

U.S. Managers Must Navigate New Fundraising Routes to Europe

*An expert discussion about the evolving regulatory
landscape for capital formation in Europe*

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An expert discussion about the evolving regulatory landscape for capital formation in Europe

This report is based on a recent Privcap webinar.
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The Panelists



James Hays
Partner
Simpson Thacher & Bartlett LLP



Alexandre Pouchard
Partner
Ernst & Young LLP



Antonis Anastasiou
Managing Director
Alter Domus

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Privcap: Before we discuss the upcoming changes to the fundraising landscape in Europe, James Hays, perhaps you can walk us through how the smartest managers are organizing fundraising in Europe today.

James Hays, Simpson Thacher & Bartlett: What we're really focused on throughout this conversation is the Alternative Investment Fund Managers Directive ("AIFMD"), which was Europe's response to the financial crisis of 2008. The aim of the AIFMD was to provide a harmonized solution for managing and marketing funds within the EU whilst at the same time providing a transparent means for investors to gain access to alternative funds. Sponsors seeking to market in Europe have seen an evolution since the AIFMD came into effect, which is the focus of this webinar. In effect, there are three basic strategies for U.S. managers looking to market their funds into Europe:

The first methodology, which has up to now been vastly utilized by U.S. managers for raising capital in Europe, is reverse solicitation. This requires the investor to initiate some form of positive action to the sponsor to request materials regarding a fund, request information regarding a fund, etc. The issue with reverse solicitation is that it requires the investor to perform some form of positive action on their own behalf. Furthermore, it places the sponsor at an increased risk of regulatory scrutiny. As a result, reverse solicitation cannot really be viewed as a marketing strategy, but rather as somewhat of an anomaly.

The second approach is for U.S. sponsors to register under the National Private Placement Regime or, as is often referred to, Article 42, which is relatively light-touch from a regulatory perspective and allows the sponsor to target those jurisdictions where it plans to actively market the fund. Article 42 does present some material downsides, those being that registration by a non-EEA fund manager of a non-EEA fund is effectively prohibited in certain jurisdictions, such as Spain, France, Italy and Austria. To the extent that you register your fund for marketing in multiple jurisdictions, those reports multiply over time.

Another issue with Article 42 is that in certain jurisdictions – let's take Ireland, the UK, Luxembourg, for example – it's merely a notification process. Unfortunately, in other jurisdictions (Germany, for example), it can actually take several months to receive approval to market the fund. As a result, your investor relations professionals and marketers are constrained in what they're able to do throughout Europe and it requires a staged fundraising process.

There is a third approach that we will focus on: the marketing passport. Certainly, with respect to my own practice, this has been much more of the recent trend within the past two years. The marketing passport enables a sponsor to market throughout the European economic area on a certain day (i.e., once the passport

is received). When the notification pack has been accepted, the sponsor is able to market throughout the EEA.

A key aspect of the marketing passport is that it is only available to EEA Alternative Investment Fund Managers managing European funds. Hence, as part of this conversation, we're going to be focused on the setup and establishment of Luxembourg funds, which is by far the most prominent jurisdiction where PE draw-down style funds are domiciled.

Alexandre Pouchard, Ernst & Young: To add to that, there are also tax benefits associated with the use of a passport. For instance, in some cases you may have the need for a so-called master holding company. The reason to use a master holding company is to get access to double tax treaty provisions and therefore mitigate the risks of double taxation.

Usually, that provision will deal with reduced or no withholding tax rate on dividends or interests, or it will deal with capital gain taxation for non-residents. Let's take an example: if you have a holding in a French company and you sell shares for a gain, most treaties entered into by France will provide the right to tax that gain in the investor jurisdiction as opposed to France. But that does assume that the right to claim the treaty benefit is valid (i.e., the business reasons associated with setting up that master holding company) and there is sufficient substance in that holding company. In the case where you have your holding company in the same jurisdiction as the firm that has obtained the passport, it will help the treaty position significantly.

Hays: I would like to second what Alex just mentioned. Within the past year or so in my practice, most sponsors were principally focused on the marketing benefits of obtaining a passport, setting up a European domiciled fund and looking into engaging a third-party AIFM. But within the last year or so, which I believe is a result of BEPS and some other tax regulations working their way through the pipeline, the tax benefits of setting up these Luxembourg funds have actually become more pronounced for sponsors. Those considerations are weighing more heavily in the analysis.

Antonis Anastasiou, Alter Domus: It might be useful to give some more details in regard to what we mean by marketing passport, which James has referenced. In effect, once the AIFM has obtained its authorization to act as the AIFM to the appointed funds, it is able to utilize its marketing passport, which enables the fund to be marketed to all of the different countries for which the fund manager would like to passport those funds.

