This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

AIFMD

Establishing and Marketing Private Funds in the E.U. Under AIFMD: Jurisdiction; AIFs and AIFMs; Private Placements; and Reverse Solicitation (Part Two of Two)

Jul. 11, 2019
By Charlie Marlow, *Hedge Fund Law Report*

A recent Carne Group program provided an overview of establishing and marketing private funds in the E.U. under the Alternative Investment Fund Managers Directive (AIFMD), a regime that U.S. managers typically adhere to in order to freely market across the E.U. The program featured Ajay Pathak and Glynn Barwick, partner and counsel, respectively, at Goodwin Procter; Edwin Chan, senior vice president at Northern Trust; and Aymeric Lechartier, managing director at Carne Group. This article, the second in a two-part series, compares Ireland and Luxembourg as private fund venues; outlines the costs and logistics of establishing an E.U. fund; addresses whether to hire a third-party E.U. fund manager; and reviews the current state of private placements and "reverse solicitation" in the E.U. The first article evaluated the key provisions of AIFMD.

See "Six Common Misconceptions U.S. Fund Managers Have About Marketing in Europe" (Mar. 9, 2017).

Ireland and Luxembourg Are Primary AIF Jurisdictions

Although it is possible to set up an alternative investment fund (AIF) and alternative investment fund manager (AIFM) in any E.U. jurisdiction, Ireland and Luxembourg are the most popular choices. Both have strong funds businesses, in addition to well-developed legal and regulatory frameworks, Pathak said. Although Ireland is a common law regime and Luxembourg is a civil law regime, their fund documentation is similar, Lechartier added. Luxembourg is a somewhat more expensive place to operate, but cost tends not to be a major factor when choosing a location.

The process and timing for AIFM authorization are similar in Luxembourg and Ireland, Pathak continued. There is no requirement that both the AIF and the AIFM be authorized in the same jurisdiction. As a result, some managers have set up their AIFs in Luxembourg and their AIFMs in Ireland.

See "Luxembourg Positions Itself As a Calm in the Brexit Storm (Part One of Two)" (Jan. 10, 2019).

Ireland has been favored by hedge funds that desire onshore structures and Undertakings for Collective Investment in Transferable Securities (UCITS) funds, Pathak said. Luxembourg has

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

been favored by UCITS fund managers and other fund managers who are based in continental Europe. Service providers in Ireland are highly attuned to the needs of hedge funds, Lechartier added. The language and common law system also make Ireland attractive. Ireland's regime does not work particularly well for illiquid strategies, however.

Service providers in Luxembourg are more attuned to illiquid strategies. In addition, Luxembourg recently introduced a limited partnership (LP) modeled closely on the U.K. Channel Islands LP, which is popular among European investors, Pathak added. There has been a significant uptick in the number of managers setting up illiquid structures in Luxembourg in the past few years. As a result, hedge fund business skews heavily toward Ireland, whereas illiquid fund business skews heavily toward Luxembourg.

Although many people in Luxembourg speak English, they may lack sufficient proficiency, Lechartier noted. Therefore, managers should speak with their prospective relationship managers to ensure that communication will be adequate. German- and French-speaking investors may be more attuned to Luxembourg, where those languages are also spoken. Anglophone investors may favor Ireland.

U.S. managers should also ensure that their E.U. service providers will be able to provide coverage during U.S. hours, Chan noted. To that end, some third-party AIFMs have established offices in New York.

See our two-part series on options for post-Brexit access to the E.U.: "Cross-Border Marketing Options and the Viability of Domiciling Funds in Luxembourg" (Nov. 10, 2016); and "Domiciling Funds in Germany or Ireland, PRIIPs and UCITS Structures" (Nov. 17, 2016).

Luxembourg Fund Vehicles

In Luxembourg, managers can set up an unregulated partnership or a Reserved Alternative Investment Fund (RAIF), Lechartier explained. A RAIF can be established very quickly as long as it has an AIFM. It can take the form of a special limited partnership (SCSp); a common limited partnership; a corporate vehicle known as a SICAV; or much less commonly, a contractual vehicle known as a "*Fonds Commun de Placement*," or FCP. The SCSp is the vehicle of choice for illiquid strategies.

