BRINGING YOUR FUND TO MARKET

SIMON THOMAS AND SAM BROOKS OF MACFARLANES LLP DISCUSS THE FACTORS EUROPEAN HEDGE FUND MANAGERS NEED TO CONSIDER WHEN BRINGING NEW PRODUCTS INTO THE MARKET

Simon Thomas is a partner in the investment management group, specialising in alternative investment funds. He advises start-up and institutional investment managers on all aspects of the structuring, establishment and operation of investment management companies and investment funds with a particular emphasis on the hedge fund industry.

Sam Brooks is a senior solicitor in the investment management group, specialising in alternative investment funds.

One of the most interesting aspects of the implementation of the AIFMD is the renewed focus it has brought to the issue of how hedge funds are marketed.

In some ways, this is curious, because if you operate a typical fund and management structure (a Cayman Islands fund with a UK-regulated manager), the AIFMD has probably made little difference to your marketing activities. Around 60% of institutional hedge fund capital comes from North America. Of the approximately 20% originating in the EU, the substantial majority is raised in the UK and the Netherlands, both of which have retained helpful private placement regimes.

For some managers, however, raising capital in Europe using the traditional hedge fund model may now be a challenge. For example, if France, Germany or Sweden are marketing targets, the private placement regimes are likely to slow or even stall your efforts. "Relying on reverse solicitation" should be approached with extreme caution.

WHERE ARE YOUR INVESTORS?

If the objective is simply to sell your fund as widely as possible, or primarily in the US and UK, then a Cayman Islands fund is probably still the optimal choice. US and UK institutional investors are very familiar with Cayman Islands structures and, as discussed below, there are no major regulatory hurdles to marketing a Cayman Islands fund under the private placement rules in the US and UK.

> "IF THE OBJECTIVE IS SIMPLY TO SELL YOUR FUND AS WIDELY AS POSSIBLE, OR PRIMARILY IN THE US AND UK, THEN A CAYMAN ISLANDS FUND IS PROBABLY STILL THE OPTIMAL CHOICE"

If continental European institutional investors are a major target then the choice of fund domicile may be less straightforward. For example, many EU-based financial institutions have internal policies prohibiting them from investing in offshore funds, and even those permitted to invest may face private and public pressure to avoid products perceived as high-risk or even ethically questionable.

Additionally, the allocations policies of many European financial institutions designate only a small portion of their overall assets for investment in hedge funds. In some jurisdictions local legislation has imposed allocation limits across whole industry sectors, most notably the German Investment Ordinance. To date, there does not appear to have been a significant relaxation of these rules as they apply to EU AIFs managed by EU AIFMs but it is easy to imagine more generous allocation limits being applied in future. An obvious parallel to this is Ucits funds, which fall outside the "alternatives" bracket.

WHAT REGULATORY FORMALITIES ARE REQUIRED?

United States

Pre-AIFMD, most managers' primary consideration was: "How do I access US capital?" Reaching the US market is undoubtedly still important, but US securities laws are a known quantity. Most offering and subscription documents will already contemplate US investors, and filings such as Form D (to register an offering as a private placement) and CFTC forms can be processed without difficulty by local counsel. There are subtleties depending on the exact target investor base but, on the whole, marketing to US investors is a well-trodden path.

Managers also need to be aware of the Advisers Act. A non-US manager whose private funds have fewer than 15 investors in the United States and less than $25m in US AuM may rely on the "foreign private adviser" exemption, which puts the manager outside the scrutiny of the SEC entirely. Clearly, these are low thresholds. However, once breached, an exemption from full registration is still available to non-US managers whose advisory activities in the US are limited solely to managing private fund assets. Although, if a US place of business is established then the manager may only manage a maximum of $150m in private fund assets from there.

Switzerland

Recently introduced rules in Switzerland require a local representative and paying agent to be appointed where a fund is distributed in Switzerland, unless the fund is marketed only to regulated qualified investors. These have undoubtedly increased the cost of marketing into Switzerland, but compliance is fairly straightforward. There is now a good selection of Swiss representatives and their appointment documents will have already been negotiated and refined, meaning that the engagement process need not be painful. A few additions are also required to funds' offering documents, but these are in standard form and will be familiar to any Swiss investors.

European Union

For many managers, the potential pitfalls of marketing in the EU now top the list of their concerns. A Cayman Islands fund, even one managed by a regulated European AIFM, cannot take advantage of the AIFMD marketing passport, leaving the national private placement regimes or so-called reverse solicitation as the only means of accepting investment.

