Regulation through the fund lifecycle

Navigating the complexity of the European regulatory landscape

The Bright Alternative

Explore: aztecgroup.co.uk | .eu | .us

AZTEC GROUP

Introduction

Before the 2008 financial crisis, private equity occupied a relatively sheltered position from a regulatory perspective. Funds themselves were generally unregulated and while certain jurisdictions specified domestic regulatory overlays, this was not universal.

Fast forward to 2021 and according to data collated as part of our recently published report, *'Conquering Complexity: How Europe's private equity CFOs and COOs are setting themselves up for success'* the single largest challenge facing the European private equity industry is the management of regulatory risk, with 86% of those surveyed agreeing that regulation will become more complex over the coming 12 months.

In this short guide, we take a high level look at the key regulatory requirements applicable to private equity sponsors throughout the lifecycle of both their business and the funds that they raise and manage. We'll also consider whether a tougher and tighter regulatory environment really is on the horizon in the short to medium term.

86%

of CFOs and COOs expect regulation to become more complex over the next 12 months

What we'll cover in this guide:

Establishing the manager:

The primary structuring models and the associated compliance and regulatory requirements.

Fundraising:

Main rules and regulations governing fundraising, marketing and distribution.

Setting up your structure:

Key regulatory points to consider when setting up a structure, including investor regulations, substance, sustainability and domestic regimes.

Ongoing management:

The core regulatory reporting requirements that managers and fund structures may be subject to.

Setting the scene

AIFMD - a paradigm shift

It won't surprise you to see that the starting point for this guide is a quick introduction to The Alternative Investment Fund Managers Directive ("**AIFMD**"). That's because it was a game changer for the industry - firmly placing private equity within the European regulatory landscape. AIFMD came into force in July 2013 and was the European Commission's response to the perceived role of alternative asset managers in the financial crisis. In return for complying with a range of investor protection measures, authorised managers were granted free rein to market and manage their funds on a cross border basis within the EEA. Non-EU managers were not entirely excluded from these developments with specified marketing pathways made available to them for more limited compliance.

While investor protection was stated as being central to these reforms, the more significant consequence of AIFMD was that, for the first time, it captured private equity in the European regulatory net, through widely drawn Alternative Investment Fund Manager ("**AIFM**" or "**manager**") and Alternative Investment Fund ("**AIF**" or "**fund**") definitions.

This has proved incredibly important in capturing private equity in the additional waves of European legislation that have emerged since 2013.

AIFMD came into force in July 2013, firmly placing private equity within the European regulatory landscape

Establishing the manager

Advisory vs management models

The first hurdle to overcome from a regulatory perspective when establishing a private equity business is to determine whether the substantive sponsor entity is established as an advisory or management entity. This brings the classic distinction between UK private equity and Continental European private equity structuring into focus and immediately starts to explain how AIFMD fits into manager and fund structuring in the private equity space.

Continental European structuring has invariably treated the substantive sponsor entity as a fund manager – the AIFM, whereas in the UK, the SPV GP was traditionally considered to be what is now often determined to be the AIFM, with the substantive sponsor entity providing advisory recommendations to that GP/AIFM.

With the advisory model, the substantive sponsor entity may assume a slightly lower compliance burden, but depending on the activities of the sponsor, this reduced regulatory position can be limiting (if, for example, the sponsor wishes to provide cross border investment advice/distribution within the EU; and which typically has required authorisation under the Markets in Financial Instruments Directive; "**MiFID**"). It also doesn't obviate the need to have an AIFM appointed (within the sponsor group or a third party) to any AIF established and which will need to be more or less substantive depending on where the AIFM/AIF are based and the AuM.

Making the substantive sponsor entity the AIFM can be advantageous (in terms of administrative simplicity, distribution and other activities, which can be separately added to an AIFM permission under the MiFID top up permissions), but it also carries with it a high compliance burden and is, therefore, expensive. Brexit has added an additional dimension for UK sponsors considering a UK AIFM and for those that already have one, contingency arrangements involving EU based entities have had to be put in place while we wait for any equivalence/third country regime developments.

Domestic regulation

Aside from AIFMD (and potentially MiFID compliance), start-up sponsors adopting an advisory model, will also need to consider any domestic regulatory overlays that are applicable. This may include a Part IV permission under the Financial Services and Markets Act 2000, for example, or may involve the use of a tied agent arrangement to deal with MiFID compliance.

