

US Hedge Fund Managers: Accessing Capital and Marketing in Europe

Authored by Dechert's Financial Services Team

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1. BACKGROUND

Recent regulatory change has made the marketing of hedge funds in the European Economic Area (the "EEA") more involved, particularly for managers based outside the EEA. This appears to have led some US investment advisors to reduce their marketing in the EEA.

However, given that European investors currently account for around 20 per cent of global hedge fund assets under management¹, this is likely a temporary reaction to the regulatory overhaul the industry has recently endured, on both sides of the Atlantic. Further, it is anticipated that European investors will increase their allocations to hedge funds in the next few years. Increased allocations from institutional investors will be key to this growth. Indeed, KPMG's 2015 report on the hedge fund industry² finds that a majority of managers expect that pension funds would be their primary source of capital by 2020. *"The days of hedge funds simply being an investment tool for high net worth individuals are over"* according to MFA President and CEO Richard H. Baker. *"Institutional investors like pension plans, university endowments and charitable organizations now make up nearly 65 percent of the industry's assets. These diverse partnerships help local economies and underscore the important role alternatives play at both the macro and micro levels."* Arguably Europe has lagged the US in terms of institutional investors allocating to absolute return strategies. As such, there is real potential for growth.

It is also possible that the recent regulation of alternative fund managers pursuant to the Alternative Investment Fund Managers Directive ("AIFMD") will act as a further driver in the growth of institutional assets being allocated to hedge funds. Such regulation may add a perceived stamp of approval providing additional comfort to institutional investors (similar to that enjoyed by managers of 40 Act funds and, in Europe, UCITS funds).

There are good reasons for US managers to target European capital. However, any capital raising strategy in Europe now requires more careful thought, in particular following the introduction of AIFMD.

Accessing European Capital Prior to AIFMD

Prior to the implementation of AIFMD, US investment advisors typically would have relied on the private placement rules of each EEA member state to access capital in the EEA. Unfortunately, most EEA member states have either withdrawn or significantly restricted their private placement rules. The United Kingdom and Switzerland (not technically in the EEA) remain generally open, but advice should be sought before marketing in these jurisdictions on a private placement basis.

Reverse solicitation (where an investor initiates an investment in the fund) remains generally available in most EEA states. However, it is likely to be subject to closer scrutiny going forward. It is also subject to different interpretation by EEA member states making a coordinated approach to reverse solicitation difficult.

¹ 2015 Preqin Global Hedge Fund Report

² "Growing Up: The new Environment for Hedge Funds", KPMG 2015

How to Access European Capital Post AIFMD

Following the implementation of AIFMD, how should a US investment advisor target capital from European investors? The answer is nuanced and the suitability of any capital raising strategy will depend on considerations unique to each investment advisor. This note seeks to outline the options available to US investment advisors and to assist in developing a successful capital raising strategy in the EEA.

2. OPTIONS AND ACCESSIBILITY

The ability to market a fund in the EEA will be strongly dependent on whether:

- The fund is domiciled inside the EEA or outside the EEA.
- The US investment advisor wishes to market the fund itself or via an EEA sub-advisor.
- The US investment advisor wishes to launch on an already established EEA domiciled fund platform.

To explain the different options available and the relative pros and cons, we deal with the following fund structures and types in turn:

- Non-EEA fund (e.g. Cayman, BVI, Delaware etc.).
- EEA fund established in accordance with AIFMD.
- EEA fund established in accordance with the UCITS directive.
- EEA fund platforms.

In general terms, a non-EEA fund is now more difficult to market in Europe as a result of both increased regulation and investor perception (many Europe investors prefer to invest in EEA domiciled funds on the basis that they are more regulated and thus 'safer'). UCITS have been particularly successful in distributing via the UCITS passport and building a trusted brand in Europe. It remains to be seen whether funds established in accordance with AIFMD will have the same success in raising capital in Europe via the marketing passport available under AIFMD.

