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2016 Guide to setting up an Alternative Investment Fund in Europe

Brexit unlikely to impact outsourced AIFM model

Understanding the depositary role under AIFMD

The four pillars of cyber defence for start-ups

In this issue...

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Introduction

The publication of this Guide comes as shockwaves from the UK's decision to withdraw from EU membership continue to reverberate across the world, raising several challenges for UK-based asset managers distributing across the EU.

As Bobby Johal, Managing Consultant, Cordium, notes: "UCITS funds will still be distributed across Europe, but not in quite so straightforward a manner as is the case presently. UK UCITS will lose their status (under the UCITS directive) and most likely become alternative investment funds (AIFs). If we assume the UK is to be a 'third country' (the so-called WTO option: a big assumption, subject to much debate over the coming months), this will result in the loss of passporting rights and so such funds will be subject to the vagaries of the private placement rules of each of the states in which they are marketed. A significant increase in complexity and cost will result. A move to re-domicile from the UK (both the fund and management company) will be the inevitable outcome.

"Third country firms do not currently have any passporting rights but ESMA is undergoing a consultation exercise to determine the feasibility of extending such rights (as per AIFMD Art 67)) to a small number of jurisdictions with financial services legislative frameworks deemed to be most closely equivalent to those of the EU."

As the industry grapples with the post-Brexit world, start-ups need to tread carefully. How do traders and prop desk alumni take the first the steps to setting up their own AIFs in the transparent and correct format required by investors and regulators? And, given Brexit and sharpening regulatory differences on either side of the Atlantic and across Europe, where should these funds be domiciled?

To help answer these and other key questions for start-ups and established managers GFM's Team, led by Hedgeweek Managing Editor James Williams, has prepared a two-part "Guide to Setting up an Alternative Investment Fund".

In the first part (published in May 2016) we focused on the factors to consider when establishing an AIF in the USA. In this second part, we tackle these issues from the perspective of setting up an AIF in Europe.

This edition of the 2016 Guide to Setting up an Alternative Investment Fund in Europe was prepared with the support and expert contributions from the following firms:

- U.S. Bancorp Fund Services;
- Deutsche Bank;
- Dillon Eustace;
- Circle Partners;
- Eze Castle Integration;
- Lawson Conner;
- Malta Financial Services Authority;
- Guernsey Finance;
- Linear Investments.

If you would like to participate in future editions of this Guide, or wish to work with GFM on producing other industry Guides, do not hesitate to contact us.

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Chapter 1: Legal & fund structuring

Unlike the relative simplicity of the US market, where a domestic Delaware LP structure is the typical route to market for an onshore hedge fund, in Europe, under AIFMD, there is a veritable feast of options; an alphabet soup of fund acronyms springing out of different jurisdictions.

But whilst they all sound quirky and may at first reference confuse managers, it is worth emphasising that they are all derivatives of the same concept; an Alternative Investment Fund.

This chapter will highlight the main jurisdictional choices available to start-up managers considering the onshore route, and provide as straightforward a summary as possible from a legal entity and fund structuring perspective.

Defining an AIF

Strictly speaking, the term 'AIF' can apply both to onshore and offshore funds under AIFMD and works by using a set of criteria; i.e. does the particular vehicle raise capital from a number of people? Is it a non-UCITS? Is it a collective investment scheme where people combine their assets and share a pooled return? Does it have a defined investment policy?

"Those are the main building blocks of defining what an AIF is under the Directive. Whether it is an EU AIF or a non-EU AIF will have an impact on how the fund can be marketed in Europe and the extent to which AIFMD would apply to a particular vehicle. In the context of the European market, the key distinction is that an onshore AIF cannot be a UCITS and vice versa. The body of rules that they are subject to are totally separate but have, in some respects, become progressively closer in the last couple of years," explains James Oussedik, Partner at Sidley Austin LLP.

The a priori question for those managers who have been running existing offshore structures is: who will the target investors be in Europe? And should the fund be a UCITS or an AIF?

In this context, having decided to launch an AIF, managers should then ask themselves: where would be the most cost-effective and familiar jurisdiction in which to launch the fund, based on the target investors? If they are largely going to be continental European investors – French, German, Dutch – then a Luxembourg fund might be advisable. If the target investors are UK-based, an Irish vehicle will probably be advised.

"Manager bias, in terms of preferred location, ease of doing business, cost, and whether the target investors have a particular preference: these will all be factors in determining which AIF structure to establish," says Oussedik.

Pari passu feature

One of the biggest advantages to launching an onshore AIF is that it can ran pari passu (on an equal footing) to an existing offshore structure. There are no rules or restrictions placed on leverage, on physical shorting, on holding commodities which apply under the UCITS regime. This gives hedge fund managers free reign to run the investment strategy as best they see fit. For private equity, real estate and infrastructure managers running illiquid strategies, they have no option but to use an AIF over and above a UCITS because of the daily/weekly liquidity provisions.

"The market purpose of the UCITS fund was for it to become the retail product of choice in Europe and for that reason the regulatory burden and investment restrictions are much more formal compared to the more institutional investor environment which the AIF product is aimed at," confirms Oussedik.

Ireland

Over the years, Ireland has built out its financial services industry to become Europe's de facto onshore alternative funds domicile.

Up until March 2015, the most popular legal entity was the Irish Plc, also known as a Part XIII Company. This has since been superceded by the hugely popular Irish Collective Asset Management Vehicle (ICAV). Since March 2015, more than 157 new funds have been registered with the CBI using the ICAV fund vehicle, equating to more than EUR8.4bn in AUM. The majority of ICAVs, moreover, have launched as AIFs to market into Europe.

The ICAV was designed to improve efficiency and accessibility for new Irish investment funds, and now sits alongside the Irish Plc as a tailor-made corporate fund vehicle for both UCITS and Alternative Investment Funds (AIFs).

Managers who might already be running an existing Plc are able to transfer it into an ICAV should they wish, provided the manager seeks shareholder approval.

"Under the legislation, the Plc 'continues' as an ICAV, so while the legal structure is changing, the intention is to avoid causing a tax event for investors," explains Donnacha O'Connor, Partner at Dillon Eustace.

Key features of the ICAV:

- Authorisation and supervision by the Central Bank;
- Establishment as a UCITS fund or an AIF;
- If established as an AIF, it may be structured as open-ended, closed ended or with limited liquidity;
- Possible establishment as an umbrella fund with segregated liability between sub-funds;
- Multiple share classes;
- The assets of the ICAV must be entrusted to a depositary;
- Registered office in Ireland;
- Board of directors and a minimum of two directors.

"I think that, given that the ICAV is subject to its own bespoke legislation and distinct from general Irish company legislation, there is a general expectation that the advantages of an ICAV over an investment company will only increase and that the ICAV will be more responsive to changes in the needs of investors over time," comments Philip Lovegrove, a partner in law firm Matheson's Asset Management and Investment Funds Group.

The Irish Qualified Investor Alternative Investment Fund ('QIAIF')

Alongside the ICAV, the Irish Qualified Investor Alternative Investment Fund (QIAIF) is the preferred fund structure used by investment managers wishing to avail of the AIFMD fund passport.

The Central Bank of Ireland ("Central Bank") and AIFMD legislation does not impose investment restrictions or parameters on QIAIFs in the same way as apply to UCITS funds. Instead, the QIAIF regime imposes minimum disclosure requirements including disclosure as to investment strategy, use of leverage borrowing and liquidity provisions in a QIAIF. The Central Bank QIAIF rules primarily relate to how an investment manager discloses to investors what it is they intend to do with the fund.

This flexibility has made the QIAIF the vehicle of choice for both hedge and private equity fund managers, with the aforementioned ICAV, Limited Partnerships, Unit Trusts and Corporate entities offering a variety of solutions for fund managers seeking efficient tax structuring for investors.

As of March 2016, there were 1961 QIAIFs (including 578 umbrella funds) registered with the CBI.

"Other jurisdictions have come up with competing fund structures over the years but my view is what Ireland got right was that, from the outset, it created a regulated product, with minimal portfolio regulation and a quick and straightforward authorisation process.

"This has worked well. The Reserved AIF and Notified AIF being introduced to Luxembourg and Malta respectively may also provide a quick route to market. However, these are both unregulated funds. Ireland sees itself as being in the regulated funds business, so it is unlikely that the Irish government will sanction an equivalent unregulated fund structure in the foreseeable future," confirms O'Connor.

An interesting derivative of the QIAIF is the loan origination QIAIF, which Lovegrove confirms is beginning to receive increased interest from clients as the EU's Capital

▶ 9

Irish ICAV continues to gather momentum

Interview with Donnacha O'Connor

Since the Irish Collective Asset Management Vehicle (ICAV) came into effect on 18th March 2015, more than 157 vehicles had been authorised by the Central Bank of Ireland (through March 2016), according to the latest statistics released by Irish Funds, the representative body for Ireland's cross-border investment funds industry. In total, these funds have more than EUR8.4bn in AUM and have attracted net positive inflows every single month.

This is a testament to Ireland's reputation as Europe's leading onshore alternative funds jurisdiction and is helping to further augment the number of Irish-domiciled funds.

"Ireland has a longstanding tradition as a fund servicing centre," says Donnacha O'Connor, Partner at Dillon Eustace, one of Ireland's leading law firms. "There are more than 50 fund administration firms here alone, from large banking groups to smaller firms, so a number of tiers exist to support fund managers of different sizes. Ireland has traditionally been a fund administration centre for all types of funds and has built a deep level of expertise."

Indeed, on the back of the ICAV's success, Ireland's funds industry grew 21 per cent through November 2015, over a 12-month period based on the net rise in assets within the Qualified Investor Alternative Investment Fund or 'QIAIF'. Through March 2016, total assets within Irish QIAIFs were approximately EUR363bn according to Irish Funds.

Commenting on the ICAV, O'Connor says that it has become the corporate fund structure of choice based on the above figures. "By comparison, the number of new Irish public limited companies (plcs), which was the ICAV's predecessor, is much lower so the ICAV has become the default corporate fund.

"The ICAV is a bespoke piece of funds legislation so general Irish Company Law doesn't apply. In addition, the ICAV is a corporate 'check-the-box' entity, which is beneficial for those wishing to market to US taxable investors and umbrella ICAVs can prepare separate audited financial statements for individual sub-funds. From a marketing and tax point of view, the ICAV is an enhanced version of the Irish Plc."

Donnacha O'Connor, Partner at Dillon Eustace

Whilst UCITS still remains the predominant fund product in Ireland – there are just shy of 4,000 funds including sub-funds – the number of QIAIFs is rising as more and more alternative fund managers bring regulated funds to market. Through March 2016, there were 1,961 QIAIFs registered with the CBI (including sub-funds).

"The numbers of QIAIFs being established are definitely accelerating, especially for managers implementing mandates for small numbers of institutional investors or managers operating in the private equity and real estate space as UCITS funds cannot invest directly in those asset classes. The fact that real estate assets have yielded good opportunities in Ireland over the past number of years and that QIAIFs are very tax efficient has meant that there have been a significant numbers of new real estate QIAIFs in particular established," observes O'Connor, who adds:

"We are also starting to see more start-up hedge fund managers coming to market than was the case over the last few years. Those managers are looking at domiciling their funds in the EU rather than offshore because it gives them easier access to the EU internal markets for funds. That trend is slowly shifting, which is good news for Ireland. If you are a start-up manager, there are real marketing advantages to be had from a carefully considered fund structure domiciled in the right jurisdiction," concludes O'Connor. ■

6 ▶ Markets Union project gathers momentum. This will harmonise regulation in the loan origination space and will, he says, help to reduce the risk of regulatory arbitrage between jurisdictions, ensuring a more coherent approach to the regulatory requirements that these funds will operate under.