Unlike the UCITS funds, which is a different regime and focused primarily on listed securities and distributed to retail investors, where the passport is assigned to the fund itself under AIFMD the passport utilized is that of the AIFM in itself. In order for the

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fund to be distributed to the countries of choice by the sponsor, the AIFM would need to prepare a marketing notification, which is then filed with the regulator of the domicile of the AIFM for review. Since the introduction of AIFMD, this process has been relatively harmonized and the review process should take, on average, two to three weeks. Either way, the regulator has a maximum of 21 days to revert back to the notification and, once this review has been finalized, the notification alongside all the relevant standard legal documentation is passed on to the host country and the fund can then be marketed within the countries of choice by the sponsor.

Privcap: What do managers need to understand about upcoming rule changes that will affect fund marketing in Europe?

Anastasiou: There have been some new developments and rules that have been introduced about who can and how the funds can be marketed. These changes are expected to come in force toward August of 2021. They make reference to pre-marketing to professional investors in the EU, and they give more significant definitions as to how this is to be implemented from 2021 onwards.

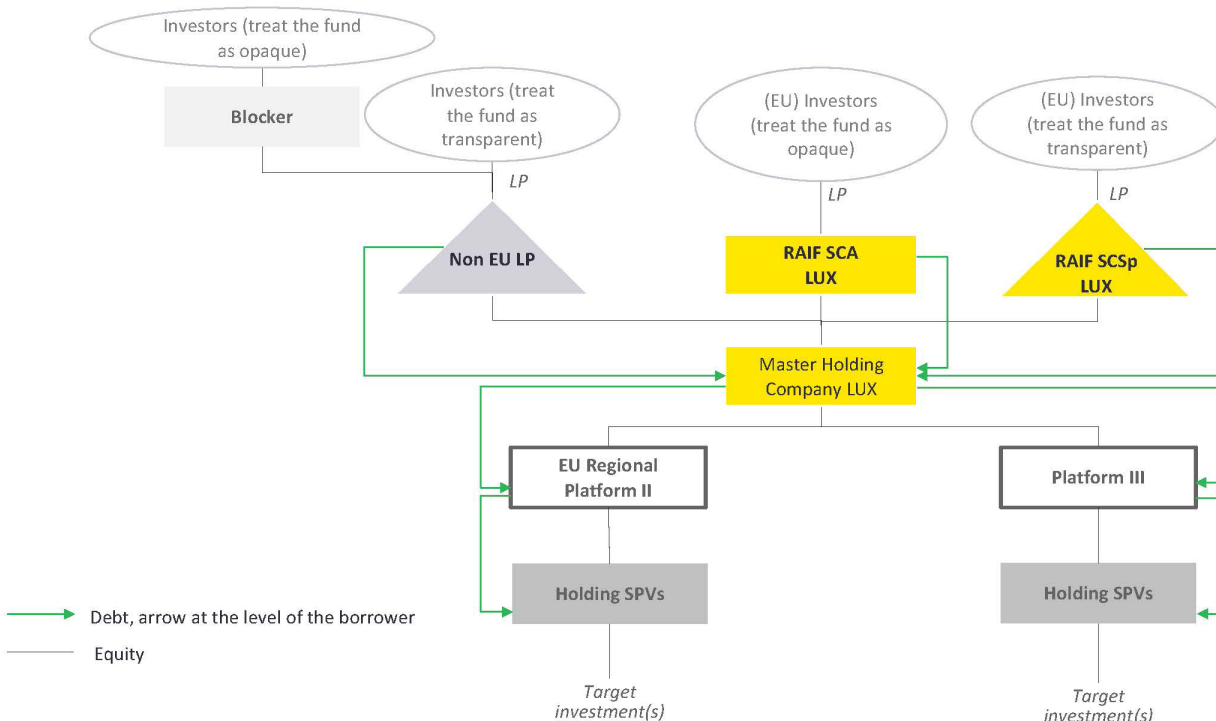
These new rules will also have an impact on reverse solicitation, as there is a definition of pre-marketing, which is now defined to be within a period of 18 months from the moment that the fund is

actually being launched to the moment that you have introduced the marketing to the investor. As there are also various rules and guidelines on pre-marketing, this theoretically cannot be deemed therefore to be reverse solicitation. This restricts a bit the position of when you can actually approach the investors within the EU. This will have a direct impact as to when you begin marketing and how you begin marketing the product within the EU, and obviously how it is that managers are going to be tackling marketing to European investors in the future.

Hays: Just to connect the first part of the conversation to what Antonis just mentioned – you really have historically come within the scope of the AIFMD by “marketing” an AIF. And, once you engage in that marketing, that’s where we’re looking at the Article 42 registrations (i.e., the country-by-country registrations) or the need to have the marketing passport.

