

# Marketing Funds into Europe: The Changing Regulatory Landscape

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## Background

- UCITS / UCITS IV / UCITS V
- Closed end funds
- ISD/MiFID
- FSA Authorisation
- EU Member State Private Placement Regimes
- Alternative Investment Fund Managers Directive (AIFMD)
- A new regime for VC Funds?

## UCITS

- Open ended, publicly marketable EU funds
- Exempted from AIFMD
- Restricted to 'listed tradable securities' – so no PE or Real Estate Funds
- Hedge Funds – 'Newcits'
- Eligible assets rules – relevant to hedge funds and hedge fund of funds
- UCITS IV:
  - Procedures for mergers of UCITS funds
  - Master feeders available for first time
  - Standardised 'Key Investor Information Document'
  - Management Company passport
  - Simplified/improved passporting mechanisms
- UCITS V

## Closed End Funds

- Caught by AIFMD
- But can be marketed publicly under Prospectus Directive if securities are 'transferable' – i.e. separate from AIFMD passport and therefore to the retail public
- May be appropriate for funds of funds, PE, Real Estate and other more illiquid strategies but 'transferable securities' requirement may be a problem
- No ability to sell open-ended fund using approved prospectus

## Structuring Funds for European Investors – Regulatory Considerations

- Most Jurisdictions require marketing to be conducted by EU authorised marketers
- Some allow non-EU persons to market but marketing then more restricted e.g. Belgium (but must register locally); UK

## Structuring Funds for European Investors - Regulatory Considerations

Private placement rules vary enormously but fall into 5 main categories:

- subject to a minimum investment amount (e.g. Belgium €250,000, Holland €50,000)
- by number of offerees - e.g. Denmark (8), Holland (100)
- by type of investors (e.g. institutional, large corporates, sophisticated individuals etc.) – Finland, Germany, Holland, Switzerland, UK
- all forms of active solicitation banned – France, Italy, Norway, Spain
- no restrictions - Sweden

## **AIFMD: Introduction / Timetable**

- Proposed by EU Commission – April 2009
- Level 1 Directive effective 21 July 2011
- Implementing measures and guidelines now being developed by ESMA (level 2)
- Transposition by 22 July 2013
- EU AIFM can be authorised from 22 July 2013 and must be by 22 July 2014

## Who will be affected?

- EU-established managers of AIFs (wherever established)
- Non-EU AIFMs marketing or managing AIFs within the EU (NB. Avoid directive if non-EU AIFM/non-EU AIF and no marketing into Europe)
- AIFM out-of-scope if AUM (incl assets acquired through leverage) less than €100m (or € 500m if the AIFs are unleveraged and closed-end for 5 years)
- Service providers to AIFMs/AIFs



## Who will be affected?

- What's an AIF? Any collective investment undertaking (including investment compartments thereof) other than UCITS. No asset class limits. Can be closed or open-ended.
- Raise capital from more than one investor with a view to investing it in accordance with a defined investment policy for the benefit of those investors.
- Not holding companies, employee participation schemes, pensions.

## Which entity is the AIFM?

- Regular business is managing one or more AIFs
- Only one per fund
- Can be internal or external
- Excludes firms providing advice only
- Must engage in both portfolio management and risk management

## Which Entity is the AIFM?

- Can delegate but cannot become “letter-box entity”
- AIFM Liability to AIF and investors unaffected by delegation
- Managers with EU and non-EU entities may have a choice: who it designate as AIFM?
- E.g. Can EU-based sub-adviser of U.S. Manager be designated as the AIFM?
- Is U.S. parent is delegate, must be ‘authorised or registered for the purpose of asset management and subject to supervision’

