ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ABOU JAOUDE & ASSOCIATES LAW FIRM
ADVOKATFIRMAET BAH R AS
ALLEN & GLEDHILL LLP
ALLEN & OVERY LLP
ARTHUR COX
BONELLIEREDE
CORRS CHAMBERS WESTGARTH
DEYNECOURT
FGE EBR AHIM HOSAIN
HENGELER MUELLER
KING & SPALDING LLP
LENZ & STAEHELIN
MAPLES GROUP
MARVAL, O’FARRELL & MAIRAL
MORI HAMADA & MATSUMOTO
PINHEIRO NETO ADVOGADOS
PRUDHOE CARIBBEAN
ROPES & GRAY LLP
SLAUGHTER AND MAY
STIKEMAN ELLIOTT LLP
URÍA MENÉNDEZ
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Country</th>
<th>Authors</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>JAPAN</td>
<td>Yasuzo Takeno and Fumiharu Hiromoto</td>
<td>183</td>
</tr>
<tr>
<td>12</td>
<td>LEBANON</td>
<td>Rita Papadopoulou</td>
<td>201</td>
</tr>
<tr>
<td>13</td>
<td>LUXEMBOURG</td>
<td>Pierre De Backer and Emmanuelle Bauer</td>
<td>212</td>
</tr>
<tr>
<td>14</td>
<td>NETHERLANDS</td>
<td>Ellen Cramer-de Jong, Daphne van der Houwen, Naomi Reijn and Friso van Orden</td>
<td>230</td>
</tr>
<tr>
<td>15</td>
<td>NORWAY</td>
<td>Peter Hammerich and Markus Heistad</td>
<td>243</td>
</tr>
<tr>
<td>16</td>
<td>PAKISTAN</td>
<td>Haroon Jan Baryalay</td>
<td>259</td>
</tr>
<tr>
<td>17</td>
<td>PORTUGAL</td>
<td>Carlos Costa Andrade, Marta Pontes, Gerard Everaert, Duarte Araújo Martins and Domingos Braga</td>
<td>272</td>
</tr>
<tr>
<td>18</td>
<td>SAUDI ARABIA</td>
<td>Nabil A Issa, James R Stull, Macky O'Sullivan and Sayf Shuqair</td>
<td>285</td>
</tr>
<tr>
<td>19</td>
<td>SINGAPORE</td>
<td>Danny Tan</td>
<td>300</td>
</tr>
<tr>
<td>20</td>
<td>SPAIN</td>
<td>Juan Carlos Machuca Siguero and Anna Viñas Miquel</td>
<td>311</td>
</tr>
<tr>
<td>21</td>
<td>SWITZERLAND</td>
<td>Shelley R du Pasquier and Maria Chiriaeva</td>
<td>333</td>
</tr>
<tr>
<td>22</td>
<td>TURKS AND CAICOS ISLANDS</td>
<td>Wilbert Harvey and Mikhail Charles</td>
<td>349</td>
</tr>
<tr>
<td>23</td>
<td>UNITED ARAB EMIRATES</td>
<td>Nabil A Issa, James R Stull, Macky O'Sullivan and Sayf Shuqair</td>
<td>361</td>
</tr>
</tbody>
</table>
Chapter 24  UNITED KINGDOM .................................................................372
            Paul Dickson

Chapter 25  UNITED STATES ...............................................................413
            Jason E Brown, Leigh R Fraser and John M Loder

Appendix 1 ABOUT THE AUTHORS ..................................................435

Appendix 2 CONTRIBUTORS’ CONTACT DETAILS ..............................453
Despite significant improvements in the global economic landscape in the years since the
global financial crisis some ten years ago, the macroeconomic position is looking increasingly
complex and global growth has been hampered by various geopolitical factors, including
political uncertainty and the rise of populist movements in Europe. As the UK prepares
for Brexit, absent any agreement to the contrary currently set to take place at the end of
October 2019, political uncertainty remains around the form and extent of any UK–EU deal
relating to financial services, and as to whether any transition period (during which UK firms
would remain able to access to EU markets on current terms) will be agreed. This has had, and
is likely to continue to have, a potentially destabilising effect on the UK asset management
sector and its clients. The impact of the UK’s decision to leave the EU is thus already being
felt, not only in the UK and across the European continent, but also more widely.

Nevertheless, the importance of the asset management industry continues to grow. Nowhere
is this truer than in the context of pensions, as the global population becomes
larger, older and richer, and government initiatives to encourage independent pension
provision continue. Both industry bodies and legislators are also increasingly interested in
pursuing environmental, social and governance (ESG) goals through private sector finance.
For example, the European Commission has proposed a package of measures seeking to
introduce sustainable finance into current regulations to make it easier for investors to
identify and invest in such projects.

This should not be a surprise: lack of shareholder engagement has been identified as
one of the key issues contributing to the governance shortcomings during the financial crisis.
Given the importance of the asset management industry in investing vast amounts on behalf
of clients, the sector is the natural focus of regulatory and governmental initiatives to promote
effective stewardship and take the lead in instilling a corporate cultural focus on sustainability
and ESG initiatives.

The activities of the financial services industry remain squarely in the public and
regulatory eye, and the consequences of this focus are manifest in ongoing regulatory
attention around the globe. Regulators are continuing to seek to address perceived systemic
risks and preserve market stability through regulation. In Europe, further significant changes
to the regulatory landscape for investment services were introduced by the revised Markets
in Financial Instruments Directive regime (known as MiFID II), which has applied since
3 January 2018. In the UK, the Financial Conduct Authority continues to focus on the
asset management industry. In 2017, it published its asset management market study on
the performance of the asset management market for retail and institutional investors, and
is beginning to implement its findings during the course of 2018. In contrast, the Trump
administration in the US has signalled a deregulatory agenda, which includes plans to
It is not only regulators who continue to place additional demands on the financial services industry in the wake of the financial crisis: the need to rebuild trust has led investors to call for greater transparency around investments and risk management from those managing their funds. Senior managers at investment firms are, through changes to regulatory requirements and expectations as to firm culture, increasingly being seen as individually accountable within their spheres of responsibility. Industry bodies have also noted further moves away from active management into passive strategies, illustrating the ongoing pressure on management costs. This may, in itself, be storing up issues for years to come.

The rise of fintech and other technological developments, including cryptocurrencies, data analytics and automated (or ‘robo’) advice services, is also starting to have an impact on the sector, with asset managers looking to invest in new technologies, seeking strategies to minimise disruption by new entrants, or both. While regulators are open to the development of fintech in the asset management sector, they also want to ensure that consumers do not suffer harm as a consequence of innovations. Regulators across various jurisdictions are working together to develop a global sandbox in which firms can test their new technologies.

This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements, and adapt to the changing geopolitical landscape. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself and the global value of assets under management continues to increase year on year. The industry is not in the clear but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the eighth edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank the team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that this edition of *The Asset Management Review* will be a useful and practical companion as we face the challenges and opportunities of the coming year.

**Paul Dickson**
Slaughter and May
London
August 2019
Chapter 1

EUROPEAN OVERVIEW

Nick Bonsall

I  INTRODUCTION

As part of the focus in the EU in the past few decades on strengthening the single market in the provision of financial services, increasing numbers of asset management activities in European Economic Area (EEA) Member States have been brought within the regulatory perimeter at European level. This trend looks likely to continue, at least in the short to medium term, as evidenced by a growing number of EU legislative proposals that are either directly aimed at the investment funds industry, or that will nonetheless catch investment funds, investment managers or depositaries within their scope. It remains uncertain how the UK’s decision to leave the EU will affect any future EU legislative proposals.

Traditionally, much of the EU’s legislative activity in financial services has been in the form of directives, which – unlike regulations – are not directly applicable within Member States and do not have national legal effect (except in limited specific circumstances) until transposed by the Member States into their national laws. Following changes to the European supervisory architecture and the proposal to introduce a single rule book for financial services, the introduction of new EU rules relevant to financial services increasingly takes the form of directly applicable regulations.

II  EUROPEAN REGULATORY AND SUPERVISORY FRAMEWORK

i  Key EU institutions

The European Commission (Commission) represents the interests of the EU as a whole, and has the sole right to propose new legislation.

The Council of the European Union (Council) represents the interests of the individual Member States.

The European Parliament (Parliament) represents the interests of EU citizens, and is directly elected by them.

1 Nick Bonsall is a partner at Slaughter and May. The author would like to thank Chris Hurn, Tanja Velling and Jack Hull for their assistance in preparing this chapter.

2 The EEA comprises the Member States of the EU and Iceland, Liechtenstein and Norway. Many European directives are extended to the non-EU Member States of the EEA by virtue of the Agreement on the European Economic Area, which came into force on 1 January 1994. New rules are adapted or extended to the EEA by decisions of the EU/EEA Joint Committee. EEA Member States outside the EU are informed of legislative proposals, but they do not have a formal role in shaping policy.
ii Legislative procedure

The Commission, after consultation with stakeholders, will put forward a legislative proposal for joint adoption by the Council and Parliament, which then usually goes through the ordinary legislative procedure (known as the co-decision procedure prior to the Treaty of Lisbon in 2009). In addition to its role in adopting legislation proposed by the Commission, the Parliament has a limited power to request the Commission to submit appropriate proposals on matters on which it considers that an EU legislative measure would be appropriate.

iii Lamfalussy approach to adoption of European financial services legislation

The Lamfalussy approach is a four-level legislative procedure adopted by the EU for the development of legislation for the financial services industry that involves the following:

a legislative act (Level 1): the framework legislation is proposed and adopted under the ordinary legislative procedure. Individual articles in the legislative act specify where power is delegated to the Commission to adopt Level 2 measures;

b implementing measures drafted and adopted by the Commission, following advice from the specialist committees (Level 2);

c consultation and guidance by the European Supervisory Authorities (Level 3); and

d supervision and enforcement, principally by the regulators in each Member State (Level 4).

iv Reform of the EU supervisory framework

Until 2011, three Level 3 Committees existed: the Committee of European Banking Supervisors, the Committee of European Insurance and Occupational Pensions Supervisors and the Committee of European Securities Regulators (CESR). These brought together regulators from each Member State to agree on the details of implementing measures and to coordinate the supervision of cross-border institutions. The failings in prudential regulation that were highlighted by the financial crisis led to criticism that these advisory committees did not have sufficient powers or influence to address the complex challenges of cross-border regulation.

Following recommendations contained in the 2009 de Larosière Report, the Commission proposed to establish a new European Systemic Risk Board, responsible for macro-prudential oversight, and a European System of Financial Supervisors (ESFS), comprising three new pan-European Supervisory Authorities (ESAs) to replace the Level 3 Committees: the European Banking Authority (EBA); the European Insurance and Occupational Pensions Authority (EIOPA); and the European Securities and Markets Authority (ESMA).

The ESAs were established to oversee the financial system at a micro-prudential level, and to achieve convergence between Member States on technical rules and coordination between national supervisors. The new authorities’ powers go beyond those of the former Level 3 Committees, and their role extends beyond being merely advisory.

Most notable of the three ESAs in this context is ESMA, which replaced the CESR on 1 January 2011. The role of the CESR had been to improve coordination among securities regulators, to act as an advisory group to assist the Commission (in particular in the

---

3 Named after Alexandre Lamfalussy, who chaired the EU group that proposed the process for the development of EU securities legislation in 2001 (later extended to the field of banking, insurance and pensions regulation).
Commission’s preparation of draft Level 2 implementing measures), and to work to ensure more consistent and timely day-to-day implementation of EU legislation in the Member States. As well as taking over all existing and ongoing tasks of the CESR, ESMA has also been granted additional responsibilities and powers, including:

- the ability to draft technical standards in connection with specific areas of directives that are legally binding in Member States;
- the ability to launch a fast-track procedure to ensure consistent application of EU law;
- the ability in emergency situations to take decisions that bind national regulators or to intervene in the supervision of financial institutions in limited cases;
- new powers to resolve disagreements between national authorities; and
- additional responsibilities for consumer protection (including the ability to prohibit financial products that threaten financial stability or the orderly functioning of financial markets for a period of three months).4

In March 2017, the Commission consulted on increased powers for the ESAs, including an extension of the EBA’s powers to address disagreements over own funds requirements for banks, and enhanced direct supervisory powers for ESMA with regard to certain capital markets segments, including data providers, pan-European investment fund schemes and post-trading market infrastructures.5 Following responses to the consultation, in September 2017 the Commission published its legislative proposals in relation to the reform of the role and powers of the ESAs. On 12 September 2018, the Commission published a communication that introduced a proposal to concentrate anti-money laundering powers related to the financial sector into the EBA, including by way of strengthening the EBA’s mandate to ensure effective and consistent supervision of the risks of money laundering by relevant EU authorities. On 21 March 2019, the Parliament and Member States reached a political agreement on a package of reforms to the supervision of EU financial services, including by way of strengthening the EBA’s role in the area of anti-money laundering. On 18 April 2019, the Parliament endorsed at first reading legislation strengthening the powers of the ESAs, including in relation to the powers for the EBA that were proposed in the 21 March 2019 political agreement.6

III Markets in Financial Instruments Directive Regime

i Background

The Markets in Financial Instruments Directive (MiFID) regime is a key component of the EU’s Financial Services Action Plan that was introduced in 2000 to further the harmonisation of financial markets within the EU to facilitate a single market in financial services. Before the introduction of the first Markets in Financial Instruments Directive (MiFID I),7 the provision of investment services within the EU was regulated by the Investment Services Directive (ISD).8 This sought to widen access to the financial services market by requiring

---

6 Available at https://oeil.secure.europarl.europa.eu/oeil/popups/printsummary.pdf?id=1582113&l=en&tt=E.
7 Directive 2004/39/EC.
8 Directive 93/22/EEC.
Member States to permit investment firms that were established in other Member States to carry on the activities authorised by the home Member State in their territories through a passport. While it introduced the concepts of home Member State regulation and passporting of investment firms across the EU, it became increasingly clear over time that the scope of the ISD was too narrow to deal with the rapid evolution in financial markets that had occurred since its original enactment. In addition, the ISD was a minimum harmonisation directive, meaning there were still varying requirements across the EU as different Member States adopted different, often protectionist, approaches. MiFID has retained and seeks to expand the passporting framework introduced by the ISD.

On 20 October 2011, the Commission published a package of proposals for reform, including a draft directive that would repeal and recast MiFID I,9 and a new, directly applicable regulation10 (together referred to as MiFID II). In the explanatory memorandum, the Commission stated that while MiFID I had, in its view, been successful in increasing EU-wide competition in the trading of financial instruments, decreasing transaction costs and furthering market integration, nonetheless legislative reform of the MiFID I regime was desirable to address the challenges posed by an increasingly complex financial landscape. In particular, one result of the liberalisation of markets under the MiFID I regime was that a great deal of trading of financial instruments now takes place away from regulated trading venues such as regulated markets and multilateral trading facilities (MTFs). In response to these developments, the Commission identified investor protection and trading transparency as broad areas that required reform and enhancement.

MiFID II entered into force on 12 June 2014 and, following a one-year delay because of challenges with implementation, became applicable in Member States on 3 January 2018. Various Level 2 measures (comprising binding regulatory technical standards and implementing technical standards), which are directly applicable in Member States, have also been introduced.

ii Scope of MiFID

The implementation of MiFID I had an important impact on investment firms across the EEA, expanding the scope of regulation of investment services. The MiFID regime applies to all EEA investment firms, which are defined as legal persons whose regular occupation or business is the provision of investment services to third parties, the performance of investment activities, or both, on a professional basis. The list of relevant investment services and investment activities that fall within the scope of MiFID includes various activities often undertaken by asset managers, such as receiving and transmitting orders relating to specified financial instruments, executing orders on behalf of clients, portfolio management and providing investment advice. The list of relevant financial instruments that fall within the ambit of the MiFID regime covers not only transferable securities such as shares, but also a wide range of other products, including money market instruments, units in collective investment undertakings (CIUs) and various forms of derivatives. Under MiFID II, the scope of the MiFID regime was extended to, among other things, certain MiFID requirements to firms when selling or advising clients in relation to structured deposits.

Investment managers accepting third-party portfolio mandates will typically be engaged in many of these activities and so will fall within the scope of MiFID.

9 Directive 2014/65/EU.
10 Regulation 600/2014.
despite the wide definition of investment firms, there are also some important exemptions from the MiFID regime. For example, CIUs and the managers of such undertakings that are subject to the prescriptive requirements of either the undertakings for collective investment in transferable securities (UCITS) regime (see Section IV) or the alternative investment funds (AIFs) regime (see Section V), will be exempt.11

The MiFID regime also contains a number of requirements (including the requirement to obtain authorisation) for market operators and investment firms that operate multilateral trading facilities (MTFs). MiFID II expanded this scope to include a new category of trading venue, organised trading facilities, which are trading venues other than regulated markets and MTFs in which multiple third-party buying and selling interests in non-equity interests are executed on a discretionary basis.

### iii Conduct of business standards

MiFID I prescribed core business standards for firms providing investment services covering a wide range of issues, including:

- a. organisational requirements;
- b. regulation of outsourcing;
- c. management of conflicts of interest;
- d. processing of client orders and execution-only business;
- e. requirements for firms to assess the suitability and appropriateness of the financial services and products offered; and
- f. marketing communications.

MiFID II has amended and enhanced the conduct of business standards in various areas, particularly in relation to investment advisory services and execution-only services. Under the new regime, investment firms providing investment advice are required to specify whether their advice is being given on an independent basis, and whether such advice has been based on a broad or restricted analysis of the market.12 Advice is deemed to be provided on an independent basis only if the investment firm has assessed a sufficient range of financial instruments available on the market before giving the advice (including products issued by entities other than issuers or product providers that have a close link to the relevant investment firm), and if the firm does not receive fees, commissions or other monetary benefits from any third party for the provision of advice.13

In addition, under MiFID II, investment firms are required to specify how investment advice provided to a client meets the personal characteristics of that client.14 MiFID II has

---

11 In addition, entities that provide investment services solely for intra-group purposes do not fall within the scope of the MiFID regime; neither does any person who deals solely on his or her own account in financial instruments other than commodity derivatives or emission allowances or derivatives thereof, unless such persons are market makers; are members of or participants in a regulated market or MTF; on the one hand, or have direct electronic access to a trading venue, on the other, except for non-financial entities that execute transactions on a trading venue that are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of those non-financial entities or their groups; apply a high-frequency algorithmic trading technique; or deal on own account when executing client orders by virtue of Article 2(1)(d) MiFID II.

12 Article 24(4) MiFID II.

13 Article 24(7) MiFID II.

14 Article 25(6) MiFID II.
also introduced provisions to regulate cross-selling practices where investment firms offer investment services together with other services as part of the same package – firms must now inform clients if it is possible to buy the constituent services in that package separately, and must also set out the costs of each separate component.\textsuperscript{15}

The list of financial instruments that are considered to be non-complex for the purposes of the execution-only services exemption under MiFID has been revised so that it is more likely that investment firms will be required to undertake an appropriateness assessment. In particular, shares in exchange traded funds (ETFs) and other structured UCITS are no longer eligible for sale on an execution-only basis.\textsuperscript{16}

MiFID II also introduced more extensive provisions dealing with corporate governance of investment firms, strengthening the existing rules under the MiFID regime. The new requirements are more prescriptive, and limit how many executive and non-executive directorships may be held by members of a firm’s management body (subject to derogations permitted by the competent authorities of Member States). In addition, larger and more complex investment firms may be required to establish nomination committees composed of non-executive directors to assess whether potential new directors have sufficient knowledge, skills and experience.

Other areas in which organisational and conduct of business rules have been enhanced include:

\begin{itemize}
\item \textit{a} the introduction of product governance requirements, under which firms that manufacture financial instruments for sale to clients must ensure that (among other things) the instruments are designed to meet the needs of an identified target market, the distribution strategy is compatible with that target market and the firm takes reasonable steps to ensure the financial instrument is distributed to the identified target market;\textsuperscript{17}
\item \textit{b} a requirement for firms to keep records of all services, activities and transactions it undertakes, which includes the obligation to record all relevant telephone conversations and electronic communications relating to (at least) transactions concluded when dealing on own account, and providing services relating to reception and transmission and execution of client orders;\textsuperscript{18} and
\item \textit{c} significant reforms to the rules regarding payment and acceptance of inducements, including investment research (see subsection \textit{v} below).
\end{itemize}

\textbf{iv} Client categorisation

A significant feature of the MiFID regime is the concept of client categorisation, whereby clients are categorised as either retail clients or professional clients, according to whether they meet specified criteria.\textsuperscript{19} A professional client possesses the experience, knowledge and expertise to make its own investment decisions and [to] properly assess the risks that it

\textsuperscript{15} Article 24(11) MiFID II.
\textsuperscript{16} Article 25(4)(a)(iv) MiFID II Directive. Structured UCITS are UCITS that provide investors with algorithm-based returns that are linked to the performance of financial assets, indices or reference portfolios, or to UCITS with similar features.
\textsuperscript{17} Article 24(2) MiFID II.
\textsuperscript{18} Article 16(6) and (7) MiFID II.
\textsuperscript{19} Set out in Annex II MiFID II.
Entities that require authorisation to operate in the financial markets will always be considered to be professional clients, and these include investment firms, other authorised financial institutions, and collective investment schemes (CISs) and their management companies.

In addition, large undertakings that satisfy two of the following criteria will also be considered professional clients: the balance sheet total for the entity is at least €20 million; the net turnover of the entity is at least €40 million; or the entity has own funds of at least €2 million.

Nonetheless, entities that are classified as professional clients under MiFID may still agree with investment firms that they are to be treated as non-professionals in order to ensure a higher degree of protection. At the same time, clients who do not fall within the definition of professional clients are entitled to waive certain protections that would otherwise be afforded to them as non-professional clients.

MiFID also includes a subcategory of professional client known as an eligible counterparty, which is effectively an enhanced form of professional client who receive lower protection in relation to certain aspects of the MiFID regime. Eligible counterparties may include investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, and other regulated financial institutions. Certain obligations of investment firms are disapplied in respect of transactions involving eligible counterparties: for example, the duties to act in a client’s best interest, assess the suitability and appropriateness of certain products before providing them to clients, and obtain the best possible result when executing client orders, and the obligation to execute a client’s orders promptly, fairly and expeditiously, are excluded where the firm executes orders, deals on own account, or receives and transmits, orders with or for an eligible counterparty.

However, the duties of investment firms to eligible counterparties have been strengthened under MiFID II so that investment firms are now required to act honestly, fairly and professionally when dealing with such clients, and must communicate with them in a way that is fair, clear and not misleading. In addition, investment firms are now required to provide the same appropriate information to eligible counterparties as is supplied to other clients (including in respect of whether investment advice is provided on an independent basis, and on what basis a market assessment has been carried out, as well as the periodic communications specifying how any advice meets the personal requirements of the client).

MiFID defines a retail client as a client who is not a professional client. Retail clients receive the highest level of regulatory protection under MiFID, and investment firms providing services to retail clients are subject to an extensive range of conduct of business requirements that are more onerous than those that apply to professional clients.

---

20 Annex II preamble, MiFID II.
21 Section 2, Annex II MiFID II.
22 Article 30(2) MiFID II.
23 Article 30(1) MiFID II.
24 ibid.
25 ibid.
Inducements

MiFID I contained certain requirements restricting the ability of firms to pay or receive fees, commission or non-monetary benefits to or from persons other than their clients (referred to as ‘inducements’). Those requirements included that:

a. the existence, nature and amount of the fee, commission or benefit (or, where the amount cannot be ascertained, the method of calculating it) must be clearly disclosed to the client in a comprehensive, accurate and understandable manner prior to the provision of the relevant financial instrument or financial service; and

b. the payment must be ‘designed to enhance the quality of the relevant service to the client’ and not impair compliance with the firm’s duty to act in the client’s best interests.

MiFID II retains these provisions and expands on them, providing further guidance as to the circumstances in which an inducement shall be considered to be designed to enhance the quality of the relevant service. The inducement must be justified by the provision of an additional or higher level service to the relevant client; proportional to the level of inducements received; not directly benefit the recipient firm, its shareholders or employees without tangible benefit to the relevant client; and be justified by the provision of an ongoing benefit to the relevant client in relation to an ongoing inducement.

The new regime also requires that the existence, nature and amount of the payment or benefit, or where the amount cannot be ascertained the method of calculating that amount, must be clearly disclosed to the client in a manner that is comprehensive, accurate and understandable prior to the provision of the relevant service. Where applicable, the investment firm must also inform the client of mechanisms for transferring the fee, commission, monetary or non-monetary benefit received to the client. MiFID II confirms that payments or benefits that enable or are necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and that by their nature cannot give rise to conflicts with the firm’s duties to act honestly, fairly and professionally in accordance with the best interests of its clients, are not subject to the above restrictions.

More significant changes were introduced by MiFID II for firms providing independent advice and portfolio management services. Such firms are prohibited from accepting third-party inducements unless those inducements constitute ‘minor non-monetary benefits’. The MiFID II Delegated Directive contains an exhaustive list of those benefits that will qualify as acceptable minor non-monetary benefits. These include, among other things, information or documentation relating to a financial instrument or an investment service that is generic in nature or personalised to reflect the circumstances of an individual client, hospitality of a reasonable de minimis value, and other minor non-monetary benefits that a Member State has deemed capable of enhancing the quality of service provided to a client.

A further area of reform that has attracted much attention from commentators and the financial media concerns the treatment of investment research. MiFID II confirms that investment research will constitute an inducement unless it is received in return for: direct

27 Article 24(9) MiFID II.
28 Article 24(7) and (8) MiFID II.
29 Article 12(3) MiFID II Delegated Directive.
payments from the investment firm out of its own resources; or payments from a separate research payment account controlled by the investment firm, provided certain conditions are met. These include that:

a the research payment account is funded by a specific research charge to the client;
b as part of establishing a research payment account and agreeing the research charge with their clients, investment firms set and regularly assess a research budget as an internal administrative measure;
c the investment firm is held responsible for the research payment account; and
d the investment firm regularly assesses the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions.

The industry response has been clear to date: the majority of asset managers will absorb the research costs themselves rather than passing them on to their clients. Pricing remains a key issue, with reports of a wide range of suggested fee levels proposed by investment banks for differing levels of access, and some commentators indicating the existence of conditions for a price war.

vi Third-country branches

In the context of asset management, a significant change introduced by Chapter IV of MiFID II relates to the provision of MiFID-regulated investment services by third-country (i.e., non-EEA) firms. Previously, such third-country firms were subject to national regimes in force in each Member State. MiFID II harmonises the approach to be taken in this regard (subject to transitional arrangements in the Markets in Financial Instruments Regulation (MiFIR), allowing existing third-country firms to continue to provide investment services in accordance with national regimes until three years after the adoption by the Commission of a decision in relation to the relevant third country).30 In place of the national regimes, two new MiFID passports, for branches and cross-border services respectively, are offered to third-country firms. The criteria for the granting of these passports are set out below.

A third-country firm wishing to provide services to retail clients anywhere in the EU is now required to establish a branch (i.e., a physical establishment) somewhere in the EU.31 MiFID II only permits the establishment of such a branch if certain specified conditions are met,32 including that:

a the third-country firm is authorised and supervised in the third country in which it is established;
b there are cooperation arrangements in place for sharing information on supervisory and taxation matters between the third country and the relevant Member State;
c sufficient initial capital is at the free disposal of the branch;
d all persons responsible for the management of the branch are appointed, and they are of sufficiently good repute and possess sufficient knowledge, skills and experience; and
e the third-country firm belongs to an investor-compensation scheme authorised or recognised in accordance with the Directive on investor compensation schemes.33

30 Article 54 MiFIR.
31 Article 39(1) MiFID II.
32 Article 39(2) MiFID II.
33 Directive 97/9/EC.
Once authorisation is granted by a Member State, the third-country firm will be able to provide the authorised investment services in other Member States without being required to establish branches in those jurisdictions in accordance with the passporting principle.

The principal criticism of the new MiFID II regime, in this context, is that it places European integration and a single market in financial services ahead of concerns about competition, in particular in relation to investment firms based outside the EU. It is certainly the case that the consequences of this legislation are likely to be somewhat protectionist, potentially limiting the capacity of investment firms based outside the EU to operate within the EU, including when communicating with EU-resident clients and potential clients. However, the extent of the effect of these new provisions on market practice remains to be seen.

IV THE UCITS REGIME

i Background

The first UCITS Directive (UCITS I) was introduced in 1985 as part of an initiative to create a cross-border single market in investment funds. UCITS I was designed to harmonise regulation of such schemes under a system of home state authorisation whereby Member States (host states) would permit UCITS schemes authorised in any other Member State (the home state) to be marketed in the host state without any further host state authorisation.

In practice, however, a combination of differing taxation regimes and a protectionist approach by several Member States, first in the drafting of UCITS I and then in its implementation, reduced its impact. However, Luxembourg was a major beneficiary, as it introduced a fund-friendly and tax-neutral regime and became, as a result, the domicile of choice for European-based funds. At the same time, other developments in financial services regulation had led to more developed passporting rights for investment firms that fell within the ambit of the Investment Services Directive that were not available to managers of UCITS schemes. A particularly significant defect in UCITS I was that it did not contain rules requiring Member States to harmonise the regulation of marketing of UCITS schemes, which had the effect that while the schemes themselves would not need new authorisation in the host state, the relevant documentation that had to be supplied to investors nonetheless varied between different host state jurisdictions.

Against the background of these difficulties, two additional directives, the Product Directive and the Management Company Directive were introduced in 2002. These widened the investment powers of UCITS schemes to permit investments in other UCITS and increased the permitted activities of UCITS management companies. The amended UCITS I is usually known informally as UCITS III (somewhat confusingly, as there was no official UCITS II: that term was used to describe a draft directive that was considered but could not be agreed and was withdrawn by the Commission in 1998).

UCITS IV\textsuperscript{38} (as amended by UCITS V)\textsuperscript{39} 

UCITS IV was introduced in 2009 in an attempt to accelerate the harmonisation of the EU asset management market and to address certain perceived defects of the UCITS III regime. UCITS IV aimed:

\begin{itemize}
  \item[\textit{a}] to facilitate the provision of cross-border management services for UCITS funds in order to permit management companies incorporated and authorised in one Member State to manage a fund in a different Member State;
  \item[\textit{b}] to accommodate master-feeder structures within the UCITS regime;
  \item[\textit{c}] to facilitate cross-border mergers of UCITS funds;
  \item[\textit{d}] to strengthen the pre-investment disclosure requirements in respect of retail investors; and
  \item[\textit{e}] to simplify the notification rules for UCITS that are engaged in cross-border promotion.
\end{itemize}

Member States were required to transpose the provisions of UCITS IV into national law by 1 July 2011, although in October 2011 ESMA released an opinion discussing the consequences of the failure of Member States to complete the implementation process within the planned timetable.\textsuperscript{40}

On 3 July 2012, the Commission announced a proposal (UCITS V Proposal) to amend UCITS IV and to address what it perceived as weaknesses in the UCITS regulatory regime. In particular, the Commission outlined its concern, in the wake of events connected with the Lehman Brothers bankruptcy and the Madoff scandal,\textsuperscript{41} that UCITS allowed national laws too much flexibility to interpret the scope of the duties of UCITS depositaries and the liability for the negligent performance of those duties, with the result that there was an uneven patchwork for investors across the EU. In the UCITS V Proposal, the Commission also argued that the evolution of market practice and the investment environment within the EU had led to an increasing use of sub-custody arrangements, which may have entailed significant risk for funds as it remained unclear the extent to which a depositary was liable for sub-custodian losses. The Commission also referred to divergences as between national regulatory regimes and weaknesses that it believed were undermining the supervision of financial services within the EU, with the result that the Commission sought to introduce proposals to set common minimum standards on issues such as the appointment and the duties of depositaries.

The UCITS V Directive was published in the Official Journal of the EU (the OJ) on 28 August 2014, and Member States were required to transpose the Directive into national law by 18 March 2016.

\textsuperscript{38} Directive 2009/65/EC.  
\textsuperscript{39} Directive 2014/91/EU.  
\textsuperscript{40} ESMA opinion, Practical arrangements for the late transposition of the UCITS IV Directive, 13 October 2011.  
\textsuperscript{41} The text of the explanatory memorandum to the proposal explains that Lehman Brothers International Europe, based in the UK, went into bankruptcy in 2008 while acting as sub-custodian in connection with the assets of a number of CISs. This raised a number of issues in relation to the relevant regulatory model that, while relating to non-UCITS funds, nonetheless had substantial similarities to the UCITS depositary regime. By contrast, the Madoff scandal did involve a UCITS feeder fund where the depositary had delegated the custody of its asset portfolio to a Madoff-operated entity, and Madoff himself also acted as the manager and broker on the fund's behalf. The Commission text states that this resulted in a loss of around €1.4 billion for the relevant fund.
The following paragraphs set out an abstract of the UCITS rules as articulated at the European level.

### iii  Definition of a UCITS

A UCITS is an undertaking that has the sole object of collective investment in transferable securities or certain other specified financial assets that operate on the principle of risk-spreading, and has units that, at the request of their holders, are repurchased or redeemed, directly or indirectly, out of the undertaking’s assets.\(^{42}\)

A UCITS does not need to have a specific legal form, and may be established via contractual arrangements, trusts or companies incorporated under statute.

Certain types of funds, however, will always fall outside the scope of the UCITS regime. They include closed-ended investment funds and funds that raise capital without promoting the sale of their units to the public within the EU.\(^{43}\)

### iv  Authorisation of a UCITS

The UCITS regime requires that a UCITS fund must be authorised by its home Member State, the competent authority of which must approve the constitution and rules of the fund, the depositary chosen to hold the fund’s investments and, to the extent relevant depending on the type of UCITS, the management company.\(^{44}\) Once the UCITS has been authorised by the home state, that authorisation is valid across all Member States of the EU.

A particular irritation for some in the sector has historically been that some Member States have taken a very long time to process applications, whether for new funds or to register overseas funds. In response to this, UCITS IV provided that the competent authority of the home state must decide whether authorisation should be granted within two months of the submission of a completed application for authorisation being received. This time limit was not amended by the UCITS V regime. The fact that this time limit applies may not, however, stop applications being delayed by Member States, as there is no sanctioning mechanism if a Member State fails to comply with this rule.

### v  Investment policies of a UCITS

UCITS IV applies restrictions to the investment policies of a UCITS, setting out a range of permitted investments that include:

\(\text{a} \) transferable securities and money market instruments that are admitted to or dealt on permitted regulated markets,\(^ {45}\) or that have been admitted to official listing on a stock exchange or are dealt with on another regulated market in a third country;\(^ {46}\)

---

\(^{42}\) Article 1(2) UCITS IV.

\(^{43}\) Article 3(d) UCITS IV.

\(^{44}\) Article 5 UCITS IV.

\(^{45}\) These include regulated markets as defined in Article 4(1)(14) of MiFID, and any other regulated markets in EU Member States that operate regularly and that are recognised and open to the public.

\(^{46}\) Provided that such exchange or market has been approved by the relevant competent authorities, or is otherwise provided for in law, in the rules of the fund or in the instrument of incorporation of the investment company (Article 50(1)(c) UCITS IV).
b recently issued transferable securities, provided that these have been issued subject to terms requiring that an application will be made for them to be admitted to official listing on a suitable stock exchange or other suitable regulated market,\textsuperscript{47} and they are admitted within a year of issue;

c units of other UCITS (thereby permitting funds of funds);

d units of other CISs provided that these meet certain conditions (essentially an equivalent level of protection for unitholders to that provided for unitholders of a UCITS);

e deposits with credit institutions that can be withdrawn or are repayable on demand, or that mature in no more than 12 months. The relevant credit institution must either have its registered office inside the EU or in a third country where it is subject to prudential rules considered by the competent authorities of the UCITS’ home state to be equivalent to the prudential requirements laid down in EU law (an approved credit institution);

f financial derivatives (which may be dealt with on a suitable regulated market or may be over-the-counter (OTC) derivatives), provided that these meet certain specified requirements; and

g certain money market instruments that are not dealt on a regulated market but that are issued by entities meeting certain specified criteria (which essentially cover low-risk issuers such as central banks, issuers listed on certain regulated markets or issuers who meet certain minimum capital requirements).

The investments eligible for UCITS investment have frequently been interpreted differently in Member States, and this has been a cause of uncertainty, so much so that the Eligible Assets Directive\textsuperscript{48} was introduced in 2007 in an attempt to improve consistency in relation to eligible and ineligible investments.

In addition to prescribing eligible investments, the UCITS regime includes rules on concentrations of investments so that all UCITS meet a minimum level of investment diversification. Those rules, which are relatively complex, include that:

a a UCITS may invest no more than 5 per cent of its assets in transferable securities or money market instruments issued by any single body, or 20 per cent of its assets in deposits made with the same body;

b a UCITS may invest no more than:

- 20 per cent of its assets in transferable securities and money market instruments issued by entities belonging to the same group;
- 20 per cent of its assets in a single body; or
- 10 per cent of its assets in the units of a single UCITS or other collective investment undertaking, provided that Member States may raise this limit to a maximum of 20 per cent;

c the exposure from OTC derivatives transactions to any one counterparty must not exceed 5 per cent of the assets (or 10 per cent where the counterparty is an approved credit institution); and

\textsuperscript{47} Any such regulated market must operate regularly and be recognised and open to the public. The stock exchange or regulated market must also have been approved by the competent authorities, or have been provided for in law or the rules of the fund or in the instrument of incorporation of the investment company (Article 50(1)(d)(i) UCITS IV).

\textsuperscript{48} Directive 2007/16/EC.
subject to the right of Member States to waive the following requirements, a UCITS may acquire no more than:

- 10 per cent of the non-voting shares of a single issuing body;
- 10 per cent of the debt securities of a single issuing body;
- 25 per cent of the units of a single UCITS or other collective investment undertaking; or
- 10 per cent of the money market instruments of a single issuing body.

Member States may raise the 5 per cent limit referred to in (a) above:

a to a maximum of 10 per cent on the condition that the total value of the transferable securities and money market instruments held by the UCITS in the issuing entities in which it holds over 5 per cent of its assets do not in the aggregate exceed 40 per cent of the value of the UCITS’ assets);

b to a maximum of 35 per cent of its assets in transferable securities or money market instruments that are issued or guaranteed by a Member State, its local authorities, the government of a third-party country or a public international body of which a Member State is a member,\(^4\) provided that Member States may derogate from this limit to authorise UCITS to invest up to 100 per cent of their assets in government securities if they consider that the unitholders of the UCITS have equivalent protection to that of the unitholders in a UCITS that did comply with the general limits; or

c insofar as it relates to bonds issued by a credit institution that has its registered office in a Member State and that is subject to public legal supervision designed to protect its bondholders, up to 25 per cent of its assets in such bonds. However, if more than 5 per cent of the UCITS’ assets are invested in bonds issued by a single issuer, the total value of its investment in all such bonds must not exceed 80 per cent of the total value of its assets.\(^5\)

These investment restrictions are considerably less onerous than the original restrictions contained in UCITS I. This has led to the evolution of the newcits phenomenon, whereby hedge funds have begun to take advantage of the ability to market themselves across the EU using the UCITS regime. In particular, it has become possible for UCITS to take an economic exposure in underlying hedge funds through the use of OTC derivatives (which under UCITS I were only permitted as a means of portfolio management and were not allowed to be used as investments in themselves), allowing retail investors to effectively invest in hedge funds through the UCITS structure. This has led to calls for UCITS to be split into complex and simple categories, with the former requiring more detailed risk warnings if they are to be sold to retail investors.

vi **UCITS management companies**

Like UCITS themselves, UCITS management companies must be authorised by the competent authorities of their home state, but once granted, such authorisation is valid throughout the EU.\(^6\)

---

49 Under Article 52(5) UCITS IV, such government securities or money market instruments do not need to be taken into account when the 40 per cent limit referred to in (a) is applied.

50 Article 52(4) UCITS IV.

51 Article 6(1) UCITS IV.
Management companies may only carry out a limited range of activities, which consist principally of management of UCITS and other CISs (where subject to prudential supervision) and, where permitted by the relevant Member State, certain other services such as investment management of certain permitted investment portfolios, or other non-core services providing investment advice in relation to certain permitted investments and safeguarding and administering units in CISs.  

Management companies must meet the following requirements before authorisation may be granted by the relevant Member State:

- the management company must have an initial capital of at least €125,000 (plus an additional 0.02 per cent of the amount by which the portfolios under management by the company exceed €250 million, provided that the total required initial capital does not exceed €10 million);  
- the individuals who conduct the business of the management company must be of sufficiently good repute and sufficiently experienced in relation to the type of UCITS being managed;  
- the head office and the registered office of the management company must be located in the same Member State;  
- if the management company has close links with other natural or legal persons, those links must not prevent the effective exercise of the supervisory functions of the relevant home state regulator;  
- the home state competent authorities must be provided with the identities and holding amounts of all shareholders or members who hold, directly or indirectly, 10 per cent or more of the capital or voting rights in the management company, and the competent authorities must be satisfied that such shareholders or members are suitable; and  
- if the management company is a subsidiary, or controlled by the same person that controls an investment firm, credit institution or insurance undertaking authorised in another Member State, the competent authorities of that other Member State must be consulted before any authorisation is granted.

In addition to meeting the initial requirements for authorisation, UCITS management companies must also meet certain ongoing operating conditions. Broadly speaking, these require management companies to:

- maintain minimum levels of regulatory capital;  
- observe prudential rules drawn up by the Member State in which the management company has been authorised;  
- have sound administrative and accounting procedures.

52 Article 6(3) UCITS IV.  
53 Article 7(1)(a) UCITS IV.  
54 Article 7(1)(b) UCITS IV.  
55 Article 7(1)(d) UCITS IV.  
56 Article 7(2) UCITS IV.  
57 Article 8(1) UCITS IV.  
58 Article 8(3) UCITS IV.  
59 Article 10(1) UCITS IV.  
60 Article 12(1) UCITS IV.  
61 Article 12(1)(a) UCITS IV.
d minimise conflicts of interest between itself and a client, between two of its clients, between a client and the underlying UCITS being managed, and between two UCITS;62 and
e establish proper procedures to handle investor complaints and ensure that the rights of investors to complain are not restricted as a result of the fact that the management company may be authorised in a Member State other than the home Member State of the relevant UCITS.63

The UCITS regime also requires management companies to establish and apply remuneration policies and practices that are consistent with, and promote, sound and effective risk management, and that neither encourage risk taking that is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS that they manage, nor impair compliance with the management company’s duty to act in the best interest of the UCITS.64

UCITS IV sets out principles that UCITS management companies must comply with when establishing and applying their remuneration policies, and these principles remain unchanged by UCITS V. For example, UCITS management companies must have remuneration policies that promote sound and effective risk management, and that do not encourage risk-taking or impair a management company’s duty to act in the best interests of the UCITS.65 At least half of the variable part of the remuneration of management companies must be paid in assets of their UCITS, unless the management of the UCITS accounts for less than half of the total portfolio.66 Payment of at least a further 40 per cent of this variable remuneration (or 60 per cent if the variable remuneration is of a particularly high amount) is to be deferred for a minimum of three years67 to encourage managers to take a long-run view. ESMA published further guidelines on these remuneration principles in March 2016, which came into force in January 2017.68

UCITS IV also contains detailed provisions relating to the freedom to provide cross-border services and the freedom of establishment for management companies within the EU. These make clear that a UCITS is free to be managed by a company that is authorised in a Member State other than the UCITS’ home Member State,69 while management companies are also permitted to establish branches in other Member States subject to compliance with certain notification requirements.70

62 Article 12(1)(b) UCITS IV.
63 Article 15 UCITS IV.
64 Article 14a UCITS IV.
65 Article 14a UCITS IV.
66 Article 14b(1)(m) UCITS IV.
67 Article 14b(1)(n) UCITS IV.
69 Article 16(3) UCITS IV.
70 Article 17 UCITS IV.
vii UCITS depositaries

UCITS must entrust the safe custody of their assets to a depositary for safekeeping. It is the responsibility of the depositary to ensure the following:

- sales, issues, repurchases, redemptions and cancellations of the units effected on behalf of a common fund comply with applicable national laws and the fund’s constitution and rules;
- the value of the units is calculated in accordance with the applicable national law and the fund’s constitution and rules;
- any instructions of the management company are carried out, unless they conflict with applicable national laws or the fund’s constitution and rules;
- any sums due to the fund or securities acquired are remitted to the fund within specified time limits;
- income is applied in accordance with applicable national laws and the fund’s constitution and rules;
- the cash flows of the UCITS are properly monitored and, in particular, that all payments made by, or on behalf of, investors upon the subscription of units of the UCITS have been received, and that all cash of the UCITS has been booked in cash accounts that must meet certain specified conditions;
- ensure the safekeeping of the UCITS’ assets;
- on a regular basis, provide the management company of the investment company of the UCITS with a comprehensive inventory of the UCITS’ assets; and
- subject to limited exceptions, ensure that the UCITS’ assets are not reused by the depositary, or any third party to which custody function has been delegated, for their own account.

The depositary must have its registered office or must be established in the home state of the UCITS. The depositary must also be a national central bank, a credit institution authorised under the CRD IV Directive or an entity authorised by a national competent authority to carry out depositary activities. An entity authorised to carry out depositary activities shall be subject to capital adequacy requirements and own funds requirements, prudential regulation and ongoing supervision, and must also satisfy certain minimum requirements, including establishing policies and procedures to ensure compliance with UCITS IV, and for all members of its management body and senior management to be of sufficiently good repute and possess sufficient knowledge, skills and experience.

UCITS IV prohibits an entity from acting as both the management company and the depositary of a UCITS, and the entities fulfilling these roles must act independently and solely in the interests of the unitholders.

In relation to sub-custody, Article 24 of UCITS IV previously stated that a depositary shall be liable for loss as a result of its ‘unjustifiable failure to perform its obligations or its improper performance of them’. This wording was interpreted differently by Member States, as was highlighted in the Madoff insolvency when Luxembourg-based depositaries were found to have a materially lower level of duties when compared with their French equivalents. To

---

71 Articles 22 UCITS IV.
72 Article 23(1) UCITS IV.
73 Directive 2013/36/EU.
74 Article 25 UCITS IV.
address this divergence, UCITS V amended UCITS IV to clarify when a depositary’s duties can be delegated to a sub-custodian. Article 24 of UCITS IV now provides that a depositary’s liability for the loss of financial instruments held in custody is not generally affected by delegation to a sub-custodian, and a depositary is not able to exclude its liability through contractual arrangements. However, a depositary will not be liable if it can show that the loss is a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. UCITS V explicitly notes that this liability of depositaries differs from the position under the Alternative Investment Fund Managers Directive (AIFMD)\(^\text{75}\) (particularly in relation to contractual modification of liability), but explains that, as the UCITS regime is designed to protect retail investors, such a divergence is justifiable.

In December 2015, the Commission adopted the 2016 Delegated Regulation\(^\text{76}\) setting out the detailed Level 2 measures that relate to depositaries. The 2016 Delegated Regulation has been applicable since 13 October 2016 and includes provisions relating to:

\(a\) the minimum requirements for contracts between the management company or the investment company and the depositary;

\(b\) obligations on the depositary relating to oversight, due diligence, segregation and insolvency protection;

\(c\) the conditions and circumstances in which financial instruments held in custody are considered to be lost and how the depositary can discharge its liability; and

\(d\) independence requirements for management companies, investment companies, depositaries and third parties to whom the safekeeping function has been delegated.

On 12 July 2018, the Commission adopted the 2018 Delegated Regulation,\(^\text{77}\) further specifying depositaries’ duties with regard to the safe-keeping of UCITS’ assets under Article 22a(3)(c) of UCITS IV, a topic addressed by the 2016 Delegated Regulation. That provision of UCITS IV requires that where a depositary delegates safe-keeping functions to third parties (custodians), the assets also need to be segregated at the level of the delegate. The 2018 Delegated Regulation seeks to restrict the scope for divergent national applications of Article 22a(3)(c) of UCITS IV, identified by ESMA in an opinion on asset segregation.\(^\text{78}\) The 2018 Delegated Regulation entered into force on 20 November 2018, and will apply from 1 April 2020.

It is clear that, as a result of the changes introduced by UCITS V and those introduced by the 2016 Delegated Regulation and the 2018 Delegated Regulation, there is greater exposure for depositaries. The consequences remain open to question, with some predicting significant fee increases, and others the concentration of depositories to a very small number of global custodians who have the expertise and coverage necessary to provide the enhanced level of protection. The answer is likely to be a combination of both.

\(^{75}\) Directive 2011/61/EU.


Chapter VI of UCITS IV contains rules designed to facilitate both domestic and cross-border mergers of UCITS funds, and again, the UCITS V regime does not amend these rules. There are three different methods of merging UCITS:

a. the merging UCITS is dissolved without going into liquidation, and transfers all of its assets and liabilities to a second UCITS in exchange for the issue of units to its unitholders (with, if applicable, a cash payment not exceeding 10 per cent of the net asset value);

b. two UCITS are dissolved without going into liquidation, and transfer all of their assets and liabilities to a new UCITS in exchange for the issue to their unitholders of units (possibly with a cash payment not exceeding 10 per cent of the net asset value); or

c. a UCITS transfers its assets to a newly formed UCITS or another existing UCITS, but is not dissolved and continues to exist until its liabilities have been discharged.

A merger must be authorised by the competent authorities of the home Member State of each merging UCITS. Those authorities must be provided with certain key information, including the terms of the proposed merger. The competent authorities of the merging UCITS’ home Member State will then forward that information to the competent authorities of the other UCITS’ home Member State, which may require that the information to be given to unitholders is modified.

The competent authorities of the home state of the merging UCITS must authorise the merger if:

a. the competent authorities in the home states of both the merging and receiving UCITS are satisfied with the information that it is proposed to be provided to unitholders;

b. the receiving UCITS has been approved to market its units in the Member State and in all Member States where the merging UCITS has been approved to market its units; and

c. certain other requirements have been met, such as the validation of the criteria used to value the assets of the relevant UCITS in order to calculate the relevant exchange ratio by the depositary.

If the national laws of Member States require unitholders to vote to approve the merger, the approval must not require more than 75 per cent of the votes cast at a unitholders’ general meeting. The quorum requirements cannot be more onerous for cross-border UCITS mergers than for domestic UCITS mergers, and cannot be more onerous for UCITS mergers than for corporate mergers.

In practice, the merger of a UCITS is a process hampered by bureaucratic and taxation hurdles, despite the rules in UCITS IV. These hurdles include the costs involved in notifying all the investors in funds that are merging, the time delay in obtaining regulatory approval for the communications to investors, and the differing tax treatments of the portfolio.

79 These methods also apply, mutatis mutandis, to the merger of investment compartments of UCITS.
80 Article 39(2) UCITS IV. Under Article 39(5), if the competent authorities of the merging UCITS' home Member State consider that the information provided is not complete, they may request additional information within 10 working days of receiving the original information. The merging and receiving UCITS are required to draw up common draft terms of merger under Article 40.
81 Article 44 UCITS IV.
transfer, cancellation and issue of units. Despite the undoubted scope for cross-border fund mergers – European funds are typically much smaller and more expensive than their counterparts in North America – there has been no significant increase in merger activity. Whether the taxation and bureaucratic impediments to a more efficient investment fund market within the EU can be removed, or at least materially reduced, depends on the politics of individual Member States; however, the omens are not favourable, at least in the short term.

ix Master-feeder UCITS structures

UCITS IV allows the use of feeder UCITS. These are UCITS that, by way of exception to the general rules preventing concentrations of investment by UCITS, are permitted to invest up to 85 per cent of their assets in another UCITS (a master UCITS). The 15 per cent balance may be held in ancillary liquid assets, derivatives used only for hedging purposes or property that is essential for the direct pursuit of the business. A master UCITS must have at least one feeder UCITS among its unitholders, may not itself be a feeder UCITS and may not hold units in any feeder UCITS.

Before a feeder UCITS can invest in a master UCITS, it must obtain the approval of the competent authorities of the feeder UCITS’ home state. If the feeder UCITS is established in a different Member State, the feeder UCITS must obtain an attestation from the competent authorities of the Member State of the master UCITS that the master UCITS is not a feeder UCITS and has not invested in a feeder UCITS.

The feeder UCITS is required to enter into an agreement with the master UCITS under which the master UCITS will supply the feeder with all necessary documents and information required under the master-feeder relationship. Where the master and feeder UCITS use different depositaries, those depositaries must also enter into an agreement to share information to allow both depositaries to fulfil their duties under UCITS IV.

These provisions, while bureaucratic and time-consuming to satisfy, nevertheless do represent a welcome change given the many benefits, in particular from economies of scale, that master-feeder structures can deliver. In the context of Europe, feeder structures are expected to be used principally to reflect the differing taxation regimes applicable to investors depending on their respective Member State. It is expected that they will be an increasing feature of investment fund structures unless and until a full harmonisation of personal and institutional taxation takes place (which is currently a very unlikely prospect).

x Investor information requirements

Chapter IX of UCITS IV contains requirements about the information that must be provided to UCITS investors. Broadly speaking, a UCITS must publish a prospectus, an annual report for each financial year within four months of the end of that year and a half-yearly financial report within two months of the half-year end.
The prospectus is required to contain all the information necessary for investors to make an informed judgement about investing in the UCITS and the risks attaching to that investment. In addition, independently from the information provided about the investment instruments themselves, the prospectus must contain a clear explanation of the general risk profile of the UCITS and the details or summary of the remuneration policy.\textsuperscript{90} The minimum content requirements for prospectuses are set out in Schedule A of Annex 1 of UCITS IV, including those related to general details of the UCITS, the rights attaching to units, its investment objectives, and its rules relating to income and asset valuation. The prospectus must also indicate the categories of assets in which the UCITS is permitted to invest and explain its approach to the use of derivatives.\textsuperscript{91}

The annual report of a UCITS must include:
\begin{enumerate}
\item a balance sheet or a statement of assets and liabilities;
\item an income and expenditure account for the relevant financial year;
\item a report on its activities during the financial year; and
\item information on the number of units in circulation, the net asset value per unit and comparative tables showing that information for the past three financial years.
\end{enumerate}

There are also content rules for half-yearly reports.

In addition, UCITS IV introduced a requirement for UCITS to provide key investor information to investors designed to assist them in making key investment decisions on an informed basis. This document must contain certain essential elements, including:
\begin{enumerate}
\item identification of the UCITS and its competent authority;
\item a description of its investment objectives and its investment policy;
\item a presentation of the UCITS’ past performance or performance scenarios;
\item the UCITS’ costs and associated charges; and
\item a risk-reward profile of the investment in the UCITS, including any appropriate guidance and warnings in relation to the risks that are associated with any investments in the UCITS.\textsuperscript{92}
\end{enumerate}

UCITS V introduced requirements that the key investor information also:
\begin{enumerate}
\item clearly specifies where and how to obtain additional information relating to the proposed investment, including but not limited to where and how the prospectus and the annual and half-yearly reports can be obtained on request and free of charge at any time, and the language in which such information is available to investors; and
\item includes a statement of the details of the up-to-date remuneration policy including, but not limited to, the following:
\begin{itemize}
\item a description of how remuneration and benefits are calculated;
\item the identities of persons responsible for awarding the remuneration and benefits, including the composition of the remuneration committee (where such a remuneration committee exists): these must be made available by means of a website; and
\item a reference to that website, and the fact that a paper copy will be made available free of charge upon request.
\end{itemize}
\end{enumerate}

\textsuperscript{90} Article 69(1) UCITS IV.
\textsuperscript{91} Article 70(1) UCITS IV.
\textsuperscript{92} Article 78(3) UCITS IV.
The information must be presented in a manner comprehensible to an investor without requiring reference to information in any other documents. There is a general requirement for all key investor information to be written in concise and non-technical language and drawn up in a common format to allow for easy comparison by investors. To encourage consistency, ESMA provides a template on its website that may be used as the basis of a key investor information document (KIID).

Investors (in particular retail investors) will receive, before units can be purchased, the KIID, on the principle that the UCITS structure is simple enough and sufficiently well regulated that the KIID provides enough basic information to permit an informed investment decision. In particular, the principal advantage of the KIID may prove to be that it can be used as a pan-European template, although language differences may limit the possibilities for economies of scale.

Sanctions for breach of UCITS requirements

UCITS IV and UCITS V set out broad categories of UCITS breaches for which national regulators must provide penalties, and lists the administrative sanctions and measures that competent authorities should be empowered to apply, including:

a. public warnings or statements of censure identifying the person responsible and the nature of the breach;

b. temporary suspension or permanent withdrawal of UCITS or management company authorisation;

c. effective, proportionate and dissuasive administrative pecuniary sanctions up to a maximum of €5 million or 10 per cent of annual turnover for companies, and up to a maximum of €5 million for individuals; and

d. fines of up to twice the amount of any profits gained or losses avoided as a result of the breach.

The competent authorities of Member States will be required to publish any sanctions or measures imposed, and simultaneously report to ESMA, which should also publish an annual report on all sanctions imposed.

Future outlook – UCITS VI proposal

In July 2012, shortly after the UCITS V legislative proposal, the Commission published a consultation on UCITS VI. The consultation did not contain any specific proposals, but asked general questions on the following areas:

a. eligible assets and the use of derivatives;

b. efficient portfolio management techniques;

c. OTC derivatives;

d. extraordinary liquidity management rules;

e. a depository passport;

f. money market funds (MMFs);

93 Article 78(5) UCITS IV.
95 Article 99(6) UCITS IV.
long-term investments; and
improvements to elements of UCITS IV.

In particular, the consultation focused on self-managed investment companies, master-feeder structures, fund mergers and notification procedures.

The Commission received responses to the consultation, but did not publish a legislative proposal. No legislative proposal on UCITS VI is anticipated in the short term. Indeed, in a speech in November 2014, Steven Maijoor, the Chair of ESMA, stated that many of the pressing issues that might have called for the introduction of UCITS VI were being dealt with in other initiatives such as the introduction of an MMF Regulation (see Section X) and issues relating to securities lending, repo and reverse repo activity, which had been addressed through guidelines originally issued by ESMA in December 2012 on ETFs and other UCITS issues. Similarly, a Regulation on European long-term investment funds (ELTIFs) was introduced to establish a new type of collective investment vehicle that allows investors to make long-term investments (i.e., ‘patient capital’) in companies and projects (see Section XIII).

On 16 April 2019, the Parliament adopted a Directive and a Regulation on the cross-border distribution of collective investment funds that contain new provisions intended to harmonise the rules governing the marketing of investment funds across the EU, and amends the UCITS Directive and the AIFMD (the Cross-border Funds Marketing Directive and the Cross-Border Funds Marketing Regulation respectively). The Directive and the Regulation were published in the OJ on 12 July 2019, and entered into force on 1 August 2019. Member States will be required to transpose the provisions of that Directive within 24 months of it coming into force. The Directive introduces obligations on UCITS management companies to provide local facilities to support investors (for instance, facilities to process subscriptions, repurchase and redemption orders, and to make other payments to unit-holders relating to the units of the UCITS). UCITS management companies will also be required to send a written notification containing certain prescribed information to the competent authorities of its home Member State if it wishes to market a UCITS in another Member State. The Directive will also provide for the ‘denotification’ of UCITS, subject to certain conditions being met, where the management company determines that it no longer wishes to market a UCITS in a Member State. The Regulation provides for certain additional rules relating to marketing communications to investors.

V THE AIFMD

Background

Even before the onset of the financial crisis, EU politicians, and to a lesser extent regulators, had sought to review regulatory policy in relation to the AIF industry, which was rapidly

---

expanding and was seen by many as an unregulated segment of the financial services market. There were concerns related to lack of transparency, short-termism, remuneration practices and the potential threat to financial stability posed by hedge funds that employ overly high levels of leverage. There was also criticism of the private equity industry and the perceived (at least by some) negative consequences on target companies of leveraged buyouts in which a target company’s assets are used to repay the acquisition financing. The onset of the financial crisis provoked a global regulatory consensus on the need to reform the shadow banking sector, and fuelled a renewed focus on the activities (and regulation) of the AIF industry.

After 18 months of political debate within the EU institutions, on 11 November 2010 the Parliament adopted a final, agreed text of the AIFMD, which was formally approved by the Council on 27 May 2011. The AIFMD came into force on 21 July 2011, and the deadline for implementation by Member States was 22 July 2013. As the AIFMD is a directive, it is not directly applicable, and Member States must implement it into national law.

The stated objective of the AIFMD is to ensure that all managers of AIFs are authorised and subject to harmonised regulatory standards across the EU. Note that the AIFMD regulates fund managers operating within the EU rather than directly regulating the funds themselves, many of which may be based offshore.

A particular complication is that the vast majority of hedge funds managed within the EU are managed from London, which is also responsible for a significant portion of other non-UCITS investment funds marketed or managed in the EU. There is widespread concern, not least in London, that this very successful industry may be harmed by regulation that places more emphasis on harmonisation than on international competitiveness.

### Overview of the AIFMD

The AIFMD applies to AIFMs, meaning any person whose regular business is managing one or more AIFs. Managing means the provision of portfolio management services and risk management services, and an AIF is any CIS that is not covered by the UCITS regime.\(^\text{100}\) As well as applying to AIFMs that manage or market AIFs (wherever those funds are established) in the EU, the AIFMD also applies to AIFMs established outside the EU that manage AIFs established in the EU, and to non-EU AIFMs that market one or more AIFs (wherever established) within the EU.\(^\text{101}\) The AIFMD has a very wide scope, with few exemptions, but AIFMs that manage AIFs the value of whose assets under management fall below specified thresholds are exempt from most of the provisions of the AIFMD.\(^\text{102}\)

Key features of the AIFMD include:

- **a** AIFMs that manage AIFs must be authorised. To be authorised, an AIFM must, among other conditions, exceed minimum capital requirements;
- **b** restrictions on the levels of remuneration for senior management and risk-takers;
- **c** AIFMs must be able to show that specific safeguards are in place against conflicts of interest;
- **d** AIFMs will be required to manage and monitor liquidity risks and conduct regular stress tests;
- **e** AIFMs will be required to set a maximum level of leverage for each AIF;

\(^{100}\) Article 4(1)(a) and (b) AIFMD.

\(^{101}\) Article 2(1) and (2) AIFMD.

\(^{102}\) Articles 2 and 3 AIFMD.
extensive requirements in relation to the valuation of managed assets, delegation of the AIFM’s functions and the use of a depositary to safeguard an AIF’s assets;

business conduct principles for AIFMs, including requirements to act with due skill, care and diligence, and to act in the best interests of the AIF and its investors;

a requirement to produce annual reports, and to make disclosures to investors and regulators on an ongoing basis;

restrictions on asset stripping; and

a marketing and passport regime that will, for the first time, enable an EU AIFM authorised in its home state to manage and market EU AIFs both domestically and in other Member States without requiring additional authorisation in those other Member States.103

Details on the key features of the AIFMD listed above, as implemented in the national law of Member States, are outlined in the national chapters.

iii Level 2 measures and Level 3 guidance

The provisions of the AIFMD outline the framework of the regime, but the details have been determined by Level 2 implementing measures.

The Commission has adopted a delegated regulation104 on exemptions, general operating conditions, depositaries, leverage, transparency and supervision. This regulation is directly applicable in all Member States, and has applied since 22 July 2013. The delegated regulation includes provisions relating to:

- the calculation of assets under management and leverage;
- additional own funds and professional indemnity insurance;
- conflicts of interest;
- risk and liquidity management;
- delegation of AIFM functions;
- transparency obligations to both investors and supervisory authorities.

Marketing is defined in the AIFMD as the direct or indirect offering or placement of units or shares in an AIF to, or with, investors domiciled in the EU. Significantly, this does not include marketing that is independent of the AIFM marketing to investors outside the EU or passive marketing, where the initiative is taken by the investor rather than the AIFM.

This extremely important concession continues to allow European pension funds and other experienced investors to access hedge funds, in particular the 70 per cent managed in the US, without the funds having to comply with the AIFMD.

The question of whether to make the passporting regime available in respect of non-EU AIFs and AIFMs was the subject of heated debate prior to the publication of the AIFMD. The compromise that was adopted involves the deferral of the non-EU passporting provisions set out in the AIFMD. This was initially expected to be deferred until 2015, though this has since been delayed until further notice. ESMA published preliminary advice on the extension of the passporting regime in July 2015 and final advice in July 2016. The Commission has so far not acted upon the final advice provided by ESMA, and in the meantime national private placement regimes continue to operate. ESMA did publish a report on the findings of its thematic study on notification frameworks and home-host responsibilities under UCITS IV and the AIFMD in April 2017, which aims to facilitate the smooth operation of EU passports for marketing and management of UCITS and AIFs.

---

103 Marketing is defined in the AIFMD as the direct or indirect offering or placement of units or shares in an AIF to, or with, investors domiciled in the EU. Significantly, this does not include marketing that is independent of the AIFM marketing to investors outside the EU or passive marketing, where the initiative is taken by the investor rather than the AIFM.

The contents of the delegated regulation depart from ESMA’s original advice, which has attracted criticism from a number of Member States, including the UK.105

The Commission adopted a delegated regulation to determine types of AIFMs, whether an AIFM is an AIFM of open-ended AIFs or closed-ended AIFs, and to ensure uniform conditions of application of the AIFMD, on 17 December 2013.106 In addition, the Commission adopted a delegated regulation on the information to be provided by national competent authorities to ESMA, which entered into force on 16 April 2015.107

The Commission has also adopted two implementing regulations, one to establish a procedure for determining the Member State of reference of a non-EU AIFM108 and the other to establish the procedure for AIFMs to opt in under the AIFMD.109

To supplement these Level 2 measures, ESMA has issued Level 3 guidelines. These provide guidance to national regulators in the EU as to how to implement directives, regulations and technical standards (Level 1 and 2 measures). While the guidelines are not legally binding, regulators and market participants should make every effort to comply with them. National regulators are required to incorporate these guidelines into their supervisory practices or explain why they have not done so.

On 11 February 2013, ESMA published Level 3 guidelines on sound remuneration policies under the AIFMD.110 A final report on the revision of these guidelines was published in March 2016, and the amended guidelines came into force on 1 January 2017. ESMA has also published guidelines on key concepts of the AIFMD111 that give guidance on the definition of an AIF,112 Q&As on the application of AIFMD,113 and guidelines114 on reporting obligations under the AIFMD that set out the information AIFMs should report to regulators and the times when reports must be made.

On 7 April 2017, ESMA published the findings of its thematic study on notification frameworks and home host responsibilities under the AIFMD and the UCITS Directive.115 ESMA subsequently produced opinions regarding the delegation model on 17 and 20 July 2017.116 For further detail on the impact of ESMA’s actions in light of Brexit, see the United Kingdom chapter.

106 Available at ec.europa.eu/internal_market/investment/docs/alternative_investments/131217_delegated-regulation_en.pdf.
107 Available at eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0514&from=EN.
112 Article 4(1)(a) AIFMD.
113 ESMA, Questions and Answers – Application of the AIFMD, 5 October 2017.
115 ESMA, Notification frameworks and home-host responsibilities under UCITS and AIFMD – Thematic Study among National Competent Authorities, 7 April 2017.
116 ESMA, Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union, 13 July 2017; and ESMA, Opinion - Asset segregation and application of depositary delegation rules to CSDs, 20 July 2017.
The reforms to the rules on marketing to investors that have been introduced by the Cross-Border Funds Marketing Regulation also apply in respect of the marketing by AIFMs or AIFs.

In addition, on 30 October 2018 a delegated regulation to amend the AIFMD Level 2 Regulation as regards safe-keeping duties of depositaries was published in the OJ. That Regulation entered into force on 19 November 2018.\textsuperscript{117} Although securities and insolvency laws are not harmonised across the EU, the delegated regulation attempts to harmonise rules on safe-keeping of AIF assets by ensuring the clear identification of those assets when they are held by a third-party custodian. The delegated regulation will apply from 1 April 2020.

In accordance with its obligations under Article 69 of the AIFMD, on 10 December 2018, the Commission published a report on the application and scope of the AIFMD.\textsuperscript{118} The report set out the Commission’s view that the AIFMD had ‘played a major role in helping to create an internal market for AIFs and a harmonised and stringent regulatory and supervisory framework for AIFMs’.\textsuperscript{119} The report identified certain areas of the application of the AIFMD for further consideration, including, among others, inadequate and duplicative reporting requirements, particularly when other EU reporting requirements are taken into account, and a lack of transparency in relation to the application of the marketing passport due to Member States taking different approaches to interpreting the meaning of ‘marketing’ for the purposes of the AIFMD.

In relation to the AIFMD, the Cross-border Funds Marketing Directive aims to clarify the scope of ‘pre-marketing’ activities that an EU AIFM may engage in without making a prior notification to the competent authority in its home Member State, and introduces a notification procedure for AIFMs that wish to discontinue marketing activities in a Member State.

VI SOLVENCY II

i Current regime

The insurance sector is a key provider of the funds under discretionary fund management. This reflects the fact that insurers hold assets and capital to meet their liabilities to policyholders and satisfy their regulatory capital requirements.

ii Overview

The Solvency II Directive (Solvency II)\textsuperscript{120} came into force on 1 January 2016, and introduces a new, harmonised EU-wide insurance regulatory regime, replacing various EU insurance


\textsuperscript{119} ibid, page 4.

\textsuperscript{120} Directive 2009/138/EC.
directives including the Recast Life Directive. The key objectives of Solvency II are improved protection of policyholders, a move towards a more risk-based approach to prudential regulation and harmonisation of national supervisory regimes.

Further detail of the regime is set out in the Solvency II Delegated Regulation (Level 2), which was published by the Commission on 10 October 2014 and came into force on 18 January 2015. EIOPA has published Implementing Technical Standards and Guidelines supplementing Level 1 and Level 2.

The Solvency II regime is divided into three areas known as pillars: quantitative requirements; governance, risk management and supervisory review; and disclosure and transparency. It applies to all EU insurers and reinsurers, subject to some very limited exceptions. Solvency II has been subject to subsequent amendments.

The Commission proposals reforming the ESFS, mentioned in Section II.v, will also amend Solvency II, giving EIOPA a greater role in contributing to supervisory convergence.

On 5 April 2018, the Commission published a report discussing concerns and issues surrounding the implementation of Solvency II. It discusses EIOPA’s concerns with regards to group supervision, including the definition of group supervision.

**Capital requirements**

Firms are required to establish technical provisions reflecting their expected future liabilities to policyholders and to hold assets sufficient to cover those technical provisions. In addition, firms need to have capital to cover the minimum capital requirement (MCR), which is the minimum level of solvency below which a firm risks the withdrawal of its authorisation, and the solvency capital requirement (SCR), which is a higher level of capital below which supervisory intervention will be triggered. In exceptional circumstances, national supervisors have the discretion to require an insurer to maintain further capital in addition to the SCR, known as the capital add-on. The types of capital (referred to in Solvency II as own funds) that insurers may use to satisfy the MCR and SCR are classified by means of a system that classifies own funds into three tiers according to the extent to which they possess the characteristics of permanent availability and subordination, with Tier 1 being the highest of the tiers. Limits will apply to the amounts of Tier 2 and Tier 3 own funds that can be used to meet a firm’s capital requirements.

---

121 Directive 2002/83/EC.
123 Article 4 Solvency II.
124 For example, amendments in line with the Securitisation Regulation (EU) 2017/2402.
128 See Section 2, Chapter VI Solvency II.
The SCR can be calculated either in accordance with a standard formula detailed in the Level 1 text (with greater detail in the corresponding Level 2 implementing measures) or using an internal model developed by the undertaking and approved by the relevant supervisory authority. The SCR calculated on the basis of the standard formula comprises a basic solvency capital requirement, a capital requirement for operational risk and an adjustment for the loss-absorbing capacity of technical provisions and deferred taxes. The basic solvency capital requirement consists of various risk modules, including to cover underwriting risk, market risk and counterparty default risk. The market risk module is based on stress testing of the insurer’s assets, the results of which govern the level of capital charge that particular assets will attract. Quantitative Impact Study 5, undertaken by EIOPA to assess the impact of the new regime, highlighted potentially higher capital charges for the following types of investment (relative to assets with similar risk profiles):

a property;
b other equities, which include most hedge funds, commodities and equities not listed in the EEA;
c non-EEA sovereign bonds; and
d structured products such as mortgage-backed securities.

There has been speculation that these capital requirements may change an insurer’s asset allocation, as the new capital charges focus attention on the balance of risk and reward within investment portfolios.

**Prudent person principle**

The concept of admissible assets no longer applies under Solvency II. Instead, it is replaced by a prudent person principle, which provides requirements relating to the investment of insurers’ assets. The key requirements are that:

a insurers only invest in assets and instruments whose risks can be properly monitored, managed and controlled;
b all assets must be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole;
c derivative instruments may be used only insofar as they contribute to a reduction of risks or facilitate efficient portfolio management; and
d assets held to cover technical provisions shall be invested in a manner appropriate to the nature and duration of the insurer’s liabilities, and in the best interests of policyholders and beneficiaries.

The matching requirements for linked contracts contained in the Recast Life Directive have been carried over into Solvency II. Linked business is also subject to the prudent person principle, subject to some exceptions. In particular, the restriction on the use of derivatives will not apply. Limitations have also been introduced on the extent to which Member States can restrict the types of assets or reference values to which policy benefits may be linked.

---

129 Article 103 Solvency II.
130 Article 104 Solvency II.
131 Article 132 Solvency II.
132 Article 132(4) Solvency II.
(permitted links). Under Solvency II, Member States cannot restrict linked policies issued to institutional policyholders, and cannot for any linked policies impose greater investment restrictions than those applicable to a UCITS under the UCITS Directive.133

**Look-through principle**

Solvency II introduces a greater focus on transparency of investments, involving a look-through approach to risk assessment whereby, for the purposes of the SCR calculation, the underlying investments held by investment funds in which an insurer is invested are treated as direct holdings.134 This may be a challenge for managers of funds of funds as, if insurers are to invest, the managers will need to be able to provide detailed information on the underlying portfolio.

