EXPERT COMMENTARY

Alter Domus' Anita Lyse and Antonis Anastasiou discuss the merits of the third-party hosted AIFM platform, the solution many managers have adopted when establishing investment funds to be marketed to investors in the EU

Accessing European capital

The alternative fund landscape has changed dramatically in recent years, and especially so in Europe since the arrival of the European Union's Alternative Investment Fund Managers Directive, and it will continue to evolve through its next iteration with AIFMD Level II.

The AIFMD aims to regulate the entities involved in the management of alternative investment funds, and sets out the requirements that must be met by alternative investment fund managers when it comes to authorization, their general conduct of business, including mandatory transparency obligations, and the marketing of an AIF.

Anyone wanting to raise capital among the European investor community today have in essence two marketing options: the national private placement regimes, in certain jurisdictions where they are (NPPR) still allowed, and the AIFMD-compliant route, which requires the use of an authorized AIFM, which by definition is established within the European Economic Area.

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These options have been running in parallel since the adoption of AIFMD for non-EU AIFs raising capital in Europe. However, that is to come to an end by August 2021 as NPPR rules are gradually being abolished. Slowly but surely, this will make the AIFMD-compliant route the more sustainable and hassle-free option – indeed, the only option – available.

Raising European capital will therefore soon, unequivocally, require an EU-domiciled authorized AIFM, which the larger fund managers might have in their home country, although many prefer the use of an externalized service provider in the form of a third-party, or hosted, AIFM. This can be either as a long-term solution or as a transitional solution in case the manager has ambitions to set up an adequate infrastructure and obtain its own license. In today's market, the vast majority of third-party AIFMs are domiciled in Luxembourg.

The impact of Brexit

Due to the uncertainty and fear of a possible hard Brexit coupled with the pressure from investors in the funds managed by UK-domiciled AIFMs, larger managers have since sought to establish a Luxembourg-based AIFM to ensure continuity to the daily management of their vehicles as well as the ability to continue to market their funds throughout the EEA investor community.

Post-Brexit, however, the UK could be deemed as a 'third country', thus losing its passporting rights and therefore its ability to continue marketing to investors. Whereas temporary permissions are being discussed at this stage for live fund structures, managers that are launching new fund structures are seeking more long-term and sustainable solutions.

Being deemed as a 'third country' following Brexit, UK managers would fall within the same scope as US or Asian managers looking to raise capital from European investors.

Why managers are using a third-party AIFM

Establishing a fully-fledged authorized AIFM is an expensive, laborious and timely exercise, especially for smaller start-up managers or non-EEA managers without a significant presence within the EU.

This is further impacted by the release of the Circular 18/698 by the Luxembourg regulator, the Commission de Surveillance du Secteur Financier (CSSF), in August 2018. The Circular enhanced the governance framework of AIFMs, with stronger and clearer requirements for local presence, limitation of mandates, and internal control functions notably around oversight over delegated functions. It also included specific provisions to be implemented by management companies in regards to Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) rules.

This has most certainly increased significantly both financially and operationally the barriers to entry for obtaining an authorization of a new AIFM license or the maintenance of an existing one. So managers that had established only a small local presence to face the minimal requirements to meet the regulations, but had the bulk of the operations being performed by central hubs throughout Europe or elsewhere, have suddenly had to staff up locally and maintain an infrastructure for additional operations in Luxembourg.

This has been the primary reason leading such managers to seek the help of third-party hosted platforms. Using such solutions provides a cost-effective contingency plan to maintaining continuity for firms without a dedicated authorized license. Managers can now leverage off the authorization of the regulated third-party AIFM and continue to focus on their core activities of raising capital and managing the portfolio of their funds.

In addition, firms, if they wish to, can minimize the scope of their local AIFM by fully or partially outsourcing the function to a dedicated third-party provider, which can provide the regulatory hub for the fund at a fraction of the cost of managing their own license and without having to worry about new regulations that could impact the AIFM in the future.

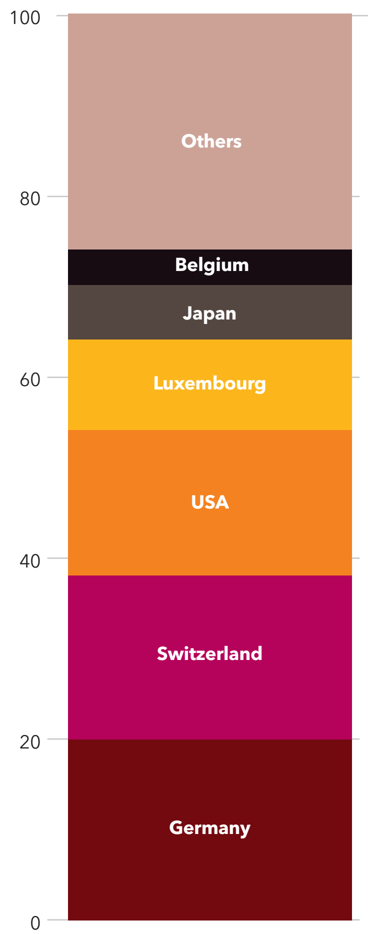
How to get comfortable with outsourcing the core business

The two core functions of an AIFM are portfolio management and risk management, of which only one – not both – can be delegated out.

In Luxembourg, for example, the delegation of one of these functions can only be permitted if the delegate is an authorized and regulated asset manager in its country of domicile and a memorandum of understanding exists between the domicile country of the AIF and that of the asset manager.

