BRIEFING

TRAVERS SMITH

Retailisation of alternative investment strategies

Opportunities abound but beware of the pitfalls

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The announcement earlier this year that ordinary savers in the United States would be able to invest in private equity funds through their employer-sponsored retirement accounts represents a significant victory for the alternative investment management industry. Managers of alternative assets (not just private equity but also private credit, infrastructure and real estate) on both sides of the Atlantic have been looking to expand the investor universe for their funds to a retail audience for a number of years.

Equally, traditional capital markets investors have seen the investment opportunities that are available shrink and they want to be able invest across a wider range of strategies, both as a diversifier to their existing portfolio and to access the impressive returns that many of these funds achieve.

There is a convergence here and the alternatives industry has been looking to take advantage. Although access to retail investors is not straightforward, solutions have emerged in this innovative and adaptable industry. Alongside the great opportunity that these options represent, there is also risk for managers. Failure to consider the correct approach can be costly and cause issues further down the line – be it financial or simply wasting time by following an approach that either is unlikely to be successful or is subject to significant risk of regulatory challenge in the future.

This briefing summarises a range of "retailisation" structures that Travers Smith is currently advising on. We are ideally placed to work with you to determine what will work best for your business and we would be delighted to explore any of these options further. We advise a number of leading alternative investment management houses on their internal structuring arrangements and specialise in implementing bespoke structures sitting alongside core fund ranges that are often designed, at least in part, to be available to retail investors.

WHAT ARE THE PROS AND CONS OF RETAIL INVESTOR ACCESS TO PRIVATE CAPITAL STRATEGIES?

Accessing retail capital at all costs is not a viable option. It is vital that a manager plans its approach to accessing retail investors in a manner that is not only successful in raising capital but does not have adverse implications for its business following fund close.

Pros	Cons
Accessing appropriate retail investors will significantly increase the investor universe for alternatives managers. Estimates of the size of the retail investor base are that it is potentially equal to, or may even exceed, existing institutional investor channels.	Large numbers of investors investing smaller amounts than institutional LPs could place significant strain on operational and administrative teams at managers. Increased compliance and anti-financial crime checks, liquidity management and default risk considerations all need to be taken into account but can be mitigated with the correct planning.

WHO ARE RETAIL INVESTORS IN THIS CONTEXT?

Retail investor
A category of investor generally afforded the highest regulatory protections under EU (and, for the time being at least, UK post-Brexit) financial services legislation. (Negatively) defined under "retail client" in the recast Markets in Financial Instruments Directive (MiFID) as someone who is **not** a professional.

Per se professional client	Elective professional	Retail investor
Certain types of entity are by their very nature "professional", including: • entities which are required to be authorised or regulated to operate in the financial markets (e.g. banks, brokers, managers of investment funds and insurers); • large corporates meeting certain size thresholds; • national and regional governments and central banks; and • other institutional investors whose main activity is to invest in financial instruments (and this category can catch certain SPVs).	Certain retail investors may "opt up" and be treated as professional provided that certain conditions are satisfied, thereby waiving the regulatory protections. To be "opted up", the investment manager must follow certain important procedural requirements while the individual must satisfy at least two of the following criteria: • they have carried out transactions, in significant size, on the *relevant market* (generally understood to mean the private fund market), at an average frequency of 10 per quarter over the previous four quarters; • the size of their portfolio, including cash deposits and financial instruments, exceeds EUR 500,000; • they work or have worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.	All 'two-legged' investors start out as retail. Many high net worth individuals and small/medium sized business will remain retail as the elective professional criteria are hard to meet. In some cases this restricts the extent to which certain financial products and services can be offered or provided to them.

For private capital funds looking to raise money from EEA investors, these definitions are key since such funds will typically qualify as "alternative investment funds" under the Alternative Investment Fund Managers Directive. The definitions of "retail investor" and "professional investor" under AIFMD correspond with the MiFID definitions. AIFMD does not contain a harmonised regime for marketing AIFs to retail investors throughout the EEA, and most EU Member State national private placement regimes are only useful when targeting professionals (Germany being an important exception with its concept of "semi-professional"). In the UK, certain exemptions do exist where AIFs are permitted to be marketed to retail investors; however, these are limited in application in so far as they relate to private capital structures.