**Disclosure and reporting**

Firms are required to produce a solvency and financial condition report on an annual basis, which must contain the following information in relation to a firm:

a. its business and performance;
b. its system of governance and an assessment of its adequacy for the risk profile of the firm;
c. risk exposure, concentration, mitigation and sensitivity for each category of risk;
d. the bases and methods used for the valuation of assets, technical provisions, and other liabilities; and
e. capital management, including (at least):
   • the structure and amount of own funds, and their quality;
   • the amounts of the SCR (including, subject to a transitional Member State option, any capital add-on) and the MCR;
   • the option used for the calculation of the SCR;
   • an explanation of the main differences between the underlying assumptions of the standard formula and the internal model used for the SCR calculation, where relevant; and
   • the amount of any non-compliance with the MCR or any significant non-compliance with the SCR during the reporting period, and an explanation of the reasons for and impact of the non-compliance and any remedial measures taken.135

Insurers are required to demonstrate that the data is sufficiently complete, accurate and appropriately verified, and asset managers must ensure that the information they supply to insurance customers meets the same standards.136

133 Article 133(3) Solvency II.
134 Article 84 European Commission Delegated Regulation (EU) No. 2015/35.
135 Article 51 Solvency II.
136 Article 105 Solvency II.
VII THE CAPITAL REQUIREMENTS DIRECTIVES

i Background

In 2006, the Banking Consolidation Directive and the Capital Adequacy Directive (together referred to as the Capital Requirements Directive (CRD))\(^{137}\) first imposed a minimum initial capital level that must be held by investment firms falling within MiFID, depending on the activities they undertake and the level of risk associated with such activities.\(^{138}\) In addition, investment firms had to meet ongoing requirements to provide against risks for their trading-book businesses and their other business activities.\(^{139}\) At the same time, the competent authority of each Member State was given supervisory powers and duties.

As part of the focus on reducing market risk after the financial crisis, the Commission introduced proposals to amend the text of the CRD, which culminated in the adoption and implementation of Directive 2009/111/EC (CRD II). This Directive aimed, among other things, to clarify the application of limits on large exposures of firms subject to the CRD regime and to introduce new rules governing hybrid capital instruments qualifying as Tier 1 regulatory capital. CRD II came into force on 7 December 2009, and Member States were required to implement it by 31 December 2010.\(^{140}\)

In the wake of CRD II, Directive 2010/76/EU (known as CRD III) was adopted on 11 October 2010, again in response to perceived regulatory failures that had been highlighted by the financial crisis. For example, CRD III addressed concerns that the remuneration policies prior to the financial crisis had incentivised risk-taking by financial institutions, including investment firms, and had undermined risk control. CRD III required firms to have remuneration policies that were consistent with, and promote effective risk management and imposed caps on, certain elements of the remuneration package. CRD III also aimed to address concerns that the models that were permitted under CRD to calculate capital requirements were flawed and did not require investment firms to maintain sufficient capital as a buffer against losses in their proprietary trading books. As a result, CRD III amended the capital requirements that apply in respect of the trading books of investment firms by introducing new capital charges depending on the risk models being used by individual firms.

CRD III was required to be implemented by Member States in stages, with the provisions relating to remuneration principles to have been transposed by 1 January 2011 and the revised rules relating to capital requirements to have been transposed by 31 December 2011.\(^{141}\)

\(^{137}\) Directive 2006/48/EC and Directive 2006/49/EC together constitute the CRD. These Directives required EEA Member States to implement the Basel II prudential standards. However, the CRD is wider in scope than Basel II, as it applies not only to internationally active banks, but also to investment firms subject to MiFID.

\(^{138}\) Chapter II, Directive 2006/49/EC. For example, investment firms falling under the definition in Article 3(1)(b)(iii) that are only authorised to provide investment advice, or receive and transmit orders from investors without holding client money or securities, have an initial capital requirement of €50,000 (Article 7), but firms dealing in financial instruments who do hold client money and securities (and which are therefore not firms referred to in Article 5 to Article 8) have an initial capital of €730,000 (Article 9).

\(^{139}\) Chapter V Directive 2006/49/EC.

\(^{140}\) Article 4 CRD II.

\(^{141}\) Article 3 CRD III.
To implement the Basel III rules made by the Basel Committee on Banking Supervision, on 20 July 2011 the Commission introduced proposals for a new directive, known as CRD IV, and a new regulation, the Capital Requirements Regulation (CRR), which would replace the CRD.

CRD IV and the CRR were published in the OJ on 27 June 2013. Member States were required to transpose CRD IV into national law by 31 December 2013. The CRR is directly applicable, and took effect from 1 January 2014. The timeline for full implementation largely depended on the timing of the delegated legislation related to enacting the net stable funding ratio (NSFR), which is now proposed as part of a package of further reforms to the CRD IV and CRR as proposed by the Commission in November 2016 (see below). Several pieces of delegated legislation have been published by the Commission since December 2013 supplementing CRD IV with regard to certain regulatory technical standards and implementing technical standards, and to the liquidity coverage ratio (LCR).

The CRD IV regime applies, broadly speaking, to investment firms that are subject to MiFID. However, the following fall outside of its scope:

- firms that are not authorised to perform safekeeping and administration of financial instruments;
- firms that provide only one or more of the investment services and activities listed in points 1 (Reception and transmission), 2 (Execution of orders), 4 (Portfolio management) and 5 (Investment advice) of Section A of Annex 1 MiFID; and
- firms that are not permitted to hold client money or securities.

In practice, this provides an exemption for many asset management firms.

CRD IV makes investment firms subject to revised capital adequacy rules that require them to maintain a basic capital conservation buffer in addition to their basic minimum regulatory capital requirement. Firms may also, at the discretion of individual supervisory authorities, be required to maintain a counter-cyclical capital buffer to guard against losses that result from a sudden downturn following a period of economic growth. If investment firms fail to maintain the required capital buffers, they are subject to restrictions on their ability to make distributions and a prohibition on the payment of variable remuneration where the obligation to pay was created at a time when the capital buffer requirements were not met.

On 10 October 2014, the Commission adopted the Delegated Regulation, which sets out detailed requirements for firms to hold sufficient unencumbered high-quality liquid assets as determined using the LCR. The Delegated Regulation was published in the OJ on 17 January 2015 and came into force on 6 February 2015. The LCR will be implemented over a period of four years, starting with a minimum ratio requirement of 60 per cent in October 2015, and gradually increasing to 100 per cent on 1 January 2018.

---

143 Directive 2013/36/EU.
144 Article 129 CRD IV.
145 Article 130 CRD IV.
146 Article 141(2)(b) CRD IV.
In addition, CRD IV requires competent authorities to ensure that firms have policies and procedures in place to identify, manage and monitor the risk of excessive leverage.\textsuperscript{148} Investment firms must address the risk of excessive leverage by taking account of potential reductions in their regulatory capital that may result from expected or realised losses, and should be able to withstand a range of potential stress events impacting regulatory capital.\textsuperscript{149}

CRD IV also subjects firms to enhanced corporate governance requirements, and a requirement to establish risk committees composed of non-executive members of their management bodies to advise management on the risk profile of a firm and on its ongoing risk strategy.\textsuperscript{150} In addition, CRD IV requires firms to disclose the number of individuals receiving remuneration of €1 million or more in each financial year.\textsuperscript{151} CRD IV also implements a bonus cap under which variable remuneration cannot exceed fixed remuneration unless authorised by shareholders, in which case variable remuneration can be up to twice the fixed remuneration.\textsuperscript{152}

With certain exceptions, CRD IV is a maximum harmonisation measure (meaning that there is little scope for national regimes to exceed the terms of the original EU legislation) that sets out the majority of the CRD’s prudential high-level requirements for investment firms. As an EU regulation, the CRR is directly applicable in all Member States, and divergences in national rules will therefore be minimised. In contrast, provisions addressing the mechanics of prudential supervision are contained in the CRD IV Directive. As an EU directive, Member States have a small element of say in how they choose to implement the requirements. For example, while Member States are not be able to impose capital requirements in excess of the CRD IV levels (as these are provided for in the CRR), they have a degree of flexibility in relation to the calibration of capital buffers (which are set out in the CRD IV Directive).

\textbf{iii Future outlook}

\textit{CRD V and CRR II}

In November 2016, the Commission published its proposals for amendments to CRD IV and the CRR (also referred to as CRD V and CRR II). On 7 June 2019, CRD IV\textsuperscript{153} and CRR II\textsuperscript{154} were published in the OJ. They entered into force on 27 June 2019. For the most part, CRR II will apply from 28 June 2021, and Member States will be required to implement and apply CRD V by 28 and 29 December 2019, respectively. CRD IV and CRR II include measures to ensure compliance with international standards and certain EU-specific reforms, including:

\begin{itemize}
  \item a binding leverage ratio requirement of 3 per cent for all firms within the scope of CRD IV;
\end{itemize}

\begin{itemize}
  \item Article 87 CRD IV.
  \item Article 87(2) CRD IV.
  \item Article 76(3) CRD IV.
  \item Article 450 CRR.
  \item Article 94(1) CRD.
  \item Directive (EU) 2019/878 amending the CRD IV Directive (2013/36/EU) as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures.
  \item Regulation (EU) 2019/876 amending the Capital Requirements Regulation (575/2013) as regards the leverage ratio, the net stable funding ratio (NSFR), requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties (CCPs), exposures to collective investment undertakings, large exposures, reporting and disclosure requirements.
\end{itemize}

© 2019 Law Business Research Ltd
b a binding NSFR of at least 100 per cent on credit institutions and systemic investment firms;

c more risk-sensitive own funds requirements, including changes in respect of the calculation of own funds requirements for market risk, counterparty credit risk, large exposures, exposures to central counterparties and equity investments in CIUs; and

d amendments to the minimum requirement for own funds and eligible liabilities to ensure that global systemically important institutions hold certain minimum levels of loss-absorbing capital and instruments in line with the total loss-absorbing capacity standards recommended by the Financial Stability Board.

The EBA recommended the introduction of the NSFR in December 2015. Now included as part of the CRD V reforms, the NSFR will sit alongside the LCR as a method to assess whether a firm has adequate stable funding to prevent liquidity mismatches. The NSFR is a ratio of an institution or firm’s available stable funding to the amount of stable funding required by it over a one-year period, and an NSFR of 100 per cent would therefore require the relevant institution or firm to hold at all times sufficient stable funding to meet its funding needs. Stable funding is defined as those types and amounts of equity and liability financing expected to be reliable sources of funds over a one-year period under conditions of extended stress.

Regarding the own fund requirements under CRD V in respect of CIUs, the amendments set out a more risk-sensitive approach to calculate own funds requirements for exposures to CIUs (which includes UCITS and AIFs). In addition to a standardised approach, CRD V incorporates a look-through and mandate approach that calculates own funds requirements based, respectively, on the underlying exposures or mandate of the relevant CIU.

Revised prudential framework for investment firms

In December 2017, the Commission adopted proposals for a Regulation (the IFR) on the prudential requirements on investment firms and a Directive (the IFD) on the prudential supervision of investment firms.155 On 19 March 2019, the Council of Europe published compromise proposals for the IFR and the IFD. On 16 April 2019, the Parliament adopted the IFD156 and the IFR.157 It is anticipated that the Directive and the Regulation will be published in the OJ in Q3 2019, following adoption by the Council. The IFR will apply 18 months after the date that it enters into force.158 The IFD will enter into force on the twentieth day following its publication in the OJ. Member States will be required to transpose the requirements of the Directive no later than 18 months after the date it enters into force, and apply measures implementing the Directive from the date that the IFR applies.

This framework will replace the existing prudential requirements set out in the CRR for most investment firms authorised under MiFID. The aim is to simplify the prudential classification of investment firms and establish a single harmonised approach to their

158 At the time of writing, the text of the IFR does not specify when the Regulation will enter into force.
prudential requirements. It also seeks to increase proportionality and risk-sensitivity and reduce the complexity of the existing system. It is not intended to increase capital requirements significantly beyond the current level.

Under the revised prudential framework, it is proposed that:

- Certain systemically important firms will be reclassified as credit institutions, and will remain subject to the existing regime under the CRR and CRD IV. If these firms are established in Member States participating in the banking union, they will come within the scope of the single supervisory mechanism.
- All other investment firms will be subject to the new prudential framework, replacing the requirements set out in the CRR and the CRD IV Directive. Certain small and non-interconnected investment firms will be subject to a more limited prudential regime.
- Quantitative indicators, referred to as ‘K-factors’, which are intended to represent various risks to which the firm is exposed, will be used to classify investment firms and determine the capital requirements methodology to which they will be subject. The K-factors include ‘risk-to-customer’ factors, ‘risk-to-market’ factors, and ‘risk-to-firm’ factors.
- Investment firms will be subject to revised remuneration and governance standards.

The new prudential framework is also intended to tighten requirements relating to equivalence decisions taken in relation to third countries and the supervision of firms with parent undertakings in third countries. Where a firm has its parent undertaking in a third country, if the relevant EU supervisory authority considers that the firm is not subject to supervision by the third country that is equivalent to the supervision under this new prudential framework, it may require the establishment of an investment holding company or mixed financial holding company in the EU.

VIII REGULATION ON SHORT SELLING AND CREDIT DEFAULT SWAPS

The European Regulation on short selling and certain aspects of credit default swaps (Short Selling Regulation) was published in the OJ on 24 March 2012 and took effect on 1 November 2012. As an EU regulation, it has direct effect in Member States and did not require any further transposition into national law. The Short Selling Regulation introduces measures to harmonise short-selling regimes across the EU for the first time. Significant provisions include:

- transparency: firms are required to disclose short positions relating to shares admitted to trading on a regulated market or MTF and EU sovereign debt, taking into account positions in credit default swaps referencing an EU sovereign debt obligation;  
- restrictions on uncovered positions: a firm that wishes to take out an open position in shares needs to have borrowed the shares, entered into an agreement to borrow the shares or made other arrangements to ensure that settlement can be effected when due. There are further restrictions on open positions in sovereign debt or through credit default swaps (where the positions are not hedged); and

---

159 Regulation (EU) No. 236/2012.  
160 Articles 5, 6 and 7 Short Selling Regulation.  
161 Chapter III Short Selling Regulation.
supervisory intervention: competent authorities in individual Member States may, in exceptional circumstances, take measures including further transparency requirements or temporary short-selling bans, while ESMA may intervene (i.e., by taking direct control of the regulation of short selling in an individual Member State and overruling the national regulator) if it considers there to be a significant threat (e.g., to the stability of the market).162

These requirements apply regardless of where the person effecting the short sale is domiciled. However, there is an exemption from the transparency requirements for shares whose principal trading venue (i.e., the regulated market or MTF) is located outside the EU.

For fund managers managing several funds, the calculation of the net short position in a particular issuer is conducted at the level of each individual fund and for each portfolio under management. A discretionary manager should aggregate net short positions of funds and portfolios for which the same investment strategy is pursued in respect of a particular issuer. Where a single entity performs management and non-management activities (such as proprietary trading), it should conduct two separate calculations and, in some instances, may have to make two reports.

On 7 July 2017, ESMA published a consultation paper on the evaluation of certain elements of the Short Selling Regulation, including the transparency requirements described above. On 21 December 2017, ESMA published its final report on its evaluation of those matters.163 ESMA’s 2019 annual work programme states that ESMA may revise and expand the technical advice in its report during the course of 2019.

IX THE QUALIFYING HOLDINGS REGIME

The ‘qualifying holdings regime’ comprises certain requirements imposed across various pieces of EU financial services sectoral legislation, particularly MiFID II, Solvency II and CRD IV. That regime has its origins in the Acquisitions Directive,164 also referred to as the ‘Qualifying Holdings Directive’, which was formally adopted on 5 September 2007 and was to be implemented into the national law of Member States by 21 March 2009. The Acquisitions Directive was repealed and replaced (in part) by MiFID II.

The qualifying holdings regime sets out harmonised criteria that regulators apply in deciding whether to approve changes of control of financial institutions (i.e., credit institutions, investment firms and insurers), and important aspects of the process by which they do so. Similar requirements apply in respect of qualifying holdings in management companies under the UCITS Directive and AIFMD.

X REFORM OF SHADOW BANKING

In March 2012, the Commission published a Green Paper165 setting out its proposals for the reform of shadow banking. The Commission’s message, articulated by Internal Market

162 See Chapters V and VI Short Selling Regulation.
164 Directive 2007/44/EC.
Commissioner Michel Barnier, is that, ‘like all financial players, [firms carrying out shadow banking activities] must be covered by regulation’\textsuperscript{166} to ensure that all activities that could affect financial stability are regulated, while at the same time opportunities for regulatory arbitrage are minimised.

However, there are substantial problems in defining precisely what shadow banking is and which organisations the reforms would cover. The Commission has adopted the Financial Stability Board’s definition, which states that shadow banking comprises ‘the system of credit intermediation that involves entities and activities outside the regular banking system’.\textsuperscript{167} This encompasses organisations performing any of the following activities:

\begin{itemize}
  \item[a] utilising funding with deposit-like characteristics;
  \item[b] performing maturity or liquidity transformation, or both;
  \item[c] undergoing credit risk transfer; and
  \item[d] using direct or indirect financial leverage.
\end{itemize}

Clearly, this creates an extremely wide scope.

Asset management was one of the areas of focus for new measures in the Green Paper, with the Commission expressing concerns regarding possible liquidity mismatches in ETFs, which heightens the risk of runs on MMFs, increases the fragility of the financial sector and augments the potential spillover effects of any failures.

On 4 September 2013, the Commission adopted a Communication on shadow banking and published a Proposal for a regulation on MMFs. The Communication outlines the five priorities on which the Commission intended to take action:

\begin{itemize}
  \item[a] the provision of a framework for MMFs;
  \item[b] reforming the securities law;
  \item[c] increasing the transparency of the shadow banking sector (e.g., through the collection and storing of trade data);
  \item[d] the provision of a framework governing the interactions of the shadow banking sector and banks; and
  \item[e] improving the supervision of the shadow banking sector at EU and national levels.
\end{itemize}

The proposal for a regulation on MMFs required such funds to have a set proportion of their portfolio in highly liquid assets, and sets limits on their exposures to a single issuer of securities. The proposal also introduced a capital buffer for fixed-net-asset-value MMFs; the proposal acknowledged this requirement may result in substantially increased management fees.

The MMF Regulation was published in the OJ on 30 June 2017 and has generally applied from 21 July 2018. It defines MMFs as CIUs that require authorisation as UCITS or are authorised as UCITS under UCITS IV, or are an AIF under the AIFMD; invest in short-term assets; and have distinct or cumulative objectives offering returns in line with money market rates or preserving the value of the investment.\textsuperscript{168}

The MMF Regulation also categorises MMFs, and includes provisions on, among other things, eligibility criteria for assets in which MMFs can invest and diversification requirements.

\textsuperscript{166} Speech made by Michel Barnier at the press conference to accompany the publication of the Commission’s Green Paper on Shadow Banking, 19 March 2012.

\textsuperscript{167} Available at www.financialstabilityboard.org.

\textsuperscript{168} Article 1(1) MMF Regulation.
In November 2017, ESMA published its a final report on certain Level 2 and Level 3 measures under the MMF Regulation. In March 2018, ESMA published guidelines on the scenarios that the Regulation requires MMFs to factor into their stress-testing processes. In accordance with the MMF Regulation, ESMA must update its guidelines at least annually, taking into account the latest market developments. Accordingly, in September 2018, ESMA published a consultation paper setting out draft 2019 guidelines on stress test scenarios under the MMF Regulation.

XI PACKAGED RETAIL AND INSURANCE-BASED INVESTMENT PRODUCTS REGULATION

In November 2010, the Commission identified concerns in the EU retail investment market and launched a consultation on packaged retail and insurance-based investment products (PRIIPs). It considered, among other things, that information about investments was weak and difficult to comprehend and use by consumers; there were many conflicts of interest present in the distribution of investment products; and the regulation of the market was fragmentary and inconsistent. The Commission noted that these issues created risks for consumers.

Further, PRIIPs do not tend to be harmonised products at the European level and can span a range of different investment products, although their unifying feature is that they are marketed to retail customers. PRIIPS can include investment funds, insurance-based investment products, retail structured securities and structured term deposits. To address some of the concerns raised in its consultation, the Commission decided to introduce a new, pre-contractual disclosure document (a key information document, or KID) for retail consumers. The rationale was that consumers would be able to refer to the KID when considering buying a PRIIP. The Commission also decided to address this issue through cross-sectoral legislation, which would apply across various existing regulations. The Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation entered into force on 29 December 2014, and it became applicable on 1 January 2018. The Commission also developed regulatory technical standards on KIDs in the delegated regulation relating to the PRIIPS Regulation, which also became applicable on 1 January 2018.

174 Regulation 1286/2014.
The PRIIPs Regulation and related delegated regulation specify the form and content of the KID, favouring a simple, clear and easy to understand format. The PRIIPs Regulation also lays down rules on how to provide the KID to retail investors. It applies to PRIIP manufacturers who are responsible for drawing up KIDs. PRIIP manufacturers are defined as an entity that manufactures PRIIPs or makes changes to an existing PRIIP, for example by altering its risk and reward profile. Therefore, this would capture fund managers, insurance companies, investment firms and banks. The PRIIPs Regulation also applies to persons advising on or selling PRIIPs, who must provide the KID to retail investors.

Articles 15 to 18 of the PRIIPs Regulation also provide national competent authorities and EOPIA with the power to monitor financial products under their supervision and prohibit or restrict the sale of certain products in the case of, for example, investor protection concerns or a threat to the orderly functioning and integrity of financial markets. Among other initiatives, the ESAs published technical advice on the inclusion of environmental or social objectives targeted by a PRIIP in a KID (pursuant to Article 8(4) of the PRIIPs Regulation).

Looking forward, the Commission is due to carry out a review of the PRIIPs Regulation by the end of 2019. It has already published a final report on retail investment products across the EU. The report concluded, among other things, that retail investors have access to a wide range of investment products, but face challenges in collecting information, comparing data and getting independent advice on the different products on offer. It also noted that the costs of similar product categories vary across EU Member States. However, it expects that the PRIIPs Regulation, together with other regulations that cover financial products, will increase transparency on fees and aid retail investors in making more informed investment decisions.

XII SECURITIES FINANCING TRANSACTIONS REGULATION

As part of its work on reforming the shadow banking sector, in January 2014, the Commission published a legislative proposal for a Regulation on reporting and transparency of financing transactions (the Securities Financing Transactions Regulation, or, SFTR). One of the central aims of the proposed SFTR was to enhance transparency and data availability in respect of transactions frequently undertaken in the shadow banking sector such as repurchase agreements and securities lending, commonly known as securities financing transactions (SFTs). The proposal sought to improve transparency in three main areas: (1) the monitoring of the build-up of systemic risks related to SFT transactions in the financial system; (2) the disclosure of the information on such transactions to the investors whose assets are employed in these or equivalent transactions; and (3) the contractual transparency of rehypothecation

176 Articles 4(4)(a) and 5, PRIIPs Regulation.
177 Articles 4(4)(b), 13 and 14, PRIIPs Regulation.
178 European Supervisory Authorities, Joint Technical Advice on the procedures used to establish whether a PRIIP targets specific environmental or social objectives pursuant to Article 8(4) of Regulation (EU) No. 1286/2014 on key information documents (KID) for packaged retail and insurance-based investment products (PRIIPs), 28 July 2017.
179 Article 33, PRIIPs Regulation.
180 European Commission, Distribution systems of retail investment products across the European Union – Final report.
activities. To that end, the SFTR requires counterparties to SFTs to report details of those transactions to trade repositories. UCITS management companies and AIFMs must make certain disclosures relating to SFTs to investors in their funds, including identifying the SFTs and total return swaps that the funds in question are authorised to use. Certain information relating to SFTs must also be disclosed in UCITS’ semi-annual and AIFs’ annual reports to investors. The SFTR also imposes conditions on the reuse of collateral received by counterparties to SFTs, including the provision of pre-contractual information on the risks of reuse and a requirement to obtain prior express consent thereto.

On 12 January 2016, the Securities Financing Transactions Regulation came into force. It has applied, for the most part, since that date. Regulatory Technical Standards and Implementing Technical Standards supplementing the SFTR came into force on 11 April 2019.

XIII ELTIFS, EUVECAS AND EUSEFS

In recent years, a number of new types of investment fund have been introduced following legislative initiatives by the Commission, each, in turn, an elaboration of the AIF concept. One of those initiatives was the European Venture Capital Funds Regulation (EuVECA) Regulation, which aims to strengthen the ability of venture capital funds to raise money across the EU by creating a new brand of investment fund targeted at investors who wish to gain exposure to venture capital investments. To be an EuVECA, a fund must meet certain eligibility criteria including that it is an EU AIF that invests at least 70 per cent of its aggregate capital contributions to qualifying investments (i.e., venture capital investments).

The European Social Entrepreneurship Funds Regulation (the EuSEF) Regulation also created a new brand of EU AIF that, in summary, intends to invest at least 70 per cent of its aggregate capital contributions in investments that primarily aim to achieve positive social impacts. Most provisions in the EuVECA Regulation and the EuSEF Regulation have applied since 22 July 2013, the date on which Member States were required to implement the AIFMD.

The aim of the ELTIF Regulation is to create a new type of investment fund designed for investors who were prepared to make long-term investments in companies and projects in return for a steady income. To qualify as a European Long Term Investment Fund, a fund must be an EU AIF, be authorised by the competent authority in its home Member State, and comply with the rules in the ELTIF Regulation, including rules on investment policies, redemption, marketing and transparency. The ELTIF Regulation came into force on 8 June 2015, and has applied since 9 December 2015.

In the absence of tax harmonisation, taxation remains a matter for the legislature of each Member State. With the exception of value added tax (VAT) and pending the outcome of current discussions on a financial transactions tax (FTT), there is no centralised tax affecting asset management. The tax treatment of investors, funds and asset managers depends mainly on the laws of individual Member States. Nevertheless, EU law materially impacts Member States’ tax laws through the application of the Treaty on the Functioning of the European Union (TFEU) as well as certain council directives requiring Member States to modify their tax rules, meaning that the TFEU and those directives have a direct bearing on the tax treatment of asset management within the EU.

i  Withholding taxes

Historically, fund structures may have been set up to take advantage of the Parent Subsidiary Directive (PSD)\(^\text{185}\) or the Interest and Royalties Directive (IRD),\(^\text{186}\) or both. Broadly, the PSD and the IRD provide for an exemption from withholding tax on, respectively, payments of dividends to qualifying corporate shareholders holding at least holding 10 per cent of the payor’s share capital and payments of interest and royalties between associated companies.

The recent Danish conduit cases\(^\text{187}\) have cast doubt on the circumstances in which taxpayers may rely on the PSD and the IRD. In each case, structures had been set up to take advantage of the PSD or the IRD and the Danish tax authorities denied the exemption on the basis that the recipient was merely a conduit and the actual beneficial owners of the payments were non-EU entities. The Court of Justice of the European Union (CJEU) held that the benefit of the IRD and the PSD must be denied in the case of an abuse of rights – for instance, where a structure is set up with the intention of claiming the exemption by artificially creating the preconditions for it, such that the formal conditions of the IRD or the PSD are met, but not their purpose. The CJEU indicated that the following factors would be taken into account in determining whether there is an abuse of rights: the circumstances around the set-up of the structure; a quick on-payment of payments received; the recipient’s ability to economically benefit from, and determine how to use, the payments received; and the recipient’s other activities (if any).

Given that the PSD and IRD apply only in respect of intra-EU payments, following Brexit, payments to and from UK companies may no longer be covered and the relevant provisions of the applicable double tax treaty may instead have to be relied on, and those provisions may not provide for a full exemption from withholding tax. Problems may, therefore, arise in respect of payments to the UK and UK source interest payments. As the UK does not generally impose a dividend withholding tax, issues in respect of payments of dividends by UK companies are unlikely to arise.

\(^{185}\) Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

\(^{186}\) Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

\(^{187}\) Joined cases *N Luxembourg 1* (Case C-115/16), *X Denmark* (Case C-118/16), *Danmark I* (Case C-119/16) and *Z Denmark* (Case C-299/16) v. *Skatteministeriet*; and joined cases *T Danmark* and *Y Denmark Aps* (C-116/16 and C-117/16).
Fundamental freedoms under the TFEU

Each of the four fundamental freedoms enshrined in the TFEU has direct effect, meaning that each of them applies without the need for national implementing legislation and can directly affect national tax rules. Of the four fundamental freedoms, the most relevant in the asset management context are the freedom of establishment under Article 49 TFEU and the free movement of capital under Article 63 TFEU (for these purposes, 'capital' includes units of CIUs). In most cases, the same result would be reached irrespective of the applicable freedom. Given, however, that the application of these two freedoms is mutually exclusive, it is important to take note of their key differences. While both freedoms are subject to certain restrictions, the restrictions that may be imposed on the free movement of capital are more extensive. In particular, Member States may restrict the free movement of capital (but not the freedom of establishment) to apply provisions of their tax law that distinguish between taxpayers who are not in the same position with regard to their place of residence or the place where their capital is invested and to take all requisite measures needed to prevent infringements of their laws and regulations. Another key difference between these two fundamental freedoms is that only nationals of, and companies formed in, Member States may rely on Article 49 TFEU, whereas Article 63 TFEU applies to movements of capital between Member States as well as between Member States and third countries.

In the asset management context, the impact of the two freedoms on the taxation of dividend flows is particularly important in situations where the recipient cannot rely on the Parent-Subsidiary Directive. In the 2009 case Aberdeen Property Fininvest Alpha Oy, it was held that, under Article 49 TFEU, it is not permissible for a Member State to impose a withholding tax on dividends distributed to a parent company in form of an open-ended investment company resident in another Member State when similar dividends paid to comparable domestic parent companies are not subject to such withholding tax. In other cases, it was held that Article 63 TFEU precludes the imposition of withholding tax on dividends distributed to a foreign company, UCITS or pension fund established in a different Member State if dividends distributed to a domestic company, UCITS or pension fund were not also subject to such withholding tax or, if in principle also subject to such withholding tax, were effectively exempt from it. In Emerging Markets Series of DFA Investment Trust Company v. Dyrektor Izby Skarbowej w Bydgoszczy, it was decided that Article 63 TFEU prevents a Member State from withholding tax from dividends distributed to an investment fund established in a third country if a similar withholding tax is not imposed on dividends distributed to investment funds established in that Member State and there is a mutual administrative assistance obligation between that Member State and that third country which enables the tax authorities in that Member State to verify information provided by the investment fund.

189 Article 65(1)(a) TFEU.
190 Article 65(1)(b) TFEU.
191 Aberdeen Property Fininvest Alpha Oy (C-303/07).
192 Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam (Case C-379/05); Santander Asset Management SGIC SA v. Directeur des résidents à l’étranger et des services généraux (C-338/11); and European Commission v. Finland (Case C-342/10).
193 Emerging Markets Series of DFA Investment Trust Company v. Dyrektor Izby Skarbowej w Bydgoszczy (C-190/12).
iii  State aid

Article 107 of the TFEU prohibits ‘state aid’, meaning measures taken by a Member State to favour certain undertakings, industries or goods in a way that could distort competition and affect trade between Member States. Such measures may take the form of selective benefits, such as subsidies, or ‘interventions which, in various forms, mitigate the charges that are normally included in the budget of an undertaking’. The state aid regime can, therefore, apply to the tax rules of a Member State if they are, or are applied in a manner that is, ‘selective’ in favour of a particular undertaking, category of undertakings or category of goods.

In recent years, the Commission has been proactive in challenging tax measures on state aid grounds. In particular, tax rulings which sanction a treatment that varies from the strict legal position may be vulnerable to attack and Member States have consequently become more cautious in granting rulings. While none of the current investigations involve the asset management industry specifically, this is an area to watch closely and, in particular to the extent that current structures rely on tax rulings or otherwise on favourable regimes, it may be prudent to undertake an assessment of the risks of a potential state aid challenge.

iv  Exchange of information

Under the Directive on Administrative Cooperation (DAC) and various amendments thereto, Member States are obliged to implement procedures for the collection and sharing of certain information in relation to tax matters. Of particular note are:

a  DAC3, which provides for the automatic exchange between tax authorities of cross-border tax rulings and advance pricing agreements. Clearly, this adds a potential further layer of scrutiny of such rulings and agreements where authorities may already be daunted by the spectre of potential state aid challenges from the European Commission; and

b  DAC6, which introduces mandatory disclosure rules for intermediaries such as lawyers, accountants and tax advisers in respect of ‘reportable cross-border arrangements’, a term that is broadly defined and may catch fund or acquisition structures. Member States have to implement this directive by 31 December 2019 to apply from 1 July 2020 and with the first disclosures to be made before 31 August 2019. Such first disclosures would cover the period from 25 June 2018.

v  VAT

Under Directive 2006/112/EC (VAT Directive), a common system of VAT has been established in the EU under which VAT may be chargeable in respect of goods and services

---

194  De Gezamenlijke Steenkolenmijnen in Limburg v. High Authority of the European Coal and Steel Community (C-30/59).
supplied in the course of carrying on a business. Asset management services provided to a fund by an asset manager would normally be a service supplied in the course of carrying on a business for these purposes.

Broadly speaking, unless an exemption applies, VAT is chargeable on the consideration paid for such services at a rate set by the relevant Member State. Normally, unless the supply of services is cross-border, the supplier (i.e., the asset manager) would have to account to the relevant tax authorities for the applicable VAT and would pass the cost on to the recipient of the supply (i.e., the fund). This is likely to be a real cost for the fund (and, ultimately, the investors) because amounts paid to suppliers in respect of VAT can only be recovered from the relevant tax authorities if the fund also makes supplies subject to VAT – which is unlikely. Therefore, from the investors’ perspective, it would likely be advantageous if the asset management services fell within an exemption from VAT. (From the asset manager’s perspective, that would be disadvantageous because it would mean that the asset manager makes supplies which are not subject to VAT and, therefore, the asset manager’s ability to recover from the relevant tax authorities amounts that it has paid to its own suppliers in respect of VAT is limited, thereby reducing its own profit margin.)

Generally, asset management is a service subject to VAT, but there is an exemption for ‘the management of special investment funds as defined by Member States’. Within the confines of the objective of the VAT Directive and the principle of fiscal neutrality, each Member State has discretion to define the scope of the ‘special investment fund’ (SIF) exemption and, over the years, a number of cases have been brought in the European Courts in respect of it. It has been held that the term SIF is specific to the business of undertakings in collective investments, but that it cannot be defined to refer to portfolio management in general, nor can it be defined in a way that distinguishes between open and closed-ended funds. It has also been held that the term does not extend to defined benefit pension schemes or common investment funds pooling the assets of such schemes, but that it may extend to certain defined contribution pension schemes where the scheme members bear the investment risk. The exemption may also extend to the management of real estate funds where the fund pools investments to spread risk, the risk is borne by the investors and the fund is subject to specific Member State supervision (i.e., regulation), but only to

198 Article 135(1)(g) VAT Directive.
199 Abbey National plc and Inscape Investment Fund v. Commissioners of Customs and Excise (C-169/04).
200 Finanzamt Frankfurt am Main V-Höchst v. Deutsche Bank AG (C-44/11).
201 JP Morgan Fleming Claverhouse Investment Trust plc v. The Commissioners of HM Revenue and Customs (C-363/05).
202 Wheels Common Investment Fund Trustees and Others v. Commissioners for Her Majesty’s Revenue and Customs (C-424/11). The claimant in the UK High Court case United Biscuits (Pension Trustees) Ltd and another v. HMRC [2017] EWHC 2895 sought to challenge this position, arguing that similar fund management services are exempt under Article 135(1)(a) of the VAT Directive (exemption from VAT for ‘insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents’). The UK High Court considered that the provision of pension fund management services did not comprise ‘insurance’ for the purposes of Article 135(1)(a) of the VAT Directive, with the result that the VAT exemption did not apply to the provision of such services (whether by insurers or non-insurers). The claimant’s appeal to the UK Court of Appeal is currently outstanding.
203 ATP PensionService A/S v. Skatteministeriet (C-464/12).
the extent that fund-specific functions, such as investment recommendations and portfolio management, are concerned; the exemption does not apply to the actual management of the immovable property of the fund.204

The amount of case law demonstrates a degree of uncertainty around the scope of the SIF exemption, which is unfortunate and undesirable. If asset management services have been priced on the assumption that the SIF exemption does not apply, the pricing may have to be revisited if this assumption is proven incorrect following a later court decision. In the meantime, the asset manager may have recovered amounts from the tax authorities that it was not entitled to recover and accounted to the tax authorities for VAT that was not due, and this situations would, somehow, have to be unwound. To the extent that VAT costs have been borne by the fund, investors would want to ensure that the asset manager reclaims from the tax authorities any amount of VAT for which it erroneously accounted and passes any refund on to the fund.

vi Financial transaction tax

On 28 September 2011, the Commission presented a formal proposal for an FTT in the (then) 27 Member States of the EU. Under the proposal, a tax would be levied at a rate of 0.1 per cent on shares and bonds, and at a rate of 0.01 per cent on derivative contracts. Currently, 10 Member States continue to participate in the enhanced cooperation procedure in the area of the FTT. The ECOFIN Report to the European Council on tax issues dated 7 June 2019205 noted that there are discussions on an FTT based on the French model of the tax. A significant amount of further work is required and, at this stage, it is not clear when (or, indeed, if) agreement on the FTT can be reached.

XV SUSTAINABLE FINANCE

The past couple of years have seen institutional investors play a more active role in holding companies to account and engaging in environmental, social and governance issues (ESG). In a similar vein, asset managers are increasingly expected by their clients to consider ESG in their investment decisions. Despite this, in a 2016 consultation, the Commission found that although ESG factors are perceived as important among investors and asset managers, most investment decisions were made on a short-term basis.206

In light of this, the Commission established a high-level expert group (HLEG) on sustainable finance in 2016 to prepare a blueprint for reforms to the financial sector, focusing on mobilising private capital towards sustainable investments. The Commission considered that the financial sector has a role to play in helping Member States achieve their ESG goals encapsulated in, among other initiatives, the Paris Agreement (signed on 12 December 2015) and the Sustainable Development Goals (adopted on 25 September 2015). On 31 January 2018,

204 Fiscale Eenheid X NV (C-595/13).
205 Document 9773/19.
206 European Commission, Summary of the responses to the public consultation on long-term and sustainable finance, October 2016.
the HLEG published a final report with recommendations ranging from establishing a common sustainability taxonomy for financial products to clarifying investor duties for ESG and upgrading disclosure rules to make sustainability risks more transparent.207

The Commission published its action plan on 8 March 2018, which built on the HLEG’s recommendations and set out a timetable for the implementation of its proposals.208 On 24 May 2018, the Commission presented a package of measures that includes its main three proposals:

a the development of an EU taxonomy for climate change and environmentally and socially sustainable activities to be able to accurately assess financial products;

b creation of a new category of benchmarks to help investors compare the carbon footprint of their investments; and

c disclosure requirements and integration of ESG in investment decisions.209

Although the current taxonomy and benchmark proposals focus only on climate change and the environment, the Commission expects to roll out similar initiatives for social and governance issues in due course. The Commission has also published for consultation draft amendments to delegated acts of MiFID II and the Insurance Distribution Directive210 to enhance sustainability in suitability assessments.211 ESMA is monitoring these proposals, and will consider making more focused guidelines to reflect any changes to the delegated acts on sustainability.212 The Parliament also voted to broadly support the Commission’s proposals on 29 May 2018, although its general rhetoric is that it would prefer the proposals to be more robust with regards to social and governance issues.213 In March and April 2019, the European Parliament adopted the three draft Regulations that will implement the Commission’s proposals in this area: the Low Carbon Benchmarks Regulation, the Taxonomy Regulation, and the Disclosure Regulation.214 It is anticipated that, following adoption by the Council,

208 European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions – Action Plan: Financing Sustainable Growth, 8 March 2018.
211 Commission draft delegated regulation amending Regulation (EU) 2017/565 supplementing Directive 2014/65/EU as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that directive; and Commission draft delegated regulation amending Delegated Regulation (EU) 2017/2359 with regard to environmental, social and governance preferences in the distribution of insurance-based investment products.
213 European Parliament resolution of 29 May 2018 on sustainable finance (2018/2007(INI)).
214 Provisional texts of the legislative resolutions adopting the Low Carbon Benchmark Regulation (P8_TA-PROV(2019)0237), the Taxonomy Regulation (P8_TA-PROV(2019)0325), and the Disclosure Regulation (P8_TA-PROV(2019)0435) were adopted on 26 March, 28 March, and 18 April 2019, respectively.
these Regulations will be published in the OJ and take effect during 2019. In terms of the
dates that the Regulations will apply, the Low Carbon Benchmarks Regulation will apply the
day following publication, the Disclosure Regulation will, for the most part, apply from the
date falling 12 months after publication, and the Taxonomy Regulation will apply in stages
from July 2020 to December 2022.
Chapter 2

ARGENTINA

Pablo Gayol

I OVERVIEW OF RECENT ACTIVITY

The most important development that the asset management industry has seen in recent times is the entry of foreign asset managers to the Argentine market as a result of the governmental policies aimed at integrating the domestic capital market into the global markets. This entry is still rather timid, but may be fostered in the near future if certain regulations, especially those related to mutual funds for qualified investors, are finally put in place.

Foreign asset managers can enter into the Argentine market in different ways, even when some of them are almost theoretical. We will expand on these channels later, but the road map would be as follows:

a Public offering of foreign mutual funds: foreign mutual funds can be registered for public offering in Argentina but the requirements are so stringent that their registration is unattractive. For instance, such funds will have to invest at least 75 per cent of the funds in assets issued or located in Argentina, Mercosur countries or Chile.

b Private placement: the asset manager, or any third party, may sell unregistered mutual funds directly to investors under a private placement in Argentina. Traditionally this has been the largest distribution channel for foreign mutual funds, but the lack of private placement safe harbours is a constraint.

c Local mutual funds: an alternative would be that local mutual funds invest in foreign mutual funds. There are several restrictions that make it unfeasible for domestic mutual funds to invest in foreign mutual funds. The proposed regulations of mutual funds for qualified investors would lift these restrictions and boost investment in foreign mutual funds.

d Marketing to investment advisers: finally, asset managers may contact local licensed investment advisers to market their products. These licensed investment advisers may then recommend those products to their clients.

Recently, many foreign asset managers have been marketing their products to local licensed financial advisers (including local broker dealers who can provide such advice) and have also started to put in place structures that would allow them to sell their funds to local mutual funds for qualified investors.

1 Pablo Gayol is a partner at Marval, O’Farrell & Mairal. The author would like to thank Fernando Vaquero, partner at the firm, for his contribution on tax aspects.

2 In this chapter we exclude from our analysis foreign exchange-traded funds, which may have different regulations.
II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The regulatory framework for the asset management industry is based mainly on Law 24,083 (as amended, the Mutual Fund Law), which regulates mutual funds. The Mutual Fund Law defines mutual funds and its main characteristics. It also regulates the main requirements and obligations that the managing companies and depositary companies must comply with. Law 26,831 (as amended, the Capital Markets Law) is also relevant since it regulates the licences for asset managers.

The Capital Markets Law, which regulates public offering of securities and capital markets, creates certain agents who are licensed to carry out regulated activities related to the capital markets. Among these agent licences, there is a licence for a ‘collective investment products administration agent,’ which includes managing companies of mutual funds, and for a ‘custody agent for collective investment products’, which includes depositary companies of mutual funds. Therefore, while most obligations, duties and responsibilities of the managing companies and depositary companies arise from the Mutual Fund Law, there are certain obligations that arise from the Capital Markets Law as these companies are licensed agents under such law.

In addition, the Capital Markets Law is also relevant regarding the public offering of quotas and foreign funds in Argentina.

The Comisión Nacional de Valores (CNV), the Argentine Securities and Exchange Commission, is the regulatory agency of both the Mutual Fund Law and the Capital Markets Law and it is also the supervisory agency of mutual funds activity.

Mutual fund definition and characteristics

The Mutual Fund Law defines mutual funds as a separate estate owned by several persons who are co-owners of the estate and whose rights are represented by quotas. Mutual funds are not companies and do not have legal personality but, in no scenario will the investors in the fund be liable in excess of the assets of the fund.

The management of the mutual funds is carried out by the managing company, which must be a corporation authorised by the CNV or a financial institution authorised by the Argentine Central Bank. Custody of the assets of the mutual fund must be held by a different company, called a depositary company, which must be a financial institution. The managing company must be completely independent from any other company, especially the depositary company with whom it cannot share its offices. Neither can the directors, managers nor attorney-in-fact of the managing company have a position on the board or supervisory board of the depositary company.

The managing company and the depositary company will be, individually and separately, liable for the damages caused to investors due to failure to perform their obligations under

---

3 ‘Agente de Administración de Productos de Inversión Colectiva’, Section 1 of the the Chapter I, Title V of the CNV Rules.
4 ‘Agente de Custodia de Productos de Inversión Colectiva’, Section 1 of the the Chapter I, Title V of the CNV Rules.
5 Section 1 of the Mutual Fund Law.
6 Section 3 of the Mutual Fund Law.
the applicable regulations, the terms and conditions of the mutual fund, and the prospectus of the offering; but in no scenario shall one of the parties be liable for the breach of the other party.\textsuperscript{7}

**Investment purpose of the mutual fund**

Mutual funds can have a broad or narrow investment purpose. Mutual funds that have one or more specific purposes must be denominated in a manner in which such specific purpose can be identified and must invest in those assets the minimum amount set forth by the CNV. Accordingly, the CNV rules provide that mutual funds that have a specialised purpose or whose name includes a reference to a certain class of assets must invest at least 75 per cent of the assets of the fund in such class.\textsuperscript{8} Additionally, the CNV has issued specific regulations for mutual funds whose purpose is to finance SMEs\textsuperscript{9} and those whose purpose is to finance productive and infrastructure projects in regional economies.\textsuperscript{10}

**Restrictions on investment by mutual funds**

Mutual funds cannot invest in:

\begin{enumerate}
\item securities issued by the managing company or the depositary company or in other mutual funds,\textsuperscript{11}
\item securities issued by the controlling company of the managing company, or any of its affiliates, in excess of 2 per cent of the capital or liabilities of such controlling party;
\item a single bond issued by the Argentine government; or
\item a class of assets in excess of the limits established by the CVN. The CNV can create exemptions to these limitations and the limitations on securities issued by the depositary company do not apply to financial trusts in which the trustee is the depositary company.
\end{enumerate}

**Classes of quotas**

Mutual funds may have different classes of quotas with different rights and they may also have fixed-income quotas, in which a fixed return is paid on the notional value, subject to the return of the assets of the fund. Fixed-income quotas may be denominated in units adjusted by inflation\textsuperscript{12} or in units adjusted by the construction index,\textsuperscript{13} provided that the amortisation is longer than two years.\textsuperscript{14} The possibility to issue quotas indexed by inflation or the construction index is an exemption to the general public policy rule that forbids the indexation of obligations and debts.

ii Classes of mutual funds: regulations of open-end and closed-end mutual funds

There are two types of mutual funds: open-end mutual funds and closed-end mutual funds.

\textsuperscript{7} Section 4 of the Mutual Fund Law.
\textsuperscript{8} Section 27 of the Chapter I, Title V of the CNV Rules.
\textsuperscript{9} Section 21 of the Chapter II, Title V of the CNV Rules.
\textsuperscript{10} Section 22 of the Chapter II, Title V of the CNV Rules.
\textsuperscript{11} Section 7 of the Mutual Funds Law.
\textsuperscript{12} i.e., \textit{Unidad de Valor Adquisitivo} (units of acquisitive value, UVA).
\textsuperscript{13} i.e., \textit{Unidad de Vivienda} (UVI).
\textsuperscript{14} Section 51 and 52 of the Chapter II, Title V of the CNV Rules.
Open-end mutual funds

Open-end funds are those in which the number of quotas can be increased continuously by new subscriptions or be reduced by redemptions.

Open-end mutual funds can be formed by the following assets:

- \( a \) publicly offered securities and sovereign and sub-sovereign public bonds traded in markets authorised by the CNV;
- \( b \) precious metals;
- \( c \) domestic or foreign currency;
- \( d \) derivatives;
- \( e \) instruments issued by financial institutions authorised by the Argentine Central Bank, including bank deposits;
- \( f \) asset portfolios that replicate stock or financial indexes; and
- \( g \) any other type of asset authorised by the regulations of the CNV.

The securities in which the mutual fund invests must be authorised for public offering either in Argentina or abroad. Also, the CNV has detailed regulations on the appraisal of the assets of the fund and the eligible assets for the liquidity reserve.\(^\text{15}\)

Open-end mutual funds must invest at least 75 per cent of the funds in assets issued and negotiated in Argentina. For the purposes of this minimum investment requirement, due to outstanding international agreements, securities that have been authorised to be issued in states that are member of the Mercosur and in Chile have the same treatment as securities issued in Argentina,\(^\text{16}\) and the Argentine certificates of deposit – certificates representing foreign securities, similar to the American depositary receipt – are not considered securities issued and negotiated in Argentina, unless the underlying asset has been issued in Argentina or in a Member State of Mercosur or Chile.

Closed-end mutual funds

Closed-end mutual funds are those whose quotas cannot be redeemed, other than in those exceptional cases set forth by the regulations, and must be publicly offered.

The closed-end mutual fund must have, at all times, at least five investors and none of them can have, directly or indirectly, a participation exceeding 51 per cent of the votes of the quota holders.\(^\text{17}\)

Closed-end mutual funds can be formed by the following assets:

- \( a \) those assets that can be part of an open-end mutual fund;
- \( b \) real estate and movable assets;
- \( c \) securities without public offering;
- \( d \) credit rights of any nature; and
- \( e \) any other type of asset authorised by the regulations of the CNV.

Regarding those assets in which only those mutual funds that are closed-end can invest, such assets must be located, originated or issued in Argentina.\(^\text{18}\) However, in those closed-end funds that invest at least 75 per cent of the funds in assets in which an open-end fund can invest,

---

15 Chapter II, Title V of the CNV Rules.
16 Section 11 of Chapter II, Title V of the CNV Rules.
17 Section 36 of the Chapter II, Title V of the CNV Rules.
18 Section 6 of the Mutual Fund Law; and Section 31 of the Chapter II, Title V of the CNV Rules.
this restriction will not be applicable to the investment in those assets.\textsuperscript{19} This restriction on investment abroad will not apply to closed-end mutual funds that are aimed at financing projects of technological innovation developed by companies organised in Argentina which have the potential to expand themselves regionally or internationally based on their activity.\textsuperscript{20}

The name of the closed-end funds must specify that they are closed-end and identify their investment purpose.\textsuperscript{21} The rules of the mutual fund must establish a schedule and a strategy for the investment of the funds, which must provide for the investment of least 75 per cent of the funds in specific assets.\textsuperscript{22} The CNV rules also set out specific regulations for closed-end funds that invest in credits\textsuperscript{23} or in real estate.\textsuperscript{24}

The subscription agreement may provide that the payment of the quotas will be made periodically, unless the quotas are paid in kind, in which case they have to be paid in at issuance.\textsuperscript{25} If a closed-ended fund issues additional quotas, investors must have a pre-emptive right and the managing company must set the price of the new quotas based on the appraisal opinion of two independent appraisers.\textsuperscript{26} The closed-end mutual fund can take debt but such indebtedness cannot exceed the net worth of the mutual fund.\textsuperscript{27}

The CNV, considering the structure and characteristics of the closed-end mutual funds, can determine that their quotas may only be publicly offered to qualified investors.\textsuperscript{28}

\textbf{Mutual funds for qualified investors}

The Mutual Fund Law provides that the CNV can create a class of mutual funds in which only qualified investors can invest.\textsuperscript{29} The definition of qualified investors must follow international standards on this matter and shall consider the investor’s net worth and annual income.

Mutual funds for qualified investors will not be subject to the requirements on minimum investment in Argentine assets and other investment restrictions provided by the Mutual Fund Law.

The CNV, through its General Resolution No. 765, in October 2018 called for comments from the general public regarding a proposed regulation on mutual funds for qualified investors. However, the regulations have not been issued yet. The main framework of the proposed regulations is described below.

\begin{itemize}
  \item Section 31 of the Chapter II, Title V of the CNV Rules.
  \item Section 31 of the Chapter II, Title V of the CNV Rules.
  \item Section 31 of the Chapter II, Title V of the CNV Rules.
  \item Section 41 of the Chapter II, Title V of the CNV Rules.
  \item Section 47 of the Chapter II, Title V of the CNV Rules.
  \item Section 50 of the Chapter II, Title V of the CNV Rules.
  \item Section 39 of the Chapter II, Title V of the CNV Rules.
  \item Section 37 of the Chapter II, Title V of the CNV Rules.
  \item Section 41 bis of the Chapter II, Title V of the CNV Rules.
  \item Section 31 of the Chapter II, Title V of the CNV Rules.
  \item Section 7 bis of the Mutual Fund Law.
\end{itemize}
Investment by qualified investors

Only qualified investors, as defined by the CNV, would be able to invest in mutual funds for qualified investors.\(^\text{30}\)

Exemption to limits on investment in foreign assets

Mutual funds for qualified investors will not need to comply with the limit set by the Mutual Fund Law, by which open-end funds have to invest at least 75 per cent of their assets in Argentina. Nonetheless, investments by these funds abroad must be made in securities that have authorisation for public offering by the Securities and Exchange Commission in their jurisdiction, which must be a jurisdiction that (1) is considered as cooperative for tax purposes by Argentine authorities, and (2) is not considered as a non-cooperative or high-risk jurisdiction by the Financial Action Task Force.

Investment guidelines and limits

Mutual funds for qualified investors must also comply with the following investment guidelines and limits:

\(a\) they will not be allowed to invest in securities issued by the managing company or the depositary company;

\(b\) investments in securities issued by one or several issuers that belong to the same economic group cannot exceed 40 per cent of the fund’s assets;

\(c\) investments in securities issued by the managing company’s parent company, or its affiliates, cannot exceed 2 per cent of the parent company’s capital or outstanding bonds;

\(d\) investment in assets that represent corporate capital of an issuer cannot represent more than 20 per cent of said issuer’s corporate capital, and investment in its corporate bonds of said issuer’s total liabilities; in both cases, according to the last published annual or trimestral financial statements;

\(e\) investments in public debt issued under the same issuing conditions (i.e., different series of a same asset where only the issuance date changes) issued by the national government, provincial government or municipal government may not exceed 40 per cent of the fund’s net worth; and

\(f\) up to 100 per cent of the net worth of the mutual fund for qualified investors can be deposited in a financial institution outside Argentina that complies with certain conditions.

\(^{30}\) According to the CNV’s regulations, the following persons will be considered as ‘qualified investors’: (1) the Argentine government, the provinces and municipalities, autarchic agencies, state-owned companies and state enterprises; (2) international organisations and public law persons; (3) public trust funds; (3) the Argentine Social Security Administration (ANSES) and the Sustainability Guaranty Fund (FGS); (4) pension funds; (5) banks and public or private financial entities; (6) mutual investment funds; (7) financial trusts with public offering; (8) insurance companies; (9) mutual guarantee companies; (10) legal entities registered before the CNV as agents, when acting on their own behalf; (11) individuals who are registered as experts with the CNV; (12) individuals or legal entities, other than those listed in the preceding paragraphs, that at the time of making the investment have investments in securities or deposits in financial institutions for an amount equal to 350,000 UVA (a unit whose value is adjusted by inflation and represents approximately US$0.87, as at 31 July 2019); and (13) legal entities established abroad and individuals with real domicile abroad.
Investment in other mutual funds

Mutual funds for qualified investors are allowed to invest in quotas of other local or foreign open-end mutual funds, as long as investment, liquidity, diversification, debt and redemption policies are consistent with those for that mutual fund, and the following investment guidelines are followed:

a. up to 40 per cent of the fund’s assets can be invested in quotas issued by the same local open-end mutual fund;

b. the mutual fund for qualified investors can invest in open-end mutual funds registered outside Argentina if they comply with certain requirements;

c. if the mutual fund for qualified investors invests exclusively in foreign funds, this must be provided in the rules of the fund, together with its fees, commissions and expenses; and

d. investment in closed-end mutual funds, either local or foreign, is limited to up to 25 per cent of the fund’s net worth.

In all cases, the managing company must disclose to investors the fees, commissions and expenses related to the mutual funds in which the mutual fund for qualified investors invests.

Indebtedness

The rules of the fund for qualified investors have to provide the indebtedness limit, which cannot exceed the net worth of fund.

Other regulations

General regulations for open-end funds will be applicable.

iii. Regulations for managing companies, depositary companies and distribution and placement agents

The Mutual Fund Law, the Capital Markets Law and the regulations of the CNV regulate the activities of managing companies, depositary companies and distribution and placement agents.

Managing companies

A managing company must:

a. manage the fund in a professional manner as a good business person and prioritise the interest of the co-owners of the fund;

b. represent the collective interest of the co-owners of the fund; and

c. have the minimum net worth requirements set forth by the regulations.

Managing companies are authorised not only to manage mutual funds, but also other types of portfolios and to distribute and place quotas of mutual funds, whether managed by them or by other managing companies. In addition, they can render advisory services on capital market investments and place transaction orders.31

31 Section 2 of the Chapter I, Title V of the CNV Rules.
Managing companies of mutual funds must be registered with the CNV as a ‘collective investment products administration agent’. The managing company must have a net worth of at least 150,000 UVA, which must be increased by 20,000 UVA with each additional mutual fund that it manages. At least 50 per cent of such minimum net worth must be held in certain eligible assets listed by the CNV.

**Depositary companies**

The depositary company must, inter alia:

a. collect and make payments to the investor resulting from the subscription and redemption of the quotas of the mutual fund;

b. supervise the compliance by the managing company of the procedures related to the acquisition and negotiation of the assets of the mutual fund;

c. carry out the custody and deposit of the securities and the instruments related to the investments, the collection of accrued benefits and the payment and collection of the purchase prices related to the transactions of the mutual; and

d. keep a register of the investors in the mutual fund.

Depositary companies, which must be financial institutions, must be registered with the CNV as a ‘custody agent for collective investment products’. The depositary company can be registered with the CNV under other categories of agents that are compatible with its activity as a depositary company.

**Mutual fund placement agents**

The managing company and the depositary company can directly place the quotas of the mutual fund. In addition, these parties may, at their own cost, enter into placement agreements with mutual fund distribution and placement agents registered with the CNV. The appointment of a mutual fund placement agent does not discharge any of the responsibilities and duties of the managing company and the depositary company.

Mutual fund placement and distribution agents can be a financial institution or any other entity that meets the requirements of the CNV.

Any employee of the managing company, the depositary company or the mutual fund distribution and placement agent who is in contact with the public must pass an exam and be registered as a qualified adviser with the CNV.

iv Public offering of offshore mutual funds in Argentina

A foreign mutual fund can be publicly offered in Argentina if it is registered with the CNV. The registration procedure requires that the mutual fund meets not only the general requirements

32 ‘Agente de Administración de Productos de Inversión Colectiva’, Section 1 of the Chapter I, Title V of the CNV Rules.

33 Section 2 of the Chapter I, Title V of the CNV Rules.

34 Section 14 of the Mutual Fund Law.

35 ‘Agente de Custodia de Productos de Inversión Colectiva’, Section 1 of the Chapter I, Title V of the CNV Rules.

36 Section 11 of the Chapter I, Title V of the CNV Rules.

37 Section 23 of the Chapter II, Title V of the CNV Rules.

38 Section 3, Chapter II, Title V of the CNV Rules.
for the registration of foreign issuers but also the specific requirements applicable to foreign mutual funds. As further described below, the current regulations are so stringent that it is not a practical possibility to register a foreign mutual fund and there has seldom been any security publicly offered by a foreign issuer in recent years.

**Registration of a foreign entity as issuer**

The Rules of the CNV provide that all foreign issuers have to fulfil certain requirements in order to be registered as a foreign issuer. For instance, the foreign issuer must not be affected by legal restrictions or prohibitions that restrain the performance of the corporate purpose and activities set forth in the by-laws or articles of incorporation in its jurisdiction of incorporation, must have a permanent representation or branch in Argentina, and must provide evidence that it has certain eligible assets outside Argentina.

The CNV regulations applicable to local issuers will apply to the foreign issuer.

**Restriction on investment in foreign assets**

The Rules of the CNV have limitations on the assets in which these foreign issuers may invest that put these entities in the same situation as local mutual funds regarding the ability to invest in non-Argentine assets. The main investment restriction is that the securities in the portfolio shall be publicly traded in Argentina or abroad, and that 75 per cent of the investments must be made in assets issued and traded in Argentina, in Chile or in a Mercosur country.

In addition, the foreign entity may not:

a. hold more than 5 per cent of the voting rights of an entity;

b. invest in securities issued by an entity of a similar nature (e.g., other mutual funds);

c. purchase securities issued by its parent company representing more than 2 per cent of the capital or debt of such parent company, as resulting from its last financial statements (the shares in excess of such limit will have no voting rights);

d. have in its portfolio securities that represent more than 10 per cent of the total liabilities of an issuing company;

e. invest in a single Argentine government bond worth more than 30 per cent of its assets; and

f. invest more than 20 per cent of the assets in securities issued by a single issuer or by issuers belonging to the same group.

**Reporting obligations**

Foreign issuers have to comply with all the information obligations applicable to Argentine issuers, and with certain specific reporting obligations for foreign mutual funds (e.g., the redemption value of the securities as of the redemption date, and details of the funds collected in Argentina).

**Publicity**

Foreign entities must inform the CNV of any publicity made by them within three business days of the date of publication. Also, the foreign issuer must describe its legal nature, in all the information, in a manner such that the public cannot confuse them with an Argentine mutual fund regulated by the Mutual Fund Law.
v Private placement
The public offering of securities is regulated by the Capital Markets Law. The Capital Markets Law defines public offering of securities as an invitation, made by an issuer or by individuals or companies engaged fully or partially in the purchase and sale of securities, to the general public, or certain sectors or groups, made through personal offers, newspaper advertisements, radio or television broadcasts, telephone, electronic means, films, billboards, signs, programmes, electronic means (including email and social networks), circulars, printed notices or by any other means, to enter into any transaction involving securities.  

The Capital Markets Law does not provide a ‘private placement’ definition or specific ‘safe harbours’ from securities registration requirements. The lack of an express definition does not mean that private placements do not exist but that exempted transactions are defined by default as any offer of securities that does not fall within the definition of public offering. Therefore, ‘private placement’ is any offering that does not qualify as a public offering. There are certain guidelines based on a reasonable interpretation of the regulations and precedents that can be followed by parties willing to carry out a private placement in Argentina.

Therefore, offshore mutual funds can also be offered in Argentina without being registered with the CNV to the extent such offer is carried out by means of a private placement.

III COMMON ASSET MANAGEMENT STRUCTURES
Open-end mutual funds continue to dominate the mutual fund structures, with the number of closed-end mutual funds still almost negligible. Regarding the type of investment of open-end mutual funds, those open-end funds dedicated to fixed income represent approximately 60 per cent of the funds, money market around 20 per cent and equity 10 per cent.

IV MAIN SOURCES OF INVESTMENT
The current breakdown, as of May 2019, of investors in mutual funds is approximately 85 per cent legal entities and 15 per cent individuals. Individual investors have participations totalling approximately 120 billion Argentine pesos and legal entities around 660 billion Argentine pesos. The participation of individuals has decreased since May 2018 when it peaked, representing 25 per cent of the invested funds.

V KEY TRENDS
The arrival to the market of large foreign asset managers is the most relevant trend in the market. These foreign asset managers are starting to market their products to those local agents who have licences (mainly, broker dealer licences) that allow them to render investment advisory services to their clients, manage portfolios on a discretionary basis and place orders

---

39 Section 2 of the Capital Markets Law.
40 The Capital Markets Law authorises the CNV to regulate private placement exemptions (Section 82 of the Capital Markets Law). However, the CNV has not regulated private placements yet.
41 Statistics are for the year 2017, as published by the Chamber of Mutual Funds.
outside Argentina. These licensed investment advisers would then recommend these products to their clients or place orders on their behalf if they manage portfolios on a discretionary basis.

Also, these foreign asset managers are putting in place structures that will allow them to render advisory services, or sell products, to local managing companies once the regulation on mutual funds for qualified investors – which will have fewer restrictions on investing outside Argentina – becomes effective. Therefore, the issuance by the CNV of the final regulation on mutual funds for qualified investors may have a large impact on the market. In the meantime, certain management companies have launched open-end mutual funds that invest outside Argentina in Latin American countries, concentrating their investments in Chile and Brazil, which have the same treatment as Argentinian assets for the purpose of the minimum investment in local assets.

Finally, regarding the distribution of local mutual funds, certain managing companies are using electronic payment platforms and apps to offer to their users the possibility to subscribe money market funds with the cash they have available in those systems.

VI SECTORAL REGULATION

Sectoral regulations are not particularly relevant to the Argentine market as regulated companies have limited importance in the market, mainly since there are very few pension funds. Insurance companies, the largest regulated sector that invests in capital markets, can invest part of their mandatory reserves in mutual funds.

VII TAX LAW

Investors who are non-Argentine residents are exempted from income tax on the income resulting from their redemption of quotas of open-end funds that have at least 75 per cent of their assets in shares issued by Argentine companies that are traded in markets authorised by the CNV. Also, capital gains and interest arising from debt quotas of open-end funds placed though a public offering are exempted from income tax. Non-Argentine residents will benefit from the exemption to the extent they are not a resident of a non-cooperative jurisdiction for tax purposes, and the funds were not delivered from any of those jurisdictions.42

In other cases, the income arising from the redemption of quotas of open-end mutual funds will be subject to a 5 per cent or a 15 per cent income tax rate depending on the currency in which the quotas are denominated. A rate of 5 per cent applies to quotas denominated in Argentine pesos (or mutual funds whose underlying assets are issued in Argentine pesos) and a rate of 15 per cent applies if the quotas were issued in a foreign currency (or the underlying assets are issued in a foreign currency).

42 The list of non-cooperative jurisdictions shall be published by the executive branch of government. Decree No. 279/2018 provides that until the executive branch issues the list of non-cooperative jurisdictions, taxpayers should use the list of ‘cooperative jurisdictions’ published by the tax authorities.
VIII OUTLOOK

The issuance of the regulations on mutual funds for qualified investors will change the landscape of the mutual fund industry since it will allow local managing companies to partner with foreign asset managers to offer a more diverse portfolio of mutual funds with global assets.
I OVERVIEW OF RECENT ACTIVITY

Australia has one of the largest asset management markets in the world, with a savings pool in excess of A$2 trillion led by a sophisticated superannuation (pension) fund and investment management industry and one of the world’s largest sovereign wealth funds: the Future Fund. Annual growth of the investible asset pool is also underpinned by the statutorily mandated employer pension contribution regime (superannuation). Australian and foreign asset management firms have continued to attract investment mandates from the burgeoning Australian superannuation fund pool, including in real estate, infrastructure and private equity opportunities.

The federal government has maintained an open stance for foreign investors, in particular with substantial investment in Australian real estate, agriculture and infrastructure in recent years.

In recent years, this openness to investment has been supported by further legislative refinements and regulatory policy pronouncements aimed at enhancing the effectiveness of investment structures used across most asset classes. The Australian managed investment trust (MIT) structure has continued to be accepted as an appropriate vehicle for access to Australian investment opportunities in the real estate, infrastructure and private equity sectors. With an MIT, the trustee may make an irrevocable statutory capital account election that will deem any eligible investment realisation gain to be a capital gain, and as such, non-resident investors will generally not be subject to Australian tax on these gains (unless the gain relates to a direct or indirect interest in real property situated in Australia or if the gain is in respect of certain interests in a limited partnership). Additionally, eligible investors that are residents in an expanded list of foreign countries may access a concessional withholding tax of 15 per cent on ‘fund payments’ (e.g., net rental income) made by MITs in respect of certain asset classes. The concessional withholding tax regime is designed to attract investment through an expanded list of local and foreign investment funds, pension funds, sovereign wealth funds and other institutional investors.

The Australian MIT regime has also benefited from the introduction several years ago of the attribution managed investment trust (AMIT) regime. The AMIT regime provides the ability of MITs to be administered with greater flexibility and with the aim of providing a statutory safe harbour curing certain tax uncertainty that traditionally attached to unit trusts. The industry has seen a heavy adoption of the AMIT regime over the past few years.
The government has also followed through with other key modernisation measures, and at the start of 2019, introduced revised draft legislation governing a new form of managed fund in Australia, the ‘corporate collective investment vehicle’. The new regime is envisaged to make the funds landscape in Australia more marketable to foreign markets that are less familiar with trust structures. The federal government has also proposed the introduction of a limited partnership collective investment vehicle regime.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The Corporations Act 2001 (Cth) (Corporations Act) is the primary legislation governing asset management sector players. The Australian Securities and Investments Commission (ASIC) is the primary securities regulator, and monitors and enforces the Corporations Act and the associated Australian financial services licence (AFSL) regime.

An AFSL is required in order to cover a range of regulated activities, including:

- the provision of investment management advice;
- the offer of interests in an investment fund;
- the provision of custodial and depository services;
- prime brokerage and other brokerage;
- market-making activity;
- underwriting; and
- the operation of registered and unregistered investment funds.

Investment funds structured as managed investment schemes generally require registration (as registered managed investment schemes) with ASIC if offered to retail clients, and may register voluntarily in other cases (for example, if offered only to wholesale clients). Wholesale clients comprise certain institutional, sophisticated and professional investors meeting relevant thresholds prescribed by the Corporations Act.

A private placement memorandum, information memorandum or other offering memorandum for an investment fund in which only wholesale clients may invest does not need to be in a prescribed form or include prescribed statements or information, and does not need not be lodged with ASIC. However, various market misconduct requirements under the Corporations Act (aimed at preventing misleading or deceptive conduct in the provision of financial services) will apply to an offering memorandum regardless of whether it needs to be lodged with ASIC.

A holder of an AFSL must:

- maintain minimum regulatory capital;
- put in place adequate arrangements for the management of conflicts of interest;
- have adequate risk management systems;
- report significant breaches to ASIC; and
- ensure personnel are trained and supervised.

An AFSL holder is subject to an overarching duty to ensure that financial services are provided efficiently, honestly and fairly. Following market sentiment that executive members of financial services entities were falling below the expectations and standards of the community for ethical behaviour, the most in-depth review of corporate Australia ever undertaken commenced in December 2017, with the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission). On
4 February 2019, Commissioner Kenneth Hayne delivered his final report (the Hayne Report), which made recommendations aimed at improving the culture and regulation of the financial sector in Australia.

Subject to some limited exemptions, issuers of interests in, and managers of, investment funds will generally need to hold an AFSL (regardless of whether the investors in the fund are retail clients or wholesale clients).

ASIC has traditionally provided regulated firms from the US, UK, Hong Kong, Singapore and Germany with the ability to apply for access to a statutory passport-like regime covering financial services to wholesale clients in Australia. ASIC has also provided relief for foreign firms that do not carry on business in Australia from the need to hold an AFSL to provide financial services to wholesale clients in Australia. A new limited ‘foreign AFS licence’ regime is expected to be introduced in 2019, and will provide a modified pathway for access to the Australian wholesale market by foreign regulated firms.

Other regulatory bodies relevant to the asset management sector are as follows:

a) the Australian Prudential Regulation Authority (APRA), which primarily focuses on the prudential regulation of banks, insurance companies, superannuation funds and, most recently, non-bank lenders;

b) the Australian Securities Exchange (ASX), which prescribes rules governing the listing of investment funds on the ASX, including listed REITs and exchange traded funds, as well as rules governing the conduct of market operators and brokers;

c) the Australian Transaction Reports and Analysis Centre, which administers Australia’s anti-money laundering and counter-terrorism financing laws, including rules relating to identification of investors in investment funds and counterparties to derivative transactions;

d) the Foreign Investment Review Board (FIRB), which screens applications for foreign investment into Australia, in particular with respect to investment into residential property, large commercial real estate investments, agricultural investments, infrastructure, or other investments above certain monetary thresholds or that raise national interest considerations. Additional screening requirements apply for investment by foreign government investors (including sovereign wealth funds) and investment funds and other entities in which any foreign government investor has a significant interest;

e) the Takeovers Panel, which focuses on resolving takeover or corporate control-related disputes arising in relation to listed or other widely held entities; and

f) the Australian Taxation Office, which is the federal revenue collection agency, and is also charged with regulating the self-managed superannuation fund sector.

III COMMON ASSET MANAGEMENT STRUCTURES

i) Unit trusts (managed investment schemes)

The investment fund vehicle most commonly used in Australia is the unit trust. A unit trust is a legal arrangement under which a trustee is bound as a fiduciary to administer the pool of assets on behalf of beneficiaries who hold unitised interests in the pool. Unit trusts are regulated as ‘managed investment schemes’ under the Corporations Act. Unit trusts are generally required to be registered with ASIC if offered to retail clients (in which case, the
trust becomes known as a registered managed investment scheme and its trustee becomes known as the responsible entity of the registered managed investment scheme). Registration is optional for a unit trust that is offered only to wholesale clients.

Unit trusts investing in portfolio interests in financial assets or core real estate will generally have tax-transparency, and distributions will instead be taxable in the hands of unitholders (if Australian tax residents) or on a withholding basis (from distributions to non-Australian tax resident unitholders). However, a public unit trust that carries on a trading business for a relevant tax year is treated as if it were a company for most tax purposes, including being subject to the applicable corporate tax rate. A unit trust will be considered to carry on a trading business if it conducts real estate development or similar activities or controls an operating entity.