2.1 Non-EEA Fund (e.g. Cayman, BVI, Delaware etc.)

A US investment advisor or an EEA sub-advisor of a non-EEA fund wishing to access capital in the EEA will need to rely on reverse solicitation and/or the national private placement rules of each EEA member state. At present, the marketing passport provided for under AIFMD (as detailed below) is not available to investment advisors of non-EEA funds.

It is possible that the marketing passport will become available to EEA investment advisors marketing non-EEA funds.³ However, this is dependent on: (i) the European Securities and Markets Authority recommending the taking of such action to the European Commission; and (ii) the European Commission adopting a delegated act to provide for such passporting. Three years after such delegated act there is a possibility that the marketing

³ Article 67, on the basis that the EEA investment advisor is the designated AIFM, see page 6 below.

passport will be further extended to non-EEA investment advisors⁴ which is likely to include the post-Brexit UK and could possibly extend to US investment advisors. There has been slow progress in the extension of the passport.

Reverse Solicitation

Reverse solicitation is founded on the basic premise that regulation should not restrict investors from approaching investment managers at their own initiative. Where an investor takes the initiative in this way, this is not considered to be “marketing” under AIFMD and is therefore outside its scope of regulation (although other local laws or regulations may still apply).

Unfortunately, there is no clear consensus as to the scope of reverse solicitation and we see a range of different approaches to the concept (both within and outside Europe – it is by no means a uniquely European concept). There is also considerable difference of opinion and practice within the market on the topic. Accordingly, reliance on reverse solicitation involves some degree of risk. If a US investment advisor wishes to rely on reverse solicitation, it is important to understand the regulatory approach in the relevant jurisdiction. It is also important to have in place well considered sales procedures and a robust compliance protocol that can also provide the appropriate backup should the sale be queried by a regulator or, potentially, an investor seeking the return of its subscription money on grounds of a non-compliant sale.

Where an existing fund has investors from jurisdictions that are subject to AIFMD it may be that requests from such investors for information about a new fund or another existing fund can be classified as “reverse solicitation”. However, this should be reviewed on a case-by-case basis.

In summary, the ability to rely on reverse solicitation is limited and most investment advisors will struggle to attract significant capital through this means alone.

Private Placement

Investment advisors managing non-EEA funds will be able to market on the basis of the private placement rules of each EEA member state.

As noted above, at present AIFMD allows each EEA member state to maintain a private placement regime until a decision is made whether or not to allow EEA and subsequently non-EEA investment advisors to take advantage of the marketing passport.

The private placement rules of each EEA jurisdiction can be seen as a patchwork of rules which vary widely by country, from those member states requiring a notification prior to marketing to investors in that jurisdiction, to member states where full local authorisation is required and others where there is no framework in place to enable private placement. In some of these jurisdictions therefore, “private” placement has changed from being a private process to one that is wholly in the hands of the local regulator.

Following the introduction of AIFMD, a number of EEA member states have either withdrawn the ability to market on a private placement basis within their jurisdiction or have severely limited the ability to do so.

⁴ Article 68

In addition to the private placement rules of each EEA member state, the AIFMD lays down five requirements that non-EEA investment advisors must meet before marketing on a private placement basis in the EEA (similar rules apply to EEA investment advisors). These are as follows:

