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Key Considerations When Launching a Fund on a Third-Party UCITS or AIFMD Compliant Platform

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The use of established third-party platforms has become increasingly popular for asset managers launching new UCITS or AIFMD compliant funds in recent years. The indicators are that this trend is likely to be even more pronounced among asset managers launching new products in Ireland for the first time due to the increased requirements relating to substance for management companies in that jurisdiction subsequent to both the Central Bank's CP86 reforms and the ESMA guidance issued to national supervisory authorities in light of Brexit. It is also likely that we will see a migration of existing self-managed structures across to separately managed third party platforms as a result of the increase in substance being required. This article provides an overview of some of the key considerations when negotiating the on-boarding of an asset manager onto an existing third-party platform in either the UCITS or AIFMD environment

General EU Regulation of Short Selling

Overview

Third-party platforms are generally umbrella fund structures established by investment managers or promoters, including distributors, which allow other previously unaffiliated (sub-)investment managers to essentially "plug and play" by joining the platform with their own separately managed sub-fund. The sector has grown significantly in recent years as the cost and complications involved in a new launch have expanded, and as asset managers have sought to access new markets for distribution through the use of more complex on-shore regulated products rather than the traditional offshore routes previously favoured. More recently the increase in substance required of management companies has put the traditional self managed model prevalent for UCITS to date under pressure and increased the attractiveness of using a third party management company.

The "on-boarding" process for a platform typically takes the form of the entry into a sub-investment management agreement with the platform promoter (the entity responsible for establishing the umbrella fund in the first instance), which acts as lead investment manager. However, direct appointment of the new asset manager by a management company or corporate fund may also occur. This later route is more likely in the post CP86 environment, where third party management companies are likely to be increasingly prevalent

Pros and Cons

Platforms naturally promote the benefits of their shared cost structures, established networks and potential to increase distribution through their capital introduction capabilities, but there is a range of both advantages and disadvantages to joining a platform rather than establishing a new stand-alone fund.

Advantages

- *Cost savings* — this is generally promoted as one of the main advantages of the platform route, because certain fixed overheads and costs (such as directors' fees) are spread across the entire platform. A platform should also be able to take advantage of economies of scale or economic efficiencies to obtain lower fee rates from service providers.
- *Access to capital base and substance*— management companies in Ireland are obliged to prove a minimum capital base and a level of substance reflecting their nature, size and complexity in order to be approved to act by the Central Bank of Ireland (the "Central Bank"). The level of substance expected has risen dramatically over the past year in particular and smaller asset

managers in particular may find a third party management company and platform an attractive solution to meet these requirements.

- *Speed to market* — the launch of a single new sub-fund on an established structure is a much smaller project than the establishment of a new umbrella from scratch. This should therefore be quicker and more efficient to manage and complete.
- *Distribution* — an established distribution network and the potential for introductions to new sources of capital are also key attractions promoted by platforms. The platform itself may be an established brand. Furthermore, market participants may look favourably on the fact that the third-party manager will typically undergo extensive due diligence as part of the on-boarding process.
- *Know-how* — other benefits of platforms that asset managers value include obtaining access to the platform managers' general know-how regarding the launch process and product specifics as well as local market knowledge. This is especially valued by those using platforms in order to enter a specific regulatory space for the first time — such as alternative fund managers launching their first UCITS.
- *Responsibility for compliance and corporate governance* — on a longer-term basis the manner in which platforms can potentially take primary responsibility for a significant portion of the on-going compliance, regulatory and corporate governance requirements inherent in the post launch operations of UCITS and AIFMD compliant funds can be a key attraction. This essentially frees the manager to focus on actual portfolio management. Following the UCITS III regulatory revisions, it has become necessary for UCITS (or the entities acting as managers thereof, if not self-managed) to create a fairly elaborate corporate governance infrastructure, which includes the preparation of a "business plan" detailing how a range of key managerial functions will be addressed. The platform sponsor will initially need to show how responsibility for these activities will be satisfied in order to obtain authorisation for the UCITS, and sub-investment managers can join the platform at a later date under the auspices of this oversight and governance. Pursuant to the AIFMD alternative investment fund managers (AIFMs) are now subject to significant compliance obligations similar in many ways to those applicable to UCITS management companies and self-managed funds. This includes the requirement to prepare an operations plan or "programme of activity", illustrating how separately identified managerial functions are addressed, much as UCITS must prepare a "business plan". There is a need for substance in this regard in terms of named personnel (although not necessarily full-time employees of a fund) with responsibility to carry out this work and the level of such substance has been steadily increasing of late. In the context of the AIFMD, the role of the AIFM is deemed to comprise both risk and portfolio management. A third-party platform will typically include the appointment of an authorised EU-domiciled AIFM whose services will include risk management.