Unit trusts that are eligible to meet the criteria for MIT status may attract a concessional taxation profile, including (potentially) a concessional withholding tax rate (15 per cent) on distributions of rental income by real estate-based MITs to non-resident investors. Additionally, MITs can elect for capital account treatment of gains on the realisation of eligible investments (subject to various exceptions including land held as trading stock, debt interests and certain financial arrangements), which may be advantageous to both Australian and foreign resident investors. For example, non-resident investors are only subject to withholding under the capital account election in relation to gains from the disposal of an interest held (directly, or in some cases, indirectly) by the MIT in real property situated in Australia (defined broadly). Australian resident individuals and superannuation funds, on the other hand, can access discounted capital gains tax treatment where the relevant investment was held by the MIT for at least 12 months.

Eligibility for MIT status requires, among other things, satisfaction of certain requirements, including a requirement that certain investment management decisions be made within Australia, a widely held requirement (which may potentially be satisfied also if a substantial part of the unitholder base comprises certain types of widely held unitholders, such as pension funds), and an investment strategy that excludes the taking of controlling interests in portfolio entities that carry on a trading business.

Unit trusts may be operated in any manner as determined in the trust deed adopted by the trustee, which may, for example, provide for operation either as an evergreen or closed-end fund.

**ii Investment companies**

Corporations are not commonly used as investment fund vehicles, given that taxation is levied at the company level. Revised draft legislation has recently been introduced to provide the asset management industry with the ability to adopt a corporate collective investment vehicle structure that operates on a tax pass-through basis, subject to operating within the parameters of the legislation.

**iii Limited partnerships**

There are two types of limited partnerships available under state-based legislation: an incorporated limited partnership and an unincorporated limited partnership.

Unincorporated limited partnerships are rarely used as investment funds, particularly as their limitation of liability regime for limited partners is less favourable than the corresponding regime in relation to incorporated limited partnerships. An incorporated limited partnership is given separate legal personality as a body corporate, and its limited partners have a statutory
limitation on liability for the debts of the incorporated limited partnership (provided limited partners do not take part in the management of the incorporated limited partnership or otherwise fall within the statutory safe harbour against such liability). Incorporated limited partnerships are commonly used (along with MIT structures) in the private equity and venture capital asset classes.

Limited partnerships are taxed as companies in Australia unless they are registered with the government as venture capital limited partnerships (VCLPs), early stage venture capital limited partnerships (ESVCLPs) or Australian funds of funds (AFOFs), or they are established as venture capital management partnerships that act as general partners of a VCLP, ESVCLP or AFOF. The legislation governing these types of limited partnerships was designed to encourage Australian and foreign investment into the private equity and venture capital asset classes, particularly in relation to early stage and other venture capital investments.

In the case of VCLPs, eligible foreign investors will generally not be subject to withholding tax on gains distributed to them as limited partners.

In the case of ESVCLPs, resident and foreign investors will generally be exempt from any tax on gains distributed to them as limited partners, and certain tax credits may also be available to limited partners.

An AFOF is permitted to invest into VCLPs, ESVCLPs and co-investment opportunities originated by underlying VCLPs and ESVCLPs.

iv Segregated mandates

A substantial part of the institutional investor asset pool is allocated to managers by way of segregated mandates under an investment management agreement arrangement or through a ‘fund of one’ structure (whereby the institutional investor is the sole investor in the fund entity, subject to any carried interest and any investment commitment made by the fund manager or any of its affiliates). A benefit of such arrangements is that the institutional investor may agree a bespoke mandate with the asset manager, including terms as to investment strategy, management fees, performance fees and carried interest terms, matters that require approval by the institutional investor and reporting requirements, as well as leverage the existing custodial arrangements of the investor.

IV MAIN SOURCES OF INVESTMENT

The funds management services industry has continued to perform strongly in recent years. In particular, funds sourced from overseas markets have grown significantly, with a positive impact on industry revenue, which is forecast to grow at an annualised 3.1 per cent to reach A$9.3 billion over the next few years.

Some drivers of revenue growth include the Australian share market’s performance, the impact of movements of investment markets in driving performance fees, consolidation leading to economies of scale, growing funds under management and increased outsourcing of back-office operations to third parties. Balancing this is some evidence of downward management fee trends caused by increased competition, including from new technology solutions such as robo-advice. Looking ahead, the continuing popularity of alternative investment products and also Australia’s aging population should support further industry revenue growth.
V  KEY TRENDS

i  Introduction of corporate and limited partnership fund structures

In the 2016–2017 budget, as part of the Ten Year Enterprise Tax Plan, the government announced that it would introduce tax and regulatory frameworks for two new types of collective investment vehicles (CIVs): the corporate collective investment vehicle (CCIV) and the limited partnership CIV. On 19 January 2019, the Treasury released comprehensive exposure drafts of both the regulatory and tax legislation for the CCIV regime. The CCIV regime enables asset management firms to structure an investment fund as a corporation, and is designed to be an internationally recognisable investment vehicle that can be marketed to foreign investors. Legislation facilitating more widespread use of a limited partnership structure is also proposed (currently, limited partnerships are used only in the private equity and venture capital sectors). The overarching aim of such legislation is to provide a choice of tax-transparent structures (unit trusts, corporations or limited partnerships) but with equivalent governance features. The introduction of these alternative structures reflects industry feedback that corporations and limited partnerships are more familiar legal structures in many markets outside Australia, including across Asia.

The new structures aim to complement other recently enacted legislation (the Corporations Amendment (Asia Region Funds Passport) Act 2018) aimed at facilitating the cross-border marketing of similarly regulated fund products across jurisdictions that are signatories to the new Asia Region Funds Passport regime (initially Australia, South Korea, Thailand, New Zealand and Japan).

ii  Reform of stapled structures and other integrity measures

Infrastructure funds and private equity real estate funds commonly adopt stapled fund structures that involve an investor subscribing for interests in a trust (MIT) and either interests in a taxpaying trust or interests (in the form of shares) in an investment company. The interests of each investor in these entities are contractually stapled together in the sense that a dealing in an interest of an investor in one entity requires a corresponding dealing in the interest of the investor in the other entity. Under a typical stapled structure, the MIT would invest in entities that do not carry out a trading business (such as entities holding real estate that is not being developed), and the other entity would invest in trading entities (such as entities that hold real estate that is being developed).

In April 2019, measures were introduced to address perceived risks posed by stapled structures and similar arrangements and limit access to concessions currently available to foreign investors for passive income. Following surveillance by the Treasury, concerns were raised over situations where a tax-transparent stapled entity was investing in developed real estate and leasing that real estate to another stapled entity to carry on a trading business on that real estate. The Treasury flagged that these types of stapled structures were sometimes used in ways to convert what would otherwise be ‘active income’ into ‘passive income’, which in turn has produced a competitive advantage to investors that are not residents in Australia. The new measures address these concerns, and from 1 July 2019, the new measures increase the MIT withholding tax rate on fund payments that are attributable to ‘non-concessional MIT income’ from 15 to 30 per cent. The non-concessional MIT withholding rate imposed on cross staple arrangements generally does not apply to traditional commercial property structures, which do not involve an ‘asset entity’ leasing or licensing assets (such as real estate) or lending money to an ‘operating entity’ that generates active business income. The new
measures are not limited to stapled instruments, and can apply where there is 80 per cent common ownership by external entities across the asset entity and operating entity. The new measures are highly complex and are accompanied by various exceptions and transitional arrangements.

The Stapled Structures Act also makes the following changes:

a modifying the thin capitalisation rules to prevent ‘double gearing’ structures;
b limiting the withholding tax exemption for foreign pension funds to interest and dividend income derived from portfolio-like interests where the income is exempt from income tax in the country in which it resides and the fund does not have influence (either directly or indirectly) over decisions that comprise the control and direction of the operations of the entity that pays the dividends; and
c codifying a longstanding administrative sovereign immunity tax exemption for non-commercial investments, and limiting it to portfolio-like interests and only where the sovereign investor cannot influence key decision-making of the portfolio entity.

iii Royal Commission inquiry into the financial services sector

The Royal Commission, which grabbed headlines for much of 2018, concluded with Commissioner Hayne delivering his report on 4 February 2019. Perhaps one of the most scrutinised sectors over the course of the Royal Commission was the financial advice industry, which led many commentators to forecast that the Commissioner would take a strong stance against vertical integration. The vertical integration model involves financial advisers and banks both making and selling financial products, and therefore raises conflict considerations. The Commissioner made recommendations on the management of conflicts of interest and executive remuneration. The effects of the recommendations in the Hayne Report on the financial advice industry will be fully understood if and when legislation is passed. Also, in response to the Hayne Report, the federal government budget for 2019–2020 allocated increased funding to the sector’s regulators, APRA and ASIC, and draft legislation has been announced that strengthens the enforcement tools available to ASIC.

iv Australian financial services licensing of foreign financial services providers

Following a consultation process, ASIC has proposed the adoption of a mandatory ‘foreign AFSL’ regime for offshore asset managers that are interested in advisory or asset management relationships with wholesale clients in Australia. The proposal is that the foreign AFS regime will mirror the existing AFSL regime, subject to the relaxation of a number of regulations where the foreign financial services provider is otherwise regulated under a sufficiently equivalent foreign regulatory regime.

Expected to be introduced in late 2019, the foreign AFSL regime will replace the passport regime currently relied on by foreign financial services providers from a number of jurisdictions with regulatory regimes that are viewed as sufficiently equivalent to the Australian regime. Under existing law, foreign financial services providers that are regulated by their equivalent securities regulator in the US, UK, Hong Kong, Singapore or Germany may access relief from the need to hold an AFSL to provide financial services to wholesale clients in Australia. The relief is provided by way of the filing of certain documents with ASIC. The existing exemptions are likely to be extended until 30 September 2020 (taking into account the 12-month extension provided by the consultation process, and a proposed further 12-month transitional period for the new regime).
v Reporting measures for credit funds

An expanded range of lenders (potentially covering debt funds) with more than A$50 million in loan receivables are subject to new obligations to report on their lending activities to APRA. The aim is to enable APRA to capture and monitor some of the metrics otherwise captured from traditional bank lenders.

vi Strengthening the dispute resolution body

The Australian Financial Complaints Authority (AFCA) has replaced the Credit and Investments Ombudsman, Financial Ombudsman Service and Superannuation Complaints Tribunal. AFCA will have a higher monetary limit (A$1 million) and a higher compensation cap (A$500,000) for most non-superannuation disputes, and unlimited monetary jurisdiction for superannuation disputes.

VI SECTORAL REGULATION

i Insurance

The insurance industry is regulated by (APRA) and ASIC. As the prudential regulator, APRA sets out both standards and practice guides for the life and general insurance industry. ASIC focuses on consumer protection.

The rules regarding the investment of insurance premiums for life insurance are set out in the Life Insurance Act 1995 (Cth). The Insurance Act 1973 (Cth) sets out some rules regarding the eligible assets that are required to be held by general insurers; however, there are no restrictions on investments that can be held by insurance companies other than the trust account requirements under the Corporations Act. APRA has issued a number of prudential standards that regulate the activities of both life insurers and general insurers from a prudential perspective.

The insurance industry has recently experienced a high level of digital disruption, and there are a number of emerging disruption models, such as virtual insurance advisers and P2P network operators that are likely to shake up the general insurance and life insurance industry in Australia. To give an indication of the extent of recent digital disruption, Australia’s insurtech sector has grown by 53 per cent over the past year, driven by the entry of internationally founded insurtechs in the Australian market, which now represents 30 per cent of the 2019 ecosystem.

ii Pensions

Pensions are referred to as ‘superannuation’ in Australia. APRA has the primary regulatory responsibility for superannuation funds under the Superannuation Industry (Supervision) Act 1993 (Cth). However, ASIC also plays a role in superannuation, as the trustee of any superannuation fund is required to hold an Australian financial services licence and be subject to the licensing, conduct and disclosure rules under Chapter 7 of the Corporations Act (which are supervised by ASIC).

---

As at the end of 2018, Australians have A$2.7 trillion in superannuation assets, making Australia the 4th largest in the world in terms of pension fund assets. These assets are held by APRA regulated superannuation entities, self-managed superannuation funds, exempt public sector superannuation schemes and life office statutory funds. The sheer size of this asset pool is attributed to the compulsory superannuation guarantee scheme, which requires employers to currently contribute 9.5 per cent of their employees’ wages and salaries to a designated superannuation fund.

In terms of recent reforms, the Treasury Laws Amendment (Protecting Your Superannuation Package) Act 2019 (Cth) received royal assent on 12 March 2019. The ‘protecting your super’ package, which limits the fees charged by funds, requires insurance to be opt-in for certain individuals and facilitates the consolidation of low balance super accounts. These rules will apply from 1 July 2019.

Under recent Federal Budgets, the government has also announced a new retirement income framework that covers a retirement covenant and standardised product disclosure metrics. Following on from recommendations directed towards the financial sector’s regulators in the Royal Commission, APRA and ASIC have both received increased funding to facilitate greater enforcement activities.

The government has also announced that it intends to draft legislation that will require new entrants to the workforce be given only one default superannuation account. The announcement follows the Productivity Commission’s report Superannuation: Assessing Efficiency and Competitiveness and recommendations in the Report to limit a person’s superannuation account to one default account, in order to prevent inappropriate account erosion.

### Real property

Australian real estate investment funds continue to attract substantial inflows from Australia and foreign investors.

As discussed above, one of the key reforms affecting the real estate and infrastructure investor sector is the recently enacted legislation affecting the concessional withholding tax treatment of fund payments attributable to income derived by cross stapled MIT investment structures and rent from other arrangements in relation to agricultural land. These new laws will significantly impact real estate and infrastructure investment structures, particularly where those investments comprise investment in real estate and in a portfolio entity that carries on a business on the real estate.

As also discussed above, Australia’s foreign investment laws require approval by FIRB of certain acquisitions of interests in Australian real estate, depending on the nature and size of the investment. A stricter regime applies if the acquisition is by a ‘foreign government investor’ (which broadly captures entities including funds) in which a foreign government or foreign government body has an interest of 20 per cent or more.

Australia’s foreign investment laws also allow investors and investment funds to apply for ‘exemption certificates’ in certain circumstances (which apply as a form of pre-approval by FIRB of certain investments by the applicant that meet some common criteria). Exemption certificates are increasingly sought by investors and investment funds that wish to obtain pre-approval by FIRB of a future programme of acquisitions, particularly given the time

---

4 ‘Superannuation Statistics’. The Association of Superannuation Funds of Australia.
and costs that would otherwise be involved in having to make individual applications for each proposed investment. An exemption certificate generally applies for a prescribed period (commonly one year), and covers acquisitions that meet certain pre-approved criteria and have an acquisition value below the prescribed individual acquisition amounts (subject to an aggregate overall acquisition value).

Furthermore, a noteworthy condition for FIRB approval in relation to certain types of acquisitions (primarily real estate) is that the applicant demonstrates that the relevant vendor has undertaken a transparent advertising process to market the investment for sale in the Australian market prior to investment by the relevant foreign person.

iv  Hedge funds

The Australian market has seen a heightened level of market activity by activist hedge funds. This has included actions by certain hedge funds calling for shareholder meetings to agitate for a change in the board or overall strategy of a portfolio company.

A high-profile foreign hedge fund (with an investment strategy that included short selling) attracted considerable attention in 2018 following publication of its in-house research asserting that the value of a particular ASX-listed company (which carried on an investment management business) was less than half the value reported by the company to the market. The company’s share price experienced a dramatic decline. Some market commentators have called for a review of the application of Australian laws (including market misconduct rules and AFSL laws) in relation to foreign short sellers making announcements in the Australian market.

In recent years, hedge funds have had to prepare for the commencement of APRA prudential requirements for margining and risk mitigation of non-centrally cleared derivatives (APRA Prudential Standard CPS 226), which is one of the latest outcomes of the G20’s response to the financial crisis. This has involved completion of self-disclosure documents and entry into new credit support documents for hedge funds that trade with a bank or other prudentially regulated entity to which the Australian margin rules apply, or any other financial institution to which any foreign margin rules apply.

v  Private equity

As discussed above, venture capital funds in Australia are commonly structured as closed-end incorporated limited partnerships that are registered with the government as VCLPs or ESVCLPs. However, given the legislative restrictions that apply to the investment activities of VCLPs and ESVCLPs (most notably, the restriction on investing in a portfolio entity that has assets totalling more than A$250 million), venture capital fund structures may include, or allow the establishment of, alternative investment vehicles to make investments that a VCLP is restricted from making. The most common alternative investment vehicle structure is parallel MITs that co-invest in the investment opportunity that falls outside the permitted investment activities of the VCLP. The alternative investment vehicles may be used to invest in more than one portfolio entity.

Private equity funds in Australia are most commonly structured as parallel closed-end MITs. The parallel fund structure gives cornerstone investors, and other investors that are making large commitments to the fund, the opportunity to each invest separately in a parallel fund entity, and for all other investors to invest in a pooled parallel fund entity. The
opportunity for a larger investor to invest separately in a parallel fund entity that qualifies as an MIT affords an investor that is a superannuation fund, pension fund or other widely held fund greater control in satisfying the ongoing widely held test that applies to the MIT.

Some common variations to the parallel fund structure for private equity funds include the use of a foreign parallel fund entity for some or all of the foreign investors, and the use of a parallel VCLP (together with alternative investment vehicles as discussed above) for some or all of the domestic superannuation fund investors and some or all of the foreign investors.

Access to co-investment opportunities (on a no management fee and no carried interest basis) remains a key focus of many larger domestic institutional investors. However, the use of overflow or co-investment funds by domestic private equity funds as means of co-investment access by investors remains less common than in other developed markets. The more common approach is for co-investment opportunities to be presented on a case-by-case basis to one or more of the larger investors, and for the co-investments to be undertaken directly by those investors.

Management fees for domestic private equity funds still tend to be set at 2 per cent per annum of committed capital (dropping down to invested capital after the investment period) but with the possibility, in some cases, of fee rebates under side letters for cornerstone or larger investors. Carried interest has generally remained at a rate of 20 per cent of distributed profits (on a whole-of-fund basis) subject to a preferred return of 8 per cent per annum to investors and a carried interest catch-up (at a rate ranging from 50 to 100 per cent). Director fees, transaction fees and break-up fees are commonly offset at a rate of 100 per cent against management fees.

Private equity funds in Australia largely adopt the best practice reporting and valuation guidelines formulated by their industry body, the Australian Private Equity and Venture Capital Association, and are largely aligned with the private equity principles formulated by the Institutional Limited Partners Association. As the domestic private equity funds industry continues to attract significant investment from foreign investors, we also expect to see the continued alignment of domestic private equity funds terms with those in other developed private equity markets.

VII TAX LAW

As discussed above, the tax profile of funds, managers and investors is driven by the particular vehicle used and the particular investment activities undertaken by it. Overall, government has maintained an investor and manager-friendly policy stance, with further legislative refinements aimed at facilitating internationally recognisable fund structures, including proposed reforms that will enable broader use of corporations and limited partnerships as collective investment vehicles.

Again as above, one recent area of Treasury focus has been in relation to the use of stapled investment holding structures, which are commonly used by domestic and foreign investors, particularly to access real estate and infrastructure investment opportunities. Existing stapled structures and MITs investing in agriculture and residential housing may access the transitional arrangements, which can apply for seven to 15 years; however, the new integrity measures relating to cross stapled arrangements will need to be taken into account in the design of new investment holding vehicles.
VIII OUTLOOK

Further M&A activity is expected in Australia, as the Royal Commission led focus on vertically integrated financial services firms is leading to some such firms demerging their financial product issuance businesses from their financial planning and investment advisory businesses.

The introduction of alternative collective investment structures, coupled with the Asia Region Funds Passport, should assist Australian asset managers to more effectively access foreign investor markets.

Australian managers should continue to be supported by the reforms of several years ago, and since adopted in practice, under the investment manager regime, which removes some traditional tax uncertainty associated with foreign funds engaging with Australian managers.

In terms of foreign asset manager access to the Australian investor market, the new foreign AFS licence regime will involve an upfront cost in the associated application process. This should, however, provide certainty for managers in terms of a clear pathway for access to the Australian market, as well as enhance Australian investor confidence associated with engaging with foreign managers.

The industry is expecting sustained foreign investor interest in Australian real estate, agriculture and infrastructure investment exposure. MIT structures are becoming understood by more and more well-known large foreign investors, and accepted as the gateway necessary to access a concessional withholding tax profile and deemed capital account election.
I OVERVIEW OF RECENT ACTIVITY

Brazil has been subject to important regulatory changes in recent years with regard to asset management activities by virtue of several new regulations issued by the National Monetary Council (CMN), the Brazilian Securities Commission (CVM) and the Central Bank of Brazil (CBB) aimed at modernising and optimising the regulatory framework in light of recent market practices.

As further detailed below, noteworthy CVM regulations include:

a) CVM Instruction No. 539 of 13 November 2013, which established the suitability rules related to securities distribution;

b) CVM Instruction No. 554 of 17 December 2014 (CVM Instruction 554), which established the new classification of qualified and professional investors;

c) CVM Instruction No. 555 of 17 December 2014 (CVM Instruction 555), which established the new general regulatory framework applicable to investment funds; and

d) CVM Instruction No. 558 of 26 March 2015 (CVM Instruction 558), which established the new rules applicable to the professional management of securities portfolios.

On 17 November 2017, the CVM enacted CVM Instruction No. 592, a new regulation applicable to securities advisory activities, with the intention of setting forth in detail the requirements and ongoing compliance obligations that investment advisers shall be subject to in order to obtain and maintain their licences, which are similar to the ones applicable to discretionary asset management activities.

Private equity funds, which are subject to specific regulation by the CVM, have also been subject to a new regulatory framework by means of the enactment of CVM Instruction No. 578 of 30 August 2016 (CVM Instruction 578) (see Section VI).

The CMN in its turn has updated its regulation on foreign investments in Brazil with the issuance of Resolution No. 4,373 of 29 November 2014 (CMN Resolution 4,373). In addition to modernising and simplifying the rules applicable to foreign investments, the new rule also implements new mechanisms to increase the volume of foreign investments in Brazil.

Within their respective areas of authority, on 27 March 2015, the CBB enacted Circular No. 3,752 and the CVM enacted Instructions Nos. 559 and 560, which further regulate foreign capital in Brazil, especially with regard to the registration of non-investors...
and investments in equity and debt securities via depositary receipts. More recently, the CVM enacted CVM Instruction No. 585 of 5 April 2017 with the purpose of facilitating the offering of foreign securities in Brazil through Brazilian depositary receipts.

It is also worth highlighting CVM Instruction No. 568 of 17 September 2015 (CVM Instruction 568), which, inter alia, amended the rules applicable to reporting obligations involving significant ownership in publicly held companies, including specific calculations for holdings through derivatives and convertible instruments.

There has been an attempt to diversify and facilitate the possibility and variety of investment opportunities by the Brazilian authorities. These new rulings effectively introduce the new regulatory framework applicable to all market participants.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The Brazilian financial system can be divided in three tranches: normative agencies, supervisory agencies and market participants.

From a general perspective, federal laws applicable to the capital markets in Brazil contain general provisions with the purpose of establishing what the Brazilian capital markets comprise, which entities may be agents of the market, and the different independent agencies that have powers to oversee it and the limits of their authorities.

The normative agencies are responsible for enacting the general regulations and guidelines of the financial system under their respective areas of authority. Such normative agencies are the CMN, which is the main normative agency of the Brazilian financial system; the National Private Insurance Council (CNSP), related to the insurance, capitalisation and open-ended private pension segments; and the National Supplementary Pension Council, related to private pension funds.

The supervisory agencies are generally responsible for monitoring and enforcing regulations and the compliance of relevant market participants (financial institutions, stock exchanges, investment funds, portfolio managers, etc.). They are responsible for regulating, supervising, developing and controlling their corresponding segments of the financial system. Such supervisory agencies are the CBB, the CVM, the Private Insurance Authority (SUSEP) and the National Supplementary Pension Authority (PREVIC).

In summary, the regulations setting forth the specific set of rules that each player and transaction has to comply with are CVM instructions, CBB circulars and CMN resolutions. The structure of the Brazilian financial and capital markets is also composed of a self-regulatory agency, the Brazilian Financial and Capital Markets Association (ANBIMA), which created a set of rules with increased corporate governance for its associates (e.g., asset managers, advisory entities and investment funds).

In this regard, ANBIMA issued a new set of rules on 4 May 2018 establishing the best practices to be adopted by its associates regarding asset management. The new Code for Regulation and Best Practices for Asset Management replaced the Code for Investment Funds; it has been in force since 2 January 2019 and was amended on 23 May 2019.
i  Portfolio management and securities advisory services

Local professional management and administration of securities portfolios can only be carried out in Brazil by a natural person or a legal entity duly authorised by the CVM. Such natural person must be resident in Brazil, and the legal entity must be organised and headquartered in Brazil.

Portfolio management activities in Brazil are distinguished by two types of portfolio managers with different areas of expertise: fiduciary administration, with direct or indirect responsibility for the custody and controllership of assets and liabilities and, generally, for the supervision of the markets; and asset management, with responsibility for the decision-making process of investments. This distinction is duly reflected by CVM Instruction 558, which establishes that portfolio managers, depending on the activities performed, shall request their registration under the fiduciary administrator category, under the asset manager category, or under both.

Additionally, CVM Instruction 558 introduced some other significant changes to rules applicable to the management of securities portfolios. The following changes are noteworthy: assignment of certain responsibilities to statutory officers; possibility of distribution of quotas of investment funds under management; and improvement of rules of conduct and information duties.

Regarding the new information duties required from portfolio managers, they must now publish their internal policies and manuals on the internet, as well as disclose and keep an updated reference form similar to a prospectus applicable to listed companies.

In addition, portfolio managers must file the annual version of their reference form with the CVM by 31 March of each year.

In addition to asset management activities, it is possible to seek a securities advisory licence with the CVM that only authorises the holder to provide non-discretionary investment recommendations, as per CVM Instruction 592. By virtue of an innovation introduced by CVM Instruction 592, asset managers accredited with the CVM pursuant to CVM Instruction 558 are no longer automatically authorised to provide securities advisory services, with a separate and specific licence for carrying out non-discretionary investment advisory activities being necessary. In addition, CVM Instruction 592 also established that such two activities cannot be carried out by the same person and, in the case of legal entities, a physical segregation between the two is required.

ii  Investment funds

Portfolio management in Brazil is usually carried out through investment funds. Under local regulations, investment funds are considered as a pool of resources incorporated under the form of a condominium (i.e., they are not corporate organisations) intended for investments in financial instruments and securities, as well as in any other assets traded in the financial and capital markets, according to the terms and conditions established in their by-laws.

A condominium is a type of unincorporated entity in which two or more persons hold joint title to certain assets, being attributed a notional part (quota).

A condominium has no legal personality apart from that of its owners. Even though funds do not have a legal identity under Brazilian law, orders for the purchase and sale of securities are carried out in its name.

Investment funds can be divided into closed-ended and open-ended funds.
Generally, open-ended funds are characterised by the possibility of quota holders to redeem their quotas at any time, and a prohibition, as a general rule, on quotas being assigned or transferred.

Closed-ended investment funds, on the other hand, do not allow the redemption of quotas at any time, except in the case of liquidation of the fund; and their quotas may be transferred by means of a term of assignment and transference, or through a stock exchange or over-the-counter (OTC) market.

The creation, management and operation of most investment funds in Brazil is currently regulated by CVM Instruction 555, which became effective on 1 October 2015. However, certain types of funds are subject to specific regulations, including, inter alia, receivables investment funds (FIDCs), real estate investment funds (FIIs) and private equity funds (FIPs), as further detailed in Section VI.

CVM Instruction 555 has introduced relevant changes to the Brazilian investment fund industry, including:

a. a new classification of investment funds;

b. a clearer obligations for portfolio liquidity management;

c. a higher threshold for offshore investments by investment funds;

d. no minimum investment being required for investing in foreign investment funds;

e. new rules regarding performance fees; and

f. all communication with quota holders may be carried out electronically.

As a general rule, the distribution of fund quotas must be carried out by duly qualified entities pertaining to the Brazilian securities dealership system. As mentioned above, however, CVM Instruction 558 authorises portfolio managers, even if they are not accredited as a securities distributor, to distribute quotas of managed funds (i.e., they are not authorised to distribute quotas of third-party funds).

iii Investor classification

To improve and structure the market, CVM Instruction 554 establishes three categories of investors in the Brazilian financial and capital markets, each requiring their own appropriate level of regulation. The rules set forth the criteria for an investor to be characterised as a qualified and as a professional investor. Retail investors are, therefore, those investors that do not fall under the previous categories (by exclusion).

Pursuant to CVM Instruction 554, the following shall be considered professional investors:

a. financial institutions and other entities authorised to operate by the CBB;

b. insurance companies and capitalisation societies;

c. open and closed-ended pension funds;

d. individuals or legal entities that hold financial investments in an amount in excess of 10 million reais;

e. investment funds;

f. investment clubs managed by a professional manager;

g. portfolio administrators and securities consultants authorised by the CVM in relation to their own monies; and

h. non-resident investors.
Likewise, the following shall be considered qualified investors:

a professional investors;
b individuals or legal entities that hold financial investments in an amount in excess of 1 million reais;
c individuals that have been approved in specific certification examinations; and

d investment clubs managed by quota holders.

CVM Instruction 554 came into effect on 1 October 2015, jointly with CVM Instruction 555.

iv Foreign investment considerations

Pursuant to CVM Instruction 555, investment funds have different limits of investment in offshore assets depending on their target public, as detailed below. In general, these limits were increased when compared with the limits imposed by the previous rule, CVM Instruction No. 409 of 18 August 2004 (CVM Instruction 409).

<table>
<thead>
<tr>
<th>Classification</th>
<th>Limit (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-income investment fund – foreign debt</td>
<td>100 (unlimited)</td>
</tr>
<tr>
<td>Funds targeted exclusively to professional investors</td>
<td>100 (unlimited)</td>
</tr>
<tr>
<td>Funds targeted exclusively to qualified investors that meet certain additional requirements</td>
<td>100 (unlimited)</td>
</tr>
<tr>
<td>Funds targeted exclusively to qualified investors that do not meet the above-mentioned conditions</td>
<td>40</td>
</tr>
<tr>
<td>Funds targeted to the public in general (retail)</td>
<td>20</td>
</tr>
</tbody>
</table>

Funds targeted exclusively to professional investors may invest 100 per cent of their assets offshore. As explained above, there is no minimum investment required from investors to acquire quotas of such funds, but they must be professional investors.

It is important to stress that Brazil still has very strict controls on foreign exchange transactions (i.e., on the inflow and outflow of funds to and from the country). According to the Brazilian foreign exchange regulations, all exchange transactions must be carried out through an authorised exchange entity in Brazil.²

With regard to foreign investment in the Brazilian capital and financial markets, CMN Resolution 4,373 establishes that they must be duly registered with the CBB and the CVM, as well as meet other requirements established therein. As a general rule, such investment must be made in organised capital markets (e.g., stock exchanges and OTC markets).

In addition to investing in the Brazilian capital and financial markets, foreign investments can also be made directly in the form of equity of Brazilian companies. Such investments shall also be registered with the CBB under the Electronic Registration System – Foreign Direct Investment.

² In addition to all foreign exchange transactions having to be carried out through an authorised exchange entity, other requirements include that a relevant foreign exchange contract must be signed describing the respective parties, the date, the nature of the transaction and the exchange rate, among other information; and that all foreign exchange transactions must be registered at the CBB electronic data system (SISBACEN).
v Offering of foreign securities

Under Brazilian law, the offering of foreign securities is subject to regulation that affects the possibility of offering such products on a public basis in Brazil.

The public offering of securities in Brazil is primarily regulated by the Securities Market Law and CVM Instruction No. 400 of 29 December 2003, as amended. According to these regulations, as a general rule, public offerings must be previously registered with and authorised by the CVM.

Foreign securities are generally not eligible for registration in Brazil. Therefore, in order for foreign entities to offer their products in Brazil, they shall adopt certain procedures to avoid their public disclosure in Brazil.

Brazilian law does not provide a definition of what constitutes a private placement of securities. Consequently, the concept of private placement is based on what would not constitute a public offering under Brazilian law, and therefore would not require registration with the CVM.

Individuals or legal entities resident in Brazil are permitted to invest abroad, provided that information relating to such assets owned abroad is fully disclosed to the CBB and the Brazilian tax authorities. The obligation to disclose to the Brazilian authorities the existence of assets owned abroad lies exclusively with the owners of such assets.

Nevertheless, specific entities of the Brazilian financial system, such as pension plans, insurance and reinsurance companies, governmental entities, banking companies and investment funds, have certain limitations when it comes to investing abroad (e.g., rules regarding portfolio diversification and asset concentration limits per investor and type of asset). The main rules regarding foreign investment restrictions by Brazilian entities are detailed in Section II.iv, and Section VI.

III COMMON ASSET MANAGEMENT STRUCTURES

The regulatory framework for investment funds (the main vehicle for investments in Brazil) recently underwent important amendments.

With the objective of streamlining and updating the structure of the investment fund industry, CVM Instruction 555 has modified the main existing types of investment funds. The new structures permitted by CVM Instruction 555 are as follows:

<table>
<thead>
<tr>
<th>Classification</th>
<th>Main risk factor</th>
<th>Possible subcategories</th>
</tr>
</thead>
</table>
| Fixed-income investment fund | Variation of interest rate, price indices or both | a short-term  
b long-term  
c indexed  
d simple  
e foreign debt  
f private credit  
g foreign investment |
| Shares investment fund | Price variation of equity securities traded in the organised market | a Level I Brazilian depositary receipts  
b access market  
c foreign investment |
| Exchange investment fund | Price variation of foreign currency or the variation of exchange coupons | a foreign investment |
| Multimarket investment fund | Various risk factors (for operators with different strategies and in different markets) | a long-term  
b private credit  
c foreign investment |
Other important types of funds not regulated by CVM Instruction 555 are further detailed in Section VI.

IV MAIN SOURCES OF INVESTMENT

The Brazilian fund industry represents a significant target for investments in the country. It is placed among the top 10 asset management industries in the world, with approximately US$1.2 trillion distributed in 16,000 funds. This also represents more than 50 per cent of the national GDP.

Despite the adverse economic and political conditions of recent years, the Brazilian investment fund industry experienced growth of 7.3 per cent in 2018, a significant growth rate with net assets in excess of US$87 billion.

The growth of the higher risk classes, to the detriment of the traditional fixed income is noticeable. Investments in fixed income in Brazil from 2017 to 2018 decreased from 46.2 per cent to 44.3 per cent of the total assets under management, while multimarket and share investment funds have grown, respectively, by 0.7 per cent and 1.1 per cent.

The Brazilian fund industry is still greatly concentrated in fixed-income investments, largely because of the high interest rates maintained in previous years, in addition to the country’s long-term investor concentration profile, such as government and private pension funds, which has culminated in fixed-income investment funds accounting for 44.3 per cent of the Brazilian fund industry’s equity.

Nevertheless, as expected, there has been an increase in the diversification of local portfolios due to the current tendency of interest rates returning to lower levels, having decreased from 13 per cent per annum in January 2017 to 6.5 per cent per annum since May 2018.

V KEY TRENDS

After being expected by market participants for a long time, a new regulatory framework for the investment fund industry was recently implemented, along with the entering into force of CVM Instructions 554, 555 and 558.

Ten years after the enactment of CVM Instruction 409, the new regulations have been designed to bring more efficiency, transparency and competitiveness to the fund industry. They also mark the maturity of the local market, demanding stricter structures, transparency and professionalism from market participants.

In addition, the regulator has demonstrated a better understanding of the market’s dynamic, thus creating and regulating new sought-after investment opportunities. This could prove essential for making the Brazilian market more attractive to international investors, paving the way for continuous growth of the industry.

On the other hand, the new regulations have also made investment in foreign markets more accessible to Brazilian investors, and an increase of investment funds aimed at investing offshore can be noted.

There is potential for development in other specific sectors governed by the CVM; for example, FIPs and securities advisory services, by virtue of the new rules being implemented.

---

3 Based on information provided by the 2018 Brazilian Mutual Fund Industry Yearbook published by the Getúlio Vargas Foundation Centre for Financial Studies.
shall contribute to the process of aligning the local rules to the industry’s international standards and best practices, as well as to the technical and operational needs of market players.

Moreover, the Brazilian regulatory authorities have been adopting a stricter stance on compliance. Since the strengthening of the anti-money laundering regulations in 2012 with the enactment of Law 12,683 of 9 July 2012, important anti-corruption rules have also been enacted (Law 12,846 of 1 August 2013 and Decree No. 8,420 of 18 March 2015).

Finally, both CVM and ANBIMA have issued stricter rules for the development of both advisory and discretionary management activities. This trend towards further regulation should be taken into account when analysing establishing a presence in the Brazilian market.

VI SECTORAL REGULATION

i Insurance

Brazilian accredited insurers are regulated by three authorities: CNSP, SUSEP and CMN.

Pursuant to CMN Resolution No. 4,444 of 13 November 2015, as amended, insurers can only invest in five different types of assets: fixed income, variable income, real estate, investments subject to currency exchange variations and others (including shares of some types of investment funds, certificates of structured transaction and others).

Brazilian insurance companies are prohibited from investing offshore, except through local investment funds and branches of Brazilian insurance companies located offshore. With respect to the former, Brazilian companies are allowed to invest up to 10 per cent of their funds and financial resources in quotas of local investment funds qualified as ‘foreign debt’. Thus, Brazilian insurance companies would invest in a local investment fund that, in turn, would invest in the offshore market.

ii Pensions

Under Brazilian legislation, there are two types of pension funds: private funds, which are classified as either open-ended or closed-ended; and public funds, which are exclusively composed of pension plans whose members are employees of authorities and government-held companies of the union, states, federal district and municipalities.

While the pension plans offered by open-ended pension funds may be contracted by any individual or group of individuals, those offered by closed-ended pension funds are generally accessible only by sponsors.

The private pension segment is generally governed by Supplementary Law 109 of 29 May 2001, as amended.

While open-ended pension funds are organised as regular joint-stock companies, being regulated by the above-mentioned authorities, closed-ended pension funds can only be organised as foundations or non-profit companies, and are regulated by PREVIC.

The investment restrictions applicable for Brazilian accredited insurers outlined in Section VI.i are the same for open-ended private pension companies.

In addition, CMN Resolution No. 4,661 of 24 May 2018, as amended, further regulates closed-ended pension funds, and sets forth the limits and rules for investment by closed-ended pension funds.

Closed-ended pension funds may invest in:

a) fixed-income assets;

b) variable income assets;
Brazil

structured transactions;
offshore investments;
real estate; and
transactions with members of a related pension plan.

Brazilian closed-ended pension funds are only allowed to invest up to 10 per cent of their net equity offshore through a local investment fund (e.g., feeder fund). In addition, a single Brazilian closed-ended pension fund may not hold more than 25 per cent of the net equity of an offshore investment fund. These restrictions are due to the government’s efforts to prevent Brazilian residents’ savings being invested outside the country and exposed to offshore risks.

There have been discussions about the possibility of changing the above-mentioned thresholds; however, there is still no concrete proposal in place in this regard.

iii Real property

FIIIs are governed by Law 8,668 of 25 June 1993, as amended, and further regulated by CVM Instruction No. 472 of 31 October 2008, as amended. Such funds are designed to invest in real estate projects and are necessarily closed-ended funds. Investments are permitted in the following:
real estate properties and rights;
equity of real estate companies;
special purpose entities with real estate business;
other funds (FIPs, FIIIs, FIDCs); and
real estate receivables certificates and other instruments.

iv Hedge funds

There are no specific rules regarding hedge funds in Brazil. Local authorities do not consider them as a separate category of investment funds, being generally regulated by CVM Instruction 555. Therefore, such funds may be organised as, for instance, multimarket investment funds with diverse investment policies.

v Private equity

FIPs are primarily governed by CVM Instruction 578, as amended.

Pursuant to CVM Instruction 578, FIPs are characterised as closed-ended investment funds that invest in shares (stock), convertible or non-convertible debentures, subscription warrants, and other securities either convertible into or exchangeable for shares issued by publicly or privately held corporations, as well as equity investments in limited liability companies; and, as a general rule, actively participate and monitor the management of the invested company. It is also permissible that FIPs invest in shares of other FIPs.

At least 90 per cent of a FIP’s net equity must be invested in permitted investments, which may now include foreign assets, provided such assets also comply with the FIP investment restrictions. Foreign investments by FIPs are limited to 20 per cent of their net equity.

In addition, FIPs shall have a definite term of duration and be targeted exclusively to qualified investors. In terms of classification, FIPs may fall under the following categories:
seed capital;
venture capital;
infrastructure;
CVM Instruction 578 stipulates that most of the operational rules governing an FIP and its operations, particularly those involving, inter alia, governance matters, minimum net equity requirements, investment policy, capital calls, distributions of proceeds and duration, may be established in the FIP’s by-laws. Therefore, the FIP structure is very flexible.

**vi Other sectors**

**FIDCs**

FIDCs are specifically governed by CVM Instruction No. 356 of 17 December 2001, as amended.

FIDCs enable the securitisation of virtually all types of receivables, and are thus the main vehicle currently used for securitisation in the local market. Moreover, they must invest at least 50 per cent of their portfolio in receivables. Quotas of FIDCs may be divided into senior and subordinated quotas. As a general rule, senior quotas shall have priority for amortisation and redemption, while subordinated quotas permit the creation of over-collateral.

The regulations also set forth rules regarding non-standardised FIDCs. Pursuant to CVM Instruction No. 444 of 8 December 2006, such funds broaden the possibility of investment in receivables such as government bonds and litigated claims.

**Exchange traded funds (ETFs)**

Governed by CVM Instruction No. 359 of 22 January 2002, as amended (CVM Instruction 359), Brazilian ETFs are index-tracking funds; therefore, their portfolios reflect a given index of reference (benchmark).

Until 2013, Brazilian ETFs investments could only reference Brazilian stock and variable-income asset indexes. However, the enactment of CVM Instruction No. 537 of 16 September 2013, which amended CVM Instruction 359, finally made fixed-income ETFs accessible from a regulatory perspective and anticipated certain issues regarding the upcoming enabling of international ETFs (local ETFs that replicate international indices).

As of 2014, upon the concession of a few waivers, the first international ETFs were launched under CVM Instruction 359, giving such ETFs investors exposure to foreign assets. On 12 July 2016, the CVM announced that additional waivers for the offering of international ETFs to the general public could be granted on a case-by-case basis.

The number of Brazilian standard ETFs has grown since the first ETF was established; however, the number of Brazilian ETFs referencing foreign indexes is still unfortunately extremely low.
VII TAX LAW

i Overview

Given that Brazilian investment funds are treated as condominiums and not as legal entities, any income or gains obtained by such funds from their transactions are not subject to taxation in Brazil. The taxation occurs only when the income or gains are eventually distributed to quota holders.

As a general rule, foreign exchange transactions are subject to tax on financial transactions (IOF F/X) pursuant to Decree No. 6,306 of 14 December 2007. Although the remittance of funds to or from Brazil are generally subject to IOF tax at a rate of 0.38 per cent, such transactions are subject to a zero rate if related to the inflow and outflow of funds invested by foreign entities in the Brazilian financial and capital markets. In addition, foreign exchange transactions carried out by Brazilian investment funds in connection with the execution of investments in the international market are subject to IOF at a rate of zero per cent.

ii Open-ended investment fund: taxation of Brazilian quota holders

Under Brazilian tax legislation (Normative Ruling No. 1,585 of 31 August 2015 (IN 1,585/15)), as a general rule, income and gains distributed from open-ended funds to quota holders resident in Brazil related to the redemption or amortisation of a fund’s quotas would be subject to a withholding income tax (WHT) assessment at variable regressive rates (22.5 to 15 per cent) depending on the holding period of the investment and on the maturity term of a fund’s portfolio.

If a fund has a long-term portfolio (assets with a redemption term exceeding 365 days), the WHT would be assessed at the following rates:

a. 22.5 per cent for a holding period of up to 180 days;
b. 20 per cent for a holding period of between 181 and 360 days;
c. 17.5 per cent for a holding period of between 361 and 720 days; and
d. 15 per cent for a holding period of longer than 720 days.

If the fund has a short-term portfolio (assets with a redemption term of less than 365 days), the WHT would be assessed at the following rates: 22.5 per cent for a holding period of up to 180 days, and 20 per cent for a holding period longer than 180 days.

In addition to the above, Brazilian quota holders of open-ended funds would be subject to a WHT assessment on a semi-annual basis (on the last days of the months of May and November) at rates of 15 or 20 per cent, depending on the classification of the fund as either long-term or short term.

This twice-yearly taxation is also known as come cotas taxation, which is deemed an advance payment of the WHT to be assessed in cases of redemption or amortisation of quotas, and shall not result in an increase of the overall tax burden of the investment (i.e., the WHT will be offset by the come cotas previously paid).

In the event that a quota holder is a legal entity, the WHT tax potentially paid by the investor as a result of its funds investment would be considered as a prepayment of the

---

4 This section was reviewed by Tiago Lopes da Cruz, an associate at Pinheiro Neto Advogados.
5 Not comprising shares investment funds, FIIs and other types of funds that are governed by particular tax rules.
corporate taxes due by such investor, which means that the investor would be entitled to
offset the WHT tax against the corporate income tax (IRPJ and CSL) assessed at, as a general
rule, a combined rate of 34 per cent on the taxable income derived by such entity.

Moreover, financial income derived by Brazilian legal entities from investment in funds
would be subject, as a general rule, to the assessment of the contribution on gross revenues
(PIS/COFINS) at a combined rate of 4.65 per cent.

### iii Closed-ended investment fund: taxation of Brazilian quota holders

Closed-ended investment funds are generally taxed upon their liquidation, the amortisation
of quotas or the disposal of quotas pursuant to the regressive rates established by IN 1,585/15: 7

- **a** 22.5 per cent for a holding period of up to 180 days;
- **b** 20 per cent for a holding period of between 181 and 360 days;
- **c** 17.5 per cent for a holding period of between 361 and 720 days; and
- **d** 15 per cent for a holding period of longer than 720 days.

In certain cases, capital gains incurred by individuals in the disposal of quotas of certain funds
in transactions carried out outside the stock exchange and the organised OTC markets could
be subject to WHT assessment at the following progressive rates:

- **a** 15 per cent on the amount of gains not exceeding 5 million reais;
- **b** 17.5 per cent on the amount of gains in excess of 5 million reais but not exceeding
  10 million reais;
- **c** 20 per cent on the amount of gains in excess of 10 million reais but not exceeding
  30 million reais; and
- **d** 22.5 per cent on the amount of gains in excess of 30 million reais.

Unlike open-ended investment funds, **come cotas** taxation (see Section VII.ii) is not applicable
to closed-ended funds.

As for investors who are legal entities, the income derived from a closed-ended
investment fund will be generally subject to the assessment of IRPJ and CSL at, as a general
rule, a combined rate of 34 per cent, and investors will be allowed to offset such tax with the
WHT previously levied on their investment in the fund.

Income derived from investment in the fund will be also subject to PIS/COFINS, as a
general rule, at a rate of 4.65 per cent for corporate entities.

### iv Taxation of non-resident quota holders

Currently, foreign investments into quotas of an investment fund (regardless of whether they
are open or closed-ended) carried out pursuant to CMN Resolution 4,373 are generally 8

---

6 More precisely, legal entities subject to the non-cumulative regime of PIS/COFINS taxation, and financial
institutions and equated entities pursuant to the applicable regulations.
7 See footnote 5.
8 See footnote 6.
9 Exception is made for certain investment funds, inter alia, shares investment funds (WHT rate of
10 per cent); FIPs, which, provided certain statutory requirements are met, may benefit from a more
favourable tax treatment; and investment funds with portfolios composed of at least 98 per cent
government bonds (WHT rate of zero per cent).
subject to WHT at a rate of 15 per cent on the income and gains distributed by the fund, unless the quota holder is located in a tax haven jurisdiction,\(^\text{10}\) in which case the investor will receive the same tax treatment applicable to Brazilian individuals.

As a general rule, the remittance of funds into Brazil carried out by foreign investors for purposes of subscribing quotas of Brazilian investment funds are currently subject to IOF assessment at a flat rate of zero per cent. Likewise, the remittance of funds from Brazil carried out by Brazilian investment funds as a return of foreign investment, regardless of whether it is derived from amortisation or redemption of quotas, is also currently subject to IOF assessment at a zero per cent rate.

\textbf{v} \quad \textbf{IOF bonds}

Finally, the IOF assessed on bonds and securities transactions (IOF bonds) may be levied on the disposition of investment fund quotas by both Brazilian and non-Brazilian investors at a rate of 1 per cent per day. IOF bonds are currently, limited to the gain ascertained in a transaction, and reduced pursuant to the length of time that the investment is held by the investor. For instance, transactions with securities held by the investor for at least 30 days will not result in the collection of the IOF bonds.

\textbf{VIII OUTLOOK}

The current regulatory framework is expected to improve the structure and profile of the Brazilian investment fund industry, creating great potential for growth and development for managers, national and international investors, and savers.

CVM Instruction 554 improves the definitions of the classes of investors and clarifies the regulations that each of such classes is subject to, thus increasing the transparency of and accessibility to asset management products.

In addition, CVM Instruction 555 offers new and efficient investment opportunities for local and foreign investors, especially with regard to the accessibility of foreign markets to Brazilian investment funds. The internationalisation of investments can also benefit the ever-increasing pension fund segment, which may be intensified by the new rule.

The rules created by CVM Instruction 558 are also evidence of progress in the continuous improvement of the Brazilian investment funds market. The modernisation of the rules applicable to portfolio managers stands out especially with regard to:

\begin{itemize}
  \item[a] the requirement to specifically assign the responsibility for compliance and risk management to a statutory officer;
  \item[b] the improvement of the rules of conduct and internal controls;
  \item[c] the segregation of custody and controllership of assets and liabilities activities from management activities; and
  \item[d] the distribution of funds quotas by portfolio managers, even though such portfolio managers are not financial institutions.
\end{itemize}

\(^{10}\) Normative Ruling No. 1,037 of 2010, as amended, lists the jurisdictions considered tax havens for the purposes of Brazilian tax law.
Notwithstanding the above, CVM Instruction 558 tends to, directly or indirectly, generate additional costs for market participants, given that it increases the monitoring and disclosure duties regardless of the size of the portfolio manager.

CVM Instruction 558 has intensified the enforcement of transparency, diligence and loyalty principles required from portfolio managers. The CVM’s intention was to implement mechanisms to allow investors to analyse and compare the way that portfolio managers are more or less structured.

The above is also true with regard to the CVM Instruction 592, the new rule that governs the development of securities advisory services in the country.

Professional asset management activity has been the target of several regulations in advanced markets such as Europe and United States since the financial crisis of 2008. The current regulations in such jurisdictions, in addition to various requirements regarding disclosure, also contain requirements, all under the strict supervision of the competent authorities, related to, for example:

- the custody of assets;
- disclosure of systemic risks;
- bookkeeping;
- registration of financial statements; and
- in some cases, the necessity to fulfil minimum financial requirements.

Therefore, it is possible to identify a move in the regulations applicable to investment funds towards those applicable to the banking and insurance markets.

It would not be surprising if, in the near future, stricter rules also become mandatory in Brazil once the local market is fully mature.
I  OVERVIEW OF RECENT ACTIVITY

Canada has a mature, competitive and well-regulated asset management sector, which has remained buoyant (along with the Canadian economy generally) despite the pressures caused by the global financial crisis of 2007/2008 and its aftermath. While the global economic downturn and concomitant scandals have arguably caused some degree of increased regulatory scrutiny of asset managers and their activities in Canada, this has so far not resulted in much in the way of (knee-jerk) redesign of the regulatory system. Rather, the most significant recent regulatory initiative in this area by and large took root prior to the economic crisis, culminating in late 2009 in the form of a complete revamping of the dealer, adviser and investment fund manager registration framework in Canada. Adjuncts to this initiative, such as the non-resident investment fund manager registration requirements noted below, as well as consequential clarifying amendments to the initial reforms, have been proposed in the years since.

II  GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

Outside the specific rules that apply to the regulation of the management of insurance and pension fund assets (described briefly below), the overriding regulatory framework applicable to asset management in Canada is that contained in securities laws. In Canada, securities regulation is a matter of provincial and territorial jurisdiction. Each of the 10 provinces and three territories has its own securities laws, policies and rules that are administered by a local securities regulatory authority. However, in many areas, including in respect of the distribution of securities to sophisticated parties and the registration of market participants in the asset management arena, the rules have been largely harmonised among the jurisdictions so that compliance with the harmonised national rules will generally result in compliance with the rules in all jurisdictions.

i  Prospectus requirements and exemptions

Asset managers purchasing securities for funds that they manage or offering securities in those funds to Canadian investors must do so on the basis of a prospectus or in reliance on a prospectus exemption. The exemption most frequently used among the capital-raising exemptions in Canada is the accredited investor exemption. This exemption is available in respect of sales of securities to qualified entities and individuals that are deemed sufficiently

---

1 Alix d’Anglejan-Chatillon and Jeffrey Elliott are partners at Stikeman Elliott LLP.
sophisticated that they do not require the protection that prospectus disclosures are intended to provide. Included among the qualified entities – many of which are advised by asset managers – are certain types of banks and other financial institutions, trust companies, pension funds, registered charities, investment funds, domestic and international governmental bodies, and entities other than individuals or investment funds with net assets of C$5 million or more. An individual may also qualify as an accredited investor if he or she, alone or with a spouse, owns financial assets having an aggregate net realisable value over C$1 million; has net assets of at least C$5 million; or has net income before taxes in excess of C$200,000 alone, or C$300,000 together with his or her spouse. Canadian securities authorities have stated that it is not sufficient to rely on a bare representation of a purchaser’s status as an ‘accredited investor’ and, where necessary, further inquiries must be made of investors to verify the eligibility represented by an investor under a specific category.

The offering of a security by way of prospectus exemption, such as the accredited investor exemption, does not require that a written document describing the business and affairs of an issuer be provided to prospective purchasers. However, if any written document is provided, it may constitute an offering memorandum under the securities legislation of some provinces in Canada, which is required to include certain prescribed disclosure, including disclosure relating to purchaser statutory rights of action for damages or rescission where the offering memorandum contains a misrepresentation, and disclosure relating to certain conflicts of interest. Issuers of eligible foreign securities may avail themselves of exemptions from the requirement to disclose some of this information provided that certain conditions are met, including that distributions be limited to qualified ‘permitted clients’.

It should be noted that securities purchased pursuant to a prospectus exemption are subject to resale restrictions or hold periods. For a private fund with securities that are never listed on a Canadian stock exchange, this effectively means that its securities will never be freely tradeable in the Canadian market. However, leaving aside contractual restrictions in a fund’s formation documents, such securities can be traded or transferred pursuant to a further prospectus exemption (e.g., to another accredited investor). In addition, when securities are issued from treasury pursuant to certain private placement exemptions, the issuer is required to file a report of trade with the securities regulators in each Canadian jurisdiction in which the securities are sold, generally within 10 days of the distribution. The form required to report private placements was amended in the summer of 2016 to impose enhanced disclosures, including (as applicable) net proceeds by jurisdiction, most recent net asset value and the type of investment fund issuer. In most jurisdictions, the filing of the report is also subject to the payment of a regulatory filing fee, and a copy of any offering memorandum that is delivered to investors must also be delivered to the local regulator. Finally, the issuer must retain a copy of a completed risk acknowledgement form signed by individual accredited investors other than those with financial assets in excess of C$5 million.

ii Registration requirements

Asset managers, and those distributing securities to asset managers, may be subject to several types of registration under Canadian securities law. The registration requirements and ongoing registrant obligations are stringent and comprehensive.

National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103) establishes registration requirements and exemptions, and sets out the categories of registration; the proficiency, capital, insurance and other basic requirements for registration; and the ongoing requirements regarding internal controls and
systems, financial condition and reporting, custody, dealing with clients and handling client accounts. Pending regulatory proposals previously published by the Canadian Securities Administrators (CSA) for comment (the ‘client first’ amendments) would, if adopted, introduce significant amendments in the area of conflicts of interest management and registrant business conduct. Under Canadian securities laws, firms generally must register if they are in the business of trading, in the business of advising, holding themselves out as being in the business of trading or advising, or if they act as an investment fund manager. If a firm engages in more than one of these registrable activities, then (unless it is otherwise exempt) the firm must register in all applicable categories.

Dealer registration

Persons who are in the business of trading in securities are required to be registered as a dealer in each Canadian jurisdiction where purchasers reside. Trading is broadly defined under Canadian securities laws to include not only the sale or disposition of a security for valuable consideration, but also any act, solicitation or conduct that is directly or indirectly in furtherance of the sale or disposition of a security. Accordingly, an asset manager that is not registered as a dealer is generally not permitted to contact and deal directly with prospective clients. Any such contact would generally be considered an act in furtherance of a trade and may accordingly trigger the dealer registration requirement. There are limited exemptions. This means that an asset manager wishing to distribute securities in Canada of a fund that it manages, or a Canadian asset manager wishing to purchase securities for portfolios that it manages, must generally do so through an appropriately registered dealer.

Where securities are being privately placed, the dealer registration requirement may be satisfied through the use of an exempt market dealer (EMD). An EMD is permitted to trade in the exempt market in securities being distributed under a prospectus exemption, or with persons or companies to whom a security may be distributed under a prospectus exemption (e.g., trading with an accredited investor). Under recent amendments, EMDs are now expressly prohibited from engaging in brokerage activities, including trading securities listed on an exchange in foreign or Canadian markets, or participating in prospectus offerings.

A second dealer category is that of an investment dealer that, unlike an EMD, may trade in virtually any security with any client, including retail clients, provided that the securities offered are covered by a prospectus (subject to know-your-client and trade suitability requirements).

A non-Canadian dealer that is appropriately registered or licensed in its home jurisdiction may make a filing to rely on the international dealer exemption in a Canadian jurisdiction, which would allow it to place foreign securities (i.e., securities issued by issuers established outside of Canada) to permitted clients (a subset of accredited investors), provided a number of other conditions are met.

Firms registered in the category of restricted dealer (which is subject to firm-specific business restrictions) may also be appropriately registered to intermediate a private placement of fund securities.

Adviser registration

Canadian securities laws require a person or company engaging in, or holding itself out as engaging in, the business of advising others in respect of the buying, selling or investing in securities to be registered as an adviser in the local jurisdiction where advice is received. Again, there are limited exemptions to this requirement. A non-Canadian firm that is
registered or exempt from registration in its home jurisdiction may make a filing to rely on the international adviser exemption provided, among other conditions, that it acts as an adviser to permitted clients (that are not registered as advisers or dealers in a Canadian jurisdiction) and does not advise on securities of Canadian issuers unless that advice is incidental to its advice on a foreign security. The provision of general advice not purporting to be tailored to the needs of the recipient of the advice may also be exempt, subject to disclosure and other conditions. An exemption is also available for unregistered foreign advisers entering into written sub-advisory agreements with a registered adviser or dealer, subject to certain terms and conditions. Significantly, certain Canadian securities regulators once took the view that advice provided outside of Canada to a non-Canadian investment fund flows through to Canadian investors in the fund. That position, however, has been discontinued, and non-Canadian advisers to funds established outside Canada are no longer subject to adviser registration solely as a result of the issuance of securities of the investment fund to Canadian-resident investors.

**Investment fund manager registration**

Canadian securities laws require a person who directs or manages the business, operations or affairs of an investment fund to be registered as an investment fund manager (IFM) in the province or territory in which its head office is located. A non-resident IFM is required to register in Ontario, Quebec, and Newfoundland and Labrador if the fund the IFM manages has security holders that are resident in those jurisdictions, and the IFM or the fund it manages has actively solicited local residents to purchase securities of the fund after the effective date of the rule. There is an exemption from this requirement to the extent that, among other conditions, the securities of the fund that the IFM manages are distributed only to permitted clients and certain other filings are made with the applicable securities regulators. Non-resident IFMs are generally not subject to registration in other Canadian jurisdictions unless fund management activities are conducted on the ground in the local jurisdiction.

### iii Derivatives regulation

Unlike the regulation of securities, the regulation of exchange-traded and over-the-counter (OTC) derivative instruments in Canada has not been harmonised, and the applicable rules and regulatory approaches vary considerably across all Canadian jurisdictions. Direct derivatives-related asset management activities in a separately managed account format and indirect activities through certain types of commingled vehicles are subject to the application of these rules in the Canadian jurisdiction in which a managed account client is located or the fund is managed. Depending on the jurisdiction, non-Canadian asset managers may rely on certain very limited regulatory exemptions, but may also be required to register or seek discretionary relief to provide derivatives-related advice. In the aftermath of the global financial crisis, the CSA published a series of consultation papers in connection with the implementation of G20 reforms relating to dealer and adviser registration and derivatives execution facilities. Final rules have now been adopted on the recognition of trade repositories and derivatives data reporting, the central clearing of OTC derivatives, which generally apply to direct clearing participants (and their affiliates) and major swap market participants (month-end gross notional above C$500 billion), and on segregation and porting for customer collateral in cleared derivatives. In addition, OTC derivatives transactions with federally regulated financial institutions are now subject to new margin requirements for
non-centrally cleared derivatives. The CSA is working on a revised registration and business conduct framework in response to significant industry comments on proposals issued for comment in 2018. In general, the CSA has expressed its intention to maintain consistency with the rule-making approaches in the United States and Europe, with necessary adjustments to accommodate the size and specificities of the Canadian OTC derivatives market.

iv Early warning, insider reporting and takeover bid requirements

Canadian and foreign asset managers are subject to reporting requirements governing significant Canadian or inter-listed equity positions under management. The acquisition of beneficial ownership of, or control or direction over, 10 per cent or more of any class of voting or equity securities of a reporting issuer in Canada (i.e., a Canadian public company) (or 5 per cent where the issuer is the subject of a current takeover bid or tender offer) is a significant event under Canadian securities laws, and triggers a number of reporting and other compliance obligations under Canadian early warning, insider reporting and, in certain cases, takeover bid rules.

v Other areas of regulation

In addition to the sector-specific regulation and tax rules described below, the management of assets of Canadian-resident investors may also be subject to detailed regulation in the areas of trading (e.g., registration, best execution, short selling, institutional trade matching, insider trading), brokerage and soft dollars, bank regulation, privacy, anti-spam, unsolicited telecommunication rules and lobbying. Quebec’s Charter of the French Language establishes French as the official language of the Province of Quebec, and imposes (absent an exemption) French-language requirements with respect to such matters as the language of contracts, business names and commercial advertising on entities doing business in Quebec. Canadian anti-money laundering and terrorist-financing legislation also applies to domestic and non-Canadian asset managers doing business in Canada, although the application of these rules in the context of cross-border asset management arrangements is an area of some difficulty.

III COMMON ASSET MANAGEMENT STRUCTURES

There is no prescribed structure for asset management vehicles in Canada. Funds may be organised as corporations, trusts or limited partnerships. The choice of structure is generally driven by the particular investment strategy of the fund, its target investor base and related tax considerations.

i Legal structures

Corporations

A fund may be organised as a corporation under either the Canadian federal business corporation statute or the corresponding statutes of any of the provinces or territories; the statutes are generally similar. A fund that is a corporation may utilise a multiple class structure, with each class of shares tracking a different portfolio of assets. Tax-deferred switches between classes are available. However, as part of the 2016 Federal Budget, the government proposed to eliminate the ability of shareholders of one corporate fund to switch to another corporate fund on a tax-deferred basis after September 2016.
Trusts
Many funds in Canada (e.g., retail mutual funds and pooled funds sold in the exempt market) are structured as mutual fund trusts, which are flow-through vehicles that are generally taxed at the highest marginal rate for individuals. However, a deduction is available in respect of income paid or payable to beneficiaries, making trusts generally efficient flow-through vehicles for investment income. To the extent that the trust incurs losses, they may not be allocated to unitholders.

A fund structured as a mutual fund trust is managed by an administrative arm, the trustee, which is independent from the beneficiaries. The management of the trust is subject to the rules applicable to the administration of the property of others. As is the case with respect to the directors of corporations, the trustees of a trust also have the power to name the officers of such trust.

Limited partnerships
A limited partnership is not a legal entity separate from its partners under Canadian law, meaning that the gains and losses of the private fund structured as such flow through to its limited partners. That said, limited partnerships may be treated as separate legal entities for certain purposes. For example, a limited partner may lend money to, and transact business with, the limited partnership. A limited partnership is required to have a general partner and at least one limited partner. A limited partner is not liable as a general partner unless, in addition to exercising rights and powers as a limited partner, the limited partner takes part in the control of the business. Unlike the limited partnership legislation in some jurisdictions, the limited partnership statutes in Canada do not contain safe harbour provisions clearly delineating conduct that is not taking part in the control of the business of the partnership. Consequently, limited partnership agreements need to be drafted with particular care regarding this issue. Although the characterisation of limited partnerships under Quebec law (which is a civil law jurisdiction) is slightly different, Quebec limited partnerships are also flow-through vehicles and the applicable rules, as with the rules in other Canadian jurisdictions, present certain structuring benefits. Canadian (provincial) limited partnerships are increasingly used as an attractive structuring alternative to limited partnerships formed in certain traditional offshore jurisdictions.

ii Product structures
There are a number of collective investment vehicles in Canada that fall under the umbrella of investment funds. Under Canadian securities laws, an investment fund is generally defined as a mutual fund or a non-redeemable investment fund, being an issuer whose primary purpose is to invest money provided by its investors that does not invest for the purpose of exercising control of an issuer or for the purpose of being actively involved in the management of any issuer in which it invests. Whether a particular vehicle should be characterised as an investment fund has important securities regulatory implications (e.g., for IFM registration (discussed in Section II.ii), post-trade reporting, regulatory fee payments in Ontario, financial reporting and fund governance). For Canadian securities law purposes, an investment fund is treated as distinct from a private equity fund that does invest for control or for the purpose of being actively involved in the management of the issuer in which it invests. Certain real estate, business income and royalty trust vehicles may also not be captured by the definition of investment fund.
Retail

Mutual funds are the conventional investment fund product for the retail market in Canada. A mutual fund under Canadian securities legislation is a fund whose primary purpose is to invest money provided by its investors, and the securities of which are redeemable on demand, or within a specified period after demand, by the investor at an amount computed with reference to the value of a proportionate interest in the whole or part of the net assets of the fund. Mutual funds generally issue an unlimited number of securities on a continuous basis. Conventional mutual funds are typically offered by prospectus to retail investors, and are governed by a number of specific rules that prescribe particular prospectus disclosure and set out, inter alia, requirements concerning permitted and prohibited investments, restrictions on leverage, short selling, and the use of derivatives and other investment practices, asset custody, conflicts of interest, security holder voting rights, incentive fees and sales commissions. Moreover, retail mutual funds are also subject to, inter alia, ongoing reporting requirements, including the annual publication, mailing to security holders and filing with the securities regulators of a simplified prospectus, annual information form, fund facts document (i.e., a prescribed summary of the material features of the fund), and annual and semi-annual financial statements.

Mutual funds are generally, although not exclusively, retail products. By contrast, non-redeemable investment funds typically issue securities with more limited redemption features by way of private placement or on an initial public offering (following which, in the latter case, the securities are generally traded on an exchange at prevailing market prices, independent of the fund’s net asset value). Non-redeemable investment funds, including hedge funds structured as such or flow-through limited partnerships, offered on a retail basis by prospectus, are subject to the general prospectus rule applicable to all types of issuers and are subject to requirements on custody, but not to other specific rules governing their permitted investments. Investment funds that are reporting issuers (a status that results from their offering by prospectus or being listed on an exchange in the local jurisdiction) are subject to rules concerning continuous disclosure and requirements for an independent review committee, National Instrument 81-106 – Investment Fund Continuous Disclosure (NI 81-106) and National Instrument 81-107 – Independent Review Committee for Investment Funds. Reform initiatives in the form of an investment fund modernisation project initiated by the CSA are increasingly introducing a level playing field in this asset class that has been subject to many of the same rules applicable to mutual funds from September 2014. Investment funds offered by prospectus that are not mutual funds would typically be listed on an exchange in Canada. As with mutual funds, non-redeemable investment funds are offered both in the public sphere to retail investors, which requires the use of a prospectus, and privately on a prospectus-exempt basis to accredited investors.

Mutual funds may also be established as regulated commodity pools, which are not subject to the detailed investment restrictions governing conventional mutual funds in the areas of derivative instruments, short selling, and investments in precious metals and other excluded asset classes.

Mutual funds include not only traditional retail mutual funds but also exchange-traded mutual funds (ETFs), the securities of which trade on a stock exchange. In the case of ETFs, typically only large institutional investors (i.e., designated brokers) purchase or redeem ETF securities directly from the fund at the fund’s net asset value, and then only in large blocks,
which are usually exchanged in kind with baskets of the underlying securities. Individual retail investors typically buy and sell units of ETFs on the exchange at prevailing market prices, which may be at a premium or discount to a fund’s net asset value.

**Institutional**

Leaving aside assets that are managed in-house (e.g., pension or insurance company assets), institutional investors in Canada typically invest through separately managed accounts with asset managers, in privately placed investment funds (e.g., hedge funds) structured with or without a redemption feature, and in private equity, real estate or infrastructure funds that may or may not be regulated as investment funds. Fund-of-one structures are also increasingly employed for large Canadian pension fund investors. Since, by virtue of their private placement, such products are intended for sophisticated investors, they are subject to few strictures as to investment restrictions, and limited or no ongoing investor disclosure requirements. The CSA has, however, signalled its intention to enhance its oversight of hedge funds and similar products sold in the exempt market in Canada.

### IV MAIN SOURCES OF INVESTMENT

As at 31 December 2017, there were C$4.214 trillion of professionally managed assets under management in Canada. This amount was composed, in part, of:

- **C$778 billion in pension segregated funds and pension pooled funds;**
- **C$188 billion in investment assets of Canadian life insurance companies;**
- **C$68 billion of assets of endowments, foundations and trust funds;**
- **C$972 billion of assets invested in mutual funds; and**
- **C$88 billion in insurance segregated funds.**

### V KEY TRENDS

As noted in Section II.ii, the recent key initiative in the regulation of the asset management sector in Canada has been the introduction of and ongoing revisions to NI 31-103, which sets out rules applicable across Canadian jurisdictions with respect to the registration of dealers, advisers and IFMs, and related exemptions from these requirements.

Canadian regulatory initiatives have broadly focused on investor protection measures. For example, the CSA implemented the Client Relationship Model, Phase 2 (CRM2), a set of regulatory initiatives requiring certain registrants to furnish their clients with greater disclosure about their investments. Second, the CSA examined Canada’s current mutual fund fee structure to determine whether there are investor protection issues that must be addressed, in particular with respect to sales and trailing commissions. Third, the CSA consulted extensively on the proposed introduction of a ‘regulatory best interest standard’ on advisers and dealers to act in the best interests of clients. Following several rounds of consultations with a cross-section of industry experts, market participants and investor advocacy groups, the CSA elected not to ban embedded commissions and to propose enhanced business

---

2 This data was obtained from the 2018 Canadian Responsible Investment Trends Report published by the Responsible Investment Association, which in turn sourced the data from the Canadian Institutional Investment Network.
conduct requirements for dealers and advisers to address potential conflicts of interest in the best interests of clients or avoid them altogether, as well as to eliminate all forms of deferred sales charges.

Robo advice, algorithmic trading, developments in the crypto currency and digital assets space, data-driven technologies, fintech and related technological disruptions are a challenge for conventional investor protection regulations. At the moment, the onus is on Canadian securities regulators to adapt to recent advances in financial technology.

The securities commissions in Ontario and Quebec recently launched their own whistle-blower programmes. Unlike the programme in Ontario, the Quebec programme does not offer financial incentives to whistle-blowers. The Quebec programme instead relies on whistle-blower protections, such as immunity from civil lawsuits, to encourage individuals to report.

Under Phase 2 of the Modernization of Investment Fund Product Regulation Project, the CSA has adopted final rules, including investment restrictions, to govern ‘alternative funds’ being publicly offered investment funds that invest in assets or use investment strategies that are not permitted under existing investment fund regulations.

Outside the regulatory sphere, a notable trend that has been developing over the past few years has been the increased internalisation of the asset management function by some of Canada’s large public sector pension funds. Large Canadian pension fund managers, such as the Canada Pension Plan Investment Board, which manages the surplus pension assets of Canadians (C$392 billion in assets under management as of 31 March 2019), the Ontario Teachers Pension Plan, which manages the pension assets of Ontario’s teachers (C$191.1 billion in assets under management as of 31 December 2018) and the Caisse de dépôt et placement du Québec, which as of 31 December 2018 managed C$309.5 billion on behalf of public and private pension and insurance funds in Quebec, have each shifted a large portion of their portfolios away from third-party asset managers and increased their direct investment activities.

Canadian public and private sector pension plans continue to invest in various asset classes both in and outside Canada. A notable trend has been to make such investments through fund-of-one vehicles with negotiated reporting and liquidity provisions. The use of foreign segregated portfolio company vehicles and other structured transparency platforms is also developing.

More recently, the demand for economic exposure to virtual currencies has spiked and investment funds have been a popular vehicle for obtaining this exposure. For example, in September 2017, First Block Capital Inc became the first registered investment fund manager in Canada for a fund dedicated solely to investments in virtual currencies. Although certain virtual currency investment fund applications have been successful, it has proven difficult for these types of funds to expand into the Canadian retail market.