"This should, in turn, create further confidence among investors and borrowers in respect of direct lending funds and thereby drive further demand for such products. A loan origination QIAIF is subject to a minor additional reporting requirement in that a list of any undrawn committed credit lines must be submitted to the Central Bank with the fund's periodic reports," explains Lovegrove.

Luxembourg

AIFMD is ultimately a manager-focused directive. Luxembourg was quick to recognise this and in 2013 it created the Luxembourg Limited Partnership Regime, allowing for Luxembourg AIFs to be treated as Luxembourg limited partnerships, which are not necessarily subject to direct supervision by the CSSF.

Alongside the existing common limited partnership or 'SCS' regime, which has a legal personality, managers can now choose to avail of the Special Limited Partnership ('SCSp' regime) with no legal personality. The SCSp regime brings greater flexibility to help attract managers used to the Anglo Saxon LP regime.

There are now more than 1,000 of these limited partnerships registered in the Grand Duchy.

The fact that managers can choose to avail of the Lux LP or Lux SLP regimes means that Luxembourg is well placed to cater to a wider range of alternative investment managers looking to bring onshore funds to market.

As referenced by O'Connor above, Luxembourg is also currently preparing to launch a new unregulated AIF, known as the Reserved AIF. This will be the latest wave of innovation, following the SCSp regime, and will bring a further unregulated option to the table.

Without going into too much detail, Luxembourg offers both regulated products

"I think going forward, the RAIF will be the norm and the regulated alternative investment fund – the SIF – will probably become more of the exception."

Claude Niedner, Arendt & Medernach

– namely the Specialised Investment Fund ('SIF') and the société d'investissement de capital à risqué ('SICAR') and now, in the spirit of AIFMD, unregulated products – namely the SCSp and the Reserved AIF ('RAIF').

"Luxembourg has deposited a new Bill of Law with the Luxembourg Parliament called the Reserved Alternative Investment Fund 'RAIF') Regime, and that regime embraces the concept of AIFMD being manager-focused regulation. These funds do not need to be under the direct supervision of the CSSF but they do need to appoint an authorised AIFM, based in Luxembourg or any other EU jurisdiction.

"I think going forward, the RAIF will be the norm and the regulated alternative investment fund – the SIF – will probably become more of the exception," comments Claude Niedner, Chairman of the ALFI Alternative Investments Committee and Partner at law firm Arendt & Medernach (Luxembourg).

It is hoped that the RAIF will be approved by the end of the summer.

In terms of the legal entity, a RAIF can be created in the form of a company or a contractual common fund (FCP). If it is established as an investment company with variable capital it will be called a 'SICAV'. There, it can choose to operate as a partnership (SCS or SCSp), a limited liability company, or a limited company form; whatever suits the manager best.

One can think of the RAIF as combining the legal and tax features of the SIF and the SICAR fund regimes, but without the regulatory oversight of the CSSF. The SICAR was first introduced in 2004. Then, in 2007, the SIF was created. Within three years, more than 1,000 SIFs had been licensed by the CSSF.

Fast forward to 2013 and over the last few years, the number of limited partnerships has likewise exceeded 1,000 in number.

The RAIF is likely to prove just as popular, and reduce interest in the SICAR. After all, this was designed only for venture capital and private equity investments and is more rigid than the all-asset class capabilities of the RAIF.

As Niedner states: "Why would you buy a 2004 car when you can go out and buy the 2016 model instead?" Following the success of the SIF and the limited partnership, I think we will likely see the number of RAIFs exceed 1,000 in the next five years."

Malta

Since joining the EU in 2004, Malta has carved out a reputation for being the go-to jurisdiction for start-up managers.

"The MFSA is very approachable to new promoters and offers appropriate guidance where necessary in order to faciliate the application process. Malta hosts a wide range of service providers, all of whom are well versed in structuring and supporting alternative investment funds, fund administration, risk management and so on," comments Nicholas Warren, Manager, Corporate Services, Chetcuti Cauchi Advocates.

From a legal entity perspective, the most common structure for hedge funds in Malta is the SICAV. This can be used for single fund structures and umbrella fund structures, depending on the manager's preference.

In addition to the SICAV, promoters can choose to avail of the investment company with fixed share capital, limited partnerships, unit trusts, common contractual funds and one structure that is becoming increasingly popular: the Recognised Incorporated Cell Company ('RICC'). The RICC does not require a CIS license, but will need to obtain a recognition certificate from the MFSA.

The RICC works in a more advantageous way to a SICAV in that different SICAVs – not just sub-funds – can be plugged in to the RICC as incorporated cells," says Dr. Stefania Grech of Chetcuti Cauchi Advocates. "The RICC will have legal agreements in place with each underlying incorporated cell, which will be fund structures in and of themselves; multi-fund SICAVs with their own underlying sub-funds for example."

This plug and play option is ideal for start-ups who wish to avoid the costs of setting up their own standalone fund. Each incorporated cell is a separate legal entity, meaning the manager can easily unplug the fund and launch it as a standalone structure.

Two rulebooks

Most managers, however, will want to get a standalone fund in place. To that end, Malta offers two rulebooks: the Professional Investor Fund ('PIF') regime and the AIF regime. Managers who prefer to remain out of scope of AIFMD and market their fund(s) under NPPR rules would ordinarily choose a PIF.

The PIF regime defines three types of investors. An Extraordinary Investor is someone who invests EUR100,000 or more in the fund. A Qualifying Investor is defined as someone willing to invest EUR75,000 to EUR100,000, and an Experienced Investor as someone willing to invest EUR20,000.

"The plan is to consolidate the PIF regime and have one category: the Qualifying Investor Fund. If a PIF is set up and does not opt to be a de minimis PIF (EUR100mn threshold for open-ended funds and EUR500mn for closed-ended funds), and the manager is aware that such thresholds will be exceeded after the fund launches, the MFSA will require the PIF to be converted into an AIF where it will fall under the full scope of AIFMD," explains Warren.

The Notified AIF

Like Luxembourg, Malta has also introduced an unregulated fund – in this case the Notified AIF – where the AIFM is responsible for the running of said vehicle.

"Once the AIFM has done all its due diligence and is happy with the NAIF's arrangements, it simply contacts the MFSA. Notification must be submitted within 30 days from date of resolution and the MFSA will then, within 10 days, include the fund in the list of notified funds, if the full application pack has been submitted," explains Warren.

Conclusion

The options available to managers wishing to establish an onshore European AIF are numerous. As with everything in the funds industry, the ultimate decision on where to structure the AIF will come down to manager preference and that of their target investors. ■

The Netherlands – A cost efficient option for start-up managers

Interview with Gerben Oldekamp

Whilst the Netherlands might not be foremost when people think about choosing their preferred European jurisdiction, there are many advantages it has to offer. The Dutch regulator, the Authority for the Financial Markets ('Autoriteit Financiële Markten', or 'AFM'), is proactive, swift at processing licenses for full-scope AIFMs, and easy to approach if the manager has anything that needs clarifying.

As well as having first-rate transport, operational and technical infrastructure supported by a deep pool of professional advisers, the Netherlands' reputation is helped by having:

- A political and economic climate, which has been stable for decades;
- An exceptional number of bilateral tax treaties, low corporate tax rate and availability of favorable tax incentives;
- A positive approach taken by successive governments and an open-minded, dialogue-based attitude of the tax authorities; and
- A highly educated, flexible and multilingual workforce.

Under AIFMD, there are two routes for managers to pursue: licensing or registration.

A Dutch AIFM wishing to manage a Dutch AIF will be required to obtain a license from the AFM and will then be subject to ongoing regulatory supervision by the regulator. Once the manager has obtained a license they are free to manage either a Dutch AIF, or an AIF domiciled in any other EU Member State, and benefit fully from the passporting regime.

An EU manager based outside of the Netherlands will be required to have a license to manage a Dutch AIF.

Gerben Oldekamp, Managing Director, Circle Partners

The second route is to avoid licensing and apply for an exemption, whereby the manager is only subject to certain registration and reporting obligations. This registration regime is referred to in the Netherlands as the 'light regime'. Managers must include a selling restriction in a prescribed form in all advertisements and documents announcing the offer of participations in their fund.

Upon registration, general information on the Dutch manager and the AIF will be published in a public register.

"The registration regime may be attractive for managers based inside and outside the Netherlands, due to the lower costs involved. In the case of a foreign manager, a management company should be incorporated in the Netherlands, which will act as the Dutch AIFM," explains Gerben Oldekamp, Managing Director, Circle Partners, a global independent fund administrator headquartered in the Netherlands.

In order to comply with an exemption from the licensing regime, a manager's total assets under management in the AIF (and other vehicles including managed accounts) must not exceed:

- EUR 100 million; or
- EUR 500 million, in the case of AIFs that are not leveraged and have no redemption rights exercisable during a period of five years from the date of initial investment in the relevant AIF.

At the same time:

- Participations are offered to fewer than 150 investors; or
- The minimum investment amount is EUR100,000; or
- Participations are only offered to professional investors.

Under the light regime, the manager – also referred to as a de minimis manager – does not need to appoint a local auditor for the AIF.

If they wish, however, start-up managers can choose to opt-in to the AIFMD from day one and apply for the license. There are certain merits to doing this: namely that it can help managers to attract institutional investors as it demonstrates that the manager is serious about the long-term prospects for their business. In addition, the AIF will have the ability to be freely passported to professional investors across the EU.

"Under the light regime, managers will only be allowed to privately place the fund to professional investors on a country by country basis using national private placement regimes," explains Oldekamp. "The benefit of remaining below the threshold is that managers can operate the fund at lower cost and still be registered in an EU country with a good reputation and a good network of service providers. There's an abundance of knowledge and talent here that start-ups can draw upon.

"Also, an important factor to consider under the light regime is time to market, which in most cases is only a few weeks."

That said, the Netherlands remains attractive even for AIFMs that are licensed and fall under the full scope of AIFMD.

For example, there is no requirement by the AIFM to appoint local parties – fund administrator, custodian, etc – and the average onboarding time is very low compared to other jurisdictions, according to Oldekamp.

"Also, the cost of launching an AIF is very reasonable. It makes the Netherlands a very attractive alternative jurisdiction.

"For AIFs that go beyond EUR100mn and fall under the full scope of AIFMD, provided the manager is authorised by an equivalent regulator in their home jurisdiction – the FCA, for example – they do not need to have any substance in the Netherlands. What managers typically do is avoid obtaining a license and instead become part of an umbrella structure where they run a sub-fund and act in an advisory capacity, or they establish a standalone fund and appoint a Dutch management company as their outsourced AIFM," says Oldekamp.

If the manager crosses the EUR100mn and does not appoint an external AIFM, the burden will fall directly on them to operate as a licensed AIFM, with all the proper risk and compliance functions in place, segregation of duties (risk management and portfolio management), regulatory reporting requirements under Annex IV and so on.

"It's difficult to do that if the team only has four or five people. It would require fund managers to significantly beef up their operations – which is why most fund managers go down the outsourced AIFM route where they take care of all the heavy lifting and managers can focus on running the fund strategy," adds Oldekamp.

In terms of structuring the AIF, the most commonly used open-ended investment fund vehicle for investing in daily traded assets in the Netherlands is the FGR; a fund for joint account. This would be the choice for hedge funds, whereas a Dutch limited partnership, commanditaire vennootschap ('CV'), would ordinarily be used for real estate and private equity funds.

Since the formation of an FGR is by way of an agreement instead of a deed of incorporation before a notary, its set-up is usually very quick and cost-efficient.

"The FGR structure is very flexible and cost efficient by comparison to Luxembourg and Ireland. In addition, there is no need to appoint local parties, unlike Luxembourg where you need a local custodian, a local fund administrator and so on; that's not the case when setting up a Dutch fund structure so it makes life easier for start-ups," says Oldekamp.

He explains that Circle Partners takes care of the entire process of setting up a new fund structure under the light regime; setting up the legal ownership, opening bank accounts, providing fund administration and fund accounting services, financial, regulatory and tax reporting services, registrar and transfer agency services.

"Then, once the manager comes close to the EUR100mn threshold, we assist with the licensing application process by referring the manager to our local law firm contacts here in the Netherlands.

"We have a boutique approach to supporting clients. We take them by the hand and help them in all aspects of getting the fund up and running," concludes Oldekamp. ■

Assessment of Malta's AIF fund structuring environment

By Dr Isabelle Agius

The transposition in Malta of the Alternative Investment Fund Managers Directive[1] ('AIFMD') strengthened the Maltese regulatory framework applicable to Alternative Investment Fund Managers ('AIFMs') and further reinforced the integrity of the financial system. Even though the AIFMD focussed on establishing a European framework aimed at regulating and supervising AIFMs, the Malta Financial Services Authority ('MFSA') went beyond the AIFMD and made provision for a structured framework for the regulation and supervision of Alternative Investment Funds ('AIFs').

Since July 2013, the authorisation and regulation of AIFs runs parallel with the authorisation and regulation of PIFs which were retained for de minimis AIFMs and third country managers. Furthermore, this specific product regulation enabled the MFSA to implement the Regulations (EU) No 345/2013 and 346/2013 on European venture capital funds and European social entrepreneurship funds respectively to the PIF and AIF regimes depending on whether the funds are managed by a full-scope AIFM or a de minimis AIFM.

The additional regulatory regime for AIFs further reinforced Malta's traditional dual layer of regulation regulating and supervising both service providers and collective investment schemes. Indeed, the transposition of the AIFMD in Malta effected the Investment Services Act[2] (the 'Act') which is the primary act regulating investment services providers and collective investment schemes, the regulations which are issued in terms of the Act and the Investment Services Rules which the Authority is empowered to issue for the better carrying out of the provisions of the Investment Services Act.

Dr Isabelle Agius, Senior Manager, MFSA Regulatory Development Unit

On 1 April 2016, the Authority launched of the Notified AIF ('NAIF') regime. This regime marks a clear departure from the MFSA's concept of AIFs as regulated and supervised products and aims at providing AIFMs with a solution to market AIFs within the European Union in the shortest timeframe possible. This article proposes to provide an overview of the salient features of the NAIF regime.

Key facts for the establishment of a NAIF

A NAIF can be established in Malta in terms of the Investment Services Act (List of Notified AIFs) Regulations, 2016 and the Investment Services Rules for Investment Services Providers (the 'Rules').

The fund manager establishing and managing the NAIF may either be a full-scope AIFM authorised in terms of the Investment Services Act to provide manage AIFs or alternatively an EU AIFM which is in possession of a management passport under Article 33 of the AIFMD.

On the other hand, the NAIF can be either open-ended or closed-ended and established in any form which is available under Maltese Law namely investment companies i.e. SICAV[3] or INVCO[4], unit trusts, contractual funds or incorporated cells within an incorporated cell company. However, the NAIF regime will not be available to all collective investment schemes. Self-managed AIFs, property funds, loan funds and funds which invest in instruments and assets other than financial instruments listed in Section C of Annex I of MiFID[5] cannot be established as NAIFs. Furthermore, collective investment schemes which are already licenced in terms of the Investment Services Act cannot convert to the NAIF Regime.

The investor base for NAIFs is restricted to professional investors and/or qualifying investors. The AIFM is required to adhere to the promotional rules applicable in the jurisdiction(s) where the NAIF is being marketed.

The notification process

The AIFM must submit to the MFSA a notification pack which includes a notification form with the required accompanying documentation within 30 calendar days from the date of resolution of the governing body of the AIF approving the prospectus. The same process is applicable in the case of notification of sub-funds of NAIFs. The accompanying documentation consists of the following:

- a prospectus containing the minimum contents required and drafted in accordance with the templates provided; prescribed in the Rules and duly compiled having regard to the appropriate pro-forma template provided;
- a resolution by the governing body of the AIF certifying that the prospectus has the minimum contents required and that it has been drafted in accordance pro-forma template;
- a self-certification by the AIFM that, having regard to any delegate manager(s) or advisers it has in place, it has the necessary competence and experience to manage the AIF and monitor effectively any delegate;
- a joint declaration by the AIFM and the governing body of the AIF by which each undertakes responsibility for the AIF, including, inter alia, the obligations arising under the AIFMD;
- a declaration by the AIFM confirming that it has carried out the necessary due diligence with regard to the service providers of the AIF and the governing body of the AIF. This declaration must include a statement that the AIFM is satisfied with the outcome of this due diligence exercise.

The MFSA will be including the AIF in the List of Notified AIFs within 10 working days from the date of filing of a duly completed notification pack.

Removal of the NAIF from the List of Notified AIFs

The MFSA retains the discretion to remove the NAIF from the List of Notified AIFs. The Regulations further specify the following instances when the AIFM may request the Authority to remove a NAIF or a sub-fund of a NAIF from the List of Notified AIFs:

- upon expiration of the duration of the NAIF or its winding up;
- in any case where the custodian has given notice of termination under the custody agreement or is in liquidation or subject to bankruptcy proceedings or has had its license to provide custody services in respect of NAIFs suspended or cancelled:
- in any case where the AIFM has given notice of termination or is in liquidation or subject to bankruptcy proceedings or has had its licence to act as an AIFM suspended or cancelled and an eligible replacement AIFM has not been appointed within thirty (30) days from notice of termination;
- in all other cases as may be specified in the agreement between the NAIF and the AIFM as grounds for requesting removal of the NAIF from the List of NAIFs; and
- in all other cases as may be specified in the custody agreement between the NAIF or the AIFM on behalf of the NAIF and the custodian as grounds for requesting removal of NAIF from the List of Notified AIFs.

Upon removal from the List of Notified AIFs, the AIF must cease trading other than for the purpose of winding down the operations of the AIF or sub-fund and the AIF or sub-fund must then be liquidated or otherwise terminated in accordance with the requirements of Maltese law.

What's next?

All legislative texts, pro-forma templates and guidance notes have been finalised and are available for download from the Authority's website. The Authority will be welcoming the first notifications shortly. ■

Footnotes:

1. *Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers.*
2. *Cap. 370 – Laws of Malta.*
3. *Investment Company with Variable Share Capital.*
4. *Investment Company with Fixed Share Capital.*
5. *Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.*

Chapter 2: Regulations & compliance

Such is the complexity of the regulatory landscape in Europe that it is enough for any new start-up manager to resemble Edvard Munch's 'The Scream'. Alongside the Markets in Financial Instruments Directive (MiFID), is the Alternative Investment Fund Managers Directive (AIFMD) and just to add to the complexity, MiFID II is scheduled to go live in 2018.

At first glance, one could be forgiven for thinking it's all too complicated.

But there are numerous forks in the road available to start-ups, and indeed solutions that can make adapting to life as a regulated entity somewhat more palatable.

The first thing to consider is that being a star trader at an existing fund management group is not necessarily enough to attract investor capital. There's a world of difference between trading in Goldman Sachs with a vast network of resources at one's disposal and running a regulated business, with third party investor capital.

Investors will want to see evidence of good governance and for any new manager to demonstrate that they are conscious of trading and operational risks and that the right risk management framework is place. For most start-ups, that's not at all easy.

"That's where the benefit comes in to using hosted platforms, which provide that substance and allow managers to focus on what they are good at – namely portfolio management – without worrying about compliance and risk management. They don't want to spend 10 hours a day operating a business," says Daniel Maycock, Director, Investment Management Services with Lawson Conner.

"Whether you are a star trader or not you need to ask yourself whether a fund is even the right vehicle. Is a family office a better option, or a managed account?" adds Alex South, Director, Saxo Capital Markets.

Start off with a managed account

Operating a managed account can be a useful first step towards eventually becoming an FCA regulated entity. It is the easiest way to trade a strategy and build a track record (unfortunately, this is not audited) whilst remaining out of scope of regulation.

The managed account might consist purely of private capital, including that of a few friends and family. All that is required is to set up a brokerage account with a bank to run a managed account. Provided the individual who sets up the managed account does not begin offering advice to external investors and encouraging them to allocate into the managed account, they can stay out of scope of regulation.

The moment any advice is offered to external investors, that individual will have to be regulated under MiFID. One cannot run a managed account or a series of managed accounts with third party money and expect to avoid the regulator's gaze.

Indeed, even if a start-up manager appoints an AIFM and establishes a standalone AIF, they, as the investment adviser to the fund, have to be FCA authorised. They cannot just trade the strategy out of London and assume that they are doing everything by the book.

Sticking with the managed account structure, the easiest way to operate within the FCA's rules is to join a MiFID hosted platform and become an Appointed Representative. This involves using the platform's MiFID license without going direct to the FCA. As long as one is on such a platform, one can invite as many people as they want into the managed account.

"From our perspective, we prefer to work with managers who are regulated. Even if this is within an Appointed Representative arrangement, it shows a level of commitment that the investment manager has to running the strategy," says South.

When to rotate from managed account to standalone fund?

Over a period of time, the individual might develop a good track record, build a good level of assets across one or a series of managed accounts, and decide that the time is right to establish a standalone fund structure.

At this point, it is important to know how to value how the managed account has performed.

"You can ask a fund administrator to do an 'NAV lite' calculation on the managed account. The problem is you don't own the managed account, your investors do, so you need them all to sign off on the managed account's performance," explains Clayton Heijman, Managing Director at Privium Fund Management, which has a fully regulated investment management entity in London as well as on the continent.

There is also no fixed answer to determine how long a track record one should have in place before deciding to launch a fund. This will ultimately depend on the investors. "What's important to any start-up manager is to have day one investors locked in; they are your seed investors. From there, you move on to attract early stage investors via book building. Investors might say they want to invest but only when the strategy has EUR10mn. So you have to build the book of soft commitments," adds Heijman.

Aside from track record, another determining factor before choosing to go down the fund route is how many managed accounts are being operated. By their very nature these are not scalable structures. There's no problem running two or three managed accounts for a series of different investors, but as Maycock states, "The minute you start running 10 or more managed accounts from a regulatory and compliance point of view that's a lot of monitoring you need to do. It's much easier to set up a fund structure as the cost of compliance would fall and the manager would get the benefit of an audited track record, more visability and so on."

Standalone AIF or platform AIF?

Assuming that the time is right to launch an AIF, start-up managers can choose to either do this on a standalone basis or decide to operate a sub-fund on a fund umbrella platform; an AIF platform such as the MontLake QIAIF platform operated by ML Capital in Ireland, for example.

Managers should ask themselves at the pre-launch phase: How much is it going to cost and how long is it going to take?

With respect to cost, it depends on the lawyers that the manager uses. Costs vary substantially but one can often find out how much they can expect to pay by looking at the disclosures in fund prospectuses, which need to name the price of the launch.

If cost is less of an issue, the standalone AIF option will always be preferable to going with a sub-fund as the manager will not be able to develop a brand identity or have full ownership of their fund in such an arrangement.

Three platforms

There are potentially three platform considerations under AIFMD.

Firstly, there is the platform for the AIF if managers choose to run a sub-fund under a SICAV or ICAV umbrella structure.

Secondly, there is a platform for the AIFM – the management company charged with overseeing the proper management of the AIF from a risk and compliance perspective; both Lawson Conner and Privium would be examples of such.

And thirdly, there is the regulatory platform (the MiFID hosted solution) for the investment advisor based in London.

The plug and play option of running a sub-fund helps avoid the costs of setting up a standalone fund but the problem with this, in a similar way to the managed account structure, is that the manager does not own the track record. This makes it quite difficult to move a sub-fund that one might have been running for a year or two across into a standalone fund structure.

However, platform providers who provide an efficient route to market under AIFMD by acting as the AIFM and also providing fund platform capabilities, will often prefer clients to run sub-funds as they are easier to manage in their role as the AIFM. After all, each sub-fund will be using the same service providers as all the other sub-funds under the umbrella.

▶ 21

Brexit unlikely to impact outsourced AIFM model for UK AIFs

Interview with Daniel Maycock

For start-up managers wishing to run an onshore European AIF, the compliance and regulatory complexities might, at first glance, appear overwhelming. There are significant reporting obligations under Annex IV and regulatory capital considerations, whilst risk management is far broader in scope, extending into every facet of a fund manager's operations.

Luckily, however, there are solutions in the market that remove the burden of acting as the AIFM to an AIF, which provide start-ups the option of using a so-called hosted third party provider. One such firm is London-based Lawson Conner, a market leader in investment management solutions for the alternative funds industry. As Daniel Maycock, Director, Investment Management Services with Lawson Conner highlights, people spinning out of existing hedge funds or private equity groups might be highly skilled investment professionals but do not have the time or resources to operate the investment manager function.

"That's where we come into the equation as a launch partner for new investment managers. We provide the entire regulatory and compliance infrastructure, risk management and governance functions and even operational capability. Our infrastructure allows new managers to set up a fund and conduct regulated activities within the UK and EU," says Maycock.

By regulated activities, Maycock is referring to the key functions of an AIFM: portfolio management, risk management and the marketing and distribution of funds as outlined within AIFMD. But with the UK voting to leave the EU, is having a UK AIFM still a viable option?

Daniel Maycock, Director, Investment Management Services, Lawson Conner

"AIFMD sets a clear framework under which an AIFM operates and markets its AIFs and when passed into law, created a scenario where, should managers/sponsors establish an AIFM as well as an AIF within any EEA member state, they would have unrestricted distribution access to professional investor capital within these states," confirms Maycock. He adds: "With Brexit, UK managers will be treated as third country managers which means the world will revert back to pre-AIFMD days and the individual national private placement regimes. However, if the UK chooses to remain as a member of the EEA, then it is likely that there would be minimal disruption from a regulatory perspective."

If the UK leaves the EEA, it is almost certain that the UK will lose access to the single market and passporting rights under AIFMD. "However, if we do have to revert back to the private placement of funds, this should have very little impact on the existing fund distribution status quo in Europe as the overwhelming majority of AIFs distributed are via private placement rather than via the passporting mechanism," says Maycock.

So it appears the potential impact of Brexit may be limited but all may not be as simple as it seems as not all jurisdictions will have the relevant infrastructure in place.

"In France, Italy and other Southern European countries, private placement mechanisms are underdeveloped and in some cases, do not exist at all. Therefore an EU passport would be the only way to access this capital unless a reverse solicitation approach was received but this is very difficult to prove in practice," confirms Maycock.

So as long as the UK remains in the EEA, what are the benefits of using an outsourced AIFM?

One benefit is speed to market as the FCA application process to conduct regulated fund activities can take nine to 12 months but by becoming an Appointed Representative of Lawson Conner, on either a temporary or permanent basis, it enables new managers to start running their fund within three to four weeks.

"From a timing perspective it creates huge efficiencies. If you're left waiting upwards of a year to receive your FCA license, the questions are, will your investors still be around and will the market opportunity still exist?

"Acting as a launch manager, we put new managers in touch with the right counterparties at the beginning of the process, introducing them to the best lawyers and administrators as well as provide introductions to seed capital and distributors. The operational aspects of a new launch are critical, with hundreds of decisions to be made and it is essential you get all of them right," adds Maycock.

Although there are a number of EU jurisdictions in which one can use the hosted AIFM solution, the Appointed Representative model only applies to the UK.

"From that perspective, we can facilitate a full AIFMD compliance solution for start-up managers. We have launched in excess of 60 funds on our platform so we know how to support managers across a range of liquid and illiquid investment strategies. We understand what is required to operate in this regulated environment," says Maycock.

Lawson Conner provides an institutional-grade infrastructure with a dedicated team of experts handling all the operations and compliance requirements. When it comes to doing their due diligence, the hosted AIFM model provides investors confidence and reassurance when deciding on whether to invest in a start-up or emerging manager.

At the beginning, emerging managers are often overwhelmed with the operational aspect of fund management, such as legal, compliance and IT, which does not leave them much time to do what they are good at: trading and generating alpha.

"When they join our AIFM platform, they are able to outsource those operational issues. In addition, the investor faces a much larger entity with a stronger balance sheet and a larger team in place with tried and tested risk management processes. That gives investors the confidence that the chances of something going wrong with the manager are greatly reduced.

"Furthermore, on the whole, we have seen that most allocations are going to big name hedge fund managers. However, statistics prove that the highest alpha generators are smaller and emerging managers. Therefore, not only can start-ups potentially generate more alpha but, by working with the third party platforms, they can also benefit from operational cost savings," says Maycock.

Up until now, clients of Lawson Conner have only been able to appoint the firm as the AIFM. In the coming weeks, however, a hosted AIF platform, located in Ireland, is set to go live. This will provide clients with the opportunity to avail of a plug-and-play solution, using Lawson Conner's regulated AIFM in London and Irish QIAIF umbrella structure to act in a sub-advisory capacity.

The benefit of doing this is that it would avoid the costs of setting up a standalone AIF. This is a strong move considering the possible implications of Brexit.

"The potential implications of the Brexit scenario are both uncertain and wide reaching. From a fund distribution perspective, in the short term it is unlikely that much will change as there will be a period of a minimum of two years that the existing legislative framework will remain. Should passporting be required, there are alternative models available for managing your fund from London while still accessing the distribution capabilities of the AIF marketing passport such as appointing an AIFM in another EEA member state, where we can still support the advisory entity in the UK – so it looks like in all probability, even in a Brexit scenario, this may not cause the pandemonium predicted from a regulatory perspective.

"With or without Brexit, third party AIFMs have become a new standard in the industry for both emerging managers and investors who are looking to capture the alpha from new strategies," concludes Maycock. ■

17 ▶ With respect to the AIFM platform, this will provide the investment manager with compliance and risk management, as well as asset management expertise. In reality, though, the asset management function is sub-delegated to the portfolio manager living in London who has appointed the AIFM.

Operating under MiFID

For the London-based start-up, assuming they have got a non UK AIFM in place, and they've launched the AIF, they have two choices. Either to become an FCA MiFID regulated entity, and act as a sub investment manager to the AIFM, or to operate under a MiFID umbrella for the purpose of dealing in asset management, which again means they can act as the sub investment manager.

If the investment manager files his own application, it might take anywhere up to 12 months to get the FCA's authorisation to perform regulated activities. By joining a MiFID hosted platform, however, they are able to operate the investment strategy using the platform's FCA license; this only takes a matter of weeks.

"We take care of all the risk, compliance and operations management. We sit at the front of all the trades going in and out of the fund – this is similar to what the outsourced AIFM is doing, but they tend to do that post trade as opposed to in real time.

"You would have to duplicate this, even if you were to become a standalone FCA regulated firm with a non-UK AIFM. You would still have to make sure trades were being filled and reconciled properly, even though that is something the AIFM is also supposed to do as part of overseeing the risk management function under AIFMD. This system works very well," explains Jerome Lussan, CEO of Laven Group, which offers a MiFID hosted solution to investment advisers.

It sounds complicated but using the outsourced AIFM solution, with the manager sitting on a MiFID hosted platform, is probably more cost efficient than going down the full standalone AIFM route.

As Lussan adds: "In my view, the only part that should be standalone in a startup's set up, if they can afford it, is the AIF itself. This helps protect the fund's track record rather than have a fund that is on a fund umbrella which limits the future options for the fund management group."

"We've seen examples of investment managers changing AIFM platforms because they found someone cheaper, only to discover that the new AIFM can't fully support their strategy. That's a disaster if you've got an investor with capital waiting to be deployed."

Daniel Maycock, Lawson Conner

Most people tend to stay on a MiFID hosted platform even after they've received their FCA approval simply because it means they don't have to set up their own compliance infrastructure.

If, however, the start-up manager decides to leave the AIFM platform and the MiFID umbrella, they would effectively combine both platforms into a standalone AIFM. Only the very largest fund managers in Europe such as the AQR's of this world, with billions of assets under management, prefer to operate their own AIFM for brand purposes.

The vast majority of fund managers will likely stick to using an outsourced AIFM and operate as a MiFID regulated entity.

AIFM needs substance

In conclusion, Maycock says that when thinking about appointing an AIFM, start-ups should look at their experience in managing different strategies.

"We've seen examples of investment managers changing AIFM platforms because they found someone cheaper, only to discover that the new AIFM can't fully support their strategy. That's a disaster if you've got an investor with capital waiting to be deployed.

"Secondly, understand what service level you are going to get. The AIFM should have proper substance. I heard one story of an AIFM that had one person doing risk management effectively on a part-time basis. At Lawson Conner, each of our clients has a dedicated risk and compliance expert supporting them."

Although it may at first glance appear to be a minefield, there are plenty of options and solutions available to new managers to make the process of running an onshore AIF as stress-free as possible. ■

Guernsey ready for third country AIFMD passport

Interview with Andrew Whittaker & Paul Wilkes

On 30th June 2016, the European Securities and Markets Authority ('ESMA') is expected to announce further details on the timing and the composition of the third country passport for the first wave of countries that include Guernsey, Jersey and Switzerland. This follows ESMA's announcement last summer that Guernsey had demonstrated the ability to satisfy the criteria required under AIFMD.

For Guernsey, being in the first wave is important for two reasons. Firstly, because it demonstrates that it has a strong regulatory framework in place and meets the OECD's tax transparency guidelines – both of which are significant if you are an investment manager looking to set-up a fund under AIFMD. And secondly, because some jurisdictions will likely turn off their national private placement regimes once the third country passport is formally introduced.

"At the moment, managers of Guernsey funds need to privately place into Europe and that works well. If Guernsey were not in the first wave, there would be a danger of there being an unknown period of time, during which managers would not be able to market into certain jurisdictions. Luckily, that won't be the case," explains Andrew Whittaker, Chairman of the Guernsey Investment Fund Association.

Certain countries, such as the UK, have left their national private placement regimes intact such that it remains 'business as usual' for managers looking to market a Guernsey fund. And whilst there will likely remain a core number of EU and non-EU managers who use Guernsey specifically to remain out of full scope of AIFMD and continue down the NPPR route, there are plenty of managers who will look to take full advantage of the third country passport and opt in to the AIFMD regime on an equivalent basis.

Andrew Whittaker, Chairman of the Guernsey Investment Fund Association

Paul Wilkes, Group Partner, Collas Crill

AIFMD opt-in regime

"We have a full set of AIFMD opt-in rules which mirror the requirements of a full scope EU AIFM," confirms Paul Wilkes, Group Partner, Collas Crill, a prominent Channel Islands law firm. "I was part of the drafting committee and the view we took was that by getting the rules in place early, it would give the Guernsey Financial Services Commission ('GFSC') sufficient time to look at the rules and carefully consider them. We wanted our clients to have the opportunity to opt-in as early as possible, even though it doesn't yet give them the right to passport their funds into Europe.

"However, what it does do is allow managers to tell investors, 'Yes, we're not in Europe but we are subject to the same rules as we have opted in to the Guernsey AIFMD regime, which is equivalent'.

Manager led product

Both Luxembourg and Malta have recently unveiled new unregulated funds in a clear sign that Europe is evolving under AIFMD. Known as the Reserved AIF and the Notified AIF respectively, the regulatory oversight of the AIF lies squarely with the AIFM, thereby avoiding a dual layer of regulation at both the manager and the fund level.

In anticipation of receiving the third country passport, Guernsey has looked at these recent developments and moved quickly to introduce an AIFMD friendly product of its own. Known as the Manager Led Product ('MLP'), "it allows fund promoters to have an AIFM and fund(s) underneath, for example, a Guernsey GP/LP structure, thereby making it more efficient for the AIFM to manage funds from Guernsey," says Whittaker.

The MLP was unveiled by the GFSC on 11th May 2016. It aims to ensure a proportionate risk-based level of product regulation for any AIFM that establishes itself in Guernsey and seeks to market an AIF into Europe under the National Private Placement Regime arrangements.

Once an AIFM has been licensed by the GFSC, they will be able to freely launch new partnership structures and corporate funds by simple notification, reducing the amount of red tape. For new managers wishing to operate under AIFMD via a hosted solution (using a 3rd party AIFM), the introduction of the MLP could be a game changer for Guernsey.

"Since the Directive was introduced I've always regarded it as a big opportunity for Guernsey," says Wilkes. "Once we have the third country passport it will give better access to European capital than Guernsey has ever had. It's a significant opportunity for Guernsey funds over the long term," adding that Guernsey's USP, compared to EU onshore jurisdictions, is the Island's expertise in asset classes such as private equity, real estate, alternative hedge fund strategies; service levels for sophisticated private funds; quick turnaround times by the GFSC, and most importantly, cost.

"There are real cost benefits to setting up a Guernsey fund. Once the third country passport is available, it's up to us to become as competitive as possible."

Fund structuring options

Investment managers may make application for authorisation or consent under one of three routes:

- Authorised Fund by standard application;
- Authorised Fund by Qualifying Investor ("QIF") application;
- Registered Fund application.

The QIF process

Promoters of authorised funds, which are typically offered to professional or experienced investors willing to invest a minimum of USD100,000, are able to take advantage of the qualifying investor fund or "QIF" fast-track application process.

Under such a scenario, an appropriately licensed Guernsey administrator must certify to the Guernsey Financial Services Commission ('GFSC') that it has performed sufficient due diligence on the promoter and that the requisite disclosures are made in the offering document of the scheme.

The benefit to managers under this arrangement (and the registered fund option) is speed to market. The administrator does all the heavy lifting, so that by the time a fund application reaches the Commission, it typically provides a guaranteed response time of three business days; a significant benefit to managers who need to get their fund to market to avoid losing investor capital commitments.

Class B Authorised Fund

For an Authorised Fund there are four choices: an authorised closed ended fund or a Class A, Class B or Class Q open-ended fund. "Class A is the Guernsey equivalent of UCITS. Class B is by far the most common open-ended vehicle for hedge funds. The basic tenet is that you have to disclose in the fund documents what the investment strategy is, what the restrictions are, etc. Traditionally HNW investors and institutional investors are the main investors in Class B funds.

"Class Q is the most flexible of the three classes of Authorised Fund in respect to how much the manager needs to involve investors should they wish to change the fund's investment objectives. Because of that flexibility it is limited to a definition of 'Qualifying Investor' – namely HNW individuals, professional investors," says Wilkes. He says that the 'QIF' process can be applied to any Guernsey authorised fund: Managers can fast track a Class B Authorised Fund using the QIF process giving them the flexibility of a Class B fund and the recognition of a Class B fund in the market."

As a general rule of thumb, all Guernsey-domiciled funds are required to appoint a locally licensed administrator, which is referred to as a "designated manager".

If a fund promoter chooses an open-ended fund structure, the fund must generally appoint a Guernsey licensed custodian to hold and safeguard its assets. By contrast, a Guernsey closed-ended fund is not required to appoint a local custodian. It is not mandatory for either an authorised or registered fund to have a locally regulated or a local manager/adviser.

All three classes of Authorised Fund, and the Guernsey Registered Fund, will be eligible for the third country passport, going forward. ■

Chapter 3: Selecting service providers

For those wishing to set up a standalone Alternative Investment Fund, getting the right service providers in place is crucial to the manager's long-term success and reputation. The following sections detail what to look for when it comes to appointing four key service providers:

- The Fund Administrator
- The third party AIFM
- The depositary
- The Prime Broker (for hedge funds).

Onshore depositary

"An AIFMD Depositary Bank is tasked with: oversight of assets, activity, and the manager; safekeeping of assets (where required); cash flow monitoring; strict liability for restoration of lost financial assets and reporting breaches. In short, the depositary has a fiscal responsibility to investors and a regulatory duty to carry out that oversight," explains Owain McNeill, Business Development Director, CACEIS, one of Europe's leading depositary banks.

Where a manager chooses to use a prime broker broker and/or administrator separate to that of the appointed depositary, the depositary has to conduct a robust risk assessment of the AIF.

Under this arrangement – referred to as an open architecture arrangement – the cost impact to the manager will be higher because the depositary will be required to enter into a discharge of liability arrangement with the prime broker charged with safekeeping the AIF's assets (less unencumbered assets).

Alternatively, by using an integrated model, much of the risk can be internalised and the cost impact to the manager is reduced. In this arrangement, a single counterparty acts as the administrator and depositary to carry out the cash monitoring and oversight functions.

Some depositaries require unencumbered assets to be held in their own custody network. Only then will they accept strict liability over the financial assets. It should be pointed out, however, that strict liability does not apply to non-financial assets or assets encumbered/re-hypothecated by the prime broker under a discharge of liability arrangement.

"Some clients take advantage of our depositary services across multiple locations, including the UK. Our ability to offer services flexibly (i.e. as a standalone depositary) is valued by managers that wish to maintain specialist relationships with other service providers. Other clients, such as those using CACEIS' Private Equity, Real Estate and Securitisation services, partner with us to provide a fully outsourced asset service covering everything from Equity Bridge Financing, Custody, AIFMD Depositary, and Fund Administration," explains McNeill.

In his view, some of the key criteria for selecting an onshore depositary should include:

Balance sheet strength of the bank

Since the purpose of the depositary is to oversee, safekeep and provide liability over financial assets lost, the bank's robustness should be a consideration.

CACEIS, for example, is a strong independent bank backed by two of the largest European banking institutions, Credit Agricole and Groupe BPCE (via Natixis).

"Our A/A-1 credit rating is a reflection of strong solvency ratio and shareholder equity," adds McNeill.

Brand Recognition

As the primary duty of the depositary is to protect investors' interests, having a strong European bank behind the fund is an important selling point for the manager.

Flexibility

A manager may well have identified its prime broker and/or fund administrator already. As such, the ability to work with a depositary willing to offer modular services is important.

Location

Is the depositary part of banking group that is operating in the location of the fund? Is the banking group close to the manager? This helps with local market and regulatory knowledge. Is the banking group also in the location of the investors? This will help with local market understanding, distribution, and generating potential new capital.

Operationally fit

Does the depositary have an established relationship with the managers' prime broker? If not, it's very unlikely that that relationship will work, as new depositary/prime brokerage contracts are notoriously difficult to put in place.

"We are one of few UK depositaries covering any UK-domiciled AIF with the requisite skill to handle the nuances of private equity and real estate funds," says McNeill. He adds that a few common misconceptions when it comes to appointing a depositary include:

- Misunderstanding the purpose of a depositary. To investors and the regulator it is an important safety net in the event of another financial crisis or other events.
- Not knowing the benefits of a bank and its financial strength versus a professional firm offering 'Depositary Lite' services.
- Recognising the value of the depositary brand and reputation as a fund selling point.

"We are one of few UK depositaries covering any UK-domiciled AIF with the requisite skill to handle the nuances of private equity and real estate funds."

Owain McNeill, CACEIS

Fund administrator

Suryanshu Mishra is Head of Hedge Fund Administration, Fund Services at Deutsche Bank. In his view, the ideal administrator for a start-up can be summed up in three words: robust, adaptive and global.

Robust

This comes from having a proven track record servicing various aspects of the fund spectrum. A good quality administrator is one that supports large established asset managers, mid-tier asset managers and start-ups as it allows the administrator to build in-house technical expertise to handle any types of complexities.

"Take accounting complexities. There could be a lot of nuances depending on the fund structures such as unusual bucketing of expenses, innovative fee models that need specific accounting treatment and so on. You can't have errors on these things. They are fundamental to the governance of the fund. As such, managers need an experienced administrator," says Mishra.

Another aspect of being 'robust' is investor relations. When out on the road raising assets, having an administrator that understands the end investors is key; a good administrator is responsive and help showcase the pedigree of the manager.

Straight through processing of data is another criterion. The administrator should demonstrate that various asset types and transaction types can be processed on a trade file quickly and accurately.

"A strong AML regime is also important. You need your administrator to provide the safety and soundness of the investor AML environment the fund needs to operate in. Managers shouldn't be expected to understand all the various nuances of AML laws in the US, Cayman, Ireland, Luxembourg and so on.

"A final point about robustness is for the administrator to show that they can be independent. If they can ask questions about the Offering Memorandum before the fund launches, that shows they are thinking carefully about how they can support the fund and are not just a dummy provider who simply relies on the manager's instructions. An administrator that is willing to question the manager is a good sign," stresses Mishra.

▶ 29

Full service solution to start-up hedge funds

Interview with Jerry Lees

There are a multitude of costs that a start-up alternative fund manager faces today, especially with respect to those looking to establish a hedge fund under AIFMD. From regulatory costs and waiting to receive FCA authorisation, to office and IT and staffing costs, the amount of burn capital that managers initially account for can rapidly disappear down the drain.

Which is why Linear Investments is proving to be a whole lot more than merely a boutique prime broker. In short, Linear has spent a number of years building out its trading and risk management systems to provide start-ups with a full front to back service offering, from execution through to prime brokerage, custody and settlement.

Linear can offer start-ups a 'hedge fund hotel' solution within its recently expanded offices in Victoria, London, an FCA regulatory umbrella where managers can operate as appointed representatives, outsourced trading services and the expertise of a dedicated capital introduction team. As Jerry Lees, Chairman, Linear Investments, explains: "Our capital introduction team focuses on connecting our managers to specialist investors who are looking at start-ups with a view to potentially providing seed capital.

"We actually have a joint venture with a USD750mn multi-manager hedge fund and we are in the process of raising USD200mn with them for the Linear Seeder Fund. In addition, we are discussing a USD40mn seeding arrangement with a European investment bank and we are discussing a further EUR500m multi-strategy seeder with finds coming from European institutional investors.

"We can therefore support start-up managers from the front-office to the back-office and provide an effective route to capital raising."

Jerry Lees, Chairman, Linear Investments

Rather than try and become a client of a tier one prime, managers who use boutique primes like Linear benefit from pooled assets, whereby Linear aggregates the AUM of all its hedge fund clients into an omnibus account.

"We have 150 clients, of which 50 or so are hedge funds (the others being brokers and banking clients). It took us the best part of three years to build the prime brokerage part of Linear's business, putting in place all the trading systems, risk management systems etc.

"Within the omnibus account we are fully hedged. We pull our clients' assets together into one account. Our appointed global prime broker trades with us on that one account with USD500mn or so in assets. We're doing USD200-300mn a day of equity trading and upwards of USD800mn a day of fixed income and futures trading so the commission fees we pay to underlying brokers are favourable. This allows us to give managers a more competitive pricing structure than they would get if they were individual clients of a bank prime," explains Lees.

This economy of scale gives start-up managers the financing and leveraging that they need, the stock lending that they need, to trade their strategies with a high-touch level of support from Linear's team that small managers simply do not get at larger tier one primes.

Currently, Linear has 45 to 50 prospective clients in the pipeline, of which Lees anticipates half will be taken on as clients.

"Right now we are working to significantly increase our balance sheet. That will allow us to take on larger hedge funds and support larger trading positions. That's where we see the next stage of Linear's evolution within the prime brokerage space," concludes Lees. ■

26 ▶ Adaptive

This is important if one assumes that the fund manager is going to grow and become successful. The fund administrator needs to be adaptive in two ways.

Firstly, with respect to flexibility of technology; as the fund grows and takes on more investors there will be more reporting requirements, additional data points. Some start-ups will launch funds even before they've got PMS and OMS systems in place and decided on their own internal technology stack. When they do, it's important that the administrator is flexible enough to handle it without issue. Technology agnosticism and flexibility are extremely important. The first year or two, start-ups will often change their technology systems.

"Secondly, listen to clients. Things change for managers and a good administrator is one who listens and can adapt by understanding their clients," says Mishra.

Global

Any start-up manager launching a fund with long-term aspirations needs to have in place an administrator with the connectivity and thought leadership in multiple markets. Understanding different jurisdictions is key – if the administrator lacks the depth of expertise to handle different regulatory requirements in different domiciles it could impact a manager's business.

"Managers should look for an administrator with good connectivity to global third parties, especially custodians and prime brokers – and when I refer to connectivity I mean both from a technology and relationship perspective. Things should 'happen by themselves' and resolved with little or no intervention needed by the manager. A good administrator is also one that has relationships with local regulators to potentially influence market regulation before it comes into play.

"Finally, is the administrator able to provide coverage in all time zones? Can they provide end of day reporting to ensure that the fund is up to date the minute the fund manager walks into the office the next day?" says Mishra in conclusion.

Outsourced AIFM

There are three models for managers to consider when it comes to operating as an alternative investment fund manager (AIFM), under AIFMD.

Alan Picone, Duff & Phelps

"We do not believe in the AIFM being a commoditised product. It needs to be a tailored service, especially to those managers who go down the full outsourcing route. The AIFM should operate as an extension of the manager's operations team in a partnership arrangement."

Alan Picone, Duff & Phelps

Full outsourcing

This is where the investment manager appoints a third party AIFM who bears the risk management function internally and sub-delegates the portfolio function back to the investment manager. Under this arrangement, the AIFM takes care of 15 of the 16 core requirements of AIFMD, the 16th being portfolio management.

Full insourcing

This is where the investment manager becomes their own AIFM, keeping the risk management and portfolio management functions internal with no delegation to a third party AIFM.

Partial outsourcing

This can best be thought of as a hybrid of models 1 and 2, whereby the manager does partial outsourcing. They may, in this instance, become a registered AIFM in the UK, for example, and outsource the risk management, compliance and regulatory reporting function with respect to Annex IV.

Cordium offers a version of this model with the Cordium Total AIFM Solution or 'CTAS'. In this arrangement, the manager retains full ownership of the AIFM, which Cordium establishes in Malta, and at the same time Cordium handles all the

Meeting Room capabilities within Linear's Hedge Fund Hotel

operational and compliance demands. This provides the best of both worlds; full ownership of the AIFM with none of the heavy lifting of operating it internally.

Alan Picone is the Managing Director and Member of the Board of Directors of Duff & Phelps' (Luxembourg) Management Company and Global Head of Risk and Management Company Solutions at Duff & Phelps. He says that if managers planning on having a wide distribution strategy for the AIF then the full outsourcing model is probably the best option.

Cost will also play an important factor. Managers of a certain size will benefit from full insourcing or partial outsourcing, where they own the AIFM; but this typically will only apply to large billion-dollar managers with an established brand pedigree.

Picone is keen to stress that the above models are all quite fluid and flexible. A manager might start with the full outsourcing route, build the strategy and AUM over a number of years, and then, potentially, become their own AIFM.

"We always clearly articulate the various options to clients. We don't believe in a static AIFM model. Our product is designed to accompany start-up managers and allow them to evolve. We can delegate the portfolio management if they are already regulated. If they are not regulated, we can run the portfolio management function ourselves and accompany the manager through their FCA or CSSF license. Once the manager receives their license, we can then sub-delegate the portfolio management function back to them," explains Picone.

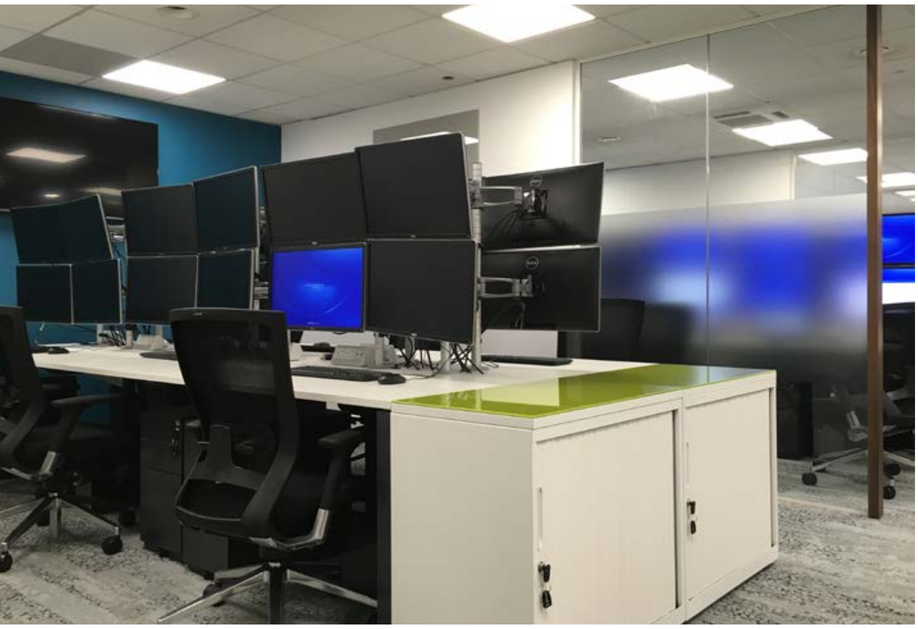
AIFM: Key criteria

Firstly, look at the nature of the AIFM business within the group. Is this purely a tactical decision? Look at the shareholder structure. At Duff & Phelps, for example, its biggest shareholders are Carlyle Group and the University of California. Knowing that the AIFM is in the business for the long haul is critical.

Secondly, look at the AIFM's expertise. Do they understand the manager's portfolio management process, the investment mandate? This should be a detailed exercise, not simply a check the box exercise.

"Thirdly, the AIFM should have an advisory mindset. We do not believe in the AIFM being a commoditised product. It needs to be a tailored service, especially to those managers who go down the full outsourcing route. The AIFM should operate as an extension of the manager's operations team in a partnership arrangement.

"We are able to apply a full range of expertise to support our clients at Duff & Phelps," says Picone.



Trading desks within Linear's Hedge Fund Hotel

Another consideration would be financial stability; does the AIFM have a strong balance sheet? The last thing a manager wants to do is appoint a third party AIFM only for them to disappear 12 or 24 months later because of cash flow issues.

"Exactly right. That is what I mean when I say that managers have to be certain that they are appointing an AIFM with long-term objectives, not just short-term tactical objectives. The AIFM is required to provide the necessary regulatory capital under AIFMD so check that the AIFM is well capitalised at the due diligence stage," concludes Picone.

Prime broker

Bank-owned prime brokers are becoming increasingly less well equipped to service small hedge funds because of the impact of Basel 3 regulations. This has led to increased costs of using balance sheet, requiring bank-owned primes to generate sufficient return on equity to justify keeping a hedge fund on their books.

"A small hedge fund generating USD150,000 a year in fees would mean that your average bank-owned prime would probably need 10 clients just to break even, 20 clients to make a profit. So the numbers don't work," says Jerry Lees, Chairman of Linear Investments, a London-based boutique prime broker.

It is much easier to service one USD500mn hedge fund than 20 hedge funds each with USD25mn in AUM, to generate the same return on capital.

For start-ups who might only have USD10mn in assets, unless the strategy is going to have a high volume of trades and employ lots of leverage, it is becoming more sensible to partner with a boutique prime.

"It's not so much that small hedge funds are spoilt for choice; many of them have no choice but to look at alternative prime brokerage solutions," says Lees. He points out that aside from the usual prime brokerage services – stock lending, financing arrangements, capital introduction services – Linear has built out its internal infrastructure to prepare for MiFID II regulation, due to come into play in 2018.

One key part element of its service offering is an outsourced trading desk.

"With MiFID II coming down the line, managers are going to have to prove statistically that they are getting best execution on their trades. We have a full trading desk covering equities with connection to multiple brokers, and a fixed income trading desk with a current team of 10 people, so we can achieve best execution on behalf of clients. We have also just expanded the office to include another 40 desks for start-ups who wish to come and operate under our MiFID regulatory umbrella," says Lees.

The cost of having three traders with respect to salaries and bonuses, Bloomberg terminals and so on, is close to GBP1mn a year. That's a lot of money, even for an established fund manager.

"By using an outsourced trading solution you just pay us commission. We can get managers a reduction on commission rates based on the right volume and remove the need for sourcing talent and building their own trading team. That's a GBP1mn saving, straight away," adds Lees.

Although there is a degree of kudos attached to appointing a big name prime broker like Goldman Sachs, many of the bank-owned primes simply cannot dedicate the same level of resources as one gets with boutique primes.

As Lees concludes: "Start-ups don't need an investor relations team, they don't need a trading team, they don't need a compliance officer, they don't need an IT team; we provide it all for them." ■

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Understanding the role of the depositary

Interview with Suryanshu Mishra

There are a number of important considerations for a fund manager, especially a start-up, when it comes to selecting an onshore depositary to an onshore AIF. But before these are explored, it is perhaps worthwhile explaining exactly what the role of the depositary is under AIFMD, given that alternative fund managers have never had to use one before.

Safekeeping of the AIF's assets

There are two parts to this. Firstly, providing custody of financial assets that are held directly by the depositary (i.e. stocks and bonds, options and futures). Secondly, performing record keeping and ownership verification of an AIF's assets, which are not required to be held in custody; i.e. private equity investments where the assets are owned and held in the manager's name.

General oversight of the AIF's assets

According to Suryanshu Mishra, Head of Hedge Fund Administration, Fund Services at Deutsche Bank, it is important that the depositary properly understands the AIF's valuation policies in order to effectively monitor them. This ensures that the policies are enforced and adhered to, in line with AIFMD and the AIF's governing documents (i.e. the Offering Memorandum).

"There is a thin line with this as a lot of fund administrators often carry out this role but they do so in a different capacity. At the end of the day, the administrator will tend to accept an instruction from the fund manager when it comes to any exceptions from the fund valuation policy, but the depositary can go a step further and actively question the valuation policy and enforce it.

"The other piece to oversight is monitoring transactions on an ongoing basis to again make sure they are in line with AIFMD and with the fund's governing documents. This might involve making sure that the AIF does not exceed leverage restrictions, for example, making sure settlement considerations for transactions are compliant with market standards, and finally, with regards to income for the fund, making sure dividend or accrual income is in line with regulation and the Offering Memorandum," explains Mishra.

Suryanshu Mishra, Head of Hedge Fund Administration, Fund Services, Deutsche Bank

He says that the depositary has to understand every single facet of the fund strategy at the onboarding stage, ideally before the OM has even been finalised by the investment manager.

Cash flow monitoring

This is arguably the most important role of the depositary, according to Mishra. In summary, it involves having a regular line of sight into the cash flow of the AIF, ensuring that there is no deviation from the AIF's primary activities, and ensuring that investors' monies are paid into the fund's bank account.

"That ties in with the two other primary duties of asset safekeeping and general oversight of the AIF. If the cash is consistent, and coming in and out of the correct bank accounts, that effectively offers an additional layer of oversight to protect the fund's investors," says Mishra.

Indeed, the premise of AIFMD is to uphold investor protection and avoid a repeat of the Madoff scandal. As such, the depositary has a fundamental role to play. It is, therefore, imperative that start-up managers – or indeed those managers who run existing offshore vehicles but wish to offer a regulated fund to continental European investors – understand what to look for in a depositary.

Firstly, it's important to look at the authorisation aspect. Is the depositary appropriately authorised and regulated by the local Member State regulator?

The next key criterion is financial strength.

"I can't emphasise how important this is," states Mishra. "The depositary needs to have a balance sheet that is strong enough (not withstanding regulatory capital), to cope if there is a strict liability call and the strict liability hasn't been discharged to the AIF's prime broker(s) or sub-custodian. The depositary must always have a safety net in place in case of this.

"Another important aspect is managing potential conflicts of interest. How does the depositary interact with the fund administrator with a level of objectivity? With the integrated model – where large financial institutions can act as both the fund administrator and depositary to the AIF – they have to functionally and hierarchically be segregated, from a data management point of view, so that the depositary really can provide objective oversight.

"The initial due diligence of speaking to a depositary that is part of the same organisation as the AIF's fund administrator, understanding the processes, and doing a detailed walkthrough of how independence is maintained, is very important."

Managers are advised to also review the depositary's operating model. What is the frequency and quality of review around investment guidelines? Make sure the depositary actually has a way of monitoring the evolution of the fund. The appointed depositary should be constantly enhancing its cash flow monitoring operation as part of its key role.

Another key consideration is cost: a worry for any new manager.

With an integrated model, whereby the depositary and fund administrator – and potentially even the prime broker – are part of the same broader firm, managers can benefit from economies of scale and get a total package cost that is likely going to cost less than appointing the fund administrator and depositary separately.

"I also believe that managers should check a depositary's legal terms. Do they have up-to-date contractual arrangements as required under UCITS V Level 2 guidelines? And last but not least, future developments. Can the depositary keep up with the growth of new funds that it is elected to support? Can it keep up with regulatory developments? When selecting the depositary, managers need to think not only about what the depositary can do today, but what it can do over the next two or three years," comments Mishra.

One way to check this is to ask questions about the depositary's views on future regulatory changes and how they plan to adapt to these changes. What is their level of engagement with local regulators? Make it an open dialogue not just a box ticking exercise.

Strict liability & asset segregation

There is still work to be done in terms of establishing what the best practice should be regarding asset segregation and remains the million dollar question.

Mishra says that at Deutsche Bank Fund Services the view is that ultimately the strict liability provisions of AIFMD will eventually require depositaries to work with prime brokers with a full discharge of liability; meaning the prime broker will be responsible for any loss of assets that they are responsible for safekeeping.

"That has to be the case and become the de facto model in terms of how depositaries interact with prime brokers. But this will involve a lot of detailed legal negotiations between the AIFM and the prime brokers and between the AIFM and the depositary in a tripartite arrangement. The AIFM needs to budget adequate time and effort to get this arrangement in place with the depositary and prime broker," says Mishra.

As for the asset segregation point, at present prime brokers can continue to pool all of the AIFs' assets together into their omnibus account without individually segregating them. But Mishra believes that any parties to whom an AIF's assets have been delegated for safekeeping should be subject to the same asset segregation requirements that apply at the depositary level.

"The standards of asset segregation for the depositary need to be applied to everybody in the value chain. That means the prime brokers will eventually be unable to operate traditional omnibus accounts and will need to provide full segregation, as is now the case for depositaries under UCITS V," says Mishra. ■

Chapter 4: Marketing & distribution

A recent survey by Preqin revealed that 60 per cent of hedge funds have less than USD100mn in AUM and that only five per cent of hedge fund flows go to funds operating below that AUM level.

There are now approximately 15,000 hedge funds in the industry, meaning investors are being bombarded by different funds every single day and thousands over the course of a year. They probably meet with 200 or so, engage in follow-up meetings with around 40 and allocate to two or three.

As such, there is one certainty that start-up managers can be sure of when launching their new fund: the ability to raise capital is exceptionally difficult and competitive. The same applies to private equity and real estate, where asset raising can take up to two years for smaller and emerging managers.

But there are different channels available to support marketing and distribution. In Europe, an increasing number of bank-owned and independent fund platforms are emerging to host funds and provide active and passive distribution support, whilst placement agents and distribution partners can prove highly effective at introducing managers to the right investors.

"It's important that start-ups know their target audience; who are they aiming the fund at? Which core markets will they distribute in to? Will they be using a hosted solution and/or a third party marketing firm? These considerations should be tailored to the marketability of the product.

"Our advice to clients is, 'Where using a hosting platform solution, look at what legal control you have to give up versus setting up a standalone fund product. Establish what the process is and what fees you will be charged to come off the platform at some later point. Consider whether coming off the platform may create a taxable investor for your investors.

"There is no single solution that fits every manager, for every investor type, in every EU jurisdiction. It will tend to be a combination of solutions based on the preferences of the target investors," outlines Donnacha O'Connor, Partner at law firm Dillon Eustace.

Zurich-headquartered ACOLIN Fund Services AG provides independent representation and distribution network management capabilities to managers, both EU and non-EU, who need to understand how the European market works and who might be the best distribution partner(s) to work with.

ACOLIN will help managers get their funds into different markets by advising on fund registration and distribution strategy, provide notifications to the relevant authorities when privately placing funds into different EU markets, as well as act as the legal representative to funds for distribution to qualified and/or non-qualified investors into Switzerland.

"The most important thing for an asset manager to understand is that setting up the fund is not enough. If you have a European AIF with a European AIFM, you still need to have a well-defined distribution network. We have a well-established network where we take on our clients' data, contract and commission management, and if needed, fund document dissemination. We handle everything so that if an asset manager wants to privately place their fund into a particular country, he can approach investors without spending time on compliance and legal issues," explains Viktor Fischer, Managing Director, ACOLIN Fund Services AG.

Having that helping hand can be a huge benefit to new managers as it can take years of book building to develop a robust investor network. To clarify, firms like ACOLIN do not physically introduce managers to investors. They merely advise.

"We have a client relationship

management team taking care and supporting more than 180 asset manager clients. We also provide our clients with a platform called ACOLIN connect.

"The platform allows the manager to strengthen his brand and reach a wide network of potential investors. It gives distributors and investors the chance get detailed information about asset managers; it allows asset managers and investors to 'meet' virtually," says Fischer.

Campbell Lutyens is a private placement agent and secondary sales advisor that specialises in raising institutional capital for illiquid strategies – private equity, infrastructure and credit strategies.

Last year it raised approximately USD15bn for its global manager client base.

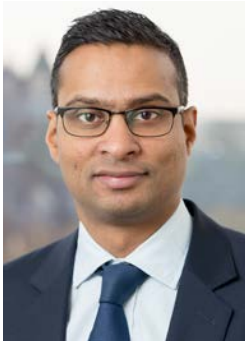
According to Penny Walker, General Counsel at Campbell Lutyens, any new manager that is looking to partner with a placement agent should do so as quickly as possibly – ideally at the pre-launch fund phase. This will allow the placement agent to help with market message consistency, help with presentation materials, provide coaching on presentation delivery; basically anything that will make the manager fully prepared to approach the investor market.

"Investors will absolutely make a decision based on the quality of the presentation materials so they have to be professionally produced," says Walker, adding: "We would always advise managers to have a very targeted approach to investors. Know who your investors are and what they want to invest in."

Walker offers the following advice on how to develop an effective approach to raising assets and building a manager's brand reputation: "For first-time managers, it is vital to try and secure cornerstone investors. You're not going to get a first-time fund off the ground unless you've got a backer. If they can give you seed capital, this could be used to make investments and build an early track record.

"Get the timing right. You don't want to launch too early because you might find that during the first round of fund raising your fund lingers in the market. That can reduce momentum in the fund raising process.

"Lots of good news is great for fund raising so communicate any successful exits, updates in the deal pipeline, the track record, etc. Finally, if you can create scarcity around the fund raising process – i.e. if investors don't allocate now they might miss out – that can also be an effective tool within the marketing strategy."



"It is becoming increasingly common for managers to offer a heavily discounted founders' share class at launch to reach a critical AUM quickly."

Praveen Joynathsin, Lyxor Asset Management

Praveen Joynathsing is Director, Hedge Fund Selection, Lyxor Asset Management. Lyxor currently runs three platforms to provide institutional investors with access to best-in-class managers: an offshore hedge fund platform in Jersey, a UCITS platform in Ireland and an AIFMD platform in Luxembourg. Both the UCITS and AIFMD platforms each have seven funds at the time of writing.

Getting on to a platform such as Lyxor's gives managers the opportunity to potentially build significant assets across a wide range of institutional investors and whilst Lyxor will typically look at established managers it also supports emerging managers that it feels offer a compelling investment opportunity.

Like Walker, Joynathsing says that attracting seed capital is a good way to kick-start a business but the disadvantage to doing this is that managers give up part of their equity; a revenue share might run for a number of years. Another route available to start-ups who have spun out of existing fund management groups is to tap in to investors that they previously dealt with. However, there will often be a non-compete clause for two years so this is not an immediate option.

The third way to raise assets is to do it internally, which these days is getting harder and harder.

"You need to have the right strategy that appeals to investors," says Joynathsing. "You've got to get to a critical mass as quickly as possible. If your fund languishes around the USD25mn mark for a number of years, it becomes very difficult to generate investor interest. It is best to try and launch when a particular strategy is in vogue, although this is hard to achieve in practice. It is becoming increasingly common for managers to offer a heavily discounted founders' share class at launch to reach a critical AUM quickly."

He says that at Lyxor, the level of a manager's AUM is a key criterion; USD100mn will often be the minimal amount although they have invested in smaller managers.

"If we write a ticket for USD25mn to invest in a manager, we don't want to put the business at risk when we pull out that capital at a later date.

"In terms of length of track record, we look for three years but we will also consider an audited track record from the manager's previous organisation. We've seeded funds before based on their prior track record.

"Finally, we would consider the operational set-up; who are the service providers and what are the systems, the risk management processes in place? Do they stand up to institutional scrutiny?" says Joynathsing.

In Ireland, DMS Offshore Investment Services (Europe) Limited is able to support fund managers with both an AIFM platform (DMS AIF Management Company) and an AIF platform for fund distribution. Indeed, it operates both an AIF and UCITS platform to support approximately 50 funds across Ireland and Luxembourg.

Speaking about distribution, Conor MacGuinness, Director at DMS Offshore Investment Services, says that the firm approaches this from two angles. Firstly, soft guidance on marketing based on the experiences it has seen other managers go through.

"Secondly, we help in terms of the legal structure; that is, understanding what structure we think is going to work best, in which domicile, that will help the manager market their fund and grow the assets as much as possible.