More generally, any UK or EU based sponsor will need to consider compliance with data protection, anti-bribery and corruption and facilitation of tax evasion and anti-money laundering rules which may become increasingly complex as the sponsor group and AuM grows.

Domestic group structuring is the final piece in the establishment jigsaw with any tax structuring arrangements for founders requiring careful thought in the context of anticipated carried interest receipts and overarching tax rules.

Key definitions:

Advisory model:
Where the substantive sponsor entity is set up (and is generally regulated) as an investment advisor, providing advisory recommendations to the appointed AIFM in connection with any relevant funds.

Management model:
Where the substantive sponsor entity is set up as the AIFM of any relevant funds and in this capacity, from an investment perspective, undertakes discretionary portfolio management activities in connection with any relevant funds.

Fundraising

Getting ready to raise

Developing a pragmatic strategy for fund distribution is one of the key regulatory considerations for any sponsor looking at fundraising. Distribution is generally global in nature and, as a result, requires some consideration of the laws of each jurisdiction in which distribution activities are undertaken.

As a general rule, most jurisdictions in which private equity distribution activities are undertaken have some kind of private offering regime, which removes local registration and regulatory requirements in connection with the offering. Nevertheless, this is not uniformly true with certain jurisdictions offering greater challenge than others.

Pathways for distribution

From a European perspective, fund distribution is completed through reverse solicitation, use of a marketing passport, through Article 42 marketing or, for sub-threshold EU AIFs, through residual national private placement regimes ("**NPPR**").

Where a fund is passportable (whether under AIFMD or under EuVECA), the distribution exercise is relatively straightforward with a single notification required to the home member state of the AIFM once marketing commences. Reverse solicitation is not generally relied on for passportable funds, but can become increasingly relevant in the case of sub-threshold EU funds and non-EU funds. Distribution using NPPR or Article 42 requires notification or registration in the jurisdiction in which marketing is being completed and will trigger Depositary Lite requirements in Germany and Denmark. Distribution in northern Europe is generally achievable whereas distribution in southern Europe relies more on reverse solicitation.

Paradoxically, distribution under NPPR is more restricted than distribution under Article 42 and this issue was considered in the Commission's recent consultation exercise on AIFMD II (the "**AIFMD II Consultation**"). It remains to be seen whether regime changes will be implemented as a result of this.

The next distribution hurdle: pre-marketing

Since AIFMD came into force, a debate has raged over what actually constitutes marketing under AIFMD and how activities that are considered a pre-cursor to marketing should be treated (generally referred to as pre-marketing). The general view is that pre-marketing activities (for ease, anything completed before a fund is established and which don't involve the communication of substantive fund terms) are acceptable and are not considered to fall within the marketing definition under AIFMD. This position, however, varies from country to country and to further complicate the matter, in certain circumstances, these pre-marketing activities may constitute a MiFID activity. This issue has become more acute following Brexit.

To further complicate this position, with effect from 2 August 2021, the distribution rules under AIFMD are being updated such that a new 'pre-marketing' definition is being introduced to capture activities aimed at the communication of investment strategies to test investor interest in funds that are yet to be established or notified for marketing. Technically, this is only supposed to apply to the activities of authorised AIFMs but, anecdotally, it seems as though Germany, Finland and the Netherlands will be introducing domestic legislation that applies this to non-EU AIFMs distributing AIFs in these jurisdictions.

Fund distribution is completed through reverse solicitation, use of a marketing passport, through Article 42 marketing or, for sub-threshold EU AIFs, through residual national private placement regimes.

Where the pre-marketing definition captures the activities of an AIFM, they will be required to notify their activities to their home member state (or for non-EU AIFMs, the member state in which they are pre-marketing). There are a range of practical and interpretative difficulties with the proposed pre-marketing rules and they will undoubtedly cause uncertainty during the early stages of their introduction.

Pre-marketing changes will be coupled with changes to the rules on 'marketing communications' with guidelines for AIF marketing communications also anticipated in August this year. While nothing seismic is anticipated, this is yet more guidance for authorised AIFMs to consider when drafting standard distribution documents (including teasers and GP pitchbooks).

Setting up your structure

Ultimately, a jurisdictional choice needs to be made in connection with the establishment of both the AIFM and AIF. From a regulatory standpoint, this is often a complex decision and can result in a fund being established across one or more jurisdictions. In addition to the distribution considerations mentioned above there are also a range of factors from a tax, cultural and cost perspective that need to be taken into account, but which are beyond the scope of this guide.

