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"Co-Investment Vehicles" under the AIFM Law: Is your Vehicle an AIF?

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INTRODUCTION

In recent years, more and more "co-investment vehicles", of all shapes and sizes, have been used in the Luxembourg alternative investment fund ("**AIF**") domain.

Their popularity can be explained by the fact that co-investments allow fund managers to fund larger deals without jeopardising contractual or legal fund diversification rules. By offering co-investment opportunities, fund managers can develop a privileged relationship with some (cornerstone) investors. Through co-investments, investors invest outside the fund structure, offering such investors direct exposure to one or more specific assets at no or reduced management fee and carried interest.

Prior to establishing any of these "co-investment vehicles", consideration should be given at an early stage as to whether or not the vehicle qualifies as an AIF. If it does, there is a risk, if no proper consideration is given to the structure, that the manager of the vehicle may be subject to the AIFM Law[1] and required to be authorised as an alternative investment fund manager ("**AIFM**").[2]

In practice, it is not always clear whether these vehicles qualify as an AIF and, hence, fall within the scope of the AIFM Law or not.

In the absence of a specific definition of "co-investment vehicles" given by the European Commission, ESMA[3] or the CSSF, the aforementioned vehicles are analysed based on (a) the definition of an AIF as provided under Article 1(39) AIFM Law and (b) the exceptions as foreseen in the AIFM Law.

1. THE AIF DEFINITION

According to Article 1(39) AIFM Law, an AIF is any (i) collective investment undertaking which (ii) raises capital (iii) from a number of investors, with a view to (iv) investing it in accordance with a defined investment policy for the benefit of those investors.[4] In its guidelines[5], ESMA also clarified that "an entity should not be considered an AIF unless all the elements included in the definition of AIF's under Article 4(1)(a) of the AIFMD[6] are present".

The first step in our analysis will be to determine whether all co-investment vehicles can be considered a "collective investment undertaking". Based on the ESMA Guidelines, "the following characteristics, if all of them are exhibited by an undertaking, should show that the undertaking is a collective investment undertaking (…). The characteristics are that:

(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 unitholders or shareholders of the undertaking – as a collective group – have no day-to-day discretion or control."

For those co-investment vehicles that qualify as "collective investment undertakings", we will explore if and when co-investment vehicles "raise capital".

2. ANALYSIS OF "CO-INVESTMENT VEHICLES" IN THE AIFM LAW CONTEXT

a. Co-investment vehicles set up as Joint Ventures ("JV")

Although Article 2(2) AIFM Law – which refers to the list of exempted entities – does not include JVs, Recital 8 of the AIFMD clearly states that it does not apply to JVs. The AIFMD does not, however, further clarify what is considered a JV. In this regard, the EU Commission's AIFMD Q&A states that the AIFMD does not define what a JV is, as the term is "commonly used to denote a number of contractual relations formed to carry out one project and generally define a business agreement in which parties agree to develop a new entity and new assets by contributing equity". Furthermore, the EU Commission indicates that JVs are characterized by parties that "exercise control over the enterprise and consequently share revenues, expenses and assets".

Guidance can also be found in the definition of a "collective investment undertaking". ESMA has clarified that in a collective investment undertaking, "the unitholders or shareholders of the undertaking – as a collective group – have no day-to-day discretion or control."

This leads to our conclusion that if a co-investment vehicle is set-up through which one or more investors co-invest(s) alongside the fund and are given some specific rights in that vehicle that go beyond "the ordinary

exercise of decision or control through voting at shareholder meetings on matters such as mergers or liquidation, the election of shareholder representatives, the appointment of directors or auditors or the approval of annual accounts"[7], the AIFM Law does not apply as such structure should not qualify as a collective investment undertaking.

Regarding the above, it is clear that each co-investor should have day-to-day discretion or control. Therefore, the number of co-investors participating should be limited to what is practically feasible to give each of them day-to-day discretion or control without compromising the effectiveness of the decision making process. That being said, in our opinion, it is not necessary that each and every decision be taken collectively. As is common in JV undertakings, it should be allowed to provide for certain qualitative and/or quantitative thresholds below which the JV management can act autonomously (i.e. "reserved matters"), as long as the co-investor rights easily exceed ordinary shareholders' rights.

