Launching a new alternative investment fund?

A quick guide to the key considerations

The Bright Alternative

Explore: aztecgroup.co.uk | .eu | .us

AZTEC GROUP

Launching a new alternative investment fund?

Establishing a closed ended fund is a complex process with a wide range of variables to be considered and, at first glance, can seem overwhelming.

While there is undoubtedly complexity in the detail of any establishment exercise, the broad-brush strokes of fund establishment are actually relatively straightforward and are often based on a few key drivers.

In this article, we will run through some of the key points that need to be considered in connection with the establishment of a fund and will then take a slightly deeper dive into what we consider to be one of the most important issues in this process – fund structuring.

Jump to:

Launching a fund

Fund structuring:

1. GP considerations

2. Investor considerations

3. Regulatory considerations

4. Tax considerations

Final thoughts

Launching a fund

While it is undoubtedly true that there is a lot to consider when looking at fund establishment, some of the key issues that arise in this process can actually be managed with relative ease and, once these issues are covered off, the detail of the establishment process will generally fall into place, following market norms developed over the past few decades.

Without exception, the most important part of the establishment process rests with the sponsor (the **"GP"**). Any aspiring GP needs to have an attractive investment proposition underpinned by a solid track record and a cohesive management team. Assuming that this is present, the key elements of the fund establishment process can be divided as follows:

1. **GP establishment and regulation:** before looking at establishing a fund, a GP will need to establish, get regulated (with some jurisdictional exceptions) and think through how it will structure economic participation in the fund.

2. **Fundraising:** of principle importance among the remaining issues to consider is fundraising. Without investors there's no fund so it's crucial that a GP has alighted on an effective fundraising strategy that can be executed either independently or with the assistance of a placement agent.

3. **Structuring and jurisdictional choice:** the fund distribution mechanism is a key output in connection with structuring decisions, but tax, regulatory, investor and GP considerations will also play a part in determining how a fund is structured.

4. **Documentation:** as a fundraising process gathers momentum and structuring decisions are made, documentation will need to be put in place covering both the investment proposition/GP pitch and in connection with the fund vehicle. The look and feel of these documents will, in part, be influenced by the structuring decisions that are made in terms of both the jurisdiction in which the fund is to be located, the vehicle type to be used and the investors targeted.

Each of these establishment considerations are multi-faceted and can cover a lot of ground. Central to the main decision making process, however, is the structuring decision and we have, therefore, focussed on this for the purposes of this article.

Fund structuring

The fund structuring process can be broken down into the consideration of a number of different factors, each of which may be given more of less weight depending on the GP involved. At a high level, the basic considerations include:

1. GP considerations;
2. investor considerations;
3. regulatory considerations; and
4. tax considerations.

Often there will be a clear leading driver in a fund structuring process (such as meeting the needs of a cornerstone investor), but in other cases, the decision making process will be more nuanced and less clear cut.

GP considerations

The starting point for any fund structuring exercise is that the GP is free to make a choice based on its own requirements:

1

Choice of vehicle: limited partnerships have been the preserve of the closed ended funds universe for decades and quite rightly given their tax transparency and flexibility from an administrative perspective. Each of the Channel Islands and Luxembourg (together the "**core jurisdictions**") has well developed limited partnership regimes so, as a general rule, vehicle choice does not really drive jurisdictional structuring decisions.

2

Market perception: market perception can be an important consideration for some GPs. In this context, market perception can be split between business suitability (the ease with which a GP considers business can be done) and international reputation, and GP opinions on the various core jurisdictions will vary.

3

Cultural alignment: cultural alignment can be an important point, particularly when dealing with service providers based in the jurisdiction. This cultural alignment can also spill over into regulatory interactions and the way in which a local regulator oversees both a GP's fund and its administrator. As with market perception, GP opinions on the various core jurisdictions will vary.