In October 2018, 3iQ Corp. (3iQ) filed a non-offering preliminary prospectus on behalf of The Bitcoin Fund (the 3iQ Fund), a non-redeemable investment fund established as a trust under Ontario law. As stated in the fund prospectus, the 3iQ Fund intended to invest in long-term holdings of bitcoin purchased from various sources, including bitcoin exchanges, in order to provide its investors with (1) exposure to bitcoin and the daily price movements of the US dollar price of bitcoin; and (2) the opportunity for long-term capital appreciation. On 15 February 2019, the Ontario Securities Commission decided that it would be contrary to the public interest to issue a receipt for the Fund’s preliminary prospectus for multiple reasons, including the difficulty of asset valuation as a result of the
fragmented and unregulated environment in which bitcoin generally trades; the difficulty of the sub-custodian to provide customary reports on the design of the 3iQ Fund’s controls and its ability to operate as intended over a defined period of time; and the lack of clarity as to how the 3iQ Fund’s auditor would be able to provide an unqualified opinion on its annual financial statements in accordance with Canadian securities laws. The decision is currently under appeal.

The CSA has issued a series of staff notices and consultation papers on the regulation of crypto assets to remind market participants, including asset managers, that advisory, trading and fund management activities involving crypto assets that, under a conventional securities analysis, would be regulated as securities or derivatives are subject to adviser, dealer and investment fund manager registration requirements and prospectus or other product qualification rules. Canadian securities regulatory authorities currently consider the regulation of virtual currencies a priority with respect to oversight and enforcement.

VI SECTORAL REGULATION

i Insurance

Canadian federally incorporated insurance companies are regulated as to solvency matters under the Insurance Companies Act (Canada) (ICA) by the federal Office of the Superintendent of Financial Institutions, which is the prudential regulator for all federally regulated financial institutions in Canada.

The ICA provides a number of detailed rules regarding the investments permitted to be made by federally incorporated insurance companies. The general constraint on investments by federally incorporated insurance companies under the ICA is that the directors ‘must establish and the company must adhere to investment and lending policies, standards and procedures that a reasonably prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return’. This provides significant investment discretion and is a move away from the pre-1992 version of the ICA, which contained very specific investment standards for permissible investments and loans by insurance companies. Federally incorporated insurance companies are also generally prohibited under the ICA from acquiring control of, or holding, acquiring or increasing a substantial investment in, any entity other than a permitted entity as described under the ICA. The ICA also contains a number of rules regulating investment by federally incorporated insurance companies in related parties.

ii Pensions

Registered pension plans must be registered under the particular federal or provincial minimum standards legislation to which the pension plan is subject and under the Income Tax Act (Canada) (the Tax Act). The federal Pension Benefit Standards Act, 1985 (PBSA) and corresponding provincial legislation impose on the plan administrator various fiduciary obligations, including the requirement to invest pension plan assets in accordance with the standard of care applicable to a person of ordinary prudence dealing with the property of another person. In addition, certain statutes (including, in particular, the PBSA and the Quebec Supplemental Pension Plans Act (SPPA)) impose an express portfolio management theory standard on those responsible for investing pension plan assets.

The legislation authorises a pension plan administrator to employ agents in the administration and investment of the pension fund. In some cases (such as the SPPA), this
authorisation is explicit; in others (such as the PBSA), it is only implicit. These persons then become subject to the standard of care that applies to the pension plan administrator, as described above.

A pension plan administrator must establish a written statement of investment policies and procedures (SIP&P) that meets the requirements of the legislation to which it is subject. As a matter of agreement between the administrator and an external investment manager, the manager will usually be required to ensure that pension fund investments comply with the SIP&P as provided to the manager. The investment manager would normally not be responsible for verifying that the contents of the SIP&P comply with applicable legislation.

The Provinces of Alberta, British Columbia, Manitoba, Ontario and Saskatchewan have formally adopted by reference the investment rules contained in Schedule III to the Regulations under the PBSA, and the Provinces of Nova Scotia, and Newfoundland and Labrador have established their own rules that are substantially similar to the rules contained in Schedule III. While the Provinces of New Brunswick and Quebec have each enacted pension fund investment rules that differ in some respects (particularly in the case of Quebec) from Schedule III, it is fair to say that there is substantial, but not perfect, harmonisation of pension fund investment rules in Canada.

Schedule III contains detailed and complex rules regarding related-party transactions, as well as qualitative and quantitative investment restrictions that are generally applicable on a plan-by-plan basis (e.g., no more than 10 per cent of the total value of a plan’s assets measured on a book or market value, depending on the jurisdiction, may be invested, directly or indirectly, in any one person, two or more associated persons, or two or more affiliated corporations). As a result, in addition to compliance with the limit itself, the administrator will generally demand exact and timely reporting from all external investment managers so that it may aggregate such information at the plan level.

Schedule III applies both to direct and indirect investments of a pension plan. Their application to indirect investments may give rise in some cases to certain complexities.

Investments of registered pension plans in Canada must also comply with the investment rules contained in the Tax Act and its Regulations or face deregistration, with adverse tax consequences for plan participants and the plan sponsor.

The Tax Act Regulations impose certain investment rules for pension plans. For example, investments in shares or debt of an employer are prohibited, unless the shares of the employer are listed on a prescribed stock exchange. The Tax Act Regulations also contain restrictions on borrowing and the giving of security over property held in connection with the pension plan. The Tax Act also contains rules governing real estate, resource property and passive investments of certain corporations owned by pension plans.

It should be noted that certain statutory pension plans, such as the Canada Pension Plan, have their own governing rules, many of which are similar but not identical to the rules outlined above.

iii Real property

There are no regulations specific to funds that invest in real estate. Depending on how they are structured, such funds may not be regulated as investment funds subject to the adviser and IFM registration requirements noted in Section II.ii. However, the sale of securities of such funds are subject to the prospectus requirement – unless privately placed – and the dealer registration requirement. It should be noted that there is a robust publicly traded real
estate investment trust (REIT) sector in Canada designed to allow retail investors to have an interest in a diversified package of income-producing real estate with cash flow distributed to unitholders.

iv  **Hedge funds**
There is no definition of hedge fund in Canadian securities legislation. CSA staff have referred to them broadly as investment pools that use alternative investment strategies not generally available to traditional mutual funds such as taking both long and short positions, and using arbitrage, leverage, options, futures, bonds and other financial instruments to capitalise on market conditions. A hedge fund would be an investment fund, and could fall under the mutual fund branch of that definition if structured with a redemption feature that meets the requirements for mutual fund status.

Most hedge funds are sold in Canada by private placement. There are no specific rules that apply to hedge funds sold on a private placement basis that regulate their investment activities or how they operate, although a privately placed hedge fund that is organised under the laws of certain provinces, including the Province of Ontario, and is structured as a mutual fund (i.e., redeemable on demand, or within a specified period after demand), is required to provide investors with continuous disclosure under certain parts of NI 81-106.

Persons or companies involved in the management of hedge funds, the provision of portfolio management services to hedge funds and the offering of hedge fund securities to investors in Canada are subject to IFM, adviser and dealer registration requirements, as noted in Section II.ii.

v **Private equity**
As with funds that invest in real property, there are no regulations specific to private equity funds. Under Canadian securities laws, the term ‘private equity fund’ refers to a fund that invests for the purpose of exercising control of an issuer or for the purpose of being actively involved in the management of an issuer in which it invests. The control or active management exerted by the private equity fund in portfolio companies is what sets it apart from an investment fund and, as a result, relieves the fund of the adviser and IFM registration requirements noted in Section II.ii. The offering of private equity securities in Canada is subject to the prospectus requirement – although there are few retail private equity funds, as most private equity funds privately place their securities with accredited investors – and the dealer registration requirement.

vi  **Alternative Investment Fund Managers Directive**
In July 2013, the four lead securities regulators in the Canadian market entered into memoranda of understanding with financial regulators in a number of European Union and European Economic Area Member States for the supervision of alternative investment fund managers as required under the Alternative Investment Fund Managers Directive (AIFMD), which entered into force on 22 July 2013. These memoranda of understanding were entered into by the Canadian regulators in anticipation of the fact that the AIFMD will directly affect both Canadian managers that manage funds in the EU and Canadian funds marketed in the EU by Canadian or EU-based fund managers. Significantly, the AIFMD effectively regulates a much broader array of fund structures than conventional alternative investment funds, and covers hedge funds, private equity funds, venture capital funds, real estate funds, commodity funds, investment trusts and other collective investment vehicles. As a result, managers of
funds that are not regulated as investment funds and are not subject to registration under Canadian securities laws may be subject to the application of AIFMD in connection with their European activities.

vii Other asset classes
Royalty-based funds and hybrid funds with separate private equity and traded portfolio sleeves or liquid side pockets have also developed in the exempt market in Canada. These vehicles are generally subject to the rules governing conventional investment funds, although, depending on the degree of active management and the manner in which portfolio assets are structured, certain types of royalty-based funds may be viewed as functionally analogous to private equity funds or royalty trusts and would not be captured by the definition of investment funds.

VII TAX LAW
The tax treatment of a fund in Canada is primarily determined by its characterisation as a partnership, mutual fund trust or mutual fund corporation (note that the term ‘mutual fund’ is separately defined under the Tax Act, and is not meant to delineate between investment funds structured as open-ended mutual funds and entities structured as non-redeemable investment funds).

i Limited partnerships
A limited partnership itself is generally not liable for income tax; nor is it required to file income tax returns, except in some cases for annual information returns. A limited partnership must compute its income (or loss) under the Tax Act for each of its fiscal periods as if it were a separate person resident in Canada. As a limited partnership, all income, capital gains, losses and capital losses of the private fund would, subject to certain exceptions, flow through to its investors. However, a specified investment flow-through (SIFT) partnership is effectively taxed as a corporation on its non-portfolio income (see the discussion regarding the SIFT rules below).

Subject to the at-risk rules discussed below, each partner of a partnership is required to include (or is entitled to deduct), when computing the partner’s Canadian income for a taxation year, the partner’s pro rata share of the income (or loss) of the partnership allocated to such partner for the fiscal period of the partnership ending in or at the end of the partner’s taxation year. This is the case regardless of whether distributions were actually made by the limited partnership. The Tax Act also contains at-risk rules that may, in certain circumstances, limit the ability of a limited partner to deduct its share of the limited partnership’s losses for a taxation year to the amount the partner has put at risk.

A disposition of an investment in a Canadian limited partnership, a mutual fund trust or a share of a mutual fund corporation (as described below) by a non-resident of Canada for the purposes of the Tax Act will generally not be subject to Canadian tax unless the investment is taxable Canadian property for the purposes of the Tax Act, and the gain is not exempt from Canadian tax by an applicable income tax treaty or convention.

Generally, limited partnership interests, units of mutual fund trusts or shares of mutual fund corporations will not be taxable Canadian property at any time, unless at any time
within the five previous years more than half of the fair market value of the partnership’s property was attributable to real or immovable property in Canada or certain Canadian resource properties.

A disposition of limited partnership interests, mutual fund trust units or shares of mutual fund corporations by a Canadian-resident investor who holds such investment as capital property will generally result in a capital gain (or loss) to such investor.

ii Trusts

A fund structured as a mutual fund trust will generally not be liable for income tax in respect of its income and net realised capital gains for a taxation year to the extent that it distributes such income and net realised capital gains to its beneficiaries. To qualify, a mutual fund trust must meet certain conditions, including that it must comply with certain prescribed conditions, including those relating to the number of its unitholders.

Provided that certain conditions are met, a mutual fund trust may designate a portion of its foreign-source income to its unitholders so that such income and a portion of the foreign tax paid by the trust may be regarded as foreign-source income of, and foreign tax paid by, the unitholder for the purposes of the foreign tax credit provisions of the Tax Act. Generally, when a mutual fund trust designates certain amounts to its unitholders, including, but not limited to, dividends received and foreign-source income, these designated amounts will retain their character in the hands of its unitholders.

The Tax Act treats non-portfolio income of a SIFT trust or partnership as if the income had been earned through a taxable Canadian corporation. Under the SIFT rules, tax is imposed at the trust or partnership level at the corporate tax rates, and investors are deemed to have received dividends from taxable Canadian corporations. Income that is subject to this tax is generally income from carrying on a business in Canada, Canadian real or immovable property, or investments in subject entities in excess of certain thresholds.

Investors in a mutual fund trust are required to include in their income, for tax purposes, the amount of net income and net realised taxable capital gains paid or payable to them by the trust and deducted by the trust in computing its income for tax purposes. Generally, to the extent that distributions to an investor by the trust exceed the investor’s share of the net income and net realised capital gains of the trust for the year, such excess distributions (except to the extent that they are proceeds of disposition of a unit) will not be taxable in the hands of the investor but will reduce the adjusted cost base of an investor’s units of the trust. To the extent that the adjusted cost base of a unit would be negative, the negative amount would be deemed to be a capital gain realised by the investor in the year, and the adjusted cost base of such unit will be increased by the amount of such deemed capital gain.

The Tax Act contains rules for Canadian residents holding non-controlling interests in non-resident entities owning primarily passive investments. The existing rules apply where a taxpayer has invested in offshore investment fund property, and one of the main reasons for the investment is to reduce or defer the tax that would have arisen had the income from the assets of the fund been earned directly. Where these rules apply, income is calculated based on the taxpayer’s cost amount multiplied by a prescribed interest rate. These rules should only apply to Canadian-resident beneficiaries of non-resident commercial trusts.

iii Corporations

A corporation is a separate legal entity for tax purposes. Corporations are generally not an efficient vehicle for the flow-through of ordinary income. However, a mutual fund
corporation is tax-efficient with respect to taxable dividends earned on shares of taxable Canadian corporations because it is able to deduct those dividends from its income and receive a refund of tax that it pays on those dividends upon paying taxable dividends out to its shareholders. In addition, taxes paid by the mutual fund corporation on realised capital gains will be refundable on a formula basis when shares are redeemed or when the fund pays capital gains dividends. As a result, capital gains dividends are taxed as capital gains in the hands of the shareholders. To qualify as a mutual fund corporation, a corporation must meet the following conditions:

a. it must be a Canadian corporation;
b. it must have shares that are redeemable at the demand of the holder, and such shares must represent at least 95 per cent of the fair market value of all of the corporation’s issued shares;
c. its only undertaking must be the investing of its funds in property; and

d. it must be a public corporation.

Taxable dividends and eligible dividends paid by a corporate fund, other than capital gains dividends, must be included in computing an investor’s income. The dividend gross-up and tax credit treatment normally applicable to taxable dividends and eligible dividends paid by a taxable Canadian corporation will apply to such dividends in the case of an investor who is an individual. Returns of capital distributions are not included in income, but reduce the adjusted cost base of the investor’s shares.

VIII OUTLOOK

In the asset management space, poor performance in equity markets and falling asset values have produced a shift in retail investment to fixed income, low-cost ETF and money market products, and a trend away from commission-based passive investment products in favour of the fee-based advice model. Manufacturers of asset management products continue to develop target date and other life cycle products tailored to the baby-boomer retirement market. In the institutional market, pension funds and other institutional investors continue to seek out returns through investments in infrastructure, structured credit, real estate investment vehicles and other alternative asset classes.

On the regulatory front, as in other countries, Canadian regulators are completing a comprehensive reform of OTC derivatives markets, leaving the byzantine regulatory framework governing exchange-traded derivatives in Canada largely untouched. The CSA has wrapped up an investment fund modernisation project to adjust Canadian mutual fund rules to global standards in mutual fund product regulation (including in the area of money market funds), address any market efficiency, investor protection or fairness issues that arise out of the differing regulatory regimes that apply to different types of publicly offered investment funds, and reduce the perceived potential for regulatory arbitrage.

To date, Canada has not entirely followed initiatives in the United Kingdom, Europe and Australia to ban or restrict the payment of trailing and other commissions for product recommendations, although fees charged by mutual fund managers, and their level of transparency, remain a particular focus of the CSA. Regulatory initiatives in Canada have centred on implementing the client relationship model and client-focused reforms, with detailed requirements to enhance point-of-sale disclosure, product fee and cost transparency, know-your-client and suitability assessments, and performance and account reporting and
other business conduct requirements. As in other countries, Canadian regulators continue to build out a client-centric regulatory framework to address conflicts of interest in the best interest of clients, including those resulting from compensation arrangements and incentive practices, and clarify what clients should expect from registrants. The CSA has also stepped up market surveillance, routine and targeted compliance sweeps, on-site regulatory audits and data-driven enforcement strategies. On the whole, and barring any catastrophic developments, the outlook for the asset management sector and the related regulatory environment in Canada is expected to remain comparatively stable.
Chapter 6

CAYMAN ISLANDS

Jonathan Green, Tim Coak and Luke Stockdale

I OVERVIEW OF RECENT ACTIVITY

Asset management vehicles established in the Cayman Islands can generally be divided into two distinct groups:

a regulated open-ended funds (predominantly hedge funds), for which there is an abundant supply of publicly available statistical information (although it lags behind the market, as is inevitably the case for information compiled by a regulator); and

b other asset management vehicles (including closed-ended and private equity funds), for which the available data is more limited.

A cornerstone to the success of the Cayman Islands’ financial services sector is its strong legal and regulatory system, which equally benefits managers and institutional or other sophisticated investors. The jurisdiction is attentive and responsive to developing international trends, continually evolving to ensure it meets the requirements of finance sector participants, including governmental and regulatory authorities. Against this background, there have been a number of noteworthy developments in recent years, which are discussed in more detail below.

The Cayman Islands continues to maintain its position as the leading jurisdiction for the registration of funds, with 10,992 funds regulated under the Mutual Funds Law (2019 Revision) (Mutual Funds Law) at the end of 2018 and 10,916 at the end of the first quarter of 2019. While the level of exceptional growth experienced in the years preceding the global financial crisis has ended, the industry has largely held its ground since the crisis. The industry’s positive outlook is reflected in the Cayman Islands Monetary Authority’s (CIMA) statistical digest for 2017, which shows growth in the net asset value of reporting funds up from US$3.592 trillion in 2016 to US$4.033 trillion in 2017.

It is more difficult to obtain an accurate overview of the state of the Cayman Islands’ asset management industry as a whole, which would necessarily include looking at the level of managed account activity and closed-ended fund activity. While single investor vehicles created as part of a managed account structure may involve registration of the relevant vehicle with the Cayman Islands registry, the vehicle will often not be required to register with CIMA because there is only one investor and therefore no pooling of investor funds (a requirement of the statutory definition of a mutual fund). There is also an exception to the need to register

1 Jonathan Green, Tim Coak and Luke Stockdale are partners at the Maples Group.
with CIMA for funds known as Section 4(4) funds, which are open-ended investment funds that pool the funds of 15 or fewer investors, a majority of whom are given the power to appoint and remove the fund’s directors, managers (in the case of a limited liability company (LLC)), general partner or trustee, as applicable.

Closed-ended funds (i.e., funds that do not afford investors the option to withdraw all or part of their investment prior to the winding-up of the fund) are not required to be registered or licensed by CIMA, so it is more difficult to gauge their numbers. The most useful indicator of the level of closed-ended fund activity (which generally includes funds investing in illiquid asset classes, such as private equity, real estate or infrastructure projects) is the number of registrations of Cayman Islands exempted limited partnerships (ELPs) and, more recently, LLCs. However, this is only a rough indicator based upon practitioners’ experience that the majority of closed-ended fund structures are formed as ELPs. By contrast, CIMA’s statistical digests show that only a small fraction of open-ended funds are formed as ELPs, highlighting that they are most prominent in the closed-ended sector. Figures released by the Cayman Islands Registrar of Exempted Limited Partnerships show that at the end of 2018, there were a total of 26,381 ELPs registered in the Cayman Islands. The years since the crisis have generally seen a consistent increase in the number of annual ELP registrations, but 2018 showed a sharp rise in ELP registrations. In 2018, 4,017 new ELPs were registered. This represents an increase of 30 per cent in the figure for new ELPs registered in 2017, which is 3,774. At the end of April 2019, less than two years since the introduction of LLCs in the Cayman Islands, the figures for LLCs registered stood at 2,132.

ELPs are utilised for a variety of purposes within closed-ended structures. An ELP may well be the primary closed-ended fund vehicle, but often ELPs will also serve other purposes (e.g., ELPs may be used as a feeder into an onshore fund, an alternative investment vehicle, a parallel fund or a co-investment vehicle). Similarly, while still a relatively new vehicle in the Cayman Islands, experience has shown that LLCs are increasingly being used as general partners as well as feeder, blocker and aggregator vehicles in closed-ended fund structures. Changes in the rate of formation of ELPs and LLCs could, therefore, indicate fluctuations in the rate of new fundraising, but are just as likely to point to variations in the level of transactional activity by established closed-ended funds themselves.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

As noted above, pooled investment funds in the Cayman Islands are either open-ended and subject to registration with or licensing by CIMA (unless falling within the Section 4(4) exception), or closed-ended and not currently required to register with or be licensed by CIMA. The primary statute regulating Cayman Islands pooled investment funds is the Mutual Funds Law. Subject to the Section 4(4) fund exception, a Cayman Islands investment fund qualifies as a mutual fund and is, therefore, required to be regulated under the Mutual Funds Law if:

a it is a company, LLC, partnership (including ELPs) or unit trust;

b it issues equity interests to investors (i.e., shares, partnership and LLC interests or trust units that carry an entitlement to participate in profits or gains, and which may be redeemed or withdrawn at the option of those investors prior to winding-up); and

c its purpose or effect is the pooling of investor funds with the aim of spreading investment risks and enabling investors to receive profits or gains from investments.
The key distinction between such an open-ended mutual fund and a closed-ended fund is the ability of investors to voluntarily redeem or withdraw some or all of their investment prior to winding-up, whether at will or on a specified period of notice. Where shares, partnership and LLC interests or trust units are subject to a lock-up period, Cayman Islands practitioners and CIMA generally consider that the lock-up period should be at least five years for an investment fund to be regarded as closed-ended at the outset. A fund with such a lock-up period will generally need to register with or be licensed by CIMA prior to the expiry of the relevant lock-up period.

Master funds are also potentially subject to registration with CIMA. A master fund in a multi-level fund structure will be deemed to be a mutual fund for the purposes of the Mutual Funds Law and, accordingly, will be required to be registered with CIMA, if it:

- is a Cayman Islands company, LLC, partnership (including ELPs) or unit trust;
- issues equity interests;
- holds investments and conducts trading activities for the principal purpose of implementing the overall investment strategy of a CIMA-regulated feeder fund; and
- has at least one CIMA-regulated feeder fund that conducts more than 50 per cent of its investment activity through the master fund, whether directly or indirectly via an intermediate entity.

Owing to the definition of master fund under the Mutual Funds Law, a master entity in a structure having only one investor (i.e., where there is, strictly speaking, no pooling element at the level of the master fund) will, nevertheless, constitute a mutual fund. The exact fund structure will, in each case, determine whether registration of a master entity, or any other entity, is necessary, although there are certain structural approaches that may allow such an entity to fall outside the scope of the master fund registration regime under the Mutual Funds Law. Where a fund is eligible for registration both as a feeder fund and as a master fund, CIMA has suggested that funds should generally opt for registration as a master fund, although there are certain circumstances in which this may not be appropriate.

Funds registered under Section 4(3) of the Mutual Funds Law account for over 96 per cent of all regulated investment funds in the Cayman Islands as of 31 December 2018.\(^4\) The straightforward requirements for registration and the absence of a pre-approval process contribute to this popularity. The basic requirements for registration under Section 4(3) (for both traditional mutual funds and master funds) are that the minimum initial investment per investor is at least US$100,000 (or its equivalent in another currency), or that the equity interests are listed on a recognised stock exchange. Registration involves completion of an online application form by a licensed corporate services provider in the Cayman Islands, together with the online filing of the fund’s offering document and consent letters from its administrator and its Cayman Islands auditor. A separate offering document is not required for a regulated master fund. On an ongoing basis, the fund must file an amended offering document within 21 days of any material change that occurs while it is still offering its equity interests. It must also file annual audited accounts, a key data elements form and a fund annual return (all submitted electronically by the fund’s auditor) with CIMA within six months of the end of each financial year.

Few investment funds are fully licensed under the Mutual Funds Law, since this is generally only applicable to retail funds, while the majority of investment funds formed in

the Cayman Islands are intended for institutional or high-net-worth investors. Of the total number of 10,992 regulated investment funds at the end of 2018, only 75 were fully licensed by CIMA under the Mutual Funds Law.\(^5\)

An alternative to obtaining a full licence under Section 4(1)(a) of the Mutual Funds Law is to be regulated as an administered fund under Section 4(1)(b) of the Mutual Funds Law. As of 31 December 2018, there were only 317 administered funds.\(^6\)

Administered funds have steadily declined in popularity in recent years (from 435 in 2010 to 317 in 2018),\(^7\) perhaps because the administrators who originally saw them as a source of higher fees came to realise that the higher fees were counterbalanced by higher risks. Registration as an administered fund is achieved by designating a Cayman Islands licensed mutual fund administrator as the fund’s principal office. The administrator must satisfy itself that the promoters of the fund are of sound reputation, that the fund’s administration will be undertaken by persons with sufficient expertise who are also of sound reputation, and that the fund’s business and its offering of equity interests will be carried out in a proper manner. The administrator is obliged to report to CIMA any suspected infringements by the fund of the Mutual Funds Law (or any other law), or any suspicion that the fund may be insolvent or may otherwise be acting in any manner prejudicial to its creditors or investors. This imposes a role of quasi-regulator and compliance monitor on the administrator themselves, potentially a burdensome task to carry out effectively.

There are no local service provider requirements for CIMA-registered investment funds, save that they are required to appoint an approved local auditor and, in the case of an administered fund, a Cayman Islands licensed mutual fund administrator.

The corporate governance regulatory framework for funds is an area of consistent focus for CIMA. Partly in response to industry trends and stakeholder requests, CIMA issued a Statement of Guidance on Corporate Governance for Regulated Mutual Funds (SOG) on 13 January 2014. The SOG is relevant to all CIMA-registered and licensed mutual funds, their individual operators and their governing bodies. It does not extend to the banking and insurance sector. The purpose of the SOG is to provide individual operators and governing bodies of funds with guidance on CIMA’s minimum expectations for the sound and prudent governance of mutual funds. While the SOG is not intended to be exhaustive and is not directly enforceable by CIMA, CIMA may look to the SOG should it need to consider whether the direction and management of a CIMA-registered and licensed mutual fund has been conducted in a ‘fit and proper manner’.

The Directors Registration and Licensing Law, 2014 (the DRL Law) entered into force in June 2014 to assist CIMA in verifying and maintaining key information on directors of companies regulated by CIMA as mutual funds under the Mutual Funds Law and companies registered with CIMA as ‘excluded persons’\(^8\) under certain heads of the Securities Investment Business Law (2019 Revision), usually because of such companies’ involvement as the investment manager in a fund structure (together, covered entities). This step was taken both for CIMA’s own purposes and to assist CIMA with overseas regulator requests and, since the availability of the LLC, also extends to any manager of an LLC that is a covered entity.

---

\(^5\) ibid.

\(^6\) ibid.

\(^7\) ibid.

\(^8\) Amendments to the Securities Investment Business Law (2019 Revision) are expected to come into force during 2019 and may remove or modify the concept of excluded persons.
The DRL Law requires the directors (or, in the case of LLCs, the managers) of covered entities to be, themselves, registered with or licensed by CIMA, and allows CIMA to regulate ‘professional directors’ and ‘corporate directors’ of covered entities. The DRL Law will be relevant to any person who is, or who intends to become, a director of a company (or a manager of an LLC) that is or will be a covered entity, whether that person is resident in the Cayman Islands or elsewhere. Under the DRL Law, it is unlawful to be appointed as a director (or, in the case of an LLC, as a manager) of a covered entity without first being registered or licensed with CIMA.

The Cayman Islands has signed two intergovernmental agreements to improve international tax compliance and the exchange of information – one with the United States (US IGA) and one with the United Kingdom (UK IGA). The Cayman Islands has also signed, along with over 100 other countries, a multilateral competent authority agreement to implement the Organisation for Economic Co-operation and Development (OECD) Standard for Automatic Exchange of Financial Account Information – Common Reporting Standard (CRS). Cayman Islands regulations have been issued to give effect to the US IGA, the UK IGA and CRS (collectively, the AEOI Regulations). Pursuant to the AEOI Regulations, the Cayman Islands Tax Information Authority (TIA) has published guidance notes on the application of the US and UK IGAs and the CRS. These developments are supported by a network of bilateral tax information exchange agreements (according to the OECD, there are over 4,000 bilateral exchange relationships activated with respect to more than 100 jurisdictions committed to the CRS, with the next exchanges between these jurisdictions set to take place at the end of September 2019), and adherence to multilateral conventions such as the OECD and Council of Europe Convention on Mutual Assistance in Tax Matters.

These initiatives further strengthen Cayman’s regulatory reputation on cooperation matters and align its regulatory framework with a trend towards automatic exchange of information on tax.

III COMMON ASSET MANAGEMENT STRUCTURES

Three types of vehicle are most commonly utilised by Cayman Islands investment funds: exempted companies, ELPs and exempted unit trusts. Essentially, exempted vehicles are not permitted to carry on business within the Cayman Islands or must conduct their business mainly outside the Cayman Islands unless they have a licence to carry on business in the Cayman Islands. LLCs are not yet commonplace as investor-facing vehicles but are becoming increasingly common in overall fund structures, and are also eligible to apply for a 50-year tax undertaking.

Exempted companies limited by shares are the most commonly used vehicle for open-ended funds. In 2014, 77 per cent of CIMA-regulated mutual funds were exempted companies (including segregated portfolio companies), and while this particular statistic was not included in the most recent CIMA statistical digest, practitioner experience suggests that this trend continues.

As previously noted, closed-ended funds established in the Cayman Islands are most commonly established as ELPs. Most jurisdictions with managers of, or investors in, such funds have become comfortable with the limited partnership structure prevalent in

---

9 CIMA: Investments Statistical Digest 2014.
the United States, which is replicated to a significant degree in the Cayman Islands ELP structure. It is expected that the use of LLCs for closed-ended funds or their downstream vehicles will increase over the coming years because of the substantial similarities between the Cayman Islands LLC and the popular United States limited liability company vehicles. While exempted companies are extremely flexible with regard to the extent to which voting and economic rights can be mixed among different classes of shares, companies with share capital have, by their very nature, certain structural and legal limitations that may not apply to ELPs or LLCs.

There are, for example, fewer statutory rules governing approval processes within ELPs and LLCs. For instance, general partners of ELPs or the managers of an LLC can be, and usually are, delegated a certain degree of unilateral authority to amend the constitutional documents of an ELP or an LLC, while such powers cannot be delegated to the directors of an exempted company in relation to its memorandum and articles of association (which can only be amended by special resolution of its shareholders). However, the key reasons for the use of ELPs (and now LLCs) for closed-ended funds relate to distributions. While the directors of a company are restricted by statutory and common law maintenance of capital rules, the general partners of an ELP or the managers of an LLC are generally limited only by basic solvency requirements and the agreed terms of the limited partnership or LLC agreement, as applicable, when considering which sources of funds to utilise. Even more significant, however, is the ability of partners or LLC members to directly enforce the constitutional documents against one another; and the fact that the terms of investment can easily be expressed to survive a partner’s or member’s withdrawal (whereas a shareholder in a company ceases to be subject to its articles of association when he or she no longer holds any shares).

Closed-ended funds generally make distributions on a waterfall basis, most commonly by paying distributions first to investors until all capital contributions have been returned and a certain level of return obtained, then to the manager or general partner until it has received a specified percentage of the aggregate amount of all distributions, and then to investors and the manager or general partner in specified percentages. Such distributions are often subject to claw back at the end of the fund’s life if, once all distributions have been made, the manager or general partner has received a higher proportion of the aggregate distributions than intended, or, in some cases, from investors to fund indemnity payments. Utilising a company in this situation would generally require these obligations to be set out in a separate shareholders’ or subscription agreement that is also signed by the company to ensure that the obligations survive a shareholder’s withdrawal, and can be directly enforced by each investor and the company as against each other. Such considerations are also critical prior to the drawdown of funds from investors in a closed-ended vehicle, who may be bound by a limited partnership agreement or an LLC agreement prior to funding, but will generally not be bound by the articles of a company until such time as they actually subscribe for and are issued with those shares.

Investment funds structured as unit trusts are primarily formed in the Cayman Islands for distribution in Japan, where the demand is generated by familiarity with the unit trust structure and historical local tax benefits relating to unit trusts as opposed to company shares or limited partnership interests. The Cayman Islands also has specific regulations\(^\text{10}\) that such investment funds can elect to comply with when applying for a licence under the Mutual

---

\(^{10}\) The Retail Mutual Funds (Japan) Regulations (2018 Revision).
Funds Law, which under current guidelines set by the Japan Securities Dealers Association permit them to be marketed to the public in Japan. Although companies and limited partnerships are also eligible to use this regime, the popularity of unit trusts with Japanese investors means that funds regulated under this regime are usually unit trusts.

IV MAIN SOURCES OF INVESTMENT

The disparity of available information between open-ended and closed-ended investment funds in the Cayman Islands is evident when analysing the source and value of investments in such funds. CIMA’s published statistics\(^\text{11}\) provide a useful indication of the scale of the open-ended industry, with the net asset value of reporting funds in 2017 being over US$4 trillion, and reported inflows and outflows during 2017 from such funds of US$1.190 trillion and US$1.213 trillion respectively. It is worth bearing in mind that the actual figures for open-ended funds alone will exceed these amounts, because CIMA’s figures are based only on the 88 per cent of regulated funds as at December 2017 that had actually filed their fund annual returns for 2016, and they do not capture open-ended funds exempted from regulation under Section 4(4) or funds held in managed accounts.

We can speculate that the size of the closed-ended fund industry in the Cayman Islands is of a similar order. However, as previously noted, the exact number of closed-ended fund vehicles is difficult to establish, and the details of equity holders in those vehicles and the size of their investments is not publicly available information. Therefore, it should be noted that this is, at best, an educated guess.

V KEY TRENDS\(^\text{12}\)

The Cayman Islands has consistently adapted its regulatory and legal system to meet the demands of the finance sector and align it with international best practice. As a jurisdiction, it has proven to be highly responsive to the needs of the global financial industry through industry consultation projects, statutory amendments and new legislation, and through the growth and development of a commercially sophisticated judicial system.

Increasingly, the majority of inflows to hedge funds are from institutional investors. Institutional money has typically favoured larger managers, and this trend, together with recent positive industry performance, is reflected in the increasing total assets under management (AUM) figure for the industry, which is currently estimated to be over US$4 trillion.

Approximately 55 per cent of new funds were launched by managers with over US$1 billion AUM at the time of launch (whether from pre-existing funds in the market or because of a launch that exceeded US$1 billion). On the other hand, approximately 26 per cent of new funds were launched by managers with under US$100 million AUM at the time of launch, showing that there are a number of new start-ups out there despite the increased regulatory burden and other challenges faced by emerging managers in the current environment.

---

\(^{11}\) Op. cit. 3.

\(^{12}\) The following trends and statistics are based upon our own client and transaction experience.

© 2019 Law Business Research Ltd
Over the past five years, there has been a steady increase in specific Employee Retirement Income Security Act of 1974 (ERISA) funds, and in funds allowing ERISA investors on the traditional limited basis, up to 81 per cent of funds in 2018 (and 87 per cent of funds with North American managers).

Equity long-short funds have consistently constituted the highest proportion of funds launched since 2010. Other strategies such as managed futures and fixed income have fluctuated in popularity, while more recently multi-strategy funds have become more popular, perhaps reflecting the current economic uncertainty in the global markets.

Since 2010, there has, unsurprisingly, been a steady increase in the number of regulated managers. This is undoubtedly driven by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into US federal law on 21 July 2010, and which removed certain exemptions to registration with US regulatory bodies. For 2018, the general upward trend in the number of regulated managers continued, with at least 91 per cent of new funds being launched by regulated managers.

Both investors and regulators have pushed for greater transparency and accountability, which has led to changes in board composition. While the use of independent directors has steadily increased, we have also seen a trend for a segment of the launch market towards split boards consisting of independent directors appointed from more than one service provider as well as a manager-affiliated director. This trend has been more marked in the US than other regions. Independent directors are now regarded as significant to the overall structuring of a fund, as a robust board can be critical to the fund’s success, and significant decisions in crisis situations (such as gating and suspending redemptions) can rest with the board. There has also been an increase in the use of independent advisory committees or independent directors on the boards of general partners where funds – particularly master funds – are structured as ELPs. Beyond a general uptick in the use of independent directors, there has been a significant shift in the manner in which directors engage with a fund, its service providers and investors. The institutionalisation of the industry and the impact of new regulatory initiatives aimed at protecting investors has led to a much greater degree of scrutiny on corporate governance, resulting in more proactive and engaged directors than ever before.

Preserving liquidity continues to be a key priority for investors. There has been a significant decrease in funds launching without a gate in 2018, with investor level gates making up the majority of that decrease. For the first time, the use of investor level gates has overtaken both the use of fund level gates and no gates at all.

Liquidity has become the most common side letter term (along with transparency) in place of fees. However, liquidity needs to be tailored to the asset class, and many investors understand that it is not always preferable to have greater liquidity. As a result, we still see a number of funds retaining the ability to, inter alia, create side pockets and effect suspensions.

Statutory revisions and new legislation

A key strength of the Cayman Islands’ funds regime continues to be the ability to combine robust yet flexible laws, which are updated to keep pace with industry needs, with a commercial approach to business. The past few years have been a particularly busy period for Cayman Islands legislation in this regard. Legislation and regulations have been amended when necessary to meet OECD, AIFMD, the US Foreign Account Tax Compliance Act and other external requirements, but change for its own sake has been avoided, and this approach
can be expected to continue. The Cayman Islands fund industry is focused on, and responsive to, the legal and regulatory changes taking place worldwide, particularly in the US, Europe and Asia.

The Cayman Islands, through the applicable regulatory agencies, continues to engage proactively with counterpart international regulators (such as the Securities and Exchange Commission and the Financial Conduct Authority), and so remains at the forefront of evolving transparency and cooperation initiatives.

In addition to the previously mentioned amendments to the Mutual Funds Law, the SOG and the DRL Law, there have been a number of other more recent legislative updates. The Cayman Islands has established two new ‘opt-in’ regulatory regimes that are consistent with (and intended to provide equivalency to) the EU Directive on Alternative Investment Fund Managers (AIFM Directive). In August 2015, the amendments to the Mutual Funds Law and Securities Investment Business Law required to implement the new regulatory regimes were passed, and in December 2016 the relevant supporting regulations were passed. This regime was brought into force on 1 January 2019, although certain requirements of the regime remain subject to a further order of the government.

The enactment of the Limited Liability Companies Law in July 2016 and the provision of a new type of vehicle – a Cayman Islands limited liability company – served to strengthen the Cayman Islands’ reputation as an innovative jurisdiction committed to developing its legislation to meet the needs of the global financial services industry. The LLC offers a new form of corporate vehicle similar in concept to the Delaware limited liability company in that it combines the most desirable features of both the exempted limited partnership and a company limited by shares. The LLC is a body corporate with separate legal personality but with substantially equivalent flexibility to an ELP in terms of operational structure. Critically, the liability of members is limited to the amount that each member has undertaken to contribute as expressly provided in the LLC agreement or other agreement between the member and the LLC. Unlike the ELP, where the general partner retains unlimited liability, all members can benefit from the limited liability provisions of an LLC.

In June 2017, the Cayman Islands passed legislation to allow for the establishment and registration of another new Cayman Islands vehicle: the limited liability partnership (LLP), and the registrar of LLPs in the Cayman Islands is expected to commence accepting applications to register LLPs in due course. An LLP combines the flexible features of a general partnership with the benefit of separate legal personality and affords limited liability status to all its partners. The LLP is expected to become the preferred manner by which professional firms operating in the Cayman Islands structure their businesses, but the LLP’s features and flexibility may also provide an additional structuring option for investment funds as, by way of example, a general partner or management vehicle, or as a holding or fund of funds partnership.

From 1 July 2017, certain companies and LLCs are required to maintain a beneficial ownership register that records details of the individuals who ultimately own or control more than 25 per cent of the equity interests or voting rights, or who have rights to appoint or remove a majority of the company directors (or LLC managers), together with details of certain intermediate holding companies through which such interests are held. This beneficial ownership regime, which is similar to that being concurrently implemented by other Crown dependencies and overseas territories, codifies a commitment agreed between the Cayman Islands and the UK government in April 2016 to enhance existing robust arrangements on the exchange of beneficial ownership information to assist law enforcement agencies combat
tax evasion and money laundering. It is expected that most managed investment funds will fall within an exemption from the requirement to maintain a beneficial ownership register, for example because they are already regulated by CIMA or because they are managed by a manager that is itself regulated in an approved jurisdiction under the relevant legislation (i.e., other oversight and avenues of accessing information already exist).

In the litigation context, statutory amendments have been introduced to allow the Grand Court to grant interim relief (including by way of a freezing order) in support of foreign proceedings without the need for substantive proceedings in the Cayman Islands (i.e., ‘free-standing’ interim relief). Prior to this legislation, in the absence of substantive proceedings, relief of this nature could only be granted against a defendant located in the Cayman Islands. Since its introduction, this legislation has been used a number of times to obtain interim relief in the Cayman Islands in support of foreign proceedings.

The Cayman Islands’ anti-money laundering (AML) and countering of terrorist financing (CFT) sanctions and countering of proliferation financing regimes implement the FATF Recommendations and global practice. The Anti-Money Laundering Regulations (2018 Revision) (AML Regulations) apply to entities carrying on ‘relevant financial business’, which includes all types of Cayman Islands investment vehicles, whether or not registered with CIMA.

All Cayman Islands investment entities must maintain AML/CFT and sanctions procedures in accordance with the AML Regulations and each investment entity must designate natural persons in the roles of anti-money laundering reporting officer, money laundering reporting officer and deputy money laundering reporting officer (together, AML officers). However, AML compliance functions (including those of AML officers) can be performed by third-party service providers, subject to certain conditions, including the requirement for a risk-based assessment and ongoing review of the service provider.

ii Recent case law

In the Cayman Islands court system, commercially significant cases are handled by the Financial Services Division of the Grand Court (FSD), and each proceeding is assigned to one of the FSD’s highly experienced commercial judges. Appeals from the Grand Court, including the FSD, are to the Cayman Islands Court of Appeal (CICA), with a further potential right of appeal to the Privy Council in London. The courts deal with a wide variety of complex commercial disputes, including disputes between investors and funds that have suspended redemptions or are being wound down. Liquidations arising out of investment fund collapses also continue to give rise to litigation before the Cayman Islands courts.

The case of Ardon Maroon raises important issues for master-feeder structures that rely on back-to-back redemptions (i.e., where a redemption from the master fund will be required in order to service a redemption request submitted to the feeder fund). In this case, the Grand Court of the Cayman Islands held that a redemption purportedly made by the master fund was invalid in the absence of a written notice from the feeder fund to the master fund (as was held to be required by the relevant fund documents). It is worth noting that the facts and documents in Ardon Maroon were particular to that case and, at the time of writing, the judgment is on appeal by the feeder fund’s liquidators.

13 The Grand Court Law (2015 Revision) and related Grand Court Rules.

14 Re Ardon Maroon Asia Master Fund (in official liquidation) (Unreported, Grand Court of the Cayman Islands, Financial Services Division, 17 July 2018).
Nevertheless, the decision highlights the importance of both the feeder fund and master fund following precisely the redemption process as set out in their constitutional and operational documents. Notably, the judgment expressly stated that there is nothing inherently wrong with ‘automatic’ back-to-back redemptions, provided that such an arrangement is contemplated in and permitted by the documents and is the clear contractual intention of both the master fund and the feeder fund.

Another topical issue in the funds context is the function and effect of side letter agreements. A side letter is a familiar feature of Cayman Islands funds and is typically used to provide large cornerstone investors with more favourable commercial terms than the fund might otherwise provide in its standard constitutional documents. There is now a series of decisions that establish that, to ensure the validity and effectiveness of a side letter agreement, it should be executed by the correct parties (i.e., executed between the fund and the investor of record and not, for example, the underlying beneficial owner or an unauthorised agent of the fund such as an investment manager), and its terms must be consistent with the fund’s constitutional documents. Although careful not to undermine the important principle that companies are not obliged to look behind their registers of members, as well as privity of contract, the court has found that principles of agency and estoppel may operate to avoid commercially unreasonable results.

Many Cayman Islands funds conduct their business and hold their assets outside of the jurisdiction. Therefore, especially in the context of a winding-up or restructuring, the Cayman Islands courts have had to deal with complex cross-border and conflicts of laws issues. In recent years, the courts have demonstrated their willingness to facilitate cooperation in cross-border and foreign proceedings to ensure the efficient administration of justice. In a number of cases, the courts have used the flexibility of the Cayman Islands provisional liquidation process to support a restructuring Chapter 11 procedure in the US. The Cayman Islands has no restructuring process equivalent to Chapter 11 or administration in the UK, so in circumstances where a Cayman Islands fund intends to undergo a restructuring, the provisional liquidation procedure is being more commonly used in support of such foreign restructuring proceedings.

VI SECTORAL REGULATION

i Insurance

CIMA requires all insurance companies licensed under the Insurance Law, 2010 to have an investment strategy, the complexity of which is dependent upon the nature of the business underwritten. CIMA’s Statement of Guidance: Asset Management & Investment Strategy for


16 The Contracts (Rights of Third Parties) Law, 2014 is an important tool in dealing with these issues. This legislation allows parties to contracts to agree expressly to extend the right to rely upon and sue under a contract to non-parties, and so offers comfort to non-parties seeking to enforce the terms of properly drafted side letters.

17 See for example Re Fruit of the Loom [2000] CILR N-7; Trident Microsystems (Far East) Limited [2012] (1) CILR 424 and Arcapita Investment Holdings Limited (Grand Court order, 19 March 2012).
Insurance Companies requires insurers, among other things, to ensure that the composition of their asset portfolio is the product of a well-structured investment process with appropriate steps for implementation, to determine asset allocation in terms of the asset mix over the investment categories selected, and, in specific cases (e.g., use of derivative contracts), to seek prior CIMA approval to make certain investments.

ii  Pensions

Local pension plans must be registered with the Superintendent of Pensions under the National Pensions Law (2012 Revision), and the administrators of such plans are subject to statutory duties of care, diligence and skill (comprising both objective and subjective tests) in their management of the plan assets. Pension plans established and maintained for the benefit of employees in the Cayman Islands are required to comply with asset management rules under the National Pensions (Pension Fund Investments) Regulations (1998 Revision), which currently restrict investments to certain types of securities.

iii  Real property

There are no specific rules that apply to property fund management in the Cayman Islands.

iv  Hedge funds

Hedge funds will generally be open-ended vehicles, and therefore need to comply with the provisions of the Mutual Funds Law, as described in Section II.

v  Private equity

There are no rules that apply specifically to private equity funds in the Cayman Islands (e.g., private equity funds, like other types of investment entities, are subject to the need for AML officers). However, the changes made to the Exempted Limited Partnership Law in 2014 bring the law more into line with the current commercial demands of private equity funds.

VII  TAX LAW

The Cayman Islands imposes no taxation on the income or capital gains of investment funds or their investors, and no transfer taxes on the transfer of interests in investment funds. Exempted companies, LLCs, limited partnerships and unit trusts can obtain undertakings from the government that if any such taxation is introduced during a 20-year period (companies) or 50-year period (limited partnerships, LLCs and unit trusts), as applicable, from the date of the undertaking (or date of creation of the unit trust), such taxation will not apply to the entity to which the undertaking is given.

---

18 Companies are entitled to a 20-year undertaking under Section 6 of the Tax Concessions Law (2018 Revision), limited partnerships are entitled to a 50-year undertaking under Section 38 of the Exempted Limited Partnership Law (2018 Revision), LLCs are entitled to an undertaking for a period not exceeding 50 years under Section 58 of the Limited Liabilities Companies Law (2016 Revision) and trusts are entitled to an undertaking under Section 81 of the Trusts Law (2018 Revision).
The Cayman Islands recently introduced legislation\(^{19}\) (Economic Substance Law) in connection with global initiatives in relation to base erosion and profit shifting.

The Economic Substance Law introduces certain reporting and economic substance requirements for ‘relevant entities’ conducting ‘relevant activities’. Such entities will be required to report certain information on their relevant activities on an annual basis to the TIA, the first such annual report being due no later than 12 months after the last day of the entity’s financial year commencing on or after 1 January 2019.

The definition of ‘relevant entity’ in the Economic Substance Law recognises that, among other things, an entity that is an ‘investment fund’ is not within the classification of a ‘relevant entity’ and, therefore, not subject to the requirements of the Economic Substance Law. The definition of ‘investment fund’ includes an entity through which an investment fund directly or indirectly invests or operates.

**VIII OUTLOOK**

As the Cayman Islands continues to respond and adapt to the implementation of new global regulatory and taxation standards and improve the laws relating to the fund vehicles preferred by sponsors and investors alike, we expect to witness ongoing growth in the jurisdiction’s share of the hedge, private equity and venture capital fund formation market.

Further, the demand for an inexpensive, tax-neutral and secure method of pooling capital from multiple jurisdictions, and of transmitting that capital to where it can best be employed, remains strong, in a world that is subject to increased regulatory and fiscal scrutiny. The Cayman Islands’ secure legal and regulatory framework and level of specialist expertise, combined with a proactive regulator and desire to comply with recognised global standards in the investment fund industry, should enable the Cayman Islands to continue taking advantage of this demand, and to maintain its position as a premier jurisdiction for offshore investment funds.

\(^{19}\) The International Tax Co-operation (Economic Substance) Law, 2018 and the International Tax Co-operation (Economic Substance) (Prescribed Date) Regulations, 2018, as amended by the International Tax Co-operation (Economic Substance) (Amendment of Schedule) Regulations, 2019 and the International Tax Co-operation (Economic Substance) (Amendment of Schedule) (No. 2) Regulations, 2019, and supplemented by the related Guidance on Economic Substance for Geographically Mobile Activities (as revised from time to time).
Chapter 7

GERMANY

Christian Schmies

I OVERVIEW OF RECENT ACTIVITY

As in the previous year, 2018 marked another successful year for the German fund industry. The number of open-ended investment funds grew from 6,370 (at the end of 2017) to 6,679 (at the end of 2018), while assets under management at the year ends, largely due to the fall in the stock markets in Q4/2018, largely remained constant (€2,057 billion at the end of 2018 in comparison to €2,055 billion at the end of 2017). During the same period, the number of registered alternative investment fund (AIF) management companies (KVGs) increased from 314 (in 2017) to 379 (in 2018), whereas the number of licensed management companies increased from 136 (in 2017) to 146 (in 2018).^{3} By contrast, the total number of non-German funds that are authorised to be distributed in Germany increased with respect to UCITS from 10,183 (in 2017) to 10,511 (in 2018), with respect to EU AIFs from 1,591 (in 2017) to 2,095 (in 2018) and with respect to non-EU AIFs from 285 (in 2017) to 321 (in 2018).^{4}

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

i Definition of captured asset management activities

The asset management activities covered by this chapter can be divided into collective asset management (i.e., the management of investments in collective investment schemes (funds)) and individual asset management (i.e., the management of individual accounts). Before the implementation of the AIFMD^{5} into German law on 22 July 2013, the German fund industry was categorised into regulated funds and non-regulated funds. Regulated funds, which were always open-ended, were subject to comprehensive product regulation and ongoing supervision under the German Investment Act (InvG). Non-regulated funds were established under general corporate law and were typically closed-ended. They were subject to statutory prospectus requirements, but were generally not subject to prudential supervision and product regulation. With the implementation of the AIFMD through the Capital Investment Act (KAGB) in July 2013, the scope was extended to all collective investment

---

1 Christian Schmies is a partner at Hengeler Mueller. The author would like to thank Markus Ernst, counsel at Hengeler Mueller, for his contribution on taxation.
2 Alternative investment fund managers within the meaning of the Alternative Investment Fund Managers Directive (AIFMD) 2011/61/EC.
3 Annual Report 2018 of the German Federal Financial Services Supervisory Authority, p. 149.
schemes in Germany, save for certain exceptions specified in the KAGB. Nonetheless, open-ended and closed-ended funds are still subject to different regulatory requirements under the KAGB.

**ii The KAGB as the central piece of legislation**

The central piece of legislation for German investment funds is the KAGB. The KAGB contains a comprehensive, single statutory framework for all collective investment schemes in Germany, covering both undertakings for UCITS and AIFs within the meaning of the AIFMD. Unlike the AIFMD, which is limited to the regulation of alternative investment fund managers (AIFMs) and AIFs distributed to professional investors, the KAGB also regulates AIFs that can be distributed to retail investors. Furthermore, also different from the AIFMD, the KAGB contains specific investment restrictions for German AIFs.

The range of collective investment schemes regulated as AIFs under the KAGB is very diverse, and includes both funds for institutional investors (i.e., German special funds) as well as the various types of non-UCITS open-ended funds accessible to private investors.

The KAGB also governs many previously unregulated German collective investment schemes in the grey (i.e., unregulated) capital market. These funds may invest in a wide variety of asset classes, including real estate, ships, containers, wind and solar energy parks, and film rights. Owing to the illiquid nature of their assets, they are typically closed-ended. These funds usually have the legal form of a partnership and are often structured to provide particular tax benefits for their investors.

**Special funds**

Special funds form a very important part of the fund industry in Germany. Traditionally, special funds have been open-ended, regulated investment funds limited to non-natural persons (i.e., institutional investors including financial institutions, corporates and other institutional investors, such as foundations or churches). German insurance companies constitute the single most important investor category; this institutional investor group holds a significant part of its restricted assets and technical reserves via German special funds. Under the KAGB, the scope of eligible investors for German special funds was broadened to cover professional investors and semi-professional investors. The category of professional investors is derived from the AIFMD, and includes professional investors within the meaning of Annex II of MiFID II and those investors upgraded to professional investor. The category of semi-professional investors is not foreseen in the AIFMD. It includes certain public law bodies as well as investors investing at least €10 million into the relevant AIF, and investors investing at least €200,000 and additionally fulfilling certain qualifications regarding investment expertise, experience and knowledge. Thus, the KAGB has also given certain private investors access to German special funds.

Owing to the limited circle of potential investors, the regulation of special funds has always been significantly lighter than for public mutual funds. Because of the well-calibrated balance of regulation and product flexibility, the German special fund has, over decades, gained enormous importance for the management of institutional assets in Germany. Attempts by

---

foreign legislators to copy the German special funds regime, such as the introduction of the Luxembourg specialised investment funds, have not had a noticeable adverse impact on the attractiveness of German special funds.

Special funds are necessarily AIFs under the KAGB because they do not qualify as UCITS, although a special fund may adhere to the investment restrictions applicable to UCITS. The KAGB provides for three types of open-ended special funds:

- a largely liberalised form of special funds subject essentially only to the general principle of risk diversification and the requirement to invest only in assets whose market value can be determined;
- special funds with fixed fund rules, which essentially take over the regulation of special funds as previously recognised; and
- special funds qualifying as hedge funds, which is only a negligible phenomenon in Germany.

Special funds with fixed fund rules are limited to a catalogue of assets specifically permitted under the KAGB, as are German mutual funds. However, most quantitative investment limitations mandatory for public funds can be waived for special funds. The general principle of risk diversification, however, must always be observed. In line with the AIFMD requirements, the German legislature introduced as a new requirement an offering document for German special funds. While the administrative effort in setting up a German special fund has thus become somewhat more cumbersome under the KAGB, special funds can still be established in a very timely fashion. In particular, their fund rules do not require approval by the Federal Financial Supervisory Authority (BaFin), even though the KAGB requires that the fund rules of special funds must be filed with BaFin.

In addition to open-ended special funds, the KAGB also governs closed-ended special funds. Private equity funds set up in Germany must necessarily be organised as closed-ended special funds, and are then subject to the particular disclosure and notification requirements as well as the asset-stripping rules foreseen by the AIFMD.

Public funds

Open-ended public funds

Regulated mutual funds were originally established by the German legislature as open-ended investment products for private investors. Despite the increasing variety and complexity of mutual funds, the main objective of their regulation is still investor protection. The fund rules must comply with the statutory requirements of one of the permissible types of fund under the KAGB, including the qualitative and quantitative investment restrictions applicable to the relevant fund type.

The most common fund type for open-ended mutual funds are UCITS. The legal provisions applicable to German UCITS are essentially limited to the implementation of the requirements under the UCITS Directive.

The permissible non-UCITS open-ended fund types under the KAGB include:

- real estate funds, which invest mainly in real estate and real estate companies;
- funds of hedge funds;
- ‘mixed funds’, which resemble UCITS but may also invest a limited portion of their assets in non-UCITS compliant target funds; and
‘other funds’, which, apart from UCITS eligible assets, may also invest in non-UCITS compatible target funds, unlisted corporate participations, precious metals and loans, and may also be established in the particular form of a microfinance fund.

Single hedge funds are permissible only as special funds.

Closed-ended public funds

The KAGB permits the establishment of closed-ended funds not only for professional (and semi-professional) investors, but also for private investors. However, it added product regulation of closed-ended funds to the ‘mere manager’ regulation required by the AIFMD. Closed-ended public funds are restricted to an exhaustive list of eligible assets. This list is broad and covers, inter alia, financial instruments such as securities, certain investment funds and participations in companies, as well as physical assets such as real estate, ships and superstructures, aircraft, renewable energy facilities, electric powered vehicles and containers; however, it is a conclusive catalogue, and does not allow closed-ended funds to invest in any other type of assets. Furthermore, closed-ended funds targeting private investors must only invest in derivatives for hedging purposes, and must generally be invested according to the principle of risk diversification, which requires an investment in at least three assets that are essentially evenly distributed, or an investment providing for a diversification of risk (e.g., real estate due to the tenant structure). The requirement of risk diversification does not apply if the minimum investment is at least €20,000.

Apart from the KAGB, there are a few other German statutes tailor-made for specific types of funds that do not provide for prudential regulation but rather offer certain benefits, typically tax benefits, to funds established in accordance with the relevant statutory requirements. The Act on Corporate Participation Companies of 1986 and the Act on Venture Capital Companies of 2008 (which has been repealed) were both designed to promote the establishment of German private equity and venture capital funds by offering certain tax benefits for funds established under the relevant statute. Neither statute has gained significant importance. The same is true for the German REIT Act: it was introduced in 2007, but at present only five German REITs exist.

iii Discretionary asset management

Discretionary asset management relating to financial instruments is an investment service subject to a licensing requirement under the German Banking Act (KWG). Besides banks and financial services institutions licensed under the KWG, UCITS and AIF management companies licensed under the KAGB can also be authorised to provide discretionary asset management services as an ancillary activity; in addition to the licensing, solvency and organisational requirements under the KWG, they must then observe rules of conduct derived from MiFID and implemented in the German Securities Trading Act.

iv Regulator: BaFin

BaFin is the competent regulator for German banks (i.e., deposit-taking credit institutions), e-money-institutions, financial services institutions (i.e., investment firms within the meaning of MiFID as well as leasing and factoring companies), insurers (including regulated pension funds) and UCITS and AIF management companies. When supervising deposit-taking credit institutions, BaFin cooperates with the European Central Bank and the German
Central Bank. It also cooperates with the German Central Bank when supervising financial services institutions, but is the sole regulator for insurers and UCITS and AIF management companies.

III COMMON ASSET MANAGEMENT STRUCTURES

i Contractual funds

Contractual funds (in contrast to corporate type funds) do not have a legal personality and must be managed by a KVG licensed under the KAGB (or passported non-German investment management companies: see below). The KVG is obliged to manage the contractual fund in its own discretion, subject always to the limitations of the KAGB and the relevant fund rules. The KVG is generally not subject to instructions by investors. Particularly in the case of special funds, which often only have one institutional investor, the KVG will typically establish an investment committee in which the investor and the KVG, and potentially the depositary, are represented. The investor can influence the management of the special fund by exercising its voting rights in this investment committee. However, from a legal perspective, the investment committee has an advisory function only.

The assets belonging to a contractual investment fund are either legally owned by the KVG as trustee for the investors of the fund or by the investors themselves (as co-owners of the portfolio assets). The fund assets must be held in safe custody by a depositary. In the case of UCITS, the depositary is also responsible for administering the issuance and redemption of fund shares. Typically, fund shares are not issued to investors in physical form, but are certificated in a global certificate deposited with the German central securities depositary, Clearstream Banking AG. Fund shares can be registered shares or bearer shares; bearer fund shares must be certificated in a global certificate without the right to demand actual securities. In accordance with the German legal framework for the safe custody of securities under the Safe Deposit Act, investors hold a fractional interest in the global certificate corresponding to their investment in the fund under a multi-tier deposit structure starting with the bank maintaining their securities account and ending with Clearstream Banking AG.

ii KVGs

With the exception of German UCITS, which can be managed by non-German UCITS management companies, and German AIFs limited to professional and semi-professional investors, which can be managed by EU-licensed AIFMs, regulated German contractual funds can only be managed by external German KVGs. Such external German KVGs can only be established as a stock corporation, a limited liability company or a limited partnership whose only general partner is a limited liability company, and must have a minimum capital of €125,000 plus 0.02 per cent of the amount of assets under management exceeding €250 million, but in any case at least an amount equivalent to one-quarter of its preceding year’s fixed overhead. They must at least have two managing directors who are qualified for investment business (i.e., collective asset management and risk management), as well as sufficient personnel to conduct their business. In addition, each KVG must establish a supervisory board (or an advisory board in the case of a limited partnership) of at least three members, one of whom must be an independent board member unless the KVG exclusively manages special funds. The KVG may outsource functions, including the portfolio management or the risk management (but not both in relation to the same fund), subject to certain limitations under the KAGB. In particular, the portfolio management may
only be delegated to an entity that is licensed to perform asset management activities and subject to effective supervision, but that does not simultaneously act as depositary for the respective investment fund. While generally all functions except controlling functions may be delegated, the KVG must retain sufficient personnel to control the delegated functions, and the scope of the delegations must not result in the KVG becoming a letter-box company.

### iii Investment stock corporations

Under the KAGB, German investment funds can also be established in corporate form, namely in the form of an investment stock corporation. The KAGB provides for two varieties of investment stock corporations: those with variable capital as the legal form for open-ended funds, and those with fixed capital as the legal form for closed-ended funds.

Investment funds in corporate form play only a minor role in Germany. The vast majority of German regulated funds are established in contractual form. The investment stock corporation with fixed capital was originally introduced in 1998, but was abolished in 2004 because it was so unattractive due to its unfavourable tax regime that, until 2004, no such stock corporation was ever established. Under the KAGB, this legal form has been reintroduced into German investment law and is no longer subject to an unfavourable tax regime (this is also the case under the ‘new’ German Investment Tax Act).

The investment stock corporation with variable capital was only introduced as a legal form for German regulated funds in 2004. Originally, it was designed in particular as a legal vehicle for hedge funds, which were introduced as a new mutual fund type at the same time. In 2007, the legislature introduced further changes that also allow the establishment of investment stock corporations with different sub-funds without cross-liability. German investment stock corporations can be established as self-managed corporations or as investment stock corporations managed by an external investment management company. In the latter case, the investment stock corporation essentially only serves as a corporate shell, whereas the operational and control functions (portfolio management, risk management, etc.) are situated in the investment management company.

### iv Investment limited partnerships

Besides contractual type funds and investment stock corporations, the KAGB permits investment limited partnerships as an additional legal form for German investment funds. Like investment stock corporations, investment limited partnerships can be set up both as open-ended or closed-ended investment limited partnerships. Investors participate as limited partners in the investment fund, and their liability is generally limited to the amount of capital contributed by them to the investment fund.

### IV MAIN SOURCES OF INVESTMENT

#### i Open-ended funds

The majority of the total assets under management in German funds of €2,057 billion is invested in special funds (€1,589 billion), while merely €468 billion is managed in public mutual funds. The biggest investor groups in special funds are, and were historically, insurers and pension vehicles.
ii Closed-ended funds
For 2018, the German Investment Funds Association (BVI) reported assets under management in German closed-ended retail funds of only €2.05 billion and in closed-ended special funds of €6.88 billion.8

iii Discretionary asset management
Reliable data on the German market for individual discretionary asset management is even more difficult to obtain than for closed-ended funds, as there is no central industry association collecting relevant data from all market participants. According to data published by the BVI, as at 31 December 2018, KVGs managed €353 billion (€379 billion in 2017) of assets on the basis of discretionary asset management agreements outside of funds.9

V KEY TRENDS
As was already the case in previous years, the long-lasting low interest rate environment forces many German institutional investors traditionally focused on fixed income investments to look for other investments promising more attractive returns at appropriate risk levels. In this context, many institutional investors have increased their asset allocation to real estate, including investments in real estate loans. Generally, there is a high demand for a large variety of debt investments outside the securities markets (commercial loans, commercial real estate loans, trade finance).

VI SECTORAL REGULATION
i Insurance
The biggest group of investors in German funds, namely insurers, are themselves subject to investment restrictions under the Insurance Supervisory Act. With effect from 1 January 2016, these investment restrictions were significantly altered by the implementation of the Solvency II Directive.10

The Investment Regulation for the Investment of Restricted Assets of Insurance Companies – applicable before the implementation of the Solvency II Directive to all insurers – was newly promulgated in April 2016 with substantially the same rules as before, but since then only governs investments of technical reserves of small insurance companies (defined primarily as non-liability, credit or bonding insurance with an annual gross written premium income of €5 million or less), pension life insurers and death benefit insurers. The Investment Regulation contains an exhaustive list of eligible assets. Each investment by a German insurance company must be allocable to one of the items in this catalogue to qualify as an eligible investment, except for investments under an opening clause generally limited to 5 per cent of the technical reserves. Furthermore, the Investment Regulation allows investments of up to 7.5 per cent of the technical reserves in EU AIFs managed by

8 BVI Investmentstatistik as at 31 December 2018, p. 1.
9 ibid.
EU AIFMs without any specific investment restrictions applicable to such AIF under the Investment Regulation. In December 2017, BaFin released its Circular 11/2017 (VA), which provides detailed regulatory guidance on the implementation of the Investment Regulation.

By contrast, insurers not subject to the Insurance Regulation must follow the prudent person principle of the Solvency II Directive: in other words, they must only invest in assets whose risks can be properly identified, measured, monitored, managed, controlled and reported, and appropriately taken into account in the assessment of the overall solvency needs of the insurer. In lieu of the catalogue of eligible investments set out in the Investment Regulation, insurers must establish their own internal investment catalogue to ensure that all investments meet the tests on security, quality, liquidity, profitability and availability.

ii Pensions

The German pension system is traditionally characterised by a strong public pension pillar that is a pay-as-you-go system financed by employees, employers and governmental subsidies. Apart from this, there is a wide variety of occupational pension schemes, each with its own regulatory framework, including:

a direct pension promises, where the employer promises certain pension payments to the employee. In recent years, many German companies have established contractual trust arrangements (CTAs) to take their pension liabilities off their balance sheets. CTAs are generally not subject to statutory regulation or investment restrictions;
b direct insurance schemes, where the employer takes out a life insurance policy for the employee and pays the premiums;
c pension life insurers are specialised life insurance companies, and as such are regulated as insurance companies whose investments are subject to the Investment Regulation;
d pension funds, which can be established as stock corporations or mutual pension fund associations, and whose investments are limited by an executive regulation similar to the Investment Regulation for insurance companies; and
e support funds, which are unregulated pension schemes not subject to statutory investment restrictions.

iii Real property

Historically, the main majority of real estate funds in Germany were open-ended. Starting in the autumn of 2008, at the height of the financial crisis and shortly after the fall of Lehman Brothers, a growing number of open-ended real estate funds suffered liquidity crunches and could no longer satisfy redemption requests. None of these funds recovered from this shock, and for the first time in the history of open-ended real estate funds in Germany, such funds had to be liquidated, which was a long and painful process for their investors whose only alternative was to sell their fund units at an organised market with a substantial discount. As a consequence, the legislature changed the redemption rules and effectively created semi-opened real estate funds, and established a mandatory lock-up period of 24 months as well as the requirement to notify the AIFM of a redemption with a period of 12 months (although these periods can be overlapping).

By contrast, the market of closed-ended real estate funds continues to be relatively small, even after they became subject to regulation with the implementation of the AIFMD. In the past, closed-ended real estate funds were often established to finance a single asset. Despite the fact that a non-diversified closed-ended fund can only target the retail public if
the minimum investment is €20,000, the risk diversification requirements under the KAGB for closed-ended public funds not meeting this threshold continue to be significantly lower than for open-ended public funds invested in real estate.

iv  Discretionary asset management
The business of discretionary asset management is subject to a licensing requirement under German law only if it relates to financial instruments. The management of real estate, therefore, does not require any licence under German law. If the management of real estate also includes the investment of rent or other income in financial instruments, a licence for discretionary asset management is generally required.

A growing number of open-ended special funds are established as ‘master funds’, in other words, relatively large funds segmented into a number of ‘virtual funds’ (not to be confused with sub-funds in an umbrella fund structure). These segments, while not legally constituting individual funds, are for all practical purposes treated like separate funds, and their management is commonly delegated to an external portfolio manager who must be licensed for the purpose of discretionary asset management. Such a delegation is possible not only for German KVGs, banks and financial services institutions holding the requisite licence, but also for requisite non-German EU service providers holding an EU passport. This is also a growing market for non-EU asset managers (e.g., US managers supervised by the Securities and Exchange Commission, who can perform asset management services for these funds on a cross-border basis under the ‘passive services exemption’ – also referred to as ‘reverse solicitation’); under this exemption, otherwise licensable financial services can be provided in Germany by non-EU service providers if the client relationship was established exclusively upon the client’s (or its agent’s) initiative. In the case of special funds, non-EU asset managers are frequently selected by investment consultants (acting for the special fund investor) who approach these managers with a request for proposal. Alternatively, non-EU asset managers may, in certain circumstances, apply for a specific licence exemption from BaFin.

v  Hedge funds
In 2004, the German legislature introduced a regulatory framework for single hedge funds and funds of hedge funds as additional fund types into the InvG. The initial hopes and expectations by some lobbyists and market participants regarding the development of a significant German hedge funds industry have, however, not materialised. With the introduction of the KAGB, German single hedge funds could no longer be established as public funds, but had to be converted to special funds limited to professional or semi-professional investors. At the end of 2018, there were only 13 German single hedge funds (14 in 2017) with total assets under management of approximately €3.36 billion (€3.43 billion in 2017) and no German funds of hedge funds.11

vi  Private equity
German-based private equity funds have traditionally been non-regulated vehicles. With the implementation of the AIFMD in Germany, managing and distributing private equity funds

11  Annual Report 2018 of the German Federal Financial Services Supervisory Authority, p. 150.
in Germany generally has become subject to regulation under the KAGB. So far, however, Germany has not been a very prominent jurisdiction for the establishment of private equity funds, and this has not changed as a result of their regulation under the KAGB.

VII TAX LAW

Germany has introduced, as of 1 January 2018, a substantially amended investment taxation regime (German Investment Tax Act 2018: InvStG 2018). This new regime abolishes the only recently introduced distinction between investment funds in the narrower sense and investing companies. The main drivers for the reform as cited by the German legislator were shortfalls of the ‘old’ regime in terms of complexity, abuse potential and non-compliance with European law.

The key aspect of the new regime is that investment funds are no longer treated as being tax-transparent, but rather subject to corporate income tax with respect to specific domestic income (e.g., from shareholdings or domestic real estate). Only special investment funds can, subject to certain requirements, opt for a tax-transparency regime similar to the ‘old’ system.

Whether a fund is an investment fund within the meaning of the InvStG 2018 very much depends on its supervisory law classification. If a fund qualifies as an investment fund for supervisory law purposes, it is in principle also treated as an investment fund for investment tax purposes. There is, however, an important exception for partnerships, which generally do not fall within the scope of the InvStG 2018 (this exception is mainly targeted at private equity funds, which are often structured as partnerships). On the other hand, one-investor vehicles, albeit not investment funds for supervisory law purposes, are explicitly covered by the scope of the InvStG 2018.

Under the new investment tax regime, both German and non-German investment funds (or sub-funds, respectively) are generally subject to a non-transparent tax regime and are therefore subject to German corporate income tax at a tax rate of 15 per cent for certain items of German-source income. These items are, in particular, dividends (or dividend equivalent payments) from German corporations and income from German-situs real estate. Investment funds, however, are not subject to tax in Germany for, inter alia, interest income, capital gains from the disposal of shares, bonds or derivatives, and all types of foreign-sourced income.

Even though certain types of income are already taxed at the fund level, investors into such investment fund who are tax-resident in Germany are nevertheless subject to German income tax or corporate income and trade tax (if any) on the investment fund’s distributions, on capital gains realised upon the disposal of their investment fund units and on income deemed to be received in the form of an advance lump-sum amount. The advance lump-sum amount was intended by the legislator to replace the concept of deemed distributed income under the ‘old’ regime in order to allocate to the investor a deemed risk-free return for tax purposes irrespective of whether the fund actually distributes or rather retains its earnings.

To avoid or at least reduce the double taxation of the same income at the level of the fund and of the investor, the InvStG 2018 provides for partial exemptions at the investor level, subject to certain requirements. The applicable partial exemption rate depends on whether the investment fund qualifies as an equity fund, mixed fund or real estate fund. To illustrate this by means of the latter, a real estate fund is an investment fund that invests continuously at least 51 per cent of its (net asset) value in real estate and real estate companies. If these requirements are met, generally 60 per cent of the total income from the investment fund
(i.e., irrespective of whether the income is derived from real estate or not) is tax-exempt at the level of the respective investor. This exemption even increases to 80 per cent if the investment fund is invested in foreign (i.e., non-German) real estate or foreign real estate companies.

