

Fund Finance Friday



De-mystifying Luxembourg Fund Structures

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The role of the various management/administrative players in a Luxembourg fund structure has become increasingly complicated, so this week *Fund Finance Friday* took the opportunity to talk with Antoine Fortier Grethen, head of fund finance and partner at SJL Jimenez Lunz, about these roles, how they are relevant to a fund finance transaction and why they may sometimes be overlooked or misunderstood. **Antoine** is a very experienced fund finance lawyer and also lectures in contract law, business law and finance transactions at the University of Lorraine, so we are very grateful to him for taking the time for this very enlightening discussion.



FFF: Thank you for speaking to us today, Antoine. We asked you to join us here at *Fund Finance Friday* as we thought it would be helpful to set out an overview of the different management/administrative roles in a Luxembourg fund and to piece together how they can impact a fund finance transaction. Perhaps if we start at the beginning, what are the three main roles, why have they been created and what needs to be considered as part of the due diligence for a fund finance transaction?

Antoine: First of all, many thanks for providing me with the opportunity to contribute to *Fund Finance Friday* on this topic!

The complexity of the numerous fund regulations in Luxembourg has indeed led to a co-existence of various different management and administration functions (in a broad sense) for a Luxembourg fund. You will find that most standard structures nowadays have (i) a corporate management body (commonly the general partner), (ii) an alternative investment fund manager or AIFM (in charge of portfolio management and risk management, with full authority in respect of those matters), and (iii) an administrator (whose purpose is mainly running administrative tasks such as bookkeeping). Alongside these entities, a depositary is in charge of the safekeeping of assets of the fund and cash flow monitoring and may also have other duties.

The main question when we look at the relationship between these entities for a financing is what power and authority each of these entities has in the structure – in particular, in respect of the “hot” topics for subscription line lenders: who decides on borrowings, who may grant pledges, who has authority and control in respect of assets and who makes capital calls. The NAV calculation question may also be relevant, notably depending on the financial covenants in the facility agreement or any NAV requirement in connection with the investors’ contributions.

Nothing should be assumed and sometimes terminology can be troublesome. One cannot assume the functions a role actually entails based solely on the title or supposed role of the entity performing that role. An analysis of the authorisations of, and delegations to, the entities involved is a must. For instance, “manager” is often used in fund documentation to designate either or both of the civil law expression *gérant* (such as a general partner managing the

fund) or the alternative investment fund manager (who, as mentioned, looks after portfolio and risk management). I always keep in mind the old saying, "Never judge a book by its cover," when it comes to the review of fund documents!

FFF: In terms of due diligence requests, what documents or information do lenders need to be requesting from the fund in order to work out what specific functions and powers each of these entities has in a fund?

Antoine: Any agreement that documents an arrangement between the fund and these entities should be provided as part of the due diligence package: essentially, the constitutional document of the fund, the (alternative investment fund) management agreement, the investment management agreement (if there is a separate agreement to the AIFM agreement), the depositary (or custodian) agreement and the administration (or service) agreement, although the exact titles may vary. These documents when taken together should provide a good picture and understanding of the various functions and authorisations of these entities.

FFF: If we take each of the roles in turn, starting with the AIFM – what functions and/or powers does the GP generally delegate to the AIFM?

Antoine: The AIFM is really the main piece of the puzzle. At a minimum, the General Partner delegates to the AIFM the functions related to portfolio and risk management, as per the AIFMD requirements.

However, this does not preclude delegation of any other authorities. In particular, the AIFM may be granted a power to issue drawdown notices or to enter on behalf of the fund into borrowing or hedging arrangements, either on an exclusive basis or alongside the General Partner. This makes sense where the AIFM is tasked with leading investments and therefore deciding whether to borrow for leverage purposes or to hedge investment(s). But often this gives rise to the question of whether the delegation of the power to enter into borrowing arrangements on behalf of the fund includes subscription lines or similar products which are not necessarily directly or exclusively related to investment leverage.

In addition to the above, in some structures the AIFM is also appointed as manager (*gérant*) of the fund. Where this is the case, the General Partner would not generally be vested with any authority to manage the fund. The AIFM will have two caps: it will act as both manager and alternative investment fund manager of the fund and, therefore, the AIFM will generally need to take on the role of the General Partner in subscription line financing documentation.

Where the AIFM is a third-party service provider, it is most likely that the minimum functions required by law are delegated by the General Partner to the AIFM. I would not expect such an AIFM to be authorised to send drawdown notices or to make any decision in relation to borrowings or security interests on its own where this is the case (although it may sometimes do so with the prior approval of the General Partner). The fund sponsor would prefer to control all decisions and retain all these authorities with its own management entity, *i.e.*, the General Partner.

