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SPOTLIGHT Credit Funds

Credit Funds: Riding the Seas of Change

Private Debt Secondaries: Time to Shine?
Is this the Private Debt Secondaries Market's Moment?

Gibraltar's Fund Renaissance
Credit Funds Protected Cell Partnerships

The Dawn of a New Era
Ireland's Investment Funds Partnership Regime

Bringing Luxembourg Securitisation Law into the 21st Century
A wide array of new tools for asset managers in Luxembourg

ESG: Less Talk, More Walk
A New Era: Mandatory Climate Disclosures

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We are delighted to bring this edition of Spotlight Magazine to you after the disruption of the past two years and the COVID-19 pandemic. There has been a sea of regulatory change that has evolved during this time, masked by nearly unprecedented times of global uncertainty.

In the lending market, despite the current humanitarian situation in Ukraine and the ongoing aftermath of the disruption from COVID, the credit fund lending appetite has remained steadfast and resilient. We examine various changes in the growing lending market showing that the market is here to stay.

The fast growth in new asset classes such as private debt secondaries has exploded onto the private debt market and we examine whether it is now time for private debt secondaries to take a starring role in continuing the extraordinary growth the private debt market has experienced in recent years.

The SEC has finally turned its attention to the fast growing private debt market and has issued some radical proposals that will significantly impact private credit asset managers. We delve into what every debt asset manager needs to know to stay abreast of these SEC changes.

There has been a spate of new fund regimes that have been dusted off over the COVD period such as the issuance of an impressive dual funds regime in Gibraltar and the long awaited publication of the Irish investment funds partnership regime. This has also coincided with the refresh of the Luxembourg Securitisation Law providing even more flexibility when it comes to structuring Luxembourg funds.

In addition, ESG has risen to the top of every investor questionnaire and we examine the SEC's proposed rule changes and how that will affect the asset management industry.

ELTIFs have also been given another revamp, this time along with the UK's Long Term Asset Fund regime providing managers with yet further structures to consider in their tool box.

We end this bumper edition with a round-up of AIFMD 2 and what the new proposals will likely look like, as well as discussing the implication of ATAD 3 when it finally comes into force.

We hope you enjoy the magazine, and please feel free to reach out to any of our contributing authors on the topics covered.

Diala Minott and the Paul Hastings Team

Reading the Lending Tea Leaves

The outlook and trends for lending terms in Europe in 2022

By Amin Doulai and Charlotte Rice

Following a record breaking 2021 in terms of direct lending deal volumes and values, many of the same positive themes are set to repeat in 2022. Even with added uncertainty due to global inflationary pressures, the geo-political and humanitarian situation in Ukraine and the continued fallout from COVID-19 in certain sectors, competition for deals between direct lenders remains fierce. A willingness by some Credit Funds to bridge a gap left as banks rein in their appetite is also presenting new opportunities.

Notwithstanding significant uncertainties in the global macroeconomic environment, namely persistent rising inflation, global supply chain instability (a still unresolved issue from the COVID-19 pandemic) and the immediate geo-political risks flowing from the Ukraine conflict, we anticipate that while the volume of deals may not hit the highs of 2021, the direct lending market will see increased competition, remain very active and will be of increased importance. With industry "dry powder" reaching a record $1.81 trillion in January 2022 and sustained investor pressure for capital to be deployed, Credit Funds will no doubt continue to seek opportunities and pockets of value in the market.

What you need to know

- Even with all the current macro and geo-political uncertainties our expectation is that lending appetite amongst Credit Funds will remain resilient.
- We expect larger deals and bigger clubs as Credit Funds are presented with new opportunities from top tier sponsors who are faced with greater uncertainty on pricing and liquidity in the public bank and bond markets.
- Sponsors will continue to push for more documentary flexibility in the core and upper mid-market, and on larger deals will expect to achieve terms with closer proximity and alignment to those achieved in the syndicated TLB market.

Blurred boundaries

Despite the current political and economic landscape, there is no reason to expect a reduction in healthy competition between Credit Funds for high-quality deals. This competition will continue to drive terms, with sponsors leveraging their key credit fund relationships to ensure maximum flexibility and optimum pricing. As a continuation of the trends seen in 2021, this will involve sponsors attempting to bring (and, importantly, expecting to achieve) concessions and flexibilities gained in the large-cap market across to their core and upper mid-market deals, particularly pushing for "covenant-lite" loans and related terms.

This trend is likely to be further entrenched as the once clear boundaries between direct lending and syndicated bank lending solutions continue to blur in 2022. Given their resilience and continued lending appetite, Credit Funds are increasingly being approached to consider and compete in larger processes, once exclusively the domain of the syndicated market as that market begins to soften in light of the global economic and political challenges.

A Continued Focus on ESG

Whilst ESG considerations have progressively become more important to all stakeholders across transactions, the key area to watch is ESG linked margin ratchets. Although not uncommon at present, we expect to see ESG linked ratchets with increasing frequency going forwards, as well as a greater degree of standardisation across deals.

Currently there is no market standard for the KPIs or verification standards a borrower needs to achieve or attain in order to move "down" the margin ratchet, and the drafting around these concepts will for now remain a key area of negotiation. In particular, the costs of attaining the relevant KPIs will be monitored carefully by borrowers. We envisage the negotiations around these clauses changing as ESG ratchets become more standard, and as verification agencies become more established.

The continued push for flexibility

We expect a key trend in 2022 in the core and upper mid-market will be sponsors demanding more "covenant loose" and "covenant-lite" structures (the latter now regularly being pushed by top tier sponsors on larger mid-market deals). On this point, a key challenge for Credit Funds will be finding the right balance between on the one hand meeting the expectations of their sponsor clients (and therefore remaining competitive in debt processes), and on the other, their internal funds' constraints (namely, those funds that require a financial covenant) and investor expectations. True "covenant-lite" structures aside, we expect more pressure on funds to offer longer covenant holidays, flat covenants with higher headroom and more generous EBITDA add-backs and synergies.

Another concept to watch is the push by sponsors to use senior secured net leverage (or "SSNL") tests rather than total net leverage (or "TNL") tests as the basis for leveraged based parameters and incurrence tests. Whilst top tier sponsors have been pushing for SSNL tests, this has not gained traction in the core mid-market, with funds keen to ensure that leverage governors capture all meaningful debt (particularly where a business may have significant junior and unsecured debt in its capital structure). However, this is not so clear-cut in the upper mid-market where sponsors are gaining more traction with SSNL tests on larger and more competitive deals.

Other documentary trends we expect to see in 2022 in the core and upper mid-market deals include:

- The falling-away of restrictions on transactions (e.g. disposals, guarantees, loans, etc.) between obligors and non-obligors. Rather, this is increasingly being regulated through the use of a non-guarantor debt cap (to ensure the non-obligor can incur only limited debt that might be secured against assets of that non-obligor) or solely through the guarantor coverage test (with lenders focussing carefully on which jurisdictions are included in that test).
- More flexible certain funds mechanics for future bolt-on permitted acquisitions, including longer "pre-baked" certain funds periods for future acquisitions.
- A creeping up of the aggregate caps for pro forma cost savings and cost synergies (from 20% to 25% LTM EBITDA) and longer time periods for the implementation of such synergies (e.g. 18 months up from the more typical 6-12 months).
- More additional debt incurrence capacity. We are seeing freebies (on top of leverage based incremental debt capacity), together with generously sized general debt baskets and specific debt baskets (e.g. grower recourse factoring baskets, unlimited non-recourse factoring baskets, grower finance lease baskets, etc.).

