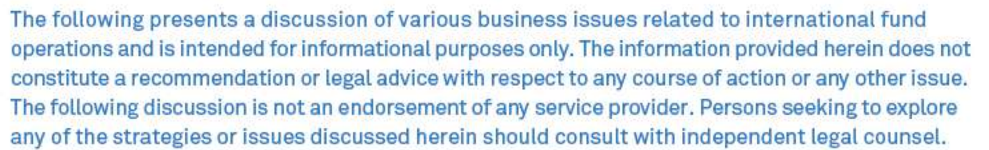
LAUNCHING ALTERNATIVE FUNDS IN EUROPE: EASIER THAN YOU THINK

An in-depth look at the
European alternative markets,
with a focus on the opportunities it offers
to U.S. alternative investment managers.

CONTENT PARTNER

BNY MELLON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The European Opportunity

Europe continues to offer alternative investment managers attractive fundraising opportunities. With the right partners, setting up and managing a European vehicle is more straightforward than it has been for many years. While asset managers today are launching alternative investment funds in the U.S. to take advantage of an investor community seeking greater diversification and higher returns, the alternative investment marketplace has become crowded and highly competitive. At the same time, investors have become more sophisticated, are demanding more of managers in terms of transparency and reporting, are being more selective in their fund choices and allocations, and are placing continued downward pressure on fund manager fees.

With business growing and allocations to alternatives increasing, U.S. managers may want to consider expanding their portfolios in Europe and diversifying their client bases. According to a report from Preqin,[1] there are more than 2,800 active institutional investors in Europe across the various private equity and hedge fund asset classes. The same report also cited that Europe-focused alternative investment fundraising surpassed the pre-global financial crisis high point of €132 billion in both 2016 and 2017. A new high mark was set in 2017 when 363 alternative funds closed, securing an aggregate of €184 billion in capital commitments.

To be successful with a European launch, managers need to familiarize themselves with European legal structures and operational differences as well as an array of regulatory requirements. As a result, many U.S. managers believe that launching in Europe is complicated and difficult to pursue.

The reality, however, is that the European alternatives market is simpler, faster and easier to enter than many U.S. managers may think. By making the right choices and aligning with the right partners, even managers with little to no experience in Europe can launch and manage funds there with relative ease.

