



Why Investment Structure Unlocks Effective Fundraising Overseas

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Product characterisation, so the author of this article argues, is vital in a money-raising campaign for investment funds in foreign countries, given the mix of rules that can apply.

Here is an article from a regular contributor to this news service – Cathy Brand, CEO of Sales Road Maps Online Ltd.®. SRMO provides analysis on a range of topics confronting fund management businesses, including those in the alternative investments space, when marketing their wares around the world. This is useful guidance also for wealth managers, private banks and advisors who want to understand compliance requirements worldwide.

The author writes here: “In this article, we explore why product characterisation is so fundamental to fundraising (legally) in a foreign country. Your views on how your product is ‘characterised’ in your home jurisdiction are not necessarily applicable in foreign countries. Investment product characterisation is a key factor in your sales compliance platform in order to mitigate your five key distribution risks when fundraising overseas.”

The editors are pleased to share these views; the usual disclaimers apply around views of outside contributors. Please email tom.burroughes@wealthbriefing.com if you wish to do so.

One of the most confusing and complex areas of cross-border fundraising for alternative investment fund managers (AIFMs)/asset managers is the issue of the manager’s product structure and how this structure is “characterised” by local regulators (or National Competent Authorities, “NCAs”) on a country-specific basis for promotion to investors.

Over the years we have observed that many investment managers are unaware that investment product structure and its classification are even a relevant consideration for fundraising overseas. To borrow a quote from Donald Rumsfeld, “there are known unknowns” and this is a good example.

“Investment products” for the purposes of this article could refer to a wide range of investment vehicle offerings including collective investment vehicles structured as open or closed end funds, limited partnerships, exchange traded funds (ETFs), corporate form funds, trusts, structured products, offshore special purpose vehicle (SPV) issued securities, “fund of one” Segregated (Separate) Managed Account and more.

The compliance analysis is a two-track process for fundraising cross-border – meaning that a business needs to investigate and comply with:

1. Each country’s marketing regulations

In order to know which regulatory regime applies for the marketing of your investment product in each country, you need to confirm how your product is classified by the regulator in each jurisdiction.

2. Each country’s licensing regulations

Is your investment product characterised by the local NCA as an Alternative Investment Fund (AIF)? An Undertaking for Collective Investment in Securities (UCITS Fund)? A security? Or any other local nomenclature (mutual fund, collective investment scheme, etc.)? NCAs also consider the types of clients you intend to target in their jurisdiction.

What do regulators expect from us while fundraising in their jurisdiction?

1: There are country-specific rules governing your marketing activities.

Marketing investment products cross-border into overseas jurisdictions constitutes a regulated activity. This means that marketers and financial service providers must comply with the local jurisdiction's rules on the promotion of the investment products, including solicitation to exempt categories of investors (non-retail clients) and licensing requirements.

2: Investment product characterisation: Confirm under which regulatory regime you are offering your product in our jurisdiction.

This analysis is critical and often confused by AIFMs/asset managers' preconceived notions of how the product is classified in their home jurisdiction. Over the years we have observed the trend by regulators to use a "substance-based analysis" to characterise investment products for offer in their jurisdiction ("substance over form").

Investment product characterisation from the local regulator's perspective is all about substance.

By way of example, you may think your offshore SPV issued security (note) is characterised as a "security" offering subject to securities offering laws. But the local NCA may "look through" to the substance of its investment characteristics and confirm that the product is characterised as a collective investment vehicle (fund) subject to that country's fund marketing regulations.

Investment product characterisation: Isn't there a standardised "one-size fits all" category across all countries?

No. Let's look at the Alternative Investment Fund Directive (AIFMD) by way of example.

Under AIFMD, ESMA defines an alternative investment fund or "AIF" as: "any collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not require authorisation pursuant to the UCITS Directive."

AIFMD was implemented in the EU as a European directive; however, each EU country was required to adopt AIFMD and additionally could "top up" the directive with "gold plating provisions," or other requirements specific to their country.

In relation to each country's conclusions on whether a fund is characterised as an "AIF" under their local rules (or not), there have been attempts to harmonise the AIF definition across the EU; however, the AIF definition may vary from one country to the next, depending on how AIFMD has been implemented locally and the NCA's guidance on the AIF definition in their jurisdiction.

This means that it is possible for an investment product to be classified as an AIF in one country – and at the same time fall outside the AIF definition in another country.

Can we assume that our product's characterisation in our home jurisdiction is valid in foreign countries?

Not necessarily.

This is a classic example of "Thinking locally while acting globally."

To demonstrate this concept, here is a recent example of comments we heard from a US investment manager: "My long only equity fund (no derivatives, no leverage) is (characterised as) a "private fund" in the US and is marketed to "Accredited Investors" including family offices under private placement exemptions available in the US for private funds. Naturally, my fund will be characterised as an "AIF" when we fundraise in region EU and it will be acceptable for us to market our fund to HNW individuals and family offices in the EU and in all other jurisdictions outside the US under available exemptions everywhere (applying US regulatory treatment on an extraterritorial basis)."

To which we replied: “Please consult your fund’s legal counsel that’s preparing your fund offering documentation and have counsel confirm characterisation of your fund in all countries in which it is marketed outside the US so that you can know which regulatory regime applies per country for the marketing of your fund. You cannot assume equal regulatory treatment in the US and outside the US.”

Fund manager reaction: (baffled and confused look, completely flummoxed).

This “wearing your local hat while acting globally” is always fraught with potential distribution risk.

Investment product characterisation is a country-by-country check

What you think about your product description in your home country should be confirmed by your legal counsel before you start fundraising overseas.

More importantly, your counsel who is preparing the product’s offering documentation should confirm the characterisation of your investment vehicle and the regulatory regime that will be used in every country in which the product is marketed.

So it is a country-by-country check and “product clearance” process, which must be reflected in your product’s offering documentation.

What happens if the product is offered in a jurisdiction using the wrong regulatory regime?

This could be a potential breach of the country’s marketing regulations.

If you breach laws in foreign countries for the marketing of your investment product under the wrong regime, you could be subject to the five key distribution risks: sanctions by the regulator, lawsuits from investors, rescission rights claims from investors, potential loss of your business franchise, and damage to your reputation.

Why would you want to trigger any of these distribution risks?

Are regulators serious about enforcing their country’s marketing regulations?

Many regulators mean business when you breach their country’s regulatory regimes: A bellwether indicator of how serious the NCA is about sanctions enforcement is to investigate what sanctions are on the books for breaches of their country’s marketing regulations and/or the level of fines a regulator will impose for “bad actor” activity. It is also helpful to review actual sanctions enforcement activity in practice to gauge how serious the regulator is on enforcement. Since you are conducting a regulated activity in each jurisdiction, you have to prove at any time that you comply with each country’s rules on promotion of investment vehicles.

Summary

Regulators expect you to comply with their regulations on marketing your investment product in their country. Compliance with the marketing regulations means that you need to know what regulations apply and how the local regulator characterises your product (and its structure) under their local rules.

Product characterisation is key to your overseas fundraising campaign. If you don’t know how your product is described in local jurisdictions, how can you know what regulations apply to your product offering? Further, how can you comply with unknown regulations?

Ask your lawyers to complete the characterisation work, then you will be clear on the rules to follow.