See "Luxembourg Fund Structures Evolve to Meet the Needs of the Private Fund Industry" (Oct. 13, 2016); and our two-part coverage of the benefits of the new RAIF structure for non-E.U. fund managers: "Access to AIFMD Passport and Marketing to E.U. Investors" (Apr. 21, 2016); and "Marketing Options and Tax Benefits" (Apr. 28, 2016).

Irish Fund Vehicles

The Irish analogue to the RAIF is the Qualifying Investor AIF (QIAIF), which is popular among hedge funds, Lechartier explained. Ireland also offers an unregulated "1907" partnership, which lacks user-friendliness, he noted. Ireland is developing a LP structure that is intended to compete with the Luxembourg LP.

QIAIFs can be established as unit trusts, common contractual funds (CCFs) or corporate structures (ICAVs). The ICAV is the default option. Asian managers tend to prefer the unit trust, a vehicle with which they are already familiar. CCFs are popular because they are tax transparent. Large institutional investors and pensions often mandate CCFs because they offer favorable withholding tax treatment, especially for U.S. equities that pay dividends.

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

See "Trends in Irish Fund Launches and the Challenges – and Solutions – for Non-E.U. Fund Managers Using These Vehicles" (Oct. 6, 2016).

Typical Fund Structures

In a typical ICAV structure, the ICAV's board appoints an AIFM and a depositary, Lechartier said. In turn, the AIFM may delegate investment management to an investment manager, which may be located in any jurisdiction. It also appoints a fund administrator and a distributor. The fund manager may serve as distributor and may sub-delegate distribution to a placement agent. The board of the ICAV has ultimate control over the fund structure, including the power to fire the AIFM. Typically, an AIFM may hold one board seat, but the fund manager controls the board. Even though the AIFM has power to fire the investment manager, as long as the manager controls the board, the manager has the power to change the AIFM.

In an LP structure, the LP's general partner (GP) – not the manager – appoints the fund's depositary, Pathak added. In a Luxembourg LP, the GP is often an unregulated corporate vehicle known as a *Société Anonyme à Responsabilité Limitée* (SRAL), according to Lechartier. The manager controls the board of the GP, which appoints the fund's AIFM and depositary. Managers can maintain control by having control over the GP's or the AIFM's board.

A typical Cayman master-feeder structure will have problems taking in E.U. investors, Lechartier continued. Therefore, managers often use parallel vehicles. For example, E.U. managers will set up an E.U. master fund, a Delaware feeder for taxable U.S. investors and a Cayman feeder for tax-exempt investors. U.S. managers may do the opposite, using an E.U. feeder.

Illiquid fund managers may take U.S. investors directly into a Luxembourg partnership. Illiquid fund managers do not often use master-feeder structures, Pathak added. They often have one fund targeted at U.S. investors and a parallel Luxembourg fund to access E.U. investors.

Establishing an AIF

Launch Process

The launch process for an AIF takes from six to eight weeks, Lechartier said. A manager must first select service providers, he said. This can be done very quickly if a manager has a preexisting relationship with an administrator that already has a presence in the E.U.

Next, a manager should coordinate with legal counsel to develop fund documents, Lechartier continued. All AIFM, administration, depositary and investment management contracts should be reviewed by fund counsel.

It is possible to adapt U.S. offering memoranda for use in the E.U., Barwick said. Many managers use their standard U.S. documents and add a section that includes the information required by Article 23 of AIFMD, with cross-references back to the relevant provisions of the manager's standard offering memorandum. Inclusion of cross-references facilitates regulators' reviews.

The AIF must file its offering and constitutional documents with the regulator, Pathak added. In his experience, regulators do not ask many questions about fund documents. Managers are also required to notify regulators of any material changes to those documents. Managers tend to take "fairly liberal views" of what constitutes a material change, he noted. There are also ongoing reporting obligations, but they are not significant.

