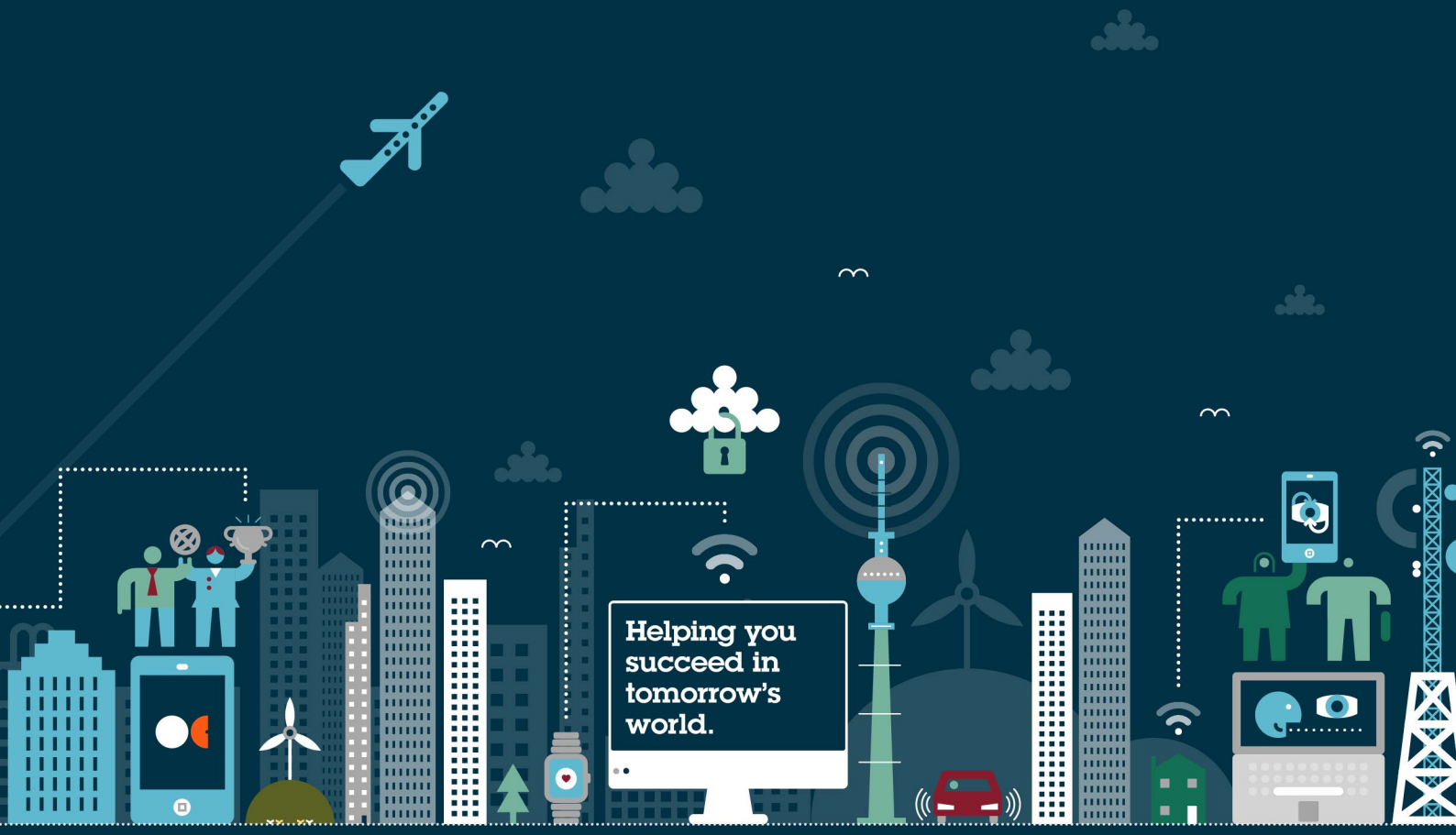
Marketing and Pre-Marketing Alternative Funds in Europe: A Technical Guide

November 2020



Introduction

With new marketing rules coming into force in Europe next summer, by which time the European Commission is expected to have published proposals for an 'AIFMD II', the post-Brexit EU asset management landscape may look quite different to how it does today. Fund managers aiming to raise capital from professional or retail investors in the EU from summer 2021 onwards should be aware of these changes and their potential impact on cross-border marketing activities.