This will allow portfolio management to be delegated to sub-investment managers appointed to specific sub-funds on that platform. Subject to the precise terms of their appointment, such sub-investment managers will generally be substantially relieved of compliance obligations outside of their portfolio management duties (primary responsibility for compliance with investment restrictions and related obligations would remain with the portfolio manager in the first instance, however). Given that the AlFMs of such platforms will be EU entities, and the platform themselves constituted as an

EU-domiciled alternative investment funds (AIFs), therefore sub-funds on the platform will be able take advantage of the passport available under the AIFMD, regardless of where the underlying portfolio manager is located, including in non-EU third countries such as the United States. The level of substance required to achieve these authorisations in Europe is increasing.

- Increasingly third party management entities will typically be authorized as "super mancos", possibly with additional portfolio management authorisations. This will allow them to use a single substantive European entity with adequate substance to act as a management company to both UCITS and AIFs, adding to potential economies of scale.

Disadvantages

- *Cost* — in some circumstances, the costs inherent in use of a platform may be a deterrent to their use. With fees calculated on an AUM basis, the platform model is often prohibitively expensive for larger funds when compared to the costs that would be incurred on a stand-alone basis. Therefore, performing cost analysis based on a number of permutations regarding expected size and the life of the fund is highly advisable. Even for smaller managers, keen pricing or even fee holidays from service providers eager to maintain relationships or seeking to expand, as well as a highly competitive landscape in the area in general, mean that asset managers may be able to negotiate a lower cost structure by dealing with service providers directly themselves than those applicable on platforms or a similar one with other advantages, especially if there is an on-boarding fee. Costs inherent in the on-boarding process can easily equal those of a new launch.
- *Control* — joining a platform essentially means that a portfolio manager is a service provider well removed from the core of a fund structure and is unlikely to have any representation on the board. Appointment would be subject to termination in accordance with the terms of the sub-investment management (or other) agreement appointing it.
- *Choice of service providers* — setting up a fund on a stand-alone basis ensures that the asset manager is free to choose the other service providers to that fund. The know-how of platform managers comes at a cost over the life of the fund, but should be equally available as part of the service provided by local lawyers and fund consultants.

It is of course also possible to appoint a third party management company without using a fund platform controlled by it. This would involve an asset manager establishing a new fund structure and then it appointing the third party management company, which in turn would appoint services providers, including the investment manager. This would have the advantage of retaining overall control of the relationship, while taking advantage of the know how and substance of the third party management company. However, it may compromise some of the other potential advantages such as speed to market and cost. This article is focusing on the use of third party platforms.

Key Terms

Some of the key terms to be considered in any on-boarding arrangement will now be examined.

Fees and Expenses

The fact that cost is frequently touted as a reason to go onto a platform rather than launch a stand-alone fund emphasises the importance of this factor in determining the appropriate route. However, calculating the all-in cost can be challenging, as a range of charges can apply for different services provided by the platform — potentially leading to significantly higher costs in

practice than the headline charge initially cited. Accordingly, it is useful to model the total expense ratio at different AUMs based on a range of assumptions, as well as seeking to identify hidden costs (for example, a requirement to use service providers affiliated with the platform sponsor, upon terms not necessarily the most favourable available). The basis for the imposition of fees is also key. For example, different fee levels may (and arguably should) apply not only based on the AUM, but also depending on whether subscriptions are obtained from the manager's own contacts or through the platform's distribution channels.

In addition to on-going fees, some platforms seek an initial on-boarding fee or may even require a termination fee. While such costs will naturally be resisted, these can be viewed in much the same manner as subscription and redemption charges for a fund. As such, they may be acceptable in the context of securing key terms that satisfy the manager's longer-term goals. For example, it may be reasonable to provide for a termination fee if the on-boarding manager determines to leave the platform earlier than anticipated, in much the same way that a fund may reserve the ability to waive a lock-up but instead apply a charge for early redemptions. A manager joining a platform may also seek reciprocal terms where it is to be ejected from a platform.