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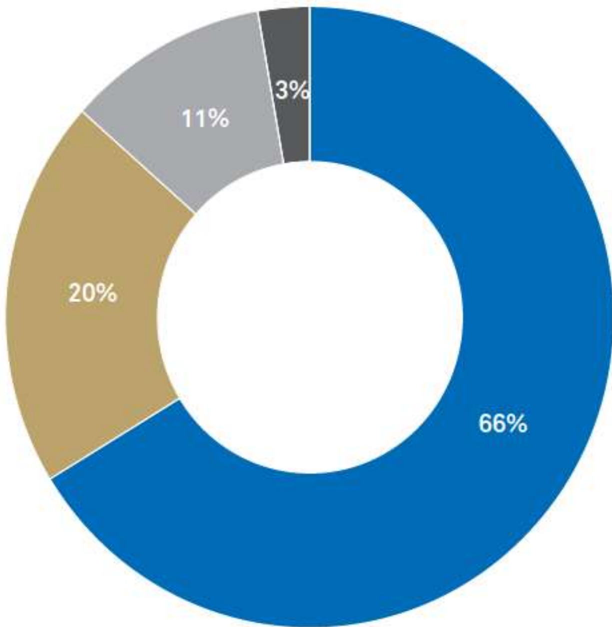
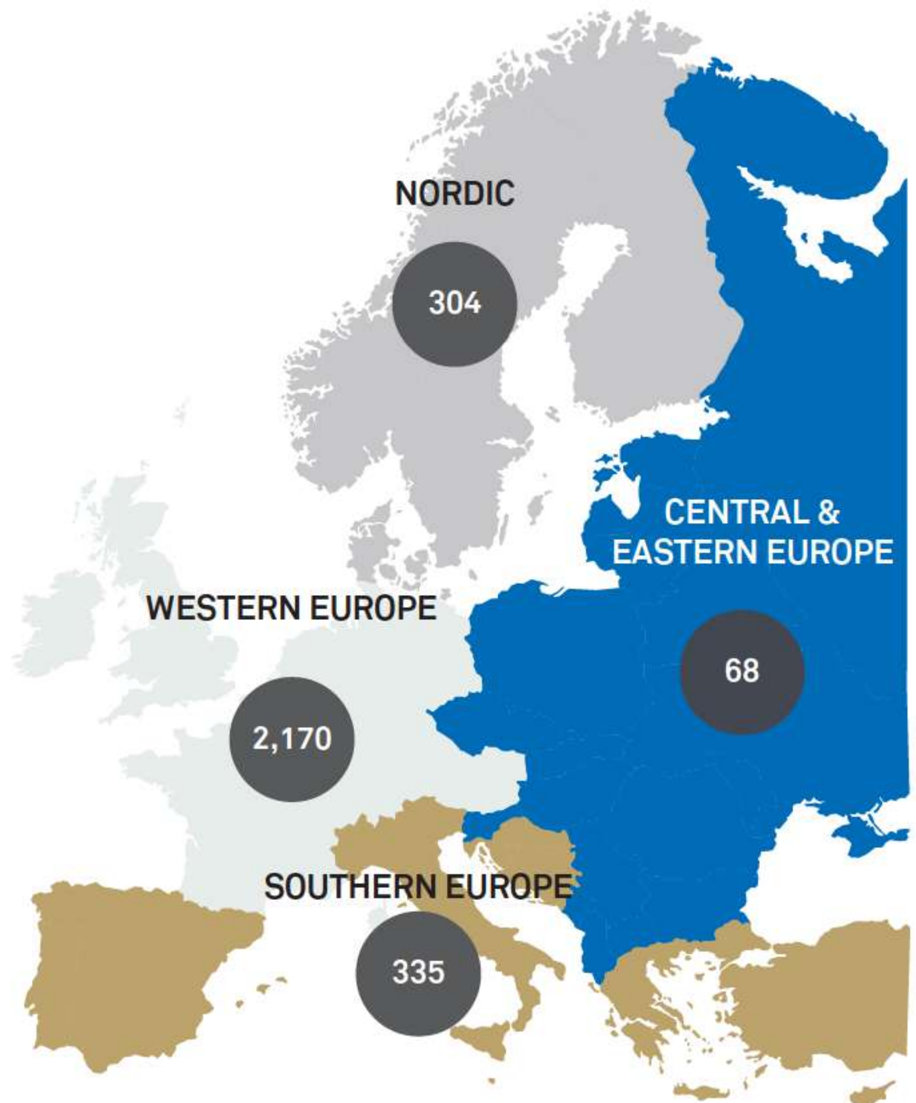
[1] *Preqin Markets in Focus: Alternative Assets in Europe*, June 2018.



ALTERNATIVE ASSETS UNDER MANAGEMENT BY REGION

(AS OF SEPTEMBER 2017)*

NUMBER OF INVESTORS ACTIVE IN ALTERNATIVES IN EUROPE BY REGION



*Source: Prequin. Based on the most recent available figure for private capital. Hedge fund assets under management (AUM) is shown for the same period for the purposes of fair comparison. AUM data is calculated in USD and has been converted to EUR using the 30 September 2017 USD:EUR exchange rate in all places.

EUROPE BY THE NUMBERS[1]

€1.48tn

European alternative assets under management (as of September 2017).

52%

of Europe-based hedge funds experienced net inflow over Q1 2018.

€601bn

Hedge funds represent the largest share (41%) of the alternatives market in Europe.[2]

Alternative Funds in Europe: Recent History

After the global financial crisis of 2008-09, the regulatory environment for investment managers in Europe entered a multi-year state of regulatory transition as EU regulators developed new regimes, structures and compliance requirements. In general, the goals of those efforts were threefold:

- build greater protections and liquidity for investors;
- reduce systemic risks; and
- create greater uniformity and transparency in private fund markets.

Over the past few years, such rules and compliance requirements have been implemented at both the EU and member state levels. While regulatory law is always evolving to some degree, these regulations have largely been solidified. With transition periods ended and implementation completed, regulatory uncertainties have been greatly diminished. In addition, service providers have evolved to help private fund managers handle the foreign regulatory requirements.