In relation to the wider regulatory landscape, there a number of important points that need to be considered:

Investor regulation

Certain European legislation (notably Solvency II) and some domestic legislation operates to make investment in funds based in non-EU jurisdictions by regulated EU investors more difficult and/or costly from a regulatory perspective than investing in an equivalent EU based structure. Careful consideration, therefore, needs to be given to the anticipated sources of capital when looking at structuring.

Where US investors are targeted and any 'plan assets' are involved, exemptions from compliance with The Employee Retirement Income Security Act of 1974 ("**ERISA**") is necessary. ERISA is relevant to fiduciaries holding employee benefit plan assets and is applied on a look through basis to private equity funds who accept commitments from investors holding such assets (e.g. US pension funds), unless relevant exemptions can be relied on. For most private equity funds, either the Venture Capital Operating Company Exemption or the Insignificant Participation Exemption will be used.

Sustainability

Economic, Social and Governance concerns have been brought into sharp focus amongst European private equity sponsors over the past 12 months as a result of the implementation of the Sustainability Finance Disclosure Regulation (and associated EU Taxonomy Regulation) ("**SFDR**"). SFDR requires EU AIFMs and, to a lesser extent, non-EU AIFMs marketing AIFs in Europe to make a range of disclosures on the integration of 'sustainability' risks into investment decision making and to complete an assessment of those risks on investment returns.

Where SFDR is not directly applicable, private equity sponsors will need to consider whether voluntary opt in is the right decision based on the underlying strategy being applied to the relevant AIF and/or to make the AIF more attractive from a distribution perspective. SFDR is interlinked with the EU Taxonomy Regulation, which establishes a classification system to assess whether the economic activities sponsors undertake or invest in are 'sustainable'. The Taxonomy Regulation is underpinned by six technical standards, which will be coming into force over the coming 18 months.

Domestic regimes

Sitting alongside the overarching European regulatory framework, domestic regimes remain in place. In Jersey for example, AIF's may still be established as Expert Funds and in Luxembourg the domestic SIF or RAIF regimes may be layered around wider AIFMD compliance. Domestic regimes are generally not particularly onerous from a compliance perspective and are unlikely to drive structuring decisions.

The interplay between these factors, distribution requirements and the other factors listed at the start of this section ultimately drive structuring decisions and the resulting regulatory complexity.

Substance

The base erosion and profit shifting ("**BEPS**") regulatory environment was introduced in 2015 by the OECD to combat multinational tax avoidance. Unfortunately, certain elements of BEPS affect private equity structures with three of the 15 Action Points commonly considered particularly relevant:

Action 2, hybrid issues: In certain circumstances anti-hybrid rules can operate to subject investors to deemed double taxation and/or can compromise the deductibility of portfolio interest payments. The use of hybrid instruments can also be affected.

Action 4, interest deductibility: Under the fixed ratio rule, the deductibility of net interest costs is limited to a percentage of EBITDA which can impact portfolio financing arrangements.

Action 6, treaty abuse: This action point probably has the most visible impact from a structuring perspective and is a major driver in the European 'substance' debate. Broadly speaking, action 6 can operate to limit the availability of treaty relief to holding companies where there is insufficient 'substance' in them. The impact of this is that withholding can apply on cross border payments which can damage returns.

Various approaches have emerged over the past few years in order to structure for substance, from ensuring that both the AIFM, AIF and holding companies are located in the same EU jurisdiction, to setting up sponsor middle offices in the EU, to seconding staff or to simply ensuring that external directors are appointed to boards who are based in the relevant jurisdiction and that all meetings are held and resolutions signed in that jurisdiction. Segregated but linked substance issues are associated with the delegation rules under AIFMD (often referred to as the 'letter box rules') and these have again come into focus recently as a result of Brexit and the AIFMD II Consultation.

Ongoing management

From a regulatory perspective, ongoing management is largely about reporting, but there can also be regulatory issues that arise as a result of decisions made pre and post establishment. Some of the key issues include:

1. **AIFMD:** Ongoing compliance under AIFMD can be complex and specified requirements covering investment decision making/portfolio management, risk, valuation and compliance more generally are relevant for affected managers. The use of a third party AIFM can further complicate this depending on the overarching regulatory and structural set up. Compliance requirements will apply to a greater or lesser extent under domestic regimes separately or in addition to AIFMD requirements.

