

Group Briefing

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Consultations on Exempt Unit Trusts, other Vehicles and Loan Funds and Updated AIFMD Q&A

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This document contains a general summary of developments and is not a complete or definitive statement of the law. Specific legal advice should be obtained where appropriate.

CENTRAL BANK CONSULTATION ON TYPES OF ALTERNATIVE INVESTMENT FUNDS UNDER AIFMD AND UNIT TRUST SCHEMES UNDER THE UNIT TRUSTS ACT 1990

On 19 July 2013, the Central Bank published Consultation Paper CP 68: "Consultation on types of alternative investment funds under AIFMD and unit trust schemes under the Unit Trusts Act 1990 (including EUTs, REITs, etc.)."

The purpose of CP 68 is to consider the status of exempt unit trusts ("EUTs"), and other investment structures (e.g. REITs and special purpose vehicles) that are not currently subject to Central Bank regulation, under Directive 2011/61/EU on Alternative Investment Fund Managers ("AIFMD"). In particular, CP 68 seeks to address (i) whether EUTs are alternative investment funds ("AIFs") under AIFMD; and (ii) whether EUTs are unit trust schemes within the scope of the Unit Trusts Act 1990.

PROPOSED TREATMENT OF EUTS

The European Securities and Markets Authority ("ESMA") has published guidelines to assist in identifying an AIF, which provide that where one compartment of an undertaking is determined to meet the criteria for an AIF, the undertaking as a whole should be regarded as an AIF. In this context, the

Central Bank has noted that, although a significant number of EUT series may each have a single investor, EUTs are likely to fall within the definition of an AIF on the basis that most EUT master trusts are likely to have at least one series with more than one investor. If this is the case, EUTs must appoint an alternative investment fund manager ("AIFM"), which is either authorised or registered in accordance with AIFMD.

The Central Bank notes that EUTs have been deemed to fall outside the scope of the Unit Trusts Act 1990 on the basis that investment in EUTs is generally limited to pension fund investors and therefore does not involve "participation by the public", as required by the Unit Trusts Act 1990. The Central Bank proposes to revisit the status of EUTs in light of AIFMD, noting that EUTs should not be considered excluded from the scope of the Unit Trusts Act 1990 simply because they are limited to pension fund investors.

EUTs within the scope of the Unit Trusts Act 1990 will require authorisation by the Central Bank either as a retail investor AIF ("RIAIF") or as a qualifying investor AIF ("QIAIF"). The Central Bank has noted that it is unlikely that investors in EUTs will meet with its QIAIF investor criteria and minimum subscription requirement and, accordingly, most EUTs will need to seek authorisation as RIAIFs. This may have

significant implications for EUTs, as RIAIFs are subject to certain investment diversification and borrowing requirements. In particular, RIAIFs are not permitted to borrow in excess of 25% of net asset value and RIAIFs which invest in real estate are prohibited from investing more than 30% of net asset value in any one property. In addition, RIAIFs falling below the AIFMD thresholds (€100 million or €500 million if the AIFs are unleveraged and closed-ended) are not permitted to have a registered AIFM and are instead required to have a fully-authorised AIFM.

With regard to timing, the Central Bank is considering a transitional deadline of July 2015 for EUTs to comply with the requirements of AIFMD.

DEADLINE FOR RESPONSES TO DISCUSSION PAPER

The Central Bank has invited responses to CP 68 by 11 October 2013.

PUBLICATION OF THE CENTRAL BANK'S DISCUSSION PAPER ON LOAN ORIGINATION FUNDS

On 22 July 2013 the Central Bank issued a discussion paper on loan origination by investment funds.

BACKGROUND

The Central Bank considers "loan origination investment funds" to be those which undertake to source loan assets for their investment portfolio by directly originating loans rather than investing via loan assignments or loan participations. In such instances the investment fund is the original lender of record and lending is (or is part of) the investment strategy of the fund. Under the Central Bank's AIF Rulebook, AIFs continue to be prohibited from originating loans, though they may take loan exposure through the assignment of, or participation in, existing loans which have been originated by another party.

KEY QUESTIONS POSED BY DISCUSSION PAPER

A number of key questions are posed in the discussion paper:

1. *Is there a public good which could be served by relaxing the current regulatory constraint whereby investment funds are prohibited from originating loans?*

In this regard, the Central Bank notes that there is a body of empirical evidence which suggests that the development of non-bank sources of credit may assist the evolution of the European economy at this juncture.

