The European Union (EU) Directive on Alternative Investment Fund Managers 2011/61/EU (the Directive or AIFMD) aims to strengthen and harmonize the regulatory framework for managers of alternative investment funds (the funds, AIFs, and the managers, AIFMs) established in the member states of the EU, including harmonizing the requirements relating to the authorization, administration, controls and remuneration of AIFMs (and their personnel) and the marketing of AIFs managed by such AIFMs. The Directive also aims to regulate certain activities (specified under the Directive) of non-EU AIFMs when these activities are conducted in the EU.

The Directive came into force on 21 July 2011 and was required to be implemented by each of the EU member states by 22 July 2013. Various national regulators, squeezed for time on their transitional regulations, implemented “grandfathering” periods in which put simplistically existing operators were given a year’s grace from compliance. These grandfathering periods came to an end on 22 July 2014 and since then the Directive has been in full effect in the EU member states that have implemented its rules.

While traditional AIFMs, both EU and non-EU, have gradually come to understand the various routes to compliance under the Directive, other market participants, especially those that are based outside the EU, are realizing the new rules present issues that are of potential concern to them too. In particular, those financial players outside the traditional asset management space who manage or implement structures that could look or feel of an AIF (e.g., such as a Master Limited Partnerships (MLPs), Real Estate Investment Trusts (REITs) and YieldCos) and their underwriters are being forced to take a hard look at the definition of an AIF and compare it against their own constitutional set up in order to determine whether such structures might be caught (intentionally or unintentionally) by the definition of an AIF in the Directive. Has the Directive entangled structures it never intended to catch?

This reflection has been prompted in large part by the Directive’s provisions on marketing. Chapter VII, “Specific Rules in Relation to Third Countries” (i.e., those outside the EU), addresses among other things, the conditions for the marketing of a non-EU AIF by a non-EU AIFM or its agent to “professional investors” in the EU. The Directive defines marketing as a direct or indirect offering or placement of units of an AIF (including limited partner interests or shares) with investors domiciled (or with a registered office) in the EU at the initiative of the AIF’s AIFM. Therefore, where a transaction’s marketing implicates the Directive through the marketing of units in an entity that is deemed an AIF inside the EU, such marketing is governed by Articles 37, 39, 40 and 42 of the Directive. Some players in the non-traditional alternative investment fund space are simply unaware that the provisions of the Directive could potentially apply to them (not thinking of their businesses in terms of AIFMs and AIFs), while others simply consider coming within scope of these rules to be a simple non-starter and opt instead not to access EU capital.

This article analyses the definition of an AIF and its key concepts under the Directive, what exemptions may be available to an AIF structure and the impact of these on the MLP, REIT and YieldCo markets respectively.

I. SCOPE OF THE AIFMD

Revisiting what will be familiar ground for many, the stated scope of the AIFMD is limited to entities managing AIFs as a regular business, regardless of whether the AIF is of an open or close ended, whatever its legal form and contractual manner and whether or not the AIF is listed.

The Directive applies to:

(A) EU AIFMs which manage one or more AIFs (irrespective of whether such AIFs are EU or non-EU)

(B) non-EU AIFMs which manage one or more EU AIFs; and

(C) non-EU AIFMs which market one or more AIFs in the EU (irrespective of whether such AIFs are EU AIFs or non-EU AIFs).

Therefore for non-EU AIFMs (e.g., AIFMs that are established or have their registered office (or head office) in the US, Switzerland, the Channel Islands, Cayman Islands or the British Virgin Islands, among others) the scope of the AIFMD is limited to:

(1) the management of those AIFs that are based in the EU; and/or

(2) EU fund raising (e.g., the marketing of non-EU AIFs based in the EU; and/or have their registered office (or head office) in the US, Switzerland, the Channel Islands, Cayman Islands or the British Virgin Islands, among others) the scope of the AIFMD is limited to:

III. DEFINITION OF AN AIF

A. Directive

Many REITs, MLPs and YieldCos wish to access EU capital. Fundamental to understanding whether the accessing of such capital would come within scope of the Directive is to understand if these structures are, or could potentially be if not structured appropriately, AIFs. It is therefore important to consider what is an AIF under the Directive.

The Directive defines an AIF as a collective investment undertaking (a CIU) which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy and for the benefit of those investors. Further, the relevant CIU does not require authorization under the UCITS Directive. The definition of an AIF has been intentionally drafted broadly by EU legislators in
order to capture the variety of fund structures in all EU member states with the intention behind such wording being the categorization of investment funds into one of two categories: AIFs or UCITS. However, this intentionally broad drafting may have also achieved something else: the bringing into scope of structures that were never meant to be governed by the Directive and whose operators would never consider to be AIFs.

