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Joint Ventures: Potential Regulation under the AIFM Directive

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Certain joint venture (JV) arrangements may potentially be subject to onerous and costly regulation under the Alternative Investment Fund Managers (AIFM) Directive (2011/61/ EU) (the Directive), which came into effect for existing AIFM on 22 July 2014. The Directive's framework gives rise to a major change, particularly for the real estate funds industry which, to date, has been regulated relatively lightly (see box "Background to the Directive").

IMPACT FOR JVS

Where an assumed JV is actually an alternative investment fund (AIF), there will be serious repercussions since managing an AIF is a regulated activity under UK law (article 51ZC, Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544)).

Managing an AIF in the UK without authorisation (or exemption) is a criminal offence, which carries a maximum sentence of two years' imprisonment and an unlimited fine.

The Directive regulates all AIFs and their managers, subject to certain exceptions. The definition of an AIF is cast widely. Some JVs can be expected to come within the regulation of the Directive, but others that may not naturally be considered as AIFs may be regulated if care is not taken when structuring and documenting them.

If a JV is inadvertently caught by the Directive, the legal person who is managing it (which may be the JV vehicle itself) will need to become authorised as an AIFM by the Financial Conduct Authority (FCA) and operate in accordance with the rules implementing the Directive in the UK, including Commission Delegated Regulation 231/2013/EU, the AIFM Regulations 2013 (SI 2013/1773) and the FCA Handbook (primarily the Investment Funds sourcebook, the Conduct of Business sourcebook and the Perimeter Guidance manual (PERG)).

Background to the Directive

The AIFM Directive was intended to introduce a harmonised regulatory framework across the EU for AIFMs. In particular, the Directive requires EU AIFMs to be authorised or, if sub-threshold, registered, and contains provisions about how AIFMs should conduct their business and market alternative investment funds. It is mostly a maximum harmonisation directive, but EU member states are allowed derogations in certain areas; for example, in relation to marketing to retail investors.

In order to fall outside the scope of the Directive, it must be established that the arrangement is not within the Directive's definition of an AIF. If an undertaking comes within the definition of an AIF, it will be regulated as an AIF, even if it is referred to as, and intended to be, a JV.

Whether or not a JV is an AIF may not be clear. There is no express exemption for JVs in the Directive and we rely upon one recital within it which expressly states that JVs are not intended to be subject to the Directive. Furthermore, JVs are not defined in the Directive (nor by any other EU legislation) and, therefore, it is necessary to analyse the definition of an AIF (see box "What is an alternative investment fund?") to determine whether an arrangement falls within it.

To the extent that an arrangement fails to satisfy any single part of the definition of an AIF, it will not be classified as an AIF, and the rules implementing the Directive will not be applicable to the arrangement. It will, therefore, be a matter of assessing in each case whether the arrangement meets each individual component of the definition.

PURPOSE. One of the most straightforward examples where a JV falls outside the definition of an AIF is where the arrangement has a commercial or industrial, rather than an investment, purpose. This type of arrangement would also have a policy that is focused on the achievement of the parties' commercial goals, rather than a defined investment policy.

Often, a JV is set up with a passive investor providing capital and an active participant providing expertise to manage the business. This is often the case, for example, in public-private partnerships running particular property development projects. This type of venture would often have a commercial or industrial purpose (and be jointly controlled (see below)) and would not, therefore, be an AIF.

Even a JV arrangement that has an investment (rather than a commercial) purpose can still be deemed to fall outside the definition of an AIF, primarily because the parties have day-to-day control or discretion, or because the JV does not raise capital from a number of investors.

CONTROL. Unlike AIF investors, JV participants often have day-to-day control over the underlying assets (which would take the relevant JV outside the scope of the AIF definition). European Securities and Markets Association (ESMA) and FCA guidance clarifies that, in order to fall within the AIF definition, investors should not have day-to- day control over strategic management issues that go over and above ordinary shareholder matters that are prescribed by the law (the guidance) (chapter 16, PERG and Guidelines on key concepts of the AIFMD (ESMA guidelines) (ESMA/2013/600); www.practicallaw.com/0- 532-4141).

This means that, to avoid being caught within the definition, there must be continuous control (whether exercised or not) over not just, for example, the appointment of directors or pre-emption rights, but also over decisions relating to the daily management of the JV's assets.

EXTERNAL CAPITAL. A JV will also fall outside the AIF definition if it does not raise external capital. According to the guidance, there is no external capital if the persons providing and investing the capital are the same, which is often the case for JVs. The FCA also refers to family investment vehicles as an example of a vehicle that typically does not raise external capital and, therefore, would not be within the scope of the definition of an AIF.

The structure of a particular project may provide that the person investing the capital of the arrangement (for example, the manager on behalf of the arrangement) is a separate legal entity from the parties providing the capital (that is, the investors). This is often the case in limited partnership structures. However, if a particular structure is set up after all the investors have come together on their joint initiative, and after all the investors have identified the underlying investments, there is not deemed to be any external capital raising.

You should note that, even where a JV arrangement initially falls outside the scope of the Directive, it may subsequently become an AIF if it is marketed to external investors or if the documentation constituting the JV allows for further interests in the JV to be issued to new investors.

WHAT DO BUSINESSES NEED TO DO?

Businesses will need to review the structures of their JVs in light of the Directive and the guidance. They will need to structure and document their JVs carefully to ensure that they do not inadvertently become regulated by the Directive. Certain JVs are clearly likely to fall outside the definition of an AIF; for example, JVs formed as commercial ventures (rather than for investment purposes). However, other JV arrangements, particularly those with passive investors and external managers, are likely to be more difficult to categorise.

What is an alternative investment fund?

"AIF" is a widely defined term in the Directive and covers funds that are not regulated by the UCITS Directive (2009/65/EC), as amended. AIFs can take any legal form (including solely contractual relationships), invest in any asset classes, and can be either private or public, listed or unlisted, EEA domiciled, or domiciled outside the EEA.

An AIF:

- Is a collective investment undertaking; that is:
  - the undertaking does not have a general commercial or ordinary industrial purpose;
  - it pools together capital raised from its investors for the purpose of investment with a view to generating a pooled return from those investments; and
  - the unitholders of the undertaking, as a collective group, have no day-to-day discretion or control
- Raises capital from a number of investors; and
- Aims to invest that capital in accordance with a defined investment policy for the benefit of those investors.

This briefing is based on an article written by Nora Bullock, professional support lawyer in the Investment Funds Team of Hogan Lovells International LLP which was first published in PLC Magazine in December 2014.

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