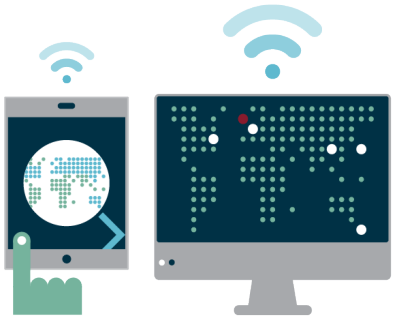
Background

The marketing of alternative investment funds (AIFs) throughout Europe is largely governed by the requirement of the Alternative Investment Fund Managers Directive (AIFMD), as interpreted by each of the member states, with an increasingly settled element of market practice.

Broadly, the proactive marketing of AIFs falls into one of two methods: either (i) marketing using the AIFMD 'passport' or (ii) the national private placement regime (NPPR). In addition, many funds are sold outside the scope of the AIFMD on the basis of so called 'reverse solicitation'.

Despite a certain amount of future proofing in the directive and the expressed desire to extend the passport to managers based outside of the EU, the AIFMD passport is currently only available to European managers (EU AIFMs) marketing EU AIFs to professional investors domiciled in the EU[1]. Most of these will therefore seek to take advantage of the passport in raising funds. Smaller AIFMs (so called 'sub-threshold' managers) are not currently eligible for the passport.

Marketing under the private placement route is generally available to any AIFM and AIF established outside of the EU, subject to each member state's individual rules and compliance with certain disclosure and reporting requirements of the AIFMD. Member states have introduced various requirements, ranging from a benign 'register and report' regime (such as in the UK) to a complete ban on private placement for non-EU funds (such as in Italy).



[1]For the EU Commission's current position on extending the passport and further amendments to AIFMD, see its June 2020 Report

Marketing under AIFMD: *the current position*

Marketing is defined under the AIFMD as being "….*a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union*".

This definition can be interpreted as follows:

Text	Comment
"a direct or indirect	It is not entirely clear what an 'indirect' offer is but it may well be that the role of third party placement agents and capital introduction teams employed on behalf of the AIFM would lead to an 'indirect' offer.
offering or placement	The FCA takes the view[2] that an offering or placement takes place for the purposes of the AIFMD UK regulation when a person seeks to raise capital by making a unit or share of an AIF available for purchase by a potential investor. This includes (but presumably is not limited to) situations which constitute a contractual offer that can be accepted by a potential investor in order to make the investment and form a binding contract, and situations which constitute an invitation to the investor to make an offer to subscribe for the investment.
at the initiative of the AIFM	The corresponding position would be for the placement to be at the initiative of the investor – in other words, a reverse solicitation, which is therefore outside of the scope of the AIFMD marketing rules. See below for further discussion as to its meaning and interpretation.
or on behalf of the AIFM	This captures offers by placement agents, broker dealers and marketing teams.
of units or shares of an AIF it manages	The terms 'unit' and 'share' are to be treated as generic and can be interpreted as encompassing all forms of equity, or other equity-like rights in, an AIF.
to or with investors domiciled or with a registered office in the Union"	The investor must be domiciled or have a registered office in the EU. Domicile in this case does not have the same meaning as under tax law but is to be interpreted as 'permanently resident'. Reference to 'investor' in the AIFMD UK regulation should be regarded as a reference to the person who will make the decision to invest in the AIF (which may not be the entity that legally invests).[3]

[2]See PERG 8.37.5
[3]PERG 8.37.9

Pre-marketing

Much thought is therefore given to whether or not the promotional activity of an investment manager is 'marketing' under the AIFMD and subject to the various regulatory and reporting requirements of the directive. Commonly, managers look to be free to approach investors with a view to discussing a particular investment opportunity without having to register the offer with the local regulator and complying with any local rules (such as the appointment of a local depositary).

The FCA is currently of the view that, in order for there to be 'marketing' under the AIFMD, the AIFM must be at a stage where it is required to submit certain documentation and information to the FCA about the AIF so as to obtain permission to market that AIF in the UK[4]. As a consequence, the FCA considers that any documentation and information supplied to investors should be in materially final form before triggering the registration requirement.

