

Raising European capital: do the benefits of a marketing passport outweigh the cost?

While an average distribution process may last six to 18 months, for sponsors who elect to complete European distribution using a marketing passport, the costs of compliance with the Alternative Investment Fund Managers Directive (“AIFMD”) over the ten plus two year lifecycle of their fund could add €3,000,000 or more in administrative costs. There’s clearly a place for a marketing passport but for non-EU sponsors looking to market non-EU funds, this should not be considered the default option.

In this article we will take a look at how non-EU funds can be effectively distributed in Europe, the impact of this from a legal/regulatory perspective and the cost differences between electing to use a passported Luxembourg based fund solution and marketing a non-EU fund under Article 42 of AIFMD.

Introduction

Following the introduction of AIFMD a decade ago, fund distribution in Europe has become increasingly complex for non-EU sponsors. The solution that’s routinely presented to deal with this is to appoint a third-party Alternative Investment Fund Manager (“AIFM”) to unlock a pan-European marketing passport. Over the past five years we have seen this approach increasingly adopted and, following the introduction of the Cross Border Distribution Rules¹ in August 2021 (the “CBD Rules”), we are now also seeing this approach being presented as a solution for pre-marketing as well. All roads seemingly lead to Luxembourg if you want to capture European capital.

One question that seems to receive little in the way of public debate however is whether the perceived distribution advantages of the marketing passport are really worth the cost and inconvenience of establishing a Luxembourg structure and engaging with a third party AIFM.

This article follows on from our Fund Structuring 101 article ([here](#)) and in it, we will explore some of the key issues arising in connection with this debate and provide some key takeaways for non-EU sponsors thinking about whether to opt for a passported structure or not².

Key takeaways

1. While a passported Luxembourg structure can be the right choice where significant southern

European distribution is anticipated or where (cornerstone) investor requirements mean that a Luxembourg structure is needed, it is a very costly and administratively complicated option with no unique upside following completion of the distribution phase.

2. Establishing a passported Luxembourg structure could easily add an additional €3,000,000 of administrative costs (including AIFM, depositary, AIFMD compliance and administration fees) over the lifetime of a fund, which will impact fund and carried interest returns.
3. While a pan-European marketing passport may seem like a good idea, only a small number of EU funds are registered for sale in more than a handful of Member States and the total equivalent cost of registering a non-EU fund in those Member States is likely to be €50,000 or less.
4. Distribution pathways for non-EU funds via Article 42 notifications/registrations are tried and tested and work well. Institutional investors based in jurisdictions in which non-EU distribution is challenging are sophisticated and apply a practical approach to reverse solicitation where this is necessary.
5. Sponsors should not be put off from notifying/registering under Article 42 by the low level AIFMD reporting obligations or the more stringent Sustainable Finance Disclosure Regulation (“SFDR”) requirements that become applicable as a result of this. All of this

reporting can be handled by a competent service provider. For example, Corvus Group's suite of services includes ESG data collection and reporting.

The argument for Luxembourg

While the focus of this article is really on explaining why Luxembourg is costly and not strictly necessary from a distribution perspective, it is worth highlighting that a Luxembourg structure, complete with a third party AIFM, can be the right option for certain non-EU sponsors.

In general, Luxembourg is worth the cost where one or more of the following distribution linked circumstances exist:

1. **Geographic outreach:** where a sponsor is looking at completing significant European outreach (in particular in southern Europe), the case for a passported EU fund structure is strong. Many southern European Member States have no specified pathways for distributing funds without a passport so, where the focus of the capital raising process is in these jurisdictions, it really is necessary to have a passported product.
2. **Cornerstone investors:** where cornerstone investors demand a passported EU product it will be hard for most sponsors to push back. Notwithstanding this though and depending on how the wider distribution process is being structured, it is worth understanding an investor's reasoning in these circumstances. If the investor's preference is driven by regulatory capital requirements or investment restrictions, clearly there will be less room for debate. If their position is purely about the perceived optical benefits of using a Luxembourg fund structure and/or a high-level familiarity with Luxembourg however, it may be possible to discuss the cost and administrative implications of a Luxembourg fund with the investor to determine whether or not their position is inflexible.

Other non-distribution linked factors may of course be relevant to jurisdictional choice (portfolio focus/associated tax considerations and/or sector focus for example) but an in-depth

discussion of these points is beyond the scope of this article.