New Developments

Lastly, a new development we have noticed is the rise of minority leverage structures with the emergence of top tier sponsors taking significant minority stakes (often in fast-growing tech companies) and being able to leverage their minority stake with no recourse to the target. This is achieved using look-through covenants and the product is therefore more complex than a typical holdco PIK, requiring lender oversight on shareholders' agreements and governance arrangements.

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Private Debt Secondaries: Time to Shine?

A growing private debt secondary market waits in the wings

By Ted Craig

There has been rapid growth in the private debt primary market in recent years, with fundraising growing from $54.8 billion in 2010 to $250 billion in 2021[1] By the end of 2024, the size of the global private debt market is expected to reach $1.5 trillion.[2] It seems a natural progression that with a growing primary market a growing secondary market will follow. Therefore, with such significant amounts of capital having been and being raised by private debt funds, consideration is increasingly being given to the development of the private debt secondaries market and whether it is likely to follow the success of the private equity secondaries market.

What you need to know

- The secondaries market is not only a source of liquidity but also a tool for active portfolio management.
- The type and complexity of significantly.
- There is clear investor appetite for dedicated private debt secondaries funds.

Private Equity Secondaries

The private equity secondaries market has transformed from a relatively small, underserved corner of the industry into an established and multi-faceted market.[3] The secondary market has grown over six times in the past decade to an estimated annual transaction volume of over $130 billion in 2021. This is in the context of total assets under private equity management of an estimated $6.5 trillion in 2020 vs. $2.4 trillion in 2010.[4]

The secondaries market was originally an option used by fund investors, typically at a significant discount, who were in need of liquidity or were looking to exit funds that were not performing well. The market has developed significantly and is now not only a source of liquidity but also a tool used for active portfolio management, enabling the reduction in exposure to, for example, a particular strategy or asset class and freeing up capital to increase exposure elsewhere. Of course, purchasing secondary fund interests is an attractive option for buyers (typically dedicated secondaries funds) who are looking to access the high returns of private equity while maintaining shorter hold periods.

The type and complexity of private equity secondaries transactions has developed significantly too, beyond the traditional sale and purchase of fund interests. GP-led transactions now form a large proportion of overall transaction volume and alternative solutions, such as preferred equity arrangements, are now also a common consideration.

Private Equity vs Private Debt

A key difference, of course, between private debt funds and private equity funds is that private debt funds typically have lower anticipated return levels (compensated by lower anticipated risk) than private equity. An increasing number (and inevitably at an increase in size) of secondaries funds have been raised recently and are currently being raised – but these are predominantly targeting returns commensurate with a private equity secondary. So, in the context of a private debt secondary, who's the buyer?

Who's the Buyer: While the majority of capital raised by secondaries funds is targeting the private equity secondaries market (private equity secondaries comprised more than 90% of all alternative fund secondaries in 2020,), with the development of the secondaries market generally, we are starting to see funds targeting particular strategies and asset classes, including private debt. Coller Capital launched its first debt secondary fund in May 2021 which, along with its co-investment vehicles, is understood to have investor commitments of approximately $1.4 billion.[5] Pantheon has raised a €250 million direct lending secondaries fund and a $800 million global private debt fund that includes secondaries; and Apollo launched their first credit secondaries platform in 2021 So, there is clearly investor appetite for dedicated private debt secondaries funds and it is expected that more funds will be raised in this space.

Another key difference between private debt and private equity is that credit is "self-liquidating". Loans have a fixed term and get contractually re-paid (or the debt is refinanced). Private debt fund lives are also typically shorter at around six to eight years instead of ten to twelve for private equity funds. As a consequence, there are arguably fewer factors that are likely to cause an investor to need to sell. So, in the context of a private debt secondary, who's the seller?

Who's the Seller: While there may be fewer reasons for investors to need to sell their positions in private debt funds, as mentioned above, the secondaries market is now frequently used as an effective portfolio management tool enabling the rebalancing of an investment portfolio. There is no reason this tool won't be used for private debt fund investments. And of course, if an investor does *need* to sell, there are certainly buyers in the market.

Time will tell whether this will lead to a meaningful level of private debt secondary transaction volume. Though, given the considerable amounts of capital raised by private debt funds and the consequent maturing stock of debt fund investments, it would be surprising if it didn't.

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The SEC's Advisers Act Proposals: Navigating these Uncharted Waters

New market trends and rule proposals impact Private Credit Fund Managers

By Ira Kustin

While credit fund structures and terms continue to evolve in the U.S., a spate of new SEC rule proposals could significantly alter the regulatory landscape in which private credit fund managers operate.

Evolution of Private Credit Fund Structures

As interest in private Credit Funds and the direct lending market by U.S. and non-U.S. institutional and pension plan investors continues to grow, managers of private funds in the credit space are continuing to face the ongoing challenge of offering fund structures that accommodate these various types of investors. Ideally, managers would like to structure their funds in a manner that provides for regulatory flexibility, tax efficiency and operational ease using one unified structure as opposed to multiple, parallel funds created for each separate class of investors. For example, non-U.S. investors may be sensitive to "effectively connected income" from U.S. loan origination, some investors may desire a leveraged vehicle while others do not, and certain investors have regulatory needs that may require the fund to offer interests in a particular type of legal entity. This has led to many U.S. credit managers developing a sometimes complicated web of U.S. /non-U.S. parallel funds, blockers, feeders and alternative investment vehicles. While the asset class has been mature for some period, the tax and regulatory landscape continues to evolve and private credit managers will need to rely on counsel to bring to market the most efficient fund structures, which address ever more complicated investor needs.

What you need to know

- Private credit fund structures continue to evolve to accommodate growing interest from a diverse investor base including U.S. and non-U.S. pension plan investors.
- The terms of many credit/direct lending funds are reflecting a "hybrid" approach exhibiting aspects of hedge and PE-style fund structures.
- The U.S. Securities and Exchange Commission has proposed a series of new rules under the Advisers Act that would impact managers of private Credit Funds.

Hybrid Fund Terms

Private credit fund managers now operate in a more mature market with investors who have significant experience in the asset class. In order to accommodate investor requests and stay nimble enough to take advantage of available investment opportunities, many managers are launching funds with "hybrid" terms that exhibit characteristics of both traditional hedge funds and PE-style funds.

For example, PE-style private Credit Funds have for some time had a shorter investment period and overall term compared with more traditional private equity funds. But investors in the private credit class are now interested in more liquid vehicles with redemption features, or at least some promise of frequent distributions of current income. Some funds may bifurcate their portfolio into liquid and illiquid pools, with periodic redemption/withdrawal rights attached to the class or series housing liquid assets and more traditional private equity terms applied to the illiquid assets. Some managers are considering using structures that provide for rolling "tranches" pursuant to which investors can elect to participate in a new investment period, functionally extending the term of the fund, rather than having the right to redeem or withdraw (and effectively allowing an investor to terminate new contributions but be required to wait for distributions until existing assets are realized in accordance with their terms). Distribution waterfalls may also be bifurcated to account for the difference in distributions relating to payments of interest and other current income rather than profits realized by the fund upon the realized of investment assets.

