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BREXIT

Dechert Partners Discuss Domiciling Funds in Germany or Ireland to Access the E.U. Post-Brexit, the Possible Introduction of PRIIPs and the Rising Prominence of UCITS Structures (Part Two of Two)

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The Hedge Fund Law Report

Brexit looms at a time ripe with new opportunities and challenges for managers seeking to market in the E.U. and around the world. On the one hand, managers must reconsider the types of vehicles and jurisdictions to use to preserve access to the E.U. markets. Additionally, new legislation – such as the impending Packaged Retail and Insurance-based Investment Products (PRIIPs) initiative – may present new barriers to managers marketing in Europe. On the other hand, however, global markets are opening up as certain vehicles, such as Undertakings for Collective Investment in Transferable Securities (UCITS), are increasingly welcomed by local regulators.

These issues were discussed at a seminar entitled "Current and Future Developments: UCITS, AIFs, Brexit and Global Fund Distribution," presented by Dechert's financial services group on October 13, 2016. Moderated by U.S.-based partner Chris D. Christian, the seminar featured U.K.-based partners Richard L. Heffner and Karen L. Anderberg; Luxembourg-based partner Marc Seimetz; Ireland-based partner Mark Browne; and Germany-based partner Angelo Lercara.

This article, the second in a two-part series, describes the increased usage of UCITS structures and the potential effect of impending PRIIPs legislation, as well as options for managers to domicile a fund in Germany or Ireland to market in the E.U. The first article in the series analyzed Brexit's impact on structuring considerations, as well as the viability of domiciling funds in Luxembourg to access E.U. markets.

For further commentary from Dechert attorneys, see "The Current State of Direct Lending by Hedge Funds: Fund Structures, Tax and Financing Options" (Oct. 27, 2016); and "What the Evolving European Marketing Environment Means for Hedge Fund GCs and CCOs" (Nov. 12, 2015).

Options in Ireland

Browne explained that Ireland primarily enjoys a strong favorable reputation as a place to domicile investment funds, rather than for fund management or distribution operations. He noted that there are roughly 6,000 authorized funds in Ireland at the moment, and of that total, about 80 percent are UCITS vehicles and 20 percent are alternative investment funds (AIFs), primarily qualifying alternative investment funds (QAIFs).

The fund management industry has a considerable presence in Ireland, with approximately 37 licensed administrators and 18 depositaries. These include familiar names such as State Street, Brevan Howard, JPMorgan and Bank of New York Mellon, Browne noted. Altogether, approximately 15,000 people work in the funds industry on the ground in Dublin.

This established infrastructure makes Ireland a desirable option for managers who wish to retain access to the E.U. markets post-Brexit. Irish legislation has made it relatively easy for companies to redomicile offshore funds to the country by filing a form with their registration office, and the establishment of new Irish entities is very straightforward.

See "Trends in Irish Fund Launches and the Challenges – and Solutions – for Non-E.U. Fund Managers Using These Vehicles" (Oct. 6, 2016); "Walkers Fundamentals Hedge Fund Seminar Addresses Fund Structuring Trends, Governance Best Practices, Fee and Liquidity Terms, Irish Vehicles, Marketing in Asia and FATCA" (Feb. 12, 2015); and "Irish Central Bank Issues Proposed Rules to Enable Private Funds to Originate Loans" (Sep. 11, 2014).

UCITS Structures

Browne pointed to the significant presence of UCITS management companies in Ireland, including 83 authorized entities to date. He noted, however, that in fact most UCITS structures – about 75 percent in Ireland – are self-managed. This option avoids the need for a separate management company, and involves having designated directors who manage business activity and delegate portfolio management back to the U.S., or having designated persons in Ireland – usually from consultancy firms – who provide services.

It is common for U.S. directors to serve on the boards of these entities, Browne noted. Currently, no obligation exists for the boards to be independent or for a majority to be composed of Irish residents. In fact, he continued, the Corporate Governance Code of Collective Investment Schemes and Management Companies – the relevant code of conduct applicable to relevant entities in Ireland – provides that there should be at least one representative from the U.S., where a U.S. entity has been appointed as the investment manager, and there is currently no cap on the number of U.S. representatives in this regard.