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

The operational work stream follows the creation of fund documentation, Lechartier said. This entails significant interaction with the depositary, the administrator and the AIFM. Interaction with the AIFM will concern risk controls and valuation.

Every time an authorized AIFM launches a new AIF, it must notify the relevant regulator and advise the regulator of the E.U. jurisdictions where the AIFM wants to activate the marketing passport, Pathak said. That process can take a month or more. Pending activation of the passport, the fund cannot be marketed, Lechartier added. After a manager has established its first AIF, it is relatively easy to launch additional funds.

Setting up bank accounts is the slowest part of the process, Lechartier cautioned. Banks take a long time to establish new accounts because of know your customer (KYC) and anti-money laundering (AML) requirements, Chan added. Managers should consult early with their administrators and depositaries about the process and the requisite documentation. In addition, when launching in Luxembourg, a fund's GP entity should be set up as early as possible so that the bank can satisfy its KYC/AML requirements, he observed.

See "FCA Fines Deutsche Bank £163 Million for Lax AML Controls, Warns Other Firms to Review AML Procedures" (Feb. 9, 2017).

Setup and Running Costs

Depositaries, administrators and AIFMs charge funds minimum fees of a specified number of basis points (bps), Lechartier explained. A fund will also incur legal and directors' fees.

All in, the cost of running an AIF typically starts at €200,000 to €300,000 per year. For example, a fund of €100 million may pay 25 bps. Funds with assets from €250 to €500 million may pay 15 to 20 bps. A fund smaller than €75 million will be very expensive and, after roughly one-and-a-half years, "will be very difficult to sustain," he cautioned.

Setup costs are typically charged to the AIF and amortized over five years, Lechartier explained. Depositary and administration fees are also charged to the fund. Therefore, the key issue is not what the fund is going to cost the sponsor but, rather, the fund's expense ratio.

In-House vs. Third-Party AIFMs

Setting up an AIFM can take up to one year, Lechartier explained. Doing so entails hiring appropriate staff and receiving regulatory approval. An AIFM with five staff members could have running costs of anything between €700,000 to €1 million or above each year, depending on the country out of which it decides to base its operations. In addition, the AIFM must be equipped with an information technology system and other infrastructure. An AIFM must also have paid-up capital of at least €125,000, Barwick noted.

Some managers set up their own AIFMs to retain full control, Lechartier continued. Others outsource to third-party AIFMs until it become financially feasible for them to set up a new AIFM. Others outsource particular segments of their businesses.

Some managers who establish their own AIFMs may later decide to outsource if their assets decline or if regulators ask for increased substance, Lechartier added. A manager that hires a third-party AIFM can charge the AIFM's costs to the fund, whereas a manager that runs its own AIFM bears the entire cost of the AIFM.

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

The only time it makes sense for a manager to set up its own AIFM is when the manager has "a proper commercial purpose to be in the E.U.," in Barwick's opinion. If the only reason for a manager to be in the E.U. is to gain access to the passport, or because E.U. investors insist on an E.U. structure, outsourcing is the only choice that makes sense.

Third-party AIFM costs vary, Lechartier explained. A fund with about €150 million in assets may pay four bps. A fund with over €1 billion may pay between one-and-a-half and one bps. A third-party AIFM's marginal cost of taking on a new fund is considerably lower than that of a non-E.U. fund manager because the manager must hire conducting officers/designated persons, who are very expensive. The third-party AIFM business has scaled up and now has sufficient technology and staff to support fund managers.

Managers setting up their own AIFMs like to hire individuals who have already been approved by the relevant regulators to avoid the risk that those regulators will not approve their hirees, Lechartier said. The cost of hiring certain approved conducting personnel is increasing dramatically, he cautioned. Moreover, there are insufficient approved compliance personnel – or people with the requisite portfolio or risk experience – in Ireland or Luxembourg.

See "Marketing Strategies for U.S. Hedge Fund Managers Under AIFMD (Part One of Two)" (Jul. 21, 2016).