2. *What are the "shadow banking" risks raised by the relaxation of the current policy?*

The Central Bank notes that financial stability concerns should be taken into account in the regulation of non-bank lending activity. Following the lead of the Financial Stability Board ("FSB") various financial authorities have started to re-evaluate the consequences of entities which provide credit and fund this activity primarily outside the banking system through the so-called 'shadow banking' system. The Central Bank states that loan origination by investment funds would be captured by the FSB definition of shadow banking.

3. *In what way could these risks be mitigated such that loan origination by investment funds could be a viable credit channel?*
4. *Does the current AIF Rulebook provide sufficient protections for investors in the case where investment funds are allowed to originate loans?*

DISCUSSION OF EXISTING REGULATORY REQUIREMENTS

The Central Bank notes that the syndicated loan market has features which (a) support credit assessment; (b) mitigate information asymmetries; and (c) may offer secondary market liquidity. For that reason, investment funds are allowed to participate in syndicated proposals.

The Central Bank notes that certain stakeholders have argued that, because it is possible to take a position in a loan by way of loan participation immediately

after another party has originated a loan, the Central Bank should allow loan origination to be consistent with what is already permitted. The Central Bank is not persuaded by this argument:

- » the syndicated loan market has an inherent discipline around credit assessment and monitoring because loans must be structured and priced to be credible to a range of potential lenders. In the absence of specific regulatory requirements, it is not clear that such a discipline exists in direct debt-financing or bilateral loan origination activity;
- » the best practice which the Central Bank has encountered amongst loan originators suggests highly involved selection process requiring specialist skills. Measured in terms of time-input, alone, from pre-screening to loan origination, this may take over six months. It contrasts with investment via loan participation which may take a number of days but no more than a few weeks; and
- » it is important that the credit assessment and monitoring which underpins any loan origination process is thorough and credible. If investment funds were effectively originating loans by making arrangements for another party to originate a loan and then participating in the loan just after it was originated, this would not be an acceptable practice as it would constitute a form of avoidance of the responsibility to conduct thorough credit assessment and monitoring and it would run the risk that the supply of credit is mis-priced and be mis-managed.

INTERACTION WITH EUROPEAN COMMISSION'S PROPOSAL FOR A EUROPEAN LONG TERM INVESTMENT FUND

The Central Bank refers to the European Commission's proposal for a European Long Term Investment Fund ("ELTIF") issued on 26 June 2013. The Central Bank's overall assessment is that if loan origination funds were allowed

at this time it would pave the way for the ELTIF option. At the very least, providing a jurisdiction with a well-considered regulatory framework for loan origination funds would provide the industry with a framework within which they could prove the concept of loan origination funds for investors reluctant to go down this road without such a regulatory framework. In addition, consideration could be given as to how to align the two by considering whether fund promoters would be allowed to design loan origination funds which would operate out of Ireland initially as AIFs but with an option to opt into the ELTIF regime, with investor consent when it becomes available.

POSSIBLE MEASURES TO MITIGATE RISKS OF LOAN ORIGINATION FUNDS

The Central Bank has identified a list of possible measures to mitigate risks, were it to permit funds to engage in loan origination:

1. a limit on the percentage of assets exposed to a single borrower, ca. 10%;
2. limits on the level of mezzanine / unsecured lending that an investment fund could engage in;
3. a requirement that the fund be closed-ended;
4. a requirement that the investment manager have “skin in the game” through a co-investment arrangement;
5. requirements for detailed credit assessment and monitoring policies;
6. a prohibition on lending:
 - » to connected parties of the investment fund, its manager or service providers;
 - » to other investment funds;
 - » to financial institutions or related entities;
 - » to persons intending to invest in equities or other quoted investments or commodities;
 - » other than on a secured basis with a loan to value of approximately 70% at

origination based on at least 2 independent valuations;

- » other than on a fully amortised basis;
- » as part of a complex investment strategy;
- » to natural persons.

DEADLINE FOR RESPONSES TO CONSULTATION

The deadline for responses to the discussion paper is 13 September 2013.

CENTRAL BANK ISSUES UPDATED AIFMD Q&A

On 19 July the Central Bank published the third edition of its AIFMD Q&A. The key updates from the second edition of the Q&A are as follows:

ENACTMENT OF IRISH AIFM REGULATIONS

The Q&A refers to the European Union (Alternative Investment Fund Managers) Regulations 2013 which transposed AIFMD into Irish law on 16 July 2013 (the “AIFM Regulations”).