"One option would be that you could put a number of U.S. residents on the board of a self-managed UCITS vehicle," Browne explained, "and then you could empower them to have a distribution-type function. So, in practice, there might be no need for the investment manager to establish a separate European entity."

AIFs

At present, there are about 90 standalone alternative investment fund managers (AIFMs) in Ireland. In addition, a large number of AIFs, with most authorized as QAIFs, are self-managed, containing both the fund and management component in a single structure. AIFs are somewhat different from UCITS structures in this respect, Browne said, as in practice the percentage of entities that are self-managed is significantly less.

In the alternative sphere, more than 500 European entities are operating in Ireland as AIFMs on a cross-border passported basis, and 270 of those are located in the U.K. In the absence of some form of reciprocal arrangement post-Brexit, Browne cautioned, all of the funds serviced by these AIFMs will require a new solution. Possibilities include setting up a separate Irish AIFM or having a self-managed structure in Ireland. If there is a U.S. underlying portfolio manager, then it will be possible to appoint U.S. residents to the board and give them roles in distribution and other daily operations.

Broker-Dealer Licenses

Yet another approach is to obtain a broker-dealer license, or distribution license, under the Markets in Financial Instruments Directive (MiFID). In Ireland, Browne said, this approach currently generally encompasses a smaller part of the funds industry. The largest of the local players in this market is Irish Life Assurance, which has about $50 billion in assets under management. Most of the other local firms are considerably smaller, Browne noted; however, he pointed to a trend in recent years of larger shops, like BlackRock, coming into Ireland. At present, there are more than 90 MiFID firms authorized in Ireland.

"The big picture is that there are lots of different options, and a lot of players using these different options," Browne summarized. "Whichever you find suitable, you definitely won't be breaking new ground or re-inventing the wheel."

The German Market

Lercara outlined the regulatory realities facing a U.K.-based MiFID entity that possesses a license from the U.K. Financial Conduct Authority (FCA) and is currently allowed to market in the E.U. In the worst-case post-Brexit scenario, that will no longer be an option as the FCA license would no longer be valid beyond the U.K.

Faced with this reality, clients are asking frequent questions about the option of a MiFID license in Germany. Lercara described Germany as a key market for raising capital, with leading institutional investors, a sophisticated legal environment and a significant U.S. manager presence. Germany is also conveniently situated with respect to the Nordic and Swiss markets, he added.

Addressing the question of what a fund manager needs to do to acquire a MiFID license in Germany, Lercara said that the ease of the process compares favorably with equivalent processes in Ireland, Luxembourg and Malta. The German license can be acquired in six to nine months, or possibly faster depending on the applicant's owner's structure. There are several requirements for the license: the manager must have at least one full-time director, a capital requirement of at least €25,000 and a presence in Germany.

"In a nutshell, you could run a MiFID firm with one person," Lercara clarified. "It would in theory be sufficient to have one director running the MiFID entity as a distribution platform and marketing your funds throughout

Europe."

PRIIPs

Lercara assessed the challenges for fund managers because of the PRIIPs – an umbrella term covering a number of financial products to be marketed to retail investors. The PRIIPs regulation provides for a more restrictive approach for the marketing of financial products, including funds, to retail investors in Europe. The legislation governing these products is expected to come into force at the end of 2016, with a grandfather clause in place for investment funds through the end of 2019.

There remains some distance before consensus about the final rules is established, Lercara noted, as intense discussions are underway among the European Parliament, the European Commission and industry participants over how to move forward with PRIIPs legislation. There is a very real possibility that PRIIPs may be postponed because of a lack of final technical rules. Just two days before the Dechert conference, Lercara recalled, a request came from the European Parliament to shelve the PRIIPs legislation for 12 months and then implement it together with the revisions to MiFID (commonly referred to as "MiFID II"). The European Commission asked for a nine-month postponement.

In its current form, PRIIPs regulation provides for the introduction of a two-page key information document (KID). The KID briefly describes the fund, presents its risk indicators and sets forth other performance figures. The document will be harmonized for all types of products, Lercara said. Using the example of a provider of unit-linked life insurance, Lercara explained that the insurance provider would produce a KID containing information about the life insurance coverage and also about the fund. Asset managers will under certain circumstances operate under a requirement to produce all information that goes into the KID.