The consequence of this interpretation is that any marketing communications made in relation to draft documentation should not be deemed to fall within the meaning of an 'offer' or 'placement' for the purposes of the AIFMD, as the AIFM cannot apply for permission to market the AIF at this point. For example, a flip book or a pathfinder version of the private placement memorandum would not constitute an offer or placement, provided such documents cannot be used by a potential investor to make an investment in the AIF.

This important interpretation has led to a marked distinction between **'pre-marketing'**, using draft documents, which does not require registration, and **'marketing'** which generally does require registration.

This interpretation also has differing consequences for closed-ended funds (such as a private equity fund) and open-ended funds (such as hedge funds). The former, and at least in relation to activity before first close, will market prior to final documents being completed or even the AIF being established. The latter conduct a continual offering of interests and are therefore (once outside the initial offer period) always likely to have documentation in a 'materially final form'.

This only relates to 'marketing' under the AIFMD. The FCA makes it clear that if a promotion is not 'marketing' it may still be subject to local **financial promotion** laws[5]. In the UK, consideration therefore needs to be given to whether such a communication is a financial promotion[6], whether it is 'fair, clear and not misleading' and that it is directed to the appropriate person.

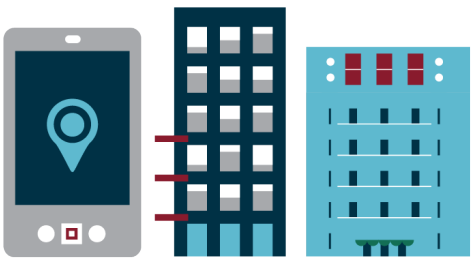
Reverse solicitation

The AIFMD is clear that the directive's marketing regulations do not apply to an offering or placement of units or shares of an AIF to an investor made at the initiative of that investor[7]. This leads to the so-called 'reverse solicitation' exemption much beloved of US managers. Consequently, if a fund is sold under the reverse enquiry exemption, the sale is entirely outside the scope of the AIFMD for all matters (but not outside of any local financial promotion rules or the requirement to produce a PRIIPS KID (as discussed below)).

The FCA is of the view that a confirmation from the investor that the offering or placement of units or shares of the AIF was made at its initiative should normally be sufficient to demonstrate that this is the case, provided this is obtained before the offer or placement takes place[8]. However, AIFMs and investment firms should not be able to rely upon such confirmation "*if this has been obtained to circumvent the requirements of AIFMD*".

Accordingly, it would seem difficult to raise an entire fund solely on reliance of reverse solicitation; a 'reverse enquiry marketing strategy' does not seem plausible.

[4]PERG 8.37.6
[5]PERG 8.37.6
[6]PERG 8.37.14
[7]Regulation 47 of the UK Alternative Investment Fund Managers Regulations 2013



What is changing?

As highlighted above, there has been limited guidance from the European Commission or the European Securities and Markets Authority (ESMA) on the meaning of marketing pursuant to the AIFMD. In turn, there is a lack of consistency from local regulators in their respective approach to marketing, pre-marketing and reverse solicitation.

New rules, introduced to address these concerns, come into force next year. The Cross-border Distribution Directive EU/2019/1160 (CBDD) and the Cross-border Distribution Regulation EU/2019/1156 (CBDR) amend the AIFMD, introducing new rules relating to the marketing of alternative investment funds in the EEA.

In a not atypical fashion, the new rules are not applicable to all managers affected by the scope of the AIFMD but instead are applied to a narrower range of fund managers, namely full-scope EU AIFMS and to managers of qualifying European venture capital funds (EuVECAs), European social entrepreneurship funds (EuSEFs) and European long-term investment funds (ELTIFs)[9]. Sub-threshold managers and non-EU managers (therefore likely to include the UK from 1 January 2021) fall outside of the scope of the CBDD and the CBDR.

The new rules will take effect from **2 August 2021**.

Definition of pre-marketing

The definition of 'marketing' under the AIFMD has not been changed by the CBDD and the CBDR. However, the Commission has now formally introduced the concept of 'pre-marketing': the provision of information about a fund that takes place before the requirement to register or notify the appropriate regulator of a sale.