A platform may also have general policies relating to matters such as soft dollar commissions, which may need to be complied with by all sub-investment managers. It is also appropriate to note the extent to which expenses of the sub-investment manager (such as independent legal advice and other third-party professional services), if any, may be charged to the fund it manages. All such expenses would be chargeable to the fund in the case of a stand-alone fund established by a manager at its discretion, so a prohibition in this regard may shift the economic justification of the platform route.

Termination

Although cost is a key consideration, termination provisions are possibly an even more important area for consideration by an asset manager when contemplating the use of a third-party platform. For many asset managers a platform is a medium-term measure undertaken while they initially assess a market or grow their fund to a certain size. Where this is the case, it is essential that the contract reflects their intention to exit the platform at some future time. However, both the investment manager and sub-investment manager are merely service providers to the AIFMD or UCITS product to which they are appointed. Therefore, even if there is no longer-term plan to set up a new stand-alone fund, asset managers need to ensure that the termination provisions in the agreement in relation to the platform minimise the potential for such asset managers to be ejected from the platform against their wishes (whether or not this is followed by being replaced by a rival manager with a similar strategy).

An asset manager leaving a platform to set up a stand-alone fund will be seeking a means to bring existing investors along, to use the track record built up while on the platform, and use the same or a similar name to the existing fund (and prevent the platform from continuing to use the fund's name, once the manager has left). It is worth considering the cleanest way in which a future move to an independent fund will be managed and each of these aims can be addressed by contractual terms when the asset manager is being on-boarded initially to assist in ensuring a smooth transition. One option is for the asset manager to have a specific right to contact existing investors to inform them of a move from the platform, and provide details as to how they can follow. The platform will typically maintain ownership of investors' contact details, but an asset manger could also be permitted to obtain such information (and, if so, this should be addressed in the investors' subscription agreements. Privacy requirements and GDPR obligations should of course be borne in mind).

However, a redemption followed by subscription into a separate fund will generally

be a taxable event and this may have negative consequences for investors. Therefore, if possible, a solution which avoids this may be preferable. One option in the case of a UCITS platform could be the establishment of a new UCITS into which the individual sub-fund would be merged.1

A departing manager would generally also be keen to ensure that the goodwill built up in a sub-fund is retained, to the greatest extent possible. Accordingly, apart from ensuring that the manager retains the (ideally exclusive) right to use the fund name, performance and investor records, it may be helpful to provide that, following the manager's departure, the platform must: close the formerly managed fund, no longer use the fund name, and refrain from citing the manager's performance data. Otherwise, there is a risk that the key value in the structure will be ascribed to the platform's brand, rather than to the underlying asset manager.

A transition may not be as smooth as anticipated, even where a termination is validly undertaken under the terms of the relevant contract. For example, the board of the fund may determine it is appropriate to withhold assets from proposed redemptions and delay a wind up of a sub-fund post-termination to provide for any contingent liabilities.
Accordingly, asset managers would be well advised to work with the platform management to minimise the likelihood of any such action by the structure's board.

Assignment or Change of Control

Further to consideration of termination provisions, asset managers should be mindful of contractual provisions that could be drafted to address other exit strategies. For example, many platform agreements will provide that a change of control constitutes an automatic termination event. In such a case, it may be difficult to realise the value of the business because such a clause may essentially render a sale impossible. Providing for a specific right of assignment may therefore be of interest — as it would facilitate a manager essentially "selling" its position (although investors could, of course, redeem in accordance with the terms of the prospectus in any event).

Duration

Most platform agreements will be open-ended in duration. However, providing for a fixed term, with potential renewal rights, is worth considering, especially if: the asset manager expects to exit the platform and offer a stand-alone fund within a specific time frame; representations have been made regarding distribution and potential capital introductions (which may take time to come to fruition); and the asset manager needs time to build a track record before potentially being replaced. Note that, in the context of Irish funds, the Central Bank will not approve an initial period of longer than three years or subsequent renewal terms of longer than one year in investment management agreements.

Non-Compete Provisions

Platforms may request the inclusion of non-compete provisions, at least within the same product range (*e.g.,* UCITS). These should be resisted by asset managers because it may be useful for them to have the right to launch similar or even identical fund offerings on separate platforms that may have alternative distribution channels, and indeed to establish a stand-alone fund in parallel with the platform. While such provisions may not seem relevant when initially signing up for a platform, they may become desirable once the asset manager is comfortable in the particular regulated environment or has identified its own investor base and is intending on transitioning into a new stand-alone fund. Including a provision guaranteeing a certain capacity to the platform (addressed further below) instead of a non-compete clause may be a satisfactory compromise from the perspectives of both the manager and platform.