As a result, a much clearer regulatory picture has emerged for managers interested in launching funds in Europe, which has helped to spur this market's growth. This is quantified in a recent report from the market research firm Preqin.[1] The report reveals that in September 2017, European alternative investment funds (AIFs) had over €1.48 trillion in assets under management. That is up 9% from the year earlier and amounts to about 20% of the global total of alternative assets under management.

[1] *Preqin Markets in Focus: Alternative Assets in Europe*, June 2018.

[2] Source: Prequin. As of September 2017 for the purposes of comparing with private capital AUM data.

STEP I: Understand European Investor Needs and Preferences

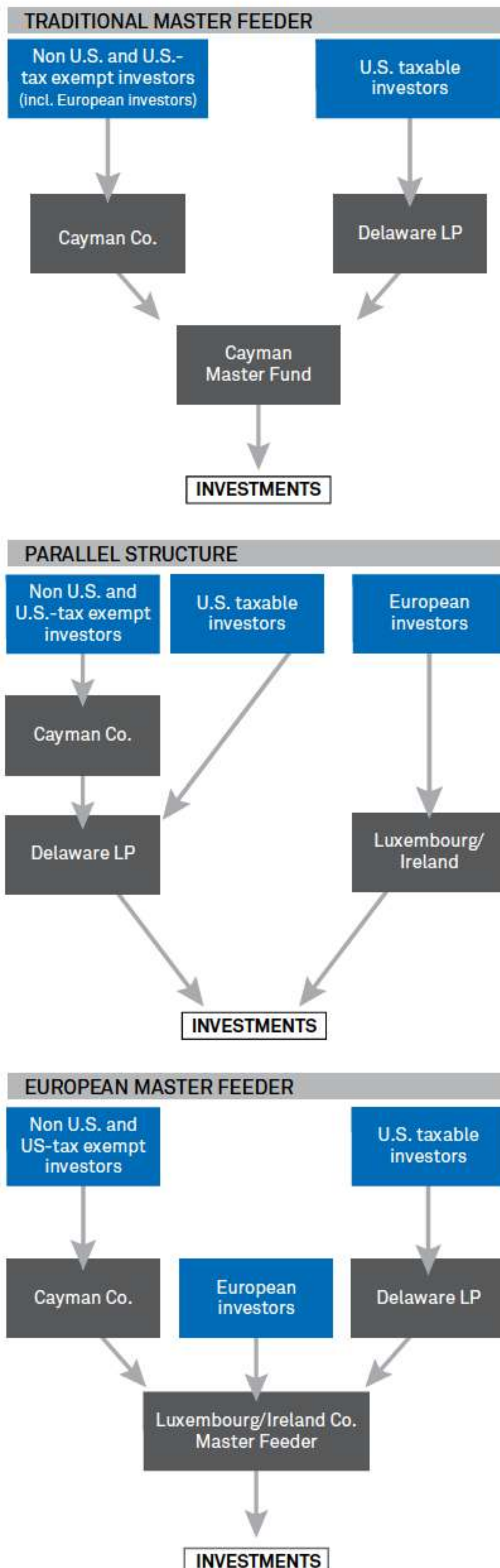
For success in Europe, managers should start with an understanding of the needs of European investors. Europe is not a monolithic market, and there are differences in investor preferences and the regulatory requirements involved in doing business in various jurisdictions. In addition, the types of funds and domiciles that will best suit various investor types may vary.

Structurally, there are two main paths that U.S. managers can take to enter the market, each with distinct characteristics. The first is to engage in targeted private placements of an offshore fund (existing or new, but one that is not domiciled within the EU) to sophisticated investors located in a limited subset of countries. The second is to launch a new fund that is domiciled within the EU. Generally, EU-domiciled funds fall under one of two investment fund regimes: the Undertakings for Collective Investment of Transferrable Securities (UCITS) product, which is like a U.S. mutual fund, or the AIFs product (details on each follow).

Deciding which regime best suits an alternative manager's needs should begin with a consideration of the preferences of various types of European investors. Certain continental European investors, for example, prefer the more regulated and EU-domiciled UCITS regime over the AIF regime. However, some investors find offshore funds attractive as an opportunity to invest in an existing structure (rather than a much smaller, new fund which will produce unique returns), while others require European-domiciled vehicles due to investment restrictions and other considerations. For example, many European pension schemes are restricted from investing offshore.

