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Direct Lending by Funds: Transformation of the Legal Regimes in Europe

*Carlo de Vito Piscicelli, Fabio Saccone, Amélie Champsaur, Robin Barriere, Manuel Metzner, and Valentin Pfisterer**

This article provides an overview of the new framework applicable to lending activities carried out by alternative investment funds in Italy, France, and Germany and to the developments on the EU level.

In Italy, France, and Germany, lending activities have traditionally been reserved to a limited number of institutions (mainly banks and other regulated intermediaries). Recent reforms in all of these countries have brought about significant developments, by extending to alternative investment funds (“AIFs”)¹ the ability to carry out lending activities, subject to certain conditions. In addition, there are developments on the EU level that may lead to the introduction of a European direct lending regime for AIFs.

This article provides an overview of the new framework applicable to lending activities carried out by AIFs in Italy, France, and Germany and to the developments on the EU level.

LENDING IN ITALY

On February 14, 2016, the Italian Government enacted Law Decree No. 18/2016 (the “Decree”) containing amendments to the Italian Securities Act² to allow Italian and EU AIFs to extend credit (including by purchasing receivables) in Italy to persons other than consumers.³

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¹ AIFs are collective investment undertakings subject to Directive 2011/61/EU (“AIFMD”).

² The Decree was published in the *Official Gazette* on February 15, 2016, and entered into force on February 16, 2016. Under Italian law, a law decree is immediately effective, but lapses retroactively unless Parliament ratifies it (with or without amendments) within 60 days of its publication in the *Official Gazette*. The Decree has been ratified with law n. 49 of April 8, 2016.

³ The Decree and the Italian Securities Act do not contain a definition of “consumer.”

With respect to Italian AIFs, the Decree clarifies that these are allowed to extend credit in compliance with the applicable Italian rules on the organization and functioning of the AIF, including risk concentration and reporting obligations.⁴

With respect to EU AIFs, the Decree states that these are allowed to extend credit, subject to the following conditions:

- That they are authorized by their home country authority to invest in receivables.⁵
- That they are established in the form of closed-ended funds and are subject to functioning rules equivalent to those applicable to Italian credit AIFs, which specify, *inter alia*, the period during which capital is called from investors following the marketing of the AIF.
- That they are subject in their home country to limitations on risk concentration and leverage equivalent to the Italian regime applicable to credit AIFs, or, failing that, that such limitations are included in the AIF's constitutional documents and that the home country authority enforces such limitations.
- That a 60 day notice is sent to the Bank of Italy prior to starting such activity.

The Decree authorizes the Bank of Italy to issue certain provisions implementing the rules applicable to EU AIFs, including in respect to the ways in which EU AIFs should participate to the Italian credit reporting database (*centrale dei rischi*). Pending these implementing measures, it is arguable that the new regime will not be effective for EU AIFs.

LENDING IN FRANCE

On October 22, 2015, the French securities regulator (*Autorité des Marchés Financiers*, “AMF”) launched a public consultation on a proposed set of rules addressing the possibility for French investment funds to extend loans. By way of background, while undertakings for collective investment in transferable securities (“UCITS”) and certain French AIFs have long been exempted from

Reference can be made to the Italian Consumers' Code which defines “consumer” as any natural person acting for purposes which are outside of his trade, business or profession.

⁴ Prior to the enactment of the Decree, the Italian Ministry of Economy and Finance and the Bank of Italy adopted regulations with respect to, *inter alia*, organizational and prudential requirements of Italian AIFs.

⁵ It is unclear how this condition can be satisfied for EU AIFs established in countries where such a specific authorization is not required.

the French banking monopoly rule, generally the specific regimes of these funds contained restrictions regarding their purpose and the assets that they may invest in, and either prohibited or did not explicitly authorize loan origination.

The AMF was seeking to clarify the possibility for certain French funds to extend loans, especially as the EU Regulation on European long-term investment funds⁶ (“ELTIFs”) (the “ELTIF Regulation”) was about to enter into force, and allows ELTIFs to lend under certain conditions.