"If the regulations are enacted, the funds will need to be able to immediately deliver the fund numbers and information based on these rules to the insurance companies, although this may not be necessary upon enactment due to the 2019 grandfathering provision for funds that has been discussed," Lercara said, "but because of the fact that there will be no grandfathering for insurance companies, they will rely on the asset managers to provide them with the information related to the underlying funds."

Elaborating on PRIIPs, Anderberg described market concerns over how negotiations will play out with respect to certain types of AIFs sold only to professional investors. There is concern that AIFs will need to prepare a PRIIPs-compliant KID if they market to investors other than professional investors (which is permitted under local laws in certain jurisdictions).

Anderberg explained that this issue is potentially quite serious. When entering into distribution agreements, managers must think very carefully about where the distributor is based and to whom the distributor is marketing. A fund manager needs to be aware of who is receiving marketing efforts; whether they are professional or non-professional investors; and what they are legally able to do in their home jurisdictions.

A Global Role for UCITS Structures

Anderberg went on to describe the growth of UCITS structures, recalling that when the UCITS directive was introduced in 1985 people generally thought it would be passported throughout the E.U. but would not become a popular vehicle globally. Over time, Anderberg recounted, UCITS gained recognition as a "gold standard" product, with the industry gaining faith in the safety and security of the vehicle.

See "FCA Policy Statement Fine-Tunes Rules to Implement UCITS V As Deadline Looms" (Feb. 18, 2016); and our two-part series on considerations for hedge fund managers launching UCITS funds: "Liquidity, Transparency and Performance Considerations" (Dec. 10, 2015); and "Distribution and Operational Due Diligence Considerations" (Dec. 17, 2015).

"We see that the focus today can be, to a considerable extent, on marketing outside the E.U.," Anderberg commented. While some of the most popular marketing destinations for UCITS vehicles are the U.K., France and Germany, the list also includes numerous countries outside the E.U., including Singapore – the thirteenth most popular destination, accounting for 3 percent of the overall market – as well as Hong Kong, Taiwan, Macao and Chile. Going a bit further down the list, Anderberg noted, one encounters Bahrain and Peru.

"There is actually a wide distribution market for the UCITS product – something that wasn't anticipated 30 years ago," Anderberg said, characterizing UCITS structures as products with sales that are likely to climb rapidly on a global scale.

Different jurisdictions present different challenges for UCITS offerings, however. Anderberg highlighted Hong Kong as one of the more challenging jurisdictions because the local regulator has scrutinized the product and imposed tough disclosure requirements. Fortunately, a fast-track program is available for fund

managers that have all their documents in order. See "Dechert Partners Provide Roadmap to China's New Shanghai-Hong Kong Stock Connect Program" (Nov. 20, 2014); and "How Can U.S. Hedge Fund Managers Use Passport and Mutual Recognition Initiatives to Market to Investors in Asia?" (Jul. 18, 2014).

Israel is another jurisdiction that is challenging in its own respect. The public sale of UCITS vehicles was not previously permitted in Israel, but recent legislative changes may make it possible to register UCITS funds for sale to Israelis. However, Anderberg noted that final regulations that will allow UCITS offerings are still pending.

"The local industry has made court filings to halt or postpone the law for the time being. There's a concern that the local players might be impacted by allowing UCITS products to come in," she explained, suggesting that the appropriate stance now is to wait and see how the Israeli government responds. See "Survey by Hedge Fund Administrator Tzur Management Highlights Growth and Characteristics of Israeli Hedge Fund Industry" (Aug. 2, 2012).

Yet another jurisdiction where recent regulations have had an impact on UCITS vehicles is the United Arab Emirates (UAE). A new regulation is in place; however, it only limits the registration period for UCITS structures to one year and subsequently requires registrants to file renewals. "If anyone is marketing UCITS products in the UAE using local distributors, the new law says that the local representative is the one to make the filing," Anderberg added. See "United Arab Emirates Implements Licensing Regime for Firms Providing Investment Management Services" (May 23, 2014).