

Credit Funds

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



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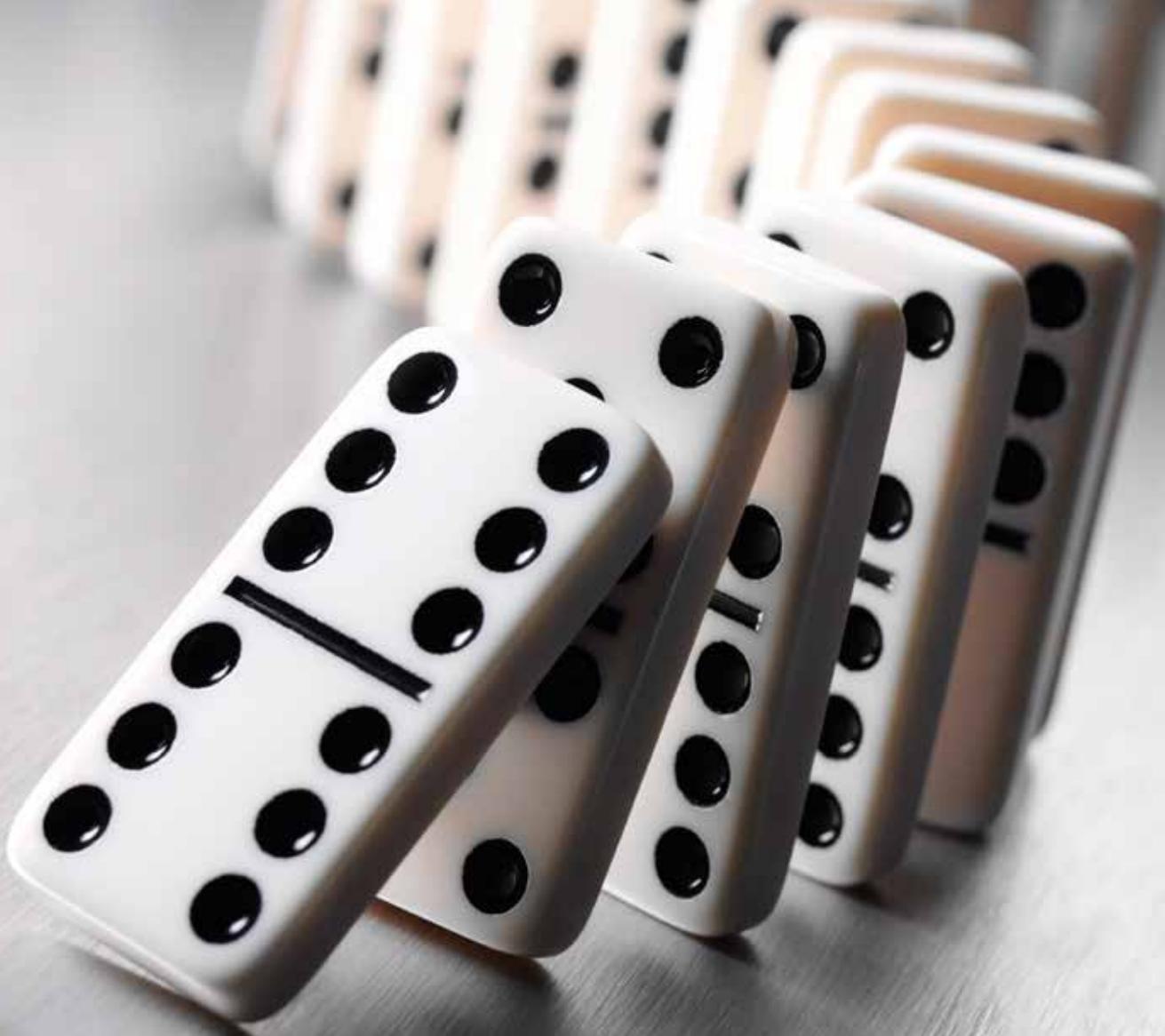
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INTRODUCTION

The domino effect

by **Diala Minott and Adam Farrell**

European countries have been loosening their banking monopoly rules one by one.

In our previous issue of *Credit Funds INSIGHT*, we put the spotlight on the sea change in non-bank lending, as banking monopoly restrictions began to be loosened across Europe. As 2016 is looking to be another robust year for the private debt sector with strong growth in the marketing of direct lending funds, this issue charts the domino effect which started with the passing of the revised German Insurance

Ordinance in February 2015. Germany, France, Spain and Italy have all loosened, or are considering loosening, their respective national bank monopoly rules. This issue covers, in particular, the seminal changes to loan originating funds which are now in force in Germany and the arrival of the ELTIF Regulation which triggered a new approach to direct lending by the French regulator.



Germany

Following on from our article “Seminal changes to loan originating funds” in the December 2015 edition of *Credit Funds INSIGHT*, the German legislature has now adopted the changes proposed by BaFin into the German UCITS V Implementation Act. The result is that closed-ended European AIFs are now permitted to originate loans within and into Germany without the use of a fronting bank. As a jurisdiction with a large potential market for the direct origination of loans, a number of managers are monitoring developments closely. Although there are risk management requirements and the new regime is subject to a number of restrictions, we fully expect managers to begin taking advantage of the new rules.

ELTIF Regulation

On a Europe-wide level, the European Union (EU) is trying to encourage capital markets union and harmonisation of rules affecting funds. This trend is illustrated by the EU Regulation on European Long Term Investment Funds (ELTIF), which was published in the Official Journal of the EU on 19 May 2015 and was effective from 9 December 2015 (the ELTIF Regulation). This is significant as it allows ELTIFs to grant loans, which in turn has forced regulators and legislators to reconsider their banking monopoly rules more generally.

France

Our “Watch this space” feature in the previous edition of *Credit Funds INSIGHT* flagged the public consultation being

run by the *Autorité des marchés financiers* (AMF) on the legal restrictions on French investment funds granting loans. This consultation was provoked by the implementation of the ELTIF Regulation. The results of this consultation have just been published and the AMF has made several proposals to the French Government which, if enacted, would allow French investment funds to become authorised to grant loans, subject to various conditions. Non-French investment funds remain outside the scope of the proposals but a new government bill may lead to a clarification of the position of such funds in the coming months.

Conclusion

As we have tracked in the past few issues, the combination of a low interest rate environment and legal reforms addressing non-bank lending has created momentum in the direct lending market. We expect that the domino effect will continue and that more and more countries will follow Germany's lead.



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DIRECT LENDING FUNDS

Proposal for European regulation

by Piers Warburton and Marianna Tothova

The European Securities and Markets Association (ESMA) has published its views of how loan origination – or “direct lending” – by investment funds should be regulated in the European Union. ESMA has provided its opinion to support the EU Commission’s planned consultation on loan origination.

ESMA’s proposal, if adopted, would be a mixed blessing at best. While it could facilitate loan origination in some jurisdictions if it replaces existing national legislation, it could also present new restrictions, timing issues and costs for direct lending funds.

Accordingly, while the opinion has no immediate legal effect and there is no timetable for implementation of any new regulation, sponsors of direct lending funds should now start to take ESMA’s proposals into account when considering

new fund structures and strategies. Sponsors should also consider participating in the EU Commission’s forthcoming consultation on the regulation of loan origination funds.

Background

Investment funds with direct lending strategies have become an important source of funding for European corporates over recent years. While the managers of alternative investment funds (AIFs) are currently regulated

What you need to know

- 📍 **The scope, form and impact of the planned regulation is not yet clear.**
- 📍 **The regulation may facilitate loan origination in some EU jurisdictions, but it may also present new restrictions for direct lending funds.**
- 📍 **The regulation could eventually require direct lending funds to be closed-ended, require specific authorisations and impose additional risk management requirements on direct lending funds.**

in Europe under the Alternative Investment Fund Managers Directive, any loan origination activities of those funds are subject to inconsistent regulation by EU member states on a national basis.

The result is that while most EU member states currently permit loan origination by AIFs, to some degree at least, there are specific restrictions in countries including Germany, Ireland, Spain, Italy and Malta. France has also recently proposed new regulation on direct lending funds.