The definition of 'pre-marketing' is broad:

"….provision of information or communication, direct or indirect, on investment strategies or investment ideas by an EU AIFM or on its behalf, to potential professional investors domiciled or with a registered office in the Union in order to test their interest in an AIF or a compartment, which is not yet established or, which is established, but not yet notified for marketing in accordance with Article 31 or 32 in that Member State where the potential investors are domiciled or have their registered office and which in each case does not amount to an offer or placement to the potential investor to invest in the units or shares of that AIF or compartment…"

[8]PERG 8.37.11

[9]The UCITS Directive was also amended to reflect the new rules.

Text	Comment
"….*provision of information or communication, direct or indirect, on investment strategies or investment ideas*	A wide ranging condition, which could conceivably include telephone calls and meetings. Again, the condition includes an 'indirect' proviso, which could catch the use of cap intro firms or placement agents.
by an EU AIFM or on its behalf,	Note that for the time being , this only relates to EU AIFMs. Third country (and possibly UK) AIFMs are currently out of scope.
to potential professional investors domiciled or with a registered office in the Union	This relates to potential sales to professional investors – sales to non-professional investors are out of scope and will be covered under domestic law.
in order to test their interest in: • *an AIF or a compartment, which is not yet established or,* • *which is established, but not yet notified for marketing in accordance with Article 31 or 32*	The distinction between funds which are not yet established and those which are is important for closed ended and open ended funds. The inclusion of 'established' funds was a late addition, and is of significance to hedge funds and other open ended funds conducting a continual offer.
in that Member State where the potential investors are domiciled or have their registered office	The investor must be domiciled or have a registered office in the EU. Domicile in this case does not have the same meaning as under tax law but is to be interpreted as 'permanently resident'. Reference to 'investor' in the AIFMD UK regulation should be regarded as a reference to the person who will make the decision to invest in the AIF (which may not be the entity that legally invests).
and which in each case does not amount to an offer or placement to the potential investor to invest in the units or shares of that AIF or compartment…"	*As set out below*, where an offering document is provided to a potential investor, it should contain a clear warning that the document is not an 'offer'.

A new Article 30a has been inserted into the AIFMD setting out the harmonised conditions for undertaking pre-marketing without triggering the formal marketing notification requirements; namely that the information presented to potential professional investors **must not**:

- be sufficient to allow investors to commit to acquiring units or shares of a particular AIF;
- amount to subscription forms or similar documents, whether in **draft or final form**; or
- amount to constitutional documents, a prospectus or offering documents of a not-yet-established AIF in final form.

Furthermore, where a draft prospectus or offering document is provided to investors, those documents should not contain information sufficient to allow investors to make investment decisions and **should clearly state** that:

"*the document does not constitute an offer or an invitation to subscribe to units or shares in the AIF*"; and

"*the information presented in the documents should not be relied upon because it is incomplete and may be subject to change*."

Practically, this should be relatively easy to comply with and is to be welcomed. The golden rule to follow for taking refuge in the pre-marketing safe harbour is therefore **'Do not hand out subscription agreements'** as part of your information pack.

Obviously, 'pre-marketing' is just that, an exercise undertaken before formal marketing. It follows therefore that no investor can be accepted into a fund (or even sign a commitment letter) without the AIFM formally completing an AIFMD marketing process in the relevant member state. In addition, and under the CBDD and CBDR, any subscription to a fund by a professional investor within a member state made within 18 months of the pre-marketing notification (see below) will be considered to be as a result of formal marketing, even in circumstances previously deemed out of scope under the reverse solicitation exemption or if the investor in question was not part of the pre-marketing round.

Note that, like the AIFMD marketing passport, the CBDD and CBDR only apply in relation to information provided to professional investors. The pre-marketing rules do not apply on a Europe-wide basis to high-net-worth investors (who do not meet the 'professional investor' test under MiFID II), in respect of whom member state law will remain the default position.

Notification of pre-marketing

Aside from additional definitions and process, a new marketing notification requirement has been introduced to the AIFMD. If an AIFM intends to pre-market in a member state, it will now be required to notify its home state competent regulatory authority within two weeks of beginning the pre-marketing setting out details of the member states and the periods the activity is taking place and a brief description of the activities, the strategies and the AIFs covered. The home regulator will then inform the regulator in each member state in which pre-marketing is taking place.

