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From Russia With Lux: Why Russian Private Equity Fund Sponsors Are Choosing Luxembourg

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In recent years, offshore locations such as the Cayman Islands, British Virgin Islands, Isle of Man, Guernsey and Jersey have been among the most popular jurisdictions for private equity funds investing in Russia. These jurisdictions have been favoured above others in part because their fund structures are generally unregulated or lightly supervised. However, times are changing.

As a consequence of the financial crisis and other extraordinary events such as the Madoff Ponzi scheme scandal, the European Union will soon subject private equity funds and their managers to tighter regulatory control through the enactment of the Alternative Investment Fund Managers (AIFM) Directive. While this new law will affect all fund managers operating or fundraising in Europe, managers in offshore fund jurisdictions, such as the Cayman Islands, will likely face even greater challenges in meeting the EU's increasingly stringent regulatory requirements. Accordingly, many sponsors of Russia-focused private equity funds are beginning to think twice about whether the benefits of registering outside the EU outweigh the costs.

In this article, we will provide a short overview of the impact of the AIFM Directive on Russia-focused private equity funds planning to approach European investors, and look at ways to minimise potential fundraising obstacles by using lightly regulated onshore European fund destinations, such as Luxembourg.

The impact of the AIFM Directive

The AIFM Directive applies to fund managers who manage at least one alternative investment fund irrespective of whether the fund is domiciled inside or outside the EU. The scope of application is very broad and is intended to cover all possible investment schemes, e.g., private equity, venture capital, hedge or debt funds of the open- or close-ended type, which are not yet regulated on an EU level. Those already subject to the strictly regulated UCITS regime are, in principle, excluded from the new Directive. The AIFM Directive will thus cover, and therefore its restrictions will apply to, all offshore funds and their fund managers if they intend to market (whether by private placement or public offering) or manage funds in the EU.

The AIFM Directive has already been voted in and will be implemented in all EU Member States by 2013. Subject to the final decision on the implementing measures, the following consequences are likely to apply. First, as from 2013, EU Member States may allow the marketing of offshore funds on their territory under the private placement regime only if the offshore fund complies with the transparency requirements of the AIFM Directive and if a cooperation agreement between the respective EU State and the offshore destination is in place. Currently, no such cooperation agreements are in place and it is not yet foreseeable which offshore destinations or Member States are willing to conclude such agreements.

Second, offshore fund managers will, subject to the recommendations of the European regulator, ESMA, and the EU Commission, which are still outstanding: (i) be allowed to apply for a passport under the AIFM Directive and consequently be allowed to market offshore funds in Europe (in which case they will become regulated in Europe and have to fully comply with the AIFM regulations); or (ii) not be allowed to approach investors in Europe at all.

In the most severe scenario, offshore funds and their managers will be completely prevented from fundraising in Europe. In a more likely scenario, an offshore fund will be able to apply for, and subsequently receive, a passport, under the AIFM Directive, but only if it complies with the AIFM regulatory provisions on, among other things: capital requirements; conduct of business; remuneration policy; risk and liquidity management; leverage limits; depository, valuation and transparency requirements; as well as on delegation of functions by the fund. Finally, the right to market under the local private placement regimes currently existing in some European jurisdictions may become impractical or impossible due to the necessity of a cooperation agreement.

Given these requirements and the associated uncertainties of the AIFM Directive, and the fact that since the crisis an increasing number of investors are now demanding 'supervised' funds, fund sponsors and initiators are taking a harder look at flexibly regulated onshore European fund destinations, like Luxembourg.

Why Luxembourg?

For a start, Luxembourg-based investment funds are exempt from all direct taxes, including corporate income, wealth and withholding tax. Additionally, the provision of management services to the fund by the general partner or an investment manager is not subject to VAT. Furthermore, any payments made by a Luxembourg investment fund to investors abroad are not subject to withholding tax.

Tax optimisation on the level of the portfolio companies, which are typi-

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cally located in Cyprus, Russia, the Netherlands or Luxembourg, can be achieved by the application of Luxembourg's solid tax treaty network and by efficiently structuring cash flows as fees, dividends or capital gains, in each case as necessary to maximise the benefits under the respective treaty.