For ease of coordination and management, feeders and parallel funds will usually follow the same allocation of authorities between the General Partner and the AIFM.

The last point to mention is that the agreements appointing the AIFM can often be drafted to contain catch-all provisions (e.g., a list of investment powers followed by a power to approve/execute all documents to facilitate such investments). Where this is the case, it is harder to say that there hasn't been some form of delegation to the AIFM that may undermine the subscription line security package, albeit unintentional, and here at a minimum the AIFM should confirm that it is neither entitled to issue capital call notices nor required to enter into or approve any borrowings or security.

FFF: Turning then to the depositary, we are also increasingly seeing notifications to the depositary as a CP. Can you talk us through what the depositary does and why a notification of the financing is needed?

Antoine: The appointment of a depositary is required in structures where assets under management exceed a statutory value threshold or where the form of fund is a RAIF. Structures that don't meet these requirements may also include a depositary, though this is optional.

Given that the duties of the depositary include the safekeeping of the fund's assets and the monitoring of cash flows, the depositary agreement may require that the depositary be informed, in one way or another, of any transaction in connection with the fund's assets and cash flows. The detail of such information requirements and methods for delivery vary from one depositary to another, depending on its internal risk policy and may well cover any pledge or security interests over assets, such as security interests over cash or accounts – which is typical of a subscription line

financing. Although less frequent, some financial institutions that act as depositary have extended the requirement to provide notification/information to a requirement to obtain prior consent.

On top of that, the depositary will almost certainly have a pledge over the assets under its custody. Such a pledge is customary practice for account banks in Luxembourg. Most of their terms and conditions provide for a right of pledge over any assets standing to the credit of accounts opened with them. In a similar way, depositary arrangements include a pledge in favour of the depositary to secure all obligations of the fund toward the depositary (such as maintenance and operation fees, costs, but also payment obligation resulting from a settlement relating to transfer(s) of financial securities executed through the depositary). A waiver of such pledge (by way of acceptance letter signed by the depositary) is necessary if the same assets are pledged in favour of the fund's creditors, depending on the security package.

FFF: And last but not least, the administrator. Can you tell us a little about the administrator's role in the fund and what lenders and their counsel need to be aware of when looking at the administrator appointment documentation?

Antoine: The administrator has a "support" role to the other entities discussed above – in particular, the corporate management body and the AIFM. Its function is mainly to provide administrative services to the fund, without having authority to make corporate decisions. Rather, it implements the decisions made by the other entities. For example, it may be that the General Partner decides to call capital from the investors, and signs the drawdown notice, while the administrator simply posts the signed drawdown notices to the investors.

Its impact on fund finance transaction is less obvious, given its remote function. That being said, we have seen examples where administrators are in charge of dispatching drawdown notices to investors and calculating the NAV or preparing information (such as the ILPA schedules) to be provided with drawdown notices. In these cases, their involvement might be of interest, should drawdown require a NAV calculation or delivery of such information and lenders may consider having a side letter with them to ensure their cooperation for the purpose of a drawdown notice issued on enforcement.

FFF: Would you have one piece of advice for the review of these AIFM, depositary or administration arrangement?

Antoine: As you may see from my previous answers, the delegation scheme is highly tailor-made. Accordingly, the devil is in the detail when it comes to analysing the governance structure. Reviewing these arrangements is not an easy task and a bit of understanding of how the fund operates surely helps.

FFF: With the above in mind, are you seeing any changes in the market to these roles that we may start seeing which could impact fund finance transactions?

Antoine: Yes. Fund managers are more and more careful about the terms of their service arrangements and tend to limit rights and duties of the depositary, administrator and AIFM service providers in respect of borrowings or pledges to the bare minimum required to fulfill their legal duties. Financial institutions and service providers are also aware that the terms of their standard arrangements may go beyond what it is really needed and are keen to accommodate the fund requests in most cases. The assistance of fund finance lawyers will certainly help to find the right balance! Hopefully, there will be fewer tense situations in the near future.

It might also be that funds start to anticipate the impact of the proposal for an AIFM Directive II, submitted by the European Commission, in their arrangements. Delegation arrangements are under scrutiny, and we may see new trends arising to follow the development of this proposal.

FFF: Finally, as it is January, it would be remiss to be talking with someone at the heart of fund finance in Luxembourg and not ask him his predictions for the market in 2022. What do you think the year ahead will bring?

Antoine: Although I do not expect major changes in structuring in the next months, the market will continue its growth, with new funds being launched, maybe even at an accelerated rate. That should keep our sector busy for 2022!