- i. *Co-operation Agreement*⁵. A co-operation agreement must be in place between the relevant EEA member state in which the fund is being marketed, the regulator of the jurisdiction of the fund and the regulator of the jurisdiction of the non-EEA investment advisor (if applicable), relating to the sharing of information and the cross-border supervision of the fund. The leading non-EEA fund domiciles have entered into such agreements with the majority of EEA member states as has the SEC.⁶ Post-Brexit we can expect similar agreements to be put in place by the UK.
- ii. *FATF Non-Cooperative Country*⁷. The jurisdiction of the fund must not be listed as a non-cooperative jurisdiction by the Financial Action Task Force. Again, the leading non-EEA fund domiciles do not appear on that list.
- iii. *Annual Report*⁸. The investment advisor must report annually in respect of each of the funds that it markets in the EEA, and such report must be made available upon request to investors in the fund and to the relevant EEA member state(s). Annex 1 summarises the information that must be contained in the annual report.
- iv. *Disclosure Obligations*⁹. The US investment advisor must comply with certain disclosure obligations which relate primarily to information on risks and fees that may be borne by investors in the fund. Annex 2 summarises the information that should be disclosed to investors prior to their making an investment in the fund (this would primarily be disclosed in the fund offering document).
- v. *Regulatory Reporting*¹⁰. An investment advisor will need to report annually to the regulator of the relevant EEA state to disclose the instruments in which it trades, the markets on which it does so and the principal exposure(s) of the fund. This regulatory reporting requirement is known as 'Annex IV Reporting' and parallels have been drawn with Form PF.

The requirements listed above are the minimum requirements that must be met by a non-EEA investment advisor marketing in the EEA on a private placement basis. The AIFMD affords member states the freedom to “impose stricter rules on the AIFM in respect of the marketing of units or shares of non-EU AIFs to investors in their territory”¹¹. Accordingly, some member states have taken steps to put rules in place that go beyond the minimum requirements. Advice should be sought in respect of the relevant EEA member state in which the fund is being privately placed.¹²

⁵ Article 42(1)(b)

⁶ <http://www.esma.europa.eu/content/AIFMD-MoUs-signed-EU-authorities-updated>

⁷ Article 42(1)(c)

⁸ Article 42(1)(a), Article 22

⁹ Article 42(1)(a), Article 23

¹⁰ Article 42(1)(a), Article 24

¹¹ Article 36(2)

¹² Dechert's World Compass system is a useful resource for the purposes of obtaining up-to-date information on private placement rules and information regarding the availability and interpretation of reverse solicitation in relevant jurisdictions. World Compass is a web-based subscription service that offers investment firms 24/7 access to concise

Marketing Passport

As noted above, investment advisors are not currently able to take advantage of the marketing passport made available under AIFMD for non-EEA funds.

Appointing an EEA Sub-Advisor

If a US investment advisor appoints an EEA sub-advisor to assist with the management and/or the marketing of the fund, a decision will need to be made as to whether the US investment advisor or the EEA sub-advisor will be the designated alternative investment fund manager for the purposes of AIFMD (the “**AIFM**”). Pursuant to AIFMD, there can only be one AIFM. To the extent that the US investment advisor is the AIFM, the US investment advisor and the EEA sub-advisor would fall largely outside the scope of AIFMD. Whether or not the AIFM is the US investment advisor or the EEA sub-advisor will currently have no real impact on the marketability of the non-EEA fund. However it might be that the marketing passport will be made available to EEA AIFMs before it is made available to non EEA AIFMs.

In order for an EEA sub-advisor to qualify as the AIFM, it would need to show sufficient substance. The US investment advisor would need to delegate sufficient portfolio and/or risk management duties to the EEA sub-advisor in respect of the fund being managed. The substance requirements do not require the EEA sub-advisor to carry out the majority of the portfolio or risk management functions or indeed a significant amount; it must just have enough substance such that it is not deemed a ‘letter box’ entity. Therefore, many EEA investment advisors who act as sub-advisors to a US investment advisor should be able to act as the designated AIFM of the fund.

Given the current unavailability of the marketing passport, it would make sense for the US investment advisor to be designated as the AIFM so as to limit the need to comply with AIFMD.

2.2 EEA Fund Established Pursuant to AIFMD

In order to benefit from the marketing passporting, an EEA fund has greater access to European capital than a non-EEA fund. This is primarily because the EEA fund has access to a marketing passport that allows it to distribute across the EEA. Some European investors also prefer EEA domiciled funds as a perceptual matter. Given the familiarity of Cayman fund structures to US investors, it is unlikely we will see Europe replacing the Cayman Islands as the domicile of choice for a fund looking to raise capital in the US and on a global basis. However, we are seeing an increase in the number of investment advisors who have set up (or are looking to set up) an EEA domiciled fund alongside their existing non-EEA offering (typically a Cayman fund). These dual products will typically follow the same investment strategy and invest in parallel.