Outbound payments from Luxembourg to Russia, i.e., distributions to investors, payments of management fees and the fees of the Russian investment adviser, are not only tax exempt in Luxembourg but may also be structured in a very tax efficient way in Russia by benefitting from the low Russian dividend taxation rate (9 percent) and the Russian participation exemption, as a result of which dividend taxation can be reduced to zero subject to certain conditions. The investment through a Cyprus entity and the use of hybrid instruments (PECs, CPECs, TPECs) is another way to optimise the taxation of these cash flows.

Luxembourg funds are furthermore very flexible in terms of structuring and allow the issue of different classes of shares for different investors.

The rights attached to such shares could be different so that holders of a specific class of shares could benefit from preferred returns. Furthermore, through the issue of classes of shares accumulating profits, it is possible to characterise dividend payments as capital gains payments, which can be advantageous in some portfolio company jurisdictions.

Luxembourg funds benefit from a very flexible legal and regulatory environment which makes Luxembourg the second most popular investment fund centre worldwide (behind the US, with a mostly domestic market) and the largest European hub for setting up private equity and venture capital funds.

Currently Luxembourg investment funds have just under €2.1 trillion in assets under management, which continue to grow from new issues at a rate of approximately €10bn per month.

Typical Luxembourg private equity fund structure

Two investment vehicles, both introduced in the past 10 years, have proved very successful: the specialised investment fund (SIF) and the investment company in risk capital (SICAR). Currently, over 13,000 funds are structured as one of these two types of vehicles.

SIFs and SICARs both offer great flexibility with regard to investment policy. The SIF has no limitations at all in terms of eligible investments and has to respect only a very basic level of diversification of assets. The SICAR must invest in risk capital of some kind but even a single target investment would be sufficient.

The lack of a promoter policy for these two vehicles makes them particularly attractive to new promoters lacking a 'track record' for launching a fund. Both structures can be set up for a single investor.

An investor, whether institutional, professional or private, is allowed to invest in a SIF or SICAR with a minimum of €125,000 or equivalent currency. This amount may be lower if a financial institution confirms the eligibility of the investor or if the investor invests through his own investment manager.

Since Russian private equity funds frequently rely on the services of a Russian investment adviser, it is worth noting that the adviser will not be subject to approval by the Luxembourg regulator and need not be a supervised entity.

SIFs and SICARs can be organised as limited partnerships or partnerships limited by shares. Similar to many offshore funds, SIFs and SICARs are typically organised as limited partnerships or partnerships limited by shares, thereby providing investors with limited liability. They have a flexible capital structure (e.g., can be structured with a variable capital which changes automatically with the net asset value without a further registration requirement) and generally can be formed quickly -- often in as little as six weeks.

Moreover, from a governance perspective, a SIF or SICAR organised as a partnership has the advantage of vesting the authority to manage the fund in the hands of a general partner controlled by the sponsor of the fund, while the investors participate passively in the fund as limited partners and have no rights to participate in management.

When a partnership structure is used, it is usual for the sponsor to form a new limited liability company to serve as the general partner of the fund since a general partner has unlimited liability under the laws of Luxembourg. The general partner must be incorporated in Luxembourg. A Russian company or a foreign company with a branch office located in Russia will also normally be included in the fund structure to act as local investment adviser, as mentioned above.

An intermediate holding company is generally established for tax reasons. The SIF or SICAR is also likely to need an intermediate holding company. As Russian sourced income received by a foreign entity, other than through a permanent establishment in Russia, may be subject to a withholding tax (in the absence of a tax treaty relieving this burden), fund investments are often made through Cyprus, Luxembourg or Dutch holding companies which can take advantage of double-taxation treaties that exist with Russia.

Fund management and advisory bodies

The general partner is ultimately responsible for the management of the fund. In a SIF or SICAR formed as a partnership, the general partner will have authority over the day-to-day management of the fund, including identifying, evaluating and negotiating prospective investments, monitoring these investments on behalf of the SIF or SICAR and exiting investments to achieve liquidity. In return for these services, the general partner is paid an annual management fee, which is expected to cover its salaries and operating costs. Management fees in Russia-focused private equity funds generally range from 2 to 2.5 percent of capital commitments. In addition, the general partner receives a carried interest as remuneration for its efforts. Typically, the carried interest is 20 percent of the profits of the fund, but this may vary depending on the agreement of the parties.

