

Direct Lending in Europe: Recent Developments

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.

This memorandum provides an overview of the new framework applicable to lending activities carried out by AIFs in Italy, France and Germany.

A. 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

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:

1. That they are authorized by their home country authority to invest in receivables.⁵

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*.

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

2. 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.
3. 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.
4. 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.

B. 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 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.

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

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

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 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.

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.

Finally, we also note that 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.

C. Lending in Germany

On May 12, 2015, the German securities regulator, the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, “BaFin”), released a new guidance in which it indicated to change its administrative practice with respect to the regulatory treatment of lending activities of German AIFMs.⁸ In this guidance, BaFin explained that, in the future, 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 new BaFin guidance and, on February 5, 2016, adopted a bill 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”).⁹ 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 funds¹⁰ or the ELTIF Regulation; or

⁸ Änderung der Verwaltungspraxis zur Vergabe von Darlehen usw. für Rechnung des Investmentvermögens, 23 May 2015 (WA 41-Wp 2100 - 2015/0001).

⁹ The main purpose of the UCITS V Implementation Act is the transposition of Directive 2014/91/EU of 23 July 2014 into national law.

¹⁰ Regulation (EU) 345/2013 of 17 April 2013 on European venture capital funds.

- subject to the rules on the organization, function, and permitted activities of the relevant type of AIF¹¹ as well as additional limitations and requirements set forth in the German Capital Investment Act. These include, *inter alia*:
 - specifications regarding the type of borrower (loans may not be extended to consumers);
 - limitations regarding leverage (AIFs may only borrow up to 30% of their aggregate available capital including undrawn commitments); and
 - requirements regarding diversification (one single loan may only amount to up to 20% 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 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 pursuant to Sec. 330 KAGB (Art. 42 AIFMD) ("PPR") 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.

It remains to be seen whether or to what extent foreign AIFs and AIFMs will actually benefit from the new legal regime. Further, in view of the statutory requirements applicable to German AIFs and AIFMs (see above) and *prima facie* inapplicable to EU

¹¹ 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.

and foreign AIFs and AIFMs, it remains to be seen whether or to what extent BaFin, in the future, will exercise its regulatory and supervisory powers in relation to the latter.

The entry into force of the UCITS V Implementation Act is expected in due course.

D. Outlook

In its Action Plan on Building a Capital Markets Union dated September 30, 2015,¹² the European Commission acknowledged 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 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.”*¹³ The legal regimes described above might, thus, soon be subject to further changes.

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If you have any questions concerning this memorandum, please feel free to contact [Carlo de Vito Piscicelli](#) or [Fabio Saccone](#) in our Milan office (+39 02 72 60 81), [Amélie Champsaur](#) or [Robin Barriere](#) in our Paris office (+33 1 40 74 68 00), [Manuel Metzner](#) or [Dr. Valentin Pfisterer](#) in our Frankfurt office (+49 69 97103 0), or any of your regular contacts at the firm.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

¹² European Commission, Action Plan on Building a Capital Markets Union, 30 September 2015 (COM(2015) 468 final).

¹³ *Ibid.*, p. 10-11.

Office Locations

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS

12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW

Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE

Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME

Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN

Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG

Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road, Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING

Cleary Gottlieb Steen & Hamilton LLP
45th Floor, Fortune Financial Center
5 Dong San Huan Zhong Lu
Chaoyang District
Beijing 100020, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES

CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO

Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI

Al Sila Tower, 27th Floor
Abu Dhabi Global Market Square
Al Maryah Island, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL

Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T: +82 2 6353 8000
F: +82 2 6353 8099