Clearly, there is a cost of managing two funds but many investment advisors are taking the view that the benefits, in terms of the increased marketability of the fund in Europe, outweigh the costs.

An EEA domiciled fund would need to appoint an EEA investment advisor as its AIFM. This could be a third-party AIFM service provider. These service providers charge a fee for risk management oversight and have the appropriate processes and systems in place to perform this role as required by AIFMD. The designated AIFM

global marketing and distribution guidance in more than 100 jurisdictions worldwide as well as beneficial ownership reporting requirements in key jurisdictions.

would then delegate the portfolio management function to the US investment advisor.¹³ An alternative would be to establish or appoint an existing EEA investment advisor as the AIFM.

Marketing Passport

The marketing passport is the most efficient way of marketing a fund across the EEA, given the flexibility and speed with which additional jurisdictions can be accessed for fundraising. As discussed above, the marketing passport is currently only available to AIFMs whose registered office is located within the EEA and are intending to market an EEA domiciled fund. The main advantage of utilising the passport is that the AIFM will only have to comply with one set of rules under AIFMD, avoiding the arduous task of complying with the national rules of multiple EEA member states (as required on a private placement basis).

The marketing passport provided by AIFMD allows EEA AIFMs to market EEA funds to professional investors throughout the EEA, subject to authorisation by the EEA member state in which the AIFM is regulated. Once authorized, the EEA AIFM will notify its regulator of the EEA member states in which it wishes to market the fund. The regulator will then make notifications to the regulators in each of these EEA member states within 20 working days of receiving the notification from the EEA AIFM¹⁴. Once this notification has been made and, if necessary, confirmed by the regulator, the EEA AIFM will be able to market the fund in the corresponding EEA member state(s).

There are a variety of fund structures available in the EEA, many of which allow investment by US taxpayers and US tax exempts.

2.3 EEA Fund Established Pursuant to UCITS

An investment advisor who wants to set up a European domiciled fund will need to choose whether to do so under AIFMD or the UCITS directive. As a general rule, AIFMD is less restrictive than the UCITS directive. Most of its requirements focus on disclosure, transparency and custody of assets. In contrast, the UCITS directive imposes restrictions on investment strategy which many hedge-funds will not be able to comply with. The reason for this is that the UCITS directive is focused on protecting retail investors. AIFMD is focused on regulating funds that are targeted at professional investors.

UCITS funds fall outside the scope of AIFMD and have been very successful in raising capital in Europe. Much of this is a result of the availability of a marketing passport under which UCITS funds can market across Europe (similar to that introduced under AIFMD). To the extent that a hedge fund strategy can comply with the requirements of the UCITS directive, a UCITS fund arguably offers a more familiar product to investors than a fund marketed under AIFMD.

2.4 Fund Platform

To reduce the costs of setting up a new fund, an investment advisor could launch on an existing AIFMD or UCITS compliant platform. The key advantages of utilizing an existing platform are that: (i) it is possible to launch the fund within a shorter timeframe; (ii) it can take advantage of the marketing passport under AIFMD or UCITS; (iii) it

¹³ Note that using the US investment advisor as the sub-advisor could lead to AIFMD required compensation disclosure, review and potential limitations; often using a subsidiary of the US investment advisor as the sub-advisor may solve this problem.

¹⁴ Article 32(3)

allows you to make use of the platform manager's resources (such as middle to back-office functions); and (iv) it potentially makes available the platform provider's capital introduction services.

There are, however, advantages in establishing your own fund structure. Whilst this may take slightly longer and cost more (at least initially), it prevents the fund and investment management business from being tied commercially to a third-party platform and its charges and, longer term, is better for building goodwill for the business. In practice, it permits greater freedom as to how the fund is managed and marketed. However, you would also need greater internal compliance and operational support within such a business.