The *Loi n° 2015-1786 de finances rectificative pour 2015* dated December 29, 2015 amended French law provisions to allow certain French AIFs to extend loans.

Starting January 1, 2016, specialized professional funds (*fonds professionnels spécialisés*), professional private equity investment funds (*fonds professionnels de capital investissement*), and securitization vehicles (*organismes de titrisation*) are authorized to extend loans, either in accordance with the ELTIF Regulation (and thus provided that they have been authorized as ELTIFs), or under certain conditions to be set by a decree that has not yet been published. Previously, specialized professional funds and professional private equity investment funds could not extend credit, while by contrast securitization vehicles could purchase loans in the secondary market but were not allowed to engage in primary lending activities.

Where French AIFs have been authorized as ELTIFs, they may now extend loans subject to the following conditions set forth in the ELTIF Regulation:

1. The loans must be granted by the ELTIF to a “qualifying portfolio undertaking,” which is defined as a portfolio undertaking other than a collective investment undertaking that fulfills the following requirements:
 - a. it is not a “financial undertaking,”⁷ unless it exclusively finances qualifying portfolio undertakings or certain qualifying real assets;
 - b. it is an undertaking which: (i) is not admitted to trading on a regulated market or on a multilateral trading facility; or (ii) is

⁶ Regulation (EU) 2015/760 of the European Parliament and of the Council of April 29, 2015 on European long term investment funds.

⁷ “Financial undertakings” are defined in the ELTIF Regulation as any of the following entities: (a) credit institutions, (b) investment firms, (c) insurance undertakings, (d) financial holding companies, (e) mixed-activity holding companies, (f) management companies within the meaning of Directive 2009/65/EC and (g) alternative investment fund managers (“AIFMs”) within the meaning of the AIFMD.

admitted to trading but has a market capitalization of no more than EUR 500 000 000; and

- c. it is established in a Member State, or in a third country provided that the third country is not a high-risk and non-cooperative jurisdiction and has signed an agreement with the home Member State of the manager of the ELTIF and with every other Member State in which the units or shares of the ELTIF are intended to be marketed to ensure that the third country fully complies with OECD tax standards.

2. The maturity of the loans must not exceed the life of the ELTIF.

We note that while French securitization vehicles are still free to purchase existing loan receivables, it is not entirely clear whether specialized professional funds and professional private equity investment funds may also do so under the ELTIF Regulation or if they are limited to primary lending activities.

In addition, following its consultation, the AMF published on June 27, 2016 an instruction⁸ on the requirements to be met by investment fund managers that manage AIFs wishing to engage in lending activities. The instruction provides that a license, or an extension of the existing license to lending activities, as the case may be, must be obtained before such activities can be conducted. In particular, under the instruction:

- The AIF must have a program of operations that allows for the possibility of granting loans, and the program must specify, *inter alia*, to which types of entities the loans will be granted (*e.g.*, portfolio companies, companies selected directly by the management company, etc.), as well as the main characteristics of the loans (*e.g.*, maturity profile, interest rate structure, security interest, etc.);
- Additional constraints will be imposed on the management company, in particular in terms of credit analysis, valuation, risk monitoring and control, management experience, use of third parties to conduct the credit analysis, legal analysis and the evaluation of capital requirements; conflicts of interest, and debt collection; and
- Management companies will have to regularly report to the AMF and

⁸ *Instruction AMD DOC-2016-02 sur l'organisation des sociétés de gestion de portefeuille pour la gestion de FIA qui octroient des prêts, available at <http://www.amf-france.org/Reglementation/Doctrine/Doctrine-list/Doctrine.html?category=III+-+Prestataires&docversion=1.0&docId=workspace%3A%2F%2FSpacesStore%2F3b67ccaf-b96e-4bb9-a2c1-e7109ded838b>.*

the *Banque de France* on all loans granted, so that their lending activities can be monitored over time.