Due to several factors (including proximity, language and culture), U.K. investors tend to prefer Irish-domiciled funds while continental Europeans tend to prefer funds domiciled in Luxembourg. However, when one is investing in private equity markets, the fund structures offered in Luxembourg have become most popular due to tax, operational and legal considerations. While Ireland remains a popular destination for hedge funds and UCITS, Luxembourg is seeing significantly more partnership and closed-ended fund launches, including real estate and infrastructure funds.

Lastly, European investors' priorities with respect to which funds are attractive investments can vary. Some investors prioritize performance while others are more concerned with transparency or liquidity. If performance is paramount, that investor may be less interested in a new smaller fund (which will produce returns distinct from the master fund), for example. Managers who take the time to understand the needs and preferences of the specific segment or segments of the European investor base they are targeting will be able to more successfully structure their operational, marketing and distribution plans to attract allocations. A discussion of these considerations follows.



STEP II: Choose a Launch Strategy

As previously mentioned, there are two well-established ways for U.S. managers to enter Europe, each with its own advantages, costs and limitations: using an existing offshore fund (typically a limited partnership or offshore company not domiciled in the EU) or launching a new fund that is domiciled within the EU.

OPTION 1: USE AN OFFSHORE (NON-EU DOMICILED) FUND

Many U.S. alternative investment managers already have private placement funds operating in offshore locations such as the Cayman Islands or British Virgin Islands. The benefit of utilizing such funds is that the manager has a fully operational fund and can leverage what exists rather than starting from scratch, which makes this a fast and simple route to market. The offshore option also enables them to avoid some of the requirements and restrictions that apply to EU-domiciled funds. However, offshore funds must comply with the Alternative Investment Fund Managers Directive (AIFMD) (see below) and local country-specific restrictions on private placement and marketing.

In particular, marketing in Europe can be complicated. Without an EU-domiciled fund, managers will find that marketing and distribution regulations differ by country and they may be limited or unable to conduct to conduct private placements in certain European countries.

Another reason marketing can be challenging is that non-EU domiciled funds are not eligible for a marketing "passport" within the EU. These passports, which have thus far only been granted by regulators to EU-domiciled funds, enable the fund to take a unified approach to marketing across all EU member states. Without an EU fund, no passport is available, and without the European passport, offshore-domiciled funds must take a country-by-country approach to marketing and private placement, which is costly, time-consuming and often less efficient. Indeed, the ability of investors to use the national private placement regime in certain countries has been much less than some might have expected.

Another key consideration for managers marketing an offshore fund is understanding how to tap into the targeted European investor base. As previously mentioned, certain investors (e.g., pension schemes) may not be able to invest in funds structured offshore, which limits a portion of the manager's potential investor base while others may prefer a primary offshore fund to an EU-domiciled, and ostensibly smaller, parallel fund.

In addition, managers should note that European funds are generally not able to act as a feeder in a master-feeder structure where the master is located offshore. As a result, managers with an offshore vehicle may find that they will need a parallel structure to target European investors (and manage trade allocations accordingly).

AIFMD Requirements for Non-EU Domiciled Funds

Under the AIFMD, each EU member state can allow non-EU AIF Managers (AIFMs) to market a non-EU AIF to professional investors in that member state under that member state's own national private placement regime (that is, without a passport). To do so, the manager must meet the AIFMD disclosure standards (i.e., a supplement to the private placement memorandum is required), provide ongoing reporting on the prescribed forms (Annex IV), and provide an annual report to investors for each fiscal year (this is generally already provided by the auditor of the relevant offshore fund).

OPTION 2: LAUNCH A EUROPEAN-DOMICILED FUND

Setting up an EU-domiciled fund has become the primary path for U.S. alternatives managers to enter the EU market. Doing so puts the manager in closer proximity to the large investor base that exists across Europe, and places that fund under the EU's laws and regulatory requirements (discussed later).

At first glance, the EU regulatory requirements for alternative funds can seem complicated. But a closer look reveals flexibility and options that managers can use to structure their funds and create routes to market that best meet their needs.