SHAPING THE INDUSTRY

Travers Smith has recently contributed to engagement with the European Commission and certain EU Member State finance ministries encouraging them to tweak the elective professional test for situations where the test is being applied to a prospective investor in the context of a specific investment. The proposed change to the test would add an additional criterion, allowing the possibility of high net worth retail investors without the transaction history or professional experience required under the current test to be opted up to professional client status, based on the size of their commitment.

It should be noted that retail investors in this context are a distinct group of investors from defined contribution pension scheme investors. The UK Government's patient capital review is focussing on this class of investors and the possibility of attracting the investment of DC pension contributions into illiquid asset classes. The trustee of a DC scheme will typically itself be a professional. The issues associated with DC commitment to private capital are more focussed on transparency of, and limits on, costs and charges. We can provide further information on these issues if they are of interest to you.

WHAT HAVE ALTERNATIVE INVESTMENT MANAGERS DONE TO DATE?

There is a range of different ways to give retail investors access to alternatives strategies that have been seen in the market, and some significant variation between jurisdictions. There is no "correct approach" – it will depend on the risk appetite of the management house, existing compliance structures and the relevant underlying asset class. For managers that wish to gain retail investor access on a fund-by-fund basis, various options exist.

In deciding which option to take, alternatives managers will need to decide between co-mingling retail investors in their main fund (potentially through a retail dedicated pooling vehicle) or establishing additional retail fund vehicles that are complementary to their core strategies. Which option is selected will largely be a decision based on the size of retail investor demand and the required level of liquidity attributable to the investment that retail investors require.

Outside of "fund-by-fund" options for attracting retail investment, several alternative investment management houses have listed their own equity on stock exchanges around the US, UK and Europe, thereby giving investors access to returns in large part determined by the performance of the underlying funds under management.

Examples include Apollo Global Management, Ares Management, Blackstone, Carlyle, ICG and EQT.

1. ADMITTING RETAIL DIRECTLY

In order to admit retail investors directly into its funds, a manager will have to tackle an additional compliance burden that it has historically not had to face. Larger GPs have faced a significant amount of additional regulation over the last decade and this additional burden will not be an insurmountable barrier – they just need to be prepared.

The first issue to be considered is establishing in which countries the retail demand may be and whether it is possible to access that demand. Securities marketing laws are generally not harmonised (even in Europe) and usually (and deliberately) make it difficult for asset managers – especially those offering unregulated products – to access retail investors.

Reverse enquiries (meaning that the investor approaches the manager rather than the other way around) are sometimes possible but different jurisdictions have different approaches and it will likely be a challenge harmonising the various requirements of target countries into a consistent fundraising process.

To the extent a manager does take retail investors into its fund, it will also need to consider the compliance requirements associated with this.

For funds marketed to retail investors in the European Economic Area (EEA) or (currently) the UK, a short, standard form "Key Information Document", or KID, will need to be produced in accordance with the Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs). The KID has been a controversial development principally because it requires simulated performance scenarios that have caused significant concern for the market participants required to produce them. KIDs for private capital have been produced, but they are potentially misleading and most managers therefore prefer to avoid them. That said, the liability for the KID is based around whether the document has been compiled in accordance with the requirements of the Regulation. This means that a number of managers have been able to take a view that, while they have fundamental issues with the content of the document which is a consequence of the requirements of the Regulation, they produce one given that their liability profile is defined. In other words, the rewards of accessing retail capital outweigh the risks of producing the KID.