A completely different regime applies, however, if the investment fund qualifies as a special investment fund. In this case, the fund has the option to be treated as tax-transparent. This means that no taxation applies at the fund level (save for a withholding tax obligation in the case of real estate income), whereas investors are fully taxable on distributions and deemed distributions.

To qualify as a special investment fund, an investment fund must not have more than 100 investors and must comply with rather narrow (investment) restrictions. In particular:

a the investment fund or its manager must be subject to investment supervision;
b the investors must be entitled to at least an annual redemption of their units;
c the fund must invest in a risk-diversified manner; and

d at least 90 per cent of the value of the investment fund must be invested into eligible assets such as securities, derivatives or real estate.

Participations in corporations are principally eligible, but are restricted in terms of fund volume (no more than 20 per cent of the fund’s value) and the size of the participation (less than 10 per cent of the respective corporation’s capital).

VIII OUTLOOK

Unlike in previous years with the implementation of MiFID II or the new German investment tax legislation, there is currently no comprehensive change to the regulatory or tax environment for investment funds in the making. Nevertheless, it will remain important for investment fund managers to monitor the changing regulatory landscapes of their various investor groups. Tailor-made special funds can provide valuable instruments, for example, for insurers to assist them in meeting the requirements of the Solvency II Directive, or for banks in meeting the requirements of the liquidity coverage ratio, especially in light of the negative interests charged by the European Central Bank.
Chapter 8

HONG KONG

Jason Webber, Peter Lake and Ben Heron

I OVERVIEW OF RECENT ACTIVITY

At the end of a volatile year for global financial markets, amid asset market corrections and weak investment sentiment, Hong Kong’s asset management and fund advisory business recorded a year-on-year decrease of 6% per cent to HK$16.447 trillion at the end of 2018. Similarly, looking at the industry on a wider level, Hong Kong’s asset and wealth management business fell from HK$24.270 trillion to HK$23.955 trillion.²

Nonetheless, asset management continues to be a growing industry in Hong Kong. The number of corporations licensed for asset management (i.e., Type 9 regulated activity) grew 11% per cent in 2018, and the number of individuals licensed for asset management also increased 11% per cent in the same time frame.

Hong Kong continues to be the pre-eminent offshore renminbi centre, offering a range of renminbi financial products. Total outstanding renminbi deposits and certificates of deposit increased from 618 billion at the end 2017 to 658 billion at the end of 2018, although this figure still remains significantly below the record 1.16 trillion at the end of 2014. The number of licensed corporations and registered institutions established by Mainland-related groups in Hong Kong also increased 8% per cent from 334 as at 31 December 2017 to 362 as at 31 December 2018.³

The Securities and Futures Commission (SFC) has been pursuing initiatives to facilitate the development of Hong Kong as a competitive full-service asset and wealth management centre and a preferred place of fund domicile. Following the implementation of mutual recognition of funds (MRF) arrangements with the Mainland and five other markets, the SFC further expanded its MRF network to include the UK in October 2018, Luxembourg in January 2019 and the Netherlands in May 2019. The new open-ended fund companies regime took effect in July 2018. The SFC also relaxed the leverage cap for inverse products to a factor of two-times negative (-2x) and introduced active exchange traded funds via a revised Code on Unit Trusts and Mutual Funds. Enhanced conduct requirements were introduced

1 Jason Webber and Peter Lake are partners and Ben Heron is an associate at Slaughter and May. The authors would like to thank Mike Ringer, associate, and James Lawrence and Ryan Martin, trainees at Slaughter and May, for their help in updating this chapter.
2 All figures are taken from the Asset and Wealth Management Activities Survey 2018 issued by the SFC in July 2019 (Asset and Wealth Management Survey), where ‘asset and wealth management business’ comprises asset management, fund advisory business, private banking and private wealth management business, and SFC-authorised real estate investment trusts management business, each as defined in the Asset and Wealth Management Survey.
3 Asset and Wealth Management Survey.
in key areas such as securities lending and repurchase agreements, custody of fund assets, liquidity risk management and disclosure of leverage by fund managers. These took effect in November 2018.4

The number of Hong Kong-domiciled funds increased 4.1 per cent to 789 between 31 March 2018 and 31 March 2019.5 However, the number of authorised collective investment schemes fell from 2,799 on 31 March 2018 to 2,797 on 31 March 2019. At the end of 2018 the total net asset value of SFC-authorised unit trusts and mutual funds stood at US$1.433 trillion.6

Going forward, Hong Kong looks set to continue to develop as a leading centre for the asset management industry for a number of reasons, including its rigorous but flexible and accommodating regulatory regime, its proximity to the mainland markets, its flexible tax regime and its world-class financial infrastructure.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The principal source of regulation of the asset management industry in Hong Kong is the Securities and Futures Ordinance (SFO) and its subsidiary codes, guidelines and circulars, and the principal regulator is the SFC.

Retail funds in Hong Kong (funds offered to the Hong Kong public) must be authorised by the SFC, whereas non-retail funds generally structure and conduct themselves in such a manner as to avoid the need to be authorised, and thereby regulated, by the SFC. Unauthorised funds, whose investors are predominantly institutions, have an aggregate net asset value thought to be in excess of the figure for authorised funds, although this is hard to quantify in the absence of any obligation to file accounts.

Even where non-retail funds are able to avoid the requirement to be authorised, the regulatory regime generally requires their Hong Kong-based fund managers to be licensed by the SFC, whether they manage retail funds or non-retail funds.

The principal source of regulation in respect of both authorisation and licensing is the SFO, and the key codes are the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products, and the SFC’s Fund Manager Code of Conduct.

i Authorisation by the SFC

The asset management structures utilised in Hong Kong and discussed below are collective investment schemes for the purposes of the SFO.7 Under Section 103(1) of the SFO, it is an offence for a person to issue any advertisement, invitation or document that to his or her knowledge is or contains an invitation to the public to acquire an interest in or participate in any collective investment scheme unless the issue is authorised by the SFC under Section 105(1) of the SFO, or is exempted by any other relevant provision.

---

4 Asset and Wealth Management Survey.
6 These figures are taken from Table D3, SFC Market & Industry statistics.
7 As defined in Part 1 of Schedule 1 to the SFO.
A common way to structure a fund to avoid the requirement to be authorised by the SFC is by ensuring that the offer and marketing is not regarded as being made to the public.\(^8\)

The meaning of ‘to be given to the public’ in the context of Hong Kong securities law has been the subject of much debate. Following previous market practice, the general consensus is that 50 persons (or fewer) in Hong Kong would not constitute the public. In 1991, an SFC working group also informally stipulated that, in order for a document or invitation not to be regarded as made to the public:

\(a\) not more than 50 copies of the offering document or invitation should be issued;
\(b\) each copy should be serially numbered;
\(c\) each copy should be individually addressed to a named person; and
\(d\) each copy should make clear that only the named addressee is entitled to take up the offer or invitation, and that he or she is not entitled to transfer his or her acceptance to any other person.\(^9\)

Another common way to structure a fund so as to avoid the requirement to be authorised by the SFC is by offering and marketing the fund only to professional investors, for which Section 103(3)(k) of the SFO provides a specific exemption. The definition of professional investors includes:

\(a\) intermediaries (i.e., licensed corporations and registered institutions);
\(b\) authorised institutions or overseas banks;
\(c\) authorised insurers;
\(d\) governments;
\(e\) trust corporations with total trust assets of not less than HK$40 million (or its equivalent in foreign currency);
\(f\) corporations or partnerships with a portfolio of not less than HK$8 million (or its equivalent in foreign currency) or total assets of not less than HK$40 million (or its equivalent in foreign currency);
\(g\) high net worth individuals with a portfolio of not less than HK$8 million (or its equivalent in foreign currency);
\(h\) corporations that have as their principal business the holding of investments and are wholly owned by one or more professional investors; and
\(i\) holding companies that wholly own another corporation that is itself a qualified professional investor.

**ii Licensing by the SFC**

The requirement for a fund manager to be licensed under the SFO arises because the fund manager will be carrying on a business\(^10\) in one or more of the following specified regulated activities:\(^11\)

\(a\) Type 1: dealing in securities;
\(b\) Type 2: dealing in futures contracts;
\(c\) Type 3: leveraged foreign exchange trading;

---

\(^8\) As noted in an SFC Working Group report on offers of securities and other investments issued in December 1991.

\(^9\) ibid.

\(^10\) Section 114(1) of the SFO.

\(^11\) Part 1 of Schedule 5 to the SFO.
Type 4: advising on securities;
Type 5: advising on futures contracts;
Type 6: advising on corporate finance;
Type 7: providing automated trading services;
Type 8: securities margin financing;
Type 9: asset management;
Type 10: providing credit rating services;
Type 11: dealing in over-the-counter (OTC) derivative products or advising on OTC derivative products; and
Type 12: providing client clearing services for OTC derivative transactions.

The general position under Hong Kong law is that if the fund manager is not performing any activities in Hong Kong it will not need to be licensed. However, the licensing provisions of the SFO can have extraterritorial effect where a person actively markets, to the public of Hong Kong, services falling within one of the regulated activities listed above. Again, following previous market practice, the general consensus is that 50 persons (or fewer) in Hong Kong would not constitute the public for these purposes.

Given the diversity of activities that fund managers conduct, the type of licence required will vary from case to case and, for each regulated activity, there are exemptions from licensing that need to be looked at on a case-by-case basis. For example, a typical hedge fund manager will hold a licence only in respect of Type 9 (asset management) regulated activity.

In considering a licensing application, the SFC seeks, among other criteria, to ensure that managers are fit and proper and have adequate resources. Licensed persons are subject to, inter alia, continuing reporting obligations, restrictions on unsolicited calls, and obligations to pay annual fees, to submit annual returns and to manage risks prudently. Substantial shareholders, officers and any other person who is or is to be employed by, or associated with, a licensed corporation for the purposes of the regulated activity for which the application is made must also satisfy the fit and proper test.

iii Other regimes

In addition to the SFO regime, other statutes, subsidiary codes, guidelines and circulars apply to specific sectors of asset management. For example, investment-linked assurance schemes (ILAS), which are discussed below, are life insurance policies issued by an insurance company, and are subject to both the SFO and the Insurance Ordinance.

A fund established in Hong Kong will also be subject to the rules and regulations applicable to its structure; for example, the Companies Ordinance, the Partnership Ordinance, the Limited Partnership Ordinance or the Trustee Ordinance.

---

12 Type 11 was added by the Securities and Futures (Amendment Ordinance) 2014. Type 11 has not yet come into operation. The SFC has recently issued a consultation to refine the scope of the regulated activity (see Section VIII.ii).
13 Type 12 was added by the Securities and Futures (Amendment) Ordinance 2014. It came into partial operation on 1 September 2016. As with Type 11, the SFC has recently issued a consultation to refine the scope of the regulated activity.
14 Section 115(1) of the SFO.
15 Section 129 of the SFO.
Specific sectors of asset management also fall under the ambit of other regulators, in addition to being under the regulation of the SFC. For example, mandatory provident fund schemes (MPF schemes), which are discussed below, are regulated by both the Mandatory Provident Fund Schemes Authority (MPFA) and the SFC. Both regulators issue their own codes, and MPF schemes are expected to comply with both codes.

Funds listed on the Stock Exchange of Hong Kong Limited (SEHK) are also subject to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (Hong Kong Listing Rules).

III COMMON ASSET MANAGEMENT STRUCTURES

Various legal structures are used for the different sectors of asset management in Hong Kong.

Hedge funds managed from Hong Kong are commonly structured as companies or limited partnerships domiciled offshore in a tax-neutral jurisdiction such as the Cayman Islands. Far less often, they are structured as unit trusts constituted under trust deeds governed by Hong Kong law.

Most private equity funds managed from Hong Kong are also established in offshore tax-neutral jurisdictions such as the Cayman Islands, commonly as limited partnerships.

The majority of pension funds available to Hong Kong residents are in the form of MPF schemes (which are generally master trust schemes consisting of multiple constituent funds that are themselves invested in either feeder funds or portfolio managed funds) or Occupational Retirement Schemes Ordinance (ORSO) schemes, each of which is discussed below.

ILAS, which are utilised in insurance fund management in Hong Kong, are life insurance policies whose premiums are invested in underlying funds that can be offshore or onshore and of varying legal structure.

Real estate investment trusts (REITs) managed from Hong Kong are required to be structured in the form of a trust.

The SFC has developed a new framework for open-ended fund companies that offers the industry an additional choice of investment fund vehicle. This framework came into operation on 30 July 2018. Further information can be found in Section VII.iii.

IV MAIN SOURCES OF INVESTMENT

Hong Kong continues to be a preferred location for international investors. Contributions from non-Hong Kong investors accounted for 62 per cent of the non-REIT asset and wealth management business in 2018.

Despite a significant fall from 2015 levels, the yuan currency remains a major source of investment in Hong Kong’s asset management industry, with total outstanding yuan customer deposits and certificates of deposit of 658 billion yuan as at the end of 2018.

---

16 Asset and Wealth Management Survey.
17 ibid.
V  KEY TRENDS

The global financial crisis and subsequent market events have led to significant regulatory reform, with profound implications for the asset management industry in relation to issues such as:

1. systemic risks;
2. liquidity and risk management;
3. enhanced custody requirements;
4. securities lending and repos;
5. conflicts of interest; and
6. product design.

The SFC is looking at some of these issues closely with a view to further enhancing the regulation of the Hong Kong asset management industry and, in particular, is now focusing on the conduct of asset managers and intermediaries in relation to:

1. commissions and independent advice;
2. securities lending and repurchase agreements;
3. safe custody of fund assets;
4. liquidity management;
5. disclosure of leverage by fund managers; and
6. conflicts of interest in the selling of investment products.

The SFC is also focused on ensuring that the regulations governing public funds in Hong Kong align with international standards and market developments. For example, amendments to the Hong Kong Code on Unit Trusts and Mutual Funds (UT Code) took effect on 1 January 2019. The revised UT Code strengthens the requirements for key operators, providing greater flexibility and enhanced safeguards for funds’ investment activities. These include enhanced risk management and collateral requirements as well as a 50 per cent limit for the net derivative exposure of ‘plain vanilla’ funds. Furthermore, the updates allow additional types of funds, including active ETFs, which is expected to significantly increase the number of ETFs registered in Hong Kong.

The market has seen the SFC taking a more robust approach in its inspection and enforcement actions. The SFC’s regulatory reach has been extended by the *Tiger Asia* case, which established that Hong Kong’s High Court may (for remedial or protective purposes) determine market misconduct and make orders against persons located outside Hong Kong, allowing for the swift sanction of asset managers engaged in market misconduct. This enforcement avenue is in addition to the other enforcement mechanics set out in Parts XIII and XIV of the SFO.

VI  SECTORAL REGULATION

i  Insurance

Formerly, any company wishing to carry on insurance business in or from Hong Kong had to apply to the Office of the Commissioner of Insurance (OCI) for authorisation to do so under

---

the Insurance Companies Ordinance. With the coming into effect of parts of the Insurance Companies (Amendment) Ordinance 2015 on 26 June 2017 the Insurance Authority (IA) took over the statutory functions of the OCI. The policy objectives of the establishment of the IA were to modernise the insurance industry’s regulatory infrastructure to facilitate stable development of the industry, provide better protection for policyholders, and comply with the requirement of the International Association of Insurance Supervisors that insurance regulators should be financially and operationally independent of government and industry. Under the new regime, the requirements for authorisation include capital and solvency requirements, adequacy of reinsurance arrangements, as well as fit and proper requirements in relation to the directors and key persons (such as officers responsible for risk management, compliance, financial control, audit and actuarial functions) of the insurer. Once authorised, insurers remain subject to various requirements, including in relation to their investment in and the holding of assets.

The IA plans to take over the regulation of insurance intermediaries from the three self-regulatory organisations that currently exist in Hong Kong and administer a statutory licensing regime by mid-2019.

**ILAS**

One of the key products used by insurance companies in Hong Kong are ILAS, which fall within the definition of Class C of Long-Term Business under the Insurance Ordinance and are also classified as collective investment schemes under the SFO.

ILAS are life insurance policies whose premiums are invested in funds chosen by the policyholder, the benefits of the ILAS policy then being linked to the performance of those investment options. As of March 2019, there were 300 SFC-authorised ILAS.

As noted in Section II, collective investment schemes, including ILAS, must fall within a relevant exemption under Section 103 of the SFO if it is to avoid the requirement to be authorised by the SFC. As ILAS will generally be marketed to the public in Hong Kong, it is unlikely that any of the exemptions will apply, and accordingly, insurers are generally required to seek authorisation for the marketing of ILAS.

The requirements for SFC authorisation of ILAS include the requirement that the insurer has obtained authorisation to carry on Class C of Long-Term Business; detailed disclosure requirements for scheme documentation; and requirements in relation to fees and charges.

Ongoing requirements for authorised ILAS include reporting obligations and the requirement to seek prior authorisation from the SFC for any changes to the scheme materials, unless an exemption applies.

---

19 The three existing self-regulatory organisations are the Hong Kong Confederation of Insurance Brokers, the Professional Insurance Brokers Association and the Insurance Agents Registration Board established by the Hong Kong Federation of Insurers.
20 See Part 2 of the First Schedule of the Insurance Ordinance.
21 These figures are taken from Table D1, SFC Market and Industry statistics.
22 Paragraph 1.8 of the Code on ILAS.
23 Paragraphs 5.1 to 5.11 and Appendix A of the Code on ILAS.
24 Paragraphs 5.14 to 5.17 of the Code on ILAS.
25 Chapter 7 of the Code on ILAS.
The SFC has published guidance stating that insurers, corporate insurance brokers and insurance intermediaries engaging in promoting, offering or selling ILAS to the public, or who advise members of the public concerning ILAS, are not, by virtue of those particular activities, required to be licensed under the SFO for the purpose of advising on securities (i.e., Type 4 regulated activity) or dealing in securities (i.e., Type 1 regulated activity).26

ii  Pensions

Retirement schemes in Hong Kong are governed primarily by ORSO and the Mandatory Provident Fund Schemes Ordinance (MPFSO). The MPFA is the primary regulator.

ORSO

ORSO, which became effective in 1993, does not impose a requirement on employers to provide a retirement scheme, but rather aims to ensure that occupational retirement schemes established voluntarily are properly regulated.

Schemes that are covered by ORSO are required to apply for either registration or exemption under ORSO. ORSO exemptions may be allowed for offshore schemes that are registered or approved by a recognised overseas authority, or for schemes with not more than either 10 per cent or 50 of their members, whichever is less, who are holders of a Hong Kong permanent identity card.

Whether registered or exempted under ORSO, such schemes are subject to certain ongoing requirements.

MPFSO

MPFSO, which became effective in 2000, imposes a requirement on employers to ensure that all relevant employees are members of a registered provident fund scheme, as well as ongoing requirements for such schemes.

When MPFSO was introduced, pre-existing ORSO schemes (whether registered or exempted under ORSO) were permitted to apply for an exemption from certain provisions of MPFSO.

Owing to the interaction of the ORSO and MPFSO regimes, retirement schemes in Hong Kong are usually ORSO schemes that are neither MPF-exempted nor MPF-registered (acting as a top-up or supplement to MPF); ORSO schemes that are MPF-exempted; or MPF-registered schemes.

iii  Real property

Real property funds in Hong Kong are commonly in the form of REITs, which are considered collective investment schemes for the purposes of the SFO. As noted in Section II, a collective investment scheme, including a REIT, must fall within a relevant exemption under Section 103 of the SFO if it is to avoid the requirement to be authorised by the SFC. As REITs will generally be marketed to the public in Hong Kong, it is unlikely that any of the exemptions will apply.

26 SFC Circular Clarifying the Licensing Requirements arising out of the Promotion, Offering or Sale of Investment-Linked Assurance Schemes to the Public, 13 August 2009.
The SFC has issued a Code on Real Estate Investment Trusts (REIT Code) establishing authorisation and ongoing requirements for REITs. The REIT Code provides that an authorised REIT must have a trustee, a management company and a principal valuer to value the real estate held under the scheme, which are, in each case, acceptable to the SFC. It is also a condition for a REIT to be authorised that it will be listed on the SEHK within a period acceptable to the SFC. Once listed, a REIT is subject to the Hong Kong Listing Rules. An SFC-authorised REIT may hold real estate located in Hong Kong or overseas, directly or indirectly, through special purpose vehicles that are legally and beneficially owned by the REIT.

The REIT Code imposes various ongoing requirements, including that at least 75 per cent of the gross asset value of the scheme must be invested in real estate generating recurrent rental income; and the REIT is obliged to distribute to unitholders as dividends each year an amount not less than 90 per cent of its audited annual net income after tax. As of March 2019, there were 11 authorised REITs.

Hedge funds
Hong Kong’s regulatory regime does not provide a clear definition of a hedge fund, but the SFC takes the view that non-traditional funds that possess characteristics and utilise investment strategies that are different from traditional funds will generally be regarded as hedge funds. As noted in Section II, a collective investment scheme, including a hedge fund, must fall within a relevant exemption under Section 103 of the SFO if it is to avoid the requirement to be authorised by the SFC. Most non-retail hedge funds structure and conduct themselves in such a manner as to avoid the need to be authorised by relying on these exemptions.

Authorisation of hedge funds
The UT Code is the applicable SFC code for authorised hedge funds, and contains a special section that deals with collective investment schemes that are hedge funds. As well as ongoing requirements, the UT Code sets out the factors the SFC will consider in determining whether to authorise a hedge fund.

SFC-authorised hedge funds (whether local or foreign) can be marketed to the public in Hong Kong subject to a minimum subscription of US$50,000, or for funds of hedge funds, US$10,000.

---

27 Paragraph 7.1 of the REIT Code.
28 Paragraph 7.12 of the REIT Code.
29 These figures are taken from Table D1, SFC Market & industry statistics.
30 Section 8.7 of the UT Code.
31 ibid.
**Regulation of typical hedge fund activities**

Certain activities typically carried out by hedge funds, whether authorised or not, are regulated, as follows:

a) there is a prohibition on on-exchange naked short selling, unless exempted;\(^{32}\)

b) subject to certain limited exemptions contained in the Hong Kong Listing Rules, on-exchange covered short sales may only be effected in certain securities designated by the SEHK, and all such short-selling activities must be executed at or through the SEHK;

c) the Securities and Futures (Contracts Limits and Reportable Positions) Rules prescribe limits and reporting positions applicable to futures contracts and stock options contracts traded on the SEHK or the Hong Kong Futures Exchange Limited;

d) if a hedge fund is interested in more than 5 per cent of voting shares in a corporation listed on the SEHK, it has an obligation to make a disclosure that arises upon the occurrence of certain relevant events, including the crossing of certain percentage threshold positions and a change in the nature of their interest in the shares. Short positions also need to be disclosed; and

e) the Securities and Futures (Short-Position Reporting) Rules set out additional short-position disclosure requirements. A short seller will need to compute his or her short position in certain listed shares on the SEHK at the end of the last trading day of each week to determine whether it amounts to, or exceeds, 0.02 per cent of the issued share capital of that particular listed company, or the value of the short position amounts to or exceeds HK$30 million, whichever is lower. If the short position amounts to or exceeds such threshold, then the gross short position must be reported to the SFC.

Following a consultation on the scope of the short-position disclosure regime, the SFC extended disclosure requirements to all securities that can be short sold under the rules of the SEHK in March 2017.

**Listing**

It is possible for a hedge fund to be listed on the SEHK. An authorised hedge fund’s listing on the SEHK would follow Chapter 20 of the Hong Kong Listing Rules. An unauthorised hedge fund’s listing on the SEHK would follow Chapter 21 of the Hong Kong Listing Rules.

v) **Private equity**

Private equity funds are generally not regulated as a specific class of investment. However, as noted in Section II, the SFO regulates the authorisation and operation of collective investment schemes, which are broadly defined and can include private equity funds. However, private equity funds will generally structure and conduct themselves so as to avoid the need to be authorised, and so regulated, by the SFC, by relying on the exemption for offers made only to professional investors.

Under the SFO, a private equity fund’s promoter, principals and manager need to be licensed if they carry out a regulated activity in Hong Kong. The most relevant regulated activity for private equity fund managers is dealing in securities (Type 1), advising on

---

\(^{32}\) Unless exempted under Section 170(3) of the SFO, naked short selling is prohibited under Section 170(1) of the SFO.
securities (Type 4) and asset management (Type 9). In practice, the licensing requirements mainly concern the fund manager who manages and carries out investment activities for the fund.

Acquisitions by private equity funds of companies listed on the SEHK or stakes in such companies are fairly common, and are governed by various laws, regulations, or both, including the Companies Ordinance, the Hong Kong Codes on Takeovers and Mergers and Share Buy-backs and the Hong Kong Listing Rules.

As described in Section VII.i, the government has introduced extensions to the profits tax exemptions that are expected to attract more private equity funds to Hong Kong.

vi Other sectors

Retail unit trusts and mutual funds

A large part of the retail asset management market in Hong Kong is in the form of non-specialised unit trusts and mutual funds (both of which fall within the meaning of collective investment scheme under the SFO) authorised by the SFC. The majority of such retail funds (by both number and net asset value) are equity funds and bond funds (there being 1,005 and 474 respectively as at 31 March 2019).33

Retail funds that are mutual funds or unit trusts are subject to the general regulatory framework noted in Section II, and to the provisions of the UT Code.

ETFs

The ETF segment is one of the fastest-growing segments in the asset management industry in Asia, and Hong Kong is at the forefront of this trend, with 115 ETFs listed on the SEHK as at 31 March 2019.34

As noted in Section II, a collective investment scheme (including index funds such as ETFs) that is offered to the Hong Kong public must be authorised by the SFC unless a relevant exemption under Section 103 of the SFO can be relied upon. To be authorised, ETFs are expected to comply with the relevant provisions of the UT Code,35 which also provides ongoing requirements for authorised schemes.

The SEHK provides a listing avenue for authorised ETFs under Chapter 20 of the Hong Kong Listing Rules, and is responsible for overseeing their compliance with the Hong Kong Listing Rules.

Streamlined process for certain ETFs listed overseas and waiver of stamp duty

Overseas ETFs that meet the core structural and operational requirements set out in the UT Code, and that are regulated in an acceptable ETF regime that has comparable or similar regulatory principles as those set out in the UT Code, may seek SFC authorisation by way of a streamlined recognition process.36

---

33 These figures are taken from Table D2, SFC Market and Industry statistics.
34 These figures are taken from the Securities and Derivatives Markets Quarterly Report (first quarter 2019), issued by Hong Kong Exchanges and Clearing Ltd.
35 Being the Guidelines for regulating index tracking exchange traded funds at Appendix I, and the requirements set out in Chapter 8.6, of the UT Code.
36 Guidelines for regulating index tracking exchange traded funds at Appendix I to the UT Code.
Since February 2015, a stamp duty waiver has been in effect for trading in ETF shares or units that are listed or traded on the SEHK, as a means to lower transaction costs and further promote the growth of the ETF market.

**Leveraged and inverse products, crude oil futures ETFs**

Adding to the diversity of the products in Hong Kong’s ETF market, in June 2016 the SFC authorised the first batch of leveraged and inverse products structured as ETFs. From 9 January 2017, the SFC accepts applications for the authorisation of leveraged and inverse products that track liquid and broadly based Hong Kong and non-mainland foreign equity indices. The SFC has also stated that it is willing to consider, on a case-by-case basis, the authorisation of funds tracking non-equity indices, provided that they meet the relevant requirements of the UT Code. As at March 2019, 22 leveraged and inverse products were listed on the SEHK.\(^3^7\) In 2016, the SFC also authorised the first crude oil futures ETF and the first ETFs with multiple trading counters. In 2019, the SFC relaxed the leverage cap for inverse products to a factor of two-times negative.

**VII TAX LAW**

Hong Kong has three separate types of income tax: property tax, salaries tax and profits tax. Of the three income taxes, profits tax is the most relevant to asset management funds, their investment managers and their investors. Unlike many other jurisdictions, Hong Kong does not have a separate capital gains tax regime.

**Hong Kong stamp duty is chargeable on certain transactions.**

**i Profits tax – funds**

Hong Kong adopts a territorial source principle of taxation.

Under the Inland Revenue Ordinance, profits tax is charged on people carrying on a trade, profession or business in Hong Kong; and in respect of income profits (and excluding capital gains profits) arising in or derived from Hong Kong from that trade, profession or business.

On 29 March 2018, the Inland Revenue (Amendment) (No. 3) Ordinance was gazetted, introducing a two-tier tax regime. For the years of assessment from 2018–2019 onwards, the applicable rate of profit tax for corporations is 8.25 per cent for the first HK$2 million of profits and 16.5 per cent for profits over HK$2 million. The application of the two-tiered rates is restricted to only one enterprise nominated among connected entities.

**Carrying on a trade, profession or business in Hong Kong**

A low threshold is required to fall within the scope of carrying on a trade, profession or business in Hong Kong.

In some cases, a non-Hong Kong resident fund, by using a Hong Kong investment manager, may be regarded as falling within that scope. The non-Hong Kong resident funds exemption referred to below was introduced to alleviate this concern.

---

\(^3^7\) These figures are taken from the Securities and Derivatives Markets Quarterly Report (first quarter 2019), issued by Hong Kong Exchanges and Clearing Ltd.
Note that the locality of a fund’s central management and control is not a determinative factor when considering whether it carries on a trade, profession or business in Hong Kong.

**Income arising in or derived from Hong Kong**

If the above test of carrying on a trade, profession or business in Hong Kong is satisfied, profits tax will (subject to exemptions) be chargeable if the income arises in or is derived from Hong Kong. This is a factual question that is determined by looking to see what the taxpayer has done to earn the relevant profit. A test often applied in difficult cases is where the operations take place from which the profits in substance arise. Note that the place where a taxpayer’s profits arise is not necessarily the place where he or she carries on business.

Inland Revenue Department guidelines and case law assist in determining the locality where income arises or is derived from. Two principles relevant to funds are as follows:

a. listed shares and other securities: profits from the sale of listed shares and other securities arise at the location of the stock exchange where those shares and other securities in question are traded; and

b. unlisted shares and other securities: profits from the sale of unlisted shares and securities arise at the place where the contracts of sale and purchase are effected (regardless of where the relevant issuer is incorporated or carries on business).

**Exemptions to profits tax**

**Publicly offered or authorised and regulated funds**

The following types of fund are exempt from profits tax:

a. mutual funds, unit trusts and similar investment schemes that are SFC-authorised (and thus available for general distribution to the Hong Kong public); and

b. other mutual funds, unit trusts and similar investment schemes where the Commissioner of Inland Revenue is satisfied that the relevant fund is (1) bona fide widely held and (2) complies with the requirements of an acceptable non-Hong Kong supervisory authority. Further details on how the Commissioner of Inland Revenue applies (1) and (2) are set out in the Inland Revenue Departmental Interpretation and Practice Notes.38

**Privately offered funds**

The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 came into effect on 1 April 2019, unifying the profits tax exemptions for privately offered funds so that they apply (for transactions in specified assets and subject to meeting certain conditions) equally to onshore and offshore funds, irrespective of their structure, location of central management and control, size or the purpose they serve, and to investments in both local and overseas private companies.39

---

38 Practice Note No. 20 (Revised) – Mutual Funds, Unit Trusts and Similar Investment Schemes.
39 The unifying changes therefore include the repeal of the recently introduced profits tax exemption for Hong Kong incorporated open-ended fund companies (OFCs), as well as amending the existing profits tax exemption for non-residents to carve out entities falling within the new definition of ‘fund’ in the Inland Revenue Ordinance (which is largely similar to the definition of ‘collective investment scheme’ in the SFO).
If an entity falls within the new definition of ‘fund’ in the Inland Revenue Ordinance, then its ‘qualifying transactions’ and transactions incidental thereto (‘incidental transactions’), or in the case of Hong Kong incorporated open-ended fund companies (OFCs) all of its transactions, will be exempt from profits tax, provided:

a the fund is a ‘qualified investment fund’; or

b the qualifying transactions are carried out in Hong Kong by a ‘specified person’ (being a corporation licensed by or a financial institution registered with the SFC), or arranged in Hong Kong by a specified person.

The above exemption does not apply to assessable profits earned from incidental transactions if the fund’s trading receipts from incidental transactions in a given tax year exceed 5 per cent of the total of the fund’s trading receipts from qualifying transactions and incidental transactions in such tax year.

‘Qualifying transactions’ include:

a shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a company (whether public or private);

b futures contracts;

c foreign exchange contracts under which the parties to the contracts agree to exchange different currencies on a particular date;

d deposits other than those made by way of a money-lending business, deposits made with a bank and certificates of deposit;

e exchange-traded commodities;

f foreign currencies;

g OTC derivative products; and

h an investee company’s shares co-invested by a partner fund and the Innovation and Technology Venture Fund Corporation (ITVFC) under the Innovation and Technology Venture Fund (ITVF) Scheme.

A key feature of the new profits tax exemption is the removal of the tainting features of the previous regime, such that the tax-exempt profits of a fund are not tainted even if such fund is taxed on its non-qualifying transactions.

40 A ‘qualified investment fund’ means a fund that falls within the following descriptions:

(a) at all times after the final closing of sale of interests:

(i) the number of investors exceeds four; and

(ii) the capital commitments made by investors exceed 90 per cent of the aggregate capital commitments; and

(b) the portion of the net proceeds arising out of the transactions of the fund to be received by the originator and the originator’s associates, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors’ capital contributions), is agreed under an agreement governing the operation of the fund to be an amount not exceeding 30 per cent of the net proceeds.

41 The ITVF aims to stimulate private investment in local innovation and technology (I&T) start-ups in Hong Kong. The ITVFC has been set up to serve as a special-purpose vehicle for co-investing with venture capital funds selected as co-investment partners (CP) in local I&T start-ups at a matching investment ratio of approximately 1:2. ITVFC acts as a passive investor, making direct investment in the start-ups concurrently with the CPs’ upon invitation of the CP.
The new exemption is available not only at the fund level, but also to special purpose entities (SPEs) set up by the fund for the sole purpose of holding and administering investments in private investee companies, to such extent as corresponds to the percentage of shares or interests that the fund holds in the SPE.

Certain measures have also been introduced to minimise the risk of tax evasion, including:

\( a \) in respect of any private company in which a fund invests (other than a private company which directly or indirectly holds immovable property in Hong Kong, or share capital in another private company that directly or indirectly holds immovable property in Hong Kong), the profits tax exemption will not be available to the fund in respect of its investment in the company unless one of the tests below is satisfied:

- the fund holds its investment in the company for at least two years (the holding period test);
- the fund does not have control over the company (the control test); or
- the company holds (directly or indirectly) short-term assets the aggregate value of which does not exceed 50 per cent of the value of the company's assets (the short-term assets test); and

\( b \) in respect of any private company in which a fund invests which directly or indirectly holds immovable property in Hong Kong, or share capital in another private company that directly or indirectly holds immovable property in Hong Kong:

- if the aggregate value of such immovable property and share capital held by the private company exceeds 10 per cent of the value of its assets, then the profits tax exemption is not available to the fund in respect of its investment in the company; and
- if the aggregate value of such immovable property and share capital held by the private company is equal to or less than 10 per cent of the value of its assets, then the profits tax exemption will not be available to the fund in respect of its investment in the company unless the holding period test, the control test or the short-term assets test is met.

**ii Profits tax – investors**

The same general principles of profits tax discussed above in respect of funds also apply to the taxation of investors.

An investor, however, typically holds investments for investment purposes (rather than as part of a trade, profession or business). In such a case, profits or income derived from his or her investments fall outside the charge to profits tax. In addition to the above, specific exclusions may also apply, in particular, an investor’s gain from disposing of shares or units in a fund will usually be a capital gain (and therefore fall outside the charge to profits tax); and dividends received by an investor are not chargeable to profits tax.\(^{43}\)

\(^{42}\) The anti-round tripping provisions relating to the existing profits tax exemption for non-residents (which continues to apply to entities that do not fall within the new definition of ‘fund’ in the Inland Revenue Ordinance, as described in footnote 39) have also been retained to prevent a person resident in Hong Kong from using the exemption to shelter otherwise taxable profits through such a non-resident entity that is not bona fide widely held.

\(^{43}\) Encyclopedia of Hong Kong Taxation, Volume 3, II 5811–5850.
iii Profits tax – fund managers
The same general principles of profits tax discussed above in respect of funds and investors also apply to the taxation of fund managers.

iv Double taxation agreements
As of 12 July 2019, Hong Kong had comprehensive double taxation agreements with Austria, Belarus, Belgium, Brunei, Canada, China, the Czech Republic, Finland, France, Guernsey, Hungary, India, Indonesia, Ireland, Italy, Japan, Jersey, Kuwait, Latvia, Liechtenstein, Luxembourg, Malaysia, Malta, Mexico, the Netherlands, New Zealand, Pakistan, Portugal, Qatar, Romania, Russia, Saudi Arabia, South Africa, South Korea, Spain, Switzerland, Thailand, the United Arab Emirates, the United Kingdom and Vietnam. Hong Kong had also signed such an agreement with Cambodia, but it had not entered into force. The terms set out in double taxation agreements take precedence over the other provisions of the Inland Revenue Ordinance.44

v Stamp duty
Stamp duty is chargeable on transfers of real property, the issue of certain bearer instruments and the transfer of Hong Kong stock. In practice, stamp duty on Hong Kong stock is usually chargeable with respect to shares in Hong Kong incorporated companies or companies listed on the SEHK.

Although stamp duty may be chargeable on unit trusts, bonds and bearer instruments, these are often structured so as to fall outside the charge of stamp duty. Stamp duty is not chargeable on redemptions of shares. Stamp duty is also not chargeable on trading in ETF shares or units that are listed or traded on the SEHK.

The current rate of stamp duty chargeable on the transfer of shares in a Hong Kong incorporated or an SEHK-listed company is 0.2 per cent of the consideration for (or, in the case of gifts, the value of) the shares.

VIII OUTLOOK
i Cooperation arrangements with the mainland and other jurisdictions
Hong Kong is expected to develop further its role as an offshore yuan business centre, with the SFC continuing to promote offshore yuan-denominated investment products in Hong Kong. There is widespread mainland governmental support for using Hong Kong as a platform to further the liberalisation of the yuan, evidenced by recent policy initiatives, including the formation of a working group with the SFC to study the implementation of mutual recognition and cross-border offering of funds between Hong Kong and the mainland aiming to bring about a wider investment platform for both jurisdictions in terms of more product offerings and a bigger investor base. The Shanghai–Hong Kong Stock Connect was launched in 2014 as a two-way arrangement under which Hong Kong and international investors can directly access the mainland A-share market, and mainland investors can directly access Hong Kong’s stock market. The Shenzhen–Hong Kong Stock Connect was established in December 2016. Its structure and rules mirror that of the Shanghai–Hong Kong Stock Connect. The CSRC and SEHK announced that from May 2018 the daily quota under the Stock Connect

44 Section 49 of the Inland Revenue Ordinance.
would be quadrupled. As at 31 March 2019, Stock Connect covered 1,321 mainland stocks and 479 Hong Kong stocks. The stock exchanges have also announced that, from July 2019, dual-class shares will be included on Stock Connect.

Under the Mainland–Hong Kong MRF initiative, the CSRC and the SFC allow mainland and Hong Kong funds that meet the relevant eligibility requirements to follow streamlined procedures to obtain authorisation or approval for offering to retail investors in each other’s market. The CSRC and the SFC have respectively prepared the ‘Provisional Rules for Recognised Hong Kong Funds’ and ‘Circular on Mutual Recognition of Funds between the mainland and Hong Kong’, which set out the eligibility requirements, application procedures, operational requirements and regulatory arrangements of the MRF. It is envisaged that this initiative will further promote Hong Kong’s development as a fund management hub and fund domicile. As of 31 March 2019, the SFC has authorised 50 mainland funds and the CRSC has approved 19 Hong Kong funds under the MRF scheme.45

Mainland-related licensed firms are expected to play an even more significant role in Hong Kong, and it is predicted that the range of yuan-denominated retail investment products managed by mainland-related licensed firms will grow significantly in future years.

Following the successful implementation of the MRF, the SFC announced it would further explore cooperation arrangements in asset management with other overseas authorities. Since October 2018, the SFC has signed memorandums of understanding with the UK Financial Conduct Authority, the Luxembourg Commission de Surveillance du Secteur Financier and the Netherlands Authority for the Financial Markets. The agreements allow eligible Hong Kong public funds and the respective foreign funds to be distributed in the other’s markets through a streamlined process. The SFC is continuing to explore MRF arrangements with other overseas jurisdictions.

ii Regulation of OTC derivatives

In April 2014, the Securities and Futures (Amendment) Ordinance was enacted, introducing a new regulatory regime for OTC derivatives in Hong Kong. The regime provides a framework for mandatory reporting, clearing, trading and record-keeping obligations in respect of OTC derivative transactions, and introduces the new regulated activities of dealing in and advising on OTC derivative products (Type 11 regulated activity), and providing client clearing services for OTC derivative transactions (Type 12 regulated activity), and also expands Type 9 (asset management) and Type 7 (providing automated trading services) to cover OTC derivative transactions.

The regime is being implemented in phases. In July 2015, the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (OTC Rules) brought into effect mandatory reporting and related record-keeping obligations for certain interest rate swaps and non-deliverable forwards. The first phase of mandatory clearing came into effect in September 2016. In July 2017, the second phase extended mandatory reporting obligations to all five key asset classes, namely interest rates, foreign exchange, equities, credit and commodities. It is not expected that the OTC Rules will impact on asset managers that only trade as a disclosed agent to an unaffiliated named principal (i.e., the fund that it manages).46

46 See FAQ, Q26.
The SFC has published a number of consultations and conclusions in relation to the OTC derivatives regime:

a in July 2017, it published consultation conclusions on capital and other prudential requirements for activities involving OTC derivatives engaged in by licensed corporations under the Securities and Futures (Financial Resources) Rules;

b in June 2018, it published consultation conclusions on mandating the use of Legal Entity Identifiers for the mandatory reporting obligation, expanding the clearing obligation and adopting a trading determination process, with consultation conclusions to be published later in 2019;

c in June 2018, it also launched a consultation on proposals to implement margin requirements for non-centrally cleared OTC derivatives, which are set out in the 'Margin requirements for non-centrally cleared derivatives' report published in March 2015 by the Working Group on Margining Requirements, with consultation conclusions to be published later in 2019;

d in December 2018, it published consultation conclusions on amendments to the Code of Conduct for Persons Licensed By or Registered with the SFC (Code of Conduct) to (1) introduce new requirements on OTC derivatives in relation to derivative risk mitigation and client clearing; (2) impose conduct requirements to address risks posed by group affiliates; and (3) make a consequential amendment on client agreement requirements; and

e in April 2019, it launched a consultation paper on mandating the use of unique transaction identifiers for the reporting obligation, revising the list of designated jurisdictions for the masking relief of the reporting obligation and updating the list of financial services providers under the clearing obligation.

In relation to the SFC’s proposal to enhance the investor compensation regime by increasing the compensation limit from HK$150,000 to HK$500,000 per investor per default, the SFC intends to publish consultation conclusions in the second half of 2019 and implement the proposals subject to completion of the legislative process.

iii Open-ended fund companies

On 30 July 2018, the Securities and Futures (Amendment) Ordinance 2016 came into operation, and introduced an OFC framework in Hong Kong as an additional investment fund vehicle option. Previously, an open-ended investment fund could be established in the form of a unit trust, but not in corporate form owing to various restrictions on capital reduction under Hong Kong company law. The new regime for OFCs is established under the SFO and supervised by the SFC, with detailed operation and procedural requirements contained in the Securities and Futures (Open-ended Fund Companies) Rules, Securities and Futures (Open-ended Fund Companies) (Fees) Regulation and Code on Open-ended Fund Companies.

iv Professional investor regime and client agreement requirements

On 25 March 2016, amendments to the Code of Conduct came into effect, providing that specified categories of professional investors who previously were not covered by a number of the Code of Conduct’s protections will be covered from this date. The amendments provide
that intermediaries are, among other obligations, bound by the Code of Conduct’s suitability requirement in relation to these clients, and need to enter into a written client agreement and provide relevant risk disclosure treatments.

On 13 July 2018, the SFC adopted amendments to the Securities and Futures (Professional Investor) Rules. The amendments include allowing joint accounts and investments to be counted towards meeting the monetary threshold for the purpose of determining individuals’ qualification as professional investors as well as accepting alternative forms of evidence. The amendments also expand the categories of corporations that qualify as professional investors, including certain holdings companies. See Section II.i.

Separately, as of 9 June 2017, intermediaries must comply with new Code of Conduct requirements governing the contents of all client agreements.

v Online trading and diversification of fund distribution channels

The SFC published a consultation paper in March 2018 on proposed guidelines on online distribution and advisory platforms, which considered the alignment of online and offline requirements applicable to complex products. The consultation conclusions were published in October 2018. The SFC decided to proceed with the proposed amendments to the Code of Conduct, which require intermediaries to have to ensure the suitability of complex products and provide product information and warning statements to clients when the complex products are sold on an unsolicited basis.

The SFC has also set out various core principles concerning governance and controls with which all platform operators should comply. They further aim to clarify how the suitability requirement set out in the Code of Conduct would operate in the context of online platforms. The SFC hopes that the new guidelines will facilitate the growth of online platforms to give investors greater choice and better access to investment advice.

Following a consultation, in October 2017 the SFC published guidelines aimed at mitigating hacking risks associated with internet trading. The guidelines cover preventive and detective controls for the protection of client trading accounts, infrastructure security management, and cybersecurity management and supervision. A requirement for two-factor authentication took effect on 27 April 2018.

vi Enhancement of asset management regulation and point-of-sale transparency

Following an SFC consultation and a 12-month transition period, a revised Fund Manager Code of Conduct came into force on 17 November 2018. The reach of the revised Fund Manager Code of Conduct has been extended so that it applies to businesses that involve the management of collective investment schemes, discretionary accounts, or both. The changes made to the Fund Manager Code of Conduct relate to, among other topics, securities lending and repurchase agreements, safe custody of fund assets, liquidity risk management and disclosure of leverage. There are certain provisions that only apply to a fund manager who is responsible for the overall operation of a fund.

A revised Code of Conduct came into force on 17 August 2018 to enhance point-of-sale transparency and to better address potential conflicts of interests. The Code of Conduct adopts a two-pronged approach and covers restrictions on the ability of intermediaries to represent themselves as ‘independent’ or as providing ‘independent advice’, and the disclosure of monetary benefits that are not quantifiable at the point of entering into a transaction. The revised Code of Conduct applies to all Hong Kong licensed fund managers.
The SFC launched further consultations on the disclosure requirements for point-of-sale transparency in relation to discretionary accounts, and published its conclusions in May 2018. The changes, which came into effect in December 2018, introduce specific disclosure requirements for monetary benefits under an explicit remuneration arrangement, and generic disclosures for monetary benefits under non-explicit remuneration arrangement and non-monetary benefits.

**vii  Senior management accountability**

On 17 October 2017 the manager in charge (MIC) regime was fully implemented. It aims to enhance the obligations of licensed corporations in relation to their senior management. There are eight core functions for which licensed corporations must identify an MIC. These are:

- overall management oversight;
- key business line;
- operational control and review;
- risk management;
- finance and accounting;
- information and technology;
- compliance; and
- anti-money laundering and counterterrorist financing.

Licensed corporations are required to submit up-to-date information regarding their management structure to the SFC, and to ensure that MICs are aware of their regulatory obligations. The SFC has noted that since the launch of the MIC regime, many firms have taken measures to enhance their governance structures, including strengthening the composition of their boards, clearly delineating the job responsibilities and reporting lines of individual senior managers, and better aligning senior management accountability with the responsible officer regime.47

**viii  Paperless securities market**

In January 2019, the SFC, Hong Kong Exchanges and Clearing Limited and the Federation of Share Registers Limited released a joint consultation paper on a new mechanism for implementing an uncertificated securities market regime in Hong Kong. The consultation paper proposes a framework to modernise the existing securities market regime in Hong Kong that is still reliant on the use of paper documents, such as documents to evidence or transfer legal title of securities, including shares. The current regime means that investors hold and transfer only the beneficial interest in securities, but not the legal title to the securities. The proposed revised model will give the investors the option of holding securities in their own name in electronic form.

The aim is for a conclusions paper to be issued in the second half of 2019, with implementation in early 2022.

---

Cryptocurrencies and security token offerings (STOs)
The offer of cryptocurrencies to investors in Hong Kong (typically as part of an initial coin offering) may, depending on the features of the offering, be subject to Hong Kong’s existing securities law. In addition, intermediaries providing services to Hong Kong investors in relation to investments in cryptocurrency-related investment products are likely to be regulated by the existing regulatory regime.

On 28 March 2019, the SFC issued a Statement on Security Token Offerings, reminding market participants about the regulatory requirements applicable to STOs. The SFC also reiterated its earlier warning (contained in the SFC’s Statement on Regulatory Framework for Virtual Asset Portfolios Managers, Fund Distributors and Trading Platform Operators, published in November 2018) to investors to be wary of the risks associated with virtual assets, including tokens that are the subject of STOs (security tokens). The SFC’s statement highlighted that, in Hong Kong, security tokens are likely to be ‘securities’ under the SFO and so subject to the securities laws of Hong Kong. Anyone who markets and distributes security tokens (whether in Hong Kong or targeting Hong Kong investors) must be licensed or registered for Type 1 regulated activity (dealing in securities) under the SFO. It is a criminal offence for any person to engage in regulated activities without a licence unless an exemption applies.
Chapter 9

IRELAND

Kevin Murphy, Elizabeth Bothwell, David O’Shea, David Kilty and Michael Shovlin

I OVERVIEW OF RECENT ACTIVITY

Brexit continues to be the most significant development affecting the financial services sector in Ireland and across the EU. Uncertainty around Brexit dominated the early part of 2019, with the UK due to leave the EU on 29 March 2019. Following an initial agreement to extend the Article 50 deadline, a second extension was agreed on 11 April 2019 providing an extension until 31 October 2019 at the latest. Therefore, at the time of writing, the shape Brexit ultimately will take remains to be seen. However, throughout the early part of Q1 2019 a number of legal and regulatory arrangements had been made at EU, UK and Irish level in anticipation of a potential ‘no-deal’ Brexit scenario. Some of the key developments of relevance for investment funds and managers are set out in Section VI below. These arrangements originally anticipated a 29 March 2019 Brexit date but their importance will come back into focus later this year as we move closer to 31 October 2019.

Ireland has proven to be a popular destination for UK firms looking to relocate or establish fund management companies in advance of Brexit. In addition, the Irish government has continued to commit its strategic support to the financial services sector. On 26 April 2019, the Irish government unveiled its new ‘Ireland for Finance’ strategy (IFS 2025) for the further development of the financial services sector in Ireland to 2025 (building on its previous IFS 2020 strategy). The vision of the strategy is to continue the development of Ireland as a top-tier location of choice for specialist international financial services. IFS 2025 includes objectives across four pillars in relation to (1) operational environment (ensuring that policies, culture, and legislative conditions support growth); (2) technology and innovation (providing a collaborative approach to addressing emerging challenges and opportunities); (3) talent (ensuring a continued supply of skilled individuals to meet the demands of the growing sector); and (4) communications and promotion of the jurisdiction. The employment target for IFS 2025 is to reach 50,000 people in direct employment in the sector by 2025. IFS 2025 will be implemented through a series of annual action plans that set out key priorities and actions for each year until 2025.

Therefore, while Brexit has been challenging for the financial services sector, Ireland has been and continues to be well placed to offer solutions for UK based financial services firms and, with the strategic support of the Irish government the Irish financial sector is well positioned to continue its rapid development over the coming years.

1 Kevin Murphy, Elizabeth Bothwell and David Kilty are partners, David O’Shea is of counsel and Michael Shovlin is a senior associate at Arthur Cox.
II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The Central Bank of Ireland (Central Bank) is responsible for the authorisation and supervision of regulated financial service providers in Ireland, including regulated investment funds, investment managers, and insurance and reinsurance undertakings. The powers delegated to the Central Bank are set out in the laws and regulations applicable to the relevant financial services sector. In addition, the Central Bank issues guidance in relation to various aspects of the authorisation and ongoing requirements applicable to financial service providers. In general terms, the Central Bank expects that best practice be adopted by an authorised entity, and requires that financial services providers have systems, procedures and policies in place to ensure that regulatory requirements are met and to mitigate risk.

The regulation of pension schemes is a matter for the Pensions Authority, the statutory body for the pensions industry in Ireland.2

III COMMON ASSET MANAGEMENT STRUCTURES

Ireland as a domicile provides a variety of potential asset management structures (structures), which can be broadly categorised as regulated by the Central Bank or unregulated.

i Regulated structures

There are four main types of regulated fund structure in Ireland: Irish collective asset management vehicles, variable capital investment companies, unit trusts and common contractual funds. Each of these regulated fund structures may be established as UCITS pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011, as amended (UCITS Regulations)3 or as an alternative investment fund (AIF) pursuant to the EU (Alternative Investment Fund Managers) Regulations 2013 (AIFM Regulations).4

A regulated investment limited partnership (established pursuant to the Investment Limited Partnership Act 1994) is also available as a structure for AIFs (see Section VI.iv, ‘Recent developments – alternative investment funds and private equity’).

These structures may be organised in the form of umbrella schemes with segregated liability between compartments (sub-funds).

Irish collective asset management vehicle

An Irish collective asset management vehicle (ICAV) is an Irish corporate investment fund vehicle that has been specifically tailored to the needs of the global funds industry. The Irish Collective Asset-management Vehicle (ICAV) Act 2015 came into effect in 2015, and since that date the ICAV has proven to be the most popular structure for new funds established in Ireland. One of the main reasons for the popularity of the ICAV is that, unlike investment companies established in Ireland as public limited companies, an ICAV that is structured as an umbrella fund is only required to produce financial accounts at a sub-fund level while a public limited company must produce financial accounts at the umbrella level (resulting in investors in a sub-fund receiving financial accounts for all of the sub-funds in the umbrella).

---

2 Established under the Pensions Act 1990 (as amended).
3 The UCITS Regulations implement the UCITS Directive in Ireland.
4 The AIFM Regulations implement the Alternative Investment Fund Managers Directive in Ireland.
In addition, there is no requirement for an ICAV to hold an annual general meeting of shareholders, and non-material changes can be made to the ICAV’s by-laws without shareholder approval. The ICAV may also be eligible to elect to be treated as a transparent entity for US federal income tax purposes, unlike an investment company established as a public limited company, which is not eligible to make such an election.5

**Variable capital investment companies**

A variable capital investment company must be incorporated as a public limited company pursuant to the Irish Companies Act 2014. The day-to-day management and control of the investment company are undertaken by a board of directors (although this can be delegated to a management company), with ultimate control resting with the shareholders. Provided that this day-to-day management and control of the investment company take place in Ireland, an investment company can obtain a certificate of Irish tax residency from the Irish tax authorities and is not liable for Irish tax on its income or gains.

**Unit trusts**

A unit trust is a contractual arrangement constituted by a trust deed entered into between an Irish management company and a trustee. The assets of the trust are held by the trustee, but the beneficial ownership of the assets remains with the unit trust’s unitholders. Unlike an investment company or ICAV, a unit trust does not have a separate legal personality, and contracts in relation to the trust are entered into by the management company on behalf of the trust, or a particular sub-fund of the trust, as provided for in the trust deed.

**Common contractual funds**

The common contractual fund (CCF) is a tax-transparent structure first established in Ireland in 2003. It was specifically developed to facilitate the pooling of pension fund assets in a tax-efficient manner so that the investing pension funds would be treated from a tax perspective in the same way as if they made the underlying investments directly rather than through the CCF.

The CCF is an unincorporated body established by an Irish management company pursuant to which investors participate and share in the property of the CCF as co-owners. As a co-owner, each investor in a CCF is deemed to hold an undivided co-ownership interest as a tenant in common with other investors. CCFs are constituted under contract law by the execution of a deed of constitution between a management company and a depositary. As an unincorporated body, a CCF does not have separate legal personality.

**ii Unregulated structures – limited partnerships**

The limited partnership established pursuant to the Limited Partnership Act 1907 is the most favoured structure for unregulated investment funds in Ireland.

A limited partnership is a partnership between one or more general partners and one or more limited partners, and is constituted by a partnership agreement. To have the benefit of limited liability, the limited partners are not permitted to engage in the management of the business of the partnership or to contractually bind the partnership; these functions are carried out by the general partner. There is a general limit of 20 partners in a limited

---

5 For further information on this point, see Section VII.vii.
partnership, although this limit can be raised to 50 where the limited partnership is formed ‘for the purpose of, and whose main business consists of, the provision of investment and loan finance and ancillary facilities and services to persons engaged in industrial or commercial activities’.6

iii Liquidity
Fund structures regulated by the Central Bank may be open-ended with liquidity, closed-ended with no liquidity or have limited liquidity, which means they are open to redemption at least one or more times during the life of the fund. One exception is where the regulated structure is authorised by the Central Bank pursuant to the UCITS Regulations, in which case the structure is required to be open-ended with at least two redemption dates per month.

Closed-ended schemes are generally subject to the Prospectus Directive7 unless otherwise exempted (qualifying investor AIFs are generally able to avail of an exemption). In addition, closed-ended schemes may, in certain circumstances, be subject to other European regulations (e.g., the Transparency Directive8 and Takeovers Directive9).

IV MAIN SOURCES OF INVESTMENT

i Regulated investment funds
Ireland’s success as an onshore domicile for investment funds is well known, and the development of Ireland’s funds industry continues to be an area of strategic importance for the Irish economy.

Statistics show that Irish-domiciled investment funds had over €2.64 trillion in net assets in March 2019 (up 9 per cent from €2.4 trillion at the end of 2018). This means the industry has now quadrupled in size in the last decade. While the majority of assets under management are held in UCITS funds, Irish-domiciled AIFs had in excess of €671 billion in net assets in March 2019.10 The majority of the investment in these regulated investment funds comes from non-Irish institutional investors.

ii Insurance and reinsurance
As of 11 June 2019, there were 43 life insurers, 97 non-life insurers (including captives) and 61 reinsurers (including captives and special purpose reinsurance vehicles) with head offices in Ireland. There were a further 14 life insurers and 35 non-life insurers with branches in Ireland. In addition, 167 life insurers and 874 non-life insurers operate in Ireland on a freedom-of-services basis pursuant to the relevant EU directives.11 In its Fact File 2017

6 Companies (Amendment) Act 1982 (Section 13(2)) Order 2004.
11 Central Bank of Ireland industry Registers.
publication, Insurance Ireland indicated that life insurance policyholder funds managed by its members amounted to €114.811 billion in 2017. Of this, 58.1 per cent was invested in equities, 23.5 per cent in gilts, 4.3 per cent in property, 9.8 per cent in cash and 4.3 per cent in other asset classes.12

iii Pension schemes

The Irish Association of Pension Funds estimates the total assets of Irish pension funds exceeds €147.6 billion (figure at the end of 2017), but no precise details are available on how these assets are invested or what proportion of assets are under the management of Irish authorised investment managers. The Pensions Authority has, however, published the results of its defined benefit scheme review of 2018 statistics (based on the annual actuarial data returns submitted to it by 31 March 2019). The asset allocation of the 582 active and frozen defined benefit schemes in Ireland (with assets of €65.6 billion) is as follows:

- 28.4 per cent in equities;
- 33.0 per cent in EU sovereign bonds;
- 9.0 per cent in other bonds;
- 4.8 per cent in property;
- 3.0 per cent in cash;
- 0.1 per cent in net current assets;
- 0.0 per cent in with profit insurance policies; and
- 21.7 per cent in ‘other’ (which includes absolute return funds, alternative assets, hedge funds, commodities, derivatives, global absolute return strategies and annuities).

V KEY TRENDS

In terms of insurance and reinsurance, there are significant international and domestic insurance and reinsurance undertakings headquartered in Ireland. The Solvency II Directive has forced insurers and reinsurers established outside the EU to assess whether to redomicile their global operations in a European centre such as Ireland, which continues to be one of the most sought-after European countries for insurers and reinsurers looking to redomicile.

With regard to asset management and investment funds, as Brexit plans matured into implemented in late 2018 and early 2019, for many investment firms in the UK and some global investment firms, Ireland emerging as a favoured EU hub because of the relative advantages it has over a number of other EU countries across a number of metrics including tax, legal system, labour laws and regulation.

VI SECTORAL REGULATION

i Insurance

Ireland has a long-established legal framework for insurance and reinsurance business, primarily composed of the Insurance Acts 1909 to 2015, various European directives and the Solvency II Directive.13

---

12 Insurance Ireland Fact File 2018.

© 2019 Law Business Research Ltd
Insurers and reinsurers must limit their activities to those for which they are specifically authorised, to the exclusion of all other business activity. The Central Bank imposes strict rules on insurers and reinsurers to formalise appropriate internal policies and procedures to ensure that investment risks relating to assets used for regulated capital purposes are adequately managed. The rules in relation to asset management activity by insurance undertakings are governed by the rules set out in the Solvency II Directive, which was implemented in Ireland by the Irish Implementing Regulations\(^\text{14}\) and came into force on 1 January 2016.

Solvency II has codified and harmonised EU insurance regulation, and sets new standards for the amount of capital that insurance and reinsurance firms must hold based on their risk profile, as well as new standards for governance, risk management and supervision, and reporting and transparency. Under Solvency II, asset managers need to provide insurance clients with greater levels of detail in relation to the assets underlying their investments than previously required. The implementation of Solvency II has been the most substantial regulatory change affecting Irish and European insurers and reinsurers in many years, as it provided for a new risk-based capital adequacy regime.

The introduction of Solvency II has involved significant changes for asset management by insurers and reinsurers. Solvency II has introduced across European Economic Area (EEA) Member States, for the first time, a solvency calculation based on an economic and prospective approach to the risks inherent to the business conducted by insurers and reinsurers. As a result, one of the key factors in the calculation of an insurer’s regulatory capital requirements is market risk. Under Solvency II, insurers and reinsurers are able to invest in any asset (in the interests of policyholders and beneficiaries), including high-risk and volatile assets, provided they are willing to hold the necessary extra capital for such risk.

Provisions in relation to asset allocation affect which funds insurers can choose to invest in because of the prescribed methods for the valuation of assets and liabilities. Solvency II requires that insurers diversify their asset portfolios, which will affect an insurer’s choices in investment funds. Asset managers should be aware of the different capital charges that are applied to assets and liabilities. Of particular interest is the market risk module, which is split into the following sub-modules: interest rate risk, equity risk, property risk, spread risk, market risk concentrations and currency risk. Different categories of assets and liabilities will be subject to different rules depending on how they are classified. For example, structure debt and equity investments are subject to favourable capital charges.

Insurers must have processes in place to ensure the appropriateness, accuracy and completeness of the data that they use to calculate their capital requirements. To comply with this requirement, insurers are likely to demand assurances from asset managers that the data they have received meets these standards, and that there are appropriate governance and control procedures in place to ensure these standards are met. Under Solvency II, there must be a higher level of transparency in the funds in which insurers invest. This includes complying with the ‘look-through’ approach, which states that insurers must base their risk assessment of a fund on the assets that underlie the fund. Asset managers of funds will be obliged to provide details of these underlying assets to insurers or risk losing insurers’ business.

Under Solvency II, insurers must have close relationships with their asset managers owing to the increased pressure to provide detailed data within tight time frames. Asset managers must ensure they have product strategies that reflect the requirements of Solvency II in relation to asset allocation to ensure that their portfolios remain attractive to insurers.

\(^{14}\) European Union (Insurance and Reinsurance) Regulations 2015.
Recent developments in the insurance sector

Regulation (EU) No. 1286/2014 on key information documents for packaged retail investment and insurance-based investment products (PRIIPs Regulation) introduced, on a pan-European level, a standardised pre-contractual disclosure document (key information document (KID)) for the benefit of retail investors purchasing certain packaged retail investment products or insurance-based products that, following the postponement of the initial application date, came into effect from 1 January 2018. Products within the scope of the PRIIPs Regulation, include:

a) life assurance-based investment products;
b) investment funds;
c) structured term deposits; and
d) derivatives.

There are a number of products explicitly excluded from the PRIIPs Regulation, including notably non-life insurance products, pension products and annuities not recognised in national law. However, any product that falls under the definition of PRIIPs must also be sold to retail investors to fall within the scope of the PRIIPs Regulation.

The KID is required to include information under certain prescribed headings, including:

a) information on the product manufacturer;
b) a description of the main features of the product as well as costs borne by the investor;
c) the risk–reward profile of the product;
d) performance information, including future performance scenarios and expected returns;
e) a comprehension alert highlighting that the product may be difficult to understand;
f) how complaints can be made; and
g) certain other relevant information that may be necessary for understanding the features of the product.

The Irish Implementing Regulations, which transpose Directive (EU) 2016/97 on insurance distribution (Insurance Distribution Directive) (IDD) in Ireland came into effect on 1 October 2018. The IDD represents a noteworthy departure from the manner in which insurance and reinsurance distribution is regulated. In particular, the IDD aims to enhance EU regulation of the insurance market by ensuring a level playing field for all participants involved in the sale of insurance products to strengthen policyholder protection, promote cross-sectoral consistency and make it easier for firms to trade on a cross-border basis. One of the most significant changes introduced by the IDD involves additional requirements that apply to insurers and insurance intermediaries when they carry on insurance distribution relating to the sale of investment-based insurance products.

ii Pensions

The trustees of a pension scheme are constrained in the investment choices they may make by the governing documents of the scheme (or, if no investment powers are contained in the

pensions scheme, by the Trustee Act, 1893 and the associated Trustee (Authorised Investment) Orders, and by statute). The Pensions Acts 1990 to 2018 impose a duty on the trustees of pension schemes to provide for the proper investment of the resources of the scheme.

In general, the trustees of a pension scheme will be given the power to appoint one or more investment managers under the scheme’s governing documents. An investment manager appointed to pension scheme assets will be bound by any restrictions on investment in the scheme’s governing documents and by the relevant statutory restrictions. These restrictions will generally be referred to in the investment management agreement. Ultimately, trustees cannot delegate their primary responsibility to invest, and trustees remain under a continuing obligation to supervise the investment manager.

Irish pension schemes must comply with domestic legislation transposing Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (IORP), which established a common basis for the operation and supervision of pension funds in EU Member States. The IORP standard will continue in force in Ireland until the introduction of domestic legislation to transpose the IORP II Directive, which is now overdue (transposition of the directive was required before 14 January 2019). Transposition has been delayed not least by judicial review proceedings relating to single member pension schemes. While the Irish government has indicated that it is working towards transposition as soon as possible, at the time of writing no definitive timeline has been confirmed. The main requirements of IORP were transposed in Ireland through the Investment Regulations, which also required trustees to invest in accordance with the prudent person rule in addition to their obligation to invest assets in the interests of beneficiaries.

The Investment Regulations require that the assets of the scheme must:

a. be invested in a manner designed to ensure ‘the security, quality, liquidity and profitability of the portfolio as a whole so far as is appropriate having regard to the nature and duration of the expected liabilities of the scheme’;

b. be invested predominantly on regulated markets as defined in the Investment Regulations;

c. be properly diversified to avoid excessive reliance on any particular asset, issuer or group of undertakings, and as to avoid accumulations of risk in the portfolio as a whole; and

d. not be invested in derivative instruments except insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management.

The Investment Regulations also state that:

a. the trustees of a scheme (other than a one-person scheme) may not borrow money except for liquidity purposes and on a temporary basis; and

b. investment in the sponsoring employer of the pension scheme (which is viewed as self-investment) shall not exceed 5 per cent, while total self-investment in the sponsoring employer group shall not exceed 10 per cent of the resources of the scheme. An exception is provided in respect of small member-controlled schemes where the investment restriction is raised to 20 per cent.

16 Directive 2016/2341/EU.
IORP II requires that trustees take account of environmental, social and governance factors when investing scheme assets. Disclosure of these factors will be required where they are considered in investment management decisions. The directive notes that IORPs are long-term investors with low-liquidity risks, and as such are in a position to invest in non-liquid assets and other instruments that have a long-term economic profile. IORP II encourages cross-border activity by permitting IORPs to invest in other Member States in accordance with certain legislative requirements of the home Member State.

Recent developments in pensions asset management

The European Market Infrastructure Regulation (EMIR), 18 which entered into force on 16 August 2012, seeks to ensure greater transparency in the financial system by, inter alia, regulating transactions in over-the-counter derivatives (OTCs) in the EU. Pension schemes that use OTCs fall within the scope of EMIR, albeit with some exemptions from the full force of the Regulation, and the trustees of a pension scheme are responsible for compliance with EMIR. Under EMIR, pension schemes are classified as ‘financial counterparties’ along with financial institutions (such as banks, hedge funds and custodians), but pension funds have been exempted from compliance with some aspects of EMIR for a period of time.

Since 12 February 2014, financial counterparties, including trustees of pension funds, have to report any new OTCs that they enter into with the trade repository within one business day of entering the contract. Any amendments to the terms of OTC transactions and any early terminations of OTC transactions must also be reported from 12 February 2014 onwards. Any OTC transactions that were entered into on or after 16 August 2012 and that remained outstanding on 12 February 2014 also had to be reported on 12 February 2014. All counterparties to a transaction, including the trustees of pension funds, must maintain a record of concluded or modified OTC transactions for at least five years after they have been concluded or modified. Pension funds were granted an exemption from the EMIR clearing requirements for certain OTC trades. In June 2015, the European Council agreed to extend the pension fund exemption until 15 August 2017. In April 2017, the pension fund exemption was extended for a further period of one year to 16 August 2018 and, again, in February 2019 it was agreed that the exemption from the requirement would continue for another two years, with the possibility of two one-year extensions if insufficient progress is deemed to have been made on solutions to deal with outstanding issues regarding ‘the cash collateral problem’.

New reporting requirements for pension schemes have been introduced by the European Insurance and Occupational Pensions Authority (EIOPA) and the European Central Bank, by regulation published in the Official Journal of the European Union on 26 January 2018. This regulation came into force on 15 February 2018 and the first annual reporting deadline is Q4 2019. This regulation requires certain pension funds to report, on a quarterly and annual basis, detailed data on assets, liabilities and members. There are reduced reporting requirements for pension funds based on their assets or size of membership. The reporting requirements apply as of the third quarter of 2019 for quarterly reporting and as of 2019 for annual reporting, taking into account the transitional period and proportionate approach for smaller IORPS. The Central Bank of Ireland is responsible for the collection, compilation and transmission of this statistical data.

---

iii Alternative investment funds

Regulated investment fund structures in Ireland may be established as UCITS (authorised by the Central Bank pursuant to the UCITS Regulations) or AIFs (authorised by the Central Bank pursuant to the AIFM Regulations that implement the Alternative Investment Funds Managers Directive (AIFMD)).

UCITS are subject to various liquidity requirements, investment restrictions (both in terms of permitted investments and required diversification), and borrowing and leverage limits. The UCITS III Product Directive and the Eligible Assets Directive significantly increased the range of permissible investments for UCITS, which enabled alternative investment fund managers to adapt their investment approach to the UCITS model, giving the market access to liquid alternative UCITS funds. However, because of the various leverage and counterparty exposure restrictions that apply to UCITS and the fact that some institutional investors and pension funds are able to invest a higher percentage of their assets in a UCITS than into unregulated funds or even regulated non-UCITS funds. However, if the strategy does not fit within a UCITS framework, managers will establish the product as an AIF.

AIFs are regulated by the Central Bank pursuant to the AIFMD Regulations, which are supplemented by the Central Bank’s AIF Rulebook. The AIFMD Regulations implement the AIFMD into Irish law. AIFs encompass all non-UCITS or alternative funds, not just hedge funds. Whether a particular AIFM is within the scope of the AIFMD depends on its location and that of the AIFs it manages, as well as the countries into which the AIFs are marketed. In summary, the AIFMD applies to all EU AIFMs that manage one or more EU or non-EU AIFs; all non-EU AIFMs that manage one or more EU AIFs; and all non-EU AIFMs that market one or more EU or non-EU AIFs in the EU.

The AIFM can be either an external manager of the AIF or the AIF itself, where the legal form of the AIF permits internal management (e.g., the Irish variable capital investment company and ICAV) and the AIF chooses not to appoint an external AIFM (an internally managed AIF). If an internally managed AIF is authorised as an AIFM and is permitted to delegate this function to a non-EU manager, that manager does not have to be authorised as an AIFM under the AIFMD. This point is of particular importance as it allows non-EU managers to access European markets without having to become authorised as AIFMs.

Irish AIFs may be established as retail investor AIFs (RIAIFs) or qualifying investor AIFs (QIAIFs) under the rules as set out in the AIF Rulebook. The AIF Rulebook also specifically provides for the establishment of particular AIF structures: for example, real estate
and private equity RIAIFs and QIAIFs (see Section VI. iv) and loan origination QIAIFs (LO-QIAIFs), the latter representing the first dedicated regulatory regime in the EU for loan origination funds. AIFMs that meet the additional conditions relating to LO-QIAIFs will be able to manage the LO-QIAIF and market it within the EU using the AIFMD passport. 23

iv Private equity and real property

As stated above, the AIF Rulebook specifically provides for the establishment of real estate and private equity RIAIFs and QIAIFs.

A key element in the development of private equity funds and real estate funds as QIAIFs has been the use of special purpose vehicles to gain access to Ireland’s extensive double taxation treaty network. QIAIFs are permitted to establish multilayered special purpose vehicles, typically wholly owned subsidiaries established pursuant to Section 110 of the Taxes Consolidation Act 1997. The Section 110 subsidiary can therefore be used as the investment vehicle for the QIAIF, which in turn effectively allows the QIAIF to gain access to Ireland’s double taxation treaty network.

The Finance Act 2013 provides for the establishment of real estate investment trusts (REITs) in Ireland. Irish REITs must be incorporated under the Irish Companies Act 2014, be resident in Ireland, have their shares listed on the main market of a recognised stock exchange, and meet a number of conditions and restrictions in terms of borrowing, permitted investments, sources of income and risk spreading. Although the Central Bank has not determined that all REITs established in Ireland are AIFs for the purpose of the AIFMD, it has indicated that the onus would be on a REIT to demonstrate otherwise. Furthermore, it has advised that REITs that are structured as unauthorised AIFs must comply with the Central Bank AIF Rulebook for retail AIFs.

Recent developments – alternative investment funds and private equity

Potential enhancements in investment limited partnership developments

In June 2019, the Irish government approved the publication of the Investment Limited Partnership (Amendment) Bill 2019 (ILP Bill). The Bill, which is on the government’s priority legislation list and is also a key deliverable in the government’s IFS 2025 Strategy (see Section I), is an important part of Ireland’s strategy to develop its international financial services sector and to take advantage of the growth in non-banking finance in Europe. The aim of the ILP Bill is to enhance Ireland’s attractiveness as domicile for private equity funds.

The existing legislation governing private equity funds in Ireland is now over 20 years old and the proposed amendments provide the opportunity to update the legislation to reflect the developments at a European level in investment funds regulation. Some of the enhancements proposed include: (1) alignment of ILP structures with other Irish fund structures, including provision for the establishment of umbrella ILPs with the possibility of having separate compartments or sub-funds with segregated liability; (2) extension of safe-harbour permissions for limited partners to act without affecting their limited liability; and (3) measures intended to ease administrative burdens around the operation of ILPs and clarification around rights and obligations of limited partners. While the publication of the

23 Recent enhancements in the LO-QIAIF regime allowing managers of AIFs more flexibility to manage broader credit strategies within a LO-QIAIF structure are discussed in the Irish chapter of the seventh edition of this publication.
ILP Bill is the first stage of the legislative process, the changes proposed in the ILP Bill are welcome and, if enacted, would enhance Ireland’s position as a domicile of choice for investment managers particularly in the private equity, infrastructure, credit and private asset space.

**Cross-border distribution of UCITS/AIFs**

In March 2018, the European Commission proposed amendments to both the UCITS Directive and AIFMD aimed at removing identified regulatory barriers to the cross-border distribution of investment funds. On 5 February 2019, political agreement on these proposals was reached in the form of a draft Regulation and Directive. The proposals were adopted together at first reading at the European Parliament’s April 2019 plenary session and were published in the Official Journal of the EU in May 2019 after which the Regulation will be directly applicable 24 months later and accordingly, Member States will have 24 months to transpose the requirements of the Directive. The proposed changes to the UCITS Directive and AIFMD will help reduce current frictions in marketing of funds within the EU. The key legislative changes also include a definition of ‘pre-marketing’ under AIFMD, which will permit alternative fund managers to more easily test the appetite of potential professional investors in new markets. The increased standardisation of marketing rules within the EU is a welcome development for Irish funds, which are sold extensively throughout the EU.

**Brexit: preparations for a no-deal scenario**

As discussed in Section I, some of the most significant developments in the regulatory landscape in Ireland during the year relate to measures adopted in early 2019 in anticipation of a potential no-deal Brexit. Some of the key measures adopted that are of relevance to Irish funds and management companies are set out below.

**Delegation**

Both the UCITS Directive and AIFMD permit third-country delegation of investment management under specified criteria and many Irish funds and management companies delegate the investment function to portfolio managers based in the UK that are regulated by the Financial Conduct Authority (FCA). On 1 February, the European Securities and Markets Authority (ESMA) confirmed that it had agreed a Memorandum of Understanding, on behalf of the EU27 national regulators, with the FCA, which ensures that delegation of portfolio management from Irish funds/management companies to UK-based portfolio managers could continue post-Brexit even in the event of a hard Brexit.

**CP86 location rule**

On 4 February, the Central Bank released a Notice of Intention regarding the location requirement for directors and designated persons of Irish fund management companies. This rule requires that a minimum number of directors and ‘designated persons’ be EEA-resident (e.g., at least half of the managerial functions required to be discharged by firms should be performed by at least two EEA-resident designated persons). The Notice confirms that, in a hard-Brexit scenario, the Central Bank will not immediately move to treat the UK as a third country for the purposes of this requirement. This came as a welcome clarification for the Irish management companies of fund promoters whose UK-based staff serve as directors and designated persons for those Irish entities.
**UK AIFMs of Irish funds**

The Central Bank confirmed in an update to its AIFMD Q&A that an Irish authorised QIAIF will be permitted to designate a UK AIFM as its AIFM, provided that the QIAIF and its UK AIFM comply with the provisions of the AIF Rulebook that apply in the case of QIAIFs with ‘registered’ or sub-threshold AIFMs. However, as the AIFM will be a non-EU AIFM, marketing of the QIAIF by the AIFM into other EU Member States under the AIFMD passport will no longer be permitted and will instead be subject to Member States’ national private placement regimes.

**Marketing in the UK post-Brexit – temporary permissions regime**

On 7 January, the notification period under the FCA’s temporary permissions regime (TPR) for firms and funds opened. The TPR provided a backstop in the event that there was no transition period and the passporting regime falls away upon a hard Brexit. Accordingly, funds or fund managers could notify the FCA of their intention to continue marketing funds in the UK post-Brexit. The closing date for notifications was originally 28 March but ultimately extended to the end of October 2019 in light of the extended Brexit date.

**Settlement – European Commission grants temporary equivalence to UK CSDs**

The European Commission has adopted a temporary equivalence decision in respect of UK authorised central securities depositories (CSDs). This means that in the event of a hard Brexit, UK CSDs, such as CREST, can continue to provide their services within the EU for a specified period. This was a welcome move for Irish securities market participants in particular as most trades in Irish securities are settled in the UK via CREST. Therefore, the inability to use CREST post-Brexit would have caused significant disruption to the Irish securities market. ESMA has since confirmed that in the event of a ‘no-deal’ Brexit, that Euroclear UK and Ireland Limited is recognised to provide its services as a CSD in the EU.

While the above measures were adopted in anticipation of the original March 2019 Brexit date, they will become increasingly important as we move towards the 31 October Brexit deadline.

**VII TAX LAW**

### Irish investment undertakings and non-Irish resident investors

Where an Irish authorised fund qualifies as an investment undertaking for Irish tax purposes, it is generally not chargeable to Irish tax on its income and gains. However, the fund may be required to account for Irish tax (known as investment undertaking tax or exit tax) on the occurrence of a chargeable event in respect of its investors. In practice, this charge is limited to payments in respect of certain Irish-resident taxable investors. Separate rules apply to Irish real estate funds (IREFs) (see Section VII.vii).

A chargeable event includes payments of any form made by a fund to an investor and on the transfer or sale of units in a fund. An investor is also deemed for Irish tax purposes to dispose of its holding in an Irish fund every eight years (deemed a chargeable event), giving

---

24 Section 739B of the Taxes Consolidation Act 1997 (TCA) applying in respect of Irish authorised funds established on or after 1 April 2000, and certain pre-31 March 2000 International Financial Services Centre funds.

© 2019 Law Business Research Ltd
rise to a rolling eight-year tax charge until such time as the holding is disposed of. If the fund becomes liable to account for exit tax on a chargeable event, it is entitled to deduct an amount equal to the appropriate tax (currently 41 per cent) from the relevant payment and, where applicable, to repurchase and cancel such number of units held by the investor as is required to satisfy the amount of tax. Importantly, however, no Irish tax arises in respect of a chargeable event where the investor is neither resident nor ordinarily resident in Ireland, or an exempt Irish resident such as another Irish authorised fund, a Section 110 company, a pension fund or a charity. In each case, the fund must be in possession of an appropriate declaration confirming the status of the investor, although the requirement for declarations in respect of non-resident investors may be relaxed on application by a fund to the Irish Revenue where certain conditions are met.

Non-Irish resident investors are thus generally not liable to Irish exit tax by deduction by the fund or on assessment in respect of their investment in Irish authorised funds. The one exception is where a non-resident investor has a branch or agency in Ireland, and invests in an Irish fund through or in connection with the branch or agency. Although no Irish tax will be accounted for by the fund, the investor will be liable to Irish corporation tax in respect of income and capital distributions it receives from the fund.

ii Investment limited partnerships

Investment limited partnerships authorised by the Central Bank after 13 February 2013 are no longer deemed investment undertakings under Irish tax law, and are not therefore subject to the exit tax rules that apply under the investment undertaking tax regime. Subject to certain reporting requirements, investment limited partnerships authorised after 13 February 2013 are tax-transparent, consistent with the tax treatment of investment limited partnerships internationally.

iii CCFs

A separate regime applies to Irish authorised CCFs, being funds that permit pension assets to be pooled in a tax-transparent structure. A CCF is treated as tax-transparent for Irish tax purposes provided the unitholders are institutional investors and certain reporting requirements are met. As a consequence, a CCF can facilitate pooling while ensuring that the double taxation treaty benefits normally enjoyed by pension funds are not affected by investing through a CCF.

iv Taxation of investment managers

An Irish resident investment manager would normally be taxed on its trading profits at the corporation tax trading rate of 12.5 per cent. Ireland’s low corporation tax rate on trading profits compares favourably with corporation tax rates in other EU and OECD countries. Management services provided by an investment manager to an authorised fund are generally exempt from VAT. In addition, the use of an Irish investment manager by a foreign UCITS will not of itself bring the foreign UCITS within the charge to Irish tax where certain conditions are met.26

25 Section 739I of the TCA.
26 Section 1035A of the TCA.
v  Private equity

Private equity investors that choose not to invest through an Irish authorised fund could invest through a standard Irish company, in which case profits would be taxed at either 12.5 or 25 per cent. Tax-neutrality at the entity level could be achieved, if appropriately structured, by the use of a company qualifying for the Irish Section 110 regime, or a tax-transparent partnership or limited partnership, to invest.

vi  REITs

REITs offer a modern collective ownership structure for Irish and international investors in real property. Provided that various conditions as to diversification, leverage restrictions and income distributions are met, an Irish REIT is exempt from Irish corporation tax on income and gains arising from its property rental business. Investors in a REIT are liable to Irish tax on distributions from the REIT. In the case of non-Irish resident investors, income distributions from the REIT are subject to dividend withholding tax (currently 20 per cent), although certain non-residents may be entitled to recover some of the tax withheld or otherwise should be entitled to claim credit against taxes in their home jurisdictions. Non-resident pension funds may also be eligible for exemption.

vii  IREFs

With effect from 1 January 2017 a new tax regime applies to regulated funds that invest in Irish real estate and related assets. Where a regulated fund derives at least 25 per cent of its value from assets that are Irish real estate, shares in unquoted real estate companies, Irish REITs and certain debt securities issued by Irish securitisation companies, then the fund will be considered to be an IREF. An IREF may be required to impose a 20 per cent withholding tax on a percentage of the amount paid on events such as the making of a distribution to investors or the redemption of its units. There are certain classes of investors that are exempt from the withholding tax, primarily Irish-taxable investors.

viii  Recent developments

The introduction of a new regulated vehicle in Ireland, the ICAV, has proven to be a welcome development to expand the attractiveness of Ireland’s authorised fund offering. Unlike the preceding Irish corporate regulated fund, the variable capital investment company, the ICAV as a private limited company allows US-taxable investors to treat the fund as a ‘check-the-box’ vehicle for US tax purposes. In so doing, the ICAV may avoid certain adverse tax consequences for US-taxable investors who invest in structures that may be deemed as a passive foreign investment company for US federal income tax purposes.

Ireland was one of the first countries to enter into an intergovernmental agreement (IGA) with the United States with respect to the Foreign Account Tax Compliance Act (FATCA) provisions of the US Hiring Incentives to Restore Employment Act 2010 in December 2012. Under the IGA, FATCA compliance will be enforced under Irish tax legislation, including the Financial Accounts Reporting (United States of America) Regulations 2014, and reporting rules and practices. Subject to certain exceptions, Irish authorised funds are generally reporting financial institutions for FATCA purposes, and are subject to FATCA due diligence and reporting requirements. Irish financial institutions that are within its scope are required to register and obtain a global intermediary identification number to avoid a 30 per cent withholding on their US-sourced income and proceeds from the sale of...
certain US income-producing assets. The Irish Revenue Commissioners will receive similar information from the Internal Revenue Service regarding Irish taxpayers. Ireland has also adopted the common reporting standard (CRS), which is the new global standard on the automatic exchange of information designed to combat tax evasion. The CRS regime requires certain investment entities (including Irish investment funds) to report certain information relating to investors to their local tax authority.

VIII OUTLOOK

In terms of the financial services industry in Ireland, Ireland has seen a significant amount of UK-based investment banks, insurance companies and investment firms relocate some or all of their business here in order to ensure continued access to European markets post-Brexit. However, while Brexit may likely be challenging for the Irish economy as a whole, the regulatory measures adopted in Ireland, the EU and UK as discussed in this chapter should help shield the Irish financial services sector from some of the worst effects of the potential disruption caused by Brexit and with the continued support of the Irish government, Ireland can be optimistic with regard to the continued development of the sector.
I  OVERVIEW OF RECENT ACTIVITY

Supportive global economic conditions, expansionary monetary policy, structural reforms and prudent fiscal policy have bolstered Italy’s economic recovery for the past four years. Exports, private consumption and investments were the main drivers of the recovery, with the added support of rising international demand, a shift in export industries towards higher value-added products and labour market reforms that helped raise the employment rate by 3 percentage points.

Although the recovery progressively slowed over the course of 2018, economic projections point to it picking up again starting in the second half of 2019, boosted by expansionary economic policies and the ensuing improvement in financial market conditions.

In the first few months of 2019, conditions improved in the Italian financial markets, which benefited also from the European Central Bank’s (ECB’s) intention to maintain highly expansionary monetary conditions for longer.

As to the asset management industry, the European regulator’s intervention in recent years (e.g., through the Alternative Investment Fund Manager Directive (AIFMD)) has played a major role in increasing investment opportunities for investment funds (e.g., by allowing alternative investment funds (AIFs) to acquire loans from non-customer originators against their own capital), while at the same time making the sector more trustworthy for less sophisticated investors. The Italian asset management industry in 2018 thus saw a confirmation of the positive trends of 2017. In the first quarter of 2019, the total assets under management (AUM) reached a new historical record with a value of more than €2 billion – approximately 120 per cent of Italy’s GDP. Italy’s venture capital sector expanded rapidly in 2018, and start-ups financed by venture capitalists were found to grow faster and be more innovative than comparable companies.

The health of the banking system has improved, and this supported private investment last year. Growth in bank lending in 2018 reached the highest level recorded since the start of the sovereign debt crisis. After the turmoil of the past few years, the stock of non-performing loans (NPLs) declined considerably in 2018 – both in absolute terms and in relation to total loans – thanks to large sales transactions and effective policy actions. Loan quality has improved and the ratio of NPLs to outstanding loans has dropped to pre-crisis level.
Nonetheless, the outlook for banks is still closely linked to the performance of the economy and the perception of country risk, which affect asset quality and the costs to raise funds on the markets.

Technology-enabled innovation in financial services is fast developing in Italy and offers numerous advantages. Indeed, fintech has the potential to: (1) increase efficiency and reduce costs; (2) improve access to, and provision of, financial services; (3) enhance the customer experience; and (4) create markets for new and innovative financial services and products.

As technology continues to break down the barriers to entry in financial services markets, asset managers, banks and other regulated entities are reacting to this changing environment and offering more online services. This involves them shifting the distribution of their standard services to online platforms via multichannel networks, thereby reducing the number of physical branches, which allows the remaining branches to specialise in high value-added services (e.g., wealth management, private banking and advisory).

Last year also saw non-banking finance affected by weakening economic growth, tensions in the financial markets and governmental uncertainty. A reduction was also seen in long-term individual saving plans (PIRs),\(^2\) which were introduced in 2017 to boost investment in financial instruments (shares, bonds, etc.) issued by Italian small and medium-sized enterprises (SMEs).

With a view to facilitating the inflow of capital for the benefit of SMEs and start-ups, in April 2019 the Italian legislature introduced a new form of investment vehicle known as ‘simple investment companies’ (SISs). SISs are a type of AIF incorporated as joint-stock companies with fixed capital that benefit from several exemptions under the asset management regulatory framework.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The Italian regulatory framework is characterised by rigorous and incisive rules, and supervisors with extensive powers.\(^3\)

The principles governing asset management are contained in the Italian Financial Act,\(^4\) and were primarily implemented – after the adoption of the AIFMD and the Undertakings for

\(^2\) PIRs can be classified as ‘investment containers’ – meaning they can be made up of funds, deposits, insurance products, etc. – on condition that: (1) 70 per cent of the portfolio is made up of securities issued by Italian or EU SMEs; and (2) 30 per cent of this share (i.e., 21 per cent of a PIR’s total assets) is invested in instruments other than those listed on the FTSE MIB market or other blue-chip indexes. Holders of PIRs are granted a tax exemption if the investments last at least five years and no more than €30,000 is invested annually.

\(^3\) The main supervisors involved are:

- the Bank of Italy: it seeks to ensure the sound and prudent management of banks and intermediaries (including Italian asset management companies and joint-stock companies);
- the National Commission for Companies and the Stock Exchange (Consob): it supervises, among other things, the provision of investment services, and ensures transparency and correctness of conduct towards investors;
- the Institution for the Supervision of Insurance (IVASS): the insurance regulator and supervisory authority since 1 January 2013; and
- the Pension Funds Supervisory Commission (COVIP): the supervisory authority for the private pension funds sector.

\(^4\) Legislative Decree No. 58/1998.
Collective Investment in Transferable Securities Directive (UCITS V) rules – by Ministerial Decree No. 30/2015, which sets out the general criteria applicable to Italian UCIs; the Bank of Italy’s regulation of 19 January 2015 on the collective asset management rules and the relevant explanatory notes; and regulations issued by Consob.

The asset management industry is represented and supported by Assogestioni, a private organisation, which has developed several codes of practice and guidelines. Other organisations such as the Italian Association of Private Equity (AIFI) are active in different fields of the industry.

The rules governing the marketing in Italy of AIF units or shares fully reflect the regime set out in the AIFMD (including the marketing of non-EU AIFs or AIFs by non-EU AIFMs) and can be summarised as follows:

- **EU AIFs to professional investors**: the EU AIFM is required to (1) obtain prior authorisation in an EU jurisdiction that has already implemented the AIFMD; and (2) subsequently notify Consob through the home country regulator, otherwise the marketing in Italy of the relevant EU AIF units is prevented; and
- **EU AIFs to retail investors**: the EU AIFM is required to, in addition to obtaining the authorisation under (1) above, request Consob’s authorisation.

As to the marketing in Italy of foreign collective investment schemes under the UCITS framework, the home country regulator must notify Consob before any marketing begins.

The Italian investment management industry was also affected by the implementation of MiFID II, which came into force in January 2018.

Although asset management companies do not fall under the scope of the product governance provisions under MiFID II, various initiatives have been adopted to facilitate

---

5 The key principles and general rules of the UCITS V (EU Directive 2014/91) were enacted in Italy in June 2016 (Legislative Decree No. 71/2016) when the Italian Financial Act was amended. The main changes concerned cooperation between ESMA and the competent national authorities, activities that can be carried out by a custodian, remuneration policies and sanctions for infringing the relevant legal provisions.

6 The Bank of Italy’s regulation of 19 January 2015 was last updated on 23 December 2016 to comply with the UCITS V Directive. One amendment concerns under-threshold Italian management companies the prudential regulation of which has been simplified to ensure Italy is more aligned with other EU Member States.

7 See, among others:
   - Resolution No. 11971/1999, which governs a fund’s key information document and the offering to the general public, etc.;
   - Resolution No. 20307/2018, which sets out, among other things, the rules of conduct and the rules on internal procedures, conflicts of interest, complaint management and record keeping applicable to collective asset management and investment services;
   - Regulation of 29 October 2007 (jointly issued with the Bank of Italy) regarding the internal organisation of intermediaries and asset management companies;
   - Resolution No. 19094/2015 and Resolution 20197/2017, which supplement and partially amend the resolutions under (a) to (c) above; and
   - Resolution No. 17297/2010, regarding UCIs’ and asset management companies’ reporting duties.

8 Italian Investment Management Association.

9 In this respect, the relevant passport rules will enter into force when the European Commission issues the measures under Article 67(6) of the AIFMD.

10 The Italian legislature and regulatory authorities opted for a gold-plating provision in this regard, pursuant to Article 43(2) of the AIFMD.
the exchange of information between manufacturers (i.e., management companies) and distributors concerning, for example, the target markets and distribution strategies – this because the distribution channel is required to comply with this regulation. Consob considers this a best practice that ultimately benefits retail investors.

Conversely, the marketing of UCIs by asset management companies is subject to MiFID II conduct rules and to product intervention measures (such as the prohibition, restriction or suspension of marketing) when investor protection or market stability – or both – are threatened. Similarly, asset management companies authorised to provide investment advisory, portfolio management or reception and transmission of orders are subject to MiFID II conduct rules for the provision of investment services.

Moreover, asset management companies that intend to market UCIs to retail investors are now required to publish a key information document on their website to enable retail investors to understand and compare the key features and risks of an investment.

III COMMON ASSET MANAGEMENT STRUCTURES

Under Italian law, UCIs can be set up as:

a) funds, notably independent pools of assets divided into units, which are:
   • set up as open-ended or closed-ended investment schemes and managed by a management company incorporated as a joint-stock company (SGR) in accordance with a defined investment policy;
   • set up without legal personality, as the SGR is the sole entity empowered to undertake obligations and exercise rights on behalf of the funds;
   • segregated completely from the SGR’s own assets, the other assets managed by the same SGR and each investor’s assets; and
   • divided into units assigned to a plurality of investors;

b) SICAVs that are open-ended collective investment schemes set up as joint-stock companies with variable capital; or

c) SICAFs that are newly introduced closed-ended collective investment schemes set up as joint-stock companies with fixed capital.

Option (a) is by far the preferred choice of Italian market operators. Specifically:

a) open-ended funds: participants may exercise the right to redeem units at any time, in accordance with the procedures established by the fund’s regulation;

11 The Bank of Italy and Consob, within their respective competences, may adopt such measures when, among other things, the marketing of UCIs gives rise to significant investor protection concerns, or poses a threat to the orderly functioning and integrity of financial markets or to the stability of whole or part of the financial system (see Article 7 bis of the Italian Financial Act and Articles 39–43 of MiFIR).
12 See Regulation (EU) No. 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).
13 Since 2012, no SICAVs have been enrolled in the relevant register under Article 35 ter of the Italian Financial Act.

As to the diffusion of the SICAF option, given the particularly broad definition of AIF, as implemented in Italy, a number of Italian investment vehicles traditionally falling outside the scope of the rules concerning collective asset management have been reclassified as AIFs, with the consequence of their falling under the Bank of Italy’s supervision.
closed-ended funds: participants may exercise the right to redeem units only at predetermined maturities, under specific circumstances and for limited amounts;

hedge funds: see Section VI.iv; and

funds reserved to qualified investors, which now qualify as reserved AIFs, can be either open-ended or closed-ended, and their units can be placed by, or reimbursed or sold to, qualified investors only.\(^{14}\)

As mentioned in Section I, SISs were introduced in April 2019 as a new form of investment vehicle to facilitate the raising of capital for SMEs and start-ups. SISs are recognised for all intents and purposes as UCIs set up as SICAFs and benefit from several exemptions from the asset management regulatory framework if they comply with the following requirements (among others): (1) their net assets do not exceed €25 million; and (2) the target companies are non-listed SMEs that are experimenting with, creating or starting up their business.\(^{15}\)

**IV MAIN SOURCES OF INVESTMENT**

The asset management industry witnessed a positive trend in the first quarter of 2019, similar to that seen in the beginning of the previous year: the total AUM reached a new historical record with a value of over €2 billion – approximately 120 per cent of Italy’s GDP – split between individual portfolio management mandates (50.4 per cent, which is a slight increase on the last few years) and funds (46.9 per cent open-ended and 2.7 per cent closed-ended, with the latter showing a slight increase on the first quarter of 2018).\(^{16}\) Nonetheless, in 2018 the net cash inflow of the asset management industry materially decreased compared to that of 2017 – mainly due to tensions in the financial markets in the second half of the year, which also affected the financial situation of household investors.\(^{17}\) Indeed, growth in disposable income weakened and the value of portfolio assets decreased considerably.

Although in 2018 sight deposits and purchases of insurance policies with guaranteed minimum returns remained high, subscriptions of investment fund units dropped sharply.

\(^{14}\) Reserved AIFs might also be subscribed by non-professional investors if certain conditions are met (including a minimum subscription amount of €500,000, see Article 14, Paragraph 2, of Ministerial Decree No. 30/2015).

\(^{15}\) See Article 27 of Law Decree No. 34 of 30 April 2019 as amended by Law No. 58/2019, which amended Article 1, Paragraph 1, of the Italian Financial Act.

\(^{16}\) Assogestioni, Quarterly Map of the Italian Asset Management Industry, I, 2019.

\(^{17}\) Bank of Italy Annual Report, 31 May 2019.
Nonetheless, asset management instruments accounted for a much larger share of household portfolios compared to previously; they allow investors to better diversify their risks, including by taking advantage of a wider range of investments on international markets.  

The number of investors in asset management products increased in 2018, reaching 7.2 million by the end of the year. The success of PIR-compliant funds also contributed to this increase, as more than 880,000 depositors adhered to them over the previous two years. However, this gain lasted only until June 2018 and then progressively came to a halt. Additionally, bond funds – which were often included in the choices of Italian investors (at one point 40 per cent of investors had them in their portfolios) – decreased by 14 percentage points in the last four years, to 25 per cent.

V KEY TRENDS

The recent trends in the Italian asset management sector can be summarised as follows:

a) confirmation of the role of funds as financing providers for the real economy and a source of liquidity for distressed banks;
b) significant increase in private equity deals;
c) progressive growth in the green and social bonds market (i.e., financial instruments whose proceeds are allocated to finance projects with a positive environmental or social impact);
d) slight increase in profitability of asset managers operating in the real estate and private equity sectors, following an increase in trading volumes;
e) increased number of AUM; and
f) increase in AUM (up by 10.9 per cent in March 2019 compared to March 2018) of exchange-traded products (the vast majority of which are UCITS-compliant exchange-traded funds (ETFs)).
To support recovery, specific measures have been adopted in recent years, including:

a. the possibility granted in 2013 to the SMEs Guarantee Fund\(^\text{28}\) to provide coverage also to SGRs, in addition to banks and other financial intermediaries;\(^\text{29}\)

b. the opportunity given in 2014\(^\text{30}\) for Italian AIFs and, in 2016, for EU AIFs, to carry out direct lending activities;\(^\text{31}\)

c. the introduction of PIRs, launched to boost investment in financial instruments (shares, bonds, etc.) issued by Italian small and medium-sized enterprises (SMEs) thanks to the tax exemption they are granted;\(^\text{32}\)

d. the levelling of the playing field between rules governing alternative funds and UCITS managers (as a result of the convergence of their respective sets of regulations) owing to the implementation of the AIFMD (see Section II);

e. the review of the crowd-funding framework so as to expand the scope of eligible investors and reduce certain regulatory entry hurdles;\(^\text{33}\) and

f. the increase in investment in ETFs.\(^\text{34}\)

Furthermore, the increasing reach of more complex and innovative technologies is rapidly transforming the structure of the financial industry. Indeed, fintech is radically innovating the way financial services and asset management are designed and offered. It represents an evolving phenomenon that involves several market segments (e.g., wealth management, investments services, crowdfunding, and peer-to-peer lending), and heterogeneous tools and techniques (e.g., robo-advice and artificial intelligence). The management and analysis of big data, the use of artificial intelligence and machine learning, and the potential offered by distributed ledger technologies are changing the services provided; they are also opening up the sector to new competitors – including, but not only, the big techs – that are able to swiftly exploit the advantages of operating and trading in the digital economy.

---

\(^\text{28}\) The SMEs Guarantee Fund is a governmental fund that provides a special guarantee to the benefit of SMEs that enter into banking loans or other credit facilities.

\(^\text{29}\) See Law No. 9/2014, which converted Law Decree No. 145/2013 (the Destination Italy Decree), which introduced a number of measures to encourage investments in SMEs.

\(^\text{30}\) See Law Decree No. 91/2014, converted with amendments into Law No. 116/2014.

\(^\text{31}\) Through the origination of receivables grounded on the AIFs’ assets (see Law No. 116/2014, which converted Law Decree No. 91/2014, and Law No. 49/2016, which converted Law Decree No. 18/2016). The Bank of Italy’s Regulation of 19 January 2015 was revised and updated to set out the legal framework for loan origination by AIFs.

\(^\text{32}\) PIR regulation was recently amended through the 2019 Budget Law (Law No. 145/2018), which introduced an obligation for PIRs to invest a percentage of their portfolio in financial instruments issued by SMEs and venture capital funds.

\(^\text{33}\) See Consob Resolution No. 19520 of 24 February 2016, which amended the Regulation on the collection of risk capital via online portals (adopted by Consob Resolution No. 18592 of 26 June 2013). The Regulation on the collection of risk capital via online portals was subsequently amended also by Consob Resolution No. 20204 of 29 November 2017; see also Bank of Italy Resolution of 9 November 2016 (which came into force on 1 January 2017). Additionally, the 2019 Budget Law recently introduced the possibility to also offer debt instruments, provided that the service is provided through a separate area of the portals and that these instruments are addressed only to professional investors and other investor categories identified by Consob. To date, the relevant implementing regulation of the 2019 Budget Law has yet to be published.

\(^\text{34}\) Consob Annual Report to the Ministry of the Economy and Finance, 31 March 2019.
As to the financial results of open-ended funds, asset managers closed the last financial year with decreased profits (more than 40 per cent), mainly owing to negative collection performance (compared to the previous year). Conversely, private equity fund profits grew because of the increase in managed assets.

VI SECTORAL REGULATION

i Insurance

Following the implementation of the Solvency II framework, and in light of the appeal of asset management products for Italian investors, the measures adopted by the Italian regulator in terms of eligible investments were particularly favourable to the insurance industry.

In this respect, IVASS allowed Italian insurers to decide how to cover their technical reserves (i.e., which asset classes to choose for investing their own funds) provided that certain conditions – namely in terms of governance – are met in accordance with the freedom to invest under Article 133 of Solvency II. Importantly, this framework confirmed the possibility for insurance companies to provide direct lending.

IVASS has also introduced rules for determining the average rate of return of separately managed accounts, allowing insurers to temporarily suspend the accounting of gains and losses deriving from the trading of derivatives, and to hold the revenues gained during favourable economic cycles for distribution to policyholders during less favourable accounting periods.

At the end of 2018, insurance companies held technical reserves of €749 billion, whereas assets covering the technical reserves amounted to €741 billion. These assets (excluding the technical provisions concerning linked policies and pension funds) are mainly invested in government bonds (58.7 per cent) and corporate bonds (25 per cent), both in line with the previous year, whereas UCIs, real estate and shares remain less significant.

On a separate note, in 2018 Italian insurers experienced a reversal of the 2017 positive trend of unit linked policies’ volumes.

37 See IVASS Regulation No. 24/2016, which thoroughly revised the pre-Solvency II regime (contained in ISVAP Regulation No. 36/2011). Previously, insurers had to cover their technical provisions with assets that met specific requirements, including the requirements to:
   
   a be chosen taking into account the nature and complexity of risks and liabilities undertaken by the insurer to secure the safety, yield, liquidity, diversification and adequate spread of investments; and
   
   b fall within one of the asset categories set out in the relevant IVASS Regulation, including:
      
      • the units of harmonised UCIs mainly investing in the bond or share market;
      
      • the units of closed-ended funds negotiated on a regulated market (up to 5 per cent of the technical provisions);
      
      • the units of closed-ended real estate funds based in Italy or another EU member state (up to 10 per cent);
      
      • alternative investments (up to 10 per cent), including shares or units of open-ended non-harmonised UCIs, shares or units of closed-ended funds that are not traded on regulated markets, reserved funds, and hedge funds, provided that specific conditions are met; and
      
      • direct lending (up to 5 per cent provided all the requirements are met).
38 See Articles 13-16 of IVASS Regulation No. 24/2016.
39 See IVASS Order No. 68/2018.
In addition, IVASS shone a spotlight on the phenomenon of ‘dormant’ life policies, requiring insurers to take actions to improve the processes for verifying the deaths of insured people and identifying beneficiaries. The payment of the insured capital related to dormant life policies releases resources that could be directed to investments in funds, especially considering the trend of low interest rates that has made traditional banking products less appealing.

ii Pensions

Over the past 30 years, the Italian pension system has undergone significant reforms aimed at progressively controlling public expenditure and setting up private sources of retirement income in addition to the mandatory state pension system.

An initial set of rules comprehensively regulating supplementary pension schemes was introduced in 1993 and radically reformed in 2005 (Legislative Decree No. 252). The reform’s cornerstones were voluntary, and defined contributions, individual capitalisation mechanisms and the transferability of positions from one pension scheme to another. In December 2018, the Italian government passed Legislative Decree No. 147 implementing Directive (EU) 2016/2341 on the activities and supervision of pension funds. The decree introduced significant changes to the previous legislation, mainly regarding two issues: (1) pension fund governance; and (2) information to potential members and beneficiaries. COVIP is thus implementing a specific set of directives – currently under consultation – to allow pension funds to promptly comply with the new regulatory framework.

Currently, 399 private pension funds are in place in Italy. The structures of those pension funds take four different forms:

- **contractual pension funds**;
- **open-ended pension funds**;
- **individual insurance pension plans (PIPs)**; and
- **‘pre-existing’ pension funds**.

The Italian private pension market is concentrated, as the 45 largest private pension funds (with more than €1 billion of AUM) hold 60 per cent of the total resources.

The sums contributed to private pension schemes must be managed according to the principles of prudence, transparency, investment diversification, risk fragmentation and cost.

---

42 ‘Dormant’ life insurance/assurance policies are policies that have gone unclaimed by their beneficiaries and are thus awaiting expiry of the statutory limit to claim them. According to IVASS, 200,000 policies have been ‘awakened’ since the beginning of the investigation into dormant life assurance policies (2017), for a value of approximately €3.9 billion. See IVASS – Thematic Review on Dormant Life Assurance Policies Results.

43 See IVASS letter to the market of 29 December 2017. With the IVASS letter to the market of 25 September 2018, IVASS announced that it was extending the investigation into dormant life policies to SEE’s insurance companies operating in Italy.


45 See Legislative Decree No. 124/1993, which also established COVIP, the authority in charge of both the prudential supervision of pension funds and the protection of its beneficiaries’ rights.

46 Of these, 33 are contractual pension funds, 43 are open-ended pension funds, 70 are PIPs and 251 are ‘pre-existing’ pension funds; as reported in the COVIP Annual Report for 2018.

containment (see Ministerial Decree No. 166/2014). Eligible assets include UCITS and AIFs; certain derivative contracts; and certain non-listed and non-rated bonds issued by SMEs, and securities backed by the same assets and issued as part of securitisation transactions.

Although the past three years saw the prolonged expansionary monetary policy – characterised by low interest rates – trigger a portfolio diversification resulting in a decrease in AUM invested in sovereign bonds, 2018 witnessed a slight increase in this type of investment (from 41.5 per cent in 2017 to 41.7 per cent in 2018).

Italian workers are becoming increasingly aware of the advantages of private pensions, whose market is steadily growing (in terms of participants and AUM) also because of the widespread distribution network used and the reduced costs to be borne by investment fund managers. Despite this growth, the participation rate in private pension funds is still modest (approximately 30.2 per cent of the workforce), which represents a market opportunity for pension funds that could target the Italian market to expand their business. However, the Italian regulator has some concerns in light of investors' low levels of expertise, which could damage them if aggressive sales strategies are adopted by pension funds.

To encourage participation in private pension schemes, COVIP has taken specific measures in the past few years, including a ban on the exclusive or automatic reliance of pension schemes on credit rating agency ratings; a simplification of the bureaucratic burdens related to certain corporate actions and extraordinary transactions; and incentives to mergers so as to reach sizes that ensure efficiency and economies of scale.

**iii Real property**

Real estate UCIs are set up as closed-ended funds to support their liquidity needs and, following the implementation of the AIFMD, the units of funds with a minimum subscription below €25,000 need no longer be listed. Italian real estate UCIs invest no less than 66 per cent of their assets (or 51 per cent, in certain circumstances) in real property, real estate rights,
stake in real estate companies and units of other real estate UCIs. To safeguard investors’ interests and an SGR’s independence, the assets of real estate UCIs are valued by external and independent appraisers (however, this valuation is not binding on the fund managers).

The development of real estate funds was initially hindered by a set of regulatory and operational constraints, which have since been gradually removed. The history of Italian real estate funds can therefore be divided into two different phases: 2000 to 2004, when the real estate fund market was dominated by retail products; and from 2005 to the present day, during which time the assets of funds reserved to qualified investors increased by 10 per cent. As to the recent trend in the real estate funds market, the number of funds and management firms (as of 30 June 2018, 501 and 56 respectively) is still quite low compared to other European countries.

Broadly speaking, the real estate market is slowly recovering from the negative tendency of the past few years; therefore, in 2018 the asset management sector benefited from this market improvement, and asset management products are thus expected to perform better in the near future. As of 31 December 2018, the total assets of real estate UCIs amounted to €51.1 billion, with an increase compared to the previous year. This trend is also likely to continue in 2019 through the growth of real estate investment in emerging markets (taking into consideration demographic aspects and developments in infrastructure).

Most investments by real estate funds in Italy in 2018 concerned assets in Milan and Rome that are becoming more and more appealing to foreign investors. This trend is likely to continue, and may be further amplified if the uncertainties regarding the future value of real estate assets in London persist. In fact, the UK real estate market may well experience a negative trend following the country’s exit from the European Union.

iv  Hedge funds

UCIs can also be set up as hedge funds, thus enabling them to invest in a wider range of eligible assets than UCITS, and derogating from the Bank of Italy’s general rules for risk containment and fragmentation. Following the implementation of the AIFMD, Italian hedge funds can now be classified as a subcategory of reserved AIFs (closed-ended or open-ended). Reserved AIFs may carry out a wide spectrum of investment strategies that are not limited to the typical policies of hedge funds.

In light of the higher risks to which hedge fund investors might be exposed, the Italian regulator introduced a set of limits affecting the distribution of and investment in these funds. For example, a fund’s regulation must expressly set out the maximum level of leverage and flag the risks of the investment. Moreover, the initial minimum subscription amount for non-professional investors is €500,000, and hedge fund units cannot be exclusively distributed to retail investors through the individual portfolio management service. Owing to these structural constraints, hedge funds have developed more slowly in the Italian market compared to other countries and are still mainly targeted to institutional investors.

56 ibid.
57 Reserved AIFs can be distributed to non-professional investors only if this is specified in the fund regulation. The fund regulation can also specify other categories of investors entitled to invest in the fund.
58 See Ministerial Decree No. 30/2015.
Since 2007, amendments to the applicable framework have been introduced to support the hedge fund sector. The provisions requiring the establishment of a special purpose SGR to set up and manage hedge funds were repealed, thus opening up the market to any legal entity licensed as an SGR, and boosting restructuring and merger transactions.

Despite these measures, the Italian hedge fund market is still in a comparatively weak position with limited fund offers.

However, the revision of the regulatory framework still needs to be accompanied by a change in the cultural approach to alternative investments. Traditionally, Italian investors tend to be risk-averse, and although this helped them protect their assets during the financial crisis, it has also hindered Italy’s ability to compete in innovative market segments (such as that of hedge funds).

v Private equity

The history of the Italian private equity market can be divided into the following main stages:

a 1996 to 2000: characterised by a favourable economic backdrop and a strong increase in investments, which were traditionally used to perform leveraged buyouts or expansion transactions to support the growth of already existing companies;
b 2001 to 2008: characterised by a complex macroeconomic backdrop that caused a reduction of internal rates of returns despite increased investment volumes;
c 2009 to 2012: characterised by the credit crunch, and a drop-in performance and investment volumes; and
d 2013 to 2018: characterised by a partial recovery, an increase in operators and in investments (with a significant increase in investments in 2018) with growing trends in the ‘buyout’ and ‘early stage’ segments, and with independent fundraising remaining the main challenge for operators.

Notwithstanding the rapid development that preceded the financial crisis, the Italian market is significantly undersized compared to France, Germany, Spain and the UK: domestic funds are suffering from the high market volatility and the limited willingness of institutional investors to invest in private equity funds.

However, according to the AIFI, in 2018 investments in the Italian private equity and venture capital markets reached a record high of around €10 billion, with 13 large and mega deals (i.e., deals exceeding €150 million and €300 million, respectively). Furthermore, the overall amount of private equity investments in 2018 grew by 98.2 per cent compared to 2017, and were distributed over 359 deals (mainly concentrated in buyout transactions, infrastructure, medical, industrial services, replacement, early stage and expansion segments involving SMEs), with a 15 per cent increase on 2017, representing an increase of approximately €5 billion.

Additionally, compared to 2017 divestments in the private equity sector decreased in terms of both the amount (-26 per cent) and number of exits (-33 per cent). In particular, sales to other private equity investors represented the main exit channel in terms of amount

59 See AIFI Yearbook 2019.
(37 per cent of the total number of divestments). In fact, taking into account the international players based in Italy, total capital inflows reached €7,393 million. As to divestments, they amounted to €2.8 billion (a 26 per cent decrease on 2017).

In addition, fundraising by private players – which remains the most critical part of asset management activity – continued slowing down in 2018 (a 42 per cent decrease on 2017), with the total resources collected by domestic operators amounting to €3,360 million compared to €6,263 million in the previous year. This decrease was strongly influenced by the activity of some domestic institutional funds that reached important closings during 2017.

Notably, the low interest rate environment caused buyouts to generally be the preferred stage for investments, and the one into which the largest portion of resources continued to flow (i.e., 67 per cent of the total amount). In addition, early-stage activity in 2018 registered a significant 143 per cent increase in amount (from €133 million to €324 million), and a 29 per cent increase in number.

Market operators are optimistic about the future economic scenario, and thus have encouraged measures aimed at providing venture capital for Italian start-ups.

**vi Other sectors**

See Section III for a summary of the main features of Italian reserved funds.

**VII TAX LAW**

The tax regime currently applied to investment funds, including the tax treatment applied to their investors, was amended a few years ago. The underlying principles of the new tax regime for investment funds are no taxation at the level of the investment vehicle and taxation at the level of the investors at the moment of distribution. Certain significant exceptions may apply to investors in real estate investment funds (REIFs).

**i Real estate investment funds**

The reform of the tax treatment of Italian REIFs was achieved through Law Decree No. 78/2010 and Decree No. 70/2011. The main changes include a more restricted definition of investment fund, particularly the concepts of plurality of participants and independence of the management company from the investors. As indicated in the government report on Law Decree No. 78/2010, the changes were mainly aimed at specifying the economic function of REIFs and discouraging REIFs from being set up merely to benefit from the favourable tax regime. In particular, the report emphasised that the aim of the amendments was to limit the application of the REIF tax regime to widely held funds and funds that pursue public interest objectives.

The applicable REIF tax regime depends on the status of the investor (i.e., institutional or non-institutional) and the type of REIF (i.e., institutional or non-institutional). A REIF is not subject to corporate income tax (IRES) and regional tax on business activities, and therefore benefits from a favourable tax regime in connection with its investment activities.

---

60 See AIFI Yearbook 2019.
61 Ibid.
62 See ‘VentureUp’, the start-up platform set up by AIFI in late 2015 in cooperation with certain prominent venture capitalists, advisers and law firms, which the European Commission has included on a list of innovative European platforms.
In general terms, any income, including capital gains on the sale of immovable property or equity interests in real estate companies, as well as income from property leasing (i.e., rental income), is not subject to IRES or regional tax on business activities in the hands of the REIF. Further, income from certain ancillary financial investments is not subject to withholding tax at source.

Under Italian law, the REIF tax regime applies if a REIF falls within the definition of a mutual fund from a legal and regulatory perspective.

Law Decree No. 1/2012 specifically provides that Italian REIFs must be considered as resident in Italy for IRES purposes, and therefore as autonomous persons liable to income tax. This amendment would allow REIFs to access treaty benefits. In this respect, the Italian tax authorities have stated that tax treaties are usually applied on a reciprocal basis.

**Institutional REIFs**

Institutional REIFs’ units are entirely owned by one or more of the institutional investors pursuant to Article 32(3) of Decree No. 78/2010. The Italian tax authorities have pointed out that the beneficial tax regime, as previously described, applies to institutional REIFs irrespective of compliance with the concept of a mutual fund (e.g., autonomous management and plurality) provided by law and regulatory provisions.

Income received by investors in REIFs upon redemption of units or a periodic distribution of proceeds is, in principle, subject to withholding tax at a rate of 26 per cent by the management company or the relevant Italian qualified intermediary, which is levied as an advance payment of the total tax due from investors that receive proceeds in connection with business activities (inter alia, Italian-resident companies, public and private entities or trusts that carry out a business activity, or non-resident companies with a permanent establishment in Italy to which these proceeds are attributable).

The 26 per cent withholding tax is levied as a final payment in all other cases. It is not levied on proceeds paid to Italian UCIs or pension schemes identified by the law.

Distributions of amounts formed with capital contributions are not subject to any income taxation at the level of the investor but reduce the tax basis of the units for a corresponding amount.

Pursuant to Article 5 of Legislative Decree 461/1997, the capital gain arising in the hands of an Italian resident individual who does not act in the context of a business activity is subject to a 26 per cent substitute tax.63 If the units are held in the context of a business activity, the relevant capital gain is included in the aggregate taxable income ordinarily subject to personal income tax.

**Non-institutional REIFs**

Non-institutional REIFs’ units are not entirely owned by institutional investors. The tax regime applied to institutional REIFs also applies to non-institutional REIFs that meet the notion of a mutual fund according to regulatory law.

---

63 Such capital gain is equal to the difference between the sale price and the tax basis in the hands of the transferring party. The taxpayer may opt for one of three alternative tax regimes, namely the tax return regime, the non-discretionary investment portfolio regime and the discretionary investment portfolio regime; however, pursuant to Article 6 of Legislative Decree 461/1997, the non-discretionary investment portfolio regime is the regime applicable to transfer or reimbursement of investment funds units, unless another option is provided by the relevant investor.
The tax regime applicable to Italian-resident investors in non-institutional REIFs depends on whether the unitholder owns more than 5 per cent of the units and whether the investor falls within the definition of an institutional investor.

Italian-resident investors (other than institutional investors) that own more than 5 per cent of the units of a non-institutional REIF are taxed, on a ‘look-through’ basis, on the income realised by the REIF.

The tax regime applicable to institutional REIFs (and to their institutional investors) also applies to investors that do not own more than 5 per cent of the units (and to institutional investors, irrespective of the units owned) in a non-institutional REIF. Therefore, 26 per cent withholding tax applies as an advance or final payment depending on the status of the investor.

In the event of transfer of units by an individual who holds less than 5 per cent of the fund units, capital gains are subject to the same principles that apply to sales of units of institutional REIFs. In the event of transfer of units by an individual who holds more than 5 per cent of the fund units (that are taxed on a ‘look-through’ basis), for purposes of determining the relevant capital gain, the tax cost of the transferred units is increased or decreased, respectively, by the income or losses attributed to the investor, and is also decreased, up to the amount of the management results attributed, by the proceeds actually distributed to unitholders. In cases of transfer, such units are treated as a participation in an Italian partnership under Article 32(4) of Law Decree 78/2010, and the relevant capital gain, if realised outside the context of a business activity, is included, up to 58.14 per cent of the amount, in the relevant taxable income of the investor according to Article 68(3) of Presidential Decree 917/1986. This is similar to the tax treatment applicable to capital gains realised from 1 January 2018 to 31 December 2018 by Italian-resident individuals through the sale or disposal of a ‘qualified’ shareholding not held in connection with a business activity. However, Article 68(3) of Presidential Decree 917/1986 has been repealed by the 2018 Budget Law with respect to capital gains realised from 1 January 2019. If the units are held in the context of a business activity, the relevant capital gain is included in the aggregate taxable income ordinarily subject to personal income tax.

Non-Italian resident investors in institutional REIFs and non-institutional REIFs

The tax regime applicable to non-Italian resident investors in REIFs remains substantially unchanged irrespective of whether the REIF is classified as institutional or non-institutional. Proceeds received as a periodic distribution or redemption of REIF units by non-Italian investors are, in principle, subject to 26 per cent withholding tax that is levied as a final payment of taxes due in Italy. As clarified by the tax authorities in Circular 11/E of 9 March 2011, the 26 per cent withholding tax could be reduced pursuant to a provision on interest payments set forth in a double tax treaty, if any, entered into by Italy and the country...
of residence of the recipient. However, proceeds received by certain qualified non-Italian resident investors (e.g., pensions funds and UCITs established in a white-listed country\textsuperscript{64}) are exempt from the 26 per cent withholding tax.\textsuperscript{65}

Capital gains realised on sales of REIF units are, in principle, taxable in Italy as other income.\textsuperscript{66} However, non-Italian resident investors may benefit from an exemption in Italy based on domestic provisions. In addition, tax treaty provisions remain applicable if certain conditions are met.

\textsuperscript{64} On 22 August 2016, the Italian published Ministerial Decree of 9 August 2016 (2016 Decree) in the Official Gazette, amending the list of jurisdictions that allow an adequate exchange of information with Italy (the white list). The 2016 Decree broadens the white list to include 51 new countries, and reserves the right to remove countries that are not compliant with the exchange of information obligation.

\textsuperscript{65} Specifically, foreign investors established in a white-listed country qualify for the withholding tax exemption provided that, among other things, they meet the prudential supervision test, meaning that either the UCI itself or its asset management company are subject to regulatory supervision by the local competent authority. To meet this latter requirement, the foreign UCI or its asset manager must obtain an initial authorisation for the investment activity and must be subject to a continuing control over its activity.

Foreign UCIs, to comply with the prudential supervision test, need to provide a written statement issued by the competent foreign authorities confirming compliance with this requirement. However, it may happen that a foreign competent authority is not in a position or available to issue the above written confirmation.

The ITA clarified with resolution No. 78/2017 that a Cayman limited partnership in an Italian REIF can prove it is subject to the prudential supervision of the local competent financial authority to the extent its general partner qualifies as a ‘relying adviser’ of a United States ‘investment adviser’ under the US Security Exchange Commission regulation (i.e., Investment Adviser Act of 1940). In this scenario, where the relying adviser is controlled by or under common control of an investment adviser and a single form ADV (which is the standard form used by investment advisers to register with both the Securities and Exchange Commission (SEC) and state securities authorities) can be filed by the latter on behalf of itself and the other advisers (i.e., umbrella registration), the form ADV together with the evidence of the registration on the SEC’s website are deemed sufficient elements to prove the requisite prudential supervision.

More recently, the Italian tax authorities issued further guidelines aimed at clarifying the conditions to benefit from the withholding tax exemption regime on distribution from Italian REIFs to foreign institutional investors. Ruling No. 43/2018 deals with a fund set up under the law of the Cayman Islands which indirectly owns a speculative Italian property fund. In the case at stake the foreign fund (1) complies with the regulations of the United States and (2) consists of a limited partnership organised under the law of the Cayman Islands (which is currently included in the white list). The Italian tax authorities clarified that as the limited partnership (i.e., the foreign fund) is a company controlled by a UCI that manages the reserves of a state, the Italian REIF indirectly involved can be considered an ‘institutional fund’ thus its proceeds are exempt from withholding tax. This exemption regime applies not only in the case of direct participation in the Italian REIF but also in case of indirect participation via a corporate vehicle (even if such vehicle is established in a state other than that of the institutional investor’s residence). This conclusion has been confirmed by Ruling 147/2018.

In regard to a sale of units in a REIF, units that exceed the 5 per cent threshold owned by investors other than institutional investors are treated as an interest in a partnership (Article 5 of the Income Tax Code). In the hands of investors that receive proceeds other than in connection with a business activity, such a qualification implies that capital gains form part of taxable income, regardless of the fact that the units are held in Italy and that those units are traded in a listed market. Only 58.14 per cent of the relevant gain is included in the taxable income (Article 68(3) of the Income Tax Code). Moreover, guidance of the tax authorities confirms that tax treaty provisions remain applicable in regard to capital gains realised upon a sale of units when the relevant conditions are satisfied.
ii  Foreign real estate investment funds

Article 13 of Legislative Decree No. 44/2014 modifies the taxation treatment of income derived from quotas held in foreign REIFs so as to align it to the treatment provided for income derived from quotas held in Italian REIFs. These changes were also necessary in light of the fact that the transposition of the AIMFD enables Italian SGRs to set up and manage real estate funds abroad under the EU free provision of service regime.

Therefore, regarding income deriving from quotas held in foreign REIFs received by resident persons, the same taxation treatment provided for participants to Italian REIFs that own quotas greater than 5 per cent of the fund shall apply, including the transparency regime for participants other than ‘institutional investors’, listed in Article 32(3) of Law Decree No. 78 of 2010.67

For income tax purposes, a foreign REIF must be framed within the ambit of non-resident persons liable for IRES pursuant to Article 73 of the Income Tax Code, and is thus subject to IRES on income that is deemed to be Italian-sourced. In cases where a resident owns a fund stake greater than 5 per cent, taxation on the fund (generally on cadastral income) coupled with quota holders’ taxation (as a result of the transparency rule) gives rise to double taxation. In the said scenario it stands to reason that, in the absence of a specific rule, the application of the transparency regime implies application of the exemption regime at the level of the foreign REIF at least on the portion of income from immovable property attributed to the Italian quota holder by operation of the transparency principle.

iii  Italian UCIs (other than Italian REIFs)

The profits of UCIs are exempt from income tax and corporation tax. UCIs receive investment income gross of withholding tax and applicable substitute taxes, with certain exceptions. In particular, UCIs remain subject to the withholding at source of interest and other income from bonds, similar securities, and finance bills that are not negotiated in regulated markets or multilateral negotiation systems of the EU and European Economic Area States included in the white list issued by non-listed resident companies, as well as the withholding on income from atypical bonds.

The provisions governing the tax regime for Italian UCIs have been included in the provisions that identify persons liable to IRES by stating that Italian UCIs are considered resident for income tax purposes. However, income realised by UCIs is exempt from IRES provided that a UCI or management company (e.g., the SGR) is subject to prudential supervision.68 In general, income from certain UCI investment activities is not subject to Italian withholding tax or substitutive taxes and, accordingly, the income is not subject to any withholding tax or substitutive taxes and, accordingly, the income is not subject to any withholding tax or substitutive taxes and, accordingly, the income is not subject to any
taxation in the hands of the UCI. However, certain categories of income realised by UCIs are subject to withholding tax. This represents a final payment of taxes due, and no tax credit is available in the hands of the UCI.

**Taxation of investors**

A withholding tax of 26 per cent applies to investment income deriving from participation in a UCI. The withholding is assessed on:

- the total of the profits distributed during the period of participation in the UCI;
- the total of the profits included in the difference between the redemption, transfer or liquidation of the shares, and the weighted mean cost of subscription for or acquisition of the same shares; and
- a net of 51.92 per cent of the proportion of the income that is referable to:
  - Italian sovereign bonds and securities and equivalents;
  - bonds issued by foreign states included in the white list; and
  - bonds issued by regional entities of the foreign states (to guarantee a tax rate of 12.5 per cent for such receipts).

The 26 per cent withholding tax is levied as an advance or a final payment of taxes due, depending on the tax status of the investor. The 26 per cent withholding tax is levied as a final payment of tax payable by Italian individual investors that hold units other than in connection with a business activity.

With regard to proceeds paid to corporate investors or commercial entities that are resident in Italy for tax purposes, the 26 per cent withholding tax is levied as an advance payment of the total tax due. Proceeds are considered taxable business income, and are subject to IRES on a cash basis. The 26 per cent withholding tax is not levied on proceeds paid to Italian REIFs, pension schemes identified by the law or Italian UCIs that invest in other Italian UCIs.

**Taxation of non-resident investors**

Proceeds collected by non-resident investors upon a redemption or sale of units, or a periodic distribution of proceeds, are in principle subject to the 26 per cent withholding tax, which is levied as a final payment of taxes due in Italy (provided that the non-resident investor does not have a permanent establishment in Italy to which the proceeds are attributed). However, proceeds realised by certain categories of non-resident investors are exempt from the 26 per cent withholding tax. In this respect, a case-by-case analysis should be performed to identify qualified investors.

If the exemption from the withholding tax provided under the relevant domestic provision does not apply, the 26 per cent withholding tax may be reduced under the provisions of an applicable tax treaty. In the absence of any guidance issued by the Italian tax authorities in respect of tax treaty characterisation of the proceeds in an Italian UCI, it

---

69 The Italian tax authorities confirmed that UCIs that meet the requirements set forth by Article 73 of the Income Tax Code are entities that are considered as ‘subject to tax’. Consequently, UCIs benefit from double taxation conventions and are not subject to withholding taxes otherwise applicable under Legislative Decree No. 239/1996, nor to withholding tax on dividends paid by Italian-resident corporations otherwise applicable under Article 24(4) of Presidential Decree No. 600/1973.

may be argued that this income must be considered interest for tax treaty purposes. This conclusion may be supported by the similarities existing between Italian REIFs and Italian UCIIs under Italian regulatory law.

**iv  Italian SICAFs**

SICAFs are closed-ended collective investment schemes set up as joint-stock companies with fixed capital. Article 9 of Legislative Decree No. 44/2014 extends to SICAFs the tax rules regarding REIFs: should a SICAF invest in real estate assets in accordance with the rules set out by civil law provisions71 or for SICAVs, the SICAF will not be considered a REIF.

**VIII  OUTLOOK**

GDP growth took a slightly positive turn in the first quarter of 2019, and investment continued to increase at a significant pace (though less than in 2017).

Markets and non-bank intermediaries are playing an increasingly important role in allocating resources at both a European and global level. This trend could bring benefits to countries such as Italy, where banks traditionally sit at the centre of financial intermediation. A diversified financial system supports economic growth and mitigates the effects of adverse shocks on production. Deep and liquid capital markets are needed to encourage investment, especially in innovative and long-term projects; specialised operators that facilitate the supply of equity and assist firms in the various stages of their development are also required.

In terms of future challenges, the asset management industry will have to face the sudden development of fintech solutions and the impact of integrating sustainability risks – and, where relevant, other sustainability factors – into organisational requirements, operating conditions, risk management and target market assessment.

Fintech and related products offer a wide range of possibilities and can be instrumental in improving the quality of services offered to clients while providing market players an important competitive edge. They also present further opportunities to fully exploit the advantages of an integrated European financial services market, as they facilitate the distribution of retail products and services on a cross-border basis. Although the benefits of technological change could take some time to fully materialise, innovation is contributing to cost savings, reduced information asymmetry, increased efficiency and competition, and wider access to financial services.

Many asset management companies are planning for the disruption that new technology-based entrants will likely cause to online fund distribution, digital advice and micro-investing with their expertise in digital experience delivery and large customer bases.

MiFID II is also likely to continue to affect the asset management industry (Section II). Indeed, full compliance with this regime has entailed higher costs but also lower profitability; at the same time, it has increased the overall transparency of the burdens and costs clients must bear when receiving investment services and led to more market competition.

The low level of financial expertise among Italian investors still remains an issue, but Italian authorities – continuing last year’s trend – are supporting various initiatives and launching their own.

71 See Article 39(1) of the Italian Financial Act.
Furthermore, while certain gaps in the regulatory landscape – including as concerns the fintech phenomenon – pose a risk to macroeconomic stability and development, they also represent an opportunity for market players in the asset management industry. It is thus becoming ever more crucial to have extensive knowledge of the increasingly sophisticated and complex European financial regulations.
I OVERVIEW OF RECENT ACTIVITY

‘From savings to investments’ has been a government slogan since the late 1990s, expressing its policy to increase Japanese household investment in financial assets. Historically, this policy has had limited success. However, Japanese household assets represent a reported ¥1,800 trillion at the end of March 2019, and encouraging the investment of those assets in growing businesses is one of the most important policies of the ‘third arrow’ of the Abe government’s growth strategy. Investment funds in particular are considered to be an important measure of the success of this investment drive by the Financial Services Agency of Japan (FSA).1 Thanks to the remarkable performance of Japanese listed companies under a relaxed monetary policy and a depreciated yen, the Nikkei average has more than doubled since the Abe government came into power in 2012, and investments made by Japanese households have witnessed impressive gains in the equity markets. The total net assets held by Japanese domestic investment funds for public offer reached a historical high of ¥100 trillion in May 2015 and was at ¥111.5 trillion in May 2019.

However, the total net assets held by Japanese domestic investment funds for public offer is only about 6 per cent of the total value of Japanese household assets. Accordingly, there is room to increase the assets that investment trusts are managing. The FSA is likely to continue to push toward ‘upgrading the asset management capacity’ of individual financial institutions, and review whether financial institutions, under their customer-oriented policy, are providing financial products and services that are genuinely beneficial to customers.

In its Strategic Directions and Priorities 2017–2018, the FSA has declared that in analysing policy issues, it puts emphasis on whether the flow of funds is at the optimum throughout the economy (including the cycle of funds from households to the corporate sector via the capital market and banks) and how to achieve better equilibrium. Asset managers play a key role in allocating household funds to the corporate sector. Many Japanese asset management companies are subsidiaries of securities companies or banks that act as distributors of investment trusts that the asset management companies are managing, or financial holding companies, which are heavily influenced by securities companies or banks. Thus, asset management companies are often criticised as having a tendency to prioritise loyalty to their parent companies (i.e., distributors) rather than their fiduciary duty to their customers (i.e., investors).

---

1 Yasuzo Takeno is a partner and Fumiharu Hiromoto is of counsel at Mori Hamada & Matsumoto.
To address this criticism, the FSA released its Principles for Customer-Oriented Business Conduct in March 2017, which encourage financial institutions in the investment chain, including those engaged in marketing, advisory services, product development and asset management, to:

a. adopt policies on customer-oriented business conduct;
b. provide services to customers fairly and faithfully in the best interest of the customers;
c. properly manage conflicts of interest;
d. clarify details of the fees directly or indirectly payable by customers, and the services that correspond to those fees;
e. provide material information in a simple manner to bridge the information gap with customers;
f. provide services suitable for each customer; and
g. organise internal management systems, such as through compensation packages, to incentivise their employees to pursue the best interest of the customers.

This is called a principle-based approach, where the regulator does not provide detailed rules and financial institutions are encouraged to compete with each other by adopting original measures to pursue best practice. As of 30 June 2018, 1,426 financial institutions, including asset management companies, securities companies, mega-banks, regional banks and insurance companies, have voluntarily adopted policies on customer-oriented business conduct.

As another example of a customer-oriented policy, Japanese regulations regarding both Japanese investment trusts and foreign-domiciled investment trusts that are publicly offered in Japan were amended as of 1 December 2014 and require, inter alia, the manager or investment manager of a fund to manage risks relating to derivatives transactions in accordance with rules adopted in advance by that manager or investment manager. The new regulations also introduced credit risk management regulations, which came into effect on the same day. However, in respect of foreign-domiciled investment trusts, the credit risk management regulations have a grandfather period of five years, during which time the new regulations do not apply to foreign funds that were publicly offered in Japan prior to 1 December 2014 (see Section II.v).

To further encourage investments, the government introduced the Nippon (Japan) individual savings account (NISA), a tax-exempt programme for small investments, in 2014. Under NISA, capital gains and income from investments in listed shares, publicly offered equity investment trusts, Japan real estate investment trusts (J-REITs) and exchange traded funds (ETFs) of up to ¥1.2 million per year are exempt from tax for up to five years. A savings-type NISA was introduced in 2018 in which capital gains and income from investments pursuant to a cumulative investment programme in certain publicly offered equity investment trusts and ETFs that satisfy stringent requirements (e.g., low-cost passive index funds) of up to ¥400,000 per year are exempt from tax for up to 20 years. Investors cannot use both an ordinary NISA and a savings-type NISA in the same year, so they must select which account they will use each year.

In the area of global cooperation in asset management, Australia, Japan, Korea and New Zealand signed a memorandum of cooperation for the Asia Region Funds Passport (ARFP) in April 2016. The ARFP is an international initiative that facilitates the cross-border offering of eligible collective investment schemes, while ensuring investor protection in the
economies participating in the ARFP. ARFP commenced on 1 February 2019 with Japan, Thailand and Australia. New Zealand and Korea are implementing the necessary domestic arrangements.

It is also worth noting that the FSA has listed concrete measures to monitor enhanced international cooperation under which it will participate more actively in discussions on international financial regulations, make its supervision more effective and efficient through enhanced cooperation with foreign authorities, and continue to upgrade its supervisory approaches with reference to those used by other regulators. This push towards cooperation with foreign authorities is likely to give the FSA access to more information on global asset management companies operating in Japan.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

i General

Japanese regulations on asset management vary depending on whether an asset manager has been delegated discretionary authority to manage a client’s assets on the client’s behalf, or whether the asset manager is simply able to provide investment advice. The provision of asset management services in Japan requires registration with the FSA, regardless of whether an asset manager has discretion to manage a client’s assets on the client’s behalf.

Following the enactment of the Financial Instruments and Exchange Act of Japan (FIEA), which replaced the Securities And Exchange Act of Japan in 2007, activities of the general partner of a foreign limited partnership are regulated as asset management business, and in principle require registration under FIEA for the solicitation of investment in Japan (self-solicitation) and the management of the assets of the limited partnership (self-management). Certain exemptions from and exceptions to this registration requirement are available. For example, self-solicitation activities will not require registration if the general partner appoints a registered securities broker as a distributor in Japan and does not itself engage in any solicitation. Self-management activities will be exempt from registration if the interests in the limited partnership are acquired by one or more qualified institutional investors (QIIs) and the number of other investors who are not QIIs but have certain financial expertise is limited.

Which regulations apply to the sale of a foreign investment trust in Japan depends on whether the sale is by public offering or private placement. A public offering requires the filing of a securities registration statement, which is filed and disclosed to the public via the internet, as well as an FSA statement, which is for administrative purposes and is not disclosed to the public. Public offerings of foreign investment trusts must comply with certain investment restrictions, which are intended to prevent excessively risky products that Japanese investment trusts are prohibited from investing in from being offered to the public. Such investment restrictions do not apply to foreign investment trusts sold by way of private placement.

---

ii Regulations applying to non-discretionary investment advisers and discretionary investment managers

The Japanese regulations classify investment managers into two categories: non-discretionary advisers and discretionary investment managers.

Non-discretionary advisory business

Non-discretionary advisory business is business providing advice on the value of securities or investment decisions based on the value of financial instruments in return for fees.

Providing advice on the value of securities or investment decisions based on the value of financial instruments through newspapers, magazines or books available to the public will not fall under the scope of non-discretionary advisory business. However, the provision of advice through a website requiring readers to register as members to pay fees where that advice is not otherwise publicly available will likely fall under the scope of non-discretionary advisory business.

Discretionary investment management business

Investment management business is divided into the following four subcategories:

a. investment management business managing assets of an investment corporation established under the Investment Trust and Investment Corporation Act (ITICA) by investing in securities or derivatives under an asset management contract with an investment corporation (investment corporation asset management services);

b. investment management business managing assets of an investor by investing in securities or derivatives under a discretionary investment management contract (discretionary investment management services);

c. investment management business managing assets of an investment trust under ITICA (including foreign investment trusts) by investing in securities or derivatives, and acting as a settlor of such investment trust (investment trust management services); and

d. investment management business managing assets of a collective investment scheme, which is generally a partnership (not including corporate type collective investment schemes) such as a partnership under the Civil Code of Japan, a silent partnership under the Commercial Code of Japan, an investment business limited partnership under the Investment Business Limited Partnership Act of Japan, a limited liability partnership under the Limited Liability Partnership Act of Japan or any similar foreign entity as a general partner of such collective investment scheme by investing predominantly in securities or derivatives (collective investment scheme management services).

With regard to items (a) and (b), if the managed assets include real property, the investment manager is required to have a real property transaction licence under the Land and Building Transaction Act of Japan (LBTA). If the assets managed are predominantly invested in real property, the investment manager is required to have a transaction discretionary representation approval under the LBTA. In addition, the management of the assets of an investment corporation (item (a)) or an investment trust (item (c)) by investing in real property falls under the definition of ‘specified investment management activities’ and requires approval from the FSA under ITICA. Almost all listed J-REITs are classified under item (a) (investment corporation) rather than item (c) (investment trust).

With respect to item (b), if the managed assets are invested in the beneficiary interests of a trust whose underlying assets are real property, such management is referred to as real
property-related specified investment management and requires registration as a general real
property investment adviser under the Real Property Investment Advisory Rules governed
by the Ministry of Land, Infrastructure, Transport and Tourism of Japan (MLIT) as a
prerequisite to the registration of the discretionary investment management services.

In a wrap account or separately managed account (SMA), assets deposited in the SMA
are managed by investing in shares, bonds or other financial instruments in accordance
with the investment policy agreed from the outset. As the operators of SMAs are given the
trading authority to manage an account by investing in securities, their services are classified
as discretionary investment management, and the operator must be registered to provide
discretionary investment management services.

Exceptions

A non-discretionary investment adviser or discretionary investment manager located and
licensed in a foreign jurisdiction may provide, respectively, non-discretionary investment
advice or discretionary investment management services to a registered Japanese discretionary
investment manager without requiring registration under FIEA.

Investment trust management services include management of a foreign investment
trust. This is intended to capture the situation where a Japanese investment manager directly
manages a foreign investment trust within the scope of the investment trust management
services. However, if a person conducting investment management business outside of Japan
pursuant to a foreign law manages a foreign investment trust, this activity will not fall under
the scope of investment trust management services, and so will not require registration under
FIEA.

iii Registration of discretionary management business and non-discretionary
advisory business

Registration of non-discretionary advisory business

Registration is normally required under FIEA for any person wishing to operate a
non-discretionary advisory business in relation to securities or derivatives (an investment
advisory business). Any individual or corporation may register to perform investment
advisory business once it has met the various requirements for qualification. These include
the satisfaction of certain registration requirements, for example, having in place compliance
systems appropriate for an investment advisory business. Successful registration also requires
the deposit of ¥5 million with the governmental deposit office. Registration further requires an
investment adviser to comply with certain conduct rules, including (for example) a restriction
on providing advice to customers that is designed to encourage entry into transactions that
would harm their interests while promoting another customer’s interests.

Successful registration of an investment advisory business also gives rise to a number of
administrative obligations, such as the preparation of business reports for each business year,
and submission of those reports to the FSA. The investment adviser will also be required to
prepare and maintain books and documents in relation to the investment advisory business.

Registration of discretionary management business

To be registered as a discretionary investment manager, a person must meet a number of
requirements, including the entity requirement. Under this restriction, only a joint-stock
corporation incorporated under the Corporation Act of Japan and having a board of directors
and a corporate auditor or a committee, or a foreign company that is similarly organised and has a business office in Japan, is eligible to register as a discretionary investment manager. The prospective discretionary manager must also meet the minimum capital amount and net worth requirements (in each case, ¥50 million or more), and certain compliance system requirements such as a personnel structure appropriate to engage in discretionary investment management.

In contrast to the requirements of an investment advisory business, the requirements for registration as a discretionary investment manager are significantly more onerous. Like a non-discretionary investment manager, a registered discretionary investment manager is subject to certain codes of conduct and is, for example, restricted from implementing investments that lead to transactions with itself, or to transactions involving any other assets managed by it. It is also required to prepare and maintain books and documents in relation to its investment management business, and prepare yearly business reports for submission to the FSA. A registered discretionary investment manager providing investment corporation asset management services or investment trust management services is also subject to certain additional obligations under ITICA, such as a duty to procure a third-party appraiser to investigate the asset value when investing in real property.

A registered discretionary investment manager is in principle prohibited from engaging in any businesses other than financial instruments transactions, in order to insulate the discretionary investment management business from risks unrelated to financial instruments transactions. That said, a registered discretionary investment manager is permitted to engage in certain businesses that are ancillary to financial instruments transactions, such as M&A advisory and business consulting. On making further filings with the regulator, a registered discretionary investment manager will be permitted to engage in certain other businesses, such as commodities-related business, money lending and real property brokerage.

iv Fund regulations

Self-solicitation

Solicitation by an issuer of certain securities, including units of a Japanese or foreign investment trust, or interests in a Japanese or foreign collective investment scheme, such as Japanese silent partnerships or foreign limited partnerships, is regulated as self-solicitation under FIEA.

An issuer of a Japanese or foreign investment trust or collective investment scheme who solicits for its own securities is in principle required to be registered as a Type II financial instruments transaction business. However, if it retains a distributor for the securities it issues, and does not make any solicitation itself, no registration will be required.

The issuer of a Japanese investment trust is the trust settlor, and in that capacity it will also act as the trust manager. How the issuer of a foreign investment trust will be classified will depend on the applicable governing law and documents. If a foreign investment trust is established by a bilateral trust deed between the manager and the trustee, and the governing law or document provides that units of the trust are issued by the manager, the manager will be the issuer of the investment trust. As a result, this will amount to self-solicitation, and the issuer will need to be registered on that basis to offer its own securities in Japan. If a foreign trust is established by a unilateral declaration of trust by the trustee, the trustee will be the issuer. To avoid the registration requirement of self-solicitation, the issuer (who is the manager or the trustee, as the case may be) must have a Japanese distributor, and not engage in any solicitation itself.
In collective investment schemes, the managing partner or general partner of a Japanese or foreign limited partnership, or the business operator of a Japanese silent partnership, will be the issuer of the securities.