Where a sponsor chooses to establish their fund in Luxembourg and engage a third party AIFM, the key advantage is the relative simplicity of the distribution process. Both pre-marketing and marketing activities are notified to the Luxembourg Regulator (the CSSF) and once this is complete, pre-marketing and/or marketing can commence in all Member States included in the notification.

The main disadvantage with this approach is that any sponsor that goes down this route will need to comply (through the appointed AIFM and managed fund) with the full provisions of AIFMD for the full duration of the fund's existence. This is a significant administrative undertaking and generates a substantial additional cost. We discuss this further in detail below.

The other option: distribution of a non-EU fund

Where a fund does not benefit from a passport, distribution is dealt with on a Member State by Member State basis. When considering distribution of non-EU funds, there are three layers to consider:

Pre-marketing

Prior to August 2021, pre-marketing was considered to cover any activities entered into in connection the offering of fund interests which fell short of the specified marketing definition in AIFMD. As a result of the way that marketing is defined, this meant that the majority of the distribution process for closed ended funds was unregulated (from a sponsor perspective) and the pre-marketing phase didn't require significant thought beyond ensuring that marketing (as defined in AIFMD) wasn't completed in any jurisdictions in which marketing notifications or registrations for non-EU funds were unavailable.

Following the implementation of the CBD Rules, pre-marketing has become a little more complex. In response to the CBD Rules certain Member States (see below) now require that a notification of pre-marketing activities be submitted in

advance of commencement, whilst other Member States no longer allow non-EU funds to be pre-marketed (i.e. only full marketing and reverse solicitation are recognised). The definition of pre-marketing is very wide and broadly speaking covers the communication of any fund specific information to prospective investors, meaning that a wide range of investor communications will now be treated as evidence of pre-marketing. The practical outcome of all of this is that pre-marketing shouldn't be commenced in a Member State unless a subsequent marketing notification/registration will be made.

Pre-marketing is available in Finland, Germany, Luxembourg and the Netherlands following notification to the relevant regulator and in Ireland and Sweden without notification. Pre-marketing notifications become irrelevant once a marketing notification/registration has been filed and/or where a sponsor is able to substantiate a valid reverse solicitation.

Marketing

Whether pre-marketing is notifiable or not, any marketing activities will require notification or registration in certain Member States under Article 42 of AIFMD. Once notification or registration is complete, a non-EU fund can be marketed in the relevant Member State in the same way a passported EU fund can.

Marketing notification is available in the Netherlands and Luxembourg while registration is available in Denmark, Finland, Germany, Ireland, Norway and Sweden.

Reverse solicitation

Where specified marketing pathways aren't available for non-EU funds in certain Member States (for example in France, Italy and Spain), reverse solicitation remains available for sponsors of non-EU funds provided this is factually supported. As a practical matter, most placement agents will be able to help sponsors structure the collection of reverse solicits in these jurisdictions and in France, for example, marketing to certain investors (primarily fund of funds) is permitted in any event.

A summary of the pre-marketing and marketing notification/registration regime is detailed in Table 1 together with indicative registration costs.

So what are the downsides to registering a non-EU fund for marketing?

Other than some relatively modest up front and ongoing costs associated with notification/registration (see Table 1), the main drawback to notifying or registering for marketing in any Member State is that it will trigger the application of a number of limited AIFMD compliance requirements and more relevantly, the application of the EU ESG regime (under SFDR). In addition, where a non-EU fund is registered for marketing in Denmark or Germany, the fund will be required to appoint a depository.

The limited AIFMD compliance requirements include:

1. PPM Investment disclosures;
2. regulatory (Annex IV) reporting (generally covering portfolio composition);
3. annual financial reporting; and
4. portfolio event driven reporting.

For UK based sponsors distributing interests in UK based funds that are above the AIFMD registration threshold (being €500m for closed ended unleveraged funds and €100m for other funds), these requirements are likely to be applicable in any event due to the fact that post Brexit, AIFMD was retained as UK law³, but they will represent additional requirements for other non-EU sponsors (albeit a lighter set of requirements than would apply to a passported product).

The imposition of SFDR is an important consideration for any non-EU sponsor (including UK sponsors) and needs to be carefully considered in the context of making any marketing notification or registration under AIFMD. As a general rule, while SFDR compliance is a significant undertaking, from a distribution perspective, European investors are increasingly expecting sponsors to meet EU requirements in

this space; with 'Article 8' (light green) funds rapidly becoming the norm.