Notification of discontinued marketing

The CBDD and CBDR introduce a formalised notification procedure for use in the circumstances where a fund is no longer marketed in a jurisdiction. The new rules therefore imply that without the discontinuation notice being filed with the home state regulator, marketing must be continued (or at the very least, the reporting requirement under the AIFMD be continued).

An AIFM making use of a discontinuation notice will need to consider carefully the logistical difficulty (and prospect of breach of the AIFMD) of ensuring that for a period of 36 months after the date of de-notification both:

- a new offer is not inadvertently made to investors in the relevant member state in respect of an AIF which has been de-notified, and
- an AIF with "similar investment strategies or investment ideas" is not subsequently pre-marketed in that member state.

An adverse consequence of this rule is that EU AIFMs may be prohibited from pre-marketing their follow-on funds to professional in the relevant member state(s) until the expiry of the 36 month period.

Application to placement agents, cap intro firms and other distributors

The new rules have introduced an important new regulatory clarification and extension for placement agents, capital introduction firms and other distributors. As noted above, distribution under the AIFMD already covers 'indirect' marketing. Any third party carrying out pre-marketing on behalf of an AIFM will need to be authorised as either: an investment firm under MiFID II, a credit institution, a UCITS management company or an AIFM or act as a tied agent in accordance with MiFID.

At this stage, it's not altogether clear what the third party should be regulated as, as 'marketing' is not in itself a regulated activity. There are differing views as to which of the MiFID regulated activities apply. Commonly it is regarded as one of 'investment advice', 'receiving and transmitting orders in relation to one or more financial instruments' or 'placing of financial instruments without a firm commitment'. But none of these activities is a perfect fit for a distributor and so further regulatory guidance would be welcomed in this regard.

Application to retail investors

As stated above, the pre-marketing rules only apply to professional investors not retail investors. A "retail investor" for these purposes will be a "retail client" as defined for the purposes of MiFID II. This may include individuals (for example, members of staff of the AIFM and high-net-worth individuals), smaller undertakings, municipalities or local authorities who do not or cannot "opt up" to "professional client" status.

Each member state may, at its discretion, permit marketing of AIFs to retail investors in accordance with local laws – however a harmonised cross-border approach is currently lacking.

The new rules amend the AIFMD and introduce a 'local facilities' requirement to ensure there is, at a minimum, a consistent treatment of retail investors in the EU.

Member states must ensure that AIFMs make available, in each member state where they intend to market an EU or a non-EU AIF to retail investors, facilities to perform the following tasks:

- processing investors' subscription, payment, repurchase and redemption orders relating to the units or shares of the AIF, in accordance with the conditions set out in the AIF's documents;
- providing investors with information on how orders can be made and how repurchase and redemption proceeds are paid;
- facilitating the handling of information relating to the exercise of investors' rights arising from their investment in the AIF in the member state where the AIF is marketed;
- making the latest annual report of the AIF and pre-investment disclosures under article 23 of AIFMD available to investors for the purposes of inspection and obtaining copies;
- providing investors with information relevant to the tasks that the facilities perform in a durable medium; and
- acting as a contact point for communicating with relevant national competent authorities.

These facilities may be provided by a third party, provided it is subject to regulation and supervision governing the tasks which it performs. Where a third party is used, a written contract is required evidencing the appointment and specifying: (i) which of the tasks are not performed by the manager marketing retail products in the EU and (ii) that the third party receives all the relevant information and documents from the manager marketing retail products in the EU.

Member states will not be able to require the managers marketing retail products in the EU to have a physical presence in host member states or to appoint a third-party representative in that state.

As currently promulgated, the PRIIPs regime[10] applies to all products that provide an investment opportunity to EEA retail investors where (irrespective of the investment's legal form) the product's return is subject to the performance of assets which are not directly purchased by the EEA retail investor. AIFs will therefore constitute PRIIPs for the purposes of the regime. Accordingly, any AIFM that promotes an AIF to a retail investor (including where there is a reverse enquiry), is required to provide that investor with a Key Information Document prior to the providing the subscription documents.

While the UK government supports the objectives of the PRIIPs Regulation[11], serious concerns about the unintended consequences of the legislation have been raised extensively by governments, regulators and industry across Europe since it came into force in 2014. In particular, the PRIIPs Regulation has been criticised for requiring the disclosure of potentially misleading information to retail investors and for the lack of clarity surrounding its scope.

