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Reverse Enquiry in the EEA

Beware of the pitfalls

Reverse enquiry has received a great deal of interest since the implementation in Europe of the Alternative Investment Fund Managers Directive (**AIFMD**) in 2014. Reverse enquiry (also known as passive marketing or reverse solicitation) is where an investor, who has not had any previous contact with an investment manager/distributor, contacts that investment manager/distributor in respect of a potential investment in a fund. At first glance, reverse enquiry appears appealing as it allows parties to raise funds without falling within the onerous scope of the AIFMD, but the reality is more complex.

What we have noticed is a major risk of market participants seeing reverse enquiry as a panacea for avoiding the more tricky aspects of the AIFMD and failing to consider the range of problems and pitfalls that can apply when using reverse enquiry as a capital-raising tool.

In this article we hope to explain a little more about those pitfalls and offer some thoughts on best practice and risk management.



AIFMD background

- AIFMD has introduced a marketing passport for alternative investment managers (AIFMs) to access European investors in relation to AIFs (essentially most funds that are not UCITS).
- The AIFMD marketing passport is applicable to professional investors only and is subject to staggered implementation across the EEA.
- The passport is currently only applicable to EEA AIFs with EEA AIFMs. ESMA is still considering whether to extend the passporting regime to countries outside the EEA. It appears that it will indeed be extended at some stage although at a slower and more limited pace than was envisaged in the original legislation.
- Where a marketing passport is not available, it may be possible to actively market to investors via a jurisdiction's private placement regime (PPR).
- When an EEA AIFM is marketing an EEA AIF via the marketing passport, compliance with the entire AIFMD is required.
- When marketing an AIF via the PPRs, compliance with certain provisions only of the AIFMD is required. The PPRs vary considerably from country to country. Jurisdictions may impose additional requirements on entities seeking to access investors in an EEA jurisdiction beyond those set out in the AIFMD.
- The AIFMD defines "marketing" as "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" (emphasis added).
- It may be possible to undertake "pre-marketing" (active marketing that falls outside the AIFMD definition of marketing) if it is recognised by a jurisdiction. Not all jurisdictions recognise this concept.
- Recital 70 of the AIFMD states that the directive is not intended to affect professional investors who are investing in funds "on [their] own initiative".
- MiFID II provides some further guidance on what European regulators view as "own initiative". In particular, it outlines that:
 - where a non EEA firm solicits clients or potential clients in the European Union or promotes or advertises its investment services, its services should not be deemed as being provided at the exclusive initiative of the client; and
 - a non EEA firm may not rely on the "own initiative" exemption to market new categories of investment product or service to the client.

Pitfall 1 - High regulatory scrutiny

Contrary to what may people believe, reverse enquiry is not an official exemption from the AIFMD marketing provisions. It is more of a tolerated practice. In fact, the first draft of the AIFMD proposed a prohibition on reverse enquiry although this was ultimately removed from the AIFMD on the basis that regulators recognised that professional investors, such as large pension funds, need the ability to invest in a wide range of investments. Market participants have shown far greater focus on reverse enquiry as a method of reaching European investors than had originally been expected. As a result, regulatory scrutiny of reverse enquiry is high. Managers and distributors will need compliance procedures in place to ensure that records are kept proving that any such investment was made as a result of a reverse enquiry. We will suggest some best practice guidelines below.

Pitfall 2 - Varying implementation across the EEA

The AIFMD provides no further guidance as to when it deems an investor to be "acting on their own initiative" and each member state is left to clarify how reverse enquiries will be treated in their jurisdiction. This makes the practical application of the use of reverse enquiry complex and varied across the EEA especially as little practical guidance has been given by regulators to date. Some jurisdictions have applied very stringent conditions to be met if using the reverse enquiry route. For example, in certain jurisdictions, the conduct of any active marketing activities will preclude an entity from later relying on the reverse enquiry route.