Conversely, the asset manager may, in turn, seek a non-compete provision from the platform with regard to rival sub-funds, as discussed further below.

Capacity

Some platforms may require that an asset manager guarantee an ability to service a certain capacity or level of assets. While many managers will be pleased to accept all subscriptions, this can be a useful negotiating point and may be of particular importance where the relevant strategy relates to a tight asset class with limited availability of, or liquidity in, target assets. This may be a reasonable alternative to a non-compete clause or a concession in response to a request to afford a manager exclusivity with regard to a given strategy on the platform. An element of reciprocity may also be appropriate here, with the platform undertaking to obtain a minimum level of subscriptions within a designated period or to meet some other such target — for example, to match the level of subscriptions that the asset manager itself brings into the fund.

Other Sub-Funds

While the presence of a range of asset managers on a platform is part of its attraction from an economic and branding perspective, this may also have negative aspect and ideally, therefore, it is in an asset manager's best interests to have an element of control over the types of funds that may be launched alongside any proposed new sub-fund they are to be appointed to. Some key concerns in this regard might be to limit the ability of asset managers with competing strategies to be taken onto the same platform (especially if such asset managers would enjoy the same distribution channels and these are a key part of the platform's attraction).

However, apart from competition issues, asset managers pursuing ethical or environmental mandates, for example, may find it embarrassing to discover that co-managers on the same platform are pursuing contrary strategies — and this may impact on marketing efforts. Asset managers may also wish to avoid being on a platform with highly leveraged strategies because, notwithstanding that segregated liability between sub-funds is provided for under statutory legislation in jurisdictions such as Ireland, there is a danger of negative publicity if a sub-fund on the same platform goes into insolvent liquidation.

Ultimately asset managers will need to be comfortable with the existing range of sub-funds on a platform, but it is in their best interest to also have rights regarding future additions. At its most extreme, this could take the form of a right of veto regarding the appointment of future asset managers or some mechanism entailing a requirement for a vote in conjunction with other managers on the platform to approve any such additions. However, consultation and notification would be appropriate at a minimum. This aspect may take the form of a contractual provision requiring sufficient advance notice of any new sub-fund or appointment of a new sub-investment manager, so that an existing party could terminate its role if it deemed this necessary.

Board Role

The general level of interaction with the management of the fund structure as a whole should also be borne in mind. At a minimum, a sub-investment manager would need to formally report annually but, given the typical standard of (at least) quarterly board meetings, more frequent interaction is likely to be expected —ideally, this will be addressed in the terms of the appointment. The potential for a representative of a sub-investment manager to obtain a seat on the board of directors of the fund or its management company could be explored in this regard. The main advantage of this from the perspective of a sub-investment manager on-boarding to a platform is to ensure that the sub-manager is kept aware of all new developments of relevance. However, a board position would necessitate additional work, and, in most cases, this is unlikely to be an option because the platform sponsor will not wish to risk the potential for a board majority to be comprised of representatives of sub-investment managers. This is also the case where a third party management company is to be appointed.

Liability Standard

A platform will typically require the inclusion of liability provisions in the agreement appointing the on-boarding manager, and the standard in this regard will normally be negligence, fraud or wilful misconduct. Negligence is a higher standard of care than the "gross negligence" standard to which U.S. managers are accustomed. However, where a platform features a third party management company and/or lead investment manager, such lead entity will generally never agree to a lesser standard of liability for a sub-investment manager than the standard to which the lead manager itself is subject and, in the context of a European fund, this will almost inevitably be "negligence". On the other hand, a platform structured without a lead investment manager or management company (for example, where new managers are appointed directly by the board of the relevant corporate fund) may be willing to agree to a "gross negligence" standard. To the extent that this term is not recognised under local law, it can be included as a defined term by reference to New York or some other law which the asset manager is familiar with (and perhaps subject to).