Now, up until this recent directive that has come through and will become effective next year, each of the separate member states of the EEA had their own definition of what constituted pre-marketing. And, since this activity was not marketing, it did not require either a registration in the jurisdiction or a marketing passport. Now, many folks and many sponsors are able to effectively arbitrage and, in certain jurisdictions (in Germany, for example), the pre-marketing regime is quite liberal. In others (let’s take Norway), it’s very constrained if it even exists at all.

Example of a Non EU & EU Parallel Fund Structure

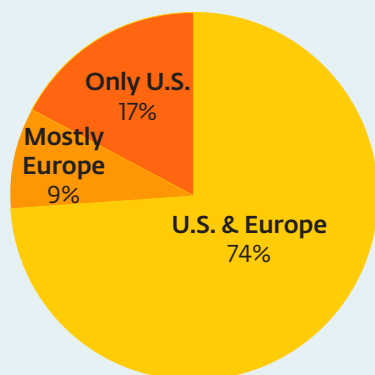


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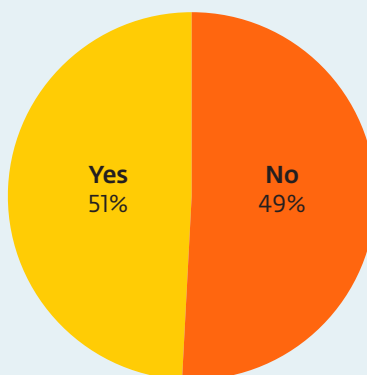
WEBINAR AUDIENCE POLL

Capital Raise

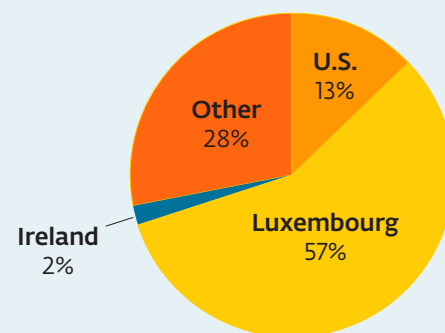
“Where do you expect to raise capital for your next fund?”

**Reverse Solicitation**

“Do you plan to leverage reverse solicitation for your next fundraise?”

**Domicile**

“Which domicile have you historically used to fundraise in Europe?”



which, in this instance, would be portfolio management. Following the delegation, the manager has control over how they will manage the portfolio of assets. They have the full authority for any investments or divestments that they would like to have in the portfolio of the fund. So, with such a delegation, even with the appointment of an AIFM, the manager does not lose the control of what allocations are made in the funds portfolio and in theory is still performing the same function as they would with their own non-EEA vehicles, whilst at the same time not having to manage the regulatory burden of managing an EEA-based fund.

Privcap: James, how have fund domiciles evolved over the years?

Hays: Historically, U.S. sponsors that have not relied on a passport were looking at two domiciles: Delaware and/or the Cayman Islands. Neither of those jurisdictions would benefit from the marketing passport because they're not within the EEA.

And, as many of you may have experienced recently with your own investor base, European investors are increasingly hesitant to subscribe to funds or even to participate in fund structures that go through the Cayman Islands, given their recent addition to the EU's blacklist of tax havens. So, to the extent that you are looking to domicile a fund in Europe, our natural inclination from being in the U.S. is to look at the UK and Ireland, which are common law jurisdictions, English speaking, etc.

In light of Brexit, the English limited partnership is out of our toolkit. And, although Ireland would seem to be a compelling alternative, unfortunately, the Irish partnership regime is not really advanced and for the moment does not have the tools needed in a PE-style partnership.

As a result, what we almost universally see in the market with respect to EEA funds in the PE space is that they are going to be a Luxembourg-domiciled vehicle. And the typical vehicle that we deal with is an SCSP or the Special Limited Partnership. An SCSP is very analogous to a Delaware Limited Partnership or a Cayman Islands Exempted Limited Partnership.

In terms of the documentation, it will be something that your outside legal counsel and your internal GC, as well as your investors, will be able to easily navigate because it matches up nicely with your historical precedence.

Privcap: Please elaborate on the benefits of domiciling in Luxembourg.

Hays: Many sponsors ask whether they should be setting up their own AIFM in Luxembourg. What's the cost? What's the timeline involved? Apart from the mega, vmega sponsors of the world, generally it is best to progress in terms of baby steps. As Antonis and Alter Domus know well, there are benefits to engaging a third-party AIFM in Luxembourg to serve as AIFM of the fund. They have boots on the ground and they have the expertise. It does not require you and your colleagues to try to figure out how to set up an office in Luxembourg.

The AIFM is responsible for portfolio management, risk management and valuation but, as Antonis said, almost universally, the third-party AIFM will fully delegate portfolio management back to your U.S.-registered investment advisor. As a result, all investment decision-making with respect to acquisitions, asset management, dispositions, etc., is identical between the two parallel funds. You're not giving up any authority in that respect. ■