Where managers intend to admit retail investors directly, they will also need to consider whether they have the appropriate regulatory licence to achieve this. If the manager is based in the UK, the investors will not generally be treated for regulatory purposes as "clients" of the manager: the relationship with the manager is a pure sales relationship on a non-advised basis. In such circumstances, the manager's client will generally be the fund, which would be categorised (in almost all cases) as a professional. Neither the manager nor its affiliates will usually be providing regulated services to the investors and will take careful steps to ensure that the investors are not treated as clients for regulatory purposes. However, some continental European jurisdictions take a different approach and might at least assume that a regulated service – for example, investment advice - was being provided by the manager to the investors. If the manager is regulated or operating in such a jurisdiction, it would need to consider its regulatory obligations vis-à-vis retail investors, for example a need to conduct suitability assessments. The manager would also need to consider whether it needs to take steps to manage conflicts of interest that may arise between its own interests as manager and promoter of the fund and those of investors.

Even if licensing is not a concern, regulated managers would do well to consider whether they have the wherewithal (the human resource, systems and procedures) to target and manage retail money safely.

High-level regulatory rules about adequate resource, and systems and controls, whilst abstract, are very important. Managers accept retail money should also be prepared for closer scrutiny by their supervisors across the board.

UK based fund managers should be aware that, due to changes in 2018 to the FCA's Financial Services Compensation Scheme rules, the inclusion of retail investors in a fund could result in higher FSCS levies becoming payable (in sometimes very material amounts) by the firm due to a "look-through" mechanism allowing such investors to be treated as eligible claimants. Similar rules in other jurisdictions need to be considered.

Managers reaching out to retail investors will need to consider whether local laws in the jurisdiction of the investor restrict the offering of fund units to such investor. The UK, for example, has two domestic regimes which place restrictions on the extent to which promotional activity in the context of a new fundraising can be carried out with retail investors: (1) the financial promotions regime; and (2) the promotion of collective investment schemes regime. Where UK retail investors are being invited to participate in a fundraising, managers will need to ensure that they comply with these rules and only make invitations or promotions through an authorised entity.

The financial promotions rules prescribe various content requirements for communications made to retail investors, meaning, for example, that any face-to-face (or video call) presentations would need to be carefully scripted, and marketing materials will look markedly different from traditional institutional equivalents. The rules also contain a restriction on the promotion of interests in "non-mainstream pooled investments" to retail investors, which is likely to include an unregulated private fund. Managers would need to carefully navigate this restriction, which in practice involves a chicken-and-egg process of obtaining certain information and certifications from retail investors to confirm their high net worth status or level of sophistication and the suitability of the investment. Considerable resources will need to be devoted to this exercise and the manager may find it difficult to source the appropriate expertise internally, particularly if it is an institutional firm not used to complying with regulatory rules aimed at protecting retail investors. It is also notable that the UK Government is currently consulting on amendments to the financial promotions regime that would allow the FCA to decide which authorised firms are able to approve financial promotions of unauthorised firms – options being consulted on are a requirement attaching to authorised firms' licences preventing them from approving financial promotions of unauthorised firms, which can only be removed following an application to the FCA, or making the approval of an unauthorised firm's financial promotions a regulated activity.

At least in the UK, and potentially elsewhere in Europe, thought will also need to be given as to whether the fact that fund interests will be held by retail investors needs to be taken into account as part of a target market assessment carried out under product governance rules deriving from MiFID. In the EEA, these rules do not directly apply to fund managers (who are not subject to MiFID), but the UK FCA has nevertheless taken the view that the rules should be taken into account by most UK firms that "manufacture" or "distribute" financial instruments (including units in a fund), at least as guidance. A fund manager will typically be regarded as a manufacturer of fund interests.

In some cases, the regulatory burden associated with admitting retail investors can be managed by "opting up" retail clients to professional client status, as discussed above. However, there are a few limitations on the effectiveness of this approach. First, many retail investors will not be eligible for opting up because they will not meet two out of the three required criteria. Second, even if an investor has opted up to professional status, the admission of investors who are natural persons increases the possibility of fund interests ending up the hands of retail investors in the future. For example, an investor may make a transfer of fund interests to trustees of a family trust or fund interests may be bequeathed to a retail investor. The latter issue may be capable of being managed in part by imposing restrictions on who fund interests can be transferred to.