February 2022 SEC Rule Proposal

On February 9, 2022, the U.S. Securities and Exchange Commission (the "SEC") proposed new rules under the Investment Advisers Act of 1940 (the "Advisers Act") that, if adopted, would impose a significant new regulatory burden on most private fund managers in the U.S., whether or not they are fully registered with the SEC under the Advisers Act. The SEC's rule proposal is not specific to managers of Credit Funds and impacts private fund managers generally. The new rules would, among other things, (1) standardize fund reporting and require quarterly template reports to investors detailing fees and expenses (and require cross references to a fund's governing documents that provide for payments of such fees/expenses), (2) standardization of the calculation and reporting of fund performance with the goal of permitting investors to compare multiple funds by multiple managers in potentially disparate or unrelated asset classes, (3) prohibit outright certain types of activities by private fund managers (including not permitting private fund governing documents to indemnify a manager or its affiliates for simple negligence which is a significant departure from market practice in the U.S.) and (4) requiring more detailed and prominent disclosure of side letters/preferential treatment than is currently standard in the private funds market. (There are additional rule proposals beyond the scope of this article.)

The new rules could have an outsized impact on managers of private Credit Funds. For example, the reporting of fees and expenses would inevitably become more complicated in an asset class where managers are entitled not only to management fees and performance compensation, but potentially to loan origination fees and fees/expense reimbursement relating to the ongoing management, administration, reorganization or other support activities for portfolio companies. While for quite some time the SEC has been vocal about its expectation that these fees be prominently disclosed to fund investors, detailed quarterly reporting would be a new regulatory burden for most private fund managers.

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Gibraltar's Fund Renaissance

Credit Funds Protected Cell Partnerships

By James Lasry

The emergence of Gibraltar allowing for a Dual AIFM Regime and the incorporation of Protected Cell Limited Partnership (PCLP) funds have brought about a renaissance in the Gibraltar funds industry making it eminently suitable for Credit Funds.

Discerning legal and regulatory analysts have long known that Gibraltar's fund legislation with its pre-authorisation launch is the most fit-for-purpose regime on this side of the Atlantic. However, much of the general industry continues to herd to the more well-known havens despite some being tainted by negative OECD reports, less ease of operations and higher costs.

What you need to know

- Suitable for Credit Funds
- Dual Regime allows funds to "opt out" of AIFMD
- Protected Cell Limited Partnerships possible
- New Limited Partnerships Law drafted by Paul Hastings' Diala Minott
- Funds are regulated but may launch immediately and before regulatory approval

Protected Cell Limited Partnerships

In 2019 and 2020, the Gibraltar Funds and Investment Association (GFIA) went out to its members to ask how it could improve Gibraltar's funds offering for them. As a result of this consultation, the Government of Gibraltar, with the assistance of Paul Hastings' Diala Minott, enacted the Protected Cell Limited Partnerships Act 2021 and updated its limited partnerships legislation with the Limited Partnerships Act 2021. These two new pieces of legislation mean that Gibraltar can capitalise on its experience as one of the first jurisdictions to enact Protected Cell Companies legislation in 1991 in the context of limited partnerships as well. Many funds prefer to be structured as limited partnerships for reasons of tax transparency and flexibility of governance, but they were constrained by having to set up new partnership funds for new strategies. It is now possible as with a Protected Cell Company in the corporate context, to set up a PCLP Fund that can have several cells that each trade as funds but are statutorily segregated from each other. This structure has become very useful for Credit Funds which attract US and Israeli investors for whom it is often more beneficial to invest as limited partners than as shareholders.

New and Improved Limited Partnerships

Other amendments allow for a Limited Partnership to choose whether it will posses a legal personality or not. Limited Partnerships under the English Limited Partnerships Act, 1907 do not have a legal personality and must therefore trade through their general partners. The Gibraltar Limited Partnerships Act 2021 was amended such that a limited partnership in Gibraltar does have legal personality and can thus own assets in its own right. It can have a bank account in its own name rather than in the name of its general partner. The default position is that a newly incorporated Limited Partnership will have legal personality, but within three months of incorporation it may elect to do away with its legal personality. Until now, complex private equity and real estate fund structures require the use of several jurisdictions in order to accommodate structures such as UBTI blockers that needed to be entities with corporate personality. Now this can be done in Gibraltar all within the same jurisdiction.

Under the new Limited Partnerships Act 2021, there are safe haven guidelines for involvement of limited partners in the management of the Limited Partnership without their running the risk of losing the limitation on their liability. This was important in structuring funds where partners wished to have some involvement in the management of the fund by acting on advisory investor committees, but they were reluctant to do so. They may now do so in Gibraltar in confidence within certain parameters. Finally, there is greater flexibility as to the types of interests that can be issued by Gibraltar Limited Partnerships. The interests can be issued as simple partnership interests or shares, units or even notes. This can be particularly helpful in the structuring of debt funds.

Dual Regime

The enactment of the Dual Regime for funds allows Gibraltar funds to "opt out" of the AIFMD requirements of appointing an AIFM and AIFM Depository on funds over certain thresholds was concluded in March 2022. Gibraltar funds that elect to comply with AIFMD can still use the marketing passport with the UK in order to market to UK-based professional investors. As a result of Brexit, Gibraltar remains the only jurisdiction to retain its marketing passport for funds and certain other financial services businesses with the UK. However, neither the UK nor Gibraltar have retained passporting rights with the EU.

Conclusion

In an interesting twist of fate, the success that Gibraltar is having with Credit Funds has highlighted the ease of use and speed to market of Gibraltar's EIF regime. In fact, promoters are also establishing traditional securities funds, energy funds, algorithmic trading funds and even SPAC and trade finance funds. Gibraltar's powerful partnership between Government, regulator and industry has again proven to be an effective triumvirate for the development and continued success of Gibraltar's funds and investment industries.

