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Fund Structures

How Fund Managers Can Navigate Establishing Parallel and Debt Funds in Luxembourg in the Shadow of Brexit and Proposed E.U. Delegation Rules

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By Vincent Pitaro, *Hedge Fund Law Report*

The Association of the Luxembourg Fund Industry (ALFI) recently organized a seminar that examined different fund structures within Luxembourg, as well as political and regulatory developments within Europe. The seminar featured panel discussions with representatives from asset managers, in addition to financial services, legal and accounting firms. This article highlights the portions of the seminar addressing the establishment of parallel E.U. funds and Luxembourg debt funds; Brexit; and the E.U.'s proposed delegation rules.

For additional coverage of the ALFI program, including a summary of the keynote address of H.E. Pierre Gramegna, Luxembourg's Minister of Finance, along with the portions of the seminar that covered marketing funds in the E.U. and setting up an E.U. alternative investment fund manager (AIFM), see "Luxembourg Remains a Significant Point of Entry for Non-E.U. Managers to Raise Capital in the E.U." (May 17, 2018).

For more on E.U. regulatory developments, see "With Brexit Looming and New Fund Structures Available, U.S. Hedge Fund Managers Face Risks and Opportunities for Marketing in Europe" (Jun. 9, 2016).

Structuring Parallel Funds

Luxembourg is a globally recognized investment fund center, said Gilles Dusemon, partner at Arendt & Medernach. The best way to market a fund in Europe is through a marketing passport available under the Alternative Investment Fund Managers Directive (AIFMD). See "Passports, Platforms and Private Placement: Options for Marketing Funds in Europe in the Post-AIFMD Era" (Apr. 30, 2015).

Parallel Fund Models

A U.S. manager can do this by creating a parallel E.U. investment fund. Luxembourg offers fund structures that are similar to U.S. limited partnerships. There are two governance models for parallel funds: the delegation model and the advisory model. See "Dechert Partners Discuss How

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Cross-Border European Fund Managers Can Prepare for Brexit's Momentous Regulatory Effect" (Apr. 6, 2017).

Delegation Model

Under this approach, the AIFM delegates portfolio management of the E.U. fund to the U.S. manager, which implements the investment strategy for both funds, Dusemon explained.

The delegation model allows U.S. managers to retain portfolio management, to which they are accustomed, according to John W. McCullough, executive vice president and general counsel at Harbert Management Corporation (HMC). This may, however, subject the U.S. manager to certain provisions of the AIFMD, the most troubling of which are the remuneration rules and related disclosures. Concerned about those provisions, HMC settled on a variant of the advisory model, under which portfolio management stays with the AIFM and there is no concern of indirect application of the AIFMD to the U.S. manager.

Advisory Model

Under this approach, the E.U. fund structure "mirrors" the U.S. structure, Dusemon clarified. The U.S. manager creates an E.U. fund and appoints an E.U. AIFM that is responsible for both portfolio and risk management. The U.S. manager and the AIFM can be aligned through a co-investment agreement that ensures the parallel fund is "implementing the same strategy, in the same assets, at the same time." The U.S. manager sources deals and investments in the U.S. and advises the AIFM on implementation of the strategy, but the AIFM retains control of portfolio management.

The main risk under the advisory model is the potential for disproportionate deployment of capital between the parallel funds, McCullough explained. The independent third-party AIFM may choose not to follow the U.S. manager's investment choices, leading to unequal deployments. HMC mitigates that risk through disclosures in fund documents and tight contractual provisions between funds. Rather than detailing a broad general strategy, its parallel E.U. fund documents disclose that its strategy is "to invest pro rata alongside . . . the U.S. fund," he said. It is not possible, however, to eliminate the AIFM's investment discretion under the advisory model.

Deciding on the Proper Structure

Whether a U.S. manager should set up its own AIFM or appoint a third-party AIFM for a parallel fund is a matter of scale, McCullough said. A smaller manager may not have sufficient staff or resources to allocate to a standalone AIFM, in which case it may be more cost-effective to use a third party.

Luxembourg's adoption of the reserved alternative investment fund (RAIF) structure in 2016 was very attractive to HMC, which is a multi-strategy manager. HMC established a RAIF platform with separate compartments (*i.e.*, sub-funds) to invest alongside each of the U.S. funds that it manages. Under HMC's approach, costs "uniquely associated" with the Luxembourg parallel fund – such as AIFM, administrator and depository fees – are borne by the E.U. investors in the parallel fund and are clearly disclosed in the fund's offering documents.

See our two-part coverage of the benefits of the RAIF structure for non-E.U. fund managers: "Access to AIFMD Passport and Marketing to E.U. Investors" (Apr. 21, 2016); and "Marketing Options and Tax Benefits" (Apr. 28, 2016).