When offering co-investment rights to investors in a vehicle structured as a Luxembourg partnership, investors will be reluctant to participate in the day-to-day discretion or control of the JV depending on how such discretion/control is structured. Indeed, the 1915 Law[8] warns that limited partners in a Luxembourg partnership, whether a special limited partnership or a common limited partnership, who participate in any act of management *with regard to third parties* risk exposing themselves to joint and several unlimited liability towards such third parties for any of the partnership's commitments in which the investor(s) participated. For this reason, most day-to-day discretion and control rights granted to such investors should be structured as *rights to be exercised internally i.e.* within the partnership and never vis-à-vis third parties. This is typically done when the limited partnership agreement contains for instance an annex dealing with "reserved matters". Through those reserved matters, co-investors ensure that the general partner of the partnership will request their pre-approval regarding day-to-day actions it would consider making and which would exceed the above-mentioned threshold.

Another element to consider is the absence of "capital raising". Even if not all parties in the co-investment vehicle have day-to-day discretion or control, the co-investment vehicle could still be classified as a non-AIF if no capital raising took place.

b. Co-investment opportunity only offered to one or more cornerstone investors

As mentioned previously, according to Article 1(39) AIFM Law, an AIF is any (i) collective investment undertaking which (ii) raises capital (iii) from a number of investors, with a view to (iv) investing it in accordance with a defined investment policy for the benefit of those investors.[9]

The "number of investors" and "defined investment policy" are criteria which are less determined than one may think. Without going beyond the scope of this article, it should be noted that the "number of investors" is interpreted so broadly by ESMA that, even if it has *de facto* only one investor, every undertaking "which is not prevented by its national law, the rules or instruments of incorporation, or any other provision or arrangement of binding legal effect, from raising capital from more than one investor should be regarded as an undertaking which raises capital from a "number of investors". Because ESMA interprets the factors that tend to indicate the existence of a defined investment policy "singly or cumulatively", any limitation or guidance that deviates from "full discretion to make investment decisions" is assimilated by ESMA to an investment policy. Therefore, for those co-investment vehicles that qualify as "collective investment undertakings", it will be of the utmost importance to understand if the co-investment vehicle raises capital in order to correctly assess if such "collective investment undertaking" is an AIF.

Based on the ESMA Guidelines, "raising capital" is defined as the "commercial activity of taking direct or indirect steps by an undertaking or a person or entity acting on its behalf (typically, the AIFM) to procure the transfer or commitment of capital by one or more investors to the undertaking for the purpose of investing it in accordance with a defined investment policy". Therefore, if parties come together through their own joint initiative, there is no external capital raising.[10]

When it comes to AIFs, a number of cornerstone investors will often be able to influence a number of commercial points to be reflected in the fund documentation. Depending on the ticket size, investors will commonly enter into side agreements (*i.e.* "side letters") with the manager providing for some specific terms. One of the most common requests made and embedded in a number of such side letters is for the investor to be informed when co-investment opportunities become available. If an investor spon-

taneously requests to be informed of co-investment opportunities, expressing therewith its desire to participate in specific types of co-investment opportunities, it appears that – and depending on the exact circumstances – given the absence of any commercial activity consisting of taking direct or indirect steps to procure the transfer or commitment of capital to the undertaking, it may be successfully argued in a number of cases that no capital raising for the co-investment vehicle took place. The absence of capital raising should lead to the conclusion that the co-investment vehicle does not qualify as an AIF, even if it would qualify as a collective investment undertaking.

c. All participants in the co-investment vehicle are also investors in the fund

When a co-investment vehicle welcomes not only some fund cornerstone investors who explicitly requested to participate in the co-investment vehicle, but also some other fund investors, the question of capital raising, at the level of the co-investment vehicle, becomes more difficult. As the group of investors in the co-investment vehicle is enlarged to include other fund investors, the question arises whether it would be possible to rely on the "pre-existing" group exemption.