Private Placements

Although AIFMD was intended to harmonize marketing, it actually resulted in very disparate treatment of private placements across the E.U., Pathak said. In certain permissive jurisdictions, like the U.K., a manager is only required to notify the regulator. In contrast, it is nearly impossible to conduct a private placement in France, he said.

A U.S. manager that wishes to undertake a private placement in the E.U. must register in each jurisdiction in which it intends to market, Barwick said. Generally, the further north in the E.U., the easier the process is. For U.S. managers, registering in the U.K., Ireland and Luxembourg is relatively easy. Some managers also register in Scandinavian nations. On the other hand, most U.S. managers avoid registering in the rest of the E.U. A U.S. manager might go through the pain of registering in one of those jurisdictions to accommodate a legacy client, but that process is painful, he cautioned.

The NPPR regime was to be eliminated upon the implementation of the third-country passport, under which authorized managers in approved non-E.U. jurisdictions would be entitled to an E.U. passport, Barwick continued. This was primarily a U.K. idea. As a result of Brexit, any proposition with "a British mark on it can be found languishing in the bottom of the wastepaper bin," he said. Therefore, the third-country regime will not be implemented any time soon, and the NPPR regime will continue in some form for the foreseeable future, he opined. In addition, countries like Germany could make their own NPPRs even more difficult. See our two-part series on the AIFMD passport extension: "ESMA Limits Positive Recommendation for AIFMD Passport Extension" (Aug. 4, 2016); and "Causes of ESMA's Recommended Delay" (Aug. 11, 2016).

For more on the NPPRs, see our two-part coverage of private placements by non-E.U. fund managers: "Guidance for Non-E.U. Hedge Fund Managers Registering Under E.U. Private Placement Regimes" (Dec. 3, 2015); and "Roadmap for Reporting Under E.U. Private Placement Regimes" (Dec. 10, 2015). See also "AIFMD Is Easier for Non-E.U. Hedge Fund Managers Than Commonly Anticipated" (Oct. 22, 2015).

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Reverse Solicitation

Marketing is a defined term under AIFMD, Barwick continued. Managers that intend to market in the E.U. must comply with several arduous obligations. “Marketing is an offer that is made by the manager at the initiative of the manager; therefore, throughout the entire E.U., if the initiative for the investment comes from the investor, then that is not marketing for these purposes,” he explained.

See “What Is the Difference Between Marketing and Reverse Solicitation Under the AIFMD?” (Nov. 6, 2014).

Different regulators interpret this concept – commonly referred to as reverse solicitation – differently. While the U.K. does not particularly care, according to Barwick, French and German regulators take a much harder line, requiring an investor to initiate contact with the manager. In practice, if a manager has had a relationships with institutions for some time, it is usually possible to claim that sales to three or four of them in a single country constituted a reverse solicitation. Managers that do so on “more tenuous” links are not following market practice and are likely to be the first to draw regulatory scrutiny.

Regulators are somewhat less concerned when managers target institutional investors, given that they are primarily focused on protecting retail investors, Pathak added. A key risk of reliance on reverse solicitation, however, is that if a manager is found to have sold fund interests in violation of AIFMD, the affected investors will have rights of rescission.

Determining what constitutes a reverse solicitation is very fact-specific, Barwick said. For purposes of that analysis, the conduct of a placement agent hired by a fund manager will be attributed to the manager. In contrast, if a consultant indicates that the consultant is working for an investor, then the consultant’s conduct is attributable to that investor, not the manager. One test is to look at which party pays the intermediary.

See also “Luxembourg Financial Regulator Issues Guidance on AIFMD Marketing and Reverse Solicitation” (Sep. 3, 2015).

IMPORTANT: This article contains information protected by copyright which can only be used in accordance with the terms of your Hedge Fund Law Report subscription agreement. You must not therefore copy or forward this article, its contents, or any contents on the password-protected Hedge Fund Law Report website. (Your subscription agreement explains how you can use contents for reports and presentations.) UNAUTHORISED USE OR DISCLOSURE IS UNLAWFUL.

© 2019 Mergermarket Limited. All rights reserved.

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL