



## Should I Market My Fund in Europe? Considerations for Non-E.U. Managers Marketing to E.U.-Based Institutional Investors

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On July 22, 2013 the rules for marketing private funds within the European Union (EU) changed dramatically. On that date the Alternative Investment Fund Managers Directive, or AIFMD, came into full effect, creating a range of regulatory requirements for managers of Alternative Investment Funds (AIFs) – principally hedge funds, private equity funds and real estate funds – to market within the borders of the E.U. The objective of the Directive is to enhance transparency in order that, in the wake of the Global Financial Crisis, the European Securities and Markets Authority (ESMA) and the European Systemic Risk Board (ESRB) will have the information they need to monitor E.U. markets holistically. AIFMD applies to the following Alternative Investment Fund Managers (AIFMs):

- i. E.U. AIFMs managing one or more AIF (regardless of whether that AIF is in the E.U.),
- ii. Non-E.U. AIFMs managing E.U. AIFs, AND
- iii. Non-E.U. AIFMs who market their AIFs in the E.U.

It is the third category above with which this piece is concerned – managers based outside of the E.U. who are considering marketing their funds/strategies to investors within the borders of the E.U.

### MAIN REQUIREMENTS & THEIR IMPLICATIONS

AIFMD, as with all regulations, carries with it a wide range of requirements, including registration, disclosure/reporting and maintenance of compliance requirements. The list of requirements is extensive and complex, and managers should always consult legal counsel for comprehensive advice of what is required under the Directive. For the purposes of this discussion, we focus on the business considerations of what is perhaps the most burdensome of the requirements, the establishment of portfolio management and/or risk management functions within the E.U. For the purposes of AIFMD, either or both of these functions must take place physically within the E.U.

From a practical perspective this means that, to be compliant with AIFMD's rules for marketing an AIF in the E.U., a manager must create an E.U. office, and base a meaningful amount of either portfolio management or risk management activities in that office, regardless of whether it is additive or dilutive to either function. Consider some of the costs associated with this:

- Salaries
- Benefits

- Office Rent
- Insurance
- Legal
- IT Set-Up/Maintenance
- Compliance
- Local Taxes
- Travel and Expenses

DMS estimates the cost of creating and maintaining one's own E.U. AIFM as being in the \$1-2 million range annually.

That cost burden is small, however, when compared to managing the effects of spreading the investment and/or risk management teams from their home base to another region. For the largest funds in the world, this is less of a concern – their investment, operations, risk, and compliance teams are typically already distributed across multiple global offices. Similarly, for the smallest emerging managers, this is a non-issue as they do not have the resources to open a location away from their home base, let alone in the E.U. But what about the mid-sized manager? Should they go through the cost, restructuring and distraction of making themselves AIFMD-compliant so they can market their strategies in the E.U.? The answer is not clear-cut and each manager's circumstances are different.



Pre-crisis, the old adage “If you build it, they will come” had some merit. Flows into alternatives were plentiful and both intermediaries and asset owners were consistently looking for managers to manage their increasing AUM. Since the crisis, however, managers cannot rely on that adage to justify making upfront investments of money,

time and other resources. A long-running bull market (4Q18 notwithstanding) has reduced the flow of capital into alternatives, as investors have preferred exposure to lower cost beta. Raising capital for alternatives has become a much more difficult endeavor, and the investment process of most allocators has become massively elongated.

## THE BIG QUESTION: TO MARKET OR NOT TO MARKET

So how does a manager of an alternative investment strategy decide whether it makes sense for them to become AIFMD-compliant and go through the other requirements to become eligible to market in the E.U.? There are a few key questions to be considered, which we pose to managers considering fund raising in the E.U.:

### Is My Strategy “In Demand”?

Where we sit on the demand curve for your particular strategy is a critical question. Demand for different products ebbs and flows, and where we are on the curve of that cycle informs the question of how salable your strategy is, and over what time frame. For example, if we are at the nadir of the demand cycle, perhaps it is the right moment to begin preparing for recovery by establishing an AIFM in the E.U. Completion of that process could coincide nicely with the return of interest in the strategy. Conversely, if we are late in the demand cycle and/or contraction has begun, one may take the decision to wait.

### How Does My Performance Compare to My Peers?

Regardless of whether demand is tepid or hot, marketing a strategy with returns that are mediocre (or worse) when compared to peers must be considered when weighing the decision to form an AIFM and market in the EU. The commitment of time, money and management attention is far too high if investors have more attractive options for exposure to your strategy or asset class. We would recommend that a manager be consistently in the top quartile of performers before embarking down the AIFM path.

### Is My Firm “Institutionally Marketable?”

By definition, an AIF is marketed to institutional investors (versus UCITS products which are geared more for individual investors). As a result, the expectations of your investors will be quite high when it comes to operational infrastructure, best practices, service providers and other elements commonly associated with an institutional-quality

fund manager. If your firm has somehow achieved success without, for example, having an independent administrator or without maintaining shadow books and records to check that administrator, it is unlikely you will be successful in marketing your strategy to European institutions. Your enterprise and your strategy must be able to stand up favorably to the most rigorous investment and operational due diligence.

### What Is My Timeline for Success?

As stated above, the process for institutional investors has become greatly elongated. What was previously a three-six month investment process is now routinely one-two years from first contact. Are you prepared to weather a period of that length with lower asset levels in your E.U.-domiciled AIF?

### Have I Demonstrated a Commitment to the Region?

Simply creating a structure that is AIFMD-compliant does not necessarily represent a “commitment” to the region. European allocators will expect to see members of the investment team with some degree of regularity and expect access to investor relations staff as needed, regardless of time zone considerations. Just setting up a small satellite office, or delegating to a third party (discussed below), is not sufficient. A manager must establish and be able to articulate their plan for servicing the needs of E.U.-based clients.

### DELEGATION

An intermediate method for achieving AIFMD compliance is to delegate either the portfolio or the risk management functions to a third party which is properly registered with the E.U. as an AIFM. Most of a fund manager’s value-proposition resides in their portfolio management function, so most managers choosing delegation select the risk management function to be delegated. This can be an efficient way for a manager to tackle some of the most burdensome elements of becoming eligible to market under AIFMD, as the cost is much lower and the set-up is managed by the delegated firm. It is not, however, without its own important considerations.

### CONCLUSION

In any industry, entering new markets is always marked with additional costs, rules, regulations and mistakes. Asset management is no different. What is different, however, is that many non-E.U. industry practitioners had previously been able to address the E.U. market like any other offshore market. That has all changed and even today, several years after AIFMD went into effect, managers are still unsure of what they can or cannot do, or how to remedy “holes” in their E.U. marketing practices.

Ultimately, those most harmed by this uncertainty are the European pensions, insurers, private banks and their clients who do not get access to the fullest possible range of fund products globally. It is our hope that, by consulting trusted advisors, as many non-E.U. managers as possible will become compliant and take advantage of the opportunities available in the EU markets.

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