## Impact of AIFMD

- AIFM to be authorised. EU AIFM to be subject to significant additional regulation – already subject to MiFID (required to be regulated, have minimum capital, subject to conduct of business rules etc.)
- From 2015, non-EU AIFMs need to be authorised under AIFMD to manage EU AIFs
- Capital requirements - €125,000 for external AIFM plus 0.02% of AUM over €250m (subject to €10 million cap) or at least €300,000 for internal AIFM plus PI cover or additional capital to cover potential liability risks arising from professional negligence
- Conduct of business standards/risk management standards etc for AIFMs
- Remuneration policy requirements

## Impact of AIFMD

- Procedures for independent valuation of assets
- Restriction on delegation of AIFM functions – eg solicitation agent
- New depositary role
- Enhance transparency to investors and regulators
- European “passport”
- Possible leverage limits
- Wide powers of inspection/intervention for regulators

## Marketing and Third Country Issues

### ➤ Passport

- principal benefit of AIFMD
- allows marketing to professional investors only
- from 22 July 2013 for EU AIFMs/EU AIFs
- potentially from 2015 for EU AIFMs/non-EU AIFs or non-EU AIFMs/non-EU AIFs but subject to full compliance with Directive

## Marketing and Third Country Issues

### ➤ Passport

- Get-out if:
  - (i) Impossible to combine compliance with compliance with mandatory provision of local law
  - (ii) local law has an “equivalent rule” having the same regulatory purpose and offering the same level of protection to investors
- Which jurisdictions will pursue equivalence? U.S.? Cayman?

## Marketing and Third Country Issues

### ➤ Passport

- Notification to home authority
- Fairly extensive disclosure
- Able to market in no more than 20 working days
- Better than “host state” notification
- Where non-EU AIFM need “Member State of Reference” and legal representative in EU (does not need to be a subsidiary)
- How viable is this approach with regard to U.S. managers?
- Can you influence the selection of Member State of Reference?



## Marketing and Third Country Issues

### ➤ Passport

- Will allow active/broader marketing into Denmark, France, Italy, Norway and Spain from 2013 (for EU AIFMs)
- But passport could restrict marketing in e.g. Belgium, Holland, Germany, UK
- However, AIFMD does envisage that Member States may permit marketing to ‘retail investors’ locally

## Marketing and Third Country Issues

### ➤ Private Placement

- At Member States' discretion
- Rules could be tightened in some jurisdictions
- May end in 2018/2019
- New conditions

## Marketing and Third Country Issues

### ➤ Private Placement

- EU AIFM/Non-EU AIF
  - whole Directive applies to manager except provisions re depositary location and liability
- Non-EU AIFM/Non-EU AIF (eg. Cayman Fund, U.S. Manager)
  - subject to AIFM complying with A.22 (Annual Report), A.23 (Disclosure to Investors), A.24 (Reporting to Regulator) and (if relevant) A.26-30 (Acquiring Control of Non-Listed Companies – Disclosure requirements/Asset Stripping)

## Marketing and Third Country Issues

### ➤ Private Placement

- Non-EU AIFM/Non-EU AIF
  - Disclosure of types and sources of leverage, description of liquidity risk management, transfer of assets to prime broker and re-use arrangements
  - Three-way co-operation arrangements required between regulators (including regulator in each Member State where fund marketed) – is SEC engaging with this?
  - Neither AIF nor AIFM may be established in a jurisdiction that is designated as non-co-operative by FATF

## Marketing and Third Country Issues

- Article 22 (Annual Report)
  - Balance sheet and income statement (in accordance with accounting standards in jurisdiction of fund)
  - Remuneration disclosures – total amount of remuneration for financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, and number of beneficiaries; also, where relevant, carried interest
  - Aggregate amount of remuneration broken down by senior management and members of staff of the AIFM who have a material impact on the risk profile of the AIF
  - Audit meeting international auditing standards in fund jurisdiction

