

## ALTERNATIVE INVESTMENT VEHICLES IN LUXEMBOURG ILLIQUID STRATEGIES

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Over the past years, Luxembourg has consolidated its position as a leading investment fund centre for private equity, real estate and other illiquid strategies. A number of American and English fund managers have recently set up new management companies or increased the capacities of existing management companies in Luxembourg, contributing significantly to this consolidation.

Success is always the result of multiple factors. Brexit and international tax initiatives are known to have accelerated the development of Luxembourg as a centre for illiquid strategies. The pragmatism of the Luxembourg lawmaker and its swift implementation of Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD) in parallel to the modernization of the Luxembourg limited partnership vehicle proved to be essential to Luxembourg's current position in the industry.

In particular, the alignment of the regime of local partnerships with those of competing jurisdictions gave comfort to asset managers that they could take advantage of the AIFMD's marketing passport while setting up their European investment vehicles in a format that they are familiar with and that allows full interaction with other vehicles of their product range (e.g., Delaware feeder of parallel funds for the US market).

The flexibility offered by the *société en commandite spéciale* (special limited partnership, or SCSp) is appreciated by a number of managers of all origins. More particularly, American and English managers have found in the SCSp a tool that is very similar to the Cayman or Delaware vehicles that they are generally used to.

However, when using the SCSp, those managers imported to Luxembourg practices and structures that have since become the norm, but that first raised a number of questions with respect to Luxembourg law and the AIFMD. This paper will explore the use by such managers of "alternative investment vehicles" (AIVs) that they form next to the main fund at that invests in parallel with it. Depending on a number of factors, a very large

portion of the investor commitment may be allocated to such AIVs.

The use of AIVs in the context of a European alternative investment fund (AIFs) that was sold on the basis of the AIFMD marketing passport (the "Passport") implied that an important amount of commitments raised through that Passport might actually be allocated to a vehicle that is not the AIF (the "Main Fund") to which such commitments were made and that might not offer investors the same protections that they would benefit from had this commitment been allocated to the "Main Fund".

The purpose of this paper is to discuss solutions that have been used by the industry to bridge the gap between the original practice of AIVs in foreign funds and the requirements of the AIFMD.

### I. WHAT ARE AIVS AND HOW DO THEY QUALIFY UNDER AIFMD?

AIVs that are set up in the form of an SCSp are governed by a limited partnership agreement (LPA). AIVs sponsored by Anglo-Saxon managers often provide that their general partner (General Partner) may set up AIVs and require a partner of the SCSp to contribute capital to such AIV in lieu of the AIF (the "Main Fund") to which they have originally made their capital commitment.

Depending on the asset manager and the complexity of the fund program, AIVs may be a major component of the deployment strategy and aggregate an important portion of the investors' commitments to the Main Fund.

Generally, AIVs are structured to accommodate one or more special investments when the Main Fund to which they relate is not the optimal vehicle to make that investment, whether for tax, regulatory or other legal reasons. AIVs are usually set up for a particular deal or a group of related deals. AIVs may invest in parallel to or in lieu of the Main Fund and their general partner (which is usually the same as the Main Fund's general partner) has the

right to draw on the commitment made by investors to the Main Fund.<sup>1</sup>

The use of AIVs for AIFMD-compliant AIFs has raised a number of questions. Among these questions is whether such AIV itself should qualify as an AIF and if AIFMD should apply to that AIV, especially where a significant portion of Main Fund commitments are drawn into AIVs.

It has been proposed that AIVs might not qualify as AIFs as they do not invest new capital but rather capital raised at the level of the Main Fund, implying that AIVs would lack one of the key components of the definition of AIF (capital raising). One of the options proposed was to consider AIVs as a form of a special purpose vehicle (SPV) of the Main Fund. This proposal was (among others) based on an analogical application of guidelines of the Financial Conduct Authority of the United Kingdom.<sup>2</sup>

This proposal is not entirely satisfactory, as an SPV would generally be held by the Main Fund itself, meaning that investors in the Main Fund continue to be treated alike whether the Main Fund has (or has not) recourse to an SPV, whereas an AIV is held by the investors themselves outside of the Main Fund. This key difference may affect the protections that the investor would benefit from in an AIV with comparison to those applicable at the Main Fund.

## II. CONTRACTUAL RIGHT OF THE GENERAL PARTNER TO CALL CAPITAL INTO AIVS AND RIGHTS OF OTHER PARTNERS

The right of a General Partner to call capital committed to the Main Fund into an AIV is usually provided for in the LPA of the Main Fund as follows:

*If the General Partner determines in good faith that for legal, tax, regulatory, accounting or other similar reasons it is in the best interests of one or more of the Partners that all or a portion of an Investment be made through an alternative investment structure, the General Partner shall be permitted to structure the making of all or any portion of such Investment outside of the Partnership, by **requiring any Partner or Partners to make all or a portion of such Investment through a partnership or other vehicle** that will invest and divest on a parallel basis with or in lieu of the Partnership (any such structure or vehicle, an "AIV"). Each Partner shall have the same economic interest in all material respects*

*in Investments made pursuant to this Section as such Partner would have if such Investment had been made solely by the Partnership, and **the other terms of such AIV shall be substantially the same in all material respects to those of the Partnership.***

This clause provides for the right of the General Partner to call capital to a vehicle (the AIV) other than the one to which such capital was initially committed. The commitment itself remains, however, to the Main Fund and is generally not transferred to the AIV.

As a safeguard for LPs, the LPA provides the assurance that LP rights in the AIV will be no different, materially and substantially, to their rights in the Main Fund. Where the Main Fund has been marketed to EU/EEA investors under the Passport, this latter provision takes a different magnitude than in the Delaware/Cayman context in which it has originated, and may imply that the AIV should provide similar regulatory protections to LPs as those that they benefit from as LPs in the Main Fund.