The Directive specifically provides that it does not regulate AIFs,8 why then all the hand wringing? As noted above, the definition of an AIF determines whether the Directive applies to aspects of a capital markets transaction. In other words, if a particular structure within a transaction - an issuer of securities - is deemed to constitute an AIF then the sponsor (or control party, or manager, or equivalent) of such AIF is regarded the AIFM and such AIFM may be brought into scope by some or all of the provisions of the Directive, including those provisions related to remuneration, transparency and marketing of the units of such AIF. This would be the case regardless of where the AIFM might be incorporated, located or operating.

Please refer to section VII below for more details on the definition of an AIFM.

B. Guidance

Supplementing the black letter law of the Directive, the European Commission has provided guidance stating that whether a structure falls within the definition of an AIF can be determined only on a case-by-case basis, taking into account its specific features.9 ESMA has stated that competent authorities (e.g., national regulators) and market participants should not consider an undertaking to be an AIF unless all the elements included in the definition of an AIF where the elements below are present. In principle all the criteria need to be met but in the Final Guidelines ESMA has left the door open to regulators considering a structure to be an AIF even though one or more of the criteria are missing.10

What are these characteristics and in examining them can we distinguish REITs, YieldCos and MLPs from AIFMs?

1. Collective Investment Undertakings

A threshold question in determining whether an entity is an AIF is whether the entity constitutes a CIU. ESMA’s “Final Report, Guidelines on key concepts of the AIFMD” (the Final Guidelines) state that a CIU must have at least the following characteristics:

(a) the undertaking does not have a general commercial or industrial purpose;

(b) the undertaking pools together capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors; and

(c) the unit holders or shareholders of the undertaking – as a collective group – have no day-to-day discretion or control.11

ESMA has defined “general commercial or industrial purpose” to mean the pursuit of a business strategy which includes a commercial activity that involves the purchase, sale and/or exchange of goods or commodities and supply of non-financial services, or an industrial activity that involves the production of goods or the construction of properties, or a combination of the foregoing. ESMA has clarified that a “pooled return” is a return generated by the pooled risk arising from acquiring, holding or selling investment assets, including activities to optimize or increase the value of those assets. Finally, with regard to “day-to-day discretion or control”, ESMA has stated that its absence was a relevant factor in assessing whether an undertaking is a CIU12 but not the only factor. Day-to-day discretion or control is defined as a form of direct and ongoing power of decision, whether exercised or not, over operational matters relating to the daily management of the undertakings’ assets and which extends substantially further than the ordinary exercise of decision or control. ESMA has clarified the day-to-day discretion or control should be granted to all the unit holders of the undertaking (whether exercised or not) in order for it to satisfy limb (c) of the test above.

On the basis of the ESMA guidance, it is crucial that an MLP, REIT or YieldCo is not structured as a CIU in order to avoid falling within the definition of an AIF. In other words, the relevant entity must demonstrate certain characteristics distinct from an AIF: non-financial assets; a commercial purpose; activities that are of an industrial nature. Otherwise, if not correctly and with consideration of the Directive, some MLPs, REITs and Yieldcos can demonstrate characteristics of both CIUs (e.g., pooled investment) and general commercial companies (e.g., large numbers of employees, industrial assets and services such as property development).

2. Defined Investment Policy

Secondly, in determining whether or not a structure contains an AIF, it is necessary to examine whether the entity in question has a “defined investment policy”. The Final Guidelines articulate the parameters of a “defined investment policy”. ESMA may regard the following factors either singularly or cumulatively to indicate the existence of a defined investment policy:

(a) the investment policy is determined and fixed, at the latest by the time that investors’ commitments to the undertaking become binding on them;

(b) the investment policy is set out in a document which becomes part of or is referenced in the rules or instruments of incorporation of the undertaking;

(c) the undertaking or the legal person managing the undertaking has an obligation to investors, which is legally enforceable by them, to follow the investment policy, including all changes to it;  

(d) the investment policy specifies investment guidelines, with reference to criteria including any or all of the following:

(i) to invest in certain categories of assets, or conform to restrictions on asset allocation;

(ii) to pursue certain strategies;

(iii) to invest in particular geographical regions;

(iv) to conform to restrictions on leverage;

(v) to conform to minimum holding periods; or

(vi) to conform to other restrictions designed to provide risk diversification.

Alive to the ability to circumvent such parameters, ESMA has directed that the flexibility and full discretion accorded to a manager (or potential AIFM) to make investment decisions should not be used as a means to structure around the concept of a defined investment policy. This guidance may have been prompted, in part, by the European Commission’s compromise text during the AIFMD tri- logues. In its final compromise text, the European Commission had wanted the definition of an AIF to include discretionary investment policies as well as “…with a view to investing it in accordance with a defined or discretionary investment policy for the benefit of those investors.”

III. MASTER LIMITED PARTNERSHIPS IN THE CONTEXT OF THE AIFMD

An MLP is a business enterprise geared towards generating stable and predictable cash flows to distribute to its owners. Fundamentally, an MLP is a partnership that is publicly traded and listed on a national securities exchange in the United States. To be an MLP, the entity – typically organized as a limited partnership (LP) or a limited liability company (LLC) pursuant to state law – must be treated as a pass-through entity for US federal tax purposes, meaning that the MLP pays no tax at the entity level, but its owners pay taxes on the distributions they receive.

To qualify for pass-through tax status, an entity must derive its income from certain “qualifying” natural resources, as specified in the tax code, including, among other things, income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil or products thereof) or the marketing of any mineral or natural resource. The MLP’s focus on generating stable and predictable cash flows and its advantageous tax structure make it a popular investment among certain investors seeking higher yields in the marketplace. An MLP generally has a two-tiered structure. The publicly-traded MLP entity is essentially a holding company – typically, its only asset is a wholly-owned lower tier LP or LLC, known as the “operating” entity.
The operating LP/LLC directly or indirectly owns the operating assets and/or other operating subsidiaries of the MLP. These operating assets generate the cash flows used to pay distributions to the unit holders of the MLP.

Sponsors of MLPs need therefore to carefully consider whether the MLP businesses they structure for US specific reasons do not mistakenly fall into the category of an AIF (when they do not need to). Sponsors of these businesses should carefully consider the above to ensure that it is clear an MLP is a general commercial company and not a CIU. In addition, it is necessary to examine whether or not MLPs have a defined investment policy as laid out by ESMA. Frequently, the discretion afforded the management of these structures to amend their investment policies and focus may be sufficient to ensure that the MLP does not satisfy ESMA’s test. Finally, if the contemplated structure still seems to be at risk, consider the exemptions provided for in the Directive itself, particularly the holding company exemption (considered more in section VI below).

IV. YIELDCOS IN THE CONTEXT OF THE AIFMD

In 2013, a new type of entity very similar to an MLP went public. This entity, referred to as a “Yielding,” is similarly focused on stable, predictable distributions to its investors, but the cash-generating assets that it owns and operates are not “MLP-able,” (e.g., they do not allow the Yieldco to qualify for pass-through tax treatment). Such assets include contracted renewable and conventional generation and thermal infrastructure assets. Like MLPs, Yieldcos position themselves as vehicles for investors seeking stable and growing dividend income from a diversified portfolio of lower-risk, high-quality assets.

Structurally, Yieldcos mimic their MLP cousins – a two-tier structure with ownership split between the sponsor and the public – but there are a few key differences. For example, a Yieldco is taxable at the corporate level and thus organized as a corporation rather than a partnership or LLC, a Yieldco sponsor typically holds a voting interest in Yieldco and an economic interest in the operating subsidiary.

Given their similar structure, Yieldcos present similar issues to MLPs, and the same Directive analysis can be necessary. Again, like MLPs they demonstrate many characteristics that can robustly trend towards being commercial businesses and not CIUs. For example, these structures (like MLPs) look to further the commercial activities of these businesses, rather than achieving gain by realizing assets. Furthermore, they frequently do this by maintaining staff and employees to actively manage these commercial, business activities, something the UK’s Financial Conduct Authority (the FCA) has viewed as relevant in distinguishing an entity from an AIF. Again, like MLPs, they also demonstrate flexibility in amending these business activities and developing and evolving them in a manner that would suggest the lack of a sufficiently defined investment policy.

V. REAL ESTATE INVESTMENT TRUSTS IN THE CONTEXT OF THE AIFMD

Generally, a REIT is a company, taxable as a corporation, which invests as least 75% of its total assets in real estate and generates a steady income from such assets. A REIT may own several commercial real estate properties, ranging from office and apartment buildings to warehouses, hospitals, schools, malls, department stores, hotels and casinos. As with MLPs and Yieldcos, REITs enable investor exposure to assets they would not have otherwise; in this case portfolios of large scale properties. By statute, REITs typically pay out all of their taxable income as dividends to shareholders, and shareholders pay the income taxes on those dividends. Two popular types of REITs are the Equity REIT and the Mortgage REIT. Equity REITs produce income from the collection of rent and, or sale of properties that are owned over a long term. Mortgage REITs as their name suggests, invest in mortgages and mortgage securities that are linked to commercial and residential properties.

During the consultation process associated with the Final Guidelines, the real estate industry lobbied hard to receive an express exemption from the definition of an AIF. Such exemption was not forthcoming. Instead, the European Commission’s Q&A on the AIFMD states that the question whether or not a REIT or real estate company is excluded from the scope of the AIFMD depends on whether or not it falls under the definition of an “AIF” in Article 4(1) (a).

As a result, like MLPs and Yieldcos, each structure should be considered on its own merits based on substance, not on form. The same analysis and the same features look at above should be considered in detail and if insufficient or inconclusive, consideration of the Directive’s exemptions may be necessary.

VI. EXEMPTIONS FROM THE DEFINITION OF AN AIF

The Directive exempts several entities from its scope, including family investment vehicles, certain joint ventures, certain holding companies, supranational institutions, national central banks, governmental bodies, social security and pension vehicles, occupational retirement vehicles, employee participation schemes and securitization special purpose entities. Particularly relevant to the present discussion are the exemptions for joint ventures and holding companies.

A. Joint Ventures

Joint ventures are generally considered to be exempt from the requirements of the Directive. However, what constitutes a joint venture is not expressly defined by the Directive. This may be because the concept has traditionally been left to EU member states and their national legislation. The European Commission conducted a Q&A series in respect of the AIFMD in 2013, during which time several stakeholders requested clarification on a number of the AIFMD concepts. With regard to the joint venture exemption, the industry sought objective criteria by which the existence of a joint venture could be assessed. The European Commission responded with “each situation should be assessed on its own merits” and that substance should prevail over the formal denomination of the specific structure. This has left the door open to certain limited partnership structures being considered joint ventures where traditionally the concept was limited to companies.

Regulators in EU member states have attempted to supplement ESMA’s limited guidance and there is now some helpful guidance as to what might constitute a joint venture. Some of this guidance may prove helpful when distinguishing or exempting a Yieldco, REIT or MLP from the terms of the Directive. For example, a joint ventures are generally considered to be arrangements in which investors raise capital for their joint investment, rather than where capital is raised from distinct investors and put to work by a third party on their behalf as in a classic
Under the Directive, an AIFM is defined as the legal person whose regular business is managing one or more AIFs. It does not matter where the AIFM or AIF is domiciled if marketing activity is conducted in the EU. The Directive also specifically states that AIFMs managing AIFs whose shares are admitted to trading on a regulated market should not be excluded from the scope of the Directive.20

Both the Directive and ESMA’s guidance expressly exempt certain entities from the definition of an AIFM – these include managers of pension funds and employee participation schemes (as these are subject to their own regulation), supranational institutions, national central banks, national, regional and local governments and bodies or institutions that manage funds supporting social security and pension systems – and more importantly, security special purpose entities or SPVs.21

VIII. CONSEQUENCES OF IDENTIFYING AN AIF AND AIFM

As soon as an AIF is identified, its parent or sponsor is deemed an AIFM and will be required to comply with some or all of the requirements of the Directive. The AIFM is also the entity that bears the brunt of any non-compliance with the Directive. The Directive is silent on the penalties that apply in such circumstances, and instead EU member states are granted discretion to use their existing tools of enforcement. It is however likely in most member states that a contravention of the rules would be a securities violation with associated penalties and involve a potential ban for the sponsor in the relevant jurisdiction and potential rescission right for effected EU investors.

It is therefore in a parent or sponsor entity’s interest to structure their subsidiary in a manner that takes it outside the scope of the Directive or allows it to avail itself of the joint venture or holding company exemptions.

It is also in an underwriter’s interest to ensure that the AIFM Directive is not implicated in any transaction structure, especially where a non-EU AIF and, or non-EU AIFM may exist. Where it or they exist, underwriters must comply with the Directive’s marketing provisions. Such marketing conduct goes beyond the typical inclusion of legends in roadshow materials and any accompanying prospectus or equivalent. A detailed analysis of the marketing provisions is beyond the scope of this article. However for present purposes it is noted that the success of a capital markets transaction that involves an MLP, a REIT or a YieldCo is often the result of an underwriter’s ability to freely market the units of the relevant structure to professional investors in the EU – and success in this case, may ride on the structure remaining outside the scope of the Directive and/or the existence of a joint venture or holding company.