   Annex IV reporting: The main AIFMD reporting output with reporting requirements varying in scope and frequency depending on the level of authorisation that the AIFM has and the assets under management (reduced reporting requirements are applied to non-EU AIFMs marketing under Article 42). The highest frequency reporting is quarterly. Reporting under AIFMD is also specified in connection with asset stripping and acquisitions of portfolio entities with elements of this regime being the subject of the AIFMD II Consultation.

2. **SFDR:** Compliance with SFDR will require constant monitoring and updating of disclosures throughout the lifecycle of any AIF. Periodic reporting obligations (on the two specified taxonomy objectives) will commence on 1 January 2022.

3. **FATCA/CRS:** The Foreign Account Tax Compliance Act and Common Reporting Standard require AIF level reporting in connection with the tax status of investors in the relevant AIF. In addition to having to complete a FATCA/CRS assessment of the AIFM/GP and collecting self-certification assessments for all investors on establishment, ongoing reporting is required.

4. **Dodd Frank:** Where an AIF raises capital from US investors in reliance on either the Venture Capital Fund Adviser Exemption or the Private Fund Adviser Exemption, the Dodd-Frank Act requires that relevant entity (typically the GP of the relevant AIF) to register as an Exempt Reporting Adviser with the SEC. An initial filing is required and, on an ongoing basis, the named adviser needs to comply with certain record keeping, market abuse and certain other US regulatory requirements.

5. **BEPS:** Under action point 13 (transfer pricing) larger private equity sponsors (with consolidated group revenue of €750m of more) may be required to file annual Country-by-Country Reports containing certain high level financial and business information on a jurisdiction by jurisdiction basis.

6. **DAC 6:** Directive 2011/16/EU, commonly known as DAC 6 was enacted in May 2018 and specifies a range of reporting obligations in connection with cross border transactions involving an EU entity or member state. The regime operates by reference to a number of hallmarks and requires reporting when one or more of the hallmarks is met. Reporting needs to be completed by the intermediary involved in the arrangement that generates the report or by the taxpayer itself if the intermediary is legally unable to report or is otherwise located outside of the EU. As DAC 6 is transposed on a member state by member state basis jurisdictional differences have emerged in connection with the interpretation of the various hallmarks, completing the necessary analysis is generally time consuming and allocating responsibility for both the analysis and reporting can create uncertainty.

7. **EMIR:** As a general rule, the European Market Infrastructure Regulation ("**EMIR**") is not applicable in connection with the ongoing management of private equity funds. However, where a fund engages in OTC derivatives trading for the purposes of hedging (or otherwise) and if such derivatives are traded at fund level, this can trigger EMIR compliance with its associated reporting obligations. In practice, this is easy to structure round with derivatives traded in the portfolio not triggering the requirements, but this can cause issues if it is not considered in advance.

Final thoughts…

The European regulatory landscape is constantly evolving. The seismic shift for private equity came in 2013 with the implementation of AIFMD and, following this, layers of complexity have been built on the back of the all-encompassing AIFM and AIF definitions.

While complexity is arguably increasing over time, the rate of change is not, perhaps, as fast as many may think. A constant drip feed of consultations, guidance and regulatory technical standards from regulators masks the fact that concrete legislative proposals encompassing significant change, only emerge every couple of years and typically with 12 to 24 month transposition times. Separately, it will be interesting to see how Brexit impacts both the rate and level of regulatory change going forwards with the UK typically seen as a brake on some of the more far reaching regulatory proposals in the past.

The impact of European regulation can be dealt with either through careful structuring – it’s still possible, for example, to establish a lightly regulated EU or non-EU structure under the advisory model to circumvent significant European regulatory compliance – or alternatively, by partnering with the right service providers – experienced in navigating complexity with sophisticated and efficient systems and controls hard baked into their operating environment.

While complexity is undoubtedly a hallmark of the European regulatory landscape and seems to be increasing over time, with the right advisers and service providers, navigating the resulting challenges can be a straightforward process.

Get in touch

To discover for yourself what makes us The Bright Alternative and how we can support you, please contact:

Kristin Holmes
Group Head of Legal
Telephone: +44 1534 833641
Email: Kristin.Holmes@aztecgroup.co.uk

Simon King
Co-Head of Private Equity - Jersey
Telephone: +44 1534 833618
Email: Simon.King@aztecgroup.co.uk

AZTEC
GROUP

The Bright Alternative

Explore: aztecgroup.co.uk | .eu | .us

Private Equity Fund Services
Real Asset Fund Services
Private Debt Fund Services
Corporate Services