European-domiciled funds generally may elect one of two regulatory regimes: the AIFMD or the UCITS directive.

AIFs

AIFs generally contain assets or pursue investment strategies that fall outside of the conventional investments such as long-only stock and bond funds. Instead, AIFs may pursue unconventional strategies involving leverage, derivatives and hedging, and hold illiquid assets such as real estate, infrastructure, private equity securities and distressed debt. Geared toward institutional investors, or professional investors and certain high-net-worth individuals, these funds may have complex terms or strategies and are less regulated than their UCITS counterparts. While such funds previously operated outside EU financial regulations for disclosure and transparency, these funds are now covered under the AIFMD, which imposes certain custody, management and risk requirements.

AIFs offer more flexibility to alternative investment managers in terms of their investment strategies. For example, there are fewer restrictions on leverage. For investors, AIFs provide opportunities for portfolio diversification and growth, and they can be used as a hedge against traditional asset classes if they are negatively correlated with the performance of stocks and bonds.

UCITS

UCITS can be thought of as European-based equivalents of U.S. mutual fund products, but with greater flexibility. The UCITS regime is designed to accommodate both retail and institutional investors. UCITS are popular in Europe among investors seeking exposure to several liquid strategies in stocks and bonds. However, alternative UCITS have grown increasingly common as well, with both long-only and other alternative managers launching alternative UCITS funds replicating their fund strategies within a UCITS.

UCITS have built-in mandatory diversification and liquidity requirements that can constrain a manager's investment strategy. For example, UCITS place limits on a fund's ability to hold above 10% of a single issuer's securities. That said, some European investors will only invest in UCITS funds because they view them as highly liquid and very transparent.

EUROPEAN-DOMICILED FUNDS GENERALLY MAY ELECT ONE OF THE TWO REGULATORY REGIMES: THE AIFMD OR THE UCITS DIRECTIVE

	AIFs	UCITS
Investment Strategy	Unconventional (e.g. real estate, loans, private equity and leveraged products)	Conventional (e.g. long-only and hedged stock and bond funds)
Market	Institutional/ Sophisticated Investors	Institutional/ Retail
Risk	Higher (relative to UCITS)	Lower (relative to AIFs)
Liquidity	High/Low	High

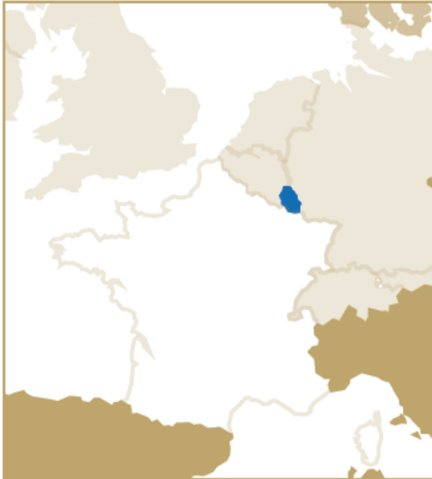
STEP III: Decide on Domicile and Legal Structure

In addition to choosing a regulatory regime, managers will need to consider the jurisdiction under which they will domicile their fund and what legal structure the fund will take. The location will determine the country-specific legal requirements and entity types that apply and which fund structure options are available to them.

When approaching these decisions, managers should consider:

- whether they have prior experience in the jurisdiction or any pre-existing relationships with the regulators in that location;
- the general reputation of a domicile and its financial ecosystem both inside and outside the EU;
- any existing business arrangements or relationships they may have with service providers in a domicile;
- the nature and implications of the legal and tax aspects of a domicile;
- native languages of a domicile and closeness of cultural alignment with the U.S. and target markets;
- the political and socio-economic stability of a domicile; and
- the familiarity of a domicile for the targeted investor base.

While a number of jurisdictions have a robust entity law, Luxembourg and Ireland are the two most prominent domiciles for alternative funds in Europe.



