying investments.
- Sections 37 – 43 then address the credit measure of the "obligors" (of the underlying investments) to create a CQS that, for a standard senior secured debt fund with an average rating of single B, would result in a high CQS and in turn a high CRM (of 5 or 6) under the CRM scale of sections 44 and 45, save to the extent that one can conclude that section 35 and its associated ESMA Q&A (SRI Q2, page 18) overrides this. If one reaches the conclusion that it does, then the CQS is indeed 0 and the resulting CRM is 1.
- Section 46, also, then states that the CRM can be reduced to 1 where "assets backing the payment obligation of the PRIIP" (which we interpret to mean the 'underlying investments') are:

  (a) at all times until maturity equivalent to the payment obligations of the PRIIP to its investors;

  (b) held with a third party on a segregated account under equivalent terms and conditions as those

6 https://www.johnkay.com/2018/01/15/i-kid-not-european-rules-rely-bent-coin/
7 Market risk is measured by the annualised volatility corresponding to the value-at-risk (VaR) at a confidence level of 97.5 % over the recommended holding period, unless stated otherwise. The VaR is the percentage of the amount invested that is returned to the investor.

Technical Insight: PRIIPs – The KIDs Aren't Alright!

laid down in Directive 2011/61/EU of the European Parliament[8] and of the Council or Directive 2014/91/EU[9]; and

(c) not, under any circumstances, accessible to any other creditors of the manufacturer under applicable law.

The crux of the analysis as to what a credit fund's CRM (and ultimately its SRI) will be seems to be (i) the degree to which each underlying investment is less than 10% of NAV and can be given a CQS of 0 (section 35); and (ii) where the relevant fund comes out on section 46 because if it cannot satisfy the three criteria its SRI will likely be no lower than 5 but, if it can meet them, it may be significantly lower. It is far from clear as to what these criteria actually mean, despite or maybe because of additional guidance in the ESMA Q&A. Our view on these criteria is as follows:

- Criterion (a) seems to require that the relevant PRIIP have the maturities of its underlying investments aligned to its own payment obligations, which would be effectively impossible. However, the answer to question 26 of the aforementioned ESMA Q&A, which says that a UCITS (open-ended by nature) should meet this criterion on the basis of its underlying investments, would appear to suggest that any fund that relies on returning the investor's investment at NAV will meet this criterion: (a) Where, however, a fund is permanent and there is no redemption facility at NAV, it would seem more difficult to meet this criterion (a) unless one takes a liberal view of what is meant, such that the very fact that there is no "maturity" obligation on the PRIIPs itself will mean that its payment obligations are always aligned to that of its underlying credit assets.
- Criterion (b) simply seems to require that a PRIIP that is also an AIF (which it invariably will be) hold its assets in compliance with the AIFMD, which (absent a breach of its legal and regulatory obligations) should be a given.
- We interpret criterion (c) to require that the relevant PRIIP's assets are not pledged to any creditors of the fund sponsor (the "manufacturer"). As with criterion (b), failure to be in compliance with this criterion would imply that the PRIIP's custodial activity fell short of the standards expected of a well-managed fund and compliance should also be a given.

The upshot of the above would appear to be that, while the MRM is relatively easy objectively to calculate, the CRM's calculation is far from straightforward and especially problematic for credit managers (and especially in relation to the application of section 46 above). The discrepancies in approach by different managers seem only to highlight the problems and our view is that, while an intelligible approach is achievable, more regulatory clarity would be welcome.

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8 The Alternative Investment Fund Managers Directive (AIFMD
9 The Undertaking for Collective Investment in Transferable Securities (UCITS) Directive V