In ESMA's view, it would be preferable for these activities to be regulated on a consistent basis across the EU, and it has set out the key principles that it believes would be appropriate for a new European regulatory framework for loan origination funds.

Scope and purpose

ESMA considers that specific regulation of direct lending funds is necessary to ensure any systemic risk presented by such funds is mitigated and, in any event, is no higher than that presented by bank lending. ESMA also believes that consistent EU regulation would contribute to a more level playing field between EU jurisdictions, reduce regulatory arbitrage and ultimately facilitate loan origination activities across Europe.

ESMA's proposal only covers investment funds which act as a sole or a primary lender, and not those funds which gain exposure to loans through secondary market participation. It also focuses specifically on AIFs (as UCITS funds are generally prohibited from originating loans), and does not consider those particular types of AIF for which direct lending is already regulated; i.e. AIFs which qualify as European Venture Capital Funds (EuVECAs), European Social Entrepreneurship Funds (EuSEFs) and ELTIFs.

Key issues

ESMA identifies a number of key issues that it believes the EU Commission should consider as part of its consultation, and makes proposals for how some of those issues should be handled under eventual regulation:

- **Authorisation:** ESMA suggests that the Commission assesses whether direct lending AIFs and their managers should be subject to specific authorisation, and suggests that this may be desirable. It is not clear how this would affect managers based outside the EU.

- **Type of AIFs:** ESMA believes that direct lending AIFs should generally be closed-ended vehicles, given the illiquid nature of their loans, but suggests that some limited redemption rights could still be offered to investors. ESMA notes that the consultation will need to consider whether direct lending funds should be permitted to carry on other activities, but gives no opinion on that.
- **Matching maturity:** Direct lending AIFs should be prohibited from providing loans with a longer maturity than the AIF's own expected lifespan.
- **Type of investors:** ESMA questions whether direct lending AIFs should be available to retail investors at all. However, if they are made available to retail investors, then ESMA proposes that specific protections should be put in place, consistent with those under the European Long Term Investment Funds (ELTIF) Regulation.
- **Risk management:** ESMA proposes that AIFMs which manage direct lending AIFs should be required to have additional procedures in place addressing specific issues related to loan origination, such as the assessment and monitoring of credit, valuation, risk and collateral management.
- **Leverage:** ESMA believes it may be appropriate to impose a leverage limit for direct lending AIFs, especially if they are available to retail investors.
- **Stress testing:** Direct lending funds should be subject to regular stress testing, and specific liquidity management and additional reporting may be needed.
- **Eligible investments:** ESMA proposes that short-selling or securities financing transactions should be not be allowed for direct lending AIFs, and that the use of derivatives should only be allowed for hedging purposes.
- **Eligible debtors:** Loans should not be: (i) granted to individuals, financial institutions, collective investment schemes or the fund's own AIFM and its related parties (e.g. depositary, general partner or delegates); and/or (ii) used for the financing of a financial institution.

What's next?

Once the Commission's consultation paper on direct lending funds is published, the fund sponsors should consider participating in the consultation. In the meanwhile, the market participants should already take ESMA's proposals into account when structuring new funds or planning new investment strategies.



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FRANCE

A new era for direct lending funds

by **Hubert Blanc-Jouvan and Maxime Samson**

A number of changes to French law have recently occurred or are currently being discussed which will allow investment funds to grant loans.

These changes should impact French investment funds using the ELTIF label, other French investment funds and non-French investment funds.

French investment funds using the ELTIF label

As a result of the European ELTIF Regulation (Regulation (EU) 2015/760 of 29 April 2015 on European long-term investment funds (ELTIF) (the ELTIF Regulation)), which came into force in December 2015 and allows ELTIFs to grant loans under specific conditions, the French legal regime governing investment funds has been amended by the law no. 2015-1786 dated 29 December 2015 (the Law).

The ELTIF Regulation is directly applicable in France without having to be transposed into French domestic law. However, the Law amended the French Monetary and Financial Code to provide that French professional specialised funds (*fonds professionnels spécialisés*), professional private equity funds (*fonds professionnels de capital investissement*) and securitisation vehicles (*organismes de titrisation*) are entitled to grant loans to undertakings, under the conditions set out in the ELTIF Regulation, when they have received the

What you need to know

- 📍 French investment funds authorised to use the ELTIF label are now authorised to grant loans.
- 📍 Other French investment funds will also become authorised to grant loans, under specific conditions to be set out in a Decree.
- 📍 Non-French investment funds could benefit from governmental Ordinances which would be designed to open new financing opportunities.

authorisation from the French *Autorité des marchés financiers* (AMF) to use the ELTIF label.

The AMF has recently issued guidance on ELTIFs. Although this document does not officially constitute the formal doctrine of the AMF, it contains guidelines drafted to help fund managers who wish to obtain the authorisation to use the ELTIF label from the AMF.

French investment funds other than those using the ELTIF label

The Law also amended the French Monetary and Financial Code. It provides that when they are not authorised to use the ELTIF label, the same categories of French investment funds are nonetheless entitled to grant loans to undertakings under conditions to be set out in a Decree.

The French Government is currently working on the Decree mentioned above. In light of the responses received from market participants to a consultation launched in October 2015, which have just been published, the AMF has made several proposals. These have been transmitted to the French Government to assist in drafting the Decree. They will also be used as guidelines for preparing the doctrine of the AMF in respect of French direct lending funds.

AMF proposals

The proposals are detailed below:

- The AMF wishes that the rules governing the ability of French investment funds to grant loans ensure the application of equivalent principles between the lenders within a secured and clarified legal framework, taking into account the economic model of each actor.
- The management companies wishing to grant loans through the investment funds they manage should be licensed by the AMF pursuant to the AIFM Directive. They should implement a programme of activity validated by the AMF, in order to be able to grant loans. The AMF indicates that it will be particularly demanding in respect of applications filed by the management companies that wish to grant loans. Notably, this applies to organisational requirements, human and technical resources, expertise (in terms of credit risk analysis notably) and experience of the employees of the management company involved in such lending activities (for example, through previous experience in credit institutions). In addition, the management companies should conduct due diligence to ensure that they comply with all obligations applicable to other types of lenders (including rules resulting from banking case law, rules relating to anti-money laundering and terrorism financing, and rules applicable to lenders in the jurisdictions of the borrowers).
- Non-French management companies which manage French investment funds granting loans will need to be authorised by their home state regulator to grant loans.
- French professional specialised funds (*fonds professionnels spécialisés*), professional private equity funds (*fonds professionnels de capital investissement*) and securitisation vehicles (*organismes de titrisation*) should be the only French investment funds allowed to grant loans.
- Management companies should report all loans which have been granted to the AMF and to the Bank of France (*Banque de France*) on a quarterly basis.



- Management companies should be authorised to carry out debt collection in respect of the loans they have granted.

Additionally, the following constraints should apply to an investment fund granting loans as soon as its lending activity is no longer accessory (i.e. the loans granted by the fund represent more than ten per cent of the net assets of the fund):

- the fund should be a closed-ended fund or should at least limit the redemption of its units or shares to a portion of its assets;
- the loans should only be granted to non-financial companies and should have a maturity date shorter than the lifetime of the fund;
- the use of leverage for lending purposes should be prohibited. A fund could borrow cash of up to 30



per cent of its net assets, provided that the purpose of such borrowing is not to finance the granting of loans;

- the fund should be prevented from short selling, securities lending and entering into derivative transactions (except for the hedging of currency risk and interest rate risk); and
- the loans should be granted by the fund with a view to be retained by the fund until their maturity date. The transfer of the loans granted by a fund should be limited, in order to avoid the development of an “originate to distribute” model.

Decree

The AMF proposals could be entirely or partly reflected in the Decree to be adopted in the coming months. The Decree should also leave some discretion to the AMF to assess the

details of the regime applicable to French investment funds wishing to grant loans.

Non-French investment funds

Non-French investment funds, even those which would be authorised to use the ELTIF label by their home state regulator, are currently outside the scope of these proposals. However, on 30 March 2016, the French Government published a bill promoting transparency, anti-corruption and economic modernisation (the Bill).