IX. CONCLUSION

In conclusion, it is clear that the structures examined here have certain characteristics that are similar to those of AIFs. They give us pause for thought and require close examination to ensure they are not AIFs. There are numerous arguments and characteristics that allow us to distinguish these structures with some confidence but none of these factors seems wholly definitive at this time. The regulatory landscape is still too unclear. As the market evolves so too will a common acceptance of what of the above is key to ensuring a clean structure free from the requirements of the Directive. In the interim, in any transaction it seems sensible to do the analysis as to why the structure in question is not AIF and ensure the other parties involved (and of course their counsel) agree. It may also be worth considering a risk factor in the offering materials to ensure the issues have been appropriately disclosed to investors. Fundamentally, these structures that “sound like a fund” and may “look like a fund” are distinguishable from those structures the Directive aimed to regulate: we just need to ensure clarity to allow business to continue on a more certain footing.

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1 Unless the context requires otherwise, a reference herein to the European Union or EU is a reference to one or more, or all, of the states of the European Economic Area (that is, the member states of the European Union, Liechtenstein, Norway and Iceland but not including Switzerland).
2 In fact many EU member states did not implement the Directive by 22 July 2013 and indeed by July 2014 only a third of member states had done so.
3 As defined under Directive 2004/39/EC.
4 AIFMD, Article 4(1) (x).
5 AIFMD, Recital 6.
6 AIFMD, Article 4(1) (j) (i).
7 “UCITS” or “undertakings for the collective investment in transferable securities” are investment funds regulated at European Union level. The relevant Directive is 2009/65/EC, more popularly known as the UCITS Directive.
8 AIFMD, Recital 10.
11 Final Guidelines, Annex III, Part VI.
12 Final Guidelines.
13 European Commission Q&A on the AIFMD Directive, Question ID 1164 and ID 1171.
14 AIFMD, Recital 7.
15 AIFMD, Recital 8.
16 European Commission Q&A on the AIFMD Directive, Question ID 1160.
18 AIFMD, Article 4(1) (o).
19 European Commission Q&A on the AIFMD Directive, Question ID 1146.
20 AIFMD, Recital 8.
21 AIFMD, Recital 8.

AIF structure. Further, the active involvement of all investors in day-to-day management and control of a commercial arrangement, something that can be seen in certain MLP structures (for example, where each party has the right to appoint a director on the entity’s board), can also indicate that the structure is a joint venture, not an AIF, and therefore exempt from the requirements of the Directive. Further, joint ventures are often a marriage of equity and expertise, with one partner having the necessary experience to carry out the day-to-day management and the equity partner being involved in making more key, strategic decisions – something they again have in common with some MLPs and YieldCo structures. The FCA have determined that even these types of structure should be excluded from the scope of the Directive provided the strategic financial and operating decisions are continuously under the control of all the parties – even if the parties have hired an outside person to manage the venture on a day-to-day basis.17

B. Holding Company

“Holding company” is a defined term under the AIFMD. A holding company is a company with shareholdings in one or more other companies, the commercial purpose of which is to carry out a business strategy or strategies through its subsidiaries, associated companies or participations in order to contribute to their long-term value and which is either a company operating on its own account and whose shares are admitted to trading on a regulated market in the Union or not established for the main purpose of generating returns for its investors by means of divestment of its subsidiaries or associated companies as evidenced in its annual report or other official documents.18

Stakeholders have sought clarification from both ESMA and the European Commission with regard to the holding company exemption and distinguishing criteria from financial holding companies. The European Commission stated that a holding company must be regarded as a separate legal entity that carries out the business of owning and holding equity shares of the companies without the intent to dispose of such shares. Importantly, “Such business is done on the account of the holding company and not on behalf of a third party. The exclusion of a holding company in Article 2(3) (a) was meant to exclude from the AIFMD large corporates such as Siemens or Shell. The fact of being listed is not in itself sufficient.”19

It is clear that many of the structures we have been considering here have the look and feel of a holding company. They are companies that carry out business strategies through subsidiaries and associated companies in order to generate long-term value. The definition of “holding company” is therefore useful for distinguishing these structures from AIFs, however, its narrow interpretation and apparent requirement for a European listing, coupled with the general lack of clarity around the issue, means it is unfortunately not definitive.