Role and Discretion — Rights regarding Counterparties

A platform will be established with specified key service providers (e.g., the administrator, custodian or depositary) and it generally will not be possible to vary these at the behest of any sub-investment manager. However, in relation to other service providers (such as brokers and trade counterparties), there may be some flexibility, and it may be appropriate to explore whether these relationships are established at the platform level or whether the sub-investment manager may be able to have the fund enter into arrangements with parties it chooses. In some cases, there may be exclusive arrangements with brokers or counterparties — these may be companies affiliated with the platform sponsor, and the related fee arrangements (which will probably be non-negotiable) may not be the most favourable available on the market.

Apart from the freedom to deal with the counterparties a manager chooses, the extent to which further sub-delegation or outsourcing is possible may also be relevant for some managers. For example, a smaller asset manager may wish to outsource currency hedging or other discrete aspects of the management of his portfolio. Where appropriate, the ability to allocate a portion of the portfolio to a sub-manager should be explored.

Marketing

Platforms often market themselves on the basis of their distribution network and access to investors. It is appropriate to obtain full details in this regard prior to joining the platform, particularly if there will be restrictions on engaging in alternative marketing or if the platform's channels are expected to be the primary or sole distribution route. Primary advantages of both UCITS-compliant, and now AIFMD-compliant, funds are their potential for international distribution under a pan-European passport, so it is appropriate to make sure that this is being used in practice. However, funds are generally sold rather than bought, so ensuring that a fund will be available for distribution in a jurisdiction is merely a first step — details should be provided as to any marketing and sales activity to be undertaken, as well as the right of the sub-investment manager to conduct its own marketing in respect of the sub-fund to which it has been appointed, or to appoint third parties in this regard at its discretion (and the cost / fee implications of this). The rights of the platform to use the manager's name in marketing (as well as vice versa) and any input or prior notice in this regard should be considered.

Conclusion

Third-party fund platforms have proven increasingly popular in recent years due to the cost and complexity involved in new fund launches and this trend seems likely to not only continue but grow due to the increasing requirements relating to substance for management companies and self-managed funds. It is clear that there are instances where a

third party platform will be the most appropriate solution for an asset manager but this will not always be the case. It is essential to undertake a thorough analysis of the benefits and potential disadvantages afforded prior to joining a platform and for new asset managers coming in to the European space to ensure that the contractual terms safeguard their position to the greatest extent possible without compromising their medium and longer term plans, while facilitating cost efficient market access in the short term.

- Footnotes

1 Mergers between UCITS, in whole or at the sub-fund level, are specifically provided for under UCITS IV. Unfortunately, however, the amending UCITS directive did not address the relevant tax implications, so the efficiency of such a transaction would need to be explored, particularly if a cross-border merger is contemplated.

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About the Author

Mark is from Clontarf in Dublin and was educated at Belvedere College S.J., University College Dublin and the Law Society of Ireland.

He trained and qualified as a solicitor in a leading Dublin law firm, where he specialised in the investment funds area and has over fifteen years related experience.

Prior to joining Clerkin Lynch as Head of Asset Management and Funds, Mark was a financial services partner in an international law firm.

His expertise primarily involves advising on the structuring, establishment and operation of investment funds in Ireland, including UCITS and Alternative Investment Funds, for international distribution. He also advises on issues affecting clients throughout the financial sector, including with regard to AML, MiFID, crypto-currencies, emoney and payment systems, data protection (including GDPR), distance selling and internet-based products and investments. His international funds experience covers a number of key global fund centres and he has previously worked in the funds practice of a leading Cayman Islands firm as well as for a global custodian based in Luxembourg. Mark was elected to the Global Board of the Alternative Investment Management Association (AIMA) in 2020.

A frequently published author and speaker with regard to issues relating to the financial services industry he is recommended as a leading investment funds lawyer by The Legal 500 and Chambers & Partners (Europe and Global). Previous editions of Chambers Global noted that "he garners significant praise for launching UCITS funds and ICAVs, as well as handling the relevant regulatory issues with clients describing him as "terrific: he is responsive, almost always available and knowledgeable." And reported that clients stated "the amount of attention he gave us was outstanding," praising his "knowledge of how to get the deal done, and his great end product." He is recognised as a "notable practitioner" by IFLR1000, the guide to the world's leading financial law firms. He was previously named as 'Investment Fund Formation Lawyer of the Year in Ireland' in the CIM Global Awards and Investment Management lawyer of the year in Ireland by the Lawyer International 's Legal 100 awards.

In addition to his Irish legal qualifications, Mark has also been admitted to the roll of solicitors in England and Wales and qualified as an attorney at law in the Cayman Islands. He currently only practices Irish law.

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