Accordingly, by a combination of the rules of the AIFMD and of the aforementioned provisions in the LPA, investors may expect, when contributing capital to an AIV, to benefit from a level of protection that is at least equivalent in all material respects and to the maximum extent applicable, to the protections that they enjoy as LPs of the Fund under the AIFMD.

Practically speaking this would mean (assuming that the investor protections provided by the AIFMD have any significance for investors) that the protections that investors enjoy in the Main Fund pursuant to its submission to the AIFMD should be extended to LPs in an AIV. The question is then: how to achieve this?

## III. COULD AIVS PROVIDE MATERIALLY SIMILAR INVESTOR PROTECTIONS THROUGH CONTRACTUAL ARRANGEMENTS?

It has been suggested that an AIV that would not qualify as an AIF could seek to implement AIFMD-type investor protections via contractual arrangements. These AIVs could, e.g., enter into agreements with selected service providers (e.g., depositary, auditor...) that would seek to replicate the terms of an engagement for similar functions under the AIFMD.

1. C. ZEISBERGER, M. PRAHL and B. WHITE, *Mastering Private Equity*, Wiley, 2017, page 203.  
2. "Sometimes, an AIFM establishes an SPV or acquisition vehicle as an administrative convenience, to facilitate a specific transaction(s) to be carried out by the AIFM. Generally, the SPV should not be treated as a separate AIF for the purposes of AIFMD. The vehicle does not raise capital from investors.

Rather, it would merely be a means of investing capital already raised by the AIF. It is merely part of the mechanical and administrative mechanisms for putting into operation a scheme of investment that has already been set up.", Financial Conduct Authority, PERG 16, May 2020, Question 2.53: "Is an acquisition vehicle for an AIF itself a separate AIF?"

There are, however, two limits at least to this approach:

- These service providers (especially the depository) have mandatory duties under the AIFMD. They are supervised in the performance of such duties by their national competent authority (NCA). A purely contractual engagement might simply not achieve the same level of commitment and effect as the direct application of mandatory rules of law would and would not be subject to the same level of supervision by their NCA. Besides, the depository of the Main AIF could resist entering into an AIFMD depository agreement with a non-AIF.
- Not all service providers will be in a position to contract with a non-AIF. For example, Luxembourg AIFMs are not permitted to be appointed as an alternative investment fund manager for a non-AIF. An AIFM would need to hold an additional license of private portfolio manager (*gestion individuelle de portefeuille*) to manage the assets of a non-AIF vehicle, however, this would still not extend the benefits of the AIFMD to such vehicle.

#### IV. WHAT ARE THE RISKS OF NOT SUBMITTING AIVS TO THE AIFMD?

Main Funds are often set-up for the European market as parallel funds to another main fund usually located in Cayman or Delaware for other markets. These Delaware or Cayman funds will also have their AIVs, which will generally be located in the same jurisdiction. An expedient solution would be for the manager of these structures to draw European commitments into these foreign AIVs.

However, drawing a material amount of commitments into a foreign, non-AIF, AIV might trigger the risk for the Main Fund's AIFM of being viewed as having abused the Passport and having misled investors in the Main Fund. Indeed, capital that would be drawn in a non-AIF AIV would initially have been raised through the Passport and committed to the Main Fund as a result of capital raising and marketing activities conducted by (or on behalf of) the Manager under the AIFMD. The benefit of the Passport for AIFMs is indeed subject to compliance with a number of investor protections and other requirements provided in the AIFMD.

NCAs (either in Luxembourg or in a Member State where marketing activities were conducted) could challenge the use of the Passport by that AIFM and seek to apply sanctions to it. NCAs could be made aware of such situation through several means, including investor complaint or mismatch between the amount of commitments made to the Main Fund and assets under management reported by the AIFM to its NCA.

Moreover, and although we are not aware that such precedent exists at the date of this article, investors that have lost money due to non-performing investments in an AIV structure could seek a remedy from the AIFM or rescission of their commitment by arguing that they were misled by the marketing of the Main Fund and that the AIFM had abused the Passport.

#### V. QUALIFYING AIVS AS AIFs: A PROTECTIVE SOLUTION

Where the use and scale of AIVs have any significance, the risk of being challenged and possibly sanctioned may bring the AIFM to seek more protective solutions than contractual arrangements or status quo. AIFMs may achieve that level of protection by treating those AIVs as full-scope AIFs. By doing so, the full AIFMD regulatory framework would automatically apply and AIVs would be in the same regulatory situation as the Main AIF, including with respect to service providers (AIFM, depository, auditor...).

At this point, applying for a separate Passport for each AIV-AIF would seem unnecessary, as capital called into such AIVs has already been committed to the Main Fund under the Passport. It is only the discretionary right of the GP as provided in the LPA that would result in that same capital eventually being drawn into the AIV.

A common set-up would be to form Luxembourg AIV-AIFs that would invest in parallel to their "sister" foreign AIVs. However, under the assumption that AIVs do not need to rely on the Passport for calling capital committed to the Main Fund, and considering the possibility that foreign AIVs be qualified as AIFs, managers could form Luxembourg AIVs as vehicles feeding into such foreign AIVs. This can be useful in scenarios where an investment requires the formation of an AIV outside of Luxembourg.

The formation of AIVs as AIFs in Luxembourg has been tested for a number of years. The process being fairly novel in our jurisdiction, it has raised several key questions under AIFMD that so far have been accommodated. Examples of such key issues are the submission of the financial statements of certain AIVs and their Main Fund to a combined audit and the use of master collateral accounts in the context of entering into subscription facility agreements. We will explore these issues and proposed solutions in separate articles. ■

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