Sapin II Bill

The main purposes of the Bill, known as the “Sapin II Bill”, are to reinforce the fight against corruption and enhance transparency in France, and to propose a series of measures designed to modernise the economy. The Bill should be discussed in the coming months before the French Parliament.

The Bill intends to allow the French Government to take, by way of Ordinances, measures designed to facilitate the financing of French undertakings by:

- amending the provisions of the French Monetary and Financial Code relating to alternative investment funds designed for professional investors and limiting the possibility of redemptions of their units or shares, and to their management companies licensed pursuant to the AIFM Directive, in order to define the conditions under which such investment funds are entitled to grant loans to undertakings;
- amending the provisions of the French Monetary and Financial Code relating to investment funds, their managers and depositaries in order to reinforce their capacity to ensure the financing or refinancing of investments, projects or risks, including through the acquisition of unmatured loan receivables; and
- changing the regime under which investors in the financial sector, whatever is the law applicable to them, could acquire loan receivables from credit institutions or financing companies by derogation to the French banking monopoly rules.

The public discussions of the Bill before the French Parliament should start in the coming months.

Once the Bill has been passed, the Government will be entitled to publish Ordinances. As a result of these Ordinances, the situation of non-French investment funds willing to grant loans in France could become much clearer.



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GERMANY

Seminal changes to loan originating funds now in force

by **Detmar Loff** and **Christian Stedler**

Loan origination by investment funds within and into Germany was once only possible to a limited extent. Now, some Alternative Investment Funds (AIFs) are allowed to originate loans within and into Germany, while others at least have more flexibility with regard to the restructuring of loans receivable.

On 12 May 2015, the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) announced significant changes to its administrative practice regarding loan origination, as well as restructuring and prolongation of loans by AIFs following the interpretation by ESMA and some other EU member states that loan origination forms part of collective investment management. The German legislator has now followed BaFin's more flexible view and adopted BaFin's changes into the German UCITS V Implementation Act.

As of 18 March 2016, some AIFs are allowed to originate loans, while others at least have more flexibility with regard to the restructuring of loans receivable, and may grant loans to subsidiaries of the AIF. EU-AIFs can now lend monies into Germany without the use of a fronting bank.

German AIFs Loan origination

The UCITS V Implementation Act provides for a detailed regulatory regime in the new version of the German Capital



What you need to know

- 📍 Closed-ended AIFs may now originate loans within and into Germany.
- 📍 The detailed risk procedures applicable to German AIF-originated loans are not applicable for foreign AIFs lending monies into Germany.
- 📍 AIFs that can acquire loans can now also restructure acquired loans receivable.

Investment Act (*Kapitalanlagegesetzbuch*, KAGB n.F.), *inter alia* with regard to loan origination by AIFs. Section 20 para. 9 KAGB n.F. now determines the cases in which AIFs are permitted to originate loans as part of their collective investment management (and thus without a banking licence which will not be granted to German AIFs and their managers (AIFMs)).

Closed-ended special AIFs

The new regime allows (general) closed-ended special AIFs to originate loans subject to the following restrictions:

- Borrowing is limited to 30 per cent of the net capital of an AIF that is available for investments pursuant to section 285 para. 2 No. 1 KAGB n.F. (the Investable Capital). In this context, the Investable Capital consists of the sum

of the aggregate contributed capital and the aggregate undrawn committed capital.

- Loans granted to a single borrower shall not exceed 20 per cent of the Investable Capital. This diversification is meant to alleviate the credit risk that comes along with the origination of loans.
- The AIF may not grant loans to consumers.

Special rules apply to loans that are granted to companies of which the closed-ended special AIF is already a shareholder (shareholder loans) according to section 285 para. 3 KAGB n.F. The restrictions mentioned above on loan origination by closed-ended special AIFs are not applicable with regard to such shareholder loans, except where the AIF's management company decides to apply section 285 para. 2 KAGB n.F. and does not wish to rely on the shareholder loan rules.

Shareholder loans are permitted up to an amount of 50 per cent of the Investable Capital where one of the following requirements is fulfilled:

- the borrower is a subsidiary of the closed-ended special AIF pursuant to section 290 of the German Commercial Code (*Handelsgesetzbuch*); or
- the shareholder loan is a subordinated loan, the principal amount of which shall only be repaid to the extent the borrower has sufficient freely available assets; or
- the shareholder loan amount is below twice the acquisition costs of the equity stake held in the portfolio company by the AIF.

In case the use of leverage by the closed-ended special AIF is below 30 per cent of the Investable Capital, the granting of subordinated shareholder loans are permitted in an amount that exceeds the aforementioned 50 per cent of the Investable Capital.

Open-ended special AIFs

Open-ended special AIFs need to be in a position to liquidate their assets within a short time-frame. Consequently, the new regime does not allow loan origination by open-ended special AIFs (not even short-term loans). However, open-ended special AIFs may originate shareholder loans under the conditions for shareholder loans set out above in relation to closed-ended special AIFs. In addition, the restructuring of acquired loans receivable (if allowed) will not be considered as origination of a loan (see below).

Closed-ended retail AIFs

The German legislator holds the view that retail investors are hardly in a position to adequately assess the risks connected with loan origination. Therefore, closed-ended retail AIFs may only originate shareholder loans subject to meeting substantial additional requirements. Again, the restructuring of loans receivable will not be considered as origination of a loan (see below).

Open-ended retail AIFs

There will be no changes for open-ended retail AIFs. In particular, the possibility for open-ended retail real estate AIFs to grant shareholder loans to subsidiaries holding real estate assets according to section 240 KAGB remains unaffected. Similar to the above, the restructuring of loans receivable (if the acquisition is allowed) will not be considered as origination of a loan (see below).

Loan restructuring

The restructuring and prolongation of loans by some AIFs will no longer be considered as loan origination for banking law purposes, i.e. licence requirements under the German Banking Act, and will consequently be allowed for all AIFs (which can acquire loans subject to existing product rules set out in the KAGB) without a banking licence. According to the wording of the new rules, the thresholds mentioned in relation to the origination of loans by AIFs do not apply to loans acquired (and subsequently restructured as the case may be) by AIFs. We hope that this is not a mistake but rather an intentional decision by the legislator.

Organisational requirements

New obligations for AIFMs managing loan originating funds

All German AIFM managing AIFs that originate and/or acquire loans (including shareholder loans and unsecured loans) will become subject to the procedures for large exposure credits (*Millionenkreditverfahren*) and thus will have to fulfil certain notification requirements.

Fully authorised AIFM

A fully authorised AIFM managing an AIF that originates and/or acquires (and restructures) loans (which are not shareholder loans) has to comply with specific risk management requirements pursuant to section 29 para. 5a KAGB n.F. These requirements will be similar to the internal procedures implemented by banks and are likely to reflect the risk management principles applicable to the credit business of banks as set out in BaFin circular 10/2012 (BA) – Minimum requirements for risk management (MaRisk) – at least for loan originating AIFs. It is expected that BaFin will specify the risk management requirements by issuing a respective guidance note. In practice, this will be challenging for some German AIFMs which cannot, or are not willing to, outsource substantial parts of the loan origination and risk assessments procedures.

Sub-threshold AIFM

Only in the case that a sub-threshold AIFM manages an AIF that originates loans (restructuring and acquisition are excluded), the sub-threshold AIFM becomes subject to certain risk management requirements that are only applicable to fully authorised AIFMs in general (section 2 paragraph 4 and 5 KAGB n.F.).

EU-AIFs/AIFMs

Under the new regime, the German legislator has not provided that EU-AIFs/AIFMs must comply with the same risk and process requirements as German AIFs/AIFMs. For EU-AIFs/AIFMs, the loan origination is deemed to be a part of the collective portfolio management which is now generally excluded from triggering banking licence requirements under the German Banking Act and will consequently be allowed to the extent that it falls within the scope of collective portfolio management under the relevant legislative regime of the home member state of the respective EU-AIF/AIFM.

Third country AIFs/AIFMs

Furthermore, third country AIFs/AIFMs will be allowed to originate loans to German borrowers after passing an AIF-distribution notification granted by BaFin for their managed third country AIFs (*Vertriebsanzeigeverfahren*). Please note that BaFin will only grant such distribution if the third country AIF/AIFM complies with the minimum requirements of the AIFMD.



