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Brexit

With Brexit Looming and New Fund Structures Available, U.S. Hedge Fund Managers Face Risks and Opportunities for Marketing in Europe

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By Michael Washburn, *Hedge Fund Law Report*

The possibility of Britain's electorate voting in a widely heralded June 23 referendum to leave the European Union – an eventuality popularly known as the "Brexit" – and the creation of the Luxembourg Reserved Alternative Investment Fund (RAIF) pose special challenges and opportunities for U.S. hedge fund managers marketing their products in the U.K. and Europe. One session of the Dechert Global Alternative Funds Symposium, held in New York on April 6, provided practical insight to help hedge fund managers understand, adapt to and take advantage of these changes and opportunities, including with respect to the marketing passport under the Alternative Investment Fund Managers Directive (AIFMD) and the growing popularity of loan origination funds in Europe. Moderated by Boston-based Dechert partner Adrienne Baker, the panel featured London-based partners Richard Heffner and Stuart Martin; Luxembourg-based partner Antonios Nezeritis; and Munich-based partner Hans Stamm.

For coverage of last year's Symposium, see "Trends in Hedge Fund Expense Allocations, Fees, Redemptions and Gates" (May 21, 2015); and "Liquid Alternative Funds and Fund Governance Trends" (Jun. 25, 2015).

Facing the Brexit

Heffner analyzed the impact of a possible "yes" vote in a referendum he characterized as fulfilling a campaign promise used by Conservative Party leader David Cameron to fend off challenges from those opposed to Britain's E.U. membership. Fortunately, even if British voters do vote to opt out of the E.U., a "yes" vote would not result in an abrupt sundering of Britain from the union. Rather, under E.U. law, a two-year process would commence.

Britain would first give formal notice to the European Commission, leading to a period of negotiation over the terms of its exit, along with what Heffner described as a potentially "very onerous" legislative process playing out in the European Parliament.

This provision of E.U. law gives law firms advising U.S. clients on their operations a bit of breathing room. "There is a two-year period in which firms would have the possibility for planning any reorganizations or changes that businesses may need to go through," Heffner said.

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"At the end of the two-year period, unless all E.U. member states agree to extend it, the exit would happen."

In that event, the impact on U.S. hedge fund managers with an actual presence in the U.K. could be considerable, but in most cases the impact will be manageable. Many of those that have an affiliated Financial Conduct Authority (FCA)-authorized firm in the U.K. must pay particularly close attention because the possibility of the Brexit proceeding cannot be dismissed. Those managers must analyze what an exit would mean for their operations. "The short answer," Heffner clarified, "is they would lose the benefits and, potentially some of the burdens, of different European directives."

Loss of AIFMD Passport

One directive that those managers would lose the benefit of is AIFMD. Of particular concern to U.S. entities with U.K. affiliates regulated under AIFMD is that European "passports" – which have been essential for cross-border funds work – may no longer be used as they currently are. See "Passports, Platforms and Private Placement: Options for Marketing Funds in Europe in the Post-AIFMD Era" (Apr. 30, 2015).

This would affect the ability of managers to rely on their U.K. affiliates to use the passport to manage funds on the European continent, explained Heffner. "So, for example, if you're a U.K. alternative investment fund manager (AIFM) managing a Luxembourg fund, you would no longer be able to do that under AIFMD."

Under this scenario, the U.K. firm would have a couple of options, including setting up a new operation in Luxembourg, hiring out a third-party AIFM in Luxembourg to manage the fund or even converting the Luxembourg fund into a self-managed fund. Yet another possibility Heffner identified is the use of a "third-country passport" under AIFMD, if it is extended to the U.K. after a Brexit. See "ESMA Recommends Extension of the AIFMD Passport for Hedge Fund Managers and Funds in Certain Non-E.U. Jurisdictions" (Aug. 6, 2015).

Reliance on MiFID Passport

Currently, the Markets in Financial Instruments Directive (MiFID) has a number of passport arrangements that permit firms to market qualified funds in various E.U. member states. See "MiFID II Will Affect Market Structure, Registration and Soft Dollars for Hedge Funds Trading in Europe" (May 19, 2016).

However, in order for firms to continue to rely on the MiFID passport after the Brexit, they would need to change how they operate. "They would need to comply with the ordinary legislation [in the country in question] for the provision by foreign managers, foreign advisors and foreign broker-dealers of different kinds of services," Heffner said.

The revised MiFID Directive (commonly known as "MiFID II") is set to take effect as of January 3, 2018 – well within the two-year negotiation period that would precede any Brexit. One of the provisions of MiFID II allows third-country managers to provide cross-border services to professional clients in any E.U. member state. To do so, the managers must register on a one-time basis with ESMA.

For more on the Brexit, see "What Hedge Fund Managers Need to Know About AIFMD's Depositary Requirement (Part Two of Two)" (May 5, 2016).

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Implications of RAIF legislation

Nezeritis explained the primary attributes of the reserved alternative investment fund (RAIF) and how it differs from other funds products used in cross-border transactions. The RAIF cannot be an internally managed alternative investment fund (AIF); rather, it must appoint an external AIFM. It is subject to a number of fairly standard requirements, including the appointment of a depositary, the appointment of a central administration agent and the provision of information to shareholders before they proceed with an investment. For more on depositaries, see our two-part interview with Bill Prew: "AIFMD Has Increased Compliance Burden on Hedge Fund Managers" (Apr. 28, 2016); and "What Hedge Fund Managers Need to Know About AIFMD's Depositary Requirement" (May 5, 2016).

"There are some guidelines issued," Nezeritis clarified, "and the most important part is that the RAIF will have to comply with all the requirements of the AIFMD."