We also note that, despite the language of the AMF instruction, it is unclear whether an ELTIF established in a Member State other than France would be able to benefit from this exemption from the French banking monopoly rule. However, a draft bill (so-called “Sapin II” bill) currently under discussion is expected to make further changes to the regime. The Sapin II bill empowers the government to issue a decree-law (*ordonnance*) and modify the provisions of the French monetary and financial code to set the conditions under which certain closed-ended AIFs open to professional investors and their management companies can extend loans. Such decree-law could potentially open the way for foreign ELTIFs and other AIFs to extend loans in France. The Sapin II bill also authorizes the government to strengthen the ability of investment funds to finance or refinance investments, projects or risks, by amending, in particular, the conditions under which such funds may purchase and dispose of unmaturing loan receivables. Finally, it is worth noting that the government may allow more broadly French or foreign financial investors to acquire professional unmaturing loan receivables from credit institutions or financing companies, by way of exception to the French banking monopoly rule.

LENDING IN GERMANY

On May 12, 2015, the German securities regulator, the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, “BaFin”), released a guidance in which it indicated to change its administrative practice with respect to the regulatory treatment of lending activities of German AIFs.⁹ In this guidance, BaFin explained that, going forward, it would consider lending activities by German AIFs as an integral component of the collective asset management activities carried out by the German AIFM on behalf of the relevant AIF. As a consequence, lending activities by German AIFs would be exclusively governed by German investment law, more precisely the German Capital Investment Act (*Kapitalanlagegesetzbuch*, “KAGB”), and, thus, fall outside the scope of the German Banking Act (*Kreditwesengesetz*, “KWG”) and the banking license requirement set forth therein. To mitigate the effects of the change in its administrative practice, BaFin established a number of requirements (“recommendations”) to be observed by German AIFMs which envisaged to engage in lending activities on behalf of the relevant AIFs.

The German legislature embraced the BaFin guidance and, effective March

⁹ Änderung der Verwaltungspraxis zur Vergabe von Darlehen usw. für Rechnung des Investmentvermögens, May 23, 2015 (WA 41-Wp 2100-2015/0001).

18, 2016, enacted a law introducing, *inter alia*, new provisions regarding lending activities of German investment fund managers on behalf of the investment funds managed by them (the “UCITS V Implementation Act”).¹⁰ The corresponding limitations and restrictions mirror, in large parts, what has been introduced as “recommendations” by BaFin in its May 2015 guidance:

- German investment fund managers continue to be prohibited to engage in lending activities on behalf of UCITS.
- German AIFMs, on the other hand, may extend loans:
 - if and to the extent permissible under the Regulation on European venture capital funds¹¹ or the ELTIF Regulation; or
 - subject to the rules on the organization, function, and permitted activities of the relevant type of AIF¹² as well as additional limitations and requirements set forth in the German Capital Investment Act. These include, *inter alia*:
 - a. specifications regarding the type of AIF (generally only closed-ended special AIFs¹³ may originate loans);
 - b. specifications regarding the type of borrower (loans may not be extended to consumers);
 - c. requirements regarding the risk management of the AIFM and other operational requirements;
 - d. limitations regarding leverage (AIFs may only borrow up to 30 percent of their aggregate available capital including undrawn commitments); and
 - e. requirements regarding diversification (one single loan may only amount to up to 20 percent of the AIF’s aggregate available capital including undrawn commitments).

In addition, the UCITS V Implementation Act introduces new provisions regarding *EU and foreign AIFs and AIFMs* primarily or exclusively engaging in

¹⁰ The main purpose of the UCITS V Implementation Act is the transposition of Directive 2014/91/EU of July 23, 2014 into national law.

¹¹ Regulation (EU) 345/2013 of April 17, 2013 on European venture capital funds.

¹² Under such AIF type-specific rules, retail AIFs or open-ended AIFs are generally subject to tighter regulation than AIFs which are only open to semi-professional and professional investors (so-called special AIFs) or closed-ended AIFs.