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DIRECT LENDING IN SPAIN

An increasing presence in the market

by Jose Christian Bertram

The Spanish market has, in recent years, witnessed growing interest by credit funds, who have significantly increased their activity in the country.

Credit funds benefited from a good starting point; namely the fact that lending, as such, is not a restricted activity requiring a banking licence in Spain.¹

The presence of debt funds in Spain manifests itself in various ways. One of the main avenues through which debt funds have entered the market has been providing funds in debt restructuring situations, be it to allow for a partial

repayment of syndicated facilities that helps to de-block restructuring negotiations or to fund the operating needs of the relevant company, i.e. using both structures where the borrower of the new money is ring-fenced from the rest of the group or not.

The other way in which direct lending is increasing its presence in Spain is lending in situations where there is no restructuring, such as pure acquisition finance transactions, real estate finance transactions or as financing add-on acquisitions. Increased liquidity and lending appetite in the

¹ The restricted activity is the intermediation in the banking market, i.e. taking refundable deposits from the public to apply them to lending.

What you need to know

- There is no regulatory restriction to direct lending in Spain.
- There are features of the legal market that credit funds should carefully analyse in order to structure a deal in the most efficient way.
- Credit funds are now addressing other types of borrowers, especially in situations that have a deal-specific element to them.

Spanish banking sector in the second half of 2015 has led to increased negotiating power of borrowers, banks accepting low yields, and terms and conditions that prevented funds from tapping into certain sectors of the lending market.

A different note

Traditionally, we have seen credit funds involved more in direct lending transactions with a financial sponsor. We are now, however, experiencing credit funds addressing other types of borrowers, especially in situations that have a deal-specific element to them that make banks wary.

This increasing presence in the market means that credit funds have to deal with: (i) making borrowers bridge the learning curve in terms of the enhanced flexibility that direct lending documentation implies and that this outweighs the enhanced yield expectation from the lender(s); and (ii) the specific matters Spanish law presents to them, with the following issues regarding structuring, insolvency risks and security interests attracting substantial attention:



- Acceleration issues: Spanish law (contrary to English law) does not allow acceleration of the facilities on the basis of any default, but only on the grounds of a limited number of substantial defaults. This is leading some funds to prefer having the finance documents subject to English law, which is a difficult ask if the borrower is not a portfolio company of a financial sponsor.
- A one-year stay on enforcement in the event of an insolvency: in the event of an insolvency heard in Spanish courts, there is an automatic stay on enforcement of up to one year over assets linked to the insolvent company's activity. The wide-ranging ambit of what is or is not linked to the activity of an insolvent company by Spanish courts has increased the perception for the need to structure direct lending using a double Luxco or double Dutchco structure, where a Dutch or Luxembourg law share pledge can be enforced more easily in the event of an insolvency.²
- The fact that certain security interests are not available to lenders that do not qualify as credit institutions (notably, a specific type of real estate mortgage).
- The enforcement of certain security interests, notably pledges over quotas in Spanish SLs (*sociedades de responsabilidad limitada*) has been made more difficult since last year, which has fostered the need for double Luxco/Dutchco structures.
- The enforceability of a pledge of receivables and its watertight character in the event of an insolvency: given the enhanced flexibility that borrowers expect when entering into direct lending transactions, in Spain often hard assets security are replaced by less expensive security, such as pledges over receivables. In this respect, long debate on the poor drafting of a section of the Spanish Insolvency Act, that caused substantial uproar in the market, has recently been put to bed by a change in law that provides for a protective regime for pledges of receivables, in the sense that the receivables will be deemed subject to the pledge in the event of an insolvency to the extent they stem from contractual relationships executed prior to the insolvency.

Conclusion

In a nutshell, although there is no regulatory restriction to direct lending in Spain, there are a number of features of the Spanish legal market that credit funds should carefully analyse in order to structure the deal in the most efficient way while making it interesting to the borrower in comparison to obtaining bank debt.

² This being always subject to COMI shifting risks.



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SPAIN

Spanish SICAVs take flight to Luxembourg

by Eduardo Gracia and Lorena Viñas

Certain Spanish Undertakings for Collective Investments in Transferable Securities (UCITS) – so-called *Sociedades de Inversión de Capital Variable* or SICAVs – which are widely used by wealthy individuals and families to channel their savings, are now encountering tax problems in order to continue benefiting from the existing exemption regime on dividends and capital gains.

These problems follow after announcements made by the main political parties in the country to toughen the conditions for applying such tax regimes, and the risks of relocating those savings to Luxembourg where they could benefit from a privileged tax regime (similar to that which applies today to SICAVs in Spain) which cannot be penalised by the use of controlled foreign company (CFC) rules in Spain.

Current Spanish tax regime applicable to SICAVs

Under current Spanish tax legislation, Spanish UCITS (SICAVs included) are taxed at a reduced Corporate Income Tax (CIT) rate of one per cent, which almost amounts to an exemption,

provided that certain requirements are met. As for SICAVs, the collective nature of the vehicle, and hence the applicability of the UCITS tax regime, is deemed to be met if the number of shareholders is not lower than 100 at any stage.

UCITS are not transparent entities from a tax perspective, nor are they subject to distribute their earnings periodically to their quotaholders/shareholders. On the contrary, they are CIT payers, while their shareholders will only be taxed when they actually receive dividends from their shares in the SICAVs, or when they obtain capital gains derived from the transfer of such shares.¹

¹ Capital gains taxation is deferred when all the sales proceeds are reinvested in another UCITS qualifying for the tax regime.

What you need to know

- 📍 There is serious legal uncertainty today regarding SICAVs because of greater tax pressures in Spain.
- 📍 There is a plan to move SICAVs to Luxembourg, which will have negative consequences for Spain.
- 📍 It would be advisable to link the privileged tax regime to collective investment undertakings of the open-ended type as regulated by the UCITS Directive.

Therefore, the special tax regime applicable to all UCITS (SICAVs included) involves only the removal of a third level of taxation on the income obtained through these investment vehicles. Further, UCITS have been regarded for decades as the most suitable savings vehicle for Spaniards, as the tax regime allows the deferral of taxation at UCITS and quotaholder levels if the above-mentioned conditions are met.

SICAVs as the preferred investment vehicle for wealthy individuals and families

As mentioned above, SICAVs are widely used by wealthy individuals and families to channel their savings. These Spanish UCITS have always received media attention for being seen as an instrument, at least in appearance, whose real purpose is obtaining tax savings outside the genuine object (collective investment) of these companies. In addition, the possible existence of abuse of the law in the use of SICAVs is discussed when the interests in them belong almost entirely to the members of a single family.

Current situation for SICAVs in Spain

There is considerable legal uncertainty in Spain today regarding SICAVs, mainly due to the fact that the main political parties in the country have all made announcements that the conditions for SICAVs should be tougher to be able to benefit from the special tax regime applicable to these entities.

As a result of this situation, Spanish SICAVs are planning to move to other jurisdictions for fear of greater tax pressures in Spain and also with the aim of finding more legal certainty.

Luxembourg has been chosen as the best destination, because its tax regime is very advantageous. Luxembourg Specialised Investment Funds (SIFs) are taxed at a 0.01 per cent CIT rate on its net assets – which ultimately means that a third level of taxation is negligible. Also, a minimum number of shareholders is not required, unlike under the Spanish legislation, and especially because Luxembourg offers more legal certainty and stability than Spain.

The transfer to Luxembourg is usually done through a merger with a Luxembourg fund, company or other similar avenue. Mergers are cheaper and, for this reason, it is the option that is being most widely used.



No application of the Spanish CFC rules to EU UCITS

Another factor encouraging this flight of Spanish SICAVs to Luxembourg is that, according to a recent amendment of the Spanish Law, CFC rules do not apply to EU UCITS, i.e. collective investment undertakings governed by Directive 2009/65/EC of the European Parliament and of the Council, of 13 July 2009, on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, incorporated and domiciled in an EU member state.