Luxembourg

With over €4 trillion in AUM, Luxembourg is the largest investment fund center in Europe, and the second largest in the world after the U.S. It is also a major center for AIFs, with more than €650 billion in assets managed by alternative fund managers.[3]

Luxembourg has a long history as a financial center, with a solid ecosystem of service providers for institutional investors. That makes it the jurisdiction of choice for managers with private equity-style structures. Due to the recent enactment of the Luxembourg partnership law, which was designed to resemble counterparts in other jurisdictions such as the U.K. and U.S., Luxembourg partnerships enable managers with U.S. investment structures to coordinate vehicle attributes and allocations among different pools of investors and different funds. In addition, Luxembourg (along with Ireland) remains a strong jurisdiction for hedge fund managers, providing an array of open-ended vehicle types, including the popular segregated portfolio company model.

Capitalizing on EU regulatory changes made after the global financial crisis, Luxembourg authorities developed several new vehicles, including:

The Special Limited Partnership: This is comprised of one general partner and one or more limited partners, similar to U.S. partnerships. The GP is jointly and separately liable for any commitments of the company on his/her private assets and property, while the LPs' liability is limited to their contributed participation interest.

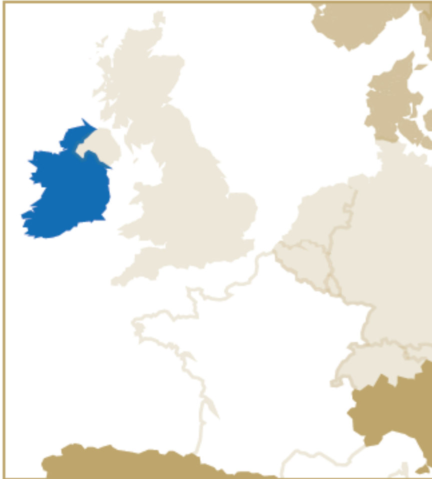
The Reserved Alternative Investment Fund (RAIF): A RAIF delivers a big advantage in shorter time to market, with the characteristics and structuring flexibilities of Luxembourg-regulated specialized investment funds (SIFs) without being subject to CSSF approval prior to launch. It also offers the ongoing benefit of regulating the manager rather than the fund itself.

Société d'investissement à Capital Variable (SICAV): This is an open-ended fund structure like open-end mutual funds in the U.S. The shares in the fund are bought and sold based on the fund's current net asset value and may be traded privately or in public markets.

Luxembourg's new regimes have been popular with alternative funds, particularly with real estate, private equity and debt.

Luxembourg has made it easy to market funds across Europe and offers the advantage of proximity to countries with large investor bases like Germany and France. In addition, Luxembourg has three official languages: French, German and the national language, Luxembourgish. Their client service teams often speak multiple other languages, which can be advantageous, and business is conducted in English.

[3]Source: Association of the Luxembourg Fund Industry: *Luxembourg: The Global Fund Centre*, November 2017



Ireland

Like Luxembourg, Ireland is another one of Europe's major investment fund centers. According to the Irish Funds Industry Association, as of June 2018, Ireland had 2,675 AIFs domiciled there with a total of €610 billion in AUM.

Clearly a strong and popular choice for managers of European AIFs and UCITS, Ireland reached and maintains its position by offering a range of innovative vehicles. While Ireland does not have a functional equivalent to Delaware partnership law, its company laws are robust and provide fund managers with multiple options for launching a European product and marketing it in EU countries. Some of these options include:

The Irish Public Limited Company (Irish Plc): This corporate entity structure has been available under Irish law for many years, and prior to 2015, was the primary fund vehicle for funds domiciled in Ireland. These entities have a minimum of two directors, with at least one of them being independent. Persons who invest as shareholders or members have limited liability for the actions of the company.

The Irish Collective Asset-Management Vehicle (ICAV): Able to be used for both open- and closed-ended funds, the ICAV (from the marketing and tax perspectives) is like a Luxembourg SICAV in that it has its own legal personality and can set up multiple segregated portfolios. In addition, the ICAV provides some synergies with U.S. fund tax accounting under U.S. GAAP.

Private funds in Ireland: These may be structured as a UCITS or a Qualifying Investor AIF (QIAIF). While UCITS may target both retail and institutional investors, a QIAIF is a regulated product exclusively for professional investors. QIAIFs are not subject to any investment or borrowing restrictions, so they can be used for a wide range of investment purposes and strategies. With its flexibility, the QIAIF is a very popular structuring choice for alternatives managers.