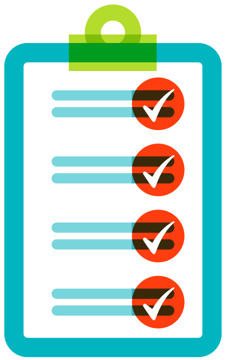
4

Cost: cost will always remain a relevant factor for a GP, although will generally be indirectly relevant as the fund (and therefore investors) will generally pick up the majority of the costs associated with its administration. As a general rule, administration costs in connection with the Channel Islands are lower than equivalent Luxembourg vehicles as the regulatory overlay is generally not as complex.

Investor considerations

Certain investors are prevented or disincentivised from investing in certain jurisdictions and products with higher capital weightings and investment restrictions.

Investor considerations will generally fall into two buckets:



1

Market perception: investors, like GPs, will have their own jurisdictional preferences based on their years of investing in funds located in a variety of jurisdictions. Unless the investor is a cornerstone, however, these views will not, provided they are a matter of preference only, typically be strongly enough held to be determinative.

2

Investment restrictions: certain investors can be restricted from investing in funds based in certain jurisdictions for legal/tax reasons and, in these circumstances, unless a structural work around can be created (feeder or parallel vehicle for example) this can be problematic and can be relevant in structuring. Similarly, certain investors are prevented or disincentivised from investing in certain jurisdictions and products with higher capital weightings and investment restrictions being variously applied.

Regulatory considerations

Following the implementation of the Alternative Investment Fund Managers Directive ("**AIFMD**"), regulatory considerations can be a significant driver for structuring from a GP perspective and the choice here should really be made following a thorough review of anticipated distribution needs in terms of scope and jurisdictional breadth.

1 AIFMD – the kite mark

The basic decision to be made by a GP is whether to embrace AIFMD and all that goes with it in terms of compliance, operational oversight, costs and regulatory inconvenience in order to secure a marketing (and perhaps management) passport, or whether to side step this and take a lighter (regulatory) touch and more cost effective structuring route.

While there are a number of advantages to embracing the AIFMD kite mark (e.g. investor risk weighting as mentioned above and a cross border management passport for some GPs), in reality the key benefit attaching to AIFMD is the availability of a marketing passport. Where a GP secures AIFMD authorisation, it will be free to market interests in its EU based funds across all Member States. This can vary in importance for GPs depending on where they anticipate sourcing capital, both within and outside of Europe, noting that marketing outside of the AIFMD umbrella is still relatively straightforward across a range of European countries and particularly across northern Europe.

2 EuVECA – an alternative path for VC

For VC (seed and growth capital) the European Venture Capital Funds Regulation ("**EuVECA**") regime can also provide an interesting light touch option. GPs should also consider the impact of Brexit if looking at UK based authorisation under AIFMD/EuVECA.

For venture focussed GPs, EuVECA can be utilised as an alternative to AIFMD. EuVECA provides all the distribution advantages of AIFMD (i.e. a pan European marketing (and management) passport) but with few of the compliance burdens. Since its introduction in 2013 there has not been huge interest in EuVECA principally due to the restrictive nature of what an EuVECA authorised manager could invest in, but following changes to the regime in 2017, the qualifying investment definition was widened and provided the specified investment requirements do not conflict with a GP's investment objectives, EuVECA can now provide an easy and cost effective marketing passport for seed and growth capital VC managers.

3 Other options

It is worth noting that when considering regulatory wrappers and distribution routes, a GP should also consider how a structure is tailored to achieve compliance. GPs can themselves become regulated under AIFMD which carries the highest cost and administrative burden, can use a service provider to achieve the same result (with a medium cost position) or can remain on the side line and push the regulatory burden onto the SPV general partner of the fund (more common with Channel Islands based products and generally cheapest). There are pros and cons to each approach.

Tax considerations

As an EU Member State, Luxembourg is a slightly more favourable regime, and income and capital can be moved cross border to both EU and non-EU jurisdictions with minimal issues.