KEY TAKEAWAY

If there are pockets of identified demand in a particular jurisdiction then this may be a viable option but for a wider, cross-jurisdictional marketing effort, a pooling vehicle may be a better bet.

2. POOLING VEHICLE AS A LP

Pooling vehicles for retail investors are certainly not new, although they have become more challenging in Europe recently. Options for such vehicles include friends and family structures (usually a sister partnership established to house a group of investors linked in some way to the GP) or a wealth management feeder.

Friends and family funds have become less common in Europe since the implementation of the PRIIPs regime, meaning that such a fund needs to produce a KID. Some fund managers have found ways to admit European retail investors into pooling vehicles but this is largely jurisdiction and fact-dependent, and burdensome.

Where a wealth management feeder fund is used, the compliance burden is in large part passed from the manager to the relevant bank that has established the feeder for its clients. There are also distribution issues where the underlying fund is offshore – even if the feeder is established in the UK or EEA, if it is established to invest 85 per cent or more of its investments in the underlying offshore fund, the feeder will not be eligible for the AIFMD marketing passport and will have to rely on applicable national private placement laws.

If a fund manager intends to admit a wealth management feeder established and managed by a third-party bank or asset manager to one of its funds, it will need to consider carefully the way in which this is documented. The manager will want to ensure that the compliance burden in relation to the feeder remains with the sponsoring bank and that it does not pick up additional regulatory burdens as a result of admitting the feeder. Documentation suggesting that the sponsoring bank is providing a "placement agent" service of procuring investors (consisting of its wealth management clients) for the main fund is likely to be unhelpful here. Potential regulatory issues that could arise include the manager being regarded as a co-manufacturer of the feeder vehicle interests for the purposes of product governance rules, entailing (among other things) the need to carry out a target market assessment, and the manager becoming subject to obligations under the PRIIPs Regulation in relation to the feeder vehicle interests. Any documentation between the manager and the sponsoring bank in relation to the feeder should ideally make clear that the feeder is simply another investor that the sponsoring bank has established to make the main fund interests available to its clients and that the sponsoring bank is fully responsible for the management and operation of the feeder and for ensuring compliance with all applicable laws. The inclusion of standard representations in the main fund's investor subscription documents that such investors are professional investors will also help manage the risk that the manager is regarded as indirectly marketing or making available fund interests to retail investors.

The characterisation of the relationship as a "placement agent service" might also raise considerations under the AIFMD delegation rules. If the placement agent service amounts to a delegation of marketing functions by the manager, the manager will need to ensure that the delegation complies with those rules.

Even if the compliance burden is largely passed on to the sponsoring bank, this does not mean that the manager is operating on an entirely liability-free basis. It is not possible for the manager to exclude its responsibilities pursuant to applicable regulation and there will be other areas where direct responsibility is taken for certain materials. For example, if marketing materials are left with the bank by the sponsor, intending that they should be passed onto underlying investors, the sponsor will be responsible for their content. In the EU, under proposed guidance which will take effect in August 2021, it is contemplated that an AIFM should have responsibility for the content of all marketing materials used by any distributor. The private bank will also typically ask for information to support it in its own compliance with its PRIIPs/KID, product governance and costs and charges disclosure duties and it may ask for contractual confirmations in respect of the accuracy of that information. The manager will need to monitor the burden of such information requests and ensure that it is only obliged to provide information that the bank strictly requires to comply with its legal obligations.

In many cases, the sponsoring bank may ask for senior professionals of the manager to appear at roadshow presentations to prospective feeder vehicle investors to support its own marketing efforts. Where the presentations are made to UK investors, such requests need to be considered very carefully as they carry the risk of a member of staff unwittingly making a financial promotion to the wealth management clients, i.e. an invitation or inducement to subscribe for units in the feeder. As noted above, there are various restrictions that apply in relation to financial promotions made to UK retail investors, which need to be carefully navigated. The risks could be managed to some extent by keeping to factual statements, but even factual statements can amount to a financial promotion if there is any element of persuasion in the manner in which they are presented. Assuming that the sponsoring bank won't be taking responsibility for managing the financial promotion risks of the manager, careful consideration will need to be given to the resources that will need to be devoted to risk management. Some alternative asset managers have taken a fairly hard line on this topic, declining to participate in presentations to prospective feeder vehicle investors.