It would be possible to initially utilise a third party platform provider and then move to your own platform in the event the business grows, though it is often difficult to affect a truly universal tax efficient switch for all investors from one fund to another fund structure.

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ANNEX 1

Annual Report

The following information must be contained in the annual report in respect of each of the funds being marketed in the EEA:

- (a) a balance sheet or a statement of assets and liabilities;
- (b) an income and expenditure account;
- (c) a report on the activities of the financial year;
- (d) any material changes in the information required to be disclosed (as detailed at Annex 2);
- (e) the total remuneration for the financial year. This is required to be separated into fixed and variable remuneration and must detail the remuneration paid by the AIFM to its staff, the number of beneficiaries and if applicable, carried interest which has been paid by the AIF; and
- (f) the total remuneration paid to the staff of the AIFM whose actions have a material impact on the risk profile of the AIF, detailing the split in remuneration between senior management and other members of staff.

ANNEX 2

Disclosure Obligations

The following is a summary of the information which should be disclosed before investors prior to their making an investment in the fund:

- (a) a description of the investment strategy and objective, any investment restrictions, trading techniques and associated risks, details as to the AIF's use of leverage (including the maximum leverage that the AIF may utilise);
- (b) the procedures by which the AIF may change its investment strategy and/or policy;
- (c) the legal implications of the investment management agreement;
- (d) the identities of and a description of each of the AIFM, the depositary of the AIF (if it has or is required to appoint a depositary), the auditor of the AIF and any other service providers;
- (e) a description of how the AIFM is complying with the Directive requirements to either: (i) hold additional funds to cover professional negligence liability risks; or (ii) hold appropriate professional indemnity insurance against professional negligence¹⁵;
- (f) details as to management functions which have been delegated by the AIFM, and safe-keeping functions which have been delegated by the depositary (if applicable);
- (g) a description of the valuation procedure and pricing methodology of the assets of the AIF;
- (h) details of the liquidity risk management employed by the AIF and the redemption rights of investors;
- (i) details of all fees, charges and expenses which are directly and indirectly borne by investors, together with the maximum amounts thereof;
- (j) a description of the procedures that the AIFM has put in place to ensure the fair treatment of investors. If the AIFM gives preferential treatment to an investor, information should be provided detailing the preferential treatment, the type of investors who obtain such treatment and if applicable, any legal or economic links that they have with the AIF or AIFM;
- (k) the latest annual report (see Annex 1);
- (l) the procedure and conditions for the issue and sale of shares in the AIF;
- (m) the latest net asset value of the AIF¹⁶;
- (n) the historical performance of the AIF (if available);
- (o) the identity and details of the prime broker and any material arrangements of the AIF therewith. The ways that conflicts of interest are managed should also be disclosed;

¹⁵ Article 9(7)

¹⁶ Calculated in accordance with Article 19

(p) details as to how and when the information referred to below will be disclosed.

Should there be any contractual arrangement with a depositary, and such arrangement allows the depositary to discharge itself of liability for the loss of financial instruments held in custody, this would also need to be disclosed to investors.

In addition to the information contained in the annual report, the AIFM must also make periodic disclosures in respect of each of the AIFs that it manages, concerned principally with risk management as follows:

- (a) the percentage of the AIFs assets which are subject to special arrangements arising from their illiquid nature;
- (b) any new arrangements for liquidity management; and
- (c) The current risk profile of the AIF and the risk management systems employed by the AIFM.

If the non-EU AIFM is marketing AIFs which employ leverage, the AIFM must ensure that it discloses the total amount of leverage employed by each AIF, together with details of any changes to the maximum level of leverage, the right to re-use collateral or any guarantee which has been granted under the leveraging arrangement. These details should be disclosed as part of the AIF's periodic reporting to investors, as required by the AIF's rules or instruments of incorporation, or at the same time as the prospectus and offering document and at least at the same time as the annual report is made available according to Article 22(1) of the Directive.