This new measure makes sense and complies with the fundamental freedoms of the Treaty on the Functioning of the European Union. It would be discriminatory and go against the free movement of capital to require tax transparency for EU UCITS when it is not required with regard to Spanish collective investment undertakings.

In addition, the inapplicability of the CFC rules to EU UCITS has been strengthened by the proposal for a Directive, of 28 January 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market (the so-called Anti-Tax Avoidance Directive). According to this proposal, CFC rules should exclude financial undertakings from their scope where those are tax resident in the Union, including permanent



establishments of such undertakings situated in the EU. This is because the scope for a legitimate application of CFC rules within the Union should be limited to artificial situations without economic substance, which would imply that the heavily regulated financial sector would be unlikely to be captured by those rules.

Negative consequences arising from the relocation of SICAVs

The relocation of Spanish SICAVs in other jurisdictions would bring negative consequences which should be factored in before new legislation is issued on this matter.

Briefly, they are mainly the following three:

- i. Loss of tax collection that will occur at the level of the SICAV (such a loss will be small but it will be a loss in any case).
- ii. Loss of business for lawyers, auditors, notaries, registrars and management companies assisting Spanish SICAVs, with the resulting indirect loss of tax collections for the Spanish Inland Revenue.
- iii. The new management companies which are hired in Luxembourg will not have among their priorities investing in assets (shares, corporate bonds, public debt, etc.) located in Spain.

Final remarks

In order to avoid Spanish SICAVs taking flight to Luxembourg (or to somewhere else within the EU) with the resulting negative consequences mentioned above, it would be advisable to link the privileged tax regime to collective investment undertakings of the open-ended type as regulated by the EU Directive on the harmonisations of the EU UCITS, removing the very old requirement for the 100 shareholders mentioned above, which triggered so much controversy in Spain in the preceding decades. In fact, SICAVs' shares are listed on the *Mercado Alternativo Bursátil* or MAB (Spain's multilateral trading system), which demonstrates the open-ended nature of these vehicles regardless of their number of shareholders.



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MALTA

The Notified AIF

by **Diala Minott and Adam Farrell**

Malta has launched a new fund structure – the Notified AIF.

The Malta Financial Services Authority (MFSA) announced on 11 February 2016 a new fund structure for Alternative Investment Funds (AIFs): the Notified AIF. This new framework is aimed at qualifying investors and professional investors under MiFID.

Key features

The new regime will only be applicable to AIFs, whether open-ended or closed-ended, which are not already licensed by the MFSA. The regime is not available for:

- i. loan funds;
- ii. AIFs which are not marketed and sold exclusively to professional and/or qualifying investors; or
- iii. funds which invest in non-financial assets (e.g. real estate).

The Notified AIF may take any form, provided that any such structure is allowed under Maltese law and is managed by a full scope alternative investment fund manager (AIFM). A Notified AIF will not be authorised or in any way approved by the MFSA, nor will they be subject to ongoing supervision. The AIFM will assume full responsibility for the Notified AIF and for the fulfilment of the obligations of the Notified AIF.

AIFMs based in the European Union or the European Economic Area may submit a notification to the MFSA for an AIF to be included on its list of Notified AIFs, which must be

What you need to know

- 📍 **Malta has launched a new notification framework for AIFs.**
- 📍 **The Notified AIF offers fund managers a straightforward and quick process for establishing AIFs in an alternative jurisdiction.**
- 📍 **The new regime will only be applicable to AIFs which are not already licensed by the MFSA.**

maintained by the MFSA. Third country AIFMs will be able to submit a request for notification of an AIF if the country in which the relevant third country AIFM is established has passporting rights pursuant to the Alternative Investment Fund Managers Directive (AIFMD).

The basis for the new regime is a set of new regulations under the Maltese Investment Services Act together with the Investment Services Rules produced by the MFSA. Once the rules are approved, the MFSA will publish a list of required documents and a pro-forma prospectus template, which must be submitted as part of the AIF's notification application. The new rules are expected to be approved in April 2016.



Notification requirements

The notification process is expected to consist of the following steps:

- i. the approval of the prospectus by the AIF's governing body (e.g. if it is a partnership, the general partner);
- ii. the submission by the AIFM of a completed notification to the MFSA within 30 days of such approval;
- iii. the inclusion of the AIF on the Notified AIF list within ten business days of the notification; and
- iv. the finalisation and dating of the prospectus.

Documents

The request for the notification of an AIF needs to be accompanied by a number of documents, including:

- i. a prospectus meeting certain basic requirements (this will be a straightforward process, as the MFSA will be publishing a pro-forma template);
- ii. a certificate of the AIFM stating that it has the necessary competence and experience to manage the AIF and to monitor any delegate which may be appointed;
- iii. a joint declaration by the AIFM and the governing body of the AIF, whereby each party undertakes responsibility for the AIF and for the obligations arising under the AIFMD; and
- iv. a declaration by the AIFM confirming that it has carried out the due diligence on the service providers and the governing body of the AIF.

The MFSA will then process the application and the supporting documents, and include the AIF in its list of Notified AIFs within a period of ten business days. The MFSA

will maintain a list of Notified AIFs in good standing on its website, but will have the discretion to strike off an AIF from the list at any time.

Benefits

Benefits include a quick process, which means fund managers can bring AIFs to market more swiftly. There is also no regulation of the AIF by the MFSA – as the name suggests, this framework only requires a notification. One important distinction to draw between the Notified AIF and the new QIAIF and RAIF structures in Ireland and Luxembourg, respectively, is that there is no requirement for domestic service providers to be appointed by the fund.

Conclusion

It is expected that the MFSA will start receiving requests for inclusion in the list of Notified AIFs from Q2 2016. Given the expected ease of the process, we expect this new regime is likely to enhance Malta's reputation as a potential fund jurisdiction among fund managers.



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LUXEMBOURG

An introduction to Luxembourg limited partnerships

by Nick Goddard, Isabelle Lentz and Paul Miller

Anglo-Saxon limited partnerships have been the “go to” vehicle for closed-ended private fund structures for many years. This is largely because they have the advantages of investor familiarity, of being flexible vehicles free from corporate law overrides, of maintaining limited liability for investors and of generally being treated as tax transparent so there is no tax leakage at the level of the fund.

Luxembourg have got in on the act by launching two limited partnerships based on the Anglo-Saxon limited partnerships: the *société en commandite simple*, otherwise known as a common limited partnership or “SCS”; and the *société en commandite spéciale*, otherwise known as a special limited partnership, or “SCSp”. These two Lux LPs are very similar and most of the legal regime which governs them is the same. The one major difference between the two vehicles is that the SCSp does not have legal personality (like an English limited partnership) and the SCS does have legal personality (like a Scottish limited partnership).

We are increasingly seeing them being used as onshore fund vehicles, segregated account vehicles, co-investment vehicles and carry vehicles primarily for the reasons described below.

Contractual freedom and flexibility

The Luxembourg law of 10 August 1915 on commercial companies, as amended (the 1915 Law) contains a very limited set of mandatory provisions and leaves significant flexibility for the partners to determine the constitutional rules of the Lux LP in its governing document (i.e. in the limited



What you need to know

- 📍 Limited partnerships have long been the “go to” vehicle for closed-ended private fund structures.
- 📍 Luxembourg has recently launched two of them: the common limited partnership (SCS) and the special limited partnership (SCSp).
- 📍 These Lux LPs are increasingly being used and have widened the onshore options available to fund managers when structuring funds.

partnership agreement). Unlike the *société en commandite par actions* (the SCA, which is generally called a corporate partnership limited by shares in English), for example, Lux LPs are not subject to the legal constraints and formalities applicable to Luxembourg corporate entities.

The principle which underpins Lux LPs is one of contractual freedom and the parties are free to contract on whatever terms suit them best from a commercial perspective. Accordingly, while there are some default provisions set out in the 1915 Law, these are usually always overridden by more bespoke terms in the limited partnership agreement.

Lux LPs are subject to the requirements of the Alternative Investment Fund Managers Directive if, of course, they constitute “alternative investment funds” and fall within

the scope of AIFMD. Except in narrow circumstances, the regulatory burdens this Directive imposes are unavoidable nowadays for multi-investor fund vehicles established or marketed into the EU (whatever fund vehicle is chosen).