A full examination of SFDR is beyond the scope of this article but see [here](#) for a summary of this legislation.

Table 1: Summary of pre-marketing and marketing rules and associated costs

Jurisdiction	Pre-marketing Process	Marketing Process	Application Costs ¹
Belgium	Not available	Register	Nothing
Denmark	Not available	Register	<i>De minimis</i>
Finland	Notify	Register	<€3,000
France	Not available	Not available	Nothing
Germany	Notify	Register	<€2,000
Ireland	Available without notification	Register	Nothing
Italy	Not available	Not available	N/A
Luxembourg	Notify	Notify	<€3,000
Netherlands	Notify	Notify	Nothing
Norway	Not available	Register	<€4,000
Spain	Not available	Not available	N/A
Sweden	Available without notification	Register	<€2,000
Switzerland ²	N/A	N/A	Nothing
United Kingdom ³	N/A	Notify	<i>De minimis</i>

1 Approximate regulatory fee listed. Legal costs will be in addition and are generally in the region of €3,000 – €5,000 per jurisdiction. Some jurisdictions charge an annual registration fee (generally <€500; Luxembourg is around €3,000).

2 Switzerland is outside of the EU so is not subject to the pre-marketing and marketing rules detailed in this article. It is included for completeness due to the attractive nature of Switzerland as an investor centre – pre-marketing and marketing is permitted through compliance with the Swiss rules.

3 The United Kingdom is outside of the EU so is not subject to the pre-marketing rules detailed in this article. Pre-marketing is effectively unregulated subject to compliance with the UK financial promotions rules. The United Kingdom has a simple notification process in connection with the marketing of non-UK funds.

Member State by Member State distribution sounds complex, why wouldn't I just set up a passportable product?

While there is undoubtedly some complexity to non-passportable fund distribution, this is all surmountable and is entirely eclipsed by the long-term cost and complexity of establishing a fund in Luxembourg and dealing with full AIFMD compliance for the lifetime of the fund:

1. **Costs:** overall, the use of a Luxembourg structure with third party AIFM could easily increase administrative costs over the lifetime of a fund by €2,000,000 to €3,000,000:

(a) **AIFM:** AIFM fees will generally include a take on fee coupled with ongoing fees which will typically include a fixed minimum fee and an AuM-linked amount. An AIFM could easily cost €100,000 to €200,000 p.a. over the lifetime of a fund resulting in €1,000,000 to €2,000,000 of additional cost.

(b) **Depositary:** where a fund is passportable, the appointment of a depositary is mandatory. Depositary fees can be charged on an AuM-linked basis or by reference to administrative costs (typically when provided by an administrator). Depositary fees of between €30,000 to €50,000 p.a. could be expected for most funds, resulting in €300,000 to €500,000 of additional cost over the lifetime of a fund.

(c) **Administration:** as a general rule, Luxembourg is a more administratively complex jurisdiction than many non-EU jurisdictions (including the UK, US and Channel Islands) so the basic cost of administration is typically higher. Administration costs could easily be €30,000 to €50,000 p.a. more expensive in Luxembourg when compared to the UK, US or Channel Islands adding €300,000 to €500,000 of additional cost over the lifetime of a fund.

(d) **Other:** legal fees on establishment and ongoing legal and accounting fees are generally greater for Luxembourg structures than their non-Luxembourg equivalents. Travel costs also need to be factored in to the extent that sponsor-side individuals need to travel to the jurisdiction for meetings and it's worth remembering that some Member States charge both initial and ongoing fees in connection with marketing registrations under a passport.

(e) **Holding structures and substance costs:** additional costs can be incurred to the extent that Luxembourg holding structures are required and the ever increasing cost of evidencing sufficient 'substance' and 'commercial purpose' in order to secure tax treaty benefits must be factored in.