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Establishing Debt Funds in Luxembourg

The number of debt funds established in Luxembourg has increased consistently over the past 10 years, explained KPMG partner Christophe Diricks; more than 70 percent of the world's top loan fund managers have funds there. As of August 2017, the size of the regulated loan fund market in Luxembourg was approximately €40 billion.

The most popular regulated vehicle, used by about 78 percent of loan funds, is the specialized investment vehicle. About 15 percent of loan funds are RAIFs. Increasingly, promoters are launching RAIFs managed by Luxembourg AIFMs. Unregulated vehicles include special limited partnerships, securitization vehicles and financing companies.

More than half of investors in Luxembourg debt funds are from the E.U., Diricks noted. Three-quarters of investors are institutional investors. Most of the rest are high net worth individuals and private banks. Many Luxembourg loan funds are open-end; they address liquidity mismatches with lockups and waiting periods.

A manager that wishes to offer loans to the public must have a banking license, Diricks said. A banking license is only required, however, if the lender cannot identify its borrowers. If a fund is lending to a limited universe of persons and companies, it will not be subject to the banking regulation.

U.S. promoters looking to establish E.U. loan funds do not want to be "guinea pigs," Diricks observed. Consequently, they seek established jurisdictions like Luxembourg and Ireland. Debt fund managers primarily choose Luxembourg for its flexibility in accommodating various primary and secondary market strategies. Many big players are already established there, which inspires confidence in newcomers.

For a look at Ireland's approach, see "Ireland Further Opens the Door for Loan Origination in Europe by Relaxing Restrictions on Eligible Investments by Certain Irish Funds" (Jan. 19, 2017).

Luxembourg is also party to dozens of tax treaties that provide benefits to funds and special purpose vehicles (SPVs). Its policy is to put fund investors in the same position as if they had invested directly in the fund's assets. Recent Organisation for Economic Co-operation and Development anti-abuse reforms, however, will make it more difficult for managers to obtain treaty benefits through Luxembourg SPVs. To obtain treaty benefits, an entity will have to show that it has sufficient economic substance in Luxembourg and that its main purpose is not to obtain tax treaty benefits. This can be done by establishing a fund or AIFM in Luxembourg, Diricks said.

For more on the anti-abuse reforms, see "How Recent Developments Under BEPS May Affect Fund Managers' Ability to Use Special Purpose Vehicles" (Oct. 5, 2017). For more on tax treaties, see "Treaties Offer Fund Managers Means to Reclaim Overpayments but Require Updating to Keep Pace With the Market" (Jun. 15, 2017); and our two-part series on the global trend toward tax transparency: "Steps That Alternative Investment Fund Managers Need to Take Today" (Apr. 7, 2016); and "Steps That Alternative Investment Fund Managers Need to Consider" (Apr. 14, 2016).

Brexit

The U.K. began the formal process of exiting the E.U. in March 2017, and "the clock is ticking," noted Josiane Schroeder, counsel at Linklaters. It is a complex process that continues to get

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more complicated, said Nicolas Mackel, CEO of Luxembourg for Finance. Despite suggestions to the contrary, "there is no such thing as a 'soft' Brexit; the United Kingdom will leave the E.U., full stop," he said.

See "ESMA Strives to Prepare Markets as MiFID II, MiFIR and Brexit Approach" (Oct. 12, 2017); and our two-part series on the potential impact of Brexit: "Effect of Hard vs. Soft Brexit on Hedge Fund Managers" (Jul. 7, 2016); and "Hedge Fund Marketing and Distribution Opportunities in a Post-Brexit World" (Jul. 14, 2016).

The actual departure will occur in less than a year, and months have been lost to political posturing and bickering, Mackel continued. Key issues include (1) the fate of E.U. citizens living in the U.K. and of U.K. citizens living in the E.U. (although it appears that those individuals will be allowed to stay); (2) resolving the U.K.'s existing financial commitments to the E.U.; and (3) the potential reimposition of border controls in Northern Ireland.

Some see Brexit as an opportunity to squeeze financial services business out of London and into Europe, Mackel noted. In October, E.U. leaders will meet and, hopefully, adopt a framework for negotiations after the U.K.'s formal exit in March 2019. It is likely that there will be a transition period through the end of 2020.

U.K. politics are complicating the process, according to Richard Marshall, product head at FundRock Management Company S.A. Theresa May lost her parliamentary majority in the 2017 general election and had to form a coalition government. One of the coalition parties will be adamant that there be no border between Northern Ireland and the rest of the U.K. Others are concerned about the U.K.'s ability to negotiate trade deals if the border remains open. Although it is very unlikely that the U.K. will reverse its position, there is talk of a second referendum to "verify" the terms of Brexit, which could create another "can of worms." The transition period could also be extended.