REGISTERED AIFMS

Registration forms for registered AIFMs which have assets under management (“AUM”) below the thresholds prescribed in AIFMD are available on the Central Bank’s website.

The Central Bank notes that “start-up AIFMs” refers to the regime applicable to new QIAIFs which have registered AIFMs. QIAIFs authorised after 22 July 2013 which have a registered AIFM are provided with a two year start-up period during which the Central Bank will not require that they have an authorised AIFM. After the start-up period, an authorised AIFM must be appointed by the QIAIF. During the start-up period, depositaries of start-up QIAIFs must

¹ AIFs with AUM, including those acquired through the use of leverage, of less than €100 million or AIFs with AUM of less than €500 million, provided that the AIFs are unleveraged and are subject to redemption lock-up periods of at least five years

comply with the AIFMD depositary regime excluding the depositary liability provisions. The current liability standard set out in the NU Notices will apply during the start-up period.

The Central Bank notes that QIAIFs authorised before 22 July 2013 which have a registered AIFM are subject to the full AIFMD depositary regime including the depositary liability provisions. The Central Bank will not require these QIAIFs to appoint an authorised AIFM at any time. The Central Bank notes that if the AIFMD thresholds are exceeded, an authorised AIFM must be appointed in accordance with the requirements of AIFMD.

NON-EU AIFMS MANAGING QIAIFs

The Central Bank clarifies that a non-EU AIFM managing a QIAIF does not have to fulfil all the obligations imposed on AIFMs and that it will allow a transition benefit to non-EU AIFMs. Any QIAIF which was authorised prior to 22 July 2013 and which designates a non-EU entity as its AIFM will only be obliged to ensure that it has an AIFM capable of carrying out all the tasks of an authorised AIFM and an authorised depositary capable of providing the required depositary services in accordance with the requirements of AIFMD, by 22 July 2015. Up until this date the depositary will continue to provide services in accordance with the requirements of the NU Notices.

MARKETING OF AIFs TO IRISH RETAIL INVESTORS

The Central Bank notes that Regulation 44 of the AIFM Regulations permits marketing of AIFs to retail investors and that this is reflected in the AIF Rulebook at chapter 1 – RIAIF Requirements.

COOPERATION ARRANGEMENTS

The Central Bank notes that ESMA has approved cooperation arrangements between EU securities regulators and 38 non-EU authorities as announced on 30 May 2013 and 18 July 2013.

PROFESSIONAL INVESTOR FUNDS

The Central Bank notes that a professional investor fund (“PIF”) will continue to be subject to the NU Series of Notices until the date that its AIFM becomes registered or authorised. From that date, the PIF will be subject to a condition that it shall comply with the provisions of its prospectus. If the PIF has a registered AIFM, its depositary will also be subject to a condition that it shall comply with the AIFMD depositary regime, except in relation to depositary liability. The current non-UCITS depositary liability regime will apply instead.

SHAREHOLDER SUITABILITY REQUIREMENTS FOR INTERNALLY-MANAGED AIFs

The Central Bank notes that the requirement in Article 8(1)(d) of AIFM allows competent authorities to assess the suitability of qualifying shareholders in light of the need of ensuring sound and prudent management. The Central Bank further notes that the European Commission has stated in its interpretation of the AIFMD that this Article applies to both external AIFMs and internally-managed AIFs. The Central Bank states that in the case of internally-managed AIFs, the Central Bank has assessed that the following categories of qualifying shareholders are suitable:

- » investors in the AIF which meet the criteria for investment in that AIF and which satisfy anti-money laundering requirements; and
- » shareholders who hold subscriber shares for the purposes of incorporating the AIF.

The Central Bank states that the requirement that the Central Bank approve any proposed change to indirect or direct ownership or in qualified

holdings is disapplied in cases where the change in direct or indirect ownership or in qualifying holdings relates to a qualifying shareholder which falls within one of the categories listed above.

MANAGEMENT COMPANIES OF IRISH AIFs

The Central Bank notes that a non-Irish AIFM may be appointed as a management company of an Irish AIF, including a unit trust or common contractual fund. The AIFM which proposes to act as a management company must be authorised to provide the administration and marketing services in Section 2(a) and (b) (and (c) which covers activities related to the AIF’s assets, if relevant) of Annex 1 of AIFMD.

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