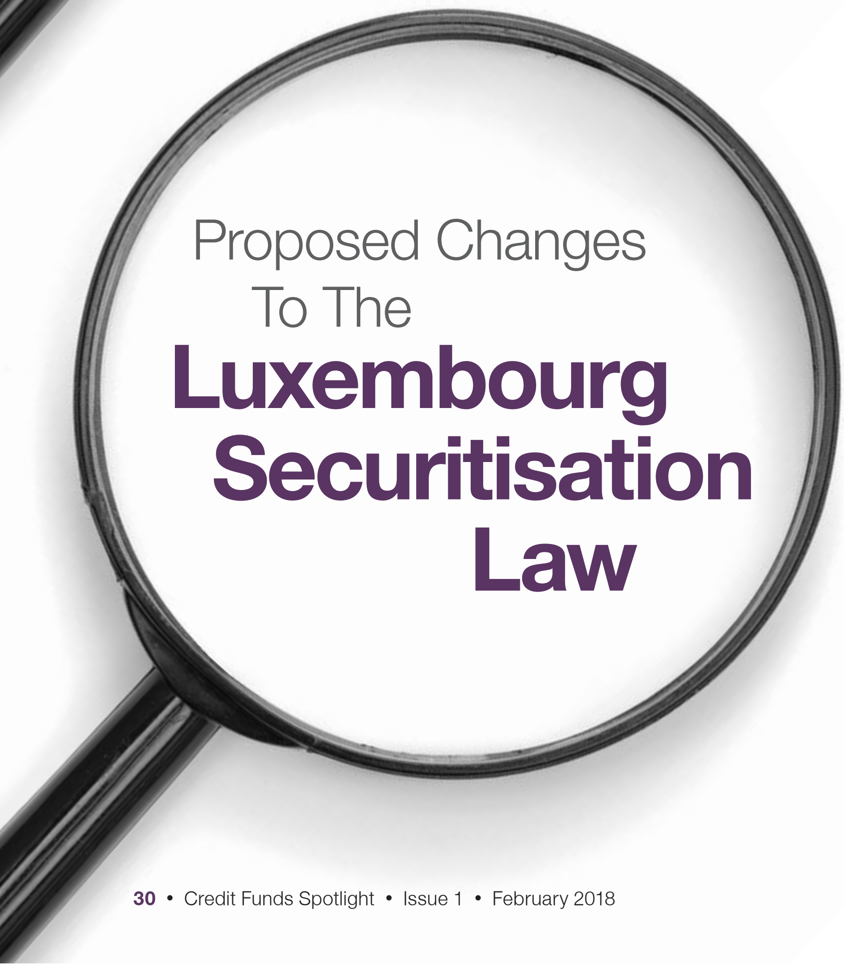
Changing **Tax Climate**

The OECD's Base Erosion and Profit Sharing ("BEPS") project has resulted in a number of initiatives (referred to as "action" plans) which seek to equip governments with domestic and international instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created. The EU has also taken steps to prevent corporate tax avoidance, adopting on 20 June 2016 the Anti-Tax Avoidance Directive ("ATAD"), with further measures adopted on 29 May 2017 to tackle hybrid mismatches (known as "ATAD2").

As a result, there is now ever increasing scrutiny on structures which seek to abuse double tax treaties using vehicles which lack requisite substance, which is particularly relevant for direct lending funds which seek to use special purposes vehicles in jurisdictions such as Luxembourg and Ireland, with favourable double taxation treaties to reduce or eliminate withholding taxes. We therefore expect to see direct lending funds looking to identify alternative tax efficient vehicles which are established in the jurisdictions from which the fund managers actually operate.

Member states must implement the ATAD/ATAD2 measures by 1 January 2019 (except that the date for implementation of the exit tax rule is extended to 1 January 2020 and the interest restriction rule to 1 January 2024 if the member state already has comparable interest restriction rules).

In the next edition we focus on the arrival of blockchain and distributed ledger technology to the loan fund market and hear the latest from service providers.



Watch this space for some news on the latest potential changes to the Securitisation Law.

EVENTS

Private Debt Investor 5th Anniversary

22nd February 2018

Dechert, 160 Queen Street, London

Structured Finance Industry Group Vegas, Information Management Network

25 – 28th February 2018

Arla Resort & Casino Las Vegas
3730 Las Vegas Blvd.
South Las Vegas, NV 89158

Creditflux Credit Symposium & Manager Awards, London

9th May 2018

The Landmark London Hotel,
222 Marylebone Road, London,
NW1 6JQ

Global ABS

5 – 7th June 2018

Centre Convencions Internacional
Barcelona, Placa de Willy Brandt,
11-14, Barcelona, 8019, Spain

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