1 Funds are largely tax transparent

When most people think about fund structuring, tax is probably top of the agenda. However, for funds, it's important but not always determinative from a jurisdictional perspective as both Luxembourg and the Channel Islands offer well understood and effective options. Provided a fund is structured as a limited partnership (or equivalent – SCSp in Luxembourg), direct taxes are largely irrelevant as the fund vehicle will be treated as tax transparent. The arbitrage between jurisdictions therefore is largely generated by indirect tax efficiency. Since the introduction of BEPS in 2016 there is also a discussion to be had about 'substance' and the wider impact of this and the BEPS anti-avoidance provisions applicable to funds and their holding structures, but a detailed look at this is beyond the scope of this guide.

2 VAT considerations

At a high level, Channel Island funds generally remain the most tax efficient as there is no VAT chargeable on any costs that can be met by the Channel Islands fund vehicle (i.e. the fund falls outside of scope of the European VAT regime). With Luxembourg based structures, VAT efficiency is achieved through reliance on the investment management exemption, so any investment management services provided together with many of the common administrative supplies consumed are treated as exempt, with no VAT charged whenever possible. This approach does generate a degree of leakage, however, due to the application of VAT to some services consumed by Luxembourg based funds (e.g. some elements of administration and legal/accounting services) but these tend to be concentrated around establishment. For most GPs, cross border supplies (of advisory/management services) are favourably treated in both the Channel Islands (outside of scope) and Luxembourg (treated as exempt for the purposes of the receiving party and exempt or standard rated for the supplier depending on its location) so there is no particular arbitrage here.

3 Portfolio tax structuring

Portfolio tax structuring can be complex and is beyond the scope of this article, but it's worth noting that most cross border transfers of dividend income and capital in a European focused portfolio are generally covered under the parent-subsidiary Directive (as enacted in most EU jurisdictions through the participation exemption) and both Luxembourg and the Channel Islands have extensive double tax treaty networks which can be helpful in reducing residual withholding taxes. As an EU Member State, Luxembourg is a slightly more favourable regime, and income and capital can be moved cross border to both EU and non-EU jurisdictions with minimal issues, but the relevance of this will depend largely on where a given GP's investors are based and what type of investor they are.

As with portfolio tax structuring, a detailed examination of the structuring considerations surrounding carried interest and co-investment returns is beyond the scope of this article, but each of the core jurisdictions offers good options.

Final thoughts

The fund establishment process can, on the face of it, seem complex and inaccessible. When this is broken down, however, it becomes clear that many of the decisions that need to be made follow a pre-set pattern based on the generally accepted market position. Provided a GP has a clear and appealing investment proposition with a cogent and well articulated fundraising strategy, the establishment process can be relatively straightforward. Fundraising, structuring and documentary processes all need to be completed, but central to fund establishment is the structuring decision that needs to be made at a relatively early stage in the process.

At a high level, fund structuring is relatively straightforward and whether a GP chooses a Luxembourg or Channel Islands based option, there are tried and tested pathways which will always yield a favourable result. As to which structuring jurisdiction to choose depends on a range of different considerations which will be specific to each GP both in terms of what they are and their relative importance.

While AIFMD and EuVECA offer straightforward and appealing European distribution pathways, the compliance burden associated with the former and the investment restrictions associated with the latter should be carefully considered before a GP opts into compliance. GPs should not be afraid to operate outside of these European regulatory umbrellas where circumstances dictate that this is appropriate, particularly if there is no marketing to EU domiciled investors.

If you would like to discuss any of the topics in this guide, as well as how the Aztec Group can support you, please talk to either your usual contact or get in touch with:

Simon King
Co-Head of Private Equity – Jersey
Telephone: +44 (0) 1534 833618
Email: Simon.King@aztecgroup.co.uk

Hana Prochaska
Head of Business Development Europe - Luxembourg
Telephone: +352 691 616 024
Email: Hana.Prochaska@aztecgroup.eu

The Bright Alternative

Explore: aztecgroup.co.uk | .eu | .us

Private Equity Fund Services
Real Asset Fund Services
Private Debt Fund Services
Corporate Services

AZTEC GROUP