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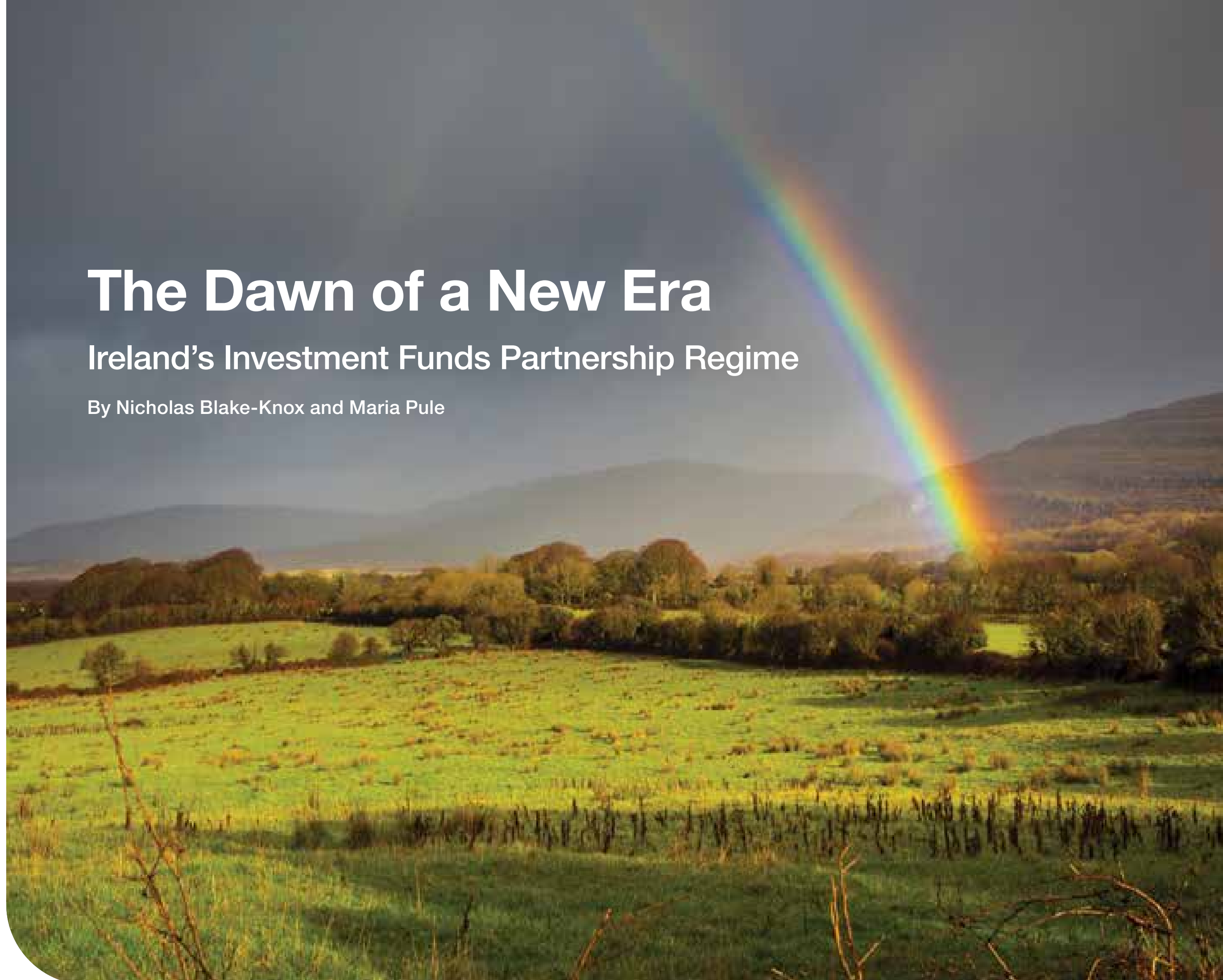

The Dawn of a New Era

Ireland's Investment Funds Partnership Regime

By Nicholas Blake-Knox and Maria Pule

While the legislation governing Ireland's regulated investment funds partnership product, the Investment Limited Partnership ("ILP"), has been in place since 1994, recent amendments have enhanced the product offering by bringing it more in line with partnership structures in other jurisdictions and introducing best in class features.

A number of shortcomings with the provisions of the Investment Limited Partnerships Act, 1994 resulted in the ILP not being as successful a fund structure as had been initially anticipated by its advocates with only a handful established in Ireland since its introduction in 1994. No substantive updates to this legislation since its enactment, left it outdated and generally unable to compete with the regulated partnership products in other jurisdictions. However, in early 2021 significant enhancements to the ILP regime were introduced in the form of the Investment Limited Partnerships (Amendment) Act 2020 (the "2020 Act"). The aim of these amendments was to modernise the existing ILP legislation and further enhance Ireland's suite of legal structures available for fund formation, in particular its offering for investment funds with real estate, infrastructure, loan origination, private equity or debt strategies or those seeking to invest in other types of illiquid assets.

What you need to know

- Enhancements to Ireland's regulated investment funds partnership product have transformed the structure into a best in class product.
- The reform demonstrates Ireland's continued commitment to grow its funds sector and to remain a leading global fund domicile.

What is an Investment Limited Partnership?

The ILP is an Irish investment partnership vehicle that must be authorised and regulated by the Central Bank of Ireland (the "Central Bank"). It is a tax transparent structure and as such the income and gains of an ILP are treated as arising directly to each partner in proportion to the value of the interests beneficially owned by that partner.

An ILP is constituted pursuant to a limited partnership agreement which is entered into between one or more general partners, who are responsible for the management of the business, and one or more limited partners. The liability of the limited partners is generally restricted to the amount of capital committed to the partnership except in circumstances where a limited partner is deemed to be involved in the management of the ILP. The 2020 Act enhanced the white list of acts that can be taken by a limited partner which will not result in the partner being deemed involved in the management of the ILP.

While partnership structures are typically used for investment funds with strategies relating to private equity or debt, real estate, infrastructure or other types of illiquid assets, the ILP is a flexible structure that can be utilised by asset managers seeking to establish both open- or closed-ended investment funds through a regulated partnership structure.

As regulated entities, ILPs can only be established as alternative investment funds ("AIFs") and therefore are authorised by the Central Bank as either a retail investor AIF or a qualifying investor AIF. To date, ILPs have sought authorisation as qualifying investor AIFs and we would expect this to continue. This allows for the Central Bank's 24-hour fast track process to be availed of, noting that depending on the intended strategy of the ILP it may be necessary to submit a pre-submission to the Central Bank in advance of the application for authorisation of the ILP. A QIAIF can also avail of the marketing passport pursuant to the AIFMD.

While the Central Bank has clarified that the entity appointed to act as a general partner to an ILP does not need to be authorised by the Central Bank, the Central Bank has confirmed that such entities will be considered regulated financial services providers for the purposes of the Central Bank's fitness and probity regime. This means that directors of the general partner will be required to seek pre-approval from the Central Bank and comply with the requirements of the fitness and probity regime on an ongoing basis.

Reform - the future looks bright

Since the commencement of the 2020 Act in early 2021, the number of ILPs authorised by the Central Bank has been steadily increasing with the ILP register having over doubled in size in the last twelve months. There has also been an increase in enquiries as more managers consider using the ILP for their fund products.

Similar to other Irish fund structures, the 2020 Act introduced the ability to establish umbrella ILPs with segregated liability between sub-funds, allowing the flexibility for asset managers to set up both open- and closed-ended funds with differing strategies within the same structure with the assets and liabilities of each sub-fund ring-fenced. We have been seeing interest from managers in exploring the use of umbrella structures for ILPs.

Against the backdrop of Ireland's robust regulatory regime, established infrastructure of service providers and strong reputation globally, the Irish funds industry is well positioned to become a key player in the alternative assets space globally. The new and improved ILP together with the range of other fund structures available in Ireland, including the ICAV, continue to increase the attractiveness of Ireland as a fund domicile of choice for managers and investors alike. This enhanced product offering will help unlock Ireland's significant potential in this space and assist with the further development of Ireland as a global centre of excellence in financial services.

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Bringing Luxembourg Securitisation Law into the 21st Century

An upgraded toolbox for asset managers in Luxembourg

By Karl Pardaens and Jean-Bernard Spinoit

Luxembourg securitisation law has been modernised to adapt to the requirements of the securitisation market and to strengthen the position of the Luxembourg market as a leading European market for securitisations.