2. **Full AIFMD compliance:** while using a third party AIFM effectively transfers the heavy lifting of full AIFMD compliance to the third party AIFM, the requirements are still applicable to the operation of any fund that the AIFM manages and covers matters such as risk and compliance, internal audit, governance arrangements, valuation rules, reporting requirements, delegation and outsourcing rules, remuneration rules, asset stripping restrictions and loan origination rules. A sponsor team member will need to take point on the AIFM relationship and a decision will need to be made as to whether portfolio management is retained by the AIFM or delegated to the sponsor. Either way, it will be necessary to spend time with the AIFM to determine how this works in practice and how a sponsor's investment and other internal processes may need to be adapted. It's questionable whether, for a well regulated and run sponsor, the additional cost and operational burden of AIFMD compliance adds any value to the way in which the sponsor runs its business or to any associated funds or their investors.

The cost/benefit analysis

When looked at in the round therefore, the key question from a distribution perspective is whether it's really worth spending upwards of an

additional €3,000,000 in order to secure European capital through the use of a marketing passport.

As mentioned at the beginning of this article, where widespread southern European investor outreach is anticipated, a Luxembourg structure and third party AIFM can definitely make sense, but it's hard to look past the fact that it has previously been reported that only 3% of EU funds are registered for sale in more than three Member States⁴. As such, while it is appealing in theory to have unfettered ability to market a fund across Europe, the reality is that distribution is usually far more targeted at a handful of jurisdictions.

Given that Article 42 marketing registrations/notifications could likely be filed in three Member States for €50,000 or less in aggregate, sponsors should think long and hard about the distribution benefits of the marketing passport before committing to getting one.

'Only 3% of EU funds are registered for sale in more than three Member States'

While the cost of obtaining a marketing passport and the associated AIFMD compliance costs are likely to be borne principally by investors, passing this cost onto investors will negatively impact fund performance and will in turn decrease a sponsor's performance-linked returns. The costs will of course be even more keenly felt by investors in a Luxembourg parallel fund if investors in other fund 'sleeves' refuse to absorb any of the Luxembourg-linked costs.

What should I do?

The purpose of this article is to stimulate debate on this topic and to challenge the *status quo*.

Over the past five plus years, Luxembourg has become the default choice for sponsors looking to raise European capital. While this is a triumph for European policy making, funnelling business and economic growth into the EU, deciding to domicile a fund in Luxembourg isn't always the right choice for sponsors whose substantive advisory business

is based elsewhere or (in the long run) for their investors.

While there are undeniable benefits to establishing and using a Luxembourg structure with a third party AIFM, this comes at significant cost in terms of time and financial resources. Where sponsors are looking to maximise investor returns (and by extension carried interest) and avoid unnecessary regulatory and operational red tape, a more cost-effective and operationally efficient structural solution needs to be explored.

For UK based sponsors, the UK surely needs to be the first choice for fund domicile. While the core provisions of AIFMD were retained as UK law following Brexit, meaning that where a UK sponsor domiciles its fund in the UK the substantive provisions of AIFMD will still apply as a matter of UK law, where a UK based sponsor wishes to step outside of the full impact of AIFMD, this can be achieved by using a Channel Islands based structure established using the classic advisory model. Both UK and Channel Islands' structures can be distributed to European investors under Article 42 of AIFMD for a fraction of the cost of a marketing passport.

Similarly for US sponsors there really is no need to establish a parallel Luxembourg vehicle if European capital is needed. A Delaware fund can be distributed under Article 42 of AIFMD in the same way that a UK fund can, with the corresponding cost saving. There is also the added administrative bonus that fund vehicles will not need to be managed from Luxembourg, resolving the practical issue of dealing with six plus hour time differences.

What a given sponsor should do when it comes to distribution and jurisdictional choice will of course vary, but sponsors should give this question the full consideration that it deserves, be robust (to the extent possible) in challenging investor preferences for Luxembourg-based structures and push for the most cost effective administrative outcome to protect both investor and sponsor returns. In short, a marketing passport isn't always the answer.

If you are looking at fundraising and/or structuring and would like to discuss any of the

points raised in this article in more detail, please feel free to contact us using the details below.

References

1. Directive (EU) 2019/1160 with regard to the cross-border distribution of collective investment undertakings and Regulation (EU) 2019/1156 on facilitation cross-border distribution of collective investment undertakings.
 2. For the purposes of clarity, we have assumed that where a non-EU fund is being marketed in the EU, the AIFM will also be non-EU and that the reverse is true for EU funds which we have assumed will benefit from a marketing passport.
 3. The Alternative Investment Fund Managers Regulations 2013 (as amended; SI 2013/1773).
 4. <https://www.jerseyfunds.org/the-case-for-nppr>
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