**Self-management**

Management of assets by operators of certain funds, including Japanese or foreign collective investment schemes, is regulated as self-management under FIEA, and requires registration to offer collective investment scheme management services if the fund invests more than 50 per cent of its assets in securities or derivatives. Typical examples of such collective investment schemes are Japanese or foreign limited partnerships and Japanese silent partnerships.

Prior to the enactment of FIEA, which replaced the Securities and Exchange Act of Japan in 2007, management of assets by such fund operators was regarded as management of the operator’s own assets, and was outside the scope of the regulation. However, the FIEA regulations, having been extended to catch such management activities by fund operators, now recognise this as management of investors’ assets.

**Qualified institutional investors exemption**

The registration requirements for carrying out a Type II financial instruments transaction business (in cases of self-solicitation) and discretionary investment management (in cases of self-management) are waived if the QII exemption under FIEA is available.

The QII exemption is available if the investors of a collective investment scheme together consist of at least one or more QIIs and up to 49 non-QII specified investors. Where the QII exemption is used to avoid registration as a Type II financial instruments transaction business, additional transfer restrictions apply so that the QIIs are prohibited from selling their interests in the collective investment scheme to anyone other than QIIs and the non-QII specified investors are prohibited from selling their interests other than by selling their interests as a whole to a QII or a non-QII specified investor.

The rationale for this exemption is that a QII usually has enough financial expertise and bargaining power against fund managers to prevent the latter from setting up and managing a fund that is one-sidedly disadvantageous to the investors. A QII under the QII exemption is expected to monitor the fund manager on behalf of the non-QIIs.

To take advantage of the QII exemption, a filing with the regulator needs to be made in advance. In the case of self-solicitation, the issuer of the collective investment scheme will make this filing, while in the case of self-management, the manager of the collective investment scheme will make the filing. The issuer or the manager (as the case may be) will normally be the general partner in the case of a limited partnership, or the business operator in the case of a Japanese silent partnership. The filing document can be prepared in English.

QIIs include banks, insurance companies, securities companies and other operators carrying out financial instruments transaction business. Business corporations can be recognised as QIIs if they have securities investments greater than ¥1 billion and make an additional filing with the FSA.

The QII exemption has been widely used, not only for domestic collective investment schemes, such as nin-i kumiai partnerships and tokumei kumiai (TK) partnerships, but also for foreign partnerships. However, it has been occasionally abused by putting in a sham QII, such as an affiliate of the general partner or another investment partnership managed by the general partner, which could not be expected to monitor the general partner. FIEA
was amended, and the requirements for the QII exemption were strengthened, effective 1 March 2016. This amendment has a grandfather period for some of the new requirements, where collective investment schemes existing as of the effective date are given a six-month period to comply with the new requirements.

In the amendments, non-QII specified investors that can invest in products offered under the QII exemption are limited to:

a certain sophisticated investors, including:

1. financial instruments business operators (such as securities firms);
2. corporations listed in Japan;
3. corporations and other legal entities with capital or net assets of ¥50 million or more;
4. subsidiaries and affiliates of those listed in (1) to (3);
5. pension funds with investment assets of ¥10 billion or more; and
6. individuals with investment assets of ¥100 million or more; and

b persons closely related to QII-targeted fund operators, including directors, employees, parent companies, subsidiaries and affiliates of QII-targeted fund operators.

This investor qualification requirement is relaxed as to venture funds investing 80 per cent or more of their investment assets in non-listed corporations. Among others, directors, employees with professional capabilities who are indispensable to the business and consultants, all of which are engaged in the establishment of the company, issuance of equity securities, and the inception of a new business or initial public offering, are also able to invest under the QII exemption as non-QII specified investors.

QIIs who may invest under the QII exemption are also limited in order to prevent the abuse of the exemption by creating a sham QII. Limited liability investment partnerships with investment assets of less than ¥500 million (less the amount of borrowings) and subsidiaries of QII-targeted operators no longer qualify as QIIs under the QII exemption.

The names of the QIIs that invest under the QII exemption must be stated in the filing document. If a fund operator is a foreign entity, it is required to appoint a representative in Japan. Such representative in Japan is supposed to act as a contact with regard to the regulator. Certain information in the filing document is disclosed to the public by the regulator, including the number (but not the names) of the QIIs. Fund operators using the QII exemption are required to file annual business reports within three months from the end of each fiscal year. In addition, starting on the day after the four-month period following each fiscal year, fund operators are required to make available to the public for one year the annual business report or, in lieu thereof, a separately prepared disclosure document.

Fund operators may de-register their QII exemption if they no longer solicit investors in Japan through self-solicitation; and the number of Japanese investors and the volume of the investment from Japan in terms of amount are relatively small, and the exception to self-management for foreign collective investment schemes (or the de minimis exception, described below) is available.

When a fund operator deregisters its QII exemption, it will be released from the obligations under a QII exemption, including periodic filing and disclosure requirements.

**Exception to self-management by delegation of all management authority**

If a general partner or similar entity of a collective investment scheme delegates its entire investment authority to a discretionary investment manager, the management activity of
that general partner or similar entity will be excluded from the scope of collective investment scheme management services, and registration as a discretionary investment manager will not be required.

**Exception to self-management for foreign collective investment schemes**

Where investments from Japan to a foreign collective investment scheme are limited, the management activity of the general partner or similar entity of the foreign collective investment scheme is excluded from the scope of the collective investment scheme management services (the *de minimis* exception). Specifically, the following requirements must be met: Japanese investors directly or indirectly investing in the foreign collective investment scheme are QIIs only; the number of such Japanese investors is less than 10; and the total contributions from such Japanese investors are less than one-third of the total contributions of all investors in the collective investment scheme.

**v Sale of a foreign investment trust in Japan**

**Public offering of a foreign investment trust in Japan**

**JSDA requirements**

For a foreign investment trust to be publicly offered in Japan, the foreign investment trust needs to satisfy certain requirements set out by JSDA, a self-regulatory body of securities companies acting as distributors in the context of foreign investment trusts. A member of JSDA cannot engage in a public offering of a foreign investment trust that does not satisfy the JSDA requirements. Most of the JSDA requirements do not apply to a private placement of a foreign investment fund, and thus members of JSDA may engage in such private placements.

The JSDA requirements for the public offering of a foreign investment trust include:

- **a** the net asset value of the fund is, or is expected to be after the public offering in Japan, greater than ¥100 million;
- **b** the net asset value of the management company of the fund that is the issuer of units of the fund is greater than ¥50 million. The JSDA requirements appear to assume that a foreign investment trust publicly offered in Japan will be established by a bilateral trust agreement between a management company and a trustee. As a result, most foreign investment trusts publicly offered in Japan are established by bilateral trust deeds, as opposed to a unilateral declaration of trust;
- **c** the Japanese courts have jurisdiction over lawsuits relating to transactions through which a Japanese investor will acquire units in the trust;
- **d** an agent company of the fund is appointed in Japan: a distributor of the fund in Japan (i.e., a Japanese securities company) is usually appointed as the agent company. The agent company is required to confirm whether the JSDA requirements have been satisfied before making the public offering, and will disclose the net asset values of the fund to the public following the public offering;
- **e** the amount of securities sold short does not exceed the net asset value of the fund;
- **f** borrowing by the fund is generally less than 10 per cent of the net asset value of the fund;
- **g** voting rights in any company held by the fund and other funds managed by the management company do not exceed 50 per cent of the total voting rights of that company;
the exposure to derivative transactions is to be calculated in accordance with a reasonable method set in advance by the management company or the investment manager, and does not exceed the net asset value of the fund. This requirement was introduced on 1 December 2014 with no grandfather arrangement; and credit concentration risks borne by the fund are managed in accordance with a reasonable method set in advance by the management company or the investment manager. This requirement was introduced on 1 December 2014. A grandfather arrangement exists whereby the requirement does not apply for a period of five years to existing funds publicly offered in Japan prior to 1 December 2014.

When a foreign investment trust is a master feeder fund and a feeder fund is publicly offered in Japan, the question arises as to whether the JSDA requirements will be applicable only to the feeder fund or also to the master fund – in other words, whether the feeder fund will be looked through to consider the master feeder fund as well. Currently, the general practice is to apply the JSDA requirements to the feeder fund only, and not to look through it to the master fund. The exception to this is the credit concentration restriction, which cannot be complied with unless one looks through the feeder fund to the master fund because all of the feeder fund’s assets are invested or concentrated in the master fund.

Disclosure: securities registration statement and prospectus

The issuer of a foreign investment trust (i.e., the management company of the fund) must file a securities registration statement with the regulator in advance via EDINET, a web-based disclosure system managed by the FSA. The securities registration statement is a disclosure document under FIEA of securities that are publicly offered in Japan and is disclosed to the public through the internet. Once filed, the securities registration statement becomes effective after 15 clear days. Solicitation of investment into the securities can be made before the securities registration statement becomes effective, but execution of the investment cannot be made until the securities registration statement becomes effective and a mandatory prospectus is delivered to the investor.

The prospectus of an investment trust consists of a mandatory prospectus and a prospectus upon request. The contents of the prospectus upon request are substantially similar to those of the securities registration statement with minor adjustments and omissions. The mandatory prospectus is a summary of the prospectus upon request. The mandatory prospectus needs to be delivered to investors on or prior to execution of the purchase of the securities. The prospectus upon request is delivered to investors only where specifically requested by investors.

FSA filing

Pursuant to ITICA, the issuer of a foreign investment trust that is publicly offered in Japan must file an FSA statement with the FSA immediately before the securities registration statement becomes effective. Most of the contents of the FSA statement overlap with those of the securities registration statement and as a result, the FSA statement is usually prepared by reprocessing the necessary information from the securities registration statement. The FSA statement is for administrative purposes only, and is not disclosed to the public.
Private placement of a foreign investment trust in Japan

Private placement of securities in Japan is classified into two categories (minor variations aside): private placement to QIIs only and private placement to small numbers of investors.

In a private placement for QIIs only, investors are limited to QIIs. There is no limit to the number of QIIs who may invest in a private placement. QIIs are, however, prohibited from selling on their securities to non-QIIs.

In a private placement to a small number of investors, the number of investors in a private placement is limited to 49. The investors are prohibited from selling their securities unless they are transferring their securities to a single investor as a whole. This restriction ensures that the cap on the total number of investors is not breached.

Neither a securities registration statement nor a prospectus is required if a foreign investment trust is offered in Japan by way of private placement.

However, an FSA statement needs to be filed even for the purposes of a private placement before any solicitation of investment is made in Japan. While an FSA statement in a public offering is filed after the securities registration statement is filed (i.e., where solicitation has begun but before the securities registration statement becomes effective), the FSA statement in a private placement must be filed prior to any solicitation in Japan.

A solicitation made in Japan by the issuer of a foreign investment trust (in the case of a bilateral trust deed type unit trust, the manager, or in the case of a unilateral declaration of trust type unit trust, the trustee) is regarded as self-solicitation under FIEA and requires registration as a Type II financial instruments transaction business (see Section II.iv). If a distributor is appointed in Japan (usually a securities company) and the issuer of the foreign investment trust does not engage in any solicitation, this registration requirement is not triggered.

Investment from Japan to a foreign investment trust without any solicitation in Japan

It may be that a Japanese investor, usually a sophisticated institutional investor, approaches a foreign investment trust without any solicitation made in Japan by the foreign investment trust and makes an investment in the foreign investment trust. In such cases (sometimes referred to as ‘reverse marketing’), an FSA statement of the foreign investment trust is not required on the basis that there has been no solicitation in Japan.

It is a matter of fact as to whether there has been any solicitation in Japan; however, it should be stressed that if a foreign investment trust has any involvement in Japan through a subsidiary, or an affiliate or representative office, there may be a risk that the activities of such entities are regarded as soliciting investment in the foreign investment trust.

III COMMON ASSET MANAGEMENT STRUCTURES

i Investment trusts and investment corporations

For retail or institutional investors seeking a diversified portfolio investment in shares and bonds, Japanese and foreign investment trusts are commonly used. For retail investors, investment trusts are sold through public offerings.

The Investment Trust Association of Japan (ITAJ) is a self-regulatory body of Japanese investment managers engaging in the management of investment trusts, and sets out certain requirements that publicly offered Japanese investment trusts must satisfy. The ITAJ requirements are quite similar to the JSDA requirements that foreign investment trusts that
are publicly offered in Japan must satisfy. Publicly offered Japanese investment trusts and publicly offered foreign investment trusts are intended to stand on an equal footing through the ITAJ requirements and the JSDA requirements.

There are two ways to bring a foreign investment trust to Japan for public offering. One is to directly make a public offering of the foreign investment trust. The other is to set up a Japanese investment trust that will invest in the foreign investment trust. There are certain complications with the latter approach. A publicly offered Japanese investment trust is generally restricted from investing in a foreign fund of funds under the ITAJ rules. As such, if the foreign investment fund to be brought into Japan is a fund of funds, it will not be possible to use a Japanese investment trust as a feeder fund. In addition, a Japanese investment trust acting as a fund of funds is generally required to make investments into multiple funds. When a foreign investment trust is brought into Japan through a Japanese investment trust as feeder fund, the feeder fund therefore invests a small portion of the fund’s assets into a money management fund to satisfy this diversification requirement. This investment aside, the remainder of the feeder fund’s assets will be invested in the foreign investment trust.

For institutional investors pursuing a diversified portfolio investment in shares and bonds, Japanese or foreign investment trusts are usually sold through private placements. A private placement of a foreign investment trust will still require an FSA statement to be filed in advance (see Section II.v).

For retail or institutional investors who wish to have a portfolio investment in real property, J-REITs are commonly used. Shares in many J-REITs are listed on Japanese securities exchanges. The number of privately placed J-REITs whose shares are not listed has recently been increasing. For regulatory issues relevant to J-REIT investment managers, see Section II.v.

ii Collective investment schemes: limited partnerships, TK-GK

For PE investments, limited partnerships in Japan and in foreign jurisdictions such as the Cayman Islands or Delaware are commonly used.

For institutional investors who want to invest in relatively limited real properties, a TK-GK scheme on a private placement basis is common. The term TK-GK refers to a silent partnership under the Commercial Code of Japan, where an investor makes a financial contribution to an operator and the operator conducts business under its own name. The identity of the TK investor is not disclosed to third parties who engage in transactions with the TK operator. A TK is a pass-through entity, where the TK itself is not a taxable entity in respect of profits generated from the TK business, and profits and losses are allocated to the TK investor and taxed at the TK investor level. A GK is a corporation under the Corporation Act of Japan that is similar to a limited liability company in foreign jurisdictions in that it exhibits some of the features of both a partnership and a corporation. However, unlike a limited liability company in other jurisdictions, a GK is not a pass-through entity. When investing in real property, a TK-GK cannot directly invest or hold real property for regulatory reasons. Accordingly, a TK-GK will invest in trust beneficiary interests, the underlying assets of which are real property. Trust beneficiary interests are securities under Japanese law; thus, a TK-GK investing in real property trust beneficiary interests is subject to regulation under FIEA.

Foreign or Japanese limited partnerships and TK-GK are collective investment schemes under FIEA. See Section II.iv, for the regulatory issues affecting collective investment schemes under FIEA.
iii  TMK

TMKs are also common as investment vehicles for institutional investors who are seeking a limited and tailored portfolio of loans and real property. A TMK is a specified purpose company used for the securitisation of assets, including loans and real property. TMKs are pay-through entities where, if more than 90 per cent of the profits are distributed to the TMK’s investors (i.e., preferred shareholders), such amount is deducted as an expense from its corporate income. A TMK is able to directly hold real property, as well as real property trust beneficiary interests.

IV  MAIN SOURCES OF INVESTMENT

Japanese pension funds remain the dominant investors in the Japanese asset management market, despite the notorious 2012 \textit{AIJ} scandal (see Section VI.ii). According to surveys by the Japan Investment Advisers Association, the total amount of Japanese pension fund assets under discretionary investment management by Japanese investment managers as of March 2019 was approximately ¥153 trillion, an increase of approximately ¥14 trillion from the previous year. In comparison, the total amount of assets under discretionary investment management by Japanese investment managers as of March 2019 was approximately ¥255 trillion. Foreign investors, including foreign institutional investors and offshore funds, are also important investors for Japanese investment managers, with total foreign investor assets under discretionary investment management amounting to ¥33 trillion as of March 2019.

V  KEY TRENDS

In terms of the scale of assets held by residents of Japan under investment trusts, investment management agreements and investment advisory agreements, the total amount of assets decreased in the wake of the global financial crisis, and did not rise again until the Abe government came into power. When Abenomics began in 2013, the total assets under management increased. According to the Japan Investment Advisers Association, as at the end of March of each year, amounts under management, including investment management, real property investment management, wrap business and fund management, were as follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amounts under management (¥ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>150,689</td>
</tr>
<tr>
<td>2009</td>
<td>141,502</td>
</tr>
<tr>
<td>2010</td>
<td>160,599</td>
</tr>
<tr>
<td>2011</td>
<td>155,697</td>
</tr>
<tr>
<td>2012</td>
<td>156,629</td>
</tr>
<tr>
<td>2013</td>
<td>183,873</td>
</tr>
<tr>
<td>2014</td>
<td>197,931</td>
</tr>
<tr>
<td>2015</td>
<td>232,343</td>
</tr>
<tr>
<td>2016</td>
<td>242,624</td>
</tr>
<tr>
<td>2017</td>
<td>261,633</td>
</tr>
<tr>
<td>2018</td>
<td>307,888</td>
</tr>
<tr>
<td>2019</td>
<td>344,236</td>
</tr>
</tbody>
</table>
One of the most important purposes of the financial monitoring policy of the FSA is to further accelerate investment flows out of bank savings. The FSA emphasises the importance of appropriate management of the massive amount of funds and assets invested by households, pension funds and institutional investors in line with the characteristics of each fund and asset and the needs of asset owners. The FSA also emphasises the importance of individual financial institutions fulfilling their roles and responsibilities in all functions involved in asset management, including product origination, financial product sales, portfolio management and asset management itself. Financial institutions’ efforts to improve their asset management capabilities will create a virtuous cycle, facilitating steady asset formation for Japanese citizens, accelerating investment flows further, and contributing to the medium to long-term growth of asset managers and relevant markets.

VI SECTORAL REGULATION

i Insurance

Variable insurance operates similarly to an investment trust. In variable insurance, the insurance premiums are managed by investment in shares, bonds and other assets, and the insurance proceeds and termination repayments depend upon the performance of the investments. While the costs associated with variable insurance are relatively higher than those of regular investment trusts, variable insurance remains a key investment alternative due to certain advantages it provides. For example, the insurance premiums of variable insurance are tax-deductible (subject to certain limitations). As variable insurance does not provide for distributions to investors during the investment period, tax that would be imposed on the distributions of an investment trust is deferred until the payment of insurance money or termination of the insurance. If an heir is designated as payee of the insurance money, the heir is able to enjoy an estate tax exemption of up to ¥5 million per heir.

In light of their similarity to investment trusts, certain regulations dealing with the marketing of investment trusts under FIEA apply mutatis mutandis to the marketing of variable insurance. Among other requirements, an explanatory paper must be delivered to a purchaser of variable insurance on or prior to execution of the contract. Items to be described in this explanatory paper are similar to those required by a prospectus prepared in respect of an investment trust. While the distributors’ fee for investment trusts must be disclosed to investors, the distributors’ fee for insurance products is not required to be disclosed. The FSA sees this as a problem and, as a result of the strong pressure it applied, in October 2016, mega-banks and many regional banks began to voluntarily disclose the distributors’ fee for certain insurance products that have the nature of investment products, such as variable insurance.

ii Pensions

Assets of Japanese pension funds are managed by:

a trust banks;
b insurance companies;
c discretionary investment managers; or
d the pension funds themselves.

Scenario (d), in which a pension fund manages itself, is called in-house management, and is permitted only for pension funds equipped with sufficient human resources. When the assets
of a Japanese pension fund are managed by a discretionary investment manager under (c), the pension fund must also enter into a trust agreement with a trust bank under which the pension fund entrusts the managed assets to the trust bank. The management authority over the trust asset is then delegated to the discretionary investment manager. This arrangement is necessary because discretionary investment managers are prohibited from being entrusted with managed assets.

In the AIJ case that came to light in 2012, the discretionary investment manager, AIJ Investment Advisory Co, Ltd, entered into discretionary investment management agreements with a number of pension funds and invested the managed assets heavily into a Cayman unit trust managed by its affiliate. The assets of the pension funds were entrusted with Japanese trust banks that held units of the Cayman unit trust. The discretionary investment manager and its affiliated manager of the Cayman unit trust manipulated the net asset values (NAVs) of the Cayman unit trust for a long period of time. The total loss of the pension funds reportedly amounted to approximately ¥200 billion. The registered unitholder of the Cayman unit trust was a securities company acting as the distributor of the unit trust in Japan, which was reportedly also affiliated with the discretionary investment manager and failed to forward the correct information received from the trustee or administrator of the Cayman unit trust to the trust banks and the pension funds.

Following the revelations in the AIJ case, regulations surrounding asset management of pension funds have been tightened. Among other measures, trust banks acting as trustees of a pension fund’s assets are now required to take measures to ensure they are able to directly access NAVs and the audited reports of funds to which they act as trustees. Pension funds are also required to set out rules regarding investment diversification, which is encouraged in order to avoid concentration in a limited number of products.

iii Real property
For retail and institutional investors who wish to have a large and diversified real property portfolio, real estate investment corporations or J-REITs are commonly used. J-REIT investment managers must have a real property transaction licence and an approval of transaction discretionary representation under the LBTA, and must be registered for discretionary investment management (see Section II.ii).

Investment managers to TK-GK structures, which are preferred by institutional investors looking for relatively limited and tailored real property portfolios, are required to hold a real property transaction licence under the LBTA, a registration as a general real property investment adviser under the Rules for Registration of Real Properties Advisory Businesses (which are not laws or regulations, but notices issued by the MLIT), and a registration of real property-related specified investment management, a subcategory of discretionary investment management services.

iv Hedge funds
The rationale behind hedge fund regulation is to protect investors in light of the complexity and high risks associated with hedge fund products, and to protect the stability of financial systems. The latter point arises as it is felt that hedge funds, which are significantly sized entities, have complicated investment techniques and are closely integrated with financial systems, pose a potential systemic risk if not appropriately regulated.

Regarding the protection of investors, hedge funds are subject to the same regulations applicable to other financial products. For example, if a hedge fund is structured as a collective
investment scheme, or a Japanese or foreign limited partnership, the marketing of the hedge fund in Japan by its manager will be treated as self-solicitation and require registration as a Type II financial instruments transaction business (unless the QII exemption is available); and the management of a hedge fund by its manager will be treated as self-management and require registration as a discretionary investment management business (unless the QII exemption or the de minimis exception is available).

Currently, no hedge fund-specific regulations exist that attempt to maintain financial system stability.

v Private equity
Both partnerships under the Civil Code of Japan and investment business limited partnerships under the Investment Business Limited Partnership Act are commonly used for private equity funds. These partnerships are treated as collective investment schemes and are subject to the same regulations on marketing (self-solicitation) and management (self-management).

VII TAX LAW
A summary of the general taxation system of Japan currently in effect in relation to investment funds and other asset management activities is discussed below. Tax treatment may vary according to the type of investor and fund, and other factors, and may be affected by subsequent changes in any relevant tax laws or tax authority decisions.

i Taxation of investment funds
Investment trusts
A securities investment trust and a publicly offered investment trust will not be subject to taxation with respect to any profits gained through the management of the trust property. A securities investment trust is an investment trust that invests more than 50 per cent of its assets in securities based on the instructions of the settler.

In the case of investment trusts other than securities investment trusts and publicly offered investment trusts, the trustees, rather than the trusts themselves, will be subject to corporation tax with respect to profits gained through the management of the trust property.

Investment corporations
Investment corporations will, in principle, be subject to corporation tax with respect to profits gained through the management of assets. However, if an investment corporation meets certain requirements, any distribution will be treated as a loss when calculating the investment corporation’s income for the business year. As a result, the tax imposed on profits can be minimised. The requirements referred to above include that the investment corporation’s issued equity is held by 50 or more investors, or by financial institutions only; the amount of its equity interests solicited in Japan exceeds 50 per cent of the total amount thereof; and distributed amounts in a single business year exceed 90 per cent of the total amount of the investment corporation’s distributable profits in that business year.
Collective investment schemes

Partnerships, silent partnerships, investment limited partnerships and limited liability partnerships are not subject to taxation. However, the relevant entity’s partner will be subject to taxation with respect to profits gained through the management of assets thereof.

Under Japanese tax laws, a foreign entity similar to the above will not, in principle, be subject to taxation with respect to profits gained through the management of assets thereof. Recently, however, the Supreme Court of Japan ruled that Delaware limited partnerships should be classified as corporations for tax purposes. This is the first Supreme Court decision to establish criteria for foreign entity classification. The Court explained that to determine if an entity is a corporation for tax purposes, one needs to consider if the entity has the legal attributes of a separate taxpayer, focusing on the rights and obligations relating to the entity’s activities. The Court said that the first question is whether the entity is clearly defined under the law of incorporation as a corporation, or simply as an aggregate of its members. The second question is whether the entity can separately have a proprietary interest in its assets, and be liable for debts and obligations incurred as a result of its legal acts under the law of incorporation. Where an entity is deemed to be a foreign corporation, the entity’s partners may not deduct the entity’s losses from their tax returns.

ii Taxation of investment managers

An investment manager that is a corporation will be subject to corporation tax, and an investment manager who is an individual will be subject to income tax, with respect to any management fees or similar compensation received.

iii Taxation of overseas investors

A non-resident investor or a foreign corporate investor (an overseas investor) will currently, in principle, be subject to income tax or corporation tax as follows with respect to income obtained from sources within Japan.

Investors in an investment trust

An overseas investor investing in an investment trust will be subject to income tax at a rate of 15.315 per cent with respect to distributions made by an investment trust.

In addition, overseas investors investing in investment trusts will be subject to income tax or corporation tax at a rate of 15.315 per cent with respect to capital gains from cancellation or redemption of beneficial interests. These tax rates may be affected by relevant tax treaties.

Investors in investment corporations

Currently, an overseas investor investing in an investment corporation will be subject to income tax at a rate of 15.315 per cent with respect to distributions made by the investment corporation.

In addition, a non-resident individual investor having no permanent establishment in Japan will not be subject to income tax with respect to capital gains arising from the transfer of an equity interest (except in certain limited cases, such as a transfer of shares of real estate-related corporations). Even where a non-resident individual investor is subject to income tax with respect to capital gains arising from the transfer of an equity interest, the tax rate may be affected by a relevant tax treaty.
Investors in collective investment schemes

Under Japanese tax laws, an overseas investor investing in a partnership, investment limited partnership or limited liability partnership will be subject to income tax at a rate of 20.42 per cent with respect to distributions of profits thereof if such investor is deemed to maintain a permanent establishment in Japan by the relevant tax authorities. The tax rate may be affected by a relevant tax treaty. However, in the case of an investment limited partnership, if an overseas investor meets certain requirements (including that such investor is a limited partner and is not the direct executor of the business of the investment limited partnership), the investor may be deemed not to maintain a permanent establishment in Japan if it files an application on this basis with the tax authority.

An overseas investor investing in a silent partnership, with or without a permanent establishment in Japan, will be subject to income tax at a rate of 20.42 per cent with respect to distributions of profits thereof.

VIII OUTLOOK

Given that the portion of household finances allocated by Japan households to investments (including shares, bonds and investment funds) is pretty small compared with other developed countries, and that most of those finances are disproportionately allocated to cash and bank deposits, the ‘from savings to investments’ policy is expected to continue. To encourage households to increase their investments, financial institutions, including asset managers and distributors, are encouraged by the FSA to adopt their own policies regarding customer-oriented business conduct. Financial institutions are also urged to compete with each other in reshaping their business practice in order to best serve their customers.

Under the prolonged low-interest policy of the Bank of Japan, Japanese banks, especially regional banks, have been seeing a decline in their profits from their core lending business and are struggling to survive. This development will encourage them to be more active in the distribution business of investment funds, which remains profitable.

The ARFP took effect from February 2019 with Japan, Thailand and Australia. However, there appear to have been no active moves among Japanese asset management companies or distributors to utilise the ARFP, although their official statement on the matter is that they are internally examining or preparing for it. As it is relatively easy to import foreign-domiciled funds into Japan even without the ARFP, it is likely that the use of the ARFP in importing foreign funds into Japan remains marginal.
I OVERVIEW OF RECENT ACTIVITY

The asset management market in Lebanon is in a transitionary and transformative phase, while still being challenged by a dominant traditional banking services and products market which offers high returns on deposits thus hindering the creation of nurturing market conditions.

Further, narrowing profit margins worldwide and stagnant local economic conditions exacerbate the pressure on asset management companies in Lebanon (henceforth Lebanese asset managers). In this challenging environment, front runner firms have been working strategically on key areas such as restructuring their product portfolios to meet higher investor demands, streamlining their operations (importantly including those of their front office) by utilising technologically advanced platforms, and creating unique digital-based customer experiences aligning with the demands as well as opportunities of a digital era.

The Lebanese asset management industry comprises an ecosystem of mainly international participants, mostly of EU domicile, with a number of local asset managers, being foremost investment arms of big local financial players, offering a broad spectrum of investment funds, while certain participants have a niche strategy of specialising in alternative investment funds.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

i Asset management supervision

The Capital Markets Authority (CMA) is an independent, administrative body, set up by way of Law No. 161 of 17 August 2011 (the Capital Markets Law), which is entrusted with duties to protect savings invested in financial instruments, organise the availability of information to those distributing financial instruments to the public, and ensure the integrity of the financial markets in Lebanon.

With regard to asset management, the CMA is the primary prudential supervisor of Lebanese asset managers as well as the investment funds they manage. The main duties of the CMA include:

a issuing of regulations and decisions for a licensed institution (‘approved institution’) (which encompasses asset managers), including in relation to licensing procedures
applicable to a collective investment scheme manager (CIS manager) and investment funds, as well as the rules applicable to the activities of collective investment scheme custodians (CIS custodians);
b licensing of Lebanese asset managers and investment funds, including securitisation funds;
c prudential and ongoing supervision of Lebanese asset managers and investment funds offered to retail clients;
d review, inquiry and investigation of the activities of CIS managers and CIS custodians (including inspections on-site);
e imposition of administrative sanctions on CIS managers, investment funds and CIS custodians in the event of breach of applicable laws and regulations; and
f supervision of the marketing of Lebanese and foreign investment funds (with emphasis on Lebanese investment funds marketed to retail clients).

For the purposes of fulfilling its duties the CMA coordinates and cooperates with its counterparts, as well as the Central Bank of Lebanon (Banque Du Liban, BDL) and any other concerned authority or institution in Lebanon or abroad.

With regard to specifically asset securitisation funds (including Islamic asset securitisation funds), which are established pursuant to Law No. 705 of 9 December 2005 (the Asset Securitisation Law), the BDL is the main regulator.

ii Legal framework for asset management activities

The laws applicable with respect to asset management activities consist of the following:

a the Capital Markets Law, which governs, inter alia, the issuance, purchase, sale and marketing of financial instruments for public offer and the financial markets in general;
b the Asset Securitisation Law, which defines the legal framework governing asset securitisation in Lebanon by way of establishing and managing asset securitisation mutual funds;
c Law No. 706 of 9 December 2005 (Law 706), which governs collective investment schemes in securities and other financial instruments;
d Law No. 160 of 17 August 2011 (Law 160), which sets out the prohibition of insider trading made on the basis of material non-public information; and
e Law No. 234 of 10 June 2000 (Law 234), which regulates the financial intermediation profession.

A number of new regulations have been recently enacted by the CMA governing generally the financial markets in Lebanon (including asset management), which have been the result of focusing on the issues of enhanced investor protection and transparency in an effort to align with international standards. In particular, with respect to asset management, the relevant regulations are:

a Collective Investment Schemes Regulation – Series 8000, dated 24 January 2019 (the CIS Regulation), which covers the establishment, approval, offering and management of collective investment schemes (including Islamic schemes) and associated activities in Lebanon (but excludes the use of collective investment schemes for asset securitisation purposes under the Asset Securitisation Law) and establishes requirements governing CIS managers, CIS custodians and approved institutions;
Regulation on Offers of Securities – Series 6000, dated 7 August 2017 (the Offers of Securities Regulation), which sets out the main rules regarding offering of financial instruments in Lebanon, including all types of investment funds, as well as the requirements for offering such funds to retail clients and professional clients;

Business Conduct Regulation – Series 3000, dated 10 November 2016 (the Business Conduct Regulation), which establishes the rules of conduct for approved institutions, including asset managers, when carrying out securities business and dealing with clients;

Market Conduct Regulation – Series 4000, dated 10 November 2016 (the Market Conduct Regulation), which details the prohibitions of insider trading and market manipulation; and

Licensing and Registration Regulation – Series 2000, dated 19 January 2017 (the Licensing and Registration Regulation), which sets out the licensing and operational requirements for approved institutions, including Lebanese asset managers.

The CIS Regulation requires collective investment schemes offered to the public to be subject to enhanced investor protection rules that align with international standards. On the other hand, ‘exempt offer schemes’, which allow for greater risks to be taken in both investments and leverage, are only permitted to be offered to professional clients, whom by definition have a sufficient level of expertise to understand the risks involved and sustain them. This distinction among the varying levels of investor protection applies regardless of whether the public offer is made in connection with Lebanese collective investment schemes or foreign ones. In addition, the international standards with which the CIS Regulation aligns are primarily those of the International Organization of Securities Commissions (IOSCO) and the European Union’s Undertakings for Collective Investments in Transferable Securities Directive (the UCITS Directive) governing publicly offered open-ended collective investment schemes, and secondarily, the regional standards of Saudi Arabia (qualified usage applying due to the regulatory framework being under revision there) and Dubai.

iii Regulation of asset managers

Licensing requirements

CIS managers

CIS managers are entities that establish, offer and manage one or several collective investment schemes in Lebanon (Lebanese or foreign), including any alternative investment funds (AIFs), such as real estate and private equity funds subject to the CIS Regulation.

Accordingly, in order for a company to offer and manage any type of Lebanese collective investment scheme, it must first be licensed by the CMA as a CIS manager.

The licensing provided by the CMA to the CIS manager is distinct from the licensing provided in connection with managing a portfolio of assets on a discretionary basis, as well as with distributing foreign investment funds.

The CIS manager may routinely be authorised to perform certain other investment services (such as investment advisory and execution dealing that is provided, for example, to other CIS managers licensed to manage niche AIFs).

The licensing procedure consists of submitting an application file to the CMA, where the CMA may conduct a review or inquiry as it deems appropriate prior to granting a licence. There is no time limit for the CMA to provide its licence.

© 2019 Law Business Research Ltd
Before licensing a company as a CIS manager, the CMA must be satisfied that the following requirements have been met with respect to the company:

a. it is established in Lebanon as (1) a bank, financial institution or financial intermediation company registered with the BDL or CMA respectively; or (2) a branch of a foreign financial entity whose parent company is engaged in securities business and is licensed by a competent authority in a recognised jurisdiction;

b. it is engaged solely in securities business, or in the case of a company licensed by BDL, solely in business covered by that licence;

c. its head office is in Lebanon;

d. it has sufficient initial capital (the minimum share capital for managing collective investment schemes is 3 billion Lebanese pounds (US$2 million) but higher limits may apply if the licence includes other securities business activities);

e. its management, personnel and agents possess the necessary integrity, skills, qualifications and experience to carry out the related activities;

f. it has obtained the prior authorisation of the CMA in the event its equity holdings are acquired by (1) any person by more than 10 per cent or (2) a board member regardless of size;

g. if it is an associate of another person, that such person has the necessary integrity, regulatory status, business record and financial soundness; and

h. it contributes to the financial institution professional indemnity (FIPI) that includes insurance coverage for risks associated with incomplete transactions and criminal and tort liabilities.

Importantly, the CIS manager must satisfy the ‘fit and proper’ test, which in turn focuses on the sound management of its business and must also employ such systems, policies and procedures that are sufficient to cover the particular obligations of corporate governance, risk management, compliance, and operations and controls associated with such asset management business. It must also employ skilled and experienced people and sufficient financial and technological resources to serve such purposes.

Ongoing requirements

Once licensed, CIS managers are subject to prudential supervision by the CMA throughout their managing of investment funds. They are also subject to the rules of the Business Conduct Regulation, as well as the specific conduct rules included in the CIS Regulation and Market Conduct Regulation on an ongoing basis. In particular, the rules require CIS managers to comply with:

a. client classification;

b. best-execution policy;

c. prevention of conflicts of interest;

d. organisational and operational requirements (bookkeeping, registration records of unitholders, audited reports and accounts, delegation of activities, remuneration policy and compliance);

e. valuation of assets;

f. liquidity management;

g. insider dealing and market manipulation prohibitions; and

h. fighting money laundering and terrorist financing (pursuant to Law No. 44 of 24 November 2015).
Importantly, following an initial offer period, CIS managers are obliged to make investment decisions that provide a prudent spread of risk in addition to aligning with the investment objectives and policies of the funds they manage.

In addition, any payment of fees, charges or any other payment in cash or in kind may be made to the CIS manager on the condition that the nature, amount and method of applying such fee, charge or payment as well as the description of how these are levied are disclosed in a clear manner in the offering document of the investment fund and are within the limits stated therein.

**Powers of the CMA**

In the event of breach of applicable laws and regulations by the CIS manager, the CMA has the power to, in addition to imposing a number of administrative sanctions that apply to all approved institutions, remove the CIS manager and appoint a replacement CIS manager in respect of managing a particular fund as well as taking any other steps as necessary.

The CMA can also revoke the licence of a CIS manager for persistent failure of one or more schemes under its management to comply with the CIS Regulation. The licensing procedure and requirements applying to CIS managers apply *mutatis mutandis* to the approved distribution agents.

**Approved distribution agents**

For a company to market the giving or offer of advice with regard to investing in a collective investment scheme in Lebanon (whether Lebanese or foreign) or deal in subscriptions and redemptions of such scheme, it must be licensed as an approved distribution agent for such scheme in accordance with the Licensing and Registration Regulation.

The licensing procedure and requirements applying to CIS managers apply *mutatis mutandis* to the approved distribution agents.

**Regulation of investment funds**

**Lebanese investment funds**

Lebanese investment funds comprise of:

- regulated funds, which are: (1) collective investment schemes, including certain types of AIFs such as real estate collective investment schemes; (2) Lebanese private equity investment vehicles, both of which (1) and (2) are supervised by the CMA; and (3) asset securitisation funds, which are supervised by the BDL; and
- non-regulated funds, which are not supervised.

**Funds for public offer**

With respect to regulated funds to be offered to the public, the CMA generally grants its approval to the investment fund within four weeks of the submission of the application, which must include all the required information and documents. The CMA has wide discretionary powers in respect of the approval application and can carry out any investigation, inquiry or on-site inspection to the CIS manager as appropriate, whereby the period for approval extends accordingly.

Licensing of additional sub-funds to an umbrella investment fund can generally be granted if the CMA raises no objection within 30 days following notice of such addition by the CIS manager.
In order to safeguard fair treatment among investors, the statute and offering documents of approved investment funds for public offer that are open-ended or interval must apply enhanced disclosure requirements, such as the following:

a specifying if different classes of units are issued, whereby the principle is that it is not permissible to include a unit class that results in disadvantaging the investors in other unit classes of the same sub-fund or scheme, or when the unit class has a structure risk that cannot be clearly explained to the public, or when it contravenes the purpose of the CIS Regulation (such as, for example, when a unit class is intended to be offered by misleading the public as to the risks they would be exposed to);

b specifying if different subscription charges, annual management charges or redemption charges apply as well as accounting in detail for such differences; and

c specifying if different currency classes apply.

In addition, there are strict borrowing limits and leverage limits applicable to investment funds for public offer.

With regard to an open-ended scheme, interval scheme or sub-fund, the CIS manager can only borrow up to a maximum of 10 per cent of the fund's total asset value for a maximum of 80 days by way of overdraft. Moreover, such borrowing is not permitted to be either rolled over, or used to meet redemptions, or for investment, or financing payment of investment returns to the investors.

With regard to a closed-ended scheme or sub-fund of a scheme, the CIS manager can borrow up to 20 per cent of the fund's total asset value, whereby the nature and duration of such borrowing must be clearly disclosed in the CIS prospectus of the scheme or sub-fund.

Importantly, responsibility for monitoring compliance of an investment fund for public offer with the investment, borrowing and leverage limits lies with the CIS custodian in accordance with Law 706 and the CIS Regulation.

Funds for exempt offer

Regulated funds to be offered by way of an exempt offer must be offered exclusively to professional clients and have a minimum subscription amount of US$50,000 per investor or their equivalent in another currency.

The CIS managers of such investment funds are only required to notify the CMA of their intention to create such funds and offer them to institutional investors. If the CMA does not object within 15 days of receipt of such notice, the CIS manager may proceed to create the scheme. Further, the CMA may, at the request of the CIS manager, issue a certificate of registration and enter the name of the scheme on its official register of schemes.

Following approval, the CMA notably does not supervise such institutionally offered investment funds; however, it can cancel its approval in the event of breach of the regulations by the CIS manager or breach of the exempt offer requirements.

Critically, there are significant disclosure requirements that apply even to the institutionally offered investment funds, and while the ability of an exempt offer scheme to borrow or apply leverage is unlimited, important details such as maximum amount, duration and type of borrowing, means of achieving leverage as well as implications analysis are required to be stated in the scheme's constituting and offering documents.
**Foreign funds**

**Funds for public offer**

Public offer of foreign funds in Lebanon is permitted only with respect to collective investment schemes that have been approved in their home jurisdiction for public offer and are further approved by the CMA as offering equivalent investor protection to Lebanon. Notification to the CMA of the public offer of the foreign fund is made by an approved institution and the CMA generally grants its approval within 30 days from the submission of the application.

**Funds for exempt offer**

The requirements for offering foreign funds by way of an exempt offer are similar as with regard to the Lebanese exempt offered funds.

**Regulation of CIS custodians**

In accordance with the CIS Regulation, the assets of investment funds (including those of AIFs that fall within the scope of the CIS Regulation) must be held by independent custodians, appointed by the CIS manager, which must be either an approved institution that the CMA has licensed to provide custody services in Lebanon or Midclear (being the national custodian and settlement agent of Lebanon). The duties of the CIS custodians are critically twofold – safekeeping as well as supervisory – with regard to the investment fund and mainly consist of the following:

a. exercising custody over the assets of the investment fund; in particular in respect of securities and real estate titles this must be done by holding these beneficially on behalf of the investors and in respect of cash and deposits, by either holding these beneficially on behalf of the investors or by exercising control over them. Importantly, the CIS Custodian has to keep the assets of the investment fund segregated from those of the CIS manager, the CIS custodian and the CIS custodian’s other clients;

b. monitoring compliance with the investment fund’s investments, borrowing and leverage requirements in accordance with Law 706 and the CIS Regulation;

c. monitoring compliance of the cash flows of the investment fund; in particular this would involve receiving full payment of subscription cash or any income due to the investment fund, making full payment of redemption cash, as well as holding all cash received in accounts in the name of the investment fund;

[d. monitoring compliance of the instructions of the CIS manager with the applicable laws and regulations and constituting documents of the fund, with the obligation to immediately notify the CMA in the event of non-compliance of the CIS manager concerning the property of the fund; and

e. keeping updated records of the transactions of the fund and reconciling those with the records of the CIS manager at least once a month.

The CIS custodian may delegate the holding of the fund’s assets, in whole or in part, to any sub-custodian outside of Lebanon, provided the latter is licensed to exercise custody in their home jurisdiction by a regulator considered as having equivalent standards by the CMA. In delegating, the CIS custodian must ensure that the beneficial ownership of the assets of the fund by the investors is clearly established and the assets are not therefore commingled with those of the foreign sub-custodian, CIS custodian or CIS manager.
Notwithstanding any delegation, the CIS custodian remains liable in relation to the investors for any losses that may be sustained by the fund through error or omission, and as this is a liability imposed by regulation, the parties cannot limit it by contract.

**Regulation of marketing of investment funds**

There is an elaborate and strict set of rules regulating the marketing of investment funds in Lebanon, by way of both the generic securities advertisements requirements under the Licensing and Registration Regulation as well as the specific securities advertisement requirements under the CIS Regulation.

Accordingly, any form of verbal, electronic, broadcast or written communication made for the purpose of inviting or inducing potential unitholders in Lebanon into investing in an approved fund would qualify as a securities advertisement and would have to be clearly identified as such and made by the CIS manager or approved distribution agent for the relevant fund.

Further, depending on whether the fund that is being marketed is an approved fund for public offer or exempt offer, different requirements will apply as to the content of promotional materials.

**Funds for public offer**

In particular, with respect to a publicly offered Lebanese fund, any security advertisement must be consistent with the CIS prospectus of the fund and include information on how to obtain a copy of the fund’s CIS prospectus and key information document if available, as well as a copy of the most recent annual report and accounts of the fund, and a statement that the value of units and the income derived from them can fall as well as rise and that investors may not get back the money they invested.

Importantly, it is prohibited for the CIS manager to include in the security advertisement any projection or prediction of future total return or performance of a fund, or any endorsement or testimonial whatsoever.

The CIS manager is also required to maintain records of all the marketing it performs via any media and provide a copy of any particular record of such marketing upon request by the CMA.

Critically, any reference in the media to total return for the fund should be stated net of subscription charges, redemption charges and annual expenses paid out of the fund, while there is an obligation to state prominently these charges and operational expense ratio as a percentage of the net asset value of the fund unit.

Similarly, total return must be presented compared with the relevant benchmark or index that the fund utilises and must state whether costs are included in such benchmark or index. If the index or benchmark does not include all elements of total return, the advertisement must disclose what elements of return are not included and how that omission affects the comparison of the scheme’s total return with the benchmark or index.

**Funds for exempt offer**

With regard to Lebanese exempt offer funds any advertisement or use of promotional materials must: (1) be directed only to professional clients; (2) comply with the Licensing and Registration Regulation provisions, mainly in that they have to be fair, accurate and not misleading; and (3) be distributed only following the expiry of a period of 14 days starting from notification to the CMA, where the CMA did not object to the offer.
Foreign exempt funds

Any advertisement or use of promotional materials in Lebanon with regard to exempt foreign funds requires the appointment of a local distribution agent that must be an approved institution. Further such advertisement or promotional material is subject to the same requirements as applicable for Lebanese exempt funds but for the notification period (without objection) to the CMA, which is 15 days.

Provision of investment services

Any dealing in, advising and managing of assets (including discretionary mandates and managing of collective investment schemes) qualifies as a regulated securities business activity and is therefore permitted to be provided only by investment services providers in Lebanon duly licensed for such activities. In respect of collective investment schemes, such entities will be licensed as a CIS manager or in the case of distributing foreign collective investment schemes, an approved distribution agent. An exemption to these licensing requirements arises in the event of occurrence of reverse solicitation, pursuant to the Licensing and Registration Regulation.

However, since reverse solicitation is an exemption from the licensing requirements, the scope of what is allowed to be provided in this way will be limited. With regard to investment funds, the potential investor approaching any locally non-licensed asset manager will have to be very specific in their request for information in respect of the particular type of fund they wish to enquire about (and will have to identify this by certain investment features of the fund and not by seeking more generic information about what types of funds are available out there for their investment needs), as otherwise it would effectively lead the asset manager into marketing, which is prohibited.

In addition, the activity of an asset manager organising local training seminars and other training events in Lebanon, which cover general topics related to asset management, is also permitted under the laws and regulations of Lebanon, provided there is no marketing of any specific product or sale and purchase of any fund units whatsoever.

III COMMON ASSET MANAGEMENT STRUCTURES

The main structures currently used for collective investment schemes in Lebanon are:

a mutual funds that are (1) open-ended schemes, (2) closed-ended schemes, (3) interval funds, which are a hybrid form of the former two introduced by the CIS Regulation, or (4) Islamic schemes; and

b companies, the use of which is obligatory under the CIS Regulation with regard to real estate funds.

Publicly offered open ended funds are not permitted to invest in alternative investments (in line with the requirement under the UCITS Directive, which represents the international standard for such funds) but closed ended funds can invest in real estate. Foreign funds offered in Lebanon may be subject to different structures such as investment companies or trusts.
IV KEY TRENDS

There are a number of challenges currently faced by Lebanese asset managers and the changes that such challenges mandate into their business models tend to shape the new trends in the market.

Main trends include primarily solutions-driven approaches based on current EU-tightening regulatory framework challenges and digital transformation challenges.

In particular, there is a distinct indirect impact from MIFID II’s heightened investor protection requirements on Lebanese asset managers with regard to the product governance rules, which affect how the Lebanese asset managers offer their products or services to EU-based clients via EU placement agents. Lebanese asset managers are now required to provide specific information on the proposed target market for a product or fund, as well as on the distribution strategy, in order for the EU placement agents to establish both the appropriateness for such a target market and ensure that marketing is directed to the relevant investor group. It has been established that the ‘target market analysis’ requires consideration of the client’s objectives and experience as well as the identification of a negative target market, which makes the use of a blanket ‘not for retail’ legend redundant.

Consequently, the additional costs of enhanced technology and operational infrastructure that Lebanese asset managers may have to bring into their business models in order to meet the MIFID II heightened investor protection obligations (such as those of best execution reporting, monitoring and controlling, or thorough investor intentions analysis and recording) may adversely affect business flow and product pricing and thus inevitably restrict the investor base to which they may be able to make an offering.

As a result, Lebanese asset managers with an EU nexus are currently seeking to integrate as competitive technologically advanced platforms as possible, while at the same time adjusting their business models to enhance the targeting of investors with optimal business returns.

Another key trend deriving from the EU-tightening regulatory framework are re-evaluations and adjustments in the corporate strategy of Lebanese asset managers due to restrictions imposed on them by way of the Alternative Investment Fund Managers Directive, 2011/61/EU (AIFMD) impact. Being non-EU based asset managers that manage non-EU AIFs, Lebanese asset managers are deprived from benefiting from passporting when targeting institutional clients within the EU. This means they have to obtain authorisation from each EU Member State in accordance with the latter’s individual private placement regime. In addition, should passporting be extended to non-EU AIFMs in the future, satisfaction of the AIFMD requirements when marketing non-EU AIFs is likely to prove problematic.

As a result, Lebanese asset managers are considering changes to their corporate strategy, whether be it by establishing branches within the EU or entering into strategic alliances by way of mergers and acquisitions with EU-AIFMs and realigning part of their funds offering to be EU based in order to retain a competitive foothold within the EU client based market.

A further trend stems from the recent notable announcement of the CMA for the creation of an electronic trading platform (ETP), to be supervised by the CMA and operated by the private consortium of one of the largest Lebanese banks (Audi Bank) in collaboration with the Athens Stock Exchange (ATHEX), which aims to list a variety of investment products among which, importantly, shares of Lebanese SMEs and start-ups, with the aim of energising the economy. It is expected that within the ecosystem that will necessarily have to evolve out of the functionality of the platform, Lebanese asset managers will play a constructive role by investing in such shares (or generally in the ETP’s products) or by straightforward assisting
the SMEs and start-ups by way of private equity funds’ investments or by establishing relationships of consultancy and advice and sharing of know-how with them. In addition, given the increasing importance within the global asset management community of the environmental, social and governance (ESG) considerations when weighing up investment options, Lebanese asset managers who integrate the ESG factor in their investment strategies related to the platform and beyond are expected to be rewarded accordingly.

A final trend stems from the global challenge of digital transformation as this is combined with the behavioural change that a new costs disclosure regulatory environment is driving, both of which lower execution and research costs and incentivise the asset managers to focus more strongly, as a matter of competition, on the client’s portfolio maximum returns. As a result of this global trend, a number of Lebanese asset managers are currently restructuring their portfolios with a macroeconomic strategic view.

V  OUTLOOK

To the extent that there may be a concerted effort by the Lebanese public authorities and the principal market players to implement effective strategies and deliver changes to the financing of the economy as a whole, the Lebanese asset management industry will enjoy new opportunities for growth for itself and the Lebanese investment funds, thus contributing to the energising of the economy. It remains to be seen whether such concerted effort will materialise.

Alternatively, increasing business pressures arising from within the local market as well as from the EU and international regulatory restrictive environment and the constantly evolving digitalised and competitive global environment may lead to consolidations and downsizing of the Lebanese asset managers in critical aspects.
Chapter 13

LUXEMBOURG

Pierre De Backer and Emmanuelle Bauer

I OVERVIEW OF RECENT ACTIVITY

Luxembourg combines a diverse fund offering with a depth of expertise developed over many years as Europe’s leading investment fund centre. As the second-largest fund servicing jurisdiction in the world after the United States, Luxembourg is a favoured destination for investment fund managers (IFMs) and investors alike, thanks to its stable political and social environment, versatile fund products, leadership in investor protection, and experienced and responsive regulator and service providers.

Assets under management in Luxembourg-regulated collective investment undertakings reached €4.3 trillion at the end of May 2019.1

The steady growth of assets under management in Luxembourg funds has been mostly driven by the country’s success in positioning itself as the leading centre for undertakings for collective investment in transferable securities (UCITS). In recent years, a second fund label has remarkably developed: alternative investment funds (AIFs), which include private equity, real estate, infrastructure, debt and hedge funds, all dedicated to an institutional, professional or sophisticated investor base.

While assets under management have risen steadily over recent years, Luxembourg has seen a consolidation in the total number of entities, driven by a preference to create umbrella structures.2 There are 3,871 entities that are subject to regulatory supervision, of which 2,513 are umbrella funds consisting of 13,553 sub-funds. In addition, 1,358 entities have adopted a standalone structure, bringing the total number of active fund units to 14,911 as at April 2019.3

In addition to 14 internally authorised managers, 207 UCITS management companies, 263 authorised alternative investment fund managers (AIFMs) and 165 other IFMs are authorised as at July 2019.4 There are 570 other IFMs that are registered as below threshold AIFMs.

Over the past few years, government efforts have been mainly directed at increasing transparency, protecting market stability and preventing the build-up of systemic risk in the financial system. Those large-scale reforms have been, to a large extent, driven by European initiatives.

---

1 Pierre De Backer is a principal and Emmanuelle Bauer is a partner at Deynecourt.
2 ALFI Global overview, July 2019.
3 CSSF Newsletter May 2019.
4 ALFI Global overview, July 2019.
More recently, the uncertainties surrounding Brexit caused a number of British and international operators with a significant presence in the United Kingdom to relocate all or part of their operations to Luxembourg or to establish Luxembourg investment funds. Of those firms that have publicly communicated their plans, more than 60 firms – half of which are in the asset management industry – have chosen to relocate to Luxembourg.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

A cornerstone of Luxembourg’s success as an investment fund centre is its comprehensive legal and regulatory system, which benefits managers and investors alike.

i Supervision

The Commission de Surveillance du Secteur Financier (CSSF), a public institution with legal personality and financial autonomy, is entrusted with the supervision of the financial sector in Luxembourg. It operates under the authority of the Ministry of Finance.

As regards the funds industry, the CSSF is the prudential regulator of IFMs, and of the regulated investment funds that they manage. Its mission is to ensure that they comply with all legal, regulatory and contractual provisions relating to their organisation and operation. The main duties of the CSSF in this respect include:

- the licensing of Luxembourg IFMs and regulated investment funds;
- the prudential and ongoing supervision of licensed IFMs and regulated investment funds based on periodic reporting and regular or ad hoc requests for information, and on-site inspections;
- the imposition of disciplinary sanctions on IFMs, regulated investment funds and depositaries; and
- the oversight of the marketing conditions of Luxembourg and foreign investment funds (in particular, those marketed to non-professional investors).

In addition to those supervisory duties, the CSSF issues regulations and circulars in accordance with existing laws.

ii Regulations applicable to investment funds

Luxembourg collective investment undertakings fall under two broad categories: regulated and unregulated vehicles. Another distinction is made as to whether these collective investment undertakings are subject to a specific law (product law) or not.

The main product laws are:

- the law of 17 December 2010 on undertakings for collective investments (the UCI Law), which implemented EU Directive 2009/65/EC, further amended by EU Directive 2014/91/EU (the UCITS Directive);
- the law of 13 February 2007 on specialised investment funds (the SIF Law);
- the law of 15 June 2004 on investment companies in risk capital (the SICAR Law); and
- the law of 23 July 2016 on reserved alternative investment funds (the RAIF Law).

---

Regulated investment funds

Regulated funds are subject to CSSF supervision and must (or their IFM must on their behalf) apply for and receive an authorisation from the CSSF before they start operating.

The CSSF supervises:

a. UCITS subject to Part I of the UCI Law;
b. other undertakings for collective investment (UCIs) subject to Part II of the UCI Law;
c. specialised investment funds (SIFs) subject to the SIF Law;
d. investment companies in risk capital (SICARs) subject to the SICAR Law;
e. European venture capital funds (EuVECA) subject to Regulation 345/2013 (EU);
f. European long-term investment funds (ELTIF) subject to Regulation (EU) 2015/760;
g. European social entrepreneurship funds (EuSIF) subject to Regulation (EU) No. 346/2013;
h. pension savings companies with variable capital (SEPCAVs) and pension savings associations (ASSEPs) subject to the law of 13 July 2005 (Pension Law); and
i. certain securitisation undertakings subject to the law of 22 March 2004 (Securitisation Law) when they offer their securities to the public on a continuous basis.

All these vehicles, once approved, are registered on official lists maintained by the CSSF and accessible on its website.

As regards investment funds subject to its supervision, the CSSF typically reviews and approves:

a. the constitutional and offering documents and contractual arrangements;
b. the persons to be appointed to the management body of the vehicle or its management company;
c. the central administration;
d. the depositary;
e. the auditor; and
f. where appropriate, the IFM and other operators of these vehicles.

The regulator may request additional information as part of the approval process. The operators of the funds or their management company as well as their service providers must demonstrate that they are of good repute and sufficiently experienced.

Any replacement of an operator or a service provider, and any change to the constitutional or offering documents or to the contractual arrangements, are subject to the prior approval of the CSSF. The appointment of a liquidator also requires prior approval, and the CSSF remains competent for the supervision of the vehicle until the close of the liquidation.

UCITS

UCITS are subject to strict, EU-driven organisation and management requirements, and rules on diversification, liquidity and use of leverage. UCITS benefit from a European distribution passport, and as such are eligible for sale to retail investors in the European Economic Area (EEA) and various non-EEA countries.
Other UCIs
Because of their more flexible rules, investment funds subject to Part II of the UCI Law do not qualify as UCITS. They are less constrained as to the type of assets they can invest in, the investment strategy they use, the diversification rules they are subject to and the liquidity they offer to investors.

SIFs
Introduced in 2007, the SIF is a lightly regulated, operationally flexible and fiscally efficient investment vehicle. Dedicated to institutional, professional and other qualified investors, a SIF may invest in any type of assets and pursue any investment strategy without any quantitative, qualitative, geographical or other restrictions. However, as with any other UCI, a SIF should in principle not invest more than 30 per cent of its assets or commitments in securities of the same kind issued by the same issuer.7

SICARs
The SICAR is an investment vehicle designed specifically for investment in risk capital, as detailed in CSSF Circular 06/241. SICARs allow direct or indirect contributions of assets to be made to entities in view of their launch, development or listing on a stock exchange. Unlike other investment funds, the SICAR is not subject to investment diversification rules, or lending or leverage restrictions.

Unregulated investment funds
Investment funds that are not directly subject to CSSF supervision include RAIFs, certain securitisation vehicles and standard commercial companies.

RAIFs
The RAIF, a new type of AIF that must be managed by an authorised external AIFM, offers to a large extent similar structuring and investment flexibility as the SIF. However, in opposition to the SIF, the RAIF is not subject to the supervision of the CSSF. RAIFs are required to comply with the specific AIFM Law requirements such as:

a the appointment of a depositary;
b the appointment of an approved statutory auditor;
c minimum content requirements for their annual reports;
d the valuation of their assets; and
e investment and leverage rules regarding certain types of assets.

However, in exchange for complying with the AIFM Law requirements, RAIFs benefit from the AIFMD passport in order to be marketed to professional investors (and retail investors if permitted) in the EEA.

Securitisation vehicles
Under certain conditions, securitisation vehicles (whether regulated or not) can be used as an alternative to the more traditional forms of investment vehicles.

7 CSSF Circular 07/309.
SOPARFIs

SOPARFIs are ordinary commercial companies whose corporate object is limited to the holding of participations in other companies. While they may in principle take any corporate form available under the law of 10 August 1915 on commercial companies (the Companies Law), in practice they will take the form of share capital companies. As an unregulated company, the SOPARFI is not subject to any risk-spreading requirements, and may in principle invest in any asset class. SOPARFIs may also manage their financial participations and conduct commercial activities that are directly or indirectly connected to the management of their holdings, including the debt servicing of their acquisitions.

iii Regulations applicable to investment fund management

Commencing business as an authorised IFM in Luxembourg is subject to prior approval by the CSSF. Authorised IFMs are UCITS management companies subject to Chapter 15 of the UCI Law; and authorised AIFMs subject to the law of 12 July 2013 on alternative investment fund managers (AIFM Law).

Management companies authorised under Chapter 15 of the UCI Law may also apply for authorisation under the AIFM Law (and vice versa) to manage both UCITS and AIFs.

Both the UCI Law and the AIFM Law allow authorised IFMs to benefit from an extended scope of activity, in particular for the provision of discretionary management services. As non-core services, those IFMs can offer investment advice on financial instruments and the administration of UCIs under certain conditions.

The application for authorisation must be accompanied by a programme of activity setting out the capital, human and technical resources, corporate governance and organisational structures of the IFM.

A new CSSF Circular 18/698 details the fundamental substance requirements that are expected from IFMs. The circular consolidates the existing practices that were applied by the CSSF and adds specific new requirements in relation to the IFMs’ corporate governance, central administration and internal controls, fight against money laundering and terrorist financing, key functions such as delegated activities, marketing and internal administration, procedures, and valuation. CSSF Circular 18/698 applies to UCITS management companies and AIFMs, as well as management companies subject to Chapters 16 and 17 of the UCI Law.

An authorisation granted to an IFM under the UCITS Directive or the AIFMD is valid for all EEA countries.

UCITS management companies

A UCITS management company is authorised to manage UCITS, as defined by Directives 2009/65/EC (as amended by Directive 2014/91/EU) and 2010/43/EU. The management of UCITS includes:

a investment management;
b marketing shares or units of the investment fund; and
c administrative functions such as:
  • legal services;
  • fund accounting;
  • portfolio valuation and the calculation of net asset value per share (including tax aspects);
  • the sale and redemption of shares or units;
Luxembourg

- client administration;
- compliance; and
- client servicing.

**AIFMs**

The business of an AIFM covers the portfolio management and risk management of one or more AIFs. AIFM authorisation is required when the AIF assets the AIFM manages are above the thresholds set out in the AIFM Law. The AIFM may be an external entity, or the AIF itself in the case of an internally managed AIF. Only corporate AIFs such as investment companies can be internally managed. Internally managed AIFs are subject to almost all of the same requirements as AIFMs.

**Other IFMs**

Under the AIFMD, IFMs that manage small AIFs (i.e., AIFs whose assets are below (1) €100 million, including assets acquired through leverage, or (2) €500 million, when the AIFs are not leveraged and have no redemption rights exercisable during a five-year period following the date of the initial closing) are subject to a lighter regulatory regime. Registered AIFMs do not benefit from the AIFMD passport, and may not freely market the AIFs that they manage on a cross-border basis. For the time being, they may continue to market the AIFs they manage within the EEA under the national private placement regimes on a country-by-country basis.

When the AIF assets under management of a management company are below the AIFM Law thresholds, an IFM subject to Chapter 16 of the UCI Law can manage that AIF without being authorised as AIFM. Otherwise, it must either seek authorisation as an AIFM or designate another entity as AIFM. Chapter 16 management companies may also manage investment vehicles other than AIFs.

**iv Regulations applicable to depositaries**

Over the past few years, the regulatory regime applicable to depositaries in Luxembourg has been subject to significant changes brought about by the AIFM and the UCITS Directives. Directive 2014/91/EU broadly aligned the role and responsibilities of UCITS depositaries with the AIFMD regime. Those two depositary regimes, however, differ in that the AIFMD allows the contractual transfer of liability from a depositary to a sub-depositary (including a broker acting as sub-depositary) and extended possibilities for rehypothecation of assets.

Under the AIFM and the UCITS Directives, the duties of Luxembourg depositaries include:

- acting as custodian of the fund’s assets they have been entrusted with;
- monitoring the fund’s cash flows, in particular ensuring that all payments made by or on behalf of investors upon the subscription of securities of a fund have been received, and that all cash of the fund has been booked in cash accounts opened in the name of the fund; and
- overseeing the fund’s operations to ensure that they comply with Luxembourg laws and the constitutional documents of the fund.

8 A RAIF cannot be internally managed and must be managed by an authorised AIFM.
9 AIFM Law.
Investment funds subject to a product law and AIFs managed by an authorised AIFM must appoint a single depositary to supervise and monitor their assets. The appointment and replacement of the depositary of a regulated investment vehicle must be approved by the CSSF.

UCITS and Part II UCIs that may be marketed to retail investors in Luxembourg are subject to the UCITS V Directive depositary regime. Their depositary must be a credit institution with its registered office in Luxembourg or a Luxembourg branch of a credit institution with its registered office in another EEA country.

Part II UCIs whose offering documents prohibit marketing to retail investors in Luxembourg are subject to the AIFMD depositary regime. SIFs, SICARs, RAIFs and other AIFs managed by authorised AIFMs, and internally managed AIFs that are subject to the AIFM Law, are also subject to the AIFMD regime. They must appoint a Luxembourg credit institution or Luxembourg branch of an EEA credit institution, a Luxembourg investment firm, a Luxembourg branch of an EEA investment firm, or – under certain conditions detailed below – a Luxembourg professional depositary of assets other than financial instruments.

Introduced by the AIFM Law, professional depositaries of assets other than financial instruments may only be used by AIFs that have no redemption rights for a period of five years from the date of the initial investments and either do not invest in financial instruments that must be held in custody in accordance with the AIFM Law (typically real estate funds), or invest in issuers or non-listed companies in order to potentially acquire control over such companies under the AIFM Law (typically private equity and venture capital funds).

v Marketing

Marketing in Luxembourg of foreign UCITS
Foreign UCITS must be notified to the CSSF by the competent authority of the fund’s home state before they can market their securities in Luxembourg. They must also appoint a Luxembourg paying agent and one or more financial correspondents whose duties are, among others, dealing with subscriptions and redemptions, informing investors, and paying the CSSF fees.

Marketing in Luxembourg of foreign AIFs
AIFMs authorised in another EEA country may market securities of EEA AIFs to professional investors in Luxembourg and, subject to certain conditions, to retail investors. Marketing to retail investors in Luxembourg requires that an EEA AIF established in a country other than Luxembourg is subject in its home country to a level of investor protection and prudential supervision considered by the CSSF as equivalent to that provided for in Luxembourg.

Regardless of whether an existing passport to do management business under another directive (such as UCITS) is held, EEA AIFMs are required to make a separate notification to their home state competent authority if they intend to manage or market an EEA AIF on the basis of the AIFMD passport.

The home state competent authority will send the management passport notification to the CSSF along with a certificate (as mentioned in Article 33(4) of the AIFMD) on behalf

---

10 UCI Law, Article 17 et seq.
11 AIFM Law, Article 19.
12 AIFM Law, Articles 31 and 33.
of the EEA AIFM if the EEA AIFM intends to distribute to investors, Luxembourg AIFs, or EEA AIFs within Luxembourg. The EEA AIFM can commence its management activities in Luxembourg from the date of notification by the home state competent authority to the CSSF.

Each foreign AIF intending to market in Luxembourg to retail investors must have an authorisation granted by the CSSF before engaging in marketing. Furthermore, those AIFs must have completed the notification procedure required for marketing to professional investors. However, if an AIF is an unregulated AIF, it may only promote such activities to professional investors in accordance with the AIFM Law.13

Currently, non-EEA AIFMs intending to market AIFs in Luxembourg are required to conduct distribution on a private placement basis and to observe the financial promotion rules.

The CSSF proceeds on a case-by-case analysis for non-EEA AIFMs (as there is no official list of equivalent countries). A list of the cooperation agreements signed by the CSSF and other EAA regulators with non-EEA authorities has, however, been published.14

Finally, the CSSF has issued guidance on reverse solicitation and marketing in respect of AIFs in Luxembourg.15

## III COMMON ASSET MANAGEMENT STRUCTURES

UCITS, Part II UCIs, SIFs and RAIFs can generally be formed as contractual vehicles (FCPs) or as corporate vehicles (investment companies) depending on, among other considerations, corporate governance or tax requirements. By contrast, SICARs can only be set up as investment companies.

### i FCPs

Similar to a unit trust in the UK or a mutual fund in the US, an FCP is organised as a co-proprietorship whose joint owners are only liable up to the amount they have committed or contributed to the fund. An FCP has no legal personality, and must be managed by a Luxembourg management company regardless of whether it is created under the UCI Law, the SIF Law or the RAIF Law. The management company acts on behalf of the FCP, which includes the appointment and oversight of its service providers.

### ii Investment companies

Corporate vehicles may be set up either as investment companies with variable share capital (SICAV) or as investment companies with fixed share capital (SICAF). In a SICAV, the capital increases or decreases in proportion to inflows or outflows of funds, or changes in the net asset value of the fund, whereas a SICAF requires a decision (usually formalised in a notarial deed) to vary the capital in accordance with company law requirements.

The legal forms typically used by investment companies are the public limited company, the private limited company, the partnership limited by shares, the common limited partnership or the special limited partnership. While SIFs and SICARs can select all

---

13 CSSF Regulation 15/03.
15 FAQ Alternative Investment Fund Managers.
these legal forms, SICAVs subject to Part I or Part II of the UCI Law must be set up as public limited companies. UCIs organised as SICAFs may also be incorporated as partnerships limited by shares.

The common limited partnership and the special limited partnership deserve special attention. Both partnerships must be formed between one or more general partners who are liable for all the debts and obligations of the partnership, and one or more limited partners whose liability is limited to the amount of capital that they contribute or commit to the partnership.

Introduced in 2013 along with the implementation of the AIFM Directive, the special limited partnership – unlike the common limited partnership – does not have separate legal personality. However, all contributions, acquisitions and dispositions of assets can made in the name of the special limited partnership rather than in a general partner’s or limited partners’ name. The common limited partnership and the special limited partnership benefit from generally being transparent for tax purposes (see Section VII).

A SOPARFI is usually organised in the form of a public or private limited company, or a partnership limited by shares, and will operate with fixed or authorised capital features. The latest company law reform of August 2016 introduced, among other noteworthy changes, the simplified limited company.

iii  Sub-funds and classes

All funds subject to a product law may be formed as umbrella structures composed of one or more sub-funds. Each sub-fund comprises a specific portfolio of assets and liabilities separate from the portfolio of assets of the other sub-funds, except if otherwise provided for in the constitutional documents of the fund. The assets of a specific sub-fund may only be used to satisfy its own debts and obligations.

Furthermore, various classes of shares, units or partnership interest may be created within regulated or unregulated investment vehicles alike (or within their compartments). The typical features of these classes include different liquidity and distribution entitlements, minimum subscription or holding requirements, fee structures, reference currencies and target investors. All classes tap into the same pool of assets within the vehicle or the specific sub-fund, but the net asset value per share, unit or interest of each class may vary as a result of the specific features of that class. Unlike for sub-funds, there is no ring-fencing of assets and liabilities among classes of the same compartment.

IV  MAIN SOURCES OF INVESTMENT

Luxembourg’s fund centre has a strong international orientation: over 97 per cent of funds under management in Luxembourg (around €4.2 trillion) are from overseas. In addition, more than 90 per cent of the large and medium-sized asset management firms in Luxembourg are owned by overseas investors.16

Luxembourg funds are distributed to investors in more than 70 countries, making the cross-border dimension of Luxembourg’s fund centre unequalled.17 Nearly two-thirds of the funds authorised for cross-border distribution are domiciled in Luxembourg.18

---

16 CSSF annual report 2018.
18 ibid.
UCITS provide the majority of funds under management in Luxembourg, contributing to more than 82 per cent of total funds in 2018. The share of assets under management of regulated AIFs managed by authorised IFMs is more modest in terms of managed assets (€704.1 billion). IFMs established in other EEA countries and managing Luxembourg UCITS or AIFs under UCI Law or AIFM Law hold €591.1 billion of assets combined.19

V KEY TRENDS

Luxembourg continues to strengthen its ranking as the world’s second-largest fund domicile after the United States: an estimated €4.3 trillion of funds was placed in Luxembourg regulated collective investment undertakings at the end of May 2019, an increase of 1.1 per cent on the previous year and the 11th successive year of growth.20 This increase is not only owed to the growth of traditional retail UCITS (for which Luxembourg contributes to more than 36 per cent of Europe’s market share) but also due to the continued increase in the number and assets of AIFs.

i RAIFs and other non-regulated AIFs

Over the past few months, Luxembourg has seen strong interest in AIFs that are not subject to a product law and in RAIFs. The main asset classes in these vehicles are typically private equity, venture capital, infrastructure, clean technology, real estate and debt. Interest in SIFs and UCITS remains continuous, in particular those that have particular strategies or are investing in more ‘exotic’ markets.