¹³ *See id.*

lending activities. Accordingly, such AIFs and AIFMs are explicitly exempted from the banking license requirement set forth in the German Banking Act, subject to certain requirements, including the following:

- In the case of a *foreign AIF or AIFM*, the interests of the relevant AIF must be allowed to be marketed in Germany based on a marketing authorization pursuant to the German Capital Investment Act.
- However, a marketing authorization obtained by a *foreign AIFM* with respect to the interests of an *EU or a foreign AIF* which is based on what is known as the private placement regime (“PPR”) pursuant to Section 330 KAGB¹⁴ (Art. 42 AIFMD) and only allows for the marketing of the relevant *EU or a foreign AIF* interests to professional investors is not considered sufficient to trigger the exemption from the banking license requirement. The reason for this is that the PPR marketing authorization does not require the relevant foreign AIFM to be subject to an effective regulatory supervision in its jurisdiction of origin or to be AIFMD-compliant.

EUROPEAN UNION

Meanwhile, on the EU level, the European Commission acknowledged in its Action Plan on Building a Capital Markets Union dated September 30, 2015,¹⁵ that some EU Member States have introduced specific regimes in their respective jurisdictions to frame the conditions under which AIFs can engage in loan originating activities.

This situation results in funds operating cross-border needing to comply with different requirements for their loan origination activities. Clarification of the treatment of loan-originating funds in the regulatory framework could facilitate cross border development whilst ensuring they are regulated appropriately from an investor protection and financial stability perspective. The Commission will work with

¹⁴ Following the publication by the European Securities and Markets Authority of its advice on the application of the AIFMD passport to non-EU AIFMs and AIFs (ESMA/2015/1236, July 30, 2015), the German PPR under Section 330 KAGB might terminate, at least in part for certain jurisdictions, in the short or medium term, subject to a delegated act by the Commission on the extension of the AIFMD passport to third country jurisdictions. For additional detail, see *Metzner/Pfisterer*, Crossing Borders — ESMA’s Advice on the Extension of the AIFMD Passporting Regime and its Implications for U.S. Fund Managers, IFLR 2016 (due to be published in September 2016).

¹⁵ European Commission, Action Plan on Building a Capital Markets Union, September 30, 2015 (COM (2015) 468 final).

Member States and the ESAs to assess the need for a coordinated approach to loan origination by funds and the case for a future EU framework.¹⁶

In this context, on April 11, 2016, the European Securities and Markets Authority (“ESMA”) issued an opinion on the key principles for a European framework on loan origination by funds.¹⁷ In its opinion, ESMA states that

a common approach at EU level would contribute to a level playing field for stakeholders, as well as reducing the potential for regulatory arbitrage. This could in turn facilitate the take-up of loan origination by investment funds, in line with the objectives of the Capital Markets Union.¹⁸

Against this background, ESMA argues that certain aspects of loan origination activities by AIFs should be uniformly regulated across the EU. Among other things, ESMA considers the following aspects key for a European framework on loan origination by funds:

- Generally only closed-ended funds should be allowed to originate loans.¹⁹
- Interests in loan originating funds should either be available only to sophisticated investors or certain investor protection rules should apply.²⁰
- Managers of loan originating AIFs should be subject to certain organizational and operational requirements including, *inter alia*, obligations relating to risk management and monitoring.²¹
- The use by loan originating AIFs of leverage should be restricted and they should be required to maintain sufficient liquidity.²²
- Loan originating AIFs should be subject to a number of operational restrictions and, thus, should be prohibited to extend loans to consumers or banks, to make use of derivatives (for purposes other than

¹⁶ *Ibid.*, p. 10–11.

¹⁷ ESMA, Key principles for a European framework on loan origination by funds, ESMA/2016/596, April 11, 2016.

¹⁸ *Ibid.*, p. 1.

¹⁹ *Ibid.*, p. 5.

²⁰ *Ibid.*, p. 7.

²¹ *Ibid.*, p. 7-8.

²² *Ibid.*, p. 8-9

hedging) or to engage in short selling activities.²³

OUTLOOK

Recent reforms in Italy, France, and Germany have extended to certain AIFs the ability to carry out lending activities, subject to certain conditions. The European Commission's Action Plan on Building a Capital Markets Union and ESMA's opinion on the key principles for a European framework on loan origination by funds indicate that, in the medium or long term, a European direct lending regime for AIFs may be implemented. ESMA's opinion outlines how such framework may look.

²³ *Ibid.*, p. 9-10.