[10]Regulation (EU) No. 1286/2014
[11]As 'onshored' in the UK by the Packaged Retail and Insurance-based Investment Products (Amendment) (EU Exit) Regulations 2019

Accordingly, and further to its policy statement in July 2020, the UK government introduced a new Financial Services Bill to UK Parliament on 21 October 2020. Designed to enhance the competitiveness of the UK's financial services sector, the Bill makes (amongst other things) targeted amendments to the PRIIPs Regulation to avoid consumer harm and provide the appropriate certainty to industry, by:

- addressing significant uncertainty as to the precise scope of PRIIPs, without changing the definition of a PRIIP;
- removing the obligation for PRIIPs manufacturers to produce performance scenarios, the methodology for which has been criticised for producing misleading predictions; and
- providing UCITS retail schemes with an extended transitional period to comply with the Regulation, up to a maximum of five years.

The Bill is expected to become law before the end of the transition period. In the longer term, HM Treasury intends to conduct a more wholesale review of the disclosure regime for UK retail investors.

Requirements for marketing communications

On 10 November 2020, ESMA launched a consultation on draft guidelines on marketing communications under the CBDR. The proposed guidelines specify that marketing communications should:

- be identifiable as marketing material;
- describe the risks and rewards of purchasing units or shares of an AIF or units of a UCITS in an equally prominent manner; and
- contain information which is fair, clear and not misleading.

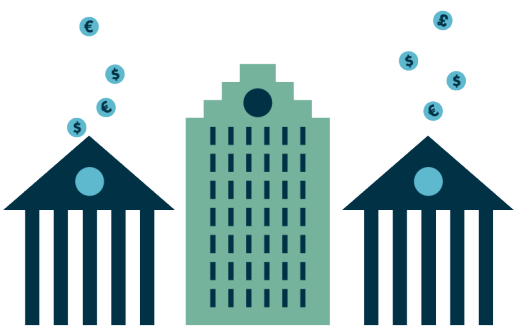
The guidelines also take into account the on-line aspects of marketing communications.

Only fund managers are subject to the guidelines. Consequently, distributors, such as investment firms, are not subject to the guidelines as such, although they may have to apply other rules governing the information issued to investors or potential investors, such as Article 44 of the Commission Delegated Regulation (EU) 2017/5655 , which contains conditions for ensuring fair, clear and not misleading information to clients.

As proposed, the guidelines would apply to all communications for UCITS and AIFs, including EuVECAs, EuSEFs, ELTIFs and Money Market Funds, that have a marketing purpose. In this context, ESMA states that it may be useful to refer to how "Marketing" is defined by Article 4(1)(x) of the AIFMD, The notion of "marketing communications" under the guidelines is proposed to encompass all communications, regardless of the medium used, which contain a direct or indirect offering or placement of units or shares of a fund to or with investors domiciled or with a registered office in the EU.

Helpfully, the draft guidelines include a (non-exhaustive) list of examples of communications that may be considered as marketing communications (which introduces reference to messages broadcast on social media platforms), and those that should not be.

The deadline for comments on the draft Guidelines is 8 February 2021. ESMA will then consider the feedback received with a view to issuing final guidelines by 2 August 2021.



Brexit

At the time of writing, the UK government has indicated that it does not intend to adopt the CBDD and the CBDR as UK law. As at 1 January 2021, the UK's ties with the EU will have been cut and the UK will be treated as a 'third country' for the purposes of AIFMD. To that extent, a UK manager will be in the same position as a US or Hong Kong manager in that any UK based AIFM will be required to market its funds in Europe by virtue of the NPPR[12]. Similarly, EEA fund managers that want to market EEA and UK AIFs in the UK after the end of the transition period on 31 December 2020 will first need to apply to enter the UK's temporary permissions regime, and thereafter notify the FCA under the UK's NPPR. Information for fund managers is available on the FCA's webpage here.

We note, however, that access to the NPPR under Article 42 of the AIFMD by a UK AIFM would require a cooperation agreement to be in place between both (i) the competent authority of the relevant EU 27 member state and the FCA (as the supervisory authority of the now third-country UK AIFM); and (ii) the competent authority of the EU 27 member state and the competent authority of the non-EEA AIF's jurisdiction of establishment.