In addition, Lux LPs can be used as regulated and unregulated investment fund vehicles. There are a number of drivers and advantages and disadvantages which determine whether a fund vehicle should be subject to regulation over and above the regulation imposed by AIFMD, with investor preference high on the list.

Where a regulated vehicle is chosen, the “specialised investment fund” (*fonds d’investissement spécialisé* or SIF) regime is often used (rather than the SICAR regime (*société d’investissement en capital à risque*, i.e. an investment company in risk capital)), largely for its relative simplicity. Whichever regime is chosen, both SIFs and SICARs must be approved by, and are subject to the supervision of, the CSSF (*Commission de Surveillance de Secteur Financier*, i.e. the Luxembourg supervisory authority) which may be cumbersome, time-consuming and add extra cost.

In acknowledgement of this, the Luxembourg Parliament is currently in the process of approving a new law introducing “reserved alternative investment funds” or RAIFFs. RAIFFs will be flexible and quick-to-market investment vehicles which are regulated under law in a way that is comparable to a specialised investment fund but, unlike a specialised investment fund, will be supervised not directly by the CSSF but indirectly through the RAIFF’s alternative investment fund manager. RAIFFs (like SIFs and SICARs) may be structured as Lux LPs.

One benefit of establishing a regulated Lux LP (whether as a SIF, SICAR or, in the near future, a RAIF) is that it can be operated as an umbrella fund (or a platform) with compartments or sub-funds whose assets and liabilities are segregated from other compartments or sub-funds under Luxembourg law. These umbrella funds or platforms are being used increasingly by fund managers as an efficient way of structuring a series of funds and/or a series of managed accounts.

Liability and management

A Lux LP must at all times have at least one partner called the “unlimited or general partner” which has unlimited liability for the debts and obligations of the Lux LP. The general partner has to carry out, as a minimum, certain corporate functions in respect of its Lux LP but can delegate many of its obligations to a third party (which may be the Lux LP’s AIFM).

A Lux LP must also at all times have at least one “limited partner” whose liability is limited to the amount that it has agreed to contribute to the Lux LP. Limited partners are generally prohibited from carrying out external management activities (i.e. vis-à-vis third parties). If they do so, they may be jointly and severally liable to such third parties for the debts and obligations of the Lux LP incurred in relation to such external management activities (and if they do so on a regular basis they will be treated as if they are a general partner of the Lux LP).

However, a limited partner is expressly permitted to be involved in internal acts of management without forfeiting its limited liability status. The 1915 law sets out a non-exhaustive list of the actions which constitute “internal acts of management” and these include the exercise of their rights as limited partners, providing advice or opinions to the Lux LP, exercising control or supervision actions over the business of the Lux LP and providing loans, guarantees or security or any other type of assistance to the Lux LP. Limited partners are also provided with the certainty that they will not lose their limited liability status as a result of being a member of an internal committee (such as the investor advisory committee) whose approval must be sought prior to the Lux LP taking certain actions.

Speed of establishment and confidentiality

Lux LPs are also quick to establish and are confidential vehicles. There is no requirement for the limited partnership agreement to be made publicly available or for a notary to be involved in its signing, although certain limited information must be published in the Official Gazette (*Mémorial C*) on the formation of the Lux LP (e.g. the identity of the general partner, the identity of the managers (i.e. the general partner’s directors), and the Lux LP’s objects). Importantly, the identity of the limited partners and their respective contributions can be kept confidential.

Although there are currently certain limited circumstances where an SCS has to file its accounts on the

public register at the *Registre de Commerce et des Sociétés*, these circumstances are unlikely to apply where the SCS is being used as a fund vehicle. An SCS does not currently have to publicly file its accounts. Accordingly, the accounts of Lux LPs used in fund structures are generally confidential documents too.

Tax treatment – Investors

Limited partners which are not resident in Luxembourg should not themselves be subject to any Luxembourg taxes merely by reason of investing in a Lux LP. Rather they would need to consider how they are taxed on the amounts allocated to them by the Lux LP in their home jurisdictions. We would generally expect those tax authorities that treat English, Scottish and Channel Island limited partnerships as tax transparent to treat Lux LPs in the same way – although as Lux LPs have only recently been introduced in their present form, this has not been tested.

Tax treatment – Lux LP

The Lux LP should not be subject to any Luxembourg taxes, save that: (i) an unregulated Lux LP (i.e. not a SIF, SICAR or RAIF) may suffer municipal business tax where it does not satisfy the conditions of a relevant exemption; and (ii) in certain circumstances a regulated Lux LP may have to pay an annual *taxe d’abonnement* equal to 1 basis point per annum on the net assets of that Lux LP.

In addition, while there may be some VAT leakage in relation to, for example, set-up costs or other costs that do not constitute “management” for VAT purposes, the VAT treatment of a Lux LP and its general partner generally compares well against other onshore structures.

Conclusion

Lux LPs replicate many of the features that have made Anglo-Saxon limited partnerships so popular as fund vehicles and their introduction has certainly widened the onshore options for fund managers when they are structuring new funds, segregated accounts, co-investments and carry arrangements.



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SEC TARGETS PRIVATE FUND SPONSORS

US regulator eyes costs, fees and allocations

by Margaret Sheehan and Piers Warburton

The US Securities and Exchange Commission (SEC) has criticized certain practices of private fund sponsors that it believes aren't transparent and may create conflicts of interest.

The SEC began examining the activities of private fund sponsors soon after the Dodd Frank Act required many of them to register as investment advisers in 2012. As a result, SEC staff have become much more aware of ways in which some private fund sponsors deal with fees, expenses and investment opportunities, and also how these have been disclosed to fund investors.

As part of that process, the SEC also began identifying and reporting on practices that it believes may keep investors in the dark or create conflicts of interest (or both). The SEC is continuing to treat these issues as an examination priority and has begun pursuing enforcement actions against wrongdoers.

We highlight below practices of private fund managers that the SEC has called out as being problematic.

Charging extra or unusual fees that are not adequately disclosed to investors

Examples of practices that the SEC has criticized include, broadly:

- charging fees which are not covered by the fund constitutional documents or disclosed in a placement memorandum;
- charging fees for ancillary services that are described in placement memoranda as at or below market rate when the manager cannot substantiate that assertion; and
- hiring affiliated service providers who deliver services of questionable value.

The SEC's view is that many of these practices are enabled by fund constitutional documents that are overly broad, and that more specific terms would be preferable. While the SEC

supports the improved disclosure by SEC-regulated private fund advisers' Forms ADV Part 2A, it has also noted that post-closing disclosure is no substitute for proper disclosure before investors commit to make their investment in a fund.

Allocating expenses in an inequitable manner

The SEC has been very critical of the way in which some fund sponsors have allocated expenses. In particular, the SEC believes that it may be a breach of a manager's fiduciary duty to allow expenses to be over-allocated to a primary fund, and under-allocated to co-investment vehicles in which, for example, selected investors, the manager's staff, or other "friends and family" invest. The SEC's first enforcement action in this area involved an adviser that had been allocating expenses in a manner that improperly benefitted one of its funds at the expense of another.¹

In any event, allocating a fund sponsor's own expenses to a fund or funds it manages without authority is an obvious breach of duty, and the SEC has brought an enforcement action against one fund sponsor for charging its own rent and its employee salaries, bonuses and other employment benefits to its funds.² Similarly, the SEC recently brought an enforcement action against an adviser for charging its legal and compliance expenses, including the expenses associated with the adviser's SEC registration and preparation for an SEC examination, to its funds.³ The funds' limited partnership agreements authorized charging the funds for their own legal expenses, but not for those of the adviser.