The problem with the national private placement regimes is that they vary significantly from country to country. In fact, not only are differing formalities involved, but there is not even any consistent definition of what constitutes "marketing", as opposed to "pre-marketing", which falls outside the scope of the AIFMD. While this is not generally an insurmountable obstacle, investor expectations need to be managed accordingly.

A possible solution is to set up a fund domiciled in the EU. The obvious advantage of an EU fund is the AIFMD marketing passport, meaning that only a single application need be made to market the fund across the EU. There may also be benefits when marketing to European institutional investors, as discussed above. On the other hand, the fund will probably need to be a regulated entity, such as an Icaf or a Sicav-Sif, meaning increased formation cost and time.

One point to note is that the EU marketing passport may in future be extended to Cayman Islands funds. No timetable for any extension has yet been provided by ESMA, so waiting for the passport to be extended is probably not a good strategy at present.

PRIVATE PLACEMENT RULES IN KEY EU JURISDICTIONS

JURISDICTION	IS PRIVATE PLACEMENT AVAILABLE? IF SO, WHAT IS THE PROCESS?	APPROXIMATE TIME TO MARKET	PRE-MARKETING?
France	Not available, although distribution to funds of funds and managed accounts is considered to be outside the scope of "marketing".	N/A.	None permitted.
Germany	Yes, but subject to approval by the BaFIN. A lengthy application pack must be submitted. A depositary services provider must be appointed.	Two to three months.	Limited pre-marketing permitted.
Netherlands	Yes, a simple notification must be submitted to the AFM.	The notification must be provided at least 20 business days prior to commencing marketing.	Limited pre-marketing permitted.
Sweden	Yes, but subject to approval by the SFSA. An application pack must be submitted. A depositary services provider must be appointed.	Two to three months.	Limited pre-marketing permitted.
UK	Yes, a simple notification must be submitted to the FCA.	Marketing may commence as soon as the notification is submitted.	Extensive pre-marketing permitted.

WHAT ABOUT REVERSE SOLICITATION?

Some managers have sought to avoid the EU marketing rules by taking advantage of reverse solicitation. Reverse solicitation refers to a situation where "marketing", as defined in the AIFMD, has not taken place because an investment in a fund is made solely at the initiative of the investor. This is helpful for an EU manager of a Cayman hedge fund because it means they need not comply with the local private placement regime. It is even more helpful for a non-EU manager because it puts the investment entirely outside the scope of the AIFMD.

While reverse solicitation strategies may have their merits, they are not without risk. It is not possible to "target" a country or region by reverse solicitation. By its nature, a reverse solicitation must not have been targeted otherwise it risks having been at the initiative manager and not the investor. Further, a representation by an investor that its investment was initiated by reverse solicitation is worthless if it is factually untrue. A standing request for information cannot refer to future funds by name so cannot be a request for information about those funds.

The real risk of relying on reverse solicitation is that, unless it is scrupulously employed only when an investment really was made at the initiative of an investor, the manager will always be at risk of a demand for rescission. This is not to say that reverse solicitation cannot happen, only that is should not be seen as a quick-fix solution or a marketing strategy in itself.

CONCLUSION

For managers aiming to sell a new product primarily in the US, the UK and Switzerland, the traditional Cayman Islands fund remains a compelling option. However, if continental Europe is likely to be a source of significant capital then more thought is required. An EU-based fund may be more attractive to institutional investors and will be able to take advantage of the marketing passport, but will take longer and cost more to launch. Marketing a Cayman Islands fund under the EU national private placement regimes is by no means impossible, but needs careful planning. ■

LEGAL ADVICE. PRECISELY CRAFTED.

We have hedge fund specialists in funds and tax who can advise start-ups in a cost-efficient way. We know the industry, understand investment strategies and can help start-ups think about the long-term to grow and develop your fund. We assist hedge funds at all stages of their life cycle.

DAMIEN CROSSLEY
DD: +44 (0)20 7849 2728
damien.crossley@macfarlanes.com

DANIEL HARRIS
DD: +44 (0)20 7849 2408
daniel.harris@macfarlanes.com

SIMON THOMAS
DD: +44 (0)20 7849 2444
simon.thomas@macfarlanes.com

Macfarlanes LLP 20 Cursitor Street London EC4A 1LT
T +44 (0)20 7831 9222 F +44 (0)20 7831 9607 DX 138 Chancery Lane
www.macfarlanes.com