The Luxembourg AIFM market and environment

More than 40% of the top 50 licensed AIFMs come from non-EEA countries



Source: CSSF

Luxembourg, as one of the founding members of the EU, and one of the world's largest investment fund domiciles has positioned itself as the go-to domicile for private real estate fund managers to establish their own authorized AIFMs or to seek the services of third-party or hosted AIFMs.

The country's success in this area is the result of several factors: solid track record over several decades in both the UCITS world and the alternative investment fund space; political stability and ambition in the field; and a solid local network of specialized advisors and service providers.

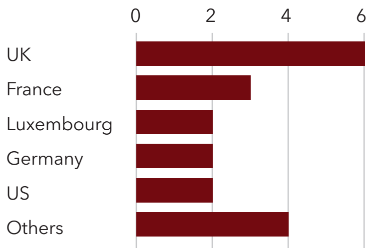
As at the end of 2018, Luxembourg had 316 authorized management company entities – both UCITS and licensed AIFMs – employing just under 6,000 people and managing approximately €3.4 trillion. Although the bulk of this number comes from plain vanilla UCITS funds, looking at the new licenses granted in 2018 for management companies, 14 have been for new AIFMs with only two being for UCITS management companies, and three for super management companies (both AIFM and UCITS).

This is a clear indication of the trend that AIFs continue to follow the UCITS's footsteps in Luxembourg.

New entrants flocked to Luxembourg in 2018

The uncertainty and fear over Brexit has driven several UK fund managers, in particular, to set up their own AIFM in Luxembourg to continue to take advantage of the EU passporting rules

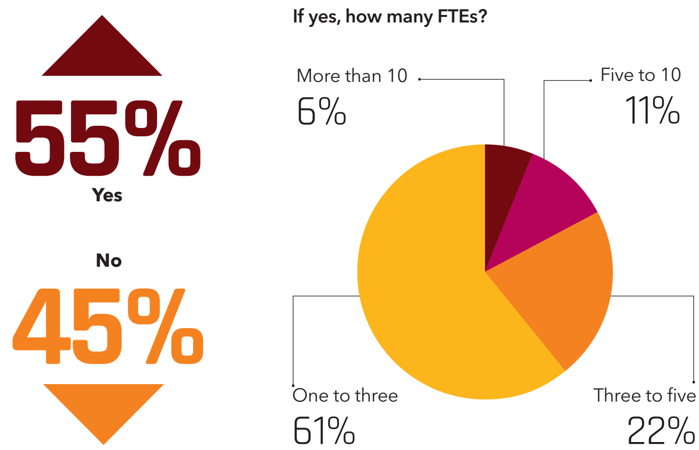
New AIFMs established in 2018, by origin



Source: CSSF

Does the implementation of Circular 18/698 require additional recruitment?

Over half of management companies and AIFMs have had to recruit more staff to manage their day-to-day operations with 22 percent of these having to recruit between three to five full-time employees.



Source: PwC's Observatory for Management Companies 2019 Barometer

In the case of Brexit, the general indication at this stage is that an MoU will be established between the Luxembourg and UK regulators and, therefore, an authorized UK AIFM could also potentially act as the delegated portfolio manager. This would give the UK AIFM full control of the daily management of the portfolio while the third-party AIFM maintains the risk management and regulatory requirements. This may be the most common set-up, although this is not yet supported by industry data and statistics.

On the other hand, for managers that are not regulated as an authorized AIFM or asset manager, the third-party AIFM maintains the role of the portfolio manager in-house, carrying the liability and control over the fund's investment portfolio. This can give rise to concern for managers; they could understandably view this as an additional layer of control, and with potentially costs and delays in the investment process, which ultimately gives a feeling of loss of control of their fund operations.

Mitigating this concern can, however, be overcome with the implementation of solid procedures designed at the on-boarding phase. This provides managers with an understanding of the requirements and duties of the third-party AIFM, but also the guidebook and processes to be followed to ensure a timely review and approval for the recommendations provided by the manager. This should give the asset manager the relevant comfort of an established and smooth operating framework and communication flow between themselves and the external AIFM.

Another key AIFM function is valuation. While this can be delegated to an external accredited appraiser under AIFMD, it is in practice very rarely done because of the liability that would go with it, among other reasons. As a consequence, third-party AIFMs usually maintain this function internally and need to demonstrate a robust and independent internal valuation framework.

In the real estate world, however, as opposed to private equity or, even more so, in venture capital where valuation is often done by the asset managers themselves and sometimes only on an ad-hoc basis, it is the norm to have an external appraiser appointed at least annually due to the multitude of reputable, local and specialist valuers. Such appraisers would provide the AIFM with a valuation which is then used as the basis of their internal review.

Over and above the regulatory, cost-effective and efficient solution a hosted AIFM can provide, the third-party AIFM's experience and expertise in real estate as an asset class is of key importance for real estate managers in the selection process. Third-party AIFMs will need to obtain specific licenses to manage funds investing in different asset classes. Managing plain vanilla UCITS funds or venture capital funds is obviously very different from investing in different types of real estate assets and strategies. Ensuring the hosted AIFM has the ability and, most importantly, the relevant skill set – with in-house dedicated personnel who are able to seamlessly integrate with the managers' operating framework and comprehend the intricacies and specificities of the asset class – can avoid potential frustrations, and ensure a smooth, efficient and long-standing relationship. ■

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