Two concepts guided the legislator in its modernisation of the Luxembourg law of 22 March 2004 on securitisation (the Securitisation Law): flexibility and legal certainty. The Securitisation Law has therefore been amended to offer a wide array of new structuring options to asset managers, with a high level of legal certainty and protection for investors. The new Securitisation Law further retains features that already made its success, such as the flexibility of compartmentalisation and the possibility to create a securitisation vehicle ("SV") in the form of a securitisation company or a securitisation fund.

What you need to know

- Securitisation undertakings may now be financed solely or partly by credit facilities and/ or financial instruments.
- Restrictions on securitisation vehicles to grant security interests and guarantees are lifted, allowing easier financings for securitisation vehicles.
- Active management of debt portfolios is now possible if the securitisation undertaking does offer its financial instruments to the public.
- Securitisation undertakings may now be organised as simple limited partnerships (SCS), special limited partnerships (SCSp), among others.

Flexibility on the financing side

SVs are no longer to be financed predominantly by securities (valeurs mobilières). The Securitisation Law now offers the possibility for SVs to be financed by financial instruments or credit facilities, or a mix of both. The term "financial instruments" is much wider than the term "securities", and extends the range of instruments that may be issued by SVs to non-negotiable instruments (e.g. to IOU, Schuldschein), and even includes warrants, futures or options, which are financial instruments but not securities.

The Securitisation Law further offers the possibility to SVs to be either fully financed or partially financed (together with issues of financial instruments) by credit facilities (meaning any form of debt creating a reimbursement obligation for the SV). Previously, credit facilities needed to be ancillary to the issuance of the securities, for warehousing purposes or for short-term liquidity purposes.

These two new changes will offer nearly unlimited possibilities for sponsors to structure the financings of their SVs and attract investors wishing for tailor made investment options.

Flexibility and legal certainty on granting of security interests

Prior to the modernisation of the Securitisation Law, the granting of security interests on the securitised assets was limited to security interests granted to secure obligations that the SV had assumed for their securitisation or in favour of its investors. Security interests that were not granted in that context were void by operation law.

SVs may now grant security interests over their securitized assets "in the context of a securitisation transaction". The wording is now wider and allows greater flexibility in the way security may be taken in the context of a securitisation transaction. It will allow SVs to grant security interests to guarantee the obligations of other persons as long as the security is related to a securitisation transaction.

The sanction of nullity has also been removed. Such new provisions will grant full legal certainty to third party lenders and investors that will no longer be at risk of seeing security interests granted by SVs being void.

New possibility for active management of debt portfolios

The Securitisation Law was silent as regards the active management of the securitised assets, even though the European Central Bank allows securitisation undertakings to manage them actively.

In order to provide more legal certainty to market participants, the Securitisation Law now allows explicitly active management by the SV itself or by a third party, subject to the portfolio of securitised assets being composed of debt securities, loans, debt financial instruments or receivables, and the SV's financial instruments being not offered to the public.

These new rules add a new tool for sponsors that are looking for a favourable legal framework to set up structures whose strategy is to invest in collateralized loan obligations (CLOs) or collateralised debt obligations (CDOs).

The Securitisation Law further confirms that SVs may acquire directly or indirectly its securitised portfolio, through asset holding vehicles.

Additional structuring possibilities with new corporate forms

The Securitisation Law opens up new possibilities by adding to the corporate forms that may qualify as securitisation companies the special limited partnership ("SCSp"), the common limited partnership ("SCS"), the general corporate partnership ("SNC") and the simplified joint stock company ("SAS").

The SCS and the SCSp are partnership structures that have been very popular in the fund industry for nearly a decade now, and introduce great structuring flexibility. Furthermore, SCS and SCSp are tax transparent and therefore add another tool for sponsors alongside securitisation funds. The SCSp is also a corporate form that has no legal personality, contrary to the other corporate forms that are available for SVs.

The SCS and SCSp allow asset managers to offer an investment in equity to potential investors, while ensuring that they will be able to retain control through the general partner. They will likely attract asset managers that are familiar with Cayman securitisation partnerships and wish to replicate such structures in an on-shore jurisdiction.

Conclusion

Luxembourg SVs were already a popular vehicle in the already large Luxembourg toolbox available for sponsors and debt fund managers. The new possibilities opened by the Securitisation Law will further strengthen the position of Luxembourg as leading market for securitisation structures.

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ESG: Less Talk, More Walk

Mandatory Climate Disclosures put Greenwashing in the crosshairs

By Tara Giunta and Daye Cho

On March 21, 2022, the U.S. Securities and Exchange Commission ("SEC") proposed rule changes that would require registrants to disclose certain climate-related information in their registration statements and annual reports.

The proposed amendments are broad in scope and rigorous in detail and, if adopted, will affect both domestic registrants and foreign private issuers. To ensure compliance with the new requirements, companies need to act now to evaluate their current reporting practices and put in place adequate systems to identify and measure climate-related risks.

Global Landscape on Climate-Related Disclosures

The SEC's proposed rule follows years of global investors seeking consistent and comparable disclosure of environmental, social, and governance ("ESG") risks. Indeed, similar proposals have been made across Europe in recent years, including the European Commission's draft Directive on corporate sustainability due diligence published on February 23, 2022. The proposed Directive would require companies to conduct and disclose ESG due diligence on not only their own operations but also those within their value chains, meaning upstream supply chain as well as downstream product use and disposal.

What you need to know

The SEC's proposed rule on climate-related disclosures would require registrants to report:

- Climate-related risks and their impacts on business, strategy, and outlook;
- Climate-related governance and risk management processes and systems;
- Climate-related financial statement metrics and related contextual information; and
- GHG emissions, including indirect emissions that can occur within value chains.

And, on March 30, 2022, the International Sustainability Standards Board (ISSB) – which was formed post-COP26 to develop a global baseline of sustainability disclosures for the capital markets – initiated a consultation on two of its IFRS Sustainability Disclosure Standards: disclosure of sustainability-related financial information and climate-related disclosures. Therefore, in both Europe and the United States, there is increased focus on promoting transparency and accountability through ESG reporting.

Climate-Related Risks and Their Impacts

Under the SEC's proposed rule, registrants would be obligated to disclose climate-related risks and the actual or likely material impacts of those risks on their business, strategy, and outlook. Registrants would need to include both physical risks arising from the impacts of climate change and transition risks arising due to the global transition to a less carbon-intensive economy. In addition, registrants would be required to disclose information about any climate-related plans, initiatives, and goals or targets.

Oversight and Governance

The SEC's proposed rule would require registrants to describe, in detail, their processes for identifying, assessing, managing, and monitoring climate-related risks. Registrants would need to identify board members or committees responsible for oversight of climate-related risks and disclose whether such board members or committees have relevant expertise. Registrants would also need to describe the management's role in addressing climate-related risks and their relevant expertise.

Financial Statement Metrics

The SEC's proposed rule would require registrants to provide certain climate-related metrics in a note to their consolidated financial statements. In particular, registrants would be obligated to disclose financial impact metrics, expenditure metrics, and any estimates and assumptions used in the preparation of climate-related metrics. These metrics, in turn, would be subject to audit by an independent registered public accounting firm.