As a country, Ireland is familiar to many Americans and certainly to U.S. investment professionals. It has a strong and vibrant ecosystem built up around institutional financial services and it has proven to be a popular domicile for hedge fund AIFs.

REGULATORY REALITIES: MIFID II

Significant amounts of news and discussion have been generated in the U.S. capital markets around the Markets in Financial Instruments Directive II (MiFID II). A broad EU law, MiFID II sets the conditions for the initial authorization and ongoing regulatory requirements to which EU domiciled investment firms and other certain financial services companies must adhere. The regulations are intended to create more competition across the EU's financial centers, while ensuring appropriate levels of protection for investors and consumers of investment services. MiFID II also aims to increase transparency and remove systemic risks.

MiFID II's broad mandates include: suitability requirements for investment advice, best execution requirements for firms carrying out client orders, new pre- and post-trade transparency requirements for equity markets, and new minimum requirements for transaction reporting.

The good news for U.S. managers thinking about domiciling their alternative funds in the EU is that MiFID II exempts fund promoters, and so generally does not directly impact them. However, MiFID II regulates distributors and investment managers that do not fall within the fund promoter exemption. Its scope only extends in limited ways to institutional investors—the professional financial services types that alternative fund managers typically target.

U.S. managers, however, should be aware of several indirect impacts. These fall mostly on the distribution side of the business, and manifest as mandates with which entities such as prime brokers and placement agents must comply. One example is distributors giving advice to underlying clients where suitability requirements come into play. A similar mandate for distributors is knowing the definitions of what constitutes a 'professional investor' across the EU (which vary somewhat across jurisdictions) and running their operations accordingly.

The bottom line here for U.S. alternatives managers is that other than some concerns to watch for on the distribution side, MiFID II need not be a major roadblock to launching in Europe.

STEP IV: Select Service Partners

Prior to the global financial crisis of 2008-09, alternative funds were less regulated in Europe than other types of investment vehicles. That was basically because alternative funds were only for sophisticated institutional and professional investors, and the funds contained non-traditional investment types. However, with the systemic risks posed by alternatives and their limited transparency, that lack of supervision ended in 2011 with the AIFMD (Directive 2011/61/EU).

This major piece of legislation created a common regulatory regime across the EU for AIF managers (AIFMs). As the governing law for all European AIFMs, the Directive requires all covered AIFMs to obtain proper authorization and maintain transparency by making various disclosures as a condition of operation. Understanding all aspects of the Directive is critical for any U.S. manager looking to launch an AIF in the European market.

Two other important requirements the AIFMD creates for U.S. managers is the necessity for a designated AIFM and a depositary. As a result, managers will generally need to appoint third parties to fulfill these regulatory roles. From a regulatory compliance perspective, that opens the broader question for U.S. asset managers about all the partners involved:

Key Partner 1–The AIFM

In all cases, the AIFM is a key player within this regime. The AIFM has overall responsibility for portfolio management and risk management. Once appointed, a third-party AIFM can delegate some functions.

Therefore, it is generally the case that a third-party AIFM will delegate the portfolio management or risk management back to an asset manager in the U.S. Managers need to carefully consider the execution strategy because it has implications on fees and on how services are delivered. The AIFM can delegate as either delegated portfolio management or as investment advisory services. If the latter, then the third-party is asked to advise about the underlying assets, but the AIFM will retain the actual portfolio management duties. Typically, AIFMs in Europe will handle risk management and will delegate some or all of the portfolio management duties (except to the extent they are required to maintain substantive oversight).

Conversely, when a U.S. manager opts for a third-party AIFM, they forego some of the longer-term benefits such as building up their areas of expertise and keeping more of their operations in-house, but they avoid all the set-up costs. The manager also achieves a much shorter time to market, which enables faster fundraising, launch and active investing.

Key Partner 2–The Depositary

Having a depositary is mandatory under the AIFMD and UCITS regimes. In European alternative fund scenarios, the depositary's fundamental function is three-fold: cash monitoring and management, safekeeping of assets and general fund oversight.

Cash monitoring and management: Keeping track of what is happening with the money, paying close attention to any large or unusual cash flows.

Safekeeping of assets: Making sure that the fund has access to and is properly entitled to the assets it has invested in (that those underlying assets are in fact real and are owned by the fund).