Finally, the SEC has raised concerns about situations in which a sponsor receives discounts from a service provider that are not also made available to the sponsor's funds. In a recent enforcement action, the SEC criticized a large private fund sponsor for failing to disclose that it had negotiated a much greater fee discount with its outside legal counsel for itself than it had for its funds.⁴

Co-investment allocation practices

The SEC has indicated that private fund advisers should have fully developed policies and procedures regarding co-investment opportunities. The SEC does not mandate what a manager's allocation policy should be, but does expect that it be consistent and transparent. In other words, there are at least two ways in which a private fund manager can get into trouble in this area: (i) by promising investors one thing with respect to co-investments and doing another; and (ii) by allocating co-investment opportunities to preferred investors and not disclosing the practice to other investors.

1 In the Matter of Lincolnshire Management Inc., SEC Release No. IA-3927 (22 September 2014).

2 In the Matter of Clean Energy Capital LLC et al., SEC Release No. 33-9667 (17 October 2014).

3 In the Matter of Cherokee Investment Partners, LLC et al., SEC Release No. IA-4258 (5 November 2015).

4 In the Matter of Blackstone Management Partners LLC et al., SEC Release No. IA-4219 (7 October 2015).

What you need to know

The SEC is focusing in particular on the following areas:

📍 **Inadequate or inaccurate disclosure of costs in placement memoranda and constitutional documents for private funds.**

📍 **Inequitable allocation of expenses.**

📍 **Undisclosed co-investment allocation priorities.**

Fund sponsors should review their internal procedures, investor reporting, placement memoranda and fund terms to ensure they properly disclose their approach to the issues above, and comply with those disclosures.

In the end, the SEC's approach to each of these issues is the same as its approach to all conflicts of interest. Under US law, an investment adviser has a fiduciary obligation to *identify* conflicts of interest and either *eliminate* them or *mitigate* them and *disclose* them to investors. In light of the SEC's continued interest and increasing enforcement activity in this area, it is a good time for private fund advisers to review their practices, compliance procedures and disclosures to identify and address any potential problems.

Actions for all fund sponsors to consider

The actions of the SEC are important for all fund sponsors, whether or not they are based in the US or otherwise subject to SEC regulation. The SEC's actions are already influencing the approach of investors who are concentrating on the issues described above in their diligence of fund sponsors and fund investment opportunities, and in their negotiation of fund terms.

In addition, the SEC's focus is also likely to influence that of other regulators, and it is certainly possible that European regulators will now address similar issues through thematic reviews and, if appropriate, audits of, or even enforcement actions against, particular fund sponsors.

Accordingly, fund sponsors should review their internal procedures and investor reporting to ensure that costs, fees and investment allocations are handled properly and in accordance with both their fiduciary duties and their fund documentation. Sponsors should also review their fund placement memoranda and legal documentation for new fund launches and clarify their treatment of these issues where appropriate.



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TECHNICAL SPOTLIGHT

Taxation of credit fund managers

by Alexander Cox, Paul Miller and Caroline Page

Individuals in the UK's asset management industry have been subject to three very significant tax changes in the last 12 months, including, most recently, the further changes to the taxation of carried interest in the Finance Bill 2016.

These changes are primarily intended to address the taxation of amounts arising to individuals in the asset management industry which are not otherwise subject to income tax, either as employment income (in the case of employees) or trading income (in the case of members of an LLP). The new rules address this by effectively:

- a. taxing all amounts arising to individuals from the funds they manage as trading income, save in respect of limited categories of co-investment and carried interest. On current rates, this results in an effective rate of tax of 47 per cent (45 per cent income tax and two per cent NICs) on amounts which may previously have benefited from a lower rate of tax, e.g. as a capital gain; and
- b. taxing carried interest, which is not regarded as trading income, at a minimum rate of 28 per cent.

Application of these changes to credit funds

The changes apply to asset managers across all asset classes and, in principle therefore, will need to be considered by managers of all forms of credit funds. There are two circumstances in which individuals may be more relaxed about their application:

- i. where they already receive all amounts in respect of the funds they manage as employment income or trading income, as those amounts will already be subject to tax at the highest income tax rates, e.g. where those individuals do not have any equity or debt interest in the underlying funds; and
- ii. where the funds they manage are not a collective investment scheme (CIS), e.g. many funds which are established as non-UK body corporates.

What you need to know

- Recent changes arguably represent the most seismic shift in the taxation of individual UK asset managers in the past 30 years.
- They apply across all asset classes, including credit and debt funds, but generally not to CLOs.
- A general understanding of their scope is critical – and is likely to help shape the structure of carry, co-investment and perhaps even investment strategy.

Many individuals in the CLO industry should not, therefore, be affected by the changes, either on the basis that they do not have any equity interest in the CLO or because the CLO is not a CIS. The changes will, however, be of direct application to managers of credit funds which are established as UK or non-UK limited partnerships.

Implementation – a brief history

The changes have been introduced in three instalments:

- the disguised investment management fee rules (DIMF Rules), which apply to amounts arising to individuals on or after 6 April 2015;
- the basic carried interest rules (CI Rules), which apply to amounts arising to individuals on or after 8 July 2015; and
- the income-based carried interest rules (IBCI Rules), which apply to amounts arising to individuals on or after 6 April 2016;

in each case, largely irrespective of when the fund was established or investments were made. The DIMF Rules and CI Rules apply to asset managers irrespective of whether they are employees or not. Somewhat oddly, the IBCI Rules do not apply to employees and are mainly of relevance to LLP members.

DIMF Rules

The DIMF Rules broadly tax all amounts arising to individuals from a CIS fund (other than defined categories of co-investment and carried interest) as trading income, i.e. at 47 per cent. UK resident doms and non-doms are taxed in the same way under these rules.

Co-investment covers most normal co-investment arrangements, i.e. where individuals co-invest alongside and *pari passu* with investors, subject to management fee and carried interest waiver, but may not cover other types of more structured co-investment arrangements, e.g. arrangements involving leverage.

Carried interest generally includes only carried interest which is profit-dependent and subject to significant risk or carried interest which is subject to a preferred return of at least six per cent.

CI Rules

Under the CI Rules, all carried interest (other than income-based carried interest – see below) is broadly treated as capital gain and subject to a minimum 28 per cent capital gains tax charge – notwithstanding a reduction in the headline rate of capital gains tax to 20 per cent for other assets. These rules operate in tandem with the existing carried interest rules, rather than replacing them, and so to the extent that any carry payment is made out of dividend or interest income, the higher income tax rates of 38.1 per cent and 45 per cent will apply, with credit for any 28 per cent charge.

UK resident doms and non-doms are taxed slightly differently under these rules, in that a proportion of any capital gain deemed to arise to a non-dom from a non-UK investment will be regarded as a foreign chargeable gain and therefore eligible for the remittance basis to the extent that the relevant asset management services are performed from outside the UK. Non-doms may therefore wish to keep a record of how much time they spend working outside the UK on their funds.

IBCI Rules

Under the IBCI Rules, carried interest which is income-based carried interest will be taxed as trading income under the DIMF Rules at 47 per cent. Again, UK resident doms and non-doms will be taxed in the same way in respect of income-based carried interest.

Summary

All amounts arising to individual asset managers will be subject to income tax and NICs at a combined 47 per cent, save for:

- vanilla co-invest; and
- carried interest which is:
 - subject to a preferred return of six per cent or significant risk; and
 - is not income-based carried interest.

Income-based carried interest

The IBCI Rules take up over 20 pages of Finance Bill 2016. The following paragraphs are not, therefore, intended to be an exhaustive guide to the new rules – rather a summary of some of the key features which may be relevant in the context of credit funds.

As noted above, employees are not within the scope of the IBCI Rules so the following is mainly of relevance to LLP members.

The general rule

The basic premise of the legislation is simple – carried interest arising to individuals (other than employees) will be regarded as income-based carried interest and taxed as trading income unless the average holding period of the investments of the fund by value is at least 40 months (assuming a whole of fund carry). A proportion of carried interest will be regarded as income-based carried interest if the average holding period is between 36 and 40 months:



Average holding period of relevant investments	Income-based carried interest proportion
Less than 36 months	100%
At least 36 months but less than 37 months	80%
At least 37 months but less than 38 months	60%
At least 38 months but less than 39 months	40%
At least 39 months but less than 40 months	20%
40 months or more	0%

Carried interest, for these purposes, follows the definition in the DIMF Rules. Carried interest which is not income-based carried interest will be taxed under the CI Rules set out above (which will thus result in lower tax rates being payable).