ESMA has specified that the pre-existing group is a "group of family members, irrespective of the type of legal structure that may be put in place by them to invest in an undertaking and provided that the sole ultimate beneficiaries of such legal structure are family members, where the existence of the group pre-dates the establishment of the undertaking". The concept of the "pre-existing group" coincides with recital 7 of the AIFMD, which states that "investment undertakings, such as family office vehicles which invest the private wealth of investors without raising external capital, should not be considered to be AIFs in accordance with (the AIFMD)". Can the "pre-existing" group exemption be interpreted more broadly to also include "investment set-ups of unchanged investor groups or legal persons not bound by a family or intimate relationship"[11]? We have to agree with T. Schell in this regard, when he points out that such broader interpretation including an "unchanged investor group" is a popular misconception, not supported by ESMA's interpretation of the concept of pre-existing group.[12]

Even if co-investment opportunities are offered to a limited group, exclusively composed of investors in the fund, such activity could be seen as capital raising and lead to the qualification of the co-investment vehicle as an AIF.

d. Club Deal vehicles

Another variation of co-investments are the so-called "club deals". Even though club deals typically refer to specific predefined or single investments that involve very few and selected investors and is therefore agnostic to the type of asset, the European Commission took a sectoral view of the term when it is said that club deals refer to leveraged buyouts ("**LBO**") or other private equity investments that involve investor groups of private equity managers that pool their assets together and acquire non-listed companies collectively.[13]

Neither the AIFMD nor the AIFM Law contain a definition of "club deals" or "club deal vehicles". This being said – and in a private equity context only – Article 24(1) (b) AIFM Law refers to managers that cooperate with one or more other managers on the basis of an agreement pursuant to which the funds managed by those managers jointly acquire control of a non-listed company. This strategy is pursued as it allows private equity managers to purchase larger and more expensive companies than each manager could acquire (or would want to acquire because of a too high concentration risk) through its own fund. By syndicating the equity ownership across a group of managers (through a club deal vehicle), each fund reduces its concentration and is able to maintain the diversification of its portfolio of investments. Another benefit of a club deal is the sharing of transaction costs and costs of buy-side due diligence. Unlike JVs, club deals do not provide all investors with control over the management of the assets.[14] The question is whether the club deal vehicle established for this purpose creates a new AIF subject to the AIFM Law alongside the funds that invest in it.

Identical to JVs, neither the AIFMD, the AIFM Law, the European Commission's AIFMD Q&A nor the ESMA Guidelines specify any set and objective criteria describing whether club deal vehicles are to be seen as mere JV vehicles or as AIFs for the purpose of the AIFM Law.

Absent specific guidance, we should rely on the composing elements of what ESMA considers to be an AIF.

The club deal vehicles structured in this context will typically not be seen as AIFs because they are merely acquisition vehicles jointly established by the managers as an administrative convenience, to facilitate a specific transaction to be carried out by them. Those vehicles do not raise capital from investors. Rather, they are merely a means of investing capital already raised by the managers of the various funds. The FCA[15] takes the position that it is consistent with the policy of the AIFMD to allow several funds to jointly acquire control of a non-listed company without that acquisition resulting in all the AIFs being considered a single AIF and AIF investors will still have the protection given by those national laws which have implemented the AIFMD.[16]

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Other club deals, *i.e.* those that are not set-up by a couple of managers in view of jointly investing in a common asset, will not qualify as a "collective investment undertaking" if all unitholders or shareholders of the undertaking – as a collective group – have day-to-day discretion or control over the club deal vehicle. The degree of continued day-to-day control over the management and strategic decisions over the activities, such as key strategic financial, operating and planning decisions for the future, is one of the criteria that should be taken into account when considering whether a club deal vehicle qualifies as an AIF. The key consideration for firms structuring a club deal vehicle in this context is whether or not to allow all investors to participate in day-to-day management. Based on the ESMA Guidelines, each participating investor will need to hold part of the decision power over the operational matters of the club deal vehicle, which extends substantially further than the powers ordinarily conferred to shareholders or limited partners, in order for the club deal vehicle to be considered as an AIF.

3. EMPLOYEE PARTICIPATION SCHEMES

Some managers allow their employees and their close family members to invest in the fund managed by the manager on preferential terms, in a so called "friends and family vehicle" or "employee participation scheme" ("**EPS**").