General oversight: This is the duty to ensure that the fund is operating properly and is in line with all relevant aspects of AIFMD. Of importance here is ensuring that the way the fund's value (NAV) is calculated is correct and ensuring that the AIFM has adhered to all its policies and procedures.

A critical point here is that if something goes wrong, such as if the underlying assets do not actually exist, then the depositary is responsible for making the fund whole. And under the AIFMD, the depository's liability is unlimited. It is therefore obviously critical for U.S. managers to choose a depositary with sufficient substance, scale, resources and credibility.

Under AIFMD, depositaries have full restitution liability for the assets they hold in custody. For U.S. managers, this drives the obvious need to include an assessment of financial strength as part of the depositary selection decision.

From the regulatory perspective, it is important for U.S. managers to understand the different structures in place around AIF asset valuation. To the liability point, the AIFMD requires that asset managers either appoint an outside asset valuation agent or establish an independent valuation committee.

Key Partner 3–The Fund Administrator

In European alternative funds, the fund administrator's responsibilities include maintaining the AIFs, accounting, preparing and distributing annual financial statements, coordinating audits, handling regulatory reporting and creating periodic NAV reports for investors.

Since the appointed fund administrator will be the entity responsible for determining the NAV of their funds, it is critical for U.S. managers to work with an administrator to establish an operating model that has the most synergy with how the U.S. asset manager currently operates. Usually the same firm acts as the depositary and the administrator.

One final point is that European laws that govern or otherwise impact alternative funds and the entities involved in creating and running them continue to evolve. That is why it is important for U.S. asset managers to select global service providers that are not only focused on this market, but also understand it from the perspective of U.S. requirements and approaches. With that focus, providers can stay on top of any changes and incorporate such changes into their service offerings as soon as possible. For U.S. managers, that enables them to deliver the right services to their clients on the date they are required—rather than playing catch-up.

Key Partner 4–Legal Counsel

When setting up alternative funds in Europe, having the appropriate legal counsel is crucially important, especially in the early days when selecting domiciles and fund structures, and drafting documents.

Managers should look for a firm with a strong track record in the alternative investment space. The firm should have investment management-focused lawyers with in-depth experience advising funds and asset managers in key areas, including fund formation, legal aspects of investment strategies, tax issues from a U.S. and European perspective, and regulatory and compliance matters. It also helps if the firm can bring broader experience to the table, such as handling the legal end of fund types and asset classes.

Managers with specialized vehicles and complex partnership structures should seek to coordinate their U.S. and Cayman vehicles with the European entity, in which case it is vital to have a cross-border legal team in place to handle issues of U.S. law applicable to the manager and the partnership structure, and of European law applicable to the investment vehicle and local regulatory regime.

Anticipating Brexit

With the pending exit of the United Kingdom from the EU, and the fact that a significant amount of fundraising for EU-domiciled funds takes place in the U.K., it is natural for U.S. managers eyeing the EU market to question the potential impact of this change.

While the actual regulatory outcomes and their ramifications remain to be seen, all signs indicate that the U.K. authorities are likely to maintain an AIFMD-like law mandating very similar if not identical requirements as the EU for alternatives fund managers. For this reason, managers that are planning to launch funds in the EU and conduct fundraising in the U.K. would be prudent to conduct their activities in line with the existing AIFMD and the U.K. private placement regime.

Conclusion

Under current business conditions, extracting solid performance, managing higher operational and regulatory costs and growing assets under management continues to be challenging for alternative fund managers. Nevertheless, expanding into the European market can help a U.S.-based alternative fund manager grow their business and diversify their client base.

What asset managers—and especially U.S.-based firms—need to do to seize this opportunity is to have a strong yet responsive fund framework in place to meet EU investors' needs. Ultimately this requires that they put forth offerings that are familiar, easy for investors to understand and instill confidence.

Setting up and operating alternative funds in the EU is not as complicated as it may seem to U.S.-based alternatives managers. Using any number of paths, managers can set up and launch funds in this market relatively easily and quickly, market those offerings effectively and manage them efficiently. By selecting experienced service provider partners and then leveraging their expertise, experience and financial strength, managers can quickly achieve their goals and compete to win in this lucrative market.

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