GHG Emissions

Under the proposed rule, all registrants would be required to report Scope 1 greenhouse gas ("GHG") emissions (that result from sources owned or controlled by a registrant) and Scope 2 GHG emissions (that result from the generation of electricity, steam, heat, or cooling consumed by operations owned or controlled by a registrant), both in terms of aggregate emissions and constituent GHGs. Any registrant that is an accelerated filer or a large accelerated filer would need a third-party attestation report, subject to limited assurance during a phase-in period. In addition, registrants except smaller reporting companies ("SRCs") would be required to disclose Scope 3 GHG emissions (all other indirect emissions that can occur in the upstream and downstream activities of a registrant's value chain) that are material or if there has been a set target or goal encompassing Scope 3 emissions.

Practical Implications

The SEC's proposed rule on mandatory climate-related disclosures is incredibly broad yet nuanced. Companies would need to disclose not only what the risks are but also how they came to those conclusions. Companies would be required to upscale their boards and ensure that there is climate-related expertise at the board level, as well as appropriate management level expertise and oversight. Even companies that have already begun collecting and disclosing climate-related information must now evaluate their current reporting practices against the new requirements and identify areas where they have previously failed to report or reported insufficiently. For private companies considering initial public offerings ("IPOs") in the near future, it is imperative to consider how the proposed rule might impact their ability to move into the public realm. Finally, while the increased attention on ESG presents an opportunity for companies to showcase their commitments, it also creates increased litigation risk. Companies should therefore be intentional in setting climate-related targets or goals and avoiding greenwashing. Whether in the exact proposed form or not, the mandatory climate disclosure rules are coming.

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ELTIFs: The Second Time's the Charm

Why is the ELTIF's popularity on the rise?

By Andrew Ritchie and Adrian Whelan

Have regulated, illiquid funds been democratised as they have become available to a wider spectrum of eligible investors? Recently, in Europe, both the European Long-Term Investment Fund (ELTIF) and the U.K.'s Long-Term Asset Fund (LTAF) have caught the attention of policymakers, investors, and asset managers alike.

Since inception, the ELTIF has not captured investment flows as intended with a distinct lack of ELTIFs since its launch in 2015, and the ones that have launched were both small and comprised mainly of local investments and investors in a handful of EU countries. Only around 28 ELTIFs have been established, with a low asset base (below €2 billion).

However, ELTIF's popularity seems to be on the rise with discernible growth in 2021 with asset managers launching usually in partnership with a private bank or wealth manager. Sizeable revisions to its rule-set are imminent - are the fortunes of the ELTIF about to change?

The European Commission (EC) has removed many of the suggested barriers to ELTIFs' success to make ELTIF 2.0 more attractive for asset managers. The proposed revisions make both portfolio composition and the distribution to a broad range of investor types easier and more attractive.

ELTIF's future success is not guaranteed. However, this revamp greatly enhances the structure's attractiveness to product manufacturers, distributors and ultimately investors. It may now act as a legitimate third option within the EU regulated funds landscape to complement the highly successful Undertakings for the Collective Investment in Transferable Securities (UCITS) and the Alternative Investment Fund Managers Directive (AIFMD) frameworks. Here's why:

What you need to know

- Changes to the ELTIF eligible asset rules will significantly increase its investment opportunities and attractiveness
- Substantial proposed changes to a range of investment permissions and restrictions will allow for much wider investment options for ELTIFs
- A cross-border marketing passport allows for a wider range of investor types with diversified illiquid exposures

Wider Range of Eligible Assets

Several changes to the ELTIF eligible asset rules significantly widen its investment opportunities and attractiveness, including:

Global Investments
There is explicit clarification that ELTIFs may invest freely in non-EU ("third country") exposures. The clarification now allows for a far more diverse range of investment opportunities.

Real Asset Definition
This now includes any asset with "intrinsic value" rather than one that can provide "investment returns" or "predictable cashflow".

Real Asset Threshold
The minimum investment in a real asset by an ELTIF is lowered from €10 million to €1 million making real asset investments much more accessible.

Listed Assets Threshold
The market capitalization threshold for permitted listed investments is raised from €500 million to €1 billion (at time of initial purchase).

Other Investment Funds
ELTIFs may now invest in Alternative Investment Funds (AIFs) who themselves invest in eligible assets on a "look through basis"; previously an ELTIF could only invest in other ELTIFs, European Venture Capital Funds (EUVECA) or European Social Entrepreneurship Funds (EUSEF) structures.

Securitizations
ELTIFs may now invest in eligible securitizations which include mortgage-backed securities, commercial, residential, and corporate loans, as well as trade receivables.

Minority Co-investments
An ELTIF can now make a minority co-investment directly or through investment conduits but doesn't need to be owned directly or via a "majority owned" subsidiary. When twinned with the allowable investments in other eligible fund structures, the ELTIF now has the type of investment flexibility usually found in other similar regulated fund structures seeking exposure to private market investments and allows for the implementation of indirect investment strategies.

More Flexible Concentration and Diversification Limits

The other criticism of ELTIF was that portfolio diversification parameters were too rigid and narrow to allow for flexible portfolio composition for illiquid strategies. As such, there are substantial proposed changes to a range of investment permissions and restrictions allowing for much wider investment options for ELTIFs, including:

- Maximum allowable amount that may be invested in other funds such as other ELTIFs, UCITS or AIFMD funds raised from 10% to 20% of capital
- Maximum allowable amount that may be invested in a single real asset raised from 10% to 20% of capital
- The maximum aggregate value of units or shares of other funds such as AIFs, UCITS or other ELTIFs is increased from 20% to 40% of capital
- An ELTIF may now own 30% of units or shares outstanding of another ELTIF, EU EUVECA or EUSEF
- The maximum aggregate amount of securitizations an ELTIF may invest in is now 20% of the total value of the ELTIF
- The maximum amount of capital that must be invested in eligible investments is lowered from 70% to 60% of capital

Increased Leverage

Another element of long-term funds that was overly restricted and made ELTIFs less attractive was the ability to finance investments through borrowing or provision of leverage. Changes will bring ELTIFs more in line with similar fund vehicles elsewhere. These include:

- The cash borrowing limit is raised from 30% to 50% of ELTIF value for retail ELTIFs and 100% of ELTIF value for ELTIFs solely marketed to professional investors
- The cash borrowing no longer needs to be in the same currency as that which the ELTIF uses to buy its assets, so long as it is hedged
- The fund may encumber its assets to implement its borrowing strategy – previously there was a fixed 30% encumbrance limitation.It was difficult to secure borrowing as liens and pledges of portfolio assets were difficult for ELTIFs and not attractive to lenders

Differentiation Between ELTIFs Marketed to Retail and Professional Investors

ELTIF 2.0 formally recognizes that the ELTIF might be sold to distinct constituents and is not exclusively a retail eligible vehicle. In particular, much lighter investment strategy and borrowing requirements now apply to ELTIFs solely marketed to professional investors.

Distribution and Structuring Enhancements

ELTIFs can be distributed across the EU with a passport to both professional and retail investors. Some positive changes have streamlined the authorization of ELTIFs under new proposals. The National Competent Authority

risks which each insurer bears, so distribution to the EU insurance and pensions segment remains attractive.