Pitfall 3 - The reality of fund raising

The classic example of reverse enquiry is where an investor, who has had no previous contact with the manager, approaches the manager or distributor about investing in a fund. In reality this scenario does not reflect the way that managers often raise funds in practice. Many managers will have links with investors who are either invested in other funds or who have a long-term relationship with the manager. However, approaching these existing investors about a new proposition will unlikely fall within the ambit of permitted reverse enquiry. In addition, proving that the investor acted on their own initiative will be easier for a large fund manager whose brand is well-known but harder for smaller managers.

Pitfall 4 - Which funds can be "marketed"?

A similar concept of "exclusive own initiative" is used in respect of reverse enquiries under MIFID II. This has been interpreted to indicate that a firm should restrict itself to providing only the services which the investor approached them about. So where an investor contacts a fund manager about Fund A, but the fund manager then wants to pitch Fund B, this may very well no longer constitute a reverse enquiry under the AIFMD. In certain jurisdictions it may also not be possible for a manager to approach an existing investor who invested on the basis of a reverse enquiry about topping-up their investment in a fund.

Pitfall 5 - Use of third parties

The definition of “marketing” under the AIFMD includes marketing on behalf of the AIFM. This means that external consultants/distributors/data providers could unknowingly exclude the manager from being able to receive reverse enquiries from investors by conducting active marketing activities in that jurisdiction.

Pitfall 6 - Open access websites

Open websites with free access to information about a fund or application forms and offering documents may prejudice reliance on reverse enquiry. Design of websites needs to carefully consider the rules in each jurisdiction where funds are to be offered.

Pitfall 7 - Capital introduction

Capital introductions throw up specific issues. There is a concern that a regulator may make an argument that a manager using capital introduction services is actively marketing which would mean that any enquiries made as a result of capital introduction cannot then be treated as made by way of reverse enquiry. The position varies across the EEA.

Pitfall 8 - What about all the other EEA and local laws!

Any investment that is made by a permitted reverse enquiry may mean that a manager is outside of the AIFMD. But that manager will still need to consider applicable requirements under MIFID and the Prospectus Directive plus additional local requirements which may be complex and onerous.

Pitfall 9 - The impact of getting it wrong

The risks of getting it wrong can be severe. As well as possible criminal and regulatory sanctions (depending on the jurisdiction), there is the risk that investors might try, at a later date, to rescind their investments on the basis that they were sold them in breach of law/regulation. They may be entitled to recover any money invested as well as seeking compensation for any loss sustained by the investment.

Guidelines

Below we have set out some thoughts on best practice guidelines for use of reverse enquiry.

- Investigate - seek a thorough understanding of the law and practice in each jurisdiction where you seek to attract investors is required prior to marketing. Don't assume the rules are the same across Europe.
- Proof - check what evidence will be required in each jurisdiction to rely on reverse enquiry.
- Audit trail/document retention - retain all emails, letters or other evidence from an EEA investor to indicate the marketing relationship was a result of reverse enquiry.
- Confirmation form - consider having investors sign a form confirming that the investment was made following a genuine reverse enquiry. However note that there could be a risk in some countries that the existence of identical signed

acknowledgements of reverse solicitation from multiple clients may indicate a "strategy" of reverse solicitation. Use of standard forms should not be a substitute for retaining records which prove the actual initial contact came from the potential investor (together with details of their contents.)

- Timing - consider how long a reverse enquiry can last in each jurisdiction and "refresh" existing requests.
- Monitor content of investor communications and calls - don't mention other fund products or invite investors to increase their existing investments in those jurisdictions where each separate transaction requires a separate reverse enquiry.
- Use of third parties - exercise caution when using external consultants/distributors/data providers.

Conclusion

For larger asset managers who want to achieve or maintain a significant European presence, "marketing" by way of reverse enquiry is probably not the best option as reverse enquiry is risky and such managers typically have the resources to consider ensuring compliance with the AIFMD. For those fund managers who want the flexibility to accept European investors but don't

necessarily have the resources for full AIFMD compliance, the reverse enquiry route may be an option, but each reverse enquiry should be a genuinely unsolicited contact and comply with any jurisdictional specific requirements. In short, reverse enquiry should not be seen as a quick fix to avoid the application of the AIFMD and those using it should take care to proceed with caution.



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