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Portfolio management and advisory boards. Most SIFs or SICARs represented by their general partners retain a manager and/or a local investment adviser to provide portfolio management and administrative services to the fund. The manager is usually an affiliate of the fund's sponsor but may be part of an established fund management group. The manager will enter into a management agreement setting forth its responsibilities, its authority (and limits on authority) and remuneration. A separate agreement will be entered into with the local adviser. Advisory boards may be created at the initiative of the general partner as well as investment committees at the insistence of major investors.

Money matters

Capital commitments are drawn down as needed to fund investments. Limited partners make commitments to contribute capital to the SICAR and SIF in specified maximum amounts when they subscribe for interests in the fund.

Limited partners are not generally required to contribute all of their capital commitments at the time of their initial subscription. Instead, the general partner draws down capital commitments as needed to fund investments, commonly on 10 to 20 days' notice. The subscription agreement and the articles of association of the SICAR or SIF typically stipulate serious consequences in the event a limited partner fails to make a capital contribution when requested, including forced sale or redemption of the defaulting limited partner's interest.

Fund profits are divided 80-20, subject to a preferred return to the investors. Profits generated by a private equity fund are generally divided according to a formula which provides the general partner with a 20 percent carried interest on realised gains distributed to the limited partners, subject to repayment of the limited partners' capital contributions and a stipulated interest component or 'preferred return' (typically around 8 percent).

To balance the general partner's desire to receive distributions of profits as investments are exited, with the limited partners' objectives of assuring that not more than the agreed carried interest percentage finds its way into the general partner's pocket, the carried interest is often subject to a 'clawback' – an obligation imposed upon the general partner to restore to the fund any carried interest distributions in the event that later exits result in a lower total return to the limited partners.

Legal and regulatory compliance

Supervision of Luxembourg funds. SIF vehicles are regulated by the Commission de Surveillance du Secteur Financier (CSSF) but enjoy a very flexible supervisory regime. The CSSF must approve, in particular, the private placement memorandum or other offering document of the SIF or SICAR. However, the CSSF insists on only a few minimum requirements in terms of the content of these documents.

In addition, the articles of association or fund regulations, as well as all major contractual documentation, should be submitted to the CSSF. The CSSF furthermore approves the choice of the custodian bank and the auditor, but will not impose any conditions with respect to the sponsor or the investment adviser.

Principal fund documents

The principal documents relating to the formation of a SIF or SICAR include the following.

Offering document. Also referred to as the private placement memorandum (PPM), this is often used as the principal fund marketing document. The contents of the offering memorandum generally include a description of the investment objectives and strategy of the fund, the projected size of the fund, the management team, a description of principal fund terms (e.g., issue of shares, valuation principles, net asset value calculation, distribution policy) and a statement on the regulatory and securities law restrictions in the jurisdictions where the limited partnership interests are being offered.

Articles of Association. This is the legal document governing the relationship between the general partner and the limited partners, including investment purpose, investment restrictions, capital commitments, distribution ratios, management of the fund, payment of expenses, management fees and restrictions on transfer.

Subscription Agreement. An agreement between each investor and the fund memorialising the fund's offer to subscribe for fund units or shares and the investor's acceptance thereof. The subscription agreement normally sets forth the amount committed to the SIF or SICAR by the investor, the mechanics for the initial closing and future draw-downs and the conditions precedent to the investment.

Management Agreement. An agreement between the fund (or its general partner) and the manager setting out the manager's duties, remuneration and limitations on other activities. It also provides for the reimbursement of expenses incurred by the manager on behalf of the fund and for the indemnification of the manager and its officers and employees.

Custodian Agreement. An agreement between the SIF or SICAR and the custodian bank responsible for the safekeeping of the assets.

Administrative Agency Agreement. An agreement between the SIF or SICAR with the local Luxembourg agent responsible for the fund accounting, issue of shares or units, registration of investors, etc.

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