Under ELTIF 2.0, retail investors may cancel their subscription and have the money returned without penalty. The two-week withdrawal period is only effective during the two weeks following effective date of the commitment or subscription agreement. The national investor facilities requirements for retail investors are also deleted to facilitate the cross-border marketing of ELTIFs and align with the new rules on Cross Border Distribution Directive (CBDD).

Second Time's a Charm

These ELTIF 2.0 revisions remove many regulatory and structural impediments managers face. Initially they have been broadly welcomed since they address many concerns market participants have with the current rules.

It is hoped that ELTIF 2.0 when applied makes the European Long-Term Investment Fund a viable investment structure for many alternatives managers to the extent they can construct a portfolio that falls within the eligible investment criteria. It sits neatly into the EU regulated fund structure toolkit between UCITS and AIFMD funds. It has a cross border marketing passport and affords opportunity to target a wide range of investor types with diversified illiquid exposures all with a robust regulatory wrapper.

Owing to increasing demand from European private bank and wealth management networks, the latest proposals serve to magnify expectations of more ELTIFs in the future. While the EU approval process means that ELTIF 2.0 would become effective six months and one year after coming into force respectively, so by 2024, market participants who begin to work on their strategies now stand to be on the front foot of the charm offensive.

(NCA) responsible for authorizing the ELTIF will be solely responsible for the authorization of an ELTIF and will not be involved in the additional authorization or 'approval' of the EU Alternative Investment Fund Manager (AIFM). The new rules also clarify that an ELTIF doesn't need to be managed by an AIFM in the same domicile.

There is the removal of duplication in the retail investor suitability tests and alignment of ELTIF to Markets in Financial Instruments Directive (MiFID) point of sale rules. This ties with the deletion of the minimum-entry ticket (€10,000), replaced with €1,000 minimum and the 10% aggregate threshold for retail investors whose financial portfolios do not exceed €500,000. ELTIFs also retain favorable capital charges under Solvency II rules, which introduce prudential requirements tailored to the specific

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AIFMD II: The Good, The Bad and The Ugly

Proposed changes to the Alternative Investment Fund Managers Directive

By Amran Hanif

Within those crisp pages from the EU's publication office is contained a requirement for the AIFMD to be reviewed four years after implementation by Member States. While a certain referendum in one former Member State delayed this process, November 2021 saw the release of the European Commission's first proposals (the "Proposals") for change. Discussions are underway across a variety of channels between the Commission, the European Parliament and the Council of the European Union, with an aim for publication in the first half of 2023 and implementation to be completed two years afterwards. Our focus is on the proposed impact it will have on Credit Funds or direct lending.

What you need to know

- Proposals to be implemented in the AIFMD II are likely to take effect in the first half of 2025.
- Responses to the European Commission's public consultation showed a reluctance on the part of stakeholders for anything too extensive.
- Proposals span loan origination, delegation, depositaries, blacklists and AML, reporting and fee disclosure, and liquidity management.

Loan Origination

European Commission (the "Commission") has introduced a proposal to "contain the risk of interconnectedness" between AIFs and market participants by requiring AIFMs to "diversify their risk and subject their exposure to specific limits". Exposure limits, which may be interpreted as leverage limits, are something which could cause widespread disruption in a market where approximately a third of all EU funds maintain a leverage near or upwards of 60% of NAV (many of which will be over 100%). When it is considered that professional US funds have no limits on their leverage (and even retail US funds have a 200% cap), any proposals for exposure limits will have to be worded very carefully if the Commission's aims are to remain realistic. What's more, the percentage of a loan origination fund's capital which may be lent to a borrower recognised as a financial undertaking (under Solvency II), AIF or UCITS is proposed to be capped to 20%. The Commission has not, however, distinguished whether the capital is based on undrawn commitments or assets either net or gross. AIFs

will be restricted from lending to its manager, its manager's staff, its depositary and its delegates.

Significantly, it is proposed also that AIFs must retain 5% of the notional value of loans it has originated and then sold on the secondary market, so long as those loans were not themselves purchased on said market.

Liquidity Management

AIFs where loan origination exceeds 60% of the fund's net asset value are required by the Proposals to be close-ended. This forms part of the Commission's attempt to negate the impact of redemption pressures in the event of market stress, but seems to be an arbitrary figure. There will be a danger in open-ended structures that this figure may be crossed over, and it is thought that redemption pressures can be protected against by other means.

The introduction by national competent authorities ("NCAs") of a variety of liquidity risk management tools has been proposed, of which AIFMs of open-ended funds must choose at least one. The assessment, selection and activation of any tool(s) remains with the AIFM, who will be required to notify the NCAs about the activation and deactivation of any tool. The existence of long notice periods before redemptions take place does beg the question of why there is a need for any further protection from market-induced pressures.

Delegation

There is a perceived risk that many AIFMs delegate significant amounts of their portfolio management function to entities outside the EU. While it is important that AIFMs do not see their ability to delegate disputed, the current Proposals do not appear to do this. Rather, they focus on increasing the amount of reporting arguably increasing bureaucracy and importantly, cost to investors.

Another proposal makes amendments which broaden the scope of delegation arrangements to include all functions and services, ancillary or otherwise. Furthermore, both credit servicing and benchmark administration have been added to the list of authorised ancillary services. At this point it should be clarified that these rules apply only to delegated activities for which the AIFM is responsible.

Existing requirements for the authorisation of an AIFM have been added to, with a license application now requiring information on the suitability of persons conducting the AIFM's business, as well as information on the human and technical resources used to supervise delegates.

It is proposed that ESMA conducts a peer review every two years on its practices which cover delegation to third country entities by AIFMs. This review is said to focus on the prevention of letterbox entities.

Depositaries

Third country depositaries in jurisdictions which are identified as high-risk under EU anti-money laundering ("AML") laws or on the EU list of non-cooperative jurisdictions for tax purposes will not be permitted under the Proposals. The Commission does, however, recognise some markets in Member States lack access to a competitive offering in depositary services. To this end it is proposed that EU AIFMs can deviate from the general rule and appoint a depositary located in another Member State (where such a depositary will be required to cooperate with the host NCAs). This will allow AIFs in smaller markets to be managed more efficiently.

Blacklists and Anti Money Laundering

AIFMs will be forbidden from marketing AIFs into Member States if the AIFM and/or AIF is located in a tax jurisdiction deemed non-cooperative by the European Council, or one considered high-risk with regard to AML. The EU list of non-cooperative tax jurisdictions has in the past included the Cayman Islands, and stakeholders should be aware that inclusion on this list can occur with little notice and is open to political factors. Grandfathering clauses and/or transition periods are desirable in this respect.

The sanction on AIFMs for breaching AML provisions in the AIFMD II (which takes the form of a ban on marketing) would actually be more severe than those contained within EU AML-specific legislation but with no ban (which is instead enhanced due diligence on customers but no ban). In contrast to this, it is proposed that servicing of securitisation vehicles by AIFMs is legalised.

Reporting and Fee Disclosure

It is proposed that some of the limitations on data reporting in the AIFMD are removed, namely a change from the need to report on "principal markets" to "markets" more broadly, as well as from "main instruments" to just "instruments". Combined with instructions for ESMA to draft new regulatory standards to replace the current template found in Annex IV, this means that AIFMs face the prospect of more time- and labour-intensive regulatory reporting.