In the Brexit vote, 60% of Scots voted to remain in the E.U., Marshall noted. Some fear that if Scotland were to hold a new referendum on remaining in the U.K., it would vote to leave and try to join the E.U. Meanwhile, Spain has been adamant that a region that breaks away from one nation should not be permitted to join the E.U. This could sway voters in Scotland to remain in the U.K. in a future referendum.

The political mood in Europe has also been shifting, added Silvio D. Cruz, senior vice president and managing director at AllianceBernstein. Brexit represents a significant crack in European unity, as do the current nationalist movements in Italy and other member states. U.S. managers must assess where their clients are and how these changes will affect them. They must also figure out how to handle the U.K. as a market distinct from the rest of the E.U.

Marketing passporting between the U.K. and the E.U. is not on the table, Marshall cautioned. Managers that wish to continue to operate in the E.U. will need to have an E.U.-domiciled fund product for Europeans and a parallel U.K. product for U.K. clients. A U.K. manager will have to set up a new office; recruit staff for it; and figure out governance and substance. U.K. financial services firms have been working on relocating almost since the day of the 2016 referendum, Mackel noted.

See "Program Highlights Malta's Fund-Friendly Environment" (Apr. 19, 2018); and "Jersey Offers Range of Marketing and Distribution Options, Operational Support for Investment Funds" (Mar. 9, 2017).

Many asset managers already have a presence in Luxembourg, often via a fund formed under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive, and are expanding those platforms to incorporate alternative investment funds (AIFs), Mackel continued.

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Because Luxembourg is also a wealth-management hub, some U.S. banks are using Luxembourg as a post-Brexit E.U. hub, as are many major insurers and FinTech firms. The major players are relocating different activities to different E.U. jurisdictions and are "going to where the ecosystem is best geared to support that particular activity," he said. Luxembourg has been a top choice for investment funds.

At the moment of Brexit, the E.U. and U.K. regulatory regimes will be quite similar, but they are likely to diverge going forward, Cruz said. The U.K. has been a fairly open market, and regulators are likely to find a way to bring in UCITS funds and AIFs, he opined. A U.K.-licensed firm that presently offers services regulated under the recast Markets in Financial Instruments Directive in the E.U. will probably have to move some of those services to the E.U. Moreover, some E.U. investors may not be able to invest through non-E.U.-licensed managers.

See "ESMA Opinion Sets Forth Four Common Principles for UCITS Share Classes" (Mar. 16, 2017); and "Dechert Partners Discuss Domiciling Funds in Germany or Ireland to Access the E.U. Post-Brexit, the Possible Introduction of PRIIPS and the Rising Prominence of UCITS Structures (Part Two of Two)" (Nov. 17, 2016).

E.U. Delegation Framework Initiative

The European Commission (EC) and the European Securities and Markets Authority (ESMA) are proposing to expand the E.U.'s powers over delegation of duties by fund managers, Schroeder noted. This is part of a larger EC initiative to revise the functioning and powers of the E.U. banking, insurance and securities markets regulators, Mackel said. The goal is to deepen the capital markets union and achieve greater convergence in supervision. ESMA has proposed requiring asset managers to contribute to its cost of operations. It is also seeking to have direct supervision of the E.U.'s long-term investment, venture capital and entrepreneurship funds.

See "ESMA Chair Calls for Stronger Supervisory Tools to Achieve Capital Markets Union" (Apr. 20, 2017).

Presently, delegation is supervised by the national competent authorities (NCA) of member states, Mackel continued. Under the pending proposals, ESMA would be given the power to review NCA delegation action and to suspend delegation pending issuance of an ESMA opinion that the NCA would be obligated to follow.

Delegation has been "part and parcel of the way the [funds] industry is functioning" worldwide, Mackel said. Consequently, the EC proposals are not necessarily receiving a warm welcome. Proponents of the delegation rules argue that they are needed to avoid managers leaving "empty shells" in the E.U. following Brexit. E.U. regulations, however, make it very difficult to use empty shells, raising the issue of "what problem this solution is trying to address," Mackel said.

Delegation is not just about portfolio management, Cruz added. It may also encompass risk, legal and operational frameworks. The delegation rules create risk and change operational models. They may require a shift in a manager's "centers of excellence," which may cause managers to reevaluate where they sell their products. If the E.U. is seen as insulating itself by making delegation more difficult, other markets may do the same. In short, delegation has worked well, is in the best interests of the E.U. and is in the best interests of investors, who have more choices. The current lack of legal predictability causes businesses to defer investment.

The delegation and other proposals suggest that the E.U. may be "preparing to raise the bridges" in a post-Brexit environment, which may also affect other countries with delegation

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arrangements, Mackel said. Nevertheless, the E.U. has been a champion of open borders and open trade, which should prevail in the long term. He encouraged the audience to voice its opinion on the delegation proposals and their implications for investors.

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