EPS are exempt under Article 2(2)(f) of the AIFML Law. Nevertheless, no clear definition of EPS is available under the AIFM Law. The European Commission in its AIFMD Q&A is of the view that there is such a large variety of these schemes in EU Member States that each scheme has to be assessed on its own merits in order to conclude whether or not it satisfies the elements of the definition of an AIF under the AIFMD. [17]

For example, within the context of EPS, the FCA confirmed that the term "employee" is not limited to an employee within the labour law meaning of the term. In the view of the FCA, the term "employee" includes individuals who contribute to the business of the undertaking concerned, by consecrating their skills and time. The FCA includes within this group partners, directors, consultants, former employees, spouses/close relatives, and trustees of an employee's family trust. The rationale for this is that EPS are established to motivate employees involved in the management of one or more companies to give their best in the framework of their professional activity.

In the experience of the authors, when interpreting the term "employee", the CSSF would probably not go as far as the FCA, although the term "employee" should not be limited to its strict labour law concept (but also include partners, directors, and consultants and spouses of such persons).

EPS generally do not meet all elements of the AIF definition as the cash being contributed by employees into an EPS does not constitute "capital raising" within the meaning of the AIFM Law, since there is no *external* capital raised. Indeed, capital is invested into such EPS "by" employees and managed "for themselves".[18]

4. CONCLUSION

This contribution has shown that many types of "co-investment vehicles" could fall within the scope of the AIFM Law framework. For structuring reasons, it will need to be assessed prior to setting up a structure whether the planned "co-investment vehicle" is intended to fall within the scope of the AIFM Law or not.

For this purpose, the most relevant criteria to be assessed in practice are (a) whether investors in the co-investment vehicle have day-to-day management or control over the vehicle, (b) the vehicle raises external capital from a number of investors and (c) the identity of the investors in the co-investment vehicle (are they employees or close family of the manager?).

Neither the European Commission, ESMA nor the CSSF have directly addressed the topic of co-investments vehicles. Although in most co-investments structures it is sufficient to rely on the correct interpretation of the AIF definition and its known exemptions, it cannot be excluded that a strict interpretation of the AIFM Law/AIFMD would lead to undesired consequences.

Notes

1 "AIFM Law" means the law of 12 July 2013 relating to alternative investment fund managers, as amended.

2 A. Hasekon, *Co-Investments & AIFMD: Is Your Co-Investment Vehicle Regulated?*, 31 March, 2013, https://privateequity.weil.com/insights/co-investments-aifmd-co-investment-vehicle-regulated/ (accessed 19 June 2019).

3 European Securities Market Authority ("ESMA").

4 T. Alabaster & G. Faleiro, *If it "looks" like a fund, if it "sounds" like a fund... - An Analysis of the Definition of an AIF, Exemptions and Consequences in the Non-Traditional Alternative Investment Space*, JurisNews – Investment Management, Vol. 2 - N° 4/2014.

5 ESMA, *Guidelines on key concepts of the AIFMD*, 13 August 2013, ESMA/2013/611, https://www.esma.europa.eu/system/files_force/library/2015/11/2013-611_guidelines_on_key_concepts_of_the_aifmd_-_en.pdf ("ESMA Guidelines") (accessed 19 June 2019).

6 Alternative Investment Fund Managers Directive (Directive 2011/61/EU).

7 *Ibid*.

8 Law of 10 August 1915 on commercial companies, as amended from time to time.

9 T. Alabaster & G. Faleiro, *If it "looks" like a fund, if it "sounds" like a fund... - An Analysis of the Definition of an AIF, Exemptions and Consequences in the Non-Traditional Alternative Investment Space*, JurisNews – Investment Management, Vol. 2 - N° 4/2014.

10 T. Partsch, *Perspective on the Guidelines on key concepts of the AIFMD*, JurisNews – Investment Management, Vol. 1- N° 3/2013.

11 T. Schell, *To be AIF(M) or non-AIF(M) – that is the question*, JurisNews – Investment Management, Vol. 3 - N° 3/2015.

12 *Ibid*.

13 European Commission, *supra* note 9.

14 *Ibid*.

15 Financial Conduct Authority ("**FCA**")

16 FCA Guidelines, question 2.54.

17 European Commission, AIFMD Q&A, https://ec.europa.eu/info/sites/info/files/aifmd-commission-questions-answers_en.pdf (accessed 19 June 2019).

18 FCA Guidelines, question 2.34.

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