"We do work with placement agents, and this has proven successful in the past, but not all managers will want to go down this route. Additionally, the investor conversation for significant allocations can often be a lengthy one before subscriptions are received. For example, one fund launch we are working with currently is based on an allocation from a pension fund. In this case, the manager had been talking to them for four years," comments MacGuinness.

Fischer makes the point that in Europe, some markets are more open to emerging alternative fund managers than others. Before approaching bank-owned platforms, which will have sophisticated institutional investor networks, Fischer says it can be beneficial for asset managers to approach independent financial advisors, family offices etc., in a few key markets as opposed to trying to convince pension fund investors from the outset.

"I would recommend start-ups to focus their marketing strategy on countries like the Nordics, UK and Switzerland, and to reach out to smaller investors.

"There is definitely demand in Europe for alternative investments but it's always a question of how the manager presents his strategy. The bottom line is you have to prove the quality of the fund; good governance, proven track record, robust risk management process etc. Credibility is always the hardest thing to prove for any start-up manager," concludes Fischer. ■

For start-ups: Four pillars of cyber security defence

By Dean Hill

There is no shortage of threats to financial services firms, and the list of requirements from investors and regulators alike is growing at a rapid pace. As a startup, it's important to demonstrate to investors that you take your business seriously, hence, investments in operational excellence are required. On the cybersecurity front, that means leveraging technology infrastructure with robust, security-rich features including intrusion detection and ongoing traffic monitoring, regular vulnerability assessments and next-generation software, firewalls and patches to keep hackers out and firm assets secure.

But beyond technology safeguards, today's successful financial firms require the wherewithal to implement comprehensive cybersecurity programmes – whether you're a seasoned firm or embarking on your first investment venture. The most effective cyber programmes will focus on four critical administrative areas: (1) developing comprehensive security policies and plans to prevent external cyber-attacks or internal breaches, (2) training firm employees on said policies and current cyber threats, (3) cultivating a culture of security awareness from Management down, and (4) managing an effective risk programme via external vendor oversight.

Dean Hill is Executive Director at Eze Castle Integration, where he is responsible for leading the firm's international business operations

Plan: True cybersecurity defence starts with proper planning. To start, funds need to develop written information security plans – comprehensive documentation of the firm's corporate security initiatives. This should include technical and administrative safeguards being employed to secure confidential data. In the development stage, firms will need to identify systems and plans currently being used, technical procedures and systems in effect, employee access controls relative to confidential data as well as user responsibilities for both prior to and in the event of a data breach.

Train: Speaking of employees, it's often said that your firm's users can either be your greatest threat or your first line of defence against cyber threats. As a result, training is not only critical but essential so employees understand the threats facing them and the company as a whole, as well as how they can take steps to prevent, detect and respond to cyber security incidents.

Cultivate: More abstract than the prior points, this third pillar suggests that firms create a culture of compliance throughout the organisation, starting from the top. Senior Management need to set the tone for the firm by spreading awareness of cybersecurity threats and their potential impact on the business by instituting annual information security awareness trainings and sending regular reminders about basic security protocols.

Manage: The fourth and final pillar of an effective cyber security defence programme relates to managing key third party relationships with vendors, and at a higher level, taking a strong position on risk management across the firm. Managers must work closely with all their third party service providers to understand how their cyber security programmes are designed and ensure the data and assets of the investment firm are protected from internal and external threats.

Emerging managers face a tough landscape from regulators and stiff competition for investors, therefore making early investments in cyber security protections is critical to demonstrating preparedness and forging successful investment endeavours. From day one, start-up alternative firms must operate at an institutional-level, vaulting themselves into competition with established funds and validating the operational excellence that has come to be expected of them. ■

Chapter 5: Technology considerations

Cloud technology

The scale of a manager's IT infrastructure will largely depend on the type of trading strategy. A quantitative market neutral statistical arbitrage fund is likely going to spend more capital on front-office portfolio management, risk management systems and server storage capabilities than a specialist credit strategy that trades infrequently.

Either way, investors will expect the manager to have a well-oiled machine in place: well-established workflow processes, operational controls, and, as far as possible, front- to back-office system integration.

One of the most popular routes to establishing a sound technology infrastructure is to appoint an outsourced cloud provider. It is cost-effective, and it allows the manager to benefit from economies of scale; after all, a cloud provider that supports hundreds of different hedge fund strategies will be able to share insights that a manager running their IT operations internally could never hope to achieve.

Eze Castle Integration has become a pioneer in this space with its Eze Private Cloud. It costs of three core components: Eze Managed Suite, Eze Managed Infrastructure and Eze Disaster Recovery.

The Eze Managed Suite includes the fundamental email, file services and back-up capabilities that any organisation would expect to derive from a cloud provider. Managers can readily access emails from mobile devices and utlilise file services when on the road. It is, as Bob Guilbert, Managing Director at Eze Castle Integration explains, "a multi-tenanted cloud that allows you to operate anywhere seamlessly.

"We've also incorporated disaster recovery into Eze Managed Suite. The way we've constructed the cloud means it will continue to operate as normal, independent of any disaster that might occur at anyone of the data centres we operate out of."

The Eze Managed Infrastructure is essentially Infrastructure-as-a-Service. If the start-up manager has a specific application that they want to use it can be hosted within the cloud without issue. The manager may want to run a CRM package for example, or a risk package alongside Eze Managed Suite, and benefit from having one cloud provider offering the entire computing infrastructure.

"We have interwoven Eze Disaster Recovery into both our cloud offerings. We believe it's important, especially for Eze Managed Suite. With Eze Managed Infrastructure, however, we give clients the option of having disaster recovery because the manager may not choose to make an application highly resilient," says Guilbert.

Third party risk is a key component of an investor's due diligence so the manager should seek assurances before selecting a cloud provider that they will allow the manager to execute their strategy without issue. In other words, the technology provider must check the box in the eyes of potential investors and demonstrate that they will be able to mitigate as much of the manager's operational risk as possible.

"Investors are asking questions to give them the confidence that the manager has chosen an institutional-grade cloud provider. Have they gone through the necessary steps to create the right IT environment, the right technology, and put the right protections in place? Clearly from an institutional investor perspective, if the manager selects a cloud provider like Eze it gives them reassurance that the fund's technology infrastructure is enterprise-quality and robust," says Guilbert.

Some of the points to consider before selecting an outsourced technology provider include:

- Reputation;
- Technology capabilities – managers should validate this with their own due diligence;

- Security Prowess – are they using the highest levels of security and encryption to store and protect clients' data on the cloud? Do they have the latest certifications?

With respect to security, Guilbert says that Eze Castle Integration uses encrypted tunnels to ensure that no one can see what data is flowing through.

"We are not security specialists per se so we leverage numerous third parties. One in particular is eSentire, which monitors traffic coming in to and out of our cloud. They provide a managed service to continuously monitor activity. If they see an attack (i.e. a rogue IP address) on one of their hedge fund client's networks they will lock down that IP address for all of their other hedge fund clients.

"We have well over 400 clients using the Eze Managed Suite which is protected by eSentire. These security layers allow us to fully protect them, should one manager be the focus of a targeted attack. In addition, we use the highest security measures in our data centres: biometrics, locked cages, segregation of client data and so on," confirms Guilbert.

Cyber insurance

Cyber insurance is becoming increasingly popular among managers of all sizes as the threats of cybersecurity rise in number and sophistication. Managers have to guard against this and although it might not be a top priority on Day One, start-ups should at least make plans to have cyber insurance in place once the fund's assets and investor base start to grow.

"It is definitely a key area of focus for the majority of our hedge fund clients. I would say that at least 75 percent of our clients have approached us to discuss cyber insurance, and all of them are doing the necessary due diligence to assess their firm's cyber exposures, evaluate their current cyber security protection and controls, and formulate a comprehensive incident response plan in the event of a cyber breach," explains Ron Borys, Managing Director, Crystal & Company, a leading New York-headquartered strategic risk and insurance advisor.

There are three main areas of insurance that a start-up manager should consider before going live: 1) Financial Insurance, 2) Employee Benefits and 3) General Insurance.

There are two main forms of financial insurances to be aware of:

- Professional indemnity insurance
- Directors and Officers insurance

Professional Indemnity insurance covers professionals for their legal liability to compensate other parties (generally their clients) for any losses they suffer as a result of the professionals' breach of their professional duty (known as professional liability).

Directors & Officers insurance cover directors and officers for their legal liability to compensate other parties for the loss which they suffer as a result of any wrongful act, error or omission committed by the directors and officers. 'Other parties' in this context could be shareholders, the Company, competitors, employees and liquidators.

Premiums & level of liability

The above are well-established insurance policies that have been used by fund managers for decades and as such are fairly straightforward to price. Cyber insurance, on the other hand, is a recent development. Hackers are stealing data not assets, and data doesn't have a 'value' per se.

"The potential liability that relates to the theft of data and breaches of confidentiality is a key area of concern for our hedge fund clients.

"With respect to the premium, we approach the broad marketplace with our clients' permission and solicit quotes from different insurers. There's no clear direction right now as to how insurers are pricing premiums for cyber insurance as the underwriters continue to work to understand and evaluate cyber risk exposures with respect to hedge funds," notes Borys.

One factor that can help determine the premium is ascertaining the amount of personally identifiable information (PII) a manager has stored on their server. Another important factor will be the fees or revenues generated by the manager.

"Those are probably the two main factors considered by insurers underwriting hedge fund cyber liability risk. Keep in mind that there is generally a minimum premium that an underwriter will look to charge for the issuance of a cyber policy.

"Our hedge fund clients are typically considering limits in the range of USD5mn to USD10mn. We are currently seeing premiums in the range of USD6,000 to USD8,000 per million, so managers considering USD5mn in coverage will be looking at an annual premium in the range of USD30K to USD40K," confirms Borys.

There are two key components that will go into a cyber insurance policy:

First party costs

These will typically include:

- Privacy notification costs. If there is a breach and personally identifiable information is stolen, the manager has an obligation to provide notification that such a breach has occurred to the US regulatory authorities.
- Business interruption costs. If the manager's systems are taken offline as a result of a cyber breach (maybe a DDoS attack) it could prevent them from trading and potentially impact the fund's performance.
- Cyber extortion. This is where someone penetrates the manager's network and threatens to do something unless they pay a ransom (often with Bitcoins).

"Some of the other first party costs would include: forensics, accounting, extra expense coverage to bring systems back on line, public relations costs that might arise to protect a manager's reputation following a breach. The coverage is written to respond to the potential expenses incurred by the manager who could be liable to pay damages as a result of a security breach," says Borys.

The second component of the coverage is written to respond to the broader liability associated with claims made against a manager for damages associated with a breach of their network, including unauthorised access to confidential or personally identifiable information.

Check your service providers

In addition to focusing on the manager's own protections and systems, they should also ensure that their third party service providers are doing the same; they need to ask the right questions to get assurances that their service providers are protecting their information that the manager could be liable for in the event of a cyber breach.

These questions might include: How are your servers protected? Who are you consulting with to stay up-to-date with the best solutions and tools? What is your disaster recovery plan? What would you do if a breach occurred and you had a system outage, which would directly or indirectly affect the fund?

"Three key insurance coverages that every fund manager should ask of their service provider are:

- Errors and Omissions – broad coverage for any actual or alleged wrongful act committed by the service provider in rendering or failure to render services to the manager or fund;
- Fidelity bond coverage – coverage for the fund's assets from theft by an employee of the service provider (i.e. the PB or custodian);
- Cyber insurance – coverage if the fund or its investors' confidential data is exposed or stolen, or if the service provider experiences a network outage that adversely impacts the fund or manager as a result of a cyber breach," concludes Borys. ■