Nezeritis identified two types of RAIFs: one that resembles the Specialized Investment Fund (SIF); and one that has more in common with the investment company in risk capital (also known as the Société d'investissement en capital à risque or SICAR).

"The SIF can invest in almost anything, subject to risk-specification rules; the rule of thumb is 30 percent," Nezeritis noted. "Thus, the SIF must invest in at least four assets."

"The SICAR can only invest in venture capital assets, or the particularly risky assets," continued Nezeritis. "Given the specificities of this type of fund, someone will need to control that it only invests in risk capital." He added that that role has typically fallen to the RAIF's auditor. During the audit of the accounts of a RAIF structured as a SICAR, the auditor will need to assess whether the assets held by the RAIF qualify as risk capital.

One feature that makes the RAIF stand out is its freedom from the control or supervision of Luxembourg's regulator – the Commission de Surveillance du Secteur Financier (CSSF). The regulator's approval is not required for initial use of or changes to the RAIF's documents. This makes the product particularly competitive in terms of time to market.

Like the SICAR and the SIF, the RAIF is a product for well-informed, professional investors, such as institutional investors. In the Luxembourg context, an individual cannot qualify as an institutional investor.

In addition to institutional investors, potential investors in a RAIF could include individuals or entities investing at least €125,000 in the RAIF. Nezeritis also mentioned that this would include investors that have received an assessment from a credit institution, a management company, an investment firm or the AIFM, establishing their qualification to handle the risks associated with RAIFs.

The benefits of RAIFs' relative freedom from regulatory oversight will not be of interest solely to existing RAIFs and their investors. Nezeritis foresaw scenarios where a SICAR or a SIF will undergo conversion to a RAIF to escape the burden of supervision.

See also our two-part series on what the RAIF structure offers to non-E.U. Hedge Fund Managers: "Access to AIFMD Passport and Marketing to E.U. Investors" (Apr. 21, 2016); and "Marketing Options and Tax Benefits" (Apr. 28, 2016).

The Complexities of Loan Origination

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Nezeritis identified certain limits to the RAIF's appeal, particularly when it comes to the increasingly popular and competitive area of loan origination. "The only caveat, in light of the investment strategy of the RAIF, is that it may not be in a position to originate loans," he explained. "A SIF could originate loans; however, for a RAIF there's a bit of uncertainty on that point."

Rather, in contrast to a SIF, Nezeritis continued, a RAIF would need to tread very carefully and ensure that any loans are originated for a limited pool of people, not for the general public.

Concurring with Nezeritis, Martin pointed to the current limitations of the RAIF in the area of loan origination. He also acknowledged the growing popularity of debt funds, including those that originate loans. "It will be no surprise to an American audience that loan origination as an asset class is increasing in Europe as it has in the U.S." Martin noted that loan origination in one form or another is currently one of the busiest areas of fund formation in the London fund market.

U.K. institutional investors tend to be happy to invest in credit strategies through a U.K. limited partnership, Martin said. However, he sees Ireland as being somewhat behind the curve given that it has only relatively recently introduced a regime allowing funds to conduct loan origination, subject to restrictions. Prior to this development, Irish funds were not permitted to originate loans. See "Irish Central Bank Issues Proposed Rules to Enable Private Funds to Originate Loans" (Sep. 11, 2014).

Martin sees Luxembourg as a hub for this market with promoters using the regulated SIF model, but he noted that the time to market was often eight to twelve weeks after submitting documentation to the CSSF. This time lag has been one factor driving the introduction of the new RAIF structure. The SIF continues to play a leading role in loan origination fund structures in Luxembourg.

Room for Further Reform

Cross-border activity by loan-originating funds is certain to increase, in Martin's analysis. The French, German and Italian authorities have made moves to relax their restrictions on funds originating loans in their jurisdictions. These relaxations tend to favor E.U. funds.

Relaxation of Rules in Germany

Regulatory change for debt funds in Germany has been a most welcome development for many, concurred Stamm. Foreign fund managers were unpleasantly surprised in the past when they first came to Germany and found that they would need to obtain a banking license to grant loans to German borrowers.

"As a consequence of the introduction of regulated debt funds in the E.U., such as so-called ELTIFs [European Long Term Investment Funds]," Stamm explained, "Germany very recently changed its legislation." Under the revised regulations, an E.U.-domiciled AIFMD-compliant fund can grant loans to German borrowers in Germany, which he described as "quite helpful." "For German-domiciled funds, there are certain minimum investment restrictions for private debt lending instruments," Stamm continued, "but I think we are expecting more activity from funds coming directly into Germany."

Italian Restrictions

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Italy is a jurisdiction where liberalization of rules and regulations would be welcome to many fund managers. Under the liberalized rules, Martin said, E.U. funds seeking to originate loans cross border in Italy must complete a sixty-day central bank pre-approval process before they may commence operations. Even once that is completed, there are reporting and transparency requirements with which funds must comply.

Moreover, the Italian regulators tend to require equivalence on the part of funds in terms of their levels of regulation, leverage, closed-end nature, etc. Martin explained that this may lead managers that are looking to originate loans cross border in Italy to ask some tough questions, and it exposes potential hurdles to the competitiveness of the less-regulated RAIF in the cross-border funds market.

“One of the questions would be, if you’re looking to act in Italy, would you use an English limited partnership or a RAIF,” Martin asked, “or would you use, for example, a more regulated Luxembourg SIF? Depending on the regulations, you might consider the SIF to be preferable.”

Taxation in Other European Jurisdictions

Martin sees European tax authorities, both at a local and an international level, scrutinizing funds’ use of tax treaty structures. Whether the fund is domiciled in the U.K., Dublin or Luxembourg, downstream treaty structures are becoming critically important.

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