In February 2019, the FCA announced the agreement of a multi-lateral memorandum of understanding (MoU) with ESMA and EU regulators covering cooperation and exchange of information in the event the UK left the EU without a withdrawal agreement[13]. On 11 November 2020, ESMA published a 'Guidelines compliance table' identifying which EU regulators have informed ESMA that they comply or intend to comply with ESMA's guidelines on the model MoU concerning consultation, cooperation and the exchange of information related to the supervision of AIFMD entities (ESMA/2013/998). The guidelines, among other things, require national competent authorities to sign an MoU to satisfy the condition set out in Article 42(1)(b) of the AIFMD for a cooperation arrangement to be in place for marketing purposes. The text of the agreed MoU will be published before the end of the year, and the expectation is that it should be sufficient in scope to permit marketing by UK AIFMs under Article 42 after the end of the transition period.

[12] Under Article 42 of AIFMD and any local rules.
[13] On 17 July 2020, FCA and ESMA confirmed that the MoU remains relevant and appropriate to ensure continued cooperation and exchange of information after the end of the transition period (see here).

Impact on non-EU managers: AIFMD II?

The pre-amble to CBDD states that "*national laws, regulations and administrative provisions necessary to comply with [AIFMD] and, in particular, with harmonised rules on pre-marketing, should not in any way disadvantage EU AIFMs vis-à-vis non-EU AIFMs. This concerns both the current situation in which non-EU AIFMs do not have passporting rights, and a situation in which the provisions on such passporting in Directive 2011/61/EU become applicable*".

As noted above, the majority of the new rules do not apply to non-EU AIFMs marketing funds in Europe under the AIFMD private placement regime. Accordingly, US (and potentially UK managers post Brexit) may continue to approach European investors in accordance with the existing private placement rules (or rely on reverse solicitation).

However, the AIFMD as a whole is likely to be amended at some point in the near future following the European Commission's report published in June 2020 reviewing the application and the scope of the Directive[14], and the Commission's public consultation on the review of the AIFMD launched on 22 October 2020. The deadline for responding to the consultation is 29 January 2021. If the Commission decides to propose changes to the existing legislation (at Level 1 and/ or Level 2), these are unlikely to be published until mid-2021.

There is some expectation that the pre-marketing definition will be reflected in "AIFMD II", and in light of ESMA's recent request for clarification around the notion of reverse solicitation[15], it is possible that AIFMD II might also include a specific definition of "reverse solicitation". In any event, in the context of the European Commission's review of the AIFMD, it seems likely that some of the new rules will then be applied to non-EU AIFMs who market their funds into the EU under the AIFMD private placement regime[16].

Next steps

The current lack of consistency in terms of approaches to marketing (or reverse solicitation) across EU Member States can be challenging for fund managers and distributors. However, in an attempt to cure this divergence, the European Commission has, at least in some respects, created a more complex regime which has the potential to make it more difficult to gauge investor interest in AIFs. As highlighted above, the new rules on pre-marketing will give rise to (i) an extremely broad definition of what could amount to pre-marketing, (ii) a requirement to notify the regulator as soon as any pre-marketing commences, and (iii) what amounts, in effect, to a major clampdown on the use of reverse solicitation (which is, as mentioned, a theme that is being continued into the Commission's latest public consultation on the AIFMD).

Once the new rules come into force, we may even see a new concept of "pre-pre-marketing" evolve in the market (being, action that can be taken by an AIFM without triggering the "pre-marketing" compliance obligation). With marketing staff eager to promote a forthcoming investment, supervising and controlling that activity is going to be a difficult task for regulators.

Nevertheless, the new regime will go live on 2 August 2021. For those managers who are already full swing into the fundraising process, the new rules should not affect them. However, funds looking to raise capital from professional investors in the EU from 2021 onwards will need to factor these new rules into their fundraising schedule.

[14] https://ec.europa.eu/transparency/regdoc/rep/1/2020/EN/COM-2020-232-F1-EN-MAIN-PART-1.PDF
[15] https://www.esma.europa.eu/press-news/esma-news/esma-recommends-priority-topics-in-aifmd-review
[16] It's unclear how the notification of the pre-marketing process will be managed, as non-EU managers do not have a 'home state competent regulatory authority' to report to.

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