Direct lending fund rules

The general rule is supplemented by a number of different regimes for different types of fund. In respect of direct lending funds, the default position is that all carried interest constitutes income-based carried interest.

A direct lending fund is a fund which is not subject to one of the other fund regimes under these rules and in relation to which it is reasonable to suppose that, when investments cease to be made, more than 50 per cent of the investments made by the fund will have been direct loans.

A direct loan for these purposes is an advance of money to any person at interest or for any other return determined by reference to the time value of money and, importantly, includes any loan acquired by the fund (on syndication or in the secondary market) within 120 days of being made.

Generally, therefore, credit funds which intend to undertake direct lending will typically fall within these rules, whereas credit funds which intend to invest in the secondary market outside of the 120 days will typically not. Credit funds which take equity stakes as part of their investment strategy may fall within one of the other fund regimes and should consider their position carefully.

The exception

The presumption that carried interest in respect of a direct lending fund is income-based carried interest is disapplied where:

- the fund is a limited partnership (or equivalent formed outside the UK);
- the carried interest is subject to a preferred return of at least four per cent; and
- it is reasonable to suppose that, when investments cease to be made, at least 75 per cent of the direct loans (calculated by reference to value) will have been qualifying loans.

Qualifying loans are arm's-length loans made to unconnected borrowers with fixed and determinable repayments, a fixed maturity and a relevant term of at least four years (the relevant term is the period from when money is advanced

until the time by which at least 75 per cent of the principal must be repaid under the terms of the loan). The fund must also have the intention to hold the qualifying loan to maturity.

Many direct lending funds are now being established as limited partnerships and, in principle therefore, will be able to benefit from this exception. The requirement that at least 75 per cent of the investments of the fund need to have been qualifying loans may present difficulties where the fund expects to syndicate some or all of its loans, however, because to be a qualifying loan the fund must intend to hold it to maturity. Any syndication policy should therefore be considered very carefully by any direct lending fund which hopes to fall within the exception.

Where a fund falls within the exception, the extent to which any carried interest in respect of that fund constitutes income-based carried interest will be determined by the general rule, i.e. by reference to the average holding period of the investments in the fund.

Average holding period

The calculation of average holding periods is clearly critical to the determination of income-based carried interest and is broadly determined by reference to when amounts are invested and when the investments funded by those amounts are disposed of. Large investments, follow-ons, part disposals and syndications may therefore have a disproportionate effect on the average holding period of investments in a fund.

Syndication

In a credit funds context, therefore, any syndication strategy needs to be considered very carefully. Certain part disposals/syndications can be disregarded where, among other things, the "unwanted investment" is disposed of within 120 days of acquisition and does not constitute more than half of the original investment but we recommend that, at least initially, this is reviewed on a case-by-case basis.

Early repayment of principal

The early repayment of loans may also have a disproportionate effect on average holding periods. In recognition of this, the IBCI Rules provide that, in the context of a direct lending fund, where the principal amount of a qualifying loan (see above) is repaid within 40 months of the loan being made, the whole loan will generally be deemed to have been held for 40 months provided it is reasonable to suppose that the borrower's repayment was not concerned with the application of these rules. This deeming provision is, however, limited to qualifying loans only.

Conclusion

Application

Individuals managing credit funds which are established as collective investment schemes (e.g. limited partnerships and open-ended fund vehicles) are likely to be affected by some or all of the rules described above.



In analysing their position, the starting point is that they should expect to pay tax at 47 per cent on all amounts arising to them from those funds which are not otherwise subject to employment or trading income taxes, except to the extent that those amounts represent returns on a vanilla co-investment or carried interest which is profit-dependent and subject to significant risk or subject to a six per cent preferred return.

In addition, those individuals who are not employees will then also need to consider whether any carried interest arising to them (which is not otherwise taxed at 47 per cent) is income-based carried interest and therefore also subject to tax at 47 per cent. This will depend on whether the fund is a direct lending fund and, if it is not a direct lending fund or falls within the exception for direct lending funds, on the average holding period of investments in the fund.

In either case, carried interest which escapes the 47 per cent charges above will be subject to a minimum 28 per cent capital gains tax charge. If the carried interest is entirely funded out of capital or capital gains, there is no further UK tax to pay. However, there will be additional tax to pay at the appropriate dividend and interest rates if the carry is funded out of income.



Finally, non-doms may benefit from the remittance rules in respect of part of their carried interest under these rules if it relates to a non-UK investment and the individual performs some or all of their services outside the UK.

Practical points

The application of some of the rules set out above depends in part on the investment strategy and profile of the fund. It may therefore be sensible to include reference, where appropriate, to anticipated holding periods in prospectuses and information memoranda.

Syndication strategies should be considered very carefully because this could have a disproportionate effect on the average holding period of investments in the fund.

Direct lending funds which intend to take advantage of the exception to the default position on direct lending funds should ensure that 75 per cent of their loans will meet the qualifying loan test.

None of these sets of rules impose employers' NICs. Thus, even where the above rules apply, it may still be worthwhile for employers to give equity interests to employees rather than pay them bonuses.

Non-doms may wish to record time worked outside the UK on their funds to benefit from the remittance basis under the carried interest rules.

Finally, any credit fund managers should approach any structuring around these rules with caution; there are targeted anti-avoidance rules in each of these regimes and the current environment is not at all sympathetic to what might be perceived as aggressive tax planning.



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WATCH THIS SPACE

What's new?

The rise of the “unsupervised” fund – the Luxembourg RAIF

Earlier in this issue of Credit Funds *INSIGHT*, we discussed the developments in Malta of the new Notified AIF which allows fund managers to utilise an “unsupervised” alternative fund structure. In the next few weeks, the Luxembourg Parliament is expected to approve the bill of law on Reserved Alternative Investment Funds (RAIFs), providing fund managers with a vehicle that has all the benefits of a SIF fund but without the supervision of the *Commission de Surveillance du Secteur Financier* (CSSF). The admittance of the RAIF regime continues to extend the fund structure offerings available to AIFMs in Luxembourg, further increasing Luxembourg’s share of the funds’ market.

The main attraction in RAIFs lies in having all the structuring flexibility from which a CSSF regulated fund benefits, such as the ability to create compartments, but without the approval or supervision of the CSSF. The RAIF can be brought to market quickly since there is no CSSF approval

required, and it can benefit from the European marketing passporting authorisations of its AIFM. To qualify for the new RAIF regime, the RAIF must be managed by an authorised AIFM, thereby obtaining indirect supervision through the supervision of the AIFM by its competent authority.

Brexit

On 23 June 2016, the UK electorate will vote on the question “Should the United Kingdom remain a member of the European Union?”. The potential exit of the UK from the EU is commonly referred to as Brexit, and the implications of such action and alternatively remaining within the EU are currently the subject of much debate.

In our next edition, we will explore in greater detail the implications for the market of the new Luxembourg RAIF and an assessment of its key attributes, and the result of the EU referendum and its impact for credit funds.



Forthcoming events

Private Debt Forum, Europe

24–25 May 2016, Marriott Champs Elysees, Paris (Informa)

The 20th Annual Global ABS

14–16 June 2016, Centre de Convencions Internacional de Barcelona, Plaça de Willy Brandt, 11–14 Barcelona 08019 (AFME/IMN)

PrivateCredit, North America

22 June 2016, Apella at Alexandria Center for Life Science, 450 E 29th St, New York, NY 10016 (Creditflux)

ABS East

18–20 September 2016, Fontainebleau Miami Beach, 4441 Collins Avenue, Miami Beach, FL 33140 (IMN)

The 4th Annual European CLO Congress

20–21 September 2016, Hotel Hilton, Barcelona (Euromoney Seminars)

This publication is not intended to be a comprehensive review of all developments in the law and practice, or to cover all aspects of those referred to. Readers should take legal advice before applying the information contained in this publication to specific issues or transactions. For more information please contact us at Broadwalk House, 5 Appold Street, London EC2A 2HA T: +44 (0)20 7638 1111 F: +44 (0)20 7638 1112 www.ashurst.com.

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