KEY TAKEAWAY

It is likely that these pooling vehicles will continue to be of use in tapping an identified group of retail investors, be it people already known to the manager or accessing a private bank network that is established and provides a reliable source of capital. For a wider retail distribution, it may be that other fund structures which are complementary to the core strategy may be more appropriate.

3. ALTERNATIVE UCITS AND OPEN-ENDED FEEDERS FOR PRIVATE CAPITAL STRATEGIES

Another increasingly used solution is partnering with a UCITs platform manager that provides a liquid feeder (often referred to as an Alternative UCITs). Alternative UCITs are primarily based around hedge fund strategies – whilst UCITS categorically prohibits physical short-selling, the availability of ETDs and OTCs meant managers could use financial instruments such as Contracts for Difference (CFDs) to replicate short exposures synthetically within a UCITs, thereby opening up opportunities for hedge funds to launch UCITS products. In recent years, a number of Alternatives UCITs platform providers have looked at methods of extending this offering to private equity related strategies.

The obvious issue with using Alternative UCITs in a private capital strategy is the liquidity mismatch between the UCITs and the underlying fund. These issues have become apparent in recent years in a number of different contexts – open ended real estate funds and illiquid equities portfolios to name two. The issue is also in the cross hairs of regulators which should not be disregarded lightly but equally there are solutions to the issues being raised. For example, fund finance facilities can assist where there are liquidity mismatches between redemption terms of the underlying portfolio and disclosure documents can (and should) make clear how the fund will operate in respect of redemption rights, suspensions and the ability to wind-down investments.

As an alternative to a UCITs fund structure, there are closed-ended alternatives that have regulatory support for retail investment, and which match the liquidity of private credit strategies.

KEY TAKEAWAY
An Alternative UCITs may be a viable option if the redemption terms and the liquidity of the underlying investments can be matched (potentially with the assistance of fund finance facilities).

4. CLOSED-ENDED RETAIL FUNDS

Closed-ended retail fund structures (often referred to as permanent capital vehicles) are a commonly used option for retail access to private capital strategies. They are ideally suited to the sector in that they provide long-term capital from both retail investors as well as institutional investors that are otherwise restricted from investing in partnership structures.

Typically (although not always) these funds provide liquidity to investors through a market listing of the fund's shares and will co-invest in assets alongside the main fund based on an agreed allocation policy. The funds may have a defined life or be evergreen, thereby allowing them to potentially invest alongside a series of limited life funds.

The funds themselves are typically unregulated and will impose less of a compliance burden on managers than other retail access opportunities. They also provide for the opportunity of profile raising for the management house given the public listing.

Examples include:

Investment companies – typically these are listed on London markets and cover a wide range of alternative asset classes. The investor base is usually UK retail and institutions although it is possible to allow for wider access if there is identified demand.

Historically, listed private equity companies were launched although these have, since the GFC, typically traded at a large discount to prevailing NAVs meaning there have not been many PE listed fund strategy launches in recent times. That said, there have been a number of successful launches of PE strategies that invest in minority positions (including ones focussed on the EEA, UK and US) and technology companies. Equally, there is a strong fundraising market for private credit, infrastructure (in particular, renewable energy assets) and real estate strategies.

The challenge of launching an investment company is reaching a critical size which will substantially increase the investor universe that will consider the shares. Typically, a fund size of £250 million is required to attract significant private wealth management investment so if a manager can bring roll over investors or house investment, this will significantly increase the likelihood of the fund launch succeeding.

Once launched, an investment company will also give the strategy access to fund supermarket platforms for retail investors. Consideration needs to be given to the product governance obligations in terms of whether or not an investment company is a complex product for MiFID purposes but the significant majority of investment companies are not categorised as complex.