## Marketing and Third Country Issues

- Article 23 (Disclosure for Investors)
  - Requirements appear to require disclosure to all investors (not just EU)
  - Detailed information similar to what would be in prospectus anyway but need to notify material changes thereof
  - Some details may go beyond what would be provided anyway – e.g. types and sources of leverage; description of liquidity risk management, including the redemption rights in normal and exceptional circumstances, description of ‘preferential treatment’ received by any investor; information on the transfer of assets to the prime broker and re-use
  - Periodic disclosures required also – e.g. on risk management systems, total amount of leverage employed

## Marketing and Third Country Issues

- Article 24 (Reporting to Regulators)
  - Principal exposures; main instruments being traded;
  - Risk management systems employed; arrangements for managing liquidity
  - Detailed information on us of leverage if ‘employing leverage on a substantial basis’ – including 5 largest sources of leverage and amount of leverage from each

## Marketing and Third Country Issues

- Reverse Solicitation
  - but how reliable?
  - no direct or indirect offering or placement



## Depositary

- Single depositary
- AIFM cannot be depositary
- Prime broker can only be depositary if ‘functional and hierarchical’ separation and conflicts managed etc.
- Does not apply to Non-EU AIF/Non-EU AIFM marketed under private placement or Non-EU AIF/EU AIFM if not marketed in EU
- Where depositary requirement applies to Non-EU AIF, depositary’s jurisdiction (which can be in the jurisdiction of the fund but not the manager) must not be listed by FATF as a Non-Co-operative Country or Territory

## Depository

- Also third country depository must be subject to effective prudential regulation, including minimum capital requirements, and supervision which have the same effect as EU law and are effectively enforced

## Depository's role

- safe custody of financial instruments
- asset verification
- cash flow monitoring
- ensuring shares valued in accordance with law
- monitor AIFM's compliance with law/AIF rules

## Depository's Liability

- Strict liability when custodied investments are lost
- Unless
  - depository proves that loss resulted from an external event beyond its reasonable control; or
  - sub-custodian has contractually assumed liability to AIF
- Depository cannot cap liability
- Additional cost of depository services - 100-150 basis points?

## Managed Funds Association Views

- Call for coordinated global approach re: data requests – better to collect from prime brokers/other market participants?
- AUM should include only assets of EU-based funds, assets of non-EU based funds beneficially owned by EU investors and assets managed in the EU (compare: Dodd-Frank)
- Transparency requirements in A.22, A.23 and A.24 are difficult to understand in the context of non-EU AIFMs/non-EU AIFs using private placement as the rest of the Directive does not (or should not) apply

## AIFMD Strategies for U.S. Managers

➤ Try to remain out of the scope of AIFMD

### ADVANTAGES

- eliminates new EU compliance burden
- still scope for U.S. manager to act as delegate of EU manager
- cheap

### DISADVANTAGES

- no EU distribution
- limited flexibility

## AIFMD Strategies for U.S. Managers

➤ Ride private placement into the grave?

### ADVANTAGES

- Minimises EU compliance burden whilst accessing EU money
- Reverse solicitation also available
- Can still potentially retain EU-based sub-advisor/solicitation agent

### DISADVANTAGES

- Will U.S. be ready?
- This route expected to end in 2019
- Private placement exemptions may be tightened
- Some jurisdictions already 'out of bounds'

## AIFMD Strategies for U.S. Managers

➤ Plan to passport from 2015

### ADVANTAGES

- Time to prepare
- Additional EU distribution

### DISADVANTAGES

- Significant EU regulatory burden
- Conflicts with SEC regulation?
- Availability of passporting option uncertain
- How much of a benefit will passport really be?



## AIFMD Strategies for U.S. Managers

- Opt into AIFMD from 2013 by establishing EU-based self managed fund or EU-based AIFM

### ADVANTAGES

- First mover advantage
- AIFMD ‘brand potential’
- Investor preference for regulated fund?
- Possibility that funds using derivatives for investment may need to switch from UCITS to AIFMD

### DISADVANTAGES

- Cost of regulatory burden
- Time/energy required to obtain EU manager licence
- Self-managed fund may only work for illiquid strategies (eg P/E, real estate)

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