There is a proposal for fees (direct and indirect) and charges allocated to the AIFM to be disclosed on a quarterly basis, and for these figures to be based on estimations. Again, the usefulness of such disclosure versus the costs in time to the AIFM is no doubt questionable, not least when quarterly estimations are compared with annual audited fee disclosures.

Conclusion

The review of AIFMD has resulted in some concerning proposals, especially with respect to loan origination funds and it remains to be seen which proposals will make the final publication. It is clear however, that managers should now be prepared for what maybe yet further regulations around loan origination funds in particular.

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ATAD3: A Deep Dive

What do the proposed changes mean for Credit Funds?

By Jiten Tank and Abigail Hung

At the end of 2021, the European Commission published a draft Directive (referred to as ATAD 3), which provides a proposal to counter the misuse of "shell entities" for tax purposes. A shell entity is, broadly, an entity that, whilst it might have an economic activity, lacks economic substance and has been used to obtain tax advantages. This proposal forms part of the Commission's wider and ongoing pursuit for Member States to have a coherent approach against aggressive tax planning measures. The consequences of falling foul of the rules include: (i) requiring an entity to report information regarding its economic substance to the relevant tax authorities (with such information ultimately being shared with other EU Member States) (the "Reporting Requirements"); and (ii) denying an entity benefits afforded pursuant to double tax treaties and/or EU Directives.

The Commission proposes that Member States transpose the Directive into their national laws by 30 June 2023 in order for the rules to come into effect as of 1 January 2024.

Whilst many jurisdictions already have rules requiring minimum substance, these vary between jurisdictions and are to some extent subjective. The proposed Directive seeks to create some degree of consistency through a prescriptive regime consisting of a 7-step process including gateways. Certain of these steps are considered below:

Step 1: Gateways

This is a crucial step as an entity (regardless of its legal form) which meets all three gateways will be subject to the Reporting Requirements.

What you need to know

- The regulations are targeted at 'shell' entities which lack substance. The rules are intended to deny such entities certain tax benefits afforded under EU directive and treaties.
- Whilst the regulations are intended to come into effect 1 January 2024, they are currently in draft form and there may be further changes to how they operate as well as the scope of exemptions thereunder.
- Further regulations are planned to extend the scope to shell entities in non-EU jurisdictions.

The three gateways are:

(i) more than 75% of the entity's income over the two preceding tax years constitutes passive income;

(ii) the entity is engaged in cross-border activity (broadly, this is where: (x) 60% or more of the entity's income is earned or paid out via cross-border transactions; or (y) more than 60% of the value of the entity's assets are located outside the entity's jurisdiction of incorporation); and

(iii) in the preceding two tax years, the entity outsourced the administration of day-to-day operations and the decision-making on significant functions.

Step 2: Exceptions

The proposal contains a number of exemptions for certain types of undertakings excluded from the scope of ATAD 3. These include regulated financial undertakings (such as AIFs, which are managed by an AIFM or supervised under national law) and companies which have a transferable security which is admitted to trading on a regulated EU market or EU MTF.

Although these exemptions may seem helpful in a Credit Funds context, there remains some uncertainty as to their scope. For example, the regulated financial undertaking exemption only applies to the entity in question itself and does not extend to the entity's subsidiaries. This might seem like an odd result given that, generally, holding companies are introduced into credit fund structures for a variety of commercial reasons (rather than tax reasons). For example, debtors are accustomed to dealing with corporate lenders rather than partnerships or similar structures (funds typically taking a partnership form). Further, holding companies may be introduced to allow for external financing or hedging or to provide for a centralised location for tax compliance and treaty relief applications, noting that the ultimate credit fund investors may themselves be entitled to treaty relief pursuant to the relevant double tax treaties.

Although there may be potential for the exemptions to be widened (especially given representations from relevant industry bodies), fund managers should be aware that certain entities within their fund structures may not fall within the prescribed exemptions. Therefore, subject to any arguments to rebut any presumption of being a shell entity, careful consideration should be given to ensuring the level of substance in new and existing fund structures rather than banking on an exemption applying.

Step 3: Reporting/Minimum Substance

If an entity is subject to the Reporting Requirements, it must provide information in its annual tax return as to whether it

meets three minimum substance requirements. The relevant considerations are as follows:

(i) whether the entity has premises available for its exclusive use;

(ii) whether the entity has a EU bank account; and

(iii) whether the entity has at least one qualified director who is resident in the same (or close to the) jurisdiction of the relevant entity who is dedicated to the entity's activities. Alternatively, the entity must have a sufficient number of employees that are resident in the same (or close to the) jurisdiction of the relevant entity who are engaged in the entity's core income generating activities.

Step 4: Presumption and Rebuttal

If an entity cannot satisfy the minimum substance requirements, it will be presumed to be a shell company. However, an entity can counter that presumption if sufficient evidence is produced to show that the entity does in fact have substance and it is not misused for tax purposes.

The proposal requires an entity to produce "concrete evidence" as to the commercial reasons for setting up and maintaining the entity (such as those commercial reasons for setting up holding companies in credit fund structures listed in Step 2 above). This information would then be assessed by the relevant tax authorities. If the tax authorities are satisfied that an entity has successfully rebutted the presumption that it is a shell entity, it will issue a certification noting the same for the relevant year. The certification can be extended for five years provided that the legal and factual circumstances evidenced by the entity do not change. After this period, the entity must apply to renew the rebuttal process.

It is currently unclear as to how exactly the rebuttal process will operate, however, fund managers should be aware that the Reporting Requirements could potentially increase administrative obligations and require extensive discussion with the relevant tax authorities.

Consequences of being a shell entity and other aspects of ATAD 3

The consequences of an entity being a shell company include denying an entity's request for a tax residence certificate, and in conjunction, denying an entity from enjoying the benefits provided for by double tax treaties and EU directives. In addition, the proposal provides for new taxing rights over the income received by the shell company's shareholders.

The proposal also provides for Member States to impose penalties on any entity that does not comply with the Reporting Requirements, with a minimum penalty of at least 5% of the turnover of the non-compliant entity.

The draft Directive also sets out a framework for establishing a central database for relevant entities and the sharing of information between tax authorities regarding the minimum substance elements of the relevant entities under the Directive on administrative cooperation (DAC).

Next steps and considerations

ATAD 3 is not currently law and will require the unanimous agreement from all EU Member States before it is adopted – therefore the final language of the proposed Directive could change.

Whilst it may therefore be premature to begin restructuring funds, it is important for fund managers to understand how ATAD 3 could apply to any holding entity in a fund structure because:

(i) although as currently drafted, the proposal only applies to entities which are tax resident in an EU Member State, the European Commission has announced a new proposal to be published later in 2022 to tackle non-EU shell entities;

(ii) the gateway tests have a look back period of two years. As such, fund managers may want to consider whether the current level of substance in their structures need to be substantiated given the possibility that a future assessment of ATAD 3 will involve consideration of an entity's historic state of affairs.

Fund managers should also ensure that the structure has commercial reasons for any holding entity in the structure to potentially serve as a rebuttal to any presumption that it is a shell entity and to demonstrate that it is not being misused for tax purposes.

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New York

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