BDCs – BDCs are used in the US for retail investors to access private credit strategies and are long-standing and vital sources of finance for small businesses in the United States. BDCs are required to lend a minimum of 70% of their capital to non-listed, small and medium-sized US businesses. The capital they lend is primarily raised from retail investors who, in return, receive income in the form of dividends with BDCs required to distribute at least 90% of income to shareholders annually.

$105 billion

The estimated amount of BDC assets under management.

It is estimated that BDC assets under management increased from about $19 billion in the final quarter of 2009 to roughly $105 billion at the end of the first quarter of 2019 (an increase of 452%). The number of investments made by these vehicles grew from about 2,500 to almost 12,500 in the same period.

ELTIFs – The European Long-Term Investment Fund (ETIFs) is a relatively new market development within the EU that seeks to provide capital for certain private credit strategies. They are in essence a sub-set of the AIFMD regime (they need to be managed by an EU AIFM and must be an EU AIF) that caters to a private capital (particularly private credit) strategy and also allows retail marketing.

Whilst not widely adopted to date, a number of managers have raised significant amounts using the structure from EU private bank networks (in particular, in Germany, Italy and Spain). However, the restrictive nature of the investment restrictions that currently apply means that the ELTIF has not been as widely adopted to date as otherwise may have been the case.

An ELTIF may only make investments in two categories of assets (i) "eligible assets" and (ii) UCITS-eligible investments (transferable securities).

In relation to credit investments, eligible assets are debt instruments (for example, bonds, notes etc) and loans issued by / made to "qualifying portfolio undertakings". Certain types of equity, real estate and ELTIF fund investments are also eligible for these purposes. Investments in securitisations, other structured products, derivatives (other than for hedging purposes), short trades and STFs are generally not permitted.

A qualifying portfolio undertaking must generally be an operating entity with a real business outside of a financial services context (as a result investment in banks, investment firms, AIFMs, other funds and other types of financial undertaking are restricted). Generally, the portfolio company (a) cannot have securities admitted to trading on an EU trading venue (which we think would include securities that have technical listings for tax reasons) unless it has a market capitalisation of EUR 500 million or less and (b) must be established in the EU, although other non-EU companies may be eligible if certain conditions are met (mainly around that country having tax cooperation arrangements in place).

An issue we have found with these restrictions is that most private credit managers want to use a strategy that is complementary to their core approach. If they adopt a global investment approach for their existing strategies, it is unlikely that an ELTIF will be able to make co-investments in a directly comparable portfolio to the core strategy (for example, if borrowers include US or UK entities).

There is no statutory right for investors to require redemptions before the end of the life of the ELTIF; however, an ELTIF's constitutional documents may offer redemptions provided that redemptions (i) are not available before the date specified in the ELTIF's constitutional documents (which must not be later than the earlier of (a) 5 years after authorisation of the ELTIF and (b) half the life of the ELTIF (which term must be consistent with the long-term nature of the ELTIF and appropriate for the assets of the ELTIF)), (ii) the manager has a defined redemption policy and is able to demonstrate appropriate liquidity management, (iii) the rights of redemption are limited to a percentage (consistent with the liquidity management strategy) of transferable securities held by the ELTIF and (iv) investors are treated fairly.

In practice, this means that the right of redemption prior to the end of the life of the ELTIF is likely to be driven by the liquidity requirements of the ELTIF's investor base and a matter for commercial negotiation when launching the vehicle.

A review is currently being undertaken on the ELTIF restrictions which is expected to conclude in 2021. It is hoped that a number of the more onerous restrictions (including the geographical investment restrictions) will be removed or relaxed, thereby opening up the structure to a wider range of investment strategies.

KEY TAKEAWAY

Closed-ended funds are ideally suited for the sector in that they provide long-term capital. However, the key question is whether a fund of sufficient size (as compared to the main institutional funds) is able to be raised that justifies the time and cost commitment required of the manager to launch a new vehicle.

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