After three years of existence, the RAIF is increasingly attracting investors (especially European institutional investors) who perhaps see it as an alternative to the SIF (and to a lesser extent to the SICAR), and as an investment fund meeting the highest standards of structural quality and flexibility that they were used to in a SIF or SICAR but without an add-on regulation of the product itself. Since July 2016, 655 RAIF vehicles have been registered in Luxembourg with a variety of different investment policies.21

There also has been strong demand for unregulated AIFs structured as partnerships (special limited partnerships or common limited partnerships), in particular for illiquid asset classes.

ii Private equity

Building on the infrastructure, expertise and knowledge that the country has developed in the retail fund industry over the past 30 years, combined with a favourable environment for private equity, Luxembourg has been used for the structuring of international acquisitions via unregulated and regulated vehicles. Today Luxembourg is home to over 25,000 SOPARFIs, mainly used to structure private equity acquisitions. Assets held through Luxembourg private equity vehicles exceed €99 billion in 647 vehicles.22

19 CSSF annual report 2018.
20 CSSF Press release 19/30.
21 ALFI Global overview, July 2019.
22 ALFI Global overview, July 2019.
iii Real estate
Over the past decade, Luxembourg has positioned itself as a hub for real estate investment funds (REIFs). Real estate assets held through Luxembourg REIFs reached an all-time high of over €78 billion in 323 vehicles (outside of fund of fund vehicles or debt fund vehicles related to property).23

iv Debt funds
Debt and credit funds are increasingly present in Luxembourg thanks to the flexible legal and regulatory environment that allows them to implement all types of debt and credit strategies, such as mezzanine, distressed and origination strategies. Luxembourg has also seen a significant development in fund finance activity, supported by efficient security packages, positive growth, strong credit performance and absence of credit defaults.

VI SECTORAL REGULATION

i Insurance
In addition to circular letters issued by the CAA, insurance companies in Luxembourg are governed by:

a the amended law of 6 December 1991 on the insurance sector;
b the amended Grand Ducal Regulation of 14 December 1994 specifying the conditions for the approval and practices of insurance companies; and
c the Grand Ducal Regulation of 5 December 2007 establishing the terms and conditions of the supplementary supervision of insurance and reinsurance undertakings that are part of an insurance or reinsurance group.

These legal provisions determine the authorisation procedure and business conduct of insurance and reinsurance companies, the mission and procedural methods of the CAA, and the free provision of services by Luxembourg insurance companies in other EEA countries. Insurance contracts are governed by the amended law of 27 July 1997 on insurance contracts.

Traditionally, life insurance companies offer guaranteed return products where premiums are managed in the insurer's general fund (or in that of its parent company). In addition, Luxembourg insurance companies propose a wide range of unit-linked products24 established as external investment funds managed by third-party asset managers; internal collective funds that operate like UCITS and that allow discretionary management tailored to the various risk profiles of investors; or internal dedicated funds that allow discretionary management that takes the subscriber's personal objectives into account.

Several dedicated funds can be grouped within the same life assurance contract.

ii Pensions

Pension funds regulated by the CSSF
Pension savings companies with variable capital (SEPCAVs) and pension savings associations (ASSEPs) are two legal entities created by the law of 8 June 1999. They are governed by the

23 ibid.
24 CAA Circular 08/1.
law of 13 July 2005 on institutions for occupational retirement provision, which implements Directive 2003/41/EC on the activities and supervision of the institutions for occupational retirement provision.

SEPCAVs have a corporate structure similar to that of SICAVs, in which the members and beneficiaries are shareholders who will receive a share of a fund’s profits when retiring. SEPCAVs can only be used for defined contribution schemes.

ASSEPs, on the other hand, work like associations that can be used for both defined contribution and defined benefit schemes. In an ASSEP, the rights of the members and beneficiaries are debt claims that, when the members and beneficiaries retire, will be paid out either as a lump sum or as an annuity. ASSEPs may also cover additional benefits on the death or disability of their members.

SEPCAVs and ASSEPs must be authorised by the CSSF to conduct their business.

iii  Pension funds regulated by the CAA

Pension funds supervised by the CAA are subject to the CAA Regulation of 31 August 2000. CAA pension funds offer flexibility in the form of the vehicle for defined contributions, defined benefits or additional benefits on the death or disability of members.

Four legal forms can be chosen, but in practice the not-for-profit association form is the most commonly used vehicle. CAA pension funds can either finance defined benefits or defined contributions schemes.

iv  Real property

Real estate funds can be set up as unregulated or regulated vehicles. When they are subject to CSSF supervision, they fall under the Part II of the UCI Law and CSSF Circular 91/75, unless they have been established under the SIF Law or, where their assets represent risk capital investments, under the SICAR Law.

CSSF Circular 91/75 requires that real estate Part II UCIs invest no more than 20 per cent of their net assets in a single property, subject to a ramp-up period of up to four years. In principle, real estate Part II UCIs may not borrow more than 50 per cent of the value of all the properties. Their net asset value must be calculated at least once a year, and an independent valuer must be appointed to assess the value of the properties.

Real estate SIFs are subject to CSSF Circular 07/309, which restricts investment in a single property to 30 per cent of their assets, but they may in practice take advantage of a similar start-up period as real estate UCIs. Although borrowing restrictions are more flexible for this vehicle, the AIFM Law requires that an AIFM determines the maximum leverage levels for the fund.

SICARs may also invest in real estate to the extent that they:

a  demonstrate an element of risk capital, such as the objective of developing the target asset, or specific risks associated with the property that are beyond the common level of real estate risk; or

b  are acquiring the property to sell at a capital gain in a relatively short time frame.

Real estate funds can also be formed under the RAIF Law under the same conditions as those detailed for SIFs and SICARs above.

Finally, SOPARFIs can also be used to set up unregulated real estate funds.
v Hedge funds

Although a limited number of UCITS employing hedge fund strategies may be marketed to retail investors on the same basis as other UCITS funds, hedge fund strategies are usually pursued under Part II of the UCI Law, the SIF Law or the RAIF Law.

CSSF Circular 02/80 sets forth specific rules applicable to Luxembourg UCIs pursuing alternative investment strategies. The Circular determines the investment restrictions generally applicable to these types of Luxembourg UCIs.

SIFs and RAIFs are not subject to any investment eligibility requirements, and are therefore best suited to accommodate all sorts of alternative strategies. They are both, however, required to diversify their investments to 30 per cent of their assets (except for certain fund of funds or feeder funds) as further set out in CSSF Circular 07/309.

CSSF Circular 08/372 specifies the rules on the appointment of prime brokers, the relationship between the depositary and the appointed prime brokers, and the liability of the depositary in that respect.

vi Private equity

Private equity funds in Luxembourg take advantage of a large choice of structuring options, such as Part II UCIs, SICARs, SIFs, RAIFs, and other types of unregulated companies or partnerships. In practice, the special limited partnership, the common limited partnership or the SOPARFI are typically used. Amid an international regulatory environment seeking to increase transparency and oversight, the SICAR and the SIF are tried-and-tested regulated private equity and venture capital structures. They combine a flexible and accessible regulatory infrastructure with strong investor protection features. The RAIF should follow the same pattern.

In addition, Luxembourg regulated and unregulated vehicles can be set up as EuVECA funds. These are restricted to equity instruments issued by or loans granted to qualifying portfolio undertakings, meaning undertakings that are at the time of the first investment by the fund in that undertaking not admitted to trading on a regulated market or multilateral trading facility, and that employ up to 499 persons. Small and medium-sized enterprises (SMEs) that are listed on SME growth markets will also be allowed under the revised EuVECA Regulation.

EuVECA funds are also subject to specific rules in respect of fund portfolio composition, investment techniques and own funds. In particular, these funds must intend to invest at least 70 per cent of their aggregate capital contributions and uncalled committed capital in assets that are qualifying investments and, as a consequence, not use more than 30 per cent for the acquisition of assets other than qualifying investments. One of the defining features of the EuVECA regime is that it does not require the appointment of a depositary.

The EuVECA Regulation applies to EEA managers that are subject to registration with the competent authorities of their home country in accordance with the AIFMD and manage qualifying venture capital funds with total assets under management of less than €500 million.

The use of the revised EuVECA label is now also open to above-threshold AIFMs that continue to be subject to the requirements of the AIFMD while complying with certain provisions of the EuVECA Regulation (those on eligible investments, targeted investors and information requirements).

EuVECA managers can also manage and market AIFs that are not EuVECA funds. However, the EuVECA passport does not apply to these funds.
vii Other sections

Microfinance

Luxembourg has a long history of commitment to the microfinance sector as part of the country’s overseas development aid and training assistance. Promoters can choose from a range of regulated and unregulated structures, such as Part II UCIs, SICARs and SIFs. Other usual structures are the securitisation vehicle and structured products. A Grand Ducal Regulation of 14 July 2010 provides that UCIs and SIFs invested in microfinance and that meet certain conditions are exempt from the annual subscription fee. 25

Other funds

Luxembourg is also home to a number of investment funds that are compliant with shariah principles, and of cleantech and other new technologies funds.

VII TAX LAW

i Investment funds subject to product laws

Regulated investment funds other than SICARs

UCITS, Part II UCIs and SIFs, whether they are established in a contractual form (FCP) or a corporate form (SICAV or SICAF), are exempt from all taxes apart from a fixed registration duty levied on the contribution of capital and a subscription tax.

The subscription tax is calculated in proportion to the net assets of funds at the end of each quarter. The standard annual rate for UCITS and Part II UCIs is 0.05 per cent. Funds investing in money market instruments and bank deposits, SIFs, and sub-funds and classes of UCIs that are reserved to institutional investors, are subject to a reduced rate of 0.01 per cent. In addition, a subscription tax exemption is available for funds investing in other Luxembourg UCIs that are subject to subscription tax, institutional money market UCIs, exchange traded funds, pension pooling funds and microfinance funds.

UCITS, Part II UCIs and SIFs are not subject to withholding tax on distributions.

As tax-exempt entities, Luxembourg funds are not entitled to local or foreign tax refunds (unless a tax treaty applies) or credits. SICAVs and SICAFs may benefit from a limited number of double taxation treaties, reducing withholding tax rates in the countries in which they invest. By contrast, FCPs cannot in principle avail themselves of double taxation treaties: however, their unitholders could claim the reduced rate under a double taxation treaty between the country of source of the income or gain and the country of residence of that investor.

SICARs

The tax treatment of SICARs will depend on whether they are formed as tax-transparent vehicles or as non-tax transparent vehicles.

SICARs incorporated as non-transparent vehicles are fully taxable companies and, as such, are subject to corporate income tax (CIT) and municipal business tax (MBT). However, income and capital gains from transferable securities are exempt from income taxes, and distributions of dividends are also exempt from withholding taxes, irrespective of

25 Grand Ducal Regulation of 14 July 2010.
the residence and tax status of their shareholders. Income on cash held by SICARs for future investment is also tax-exempt for a period of 12 months. Other income is subject to CIT and MBT at an aggregate rate of 24.94 per cent (for Luxembourg City in 2019).

SICARs are also subject to an annual net wealth tax (NWT) of €4,815 if their financial assets, transferable securities, bank deposits and receivables against related parties exceed 90 per cent of the total of their balance sheet and €350,000. If any one or more of these requirements are not met, the NWT ranges from €535 to €32,100, depending on a SICAR's balance sheet total.

SICARs can take advantage of most double taxation treaties concluded by Luxembourg, as well as the EU Directives.

SICARs formed as a tax-transparent vehicle for Luxembourg tax purposes are subject to the provisions detailed under subsection ii.

**RAIFs**

RAIFs can generally elect to be treated as SICARs or SIFs for Luxembourg tax purposes. If their exclusive purpose is to invest in risk capital, RAIFs are subject to the same tax regime as SICARs. If they pursue another strategy, they are subject to the same provisions as SIFs.

**ii  Investment funds not subject to product laws**

**Partnerships**

Funds that are not subject to a product law are usually set up in the form of partnerships (common or specialised limited partnerships). As transparent entities for Luxembourg tax purposes, partnerships are not subject to CIT or NWT. Further, a partnership that is an AIF is not subject to MBT, provided that (as is usually the case) its general partner holds less than 5 per cent of the interests in the partnership.

Partnerships are not eligible for the benefits of double taxation treaties. However, an investor in a Luxembourg partnership should in theory be able to claim the reduced rate under a double taxation treaty between the country of the source of the income or gain and the country of residence of the investor: this would typically be possible if the partnership is recognised as tax-transparent by both the investee's and the investor's countries.

**SOPARFIs**

SOPARFIs are companies subject to CIT and MBT on their income at an aggregate rate of 24.94 per cent (in Luxembourg City in 2019). However, income received by a SOPARFI from its shareholdings (dividends, liquidation proceeds) and capital gains realised upon the sale of these shareholdings are exempt to the extent that the conditions of the Luxembourg participation exemption regime are met. Further, dividend distributions to corporate shareholders are exempt from withholding tax under certain conditions. The distribution of liquidation proceeds is also exempt from withholding tax without any condition.

SOPARFIs benefit from the double taxation treaties concluded by Luxembourg, as well as from the EU Directives.

SOPARFIs are also subject to NWT in Luxembourg: a rate of 0.5 per cent applies on the portion of net wealth that is lower than or equal to €500 million, while the exceeding portion is subject to a reduced rate of 0.05 per cent. However, subject to the application of the participation exemption regime, qualifying shareholdings are exempt from NWT.
A SOPARFI is subject to an annual minimum amount of NWT of €4,815 if the financial assets, transferable securities, bank deposits and receivables against related parties of the SOPARFI represent more than 90 per cent of its balance sheet and exceed €350,000. If the SOPARFI does not meet these requirements, the minimum NWT varies between €535 and €32,100, depending on the level of its total balance sheet.

**Taxation of managers**

Luxembourg IFMs generally take the form of companies with share capital, which are fully subject to CIT, MBT and NWT under the same conditions as those applicable to SOPARFIs.

**VAT**

The management of funds that are structured under a product law is exempt from VAT in Luxembourg.

The VAT exemption applies to, among other services, investment management (including risk management) and administration (e.g., investment advice, transfer agent and registrar functions).

Management services outsourced to third-party managers also benefit from the VAT exemption under certain conditions (they should notably be specific to, and essential for the management of, the fund). In addition to management services, services related to the distribution of investment funds are also exempt from VAT.

Other services rendered to investment funds, such as legal and audit services, cannot benefit from a VAT exemption and are subject to the standard VAT rate of 17 per cent.

Depositary services are partly exempt from VAT; services related to the control and supervision functions of the depositary are subject to a reduced VAT rate of 14 per cent.

Funds with corporate form are VAT persons, and may be subject to Luxembourg VAT registration if they receive goods or services from abroad for which they must account for Luxembourg VAT on a reverse-charge basis. FCPs must account for Luxembourg VAT on a reverse-charge basis through the VAT number of their management company.

**VIII OUTLOOK**

The agenda will remain challenging for the asset management industry in the years to come, but will also offer many opportunities for development. New EU regulatory developments will continue to dominate the outlook of the Luxembourg fund industry. Luxembourg’s asset management industry will continue to face regulatory challenges, and will need to undertake digital and environmental transitions.

**i Brexit**

Assuming that the UK will become a third country after its withdrawal from the EU, the Luxembourg Parliament has passed on 8 April 2019 two laws that aim to mitigate disruptions caused by Brexit.

The first Brexit law would only apply if the UK leaves the EU without an agreement. It introduces a form of EU passport for UK financial service providers currently operating in Luxembourg during a transitional period of 21 months in line with EU contingency plans. In addition, the law gives the CSSF and the CAA powers to take temporary emergency measures.
in their area of their supervisory activities. In order to ensure the proper functioning of the financial markets, these regulatory bodies would therefore have the possibility to decide, on a case-by-case basis, to allow UK service providers to benefit from an EU passport regime.

The second Brexit law applies whether the UK leaves the EU with or without an agreement with the EU. The law sets out a 12-month grace period for IFMs of Luxembourg UCITS, Part II UCIs and SIFs to address breaches of investment rules resulting from the UK’s withdrawal, such as divesting from positions in UK UCITS which could no longer be deemed compliant due to Brexit. It also authorises UK UCITS to continue to be marketed to retail investors in Luxembourg during the grace period. Where the UK UCITS is managed from outside the UK by an EEA IFM also authorised as an AIFM, then the UK UCITS will be considered an AIF for these purposes and permitted to be marketed to retail investors in Luxembourg under local AIF rules after the grace period.

ii  Defining and redefining marketing
On 16 April 2019, the European Parliament adopted a package of measures aimed to eliminate current regulatory barriers to the cross-border distribution of investment funds in order to enable a better functioning Single Market and economies of scale. The proposal is designed to improve transparency, remove overly complex and burdensome requirements and harmonise diverging national rules. This marked the end of a review process of cross-border distribution of collective investment undertakings started in 2016 in connection with the Capital Markets Union.

The proposed Regulation will align national marketing requirements and regulatory fees, and will harmonise the process and requirements for the verification of marketing material by national competent authorities. It will further enable the European Securities and Markets Authority (ESMA) to better monitor investment funds.

The proposed Directive will harmonise the conditions under which investment funds may exit a national market and will allow European asset managers to test the appetite of potential professional investors for new investment strategies through pre-marketing activities.

The Directive and Regulation are to be published during the third quarter of 2019 and become effective by the end of 2021.

iii  Tax
Luxembourg has recently adopted Organisation for Economic Co-operation and Development proposals as part of the base erosion and profit shifting initiative. On 18 December 2018, the Luxembourg Parliament passed the law implementing the EU Anti-Tax Avoidance Directive (ATAD I). The law covers:

- controlled foreign company rules;
- interest limitation rules;
- exit taxation;
- hybrid mismatches; and
- general anti-abuse rules.

It also contains two additional provisions that are unrelated to ATAD I. The first provision repeals the provision that allows (among others) a debtholder to convert a loan into shares in a tax-neutral manner, while the second amends the permanent establishment provisions under Luxembourg law.
By the end of 2019, Luxembourg will have to implement more extensive anti-hybrid rules when the Anti-Tax Avoidance Directive II (ATAD II) is transposed into domestic law. This will expand the territorial scope of the hybrid mismatch measures under ATAD I to third countries as well as the type of hybrid mismatches covered, which will include hybrid PE mismatches, hybrid transfers, imported mismatches, reverse hybrid mismatches and dual residence mismatches.

The provisions of ATAD II are expected to have a significant impact on fund structures that historically have been financed with shareholder debt throughout with the aim of facilitating funding as well as repatriation of investment proceeds to investors.

iv Retail investors
The flexibility enjoyed by SIFs, SICARs and other UCIs may be reduced in the future. In January 2016, bill of law 6936 was deposited with the Luxembourg Parliament, amending a number of product laws and the AIFM Law. Under the bill, UCI investors that are not professional investors under MiFID II will only be able to invest in certain types of assets (as determined by the CSSF). It is expected that the CSSF will restrict investment in certain tangible assets or investments related to individuals (or their rights). In addition, closed-ended UCIs will no longer be required to issue shares based on their total net asset value. Instead, this will be based on a price fixed in accordance with their constitutional documents.

v Pan-European personal pension product
Luxembourg welcomes the European Commission's plan to create a standardised pan-European personal pension product (PEPP). The PEPP aims to link investment products to individuals rather than to an employment relationship, and provides opportunities not only for workers and job seekers, but also for the Luxembourg asset management industry.

vi Fintech
Fintech, and technology in general, will remain an important area of focus for Luxembourg. Various associations aim to raise awareness, identify the challenges and develop opportunities inherent in new digital technologies for the fund industry, such as regtech and blockchain tools, which are expected to reduce costs and increase efficiency in the industry over time.
The following are active in the asset management market in the Netherlands:

1. asset managers that may be linked to a pension fund;
2. asset managers that are part of a financial conglomerate or family office;
3. asset managers that act as managers of undertakings for collective investment in transferable securities (UCITS) (UCITS management companies (UCITS ManCos)) or alternative investment funds (AIFs) (AIF managers (AIFMs)); and
4. asset managers that operate independently.

The Netherlands asset management market is stable and permanent from a regulatory, legal and tax perspective. Some recent developments relating to Brexit, and changes in laws and regulations relevant to the asset management industry, are outlined below.

i. **Brexit**

Many asset and fund managers are reorganising their operations in view of a hard Brexit and are finalising their licence application processes. Most of the focus is on UK-based entities, but asset and fund managers targeting the EU market from outside the EU are considering how they best can provide services or offer fund participations to EU and UK investors as well.

ii. **Markets in Financial Instruments Directive and Regulation**

The Markets in Financial Instruments Directive (MiFID II) introduced enhanced requirements for asset managers. To the extent UCITS ManCos and AIFMs perform top-up MiFID services, the MiFID II rules as implemented by the Dutch Financial Supervision Act (FSA) and the directly applicable Markets in Financial Instruments Regulation (MiFIR) rules only apply in relation to these top-up MiFID services. These asset managers have been assessing what impact these rules will have on their business and operating models, and have adapted their business and business models to the extent necessary to comply with these rules.

iii. **UCITS**

The Securities and Futures Commission (SFC) and the Dutch Authority for the Financial Markets (AFM) signed a memorandum of understanding concerning the mutual recognition
of covered funds and management companies and related cooperation (the Memorandum) on 15 May 2019. The Memorandum provides a recognition of asset managers as well as a framework for mutual recognition of recognised funds to be offered to the public in both markets. Eligible UCITS are general equity funds, bond funds, mixed funds and index funds (other than exchange-traded funds). This will enable Dutch UCITS to broaden their international activities.

**iv New Prospectus Regulation**

As from 21 July 2019 the Prospectus Regulation (EU) 2017/1129 will enter into force. The main changes relate to the format of the summary, the risk factors and advertisements. In addition, the Prospectus Regulation requires it to be written in plain intelligible language. A prospectus or information memorandum that falls within the scope of the Prospectus Directive and Prospectus Regulation will need to comply with these new rules.

**v Pension funds**

The Netherlands market has seen a consolidation of pension funds. On 1 January 2016, the general pension fund (APF) was introduced by the Dutch Pension Act (DPA) to facilitate this consolidation. The larger Dutch-based asset managers and insurance companies considered the APF to be an opportunity to increase their assets under management and sponsored the establishment of such APF.

The APF may carry out one or more pension schemes in collectivity circles. It may ring-fence assets and liabilities per collectivity circle, which is the main feature of the APF. Each collectivity circle has its own coverage ratio, premium policy, indexation policy and investment policy.

An APF must have minimum funding that is treated as equity. The minimum funding is set at 0.2 per cent of the assets under management, with a minimum of €500,000 and a maximum of €20 million. For the coverage of the liability risk, additional funding of 0.1 per cent of the assets under management will be required unless professional liability insurance is obtained or the risk analysis outcome requires an increase of this minimum funding.

**iv Remuneration management companies of UCITS or AIFs**

The Dutch Act on remuneration policies for financial undertakings as included in the FSA (the Remuneration Act) applies to those AIFMs and UCITS ManCos with their seat in the Netherlands. The Remuneration Act may also apply if an AIFM or UCITS ManCo, having its seat outside the Netherlands, is a subsidiary of a financial undertaking with its seat in the Netherlands or is part of a group where the ultimate parent company has its seat in the Netherlands, and where the main activities consist of providing financial services or offering financial products.

With respect to the remuneration of an AIFM and UCITS ManCo, the Remuneration Act, which came into force on 1 January 2015, contains an exception to its 20 per cent bonus cap for AIFMs and UCITS ManCos pursuant to which no bonus cap applies at all.

Although it was foreseen in 2017 pursuant to the draft version of the Amendment Act Financial Markets 2018 (Amendment Act) that the Remuneration Act would include a new provision pursuant to which a 100 per cent bonus cap (or, in cases where shareholder approval has been obtained, 200 per cent) would apply to all persons working under the supervision of an AIFM or UCITS ManCo that forms part of a Capital Requirements Directive (CRD IV)
governed group, this part of the Act was redrawn in parliamentary discussions and never came into force. Up to this date, AIFM and UCITS Mancos are therefore exempted from the 20 per cent bonus cap.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

i Alternative Investment Fund Managers Directive, UCITS and MiFID II

The Alternative Investment Fund Managers Directive (AIFMD), UCITS Directive and MiFID II are very much interconnected, simply because they are regulating the same core activity of asset management. However, their impact on an asset manager depends on how that manager raises its assets under management, whether through directly managing collective investment undertakings (either UCITS or AIFs), or being appointed to provide portfolio management services either to a client who is not a collective investment undertaking or to such an undertaking, but as a delegate of the manager (or sub-manager) of such an undertaking.

Subject to receiving an extension to the relevant existing licence from the Dutch Authority for the Financial Markets (AFM), a UCITS ManCo can manage AIFs (and must comply with the AIFMD) and an AIFM can manage UCITS (but in doing so must comply with the UCITS Directive). The AIFMD clearly envisages that a single investment management entity in Europe may manage both AIF and UCITS.

The AIFMD, UCITS Directive and MiFID II have been transposed into Dutch law via the FSA and secondary legislation.

AIFMD

With respect to AIFs and AIFMs, the FSA provides for the full regime pursuant to which a licence is required and the small AIFM regime pursuant to which no licence will be required, although registration and reporting requirements to the Dutch supervisory authorities do apply. In addition, the FSA distinguishes between an offer of participations in AIFs to professional and retail investors.

Small AIFM regime

The small AIFM regime is applicable to small AIFMs that either directly or indirectly, through a company with which the AIFM is linked by common management or control or by a substantive (direct or indirect) holding, manages portfolios of AIFs whose total assets under management, including any assets acquired through use of leverage, do not exceed a threshold of €100 million; or do not exceed a threshold of €500 million when the portfolios of AIFs consist of AIFs that are unleveraged and have no redemption rights exercisable for five years starting from the date of initial investment in each AIF.

The conditions that must be met to avoid full application of the FSA are that the AIFM:

a is registered with the AFM, the competent supervisory authority;

b at the time of registration:

• identifies itself and the AIFs managed by it to the AFM; and
• provides information on the investment strategy of the AIFs managed by it to the AFM; and

c regularly provides information to the Dutch Central Bank on the main instruments in which it is trading, and the principal exposures and most important concentrations of the AIFs it manages.
The small AIFM regime is available for Dutch small AIFMs only, provided that the participation rights in the AIFs under their management are solely offered in the Netherlands to professional investors or, if to retail investors, to fewer than 150 persons or in a minimum amount of €100,000 per investor.

The small AIFM regime as implemented in the Netherlands does not provide for a passport as provided for in Articles 32 and 33 of the AIFMD. This means that AIFMs registered under the small AIFM regime in the Netherlands are neither able to market AIFs in Member States other than the home Member State nor to manage EU AIFs established in other Member States.

However, small AIFMs that are registered in accordance with the European venture capital funds (EuVECA) or European social entrepreneurship funds (EuSEF) regulation may market their VC and SE funds, respectively, in Member States to professional investors, and to investors who commit to invest at least €100,000 and who declare that they are aware of the risks attached to the investment.

**Full regime**

AIFMs that cannot or do not wish to benefit from the small AIFM regime, and to which no exemption applies, must apply for a licence. To obtain a licence, the AIFM must comply with, inter alia, the following licence requirements:

a. the investment strategy, the risk profiles and other characteristics of the AIFM, policies and practices on remuneration, conflicts of interest, risk management, liquidity, valuation and accounting, and arrangements made for the delegation and sub-delegation to third parties of functions, must be drawn up and approved by the AFM;

b. the integrity of the day-to-day policymakers, supervisory directors and certain shareholders of the AIFM is beyond doubt and is, as such, screened and approved by the AFM; and
c. the AFM has established the suitability of the policymakers and supervisory directors.

Ongoing obligations will apply, including, but not limited, to obligations regarding:

a. the appointment of a depositary;

b. extensive disclosure requirements regarding the acquisition of listed and non-listed companies having their statutory seat within the European Economic Area (EEA);

c. valuation;

d. risk management; and

e. remuneration.

Since the entry into force of the amended EuVECA and EuSEF regulations, licensed AIFMs will also be able to register as EuVECA or EuSEF regulation authorised managers and benefit from the EuVECA or EuSEF label.

**UCITS**

UCITS V has been implemented in the FSA, and Dutch UCITS, to the extent required, have appointed a depositary.

**MiFID II/MiFIR**

The Dutch MiFID II implementation legislation does not include any gold-plating provisions, although the Dutch legislature indicated in July 2017 that non-EEA investment
firms targeting non-professional investors (regardless of whether they have chosen to opt up to be treated as professional investors) are required to open a Dutch branch when applying for an investment firm licence; and solely professional investors (no opt up) and eligible counterparties are not required to establish a Dutch branch, but are required to appoint a contact person in the Netherlands to communicate and to transfer data between the non-EEA investment firm and the Dutch regulator in an orderly and efficient manner.

A MiFID II firm cannot directly manage a UCITS or an AIF. While a MiFID II firm, a UCITS ManCo or an AIFM may all provide the investment management service of portfolio management, only an UCITS ManCo or an AIFM can manage a UCITS or an AIF.

**Marketing activities**

*Marketing*

In the Netherlands, marketing is defined as making a sufficiently specific proposal in the pursuit of a profession or business, either directly or indirectly, to enter into a contract regarding any participation rights in a collective investment scheme, or to request or acquire, either directly or indirectly, funds or other goods from a client for participation in a collective investment scheme. Passive marketing is not caught by the AIFMD or UCITS Directive. Passive marketing of AIFs and UCITS is permitted provided that any reverse enquiry is part of the investor’s own exclusive initiative.

As opposed to the insurance mediation directive for insurance policies, the marketing of the investment funds is not expressly governed by a single directive. Rather, the UCITS Directive and the AIFMD have similar regimes, tailored to reflect that an EU-wide distribution passport is available to both types of funds.

The European Commission has proposed the following definition of ‘pre-marketing’ to address inconsistencies: ‘a direct or indirect provision of information on investment strategies or investment ideas by an alternative investment fund manager (AIFM) or on its behalf to professional investors domiciled or registered in the Union in order to test their interest in an alternative investment fund (AIF) which is not yet established’. In this case pre-marketing is permitted without regulatory notification and approval, provided certain conditions are met.

*Marketing passport AIFs*

Marketing an EEA AIF with an EEA AIFM into the Netherlands is possible via the AIFMD marketing passport, which applies in respect of professional investors only. EEA AIFMs are authorised to market EEA AIF to retail investors in the Netherlands, subject to prior completion of the AIFMD passport procedure and notification to the AFM pursuant to the retail distribution notification form. In addition to this notification procedure, the EEA AIFM must comply with the top-up regime, which entails, among other things, additional disclosure obligations and, if the AIF is an open-ended fund or issues non-transferable participation rights, the obligation to draw up a key investor information document. However, neither notification to the AFM pursuant to the retail distribution notification form nor compliance with the top-up regime is required if each participation right has a nominal value of at least €100,000 or if the participation rights on offer can only be acquired for an equivalent of at least €100,000 per investor.
**Private placement regime AIFs**

For AIFs where either the AIFM or the AIF has a registered office outside the EEA, the AIFMD marketing passport is not yet available. The marketing of such AIFs must currently be conducted in accordance with the private placement regime in the Netherlands (via Article 36 or 42 of the AIFMD).

For non-EEA AIFMs caught by Article 42 of AIFMD there are two regimes available: the designated states regime, which is available to fund managers from Guernsey, Jersey and the US, and is primarily relevant where the marketing is to be directed at investors who are not qualified investors, provided the top-up regime requirements are met; and the AIFMD third-country regime, which allows for marketing to qualified investors only.

**Marketing passport UCITS**

To actively market or sell UCITS to investors in the Netherlands, it is necessary to complete the notification process. Non-passported UCITS cannot be actively marketed or sold to investors in the Netherlands. As set out above, the Memorandum will enhance cooperation in relation to (1) collective investment schemes domiciled in either Hong Kong or the Netherlands and offered, marketed and distributed to the public in the Netherlands or Hong Kong on a cross-border basis; and (2) authorised management companies of collective investment schemes, based in either Hong Kong or the Netherlands.

**III COMMON ASSET MANAGEMENT STRUCTURES**

In the Netherlands, an investment institution can be structured through vehicles with or without legal personality. Commonly used vehicles with legal personality are the public limited liability company (NV), the private limited liability company (BV) and the cooperative (co-op), whereas a limited partnership (CV) and a fund for the joint account of the participants (FGR) are regularly used vehicles without legal personality.

All of these vehicles can be used for structuring both open-ended and closed-ended funds. The choice for a certain type of vehicle is often determined based on the tax aspects of such vehicle. The different tax regimes that can apply to the different vehicles are set out in Section VII. Asset management structures can be divided roughly into tax-transparent and non-transparent structures. Other relevant considerations for choosing a structure are flexibility, statutory restrictions and the preferences of the proposed investors.

i **Tax-transparent structures**

The CV and the FGR are used for tax-transparent structures. These vehicles, which are without legal personality, can be considered transparent for tax purposes if certain conditions are met. Both are contractual arrangements, and are considered to be very flexible for that reason. Detailed descriptions of the legal aspects of these vehicles are given below.

**CV**

Dutch law stipulates some specific provisions applicable to CVs. A CV is a partnership between one or more general partners and one or more limited partners. All assets and liabilities of the CV are held by the general partners (unless a separate custodian is used to hold the assets, something that is mandatory if the fund is regulated under the FSA). Unless otherwise agreed, each general partner is authorised to represent and bind the CV.
Regardless of other internal arrangements, each general partner is jointly and severally liable for all obligations of the CV. The liability of limited partners is limited to the amount of their respective capital commitments or, if the limited partnership agreement so stipulates, its capital contributions to the CV. If, however, a limited partner performs acts of management for the CV (directly or by proxy), his or her liability will become unlimited (even if third parties know of his or her status as a limited partner).

**FGR**

No specific law applies to an FGR, except for Dutch contractual law. An FGR is a contractual arrangement between the manager and the legal title holder, to which participants to the agreement accede by way of subscribing to the participations. Whether and to what extent the investors are liable shall depend on the terms of the contractual arrangements, which often consist of a set of documents, including in any case the terms and conditions applicable to the FGR and subscription agreements subject to which the investors participate. In the case of an FGR, an investor’s liability is, in principle, limited, unless the FGR is considered a general partnership, which may be the case in very limited circumstances.

The features of an FGR depend on the contractual arrangements. Typically, the manager and the legal title holder of an FGR are legal entities. The legal title holder acquires the legal ownership of the assets and enters into obligations on behalf and for the benefit of the participants in the FGR.

**ii Non-transparent structures**

Both the CV and the FGR can also be used for taxable structures. In that case, their aforementioned legal characteristics remain the same, but the conditions that need to be met to qualify as a tax-transparent vehicle do not apply. The NV, BV and co-op are all non-transparent vehicles by definition. Detailed descriptions of the legal aspects of these vehicles are given below.

**NV and BV**

Both of these vehicles have capital that is divided into shares. The minimum capital required upon incorporation of an NV is €45,000. For a BV, no minimum capital upon incorporation applies. Shares have to be issued, but their nominal value can be even lower than €0.01 and can be paid up at a later date. Although the two vehicles have a lot of other similarities, there are important differences, one of which is that less mandatory law applies to a BV, making it a more flexible vehicle than an NV in terms of, for example, its share capital requirements, the allocation of voting rights, prescribing and enforcing certain obligations of shareholders and the reduction of capital, whether through distributions or otherwise. Another difference is that the Dutch legislation applicable to NVs is well equipped for listings of NV shares. Listing BV shares is possible, but such listings have not been tested thoroughly in practice.

Dutch law facilitates a specific type of NV, namely an investment company with variable capital (BMVK). This type of NV provides for more flexibility with regard to the capital of the NV by giving the management board the authority to issue and repurchase shares (instead of the default statutory arrangements where such powers are attributed to the general meeting of shareholders). An NV must meet certain conditions to qualify as a BMVK.
Co-op
A co-op is a specific form of association under Dutch law, and is a corporate vehicle for collaboration between its members. Its statutory object is to cater for the material needs of its members by concluding agreements with them in the business it conducts or causes to be conducted for their benefit. Statutory provisions on governance and certain rights and obligations of members apply, but a lot of flexibility remains regarding, among other things, arrangements on profit entitlement and distributions. No minimum capital is prescribed. Members of a co-op are not liable for any deficit at the moment it is liquidated, provided that the articles of association of the co-op exclude the members’ liability for such deficit. If the articles of association do not exclude liability or maximise it to a certain amount, members are liable for equal shares, unless the articles of association of a co-op provide otherwise. Generally, in practice, all liability of members is excluded when a co-op is used to structure a fund.

IV  MAIN SOURCES OF INVESTMENT

<table>
<thead>
<tr>
<th>Source</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government</td>
<td>€776</td>
<td>€704</td>
<td>€607</td>
<td>€602</td>
<td>€392</td>
</tr>
<tr>
<td>Monetary financial institutions</td>
<td>€703</td>
<td>€968</td>
<td>€582</td>
<td>€568</td>
<td>€532</td>
</tr>
<tr>
<td>Insurers</td>
<td>€66,326</td>
<td>€79,069</td>
<td>€72,825</td>
<td>€67,582</td>
<td>€65,805</td>
</tr>
<tr>
<td>Pension funds</td>
<td>€484,777</td>
<td>€560,631</td>
<td>€566,752</td>
<td>€638,652</td>
<td>€662,887</td>
</tr>
<tr>
<td>Investment funds</td>
<td>€24,120</td>
<td>€27,734</td>
<td>€25,499</td>
<td>€27,176</td>
<td>€42,205</td>
</tr>
<tr>
<td>Other financial institutions</td>
<td>€1,617</td>
<td>€3,156</td>
<td>€2,868</td>
<td>€3,259</td>
<td>€4,015</td>
</tr>
<tr>
<td>Non-financial corporations</td>
<td>€1,310</td>
<td>€1,355</td>
<td>€1,404</td>
<td>€938</td>
<td>€1,198</td>
</tr>
<tr>
<td>Households</td>
<td>€24,732</td>
<td>€26,832</td>
<td>€40,699</td>
<td>€43,509</td>
<td>€46,959</td>
</tr>
<tr>
<td>Total</td>
<td>€615,625</td>
<td>€715,756</td>
<td>€731,460</td>
<td>€802,497</td>
<td>€849,694</td>
</tr>
<tr>
<td>Non-residents</td>
<td>€11,266</td>
<td>€15,307</td>
<td>€20,224</td>
<td>€20,212</td>
<td>€25,702</td>
</tr>
</tbody>
</table>

V  KEY TRENDS
In general, asset managers need to deal with pressure on fees and higher costs. Those costs not only relate to compliance with (new) regulatory requirements, but also to investments in financial technology and data required to be able to comply with rules and regulations and to stay ahead of new ventures disrupting the asset management industry. Consolidation and reorganisation of asset managers will therefore continue, as will a shift from active to passive products. In the funds industry, we expect a continued focus on alternative asset classes and the increased appetite of Dutch and foreign investors to set up individual mandates with Dutch asset and fund managers to invest in alternative asset classes such as mortgages. Mortgage funds remain a very popular asset class in the Netherlands for institutional investors.
VI SECTORAL REGULATION

i Insurance

As of 1 January 2016, Dutch insurance and reinsurance undertakings (insurers) are subject to (the implementing rules) of the Solvency II Directive. 2

Pursuant to Solvency II, insurers are obliged to establish technical provisions with respect to all of their insurance and reinsurance obligations towards policyholders and beneficiaries of insurance or reinsurance contracts. The technical provisions must correspond to the current amount insurers would have to pay if they were to transfer their insurance (and reinsurance) obligations immediately to another insurer. The technical provisions must be covered by assets.

Insurers must invest all their assets in accordance with the ‘prudent person’ principle. This means, inter alia, that:

a insurers may only invest in assets and instruments whose risk the insurer can properly identify, measure, monitor, control and report, and appropriately take into account in the assessment of its overall solvency needs;

b all assets must be invested by insurers in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole; and

c assets held to cover the technical provisions shall also be invested in a manner appropriate to the nature and duration of the insurance and reinsurance liabilities.

In addition, insurers must ensure that their assets are properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings, or geographical area and excessive accumulation of risk in the portfolio as a whole; and extensive risk concentration in connection with investments in assets issued by the same issuer or by issuers belonging to the same group. With respect to assets held in respect of life insurance contracts where the investment risk is borne by policyholders, additional prudent person requirements apply.

There are no restrictions with respect to the categories of assets in which insurers may invest. Insurers are also free to make their own investment decisions; they are not subject to any kind of prior approval or systematic notification requirements in this respect. In addition, insurers are not required to invest in assets that are located in an EU Member State.

ii Pensions

General

Dutch pension funds must invest the assets they have under management for future pension benefits. In accordance with the 2003 Institutions for Occupational Retirement Provision (IORP) Directive (2003/41/EC, recently replaced by the IORP II Directive 2016/2341/EC), the DPA stipulates that the investment policy of Dutch pension funds must comply with the prudent person rule and be in the interest of members and beneficiaries. The Financial Framework Decree (Decree) and the policy rules provide some more details on the general principle, in line with the IORP Directive. Except for investments in affiliated companies, the DPA does not provide for quantitative restrictions for investment in certain assets or asset classes. The Decree and policy rules also provide guidance to both pension funds and asset managers with regard to valuation of assets, alternative investments, integrity, provision of

---

2 Directive 2009/138/EC.
information and outsourcing. For example, the Decree explicitly allows for investment in derivative instruments, insofar as such instruments contribute to a reduction in investment risks or facilitate efficient portfolio management.

A pension fund should establish a strategic investment policy – in accordance with its objectives and policy principles, including its risk attitude – and should include the composition of the intended investment portfolio and a description of the possibilities to deviate from the portfolio. On the basis of the strategic investment policy, an investment plan should be defined by the pension fund, including a detailed outline of the level and range per asset class.

**Premium Schemes (Improvements) Act**

As of 1 September 2016, the Premium Schemes (Improvements) Act came into effect. As a result, the legal framework has been changed for the defined-contribution agreement and the agreement to pay a capital sum (premium schemes). The capital that is accrued within the scope of these types of arrangements no longer needs to be converted into a fixed pension benefit (annuity) on the retirement date, but can instead also be used for a (partly) risk-bearing investment during the pay-out phase. Accordingly, a new type of pension benefit is introduced (a variable pension). It is generally expected that continued investments lead to a higher pension outcome compared to the current fixed allowance. However, this also creates more uncertainty regarding the amount of the benefits. The risk-bearing investment during the pay-out phase will require new life cycle investments since the risk in that case will not need to be phased out towards the retirement date.

**iii Real property**

No specific asset management rules apply to investments in real property. Some real estate funds fall outside the scope of the AIFMD as they raise debt only, and therefore no licence requirement applies. The AFM has published a question-and-answer segment on its website regarding investments in real property (available in Dutch only).

**iv Hedge funds**

The AIFMD was originally intended to focus on hedge funds and private equity funds. Any hedge fund qualifying as an AIF will need to comply with the AIFMD as implemented by the FSA. The FSA does not provide for additional rules that apply to hedge funds only. Some hedge fund managers are operating not as managers but as sub-advisers, and are regulated under MiFID. These managers must comply with MiFID II and MiFIR, including the rules on algorithmic trading.

**v Private equity**

The AIFMD imposes obligations on AIFMs that acquire major holdings in or control of certain types of portfolio companies that have their statutory seat in a Member State. These obligations include the notification of acquisition of major holdings and control of non-listed companies, disclosure requirements on the acquisition of control of these companies and issuers, and some specific annual reporting requirements for AIFs exercising control of non-listed companies. The obligations do not apply if the portfolio companies qualify as small or medium-sized enterprises or real estate special purpose vehicles. In addition, the
AIFMD imposes some restrictions on asset stripping for AIFs that acquire control over non-listed companies or issuers. These asset stripping rules will be particularly relevant to the buyout industry.

VII TAX LAW

The choice for a certain fund vehicle is often tax-driven. A fund can be either transparent or non-transparent for Dutch tax purposes. A tax-transparent fund vehicle is not subject to corporate income tax and does not need to withhold dividend tax on distributions to investors. Instead, the investors are taxed as if they had directly held a pro rata portion of the investments made by the fund. Non-transparent fund vehicles can be subject to a special regime – either the fiscal investment institutions regime (FBI regime) or the exempt investment institutions regime (VBI regime) – or the regular Dutch corporate income tax regime.

i Tax-transparent vehicles

The most commonly used tax-transparent fund vehicles are a CV and an FGR. Specific conditions apply for a CV and an FGR to qualify as tax-transparent vehicles. A CV is tax transparent if limited partners can only be admitted or replaced after the prior written consent thereto of all partners. An FGR is tax-transparent if the units can only be transferred to the fund itself, or to a third party with the prior consent of all other participants. A tax-transparent CV and a tax-transparent FGR are not subject to corporate income tax and do not need to withhold dividend tax on profit distributions to investors.

ii Non-transparent vehicles

Regular regime

The regular regime by default applies in respect of an NV, a BV, a co-op and non-transparent CVs and FGRs. The corporate income tax rate over the first €200,000 of taxable profit is 19 per cent. The rate over taxable profit in excess of €200,000 is 25 per cent. Please note that the government intends to reduce the applicable tax rate to respectively 16.5 and 22.55 per cent in 2020 and 15 and 20.5 per cent in 2021. No distinction is made between capital gains and trading income.

All income and gains received and losses incurred by a taxpayer holding 5 per cent or more of the shares in a qualifying participation are exempt from corporate income tax (participation exemption). Generally, entities with operational business activities, as well as entities that are effectively taxed at a rate of 10 per cent or more on profit calculated in accordance with Dutch standards, are qualifying participations.

Profit distributions by an NV, a BV or a non-transparent CV or FGR are in principle subject to a standard 15 per cent dividend withholding tax. This rate can be reduced or refunded under applicable tax treaties provided that certain conditions are satisfied. Under Dutch domestic law, a dividend withholding tax exemption may be available; for instance, if the recipient of the profit distribution holds a qualifying participation in the distributing fund vehicle and such recipient is a Dutch or EU resident entity, provided that a number of other conditions are met. As of 1 January 2018 this exemption is, under conditions, also available to recipients that are resident in jurisdictions outside the EU with which the Netherlands have concluded a tax treaty that contains a provision on dividend payments.
The dividend withholding tax position of co-ops used to deviate from the above-mentioned type of vehicle as, historically, co-ops were not obliged to withhold dividend tax on profit distributions. As of 2018, the Dutch dividend withholding tax provisions have been amended, and ‘holding cooperatives’ are largely treated the same as an NV, BV, non-transparent CV or FGR. These amendments introduce a withholding obligation for holding cooperatives on distributions to members that, together with their related entities and persons, are entitled to at least 5 per cent of the annual profits, or 5 per cent or more of the proceeds upon liquidation of the holding cooperative. Non-holding cooperatives can in principle still distribute profits without withholding dividend withholding taxes on these distributions, even to members with an interest of 5 per cent or more.

A cooperative is considered a holding cooperative if its activities, in the year preceding a distribution, predominantly consist (i.e., at least 70 per cent) of holding participations of at least 5 per cent, or directly or indirectly financing related entities and persons.

For the 70 per cent test, the activities are primarily assessed on the basis of the total assets held by the cooperative. However, other factors such as revenue, profit-generating activities, the time spent by employees, and the total amount of assets and liabilities, may also be taken into account.

A related entity or person is a parent company, person, subsidiary or sister company, in each case determined by reference to an interest (directly or indirectly) of at least one-third. Furthermore, companies and persons that are part of a ‘collaborating group’ that holds an interest of at least one-third in an entity are considered to be related. The concept of a ‘collaborating group’ is not defined, but determined based on the facts and circumstances of a specific case. Bundled portfolio interests in a coordinating holding cooperative are one example of a collaborating group.

**FBI regime**

Under the FBI regime, an NV, BV or non-transparent FGR is taxed at a rate of zero per cent, and is thus effectively exempt from corporate income tax. The purpose of this tax facility is to allow individual shareholders to invest jointly in, inter alia, shares, bonds or real estate property without triggering higher taxes than if they had made investments directly and individually. A number of conditions apply for a fund entity to be eligible for the FBI regime. For instance, the entity may:

- only carry out passive investment activities;
- be subject to maximum leverage criteria;
- be required to distribute (a defined part of) its profits within eight months of each financial year-end; and
- be subject to certain shareholder and participant conditions.

Distributions by a fund entity that applies the FBI regime are subject to 15 per cent dividend withholding tax. As an entity that enjoys the FBI regime is technically subject to tax, albeit at a rate of zero per cent, such entity may be eligible for tax treaty benefits. Typically, specific arrangements have been made between the Netherlands and its treaty partners in this respect, such as regarding its treaties with Switzerland and Canada.
**VBI regime**

An NV or non-transparent FGR may elect to apply the VBI regime, resulting in an exemption from corporate income tax. This election is subject to certain conditions. A fund may elect to claim an exemption from corporate income tax if:

- it is an investment institution as defined in the FSA;
- the purpose and actual activities of the fund consist solely of passive portfolio investment activities;
- it only invests in certain financial instruments; and
- the fund spreads its risks.

Further, the fund is obliged upon request to repurchase or pay back shares or interests held by participants at the expense of its assets (open-end fund).

Only passive investments in certain financial instruments are allowed (and therefore no direct investments in, for example, real estate property).

Profit distributions by a fund that applies the VBI regime are not subject to dividend withholding tax. As a fund that applies the VBI regime is tax-exempt, such fund is not treated as a resident for tax treaty purposes and will, therefore, not be eligible for a refund or credit of any withheld Dutch dividend tax or any foreign withholding tax, or a reduction in withholding tax at source.

**VIII OUTLOOK**

Brexit is likely to be of significant consequence for asset and fund managers who have UK-managed funds (whether AIFs or UCITS) offered into the EU and, in the case of UCITS, the rest of the world; EU AIFs or UCITS managed in the UK and offered into the EU; and asset and fund managers targeting the UK market.

Most asset managers and fund managers will continue to assess the impact Brexit will have on their business model and operations, and to further develop contingency plans.

The amended EuVECA and EuSEF regulations as agreed on by the European Parliament, Council and Commission entered into force on 1 March 2018, and therefore the range of eligible managers extended to larger asset managers, and the diversification possibilities offered by VC and SE funds, have increased.
I OVERVIEW OF RECENT ACTIVITY

The Norwegian asset management industry is, as other parts of the Norwegian economy, interconnected with the Norwegian oil and oil services industry, as well as a state active in the financial markets. The state has substantial net financial assets in its sovereign investment fund, the Petroleum Fund, with a current value of over approximately 9 trillion kroner (see Section VI.v). This is, at least partly, because of income from oil and gas extraction, and the high level of activity related to this sector for several years until 2015. The Petroleum Fund does not invest in the Norwegian economy, but the economic growth spurred by the oil and gas sector benefits the mainland economy as a whole, making Norway (relative to its size) an attractive investor market for both foreign and domestic asset managers. However, with a combination of an open market for foreign actors and a less developed legal framework for Norwegian asset managers, the Norwegian asset management industry has only partially been able to capitalise on a strong domestic market to make significant forays into other investor markets.

The abrupt and relatively large drop in crude prices that started at the end of 2014 has had its effects felt in the Norwegian ‘real’ economy. In 2016, for the first time since the inception of the Petroleum Fund, more money was transferred out of the Fund (for public spending) than into it (petroleum-derived income), and this was also the case in 2017. Oil exploration was reduced (with a number of fields proving unsustainable under current oil prices) and activity in the oil services industry, where several companies are private equity-owned, was severely reduced. This development brought with it reduced investment activity by private equity funds with respect to oil and gas. Since 2016, however, crude prices have risen from the low thirties to the high seventies per barrel. This has led to resumed activity in the sector and several large deals and, in 2018, more money was deposited to the Petroleum Fund than transferred out.

After record fundraising levels in 2016, totalling 17 billion kroner over nine funds,² the level of fundraising decreased in 2017 to a total of 899 million kroner before increasing again to 4.5 billion kroner in 2018. As Norway is a small market and the number of Norwegian managers of private funds is relatively low, there are generally large variations year on year. Both 2017 and 2018 saw a decrease in investment activity by Norwegian private equity firms.

---

1 Peter Hammerich is a partner and Markus Heistad is an attorney at Advokatfirmaet BAHR AS.
2 Norwegian Venture Capital Association.
with 8.5 billion kroner and 8.1 billion kroner respectively, compared to the highest ever recorded investment activity by Norwegian private equity firms with 11.7 billion kroner in 2016.

At the end of 2019, there were 29 authorised mutual fund management companies and 423 mutual funds established and registered in Norway. The Norwegian mutual funds market is, however, dominated by a small number of large managers, such as the major banks and credit institutions present in Norway (e.g., DNB, KLP and Nordea). The previously independent management company Skagen was acquired by insurance group Storebrand in 2017, meaning that the market is largely divided between these four, together representing approximately 75 per cent of total assets under management. Total assets under management by Norwegian mutual fund managers amounted to 1.140 trillion kroner at the end of 2018.\(^3\) 2018 marked a slight increase from 1.138 trillion kroner at year-end 2017. The timid results reflect a volatile stock market throughout 2018.

No new hedge funds managed by Norwegian managers have been established since the Incentive Active Value Fund was launched in 2014, managed by Incentive AS under Sector Asset Management AS’ umbrella. This may be related to the international trend of investors generally reducing their allocation to hedge funds. As Norwegian insurers now are under the Solvency II freedom of investment rules, as are Norwegian pension funds (as of 1 January 2019), the marketability of such products may increase as such investors are searching for better returns, provided managers are capable of offering sufficient reporting facilities for regulated clients to perform a ‘look-through’ to the underlying investments.

Unregulated funds make up a significant portion of collective investments in Norway in both the retail and professional markets. This is particularly the case within real estate investments, which is an important asset category in both the institutional and retail investor markets. For such funds, few official or public figures currently exist. With the implementation of the Alternative Investment Fund Managers Directive (AIFMD)\(^4\) and reporting requirements for all Norwegian alternative investment fund managers (AIFMs), statistics have become available, creating a more transparent fund landscape across different segments. At the end of 2018, a total of 39 managers were authorised as AIFMs (including managers of regulated mutual funds that are AIFs) by the Financial Supervisory Authority of Norway (FSAN). A total of 99 AIFMs were registered and 351 alternative investment funds established in Norway (including regulated mutual funds that are AIFs) were registered. Although no official statistics exist, the number of real estate funds has been reduced over the past couple of years, due mainly to developments in the credit and real property markets.

Assets under management by Norwegian investment firms offering (individual) portfolio management amounted to 92 billion kroner at the end of 2018, compared to 106 billion kroner at the end of 2017.\(^5\) This previous reduction was primarily caused by regulatory changes, as the largest Norwegian investment firms providing portfolio management have been consolidated into asset management companies and regulated as either undertakings for collective investment in transferable securities (UCITS) management

---

5. FSAN statistics.
Norway is a Member State of the European Economic Area (EEA). As such, the main body of legislation regulating asset management (whether as part collective investment schemes or insurance companies and pension funds) consists of EU legislation implemented in Norwegian law.

Since the entry into force of the EEA Agreement in 1994, Norway has generally implemented EU legislation with great assiduity, and often chosen stricter regulation where possible. This changed significantly following the establishment of the EU system of financial supervision in 2011. The EU supervisory organisations, the European Banking Authority, the European Securities and Markets Authority, the European Insurance and the Occupational Pensions Authority, hold competences that are partly supranational. These run afof of the principle of the EEA Agreement, whereby no sovereignty shall be relinquished by the EEA Member States, and which was an important issue for Norwegian authorities when entering into the EEA Agreement (after EU membership was rejected by referendum in 1994, for the second time).

The European Free Trade Association and the EU did not reach an agreement concerning the incorporation of the EU Regulations establishing the European Supervisory Authorities into the EEA Agreement and integration into the EU system of financial supervision before 14 October 2014.\(^7\) The Agreement was approved by the Parliament in June 2016, but EU financial regulations passed since 2015 largely continue to see delays in being incorporated into the EEA agreement (see Section V).

The following is restricted to Norwegian law, and where stated, Norwegian regulation of foreign entities’ activity in Norway on a cross-border basis.

Collective investment schemes are both regulated and unregulated under Norwegian law (at the fund level). From a regulatory point of view, a distinction can be made between three types of collective investment schemes: mutual funds that are UCITS funds,\(^8\) non-UCITS mutual funds and other collective investment schemes. Norwegian law will reflect the additional EU fund types as European venture capital funds (EuVECAs), European social entrepreneurship funds (EuSEFs), European long-term investment funds (ELTIFs), and money market fund regulations are incorporated into the EEA Agreement and implemented in Norwegian law.

UCITS funds and non-UCITS mutual funds fall within the scope of the Norwegian Investment Fund Act (IF Act). Such funds may (if established in Norway) only be organised, managed and marketed according to the rules of the IF Act (and appurtenant regulations). Whether a collective investment scheme is a mutual fund falling within the scope of the IF

---

6 FSAN.
Act (or rather an unregulated alternative investment fund) must be assessed on a case-by-case basis. As a general rule, all open-ended funds investing in financial instruments and bank deposits fall within the scope of the IF Act. Managers of non-UCITS mutual funds exceeding the threshold values of the AIFMD (€100 million under management) are regulated by the Norwegian Alternative Investment Fund Manager Act (AIF Act), implementing the AIFMD, meaning that such managers must be authorised AIFMs and comply with the AIF Act. Sub-threshold managers may ‘opt in’ to benefit, in the future, from the marketing provisions of the AIF Act in other EEA jurisdictions.

Currently, several categories of investment funds (at the fund level) are unregulated in Norway (all types of funds other than mutual funds regulated under the IF Act). Closed-ended funds and open-ended funds investing in asset classes other than financial instruments and bank deposits (e.g., real property, commodities (directly and not in derivatives)), generally fall outside the scope of the IF Act. Such collective investment schemes are unregulated in Norway. Following the entry into force of the AIF Act on 1 July 2014, the management and marketing of shares in such funds are regulated under the AIF Act.

The AIF Act and the implementation of the AIFMD in Norway are to a large extent based on a copy out approach, with little to no ‘gold-plating’. Norway has implemented the AIFMD thresholds, allowing for light-touch regulation of asset managers of smaller funds that are not mutual funds (in simple terms, less than €500 million for closed-ended funds and less than €100 million for open-ended funds). Managers of sub-threshold funds may ‘opt in’ to benefit from the marketing provisions of the AIF Act. Management of Norwegian unregulated funds by managers falling below the threshold values of the AIFMD and that are established in Norway will remain unregulated (although the manager will have to register with the regulator, the FSAN).

The AIF Act and its marketing rules have had a substantial impact in the Norwegian market. While marketing of unregulated funds previously could be made without specific restrictions (other than prospectus rules, rules concerning investment services and general marketing law), the AIF Act introduced common marketing rules for all types of alternative investment funds (both those falling within and outside the scope of the IF Act). The FSAN has focused on monitoring marketing carried out by sub-threshold managers, as such managers no longer may market to non-professional investors (without opting in), and in particular reliance upon reverse solicitation practices.

The marketing rules are dependent upon the jurisdiction of the manager and the fund. Norway has implemented the ‘private placement’ provisions of the AIFMD with respect to funds and managers established outside the EEA. On this point, however, the rules are somewhat more strict than under the AIFMD, as they require prior authorisation from the FSAN to market, rather than relying on notification. In addition, for fund managers established outside the EEA, there is a requirement that they are registered with a competent authority and subject to prudential supervision in their home state for the purposes of asset management. If the interests issued by unregulated investment funds are financial instruments (shares), then services related to such shares (such as arrangement services or second-hand share sales) constitute investment services that fall within the scope of the Securities Trading Act (ST Act). There is a relatively large number of funds authorised for marketing in Norway under these rules. A revised ST Act, implementing the substantive rules of MiFID II entered

---

into force on 1 January 2019 (see Section V). In addition, the offer of such shares may trigger a requirement to publish a prospectus under the public offering rules of the ST Act, unless an appropriate exemption is available. Shares in limited partnerships are not viewed as financial instruments (transferable securities) under Norwegian law, meaning that prospectus requirements do not apply to offerings of interests in such funds. No change has been made to this through the implementation of MiFID II. Rules implementing the Prospectus Regulation have recently been adopted and are expected to enter into force shortly.

Provision of investment services as a regular occupation (i.e., not in an incidental manner) related to limited partnership interests requires a corresponding licence under the ST Act (alternatively for foreign firms, a passport for providing such services in Norway). A licence is not required when services are provided in relation to interests with a minimum commitment of 5 million kroner (or the equivalent in another currency), or if the client is a professional client as defined in MiFID Annex II Section I (per se professional clients and not elective professional clients). The purpose of this requirement was to regulate retail sales of closed-ended funds after what has been perceived as mis-selling of shares in such funds to retail clients, especially with respect to closed-ended real property funds, feeder funds of private equity funds or fund of funds in such categories. After the entry in effect of the AIF Act, this is largely regulated by the marketing rules of that Act (with respect to the primary market), and the FSAN has recently announced change of practice to regulate a wider array of collective investments under the AIF Act (see Section VI.v).

Individual portfolio management is an investment service under the ST Act, and subject to the rules and appurtenant regulations of the ST Act. Only investment firms and credit institutions authorised under the ST Act, management companies for mutual funds or AIFMs authorised to provide portfolio management (as an ancillary service) may provide individual portfolio management services.

Activity falling within the scope of the IF Act, the AIF Act and the ST Act is under the supervision of the FSAN.

Asset management carried out by insurance companies and pension funds is regulated through the insurance company legislation and under the supervision of the FSAN. Norway has implemented the Solvency II capital adequacy rules for insurance companies with effect from 1 January 2016 (on a ‘lookalike’ basis: see Section V). The main rule applicable to their asset management is the prudent person principle. This requirement concerns both the investment process and the placements themselves. Pension funds are, as of 1 January 2019, subject to a risk-sensitive capital requirement under freedom of investment based on a Solvency II ‘light’.

III COMMON ASSET MANAGEMENT STRUCTURES

As mentioned in Section II, collective investment schemes established in Norway either fall within the IF Act, or outside specific regulation (at the fund level).

Funds that are regulated under the IF Act are required to be organised as contractual (rather than corporate) mutual funds under that Act. This is a specific form of organisation that, as a general observation, implies a high degree of connectedness between the management company and the funds managed by such company. For example, shareholders in the funds are entitled to elect a number of members of the board of the management company (and the management company obliged to appoint such board members). The fund has a legal personality, but all dispositions shall be taken by the management company.
Norwegian company law is generally not adapted to organise open-ended fund structures, as Norwegian limited company law does not allow for limited companies with variable capital. Unregulated (closed-ended) funds are almost without exception organised as corporate structures (private limited companies), partnerships or silent limited partnerships. In recent years, some fintech actors have begun structuring crowdfunding vehicles as cooperatives, because shares in cooperatives may be marketed and sold without restriction under the prospectus rules or the ST Act.

Before June 2010, Norwegian legislation did not allow for the establishment of hedge funds in Norway. Pursuant to an amendment of the IF Act enacted in 2010, such funds may be established and marketed under the IF Act. Because of this legislation having entered into effect relatively recently, many Norwegian promoters of hedge funds have traditionally chosen to establish funds in other fund jurisdictions, such as Ireland, Luxembourg or Malta. Such funds have been, and continue to be, managed by Norwegian teams under delegation arrangements with self-managed corporate fund structures (plc or SICAV). Such managers were previously subject to the ST Act, and required to be authorised as an investment firm providing the investment service of portfolio management. Following the entry into effect of the AIF Act, such managers will typically (depending on the organisation of the relevant fund structure) be required to be authorised under the AIFMD as an alternative investment fund manager.

No changes have been made to the IF Act with the implementation of the AIFMD (except certain changes to the marketing rules). Nor has any new fund legislation been proposed or passed. Norway therefore lacks appropriate legislation (or infrastructure) to be an attractive jurisdiction for fund establishment, compared to other jurisdictions. The Ministry of Finance is currently in the process of implementing the regulations underpinning EuVECA, EuSEF and ELTIFs. These EU regulations will represent wholly new types of regulated investment vehicles in Norwegian law. Due to the delay in incorporating these regulations into the EEA Agreement, such rules will likely not enter into force until 2020.

Authorised AIFMs are required to appoint a depositary to their funds. This includes unregulated funds not previously subject to such a requirement. Although there is a limited number of available service providers in this segment in Norway, this has not proven to be a bottleneck for the establishment of new funds.

Since the entry into force of a new Act on Financial Undertakings and Financial Groups on 1 January 2016, Norwegian law no longer allows for the establishment of securitisation vehicles, and securitisation outside covered bonds is generally not possible on suitable terms. It is expected that Norway will implement any EU securitisation rules if and when they are proposed as part of the Capital Markets Union initiative. Whether there will be a delay in implementation of such rules, as with other financial regulations these past few years, remains to be seen. Rules governing synthetic securitisation will be implemented upon incorporation of the Capital Requirements Regulation into the EEA Agreement and full transposition of the regulation into Norwegian law.

Individual portfolio management is mainly restricted to institutional clients (pension funds) and high-net-worth investors through private banking offerings. The structuring of investments will typically be bespoke and adapted to the client at hand.

In the retail segment of asset management, significant amounts are invested through unit-linked insurance policies. Several Norwegian insurance companies offer unit-linked life insurance, which offers policyholders the opportunity to invest in a number of assets (although mainly mutual funds and listed instruments) as underlying in a unit-linked
insurance contract. Tax rules make holding investments through a unit-linked insurance policy more favourable (for private individuals) compared to holding such investments directly or through mutual funds. Insurers generally provide web-based tools for investors to monitor and make changes to their portfolio, without triggering taxation. The government has enacted changes to the applicable tax rules to avoid different tax treatment of what – in substance – are similar-type investment products which require that the relevant unit link policy has a larger insurance element. Whereas previously the contracts promised a 101 per cent payout upon an insurance event, the new rules require a payout of 150 per cent for the insurance policy to qualify. In this context, the Ministry of Finance also adopted rules for an ‘equities savings account’, which is a specific tax treatment of securities accounts of private individuals containing only equity instruments and equities mutual funds. This provides more favourable tax treatment for investments in such asset classes than direct investment. Investments are made directly in the name of the investors (as is the case for individual portfolio management), and may be offered by credit institutions, investment firms and management companies for mutual funds.

IV MAIN SOURCES OF INVESTMENT

Sources of investment into managed investment products may be divided in several categories, but the main distinction is between retail investors and professional and institutional investors. High-net-worth individuals and family offices will often be a residual category, where the size of the portfolio will be the main differentiator. One key trend, only recently reversed, has been a decline in funds stemming (directly) from retail investors. Indirect investments from such clients have, however, continued to grow as defined contribution pension schemes (rather than defined benefit) have become the norm for all employees.

Through various investment companies and schemes, the government is also a sizeable investor in the Norwegian financial markets in listed securities, private equity and the venture and seed segment (see Section VI.v).

It is worth noting that the government is also a heavy investor in Norwegian private equity funds (e.g., through the government-owned investment company Argentum Fondsinvesteringer AS and its affiliates). The government has established a seed fund initiative through Innovasjon Norge (a government-funded initiative for the development of Norwegian businesses). Alliance Venture Spring and ProVenture Management have been appointed as the managers for the new seed funds. Each fund will have commitments equal to approximately 500 million kroner, of which 50 per cent will be subscribed by the government.

With regard to Norwegian mutual funds, the majority of assets under management stem from Norwegian institutional clients (representing 626 billion kroner at the end of 2018, compared to 631 billion kroner the previous year, and 564 billion kroner the year before that). At the end of 2018, Norwegian retail investors held 420 billion kroner (including holdings through pension savings schemes where the client elects underlying, compared to 398 billion kroner the year before and 316 billion kroner in 2016), while foreign investors (all categories) at the end of 2018 held 117 billion kroner of assets under management in

---

10 Norwegian Fund and Asset Management Association annual statistics for 2016, 2017 and 2018. Institutional clients are defined as all non-retail clients.
Norwegian mutual funds, compared to 109 billion kroner in 2017 and 102 billion kroner in 2016. These figures do not include mutual funds established in other states and managed by a Norwegian manager (see Section VI.iii).

One notable absence is the lack of investment in infrastructure through market-based vehicles. This may change with the implementation of the ELTIF regulation, which allows for marketing to non-professional investors. Insurance companies and pension funds were prohibited from owning more than 15 per cent of an issuer conducting business other than insurance activities. This rule has effectively prohibited life insurance companies from making appropriate investments into infrastructure, both directly and through collective investment undertakings. Following action by the EFTA surveillance authority citing the provisions of freedom of investment under Solvency II the government proposed to repeal the restriction and the amendment entered into effect on 1 January 2019. Norwegian life insurance companies and pension funds may now benefit more fully from the Solvency II infrastructure investment risk weights.

V KEY TRENDS

i Intensified competition

In general, the Norwegian economy weathered the effects of the global financial crisis without experiencing significant difficulties. This is at least partly because of Norway's income from oil and gas extraction, providing the state with significant and steady tax income. With respect to the asset management industry, the market turmoil of 2008 led to a shrinking market, and increased competition among asset managers and managers of mutual funds for the remaining market share. This was compounded by the effect of the fall in oil prices since 2014.

The fall in oil prices was a negative factor for issuers listed on the Oslo Stock Exchange, and losses typically led to mutual funds falling out of favour with retail investors in the short term. The total number of funds was reduced from 441 in 2014 to 404 at the end of 2015, illustrating a consolidation. This increased since to 433, but has decreased again to 423.

Combined with generally low returns in fixed income markets, the value reductions have led to investors across all categories to be more aware of the level of fees. In the retail market, the Norwegian Consumer Council has focused on a long-time practice among Norwegian managers of mutual funds to levy success fees without implementing a high-water mark, meaning that volatility will benefit the manager and be to the detriment of investors. This practice has not been present in the institutional market, but larger investors are increasingly pushing for lower management fees for all fund types.

On the regulatory side, the FSAN has compelled both DNB Asset Management (the asset management arm of Norway's largest bank) and Nordea to take fee cuts on some of their mutual fund offerings boasting 'active management'. The FSAN found the funds to be 'closet index funds', where the fees imposed on investors did not provide the investors with any realistic chance for higher returns. The consumer organisation Forbrukerrådet has since led a class action lawsuit against DNB claiming damages on behalf of 150,000 investors. On 2 June 2017, the appellate court upheld the decision by the city court to approve the class action lawsuit (which is the first class action lawsuit in Norway) sponsored by the Norwegian

---

11 FSAN.
Consumer Council, which it lost in the judgment of the city court on 12 January 2018. The verdict was appealed by Forbrukerrådet, and in its judgment on 8 May 2019, the appellate court awarded damages to the relevant clients. DNB has decided to appeal to the Supreme Court.

It remains to be seen whether the regulator will take any further initiatives concerning costs and fees in collective investment schemes as has been done in other jurisdictions. Notwithstanding, the advent of the requirement to produce a key information document under the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation (albeit in the retail market) will provide additional transparency and may favour investment in low-cost index funds. As with other EU regulations, the implementation of this Regulation is delayed, and will likely not happen before 2020.

ii Regulatory delay

As a member of the EEA, Norway is required to implement EU financial sector legislation. Norwegian authorities are currently working on the implementation of the backlog of EU financial legislation, which has been delayed by the EU financial supervisory system (see Section II). This concerns both legislation that has been implemented on a lookalike basis (such as the Capital Requirements Directive (CRD IV along with delegated acts), the European Market Infrastructure Regulation (EMIR), MiFID II/MiFIR, and legislation that has not yet been implemented in any way (e.g., the PRIIPS Regulation, the EuVECA, EuSEF, ELTIF and MMF Regulations, and the Securities Financing Transactions Regulation).

Legislation of particular interest to the legislator has been implemented in Norwegian law on a lookalike basis (e.g., Solvency II, CRD IV, the Capital Requirements Regulation and the revised Payment Services Directive). Often, this approach leads to certain discrepancies in the rules, which may be problematic in some cases.

The high level of change in EU financial legislation since the financial crisis in 2008, combined with the long-time unresolved supervisory question, have led to long delays in the implementation of several pieces of EU financial legislation in Norway.

Following the agreement concerning the EU financial supervisory system, outstanding legislation is expected to be incorporated into the EEA Agreement as soon as possible. The combined effect of more extensive EU financial sector legislation than before, and trying to ‘catch up’ with the EU, has put a strain on the resources of the FSAN and the Ministry of Finance. Together, this negatively affects the asset management industry and the Norwegian financial industry as a whole, which must cope with higher regulator fees and reduced service.

VI SECTORAL REGULATION

i Insurance and pensions

Norwegian insurance companies and pension funds are regulated under the Act on Insurance Activity with appurtenant regulations and the Act on Financial Undertakings and Financial Groups, which contains the ‘institutional’ rules and capital requirements. Together, these acts implement Solvency II, including the rules concerning investment freedom and qualitative investment rules (the ‘prudent person principle’).

13 Act on Insurance Activity No. 44 of 10 June 2005.
Before Solvency II, for both life and non-life companies, a maximum of 10 per cent of their total technical reserves could be invested in ‘miscellaneous assets’. This category consisted of non-listed equity and fixed income investments, including loans and various collective investment vehicles that fell outside UCITS. Hence, investments in, inter alia, private equity funds, offshore funds, European or offshore domiciled hedge funds (including special funds: see below) fell into this category of investments. The new rules have not yet produced any significant changes to the asset allocation of insurers, but this may change over time.

Pension funds were, until the end of 2018, subject to Solvency I-based legislation and provisions, requiring that assets covering technical reserves are invested prudently, duly taking into account security (risk), diversification, liquidity and potential return. Further regulations contained specific quantitative investment restrictions for assets covering technical reserves. As of 1 January 2019, pension funds are subject to a Solvency II ‘lite’, with risk-sensitive capital requirements combined with investment freedom. The new rules are more complex than before, and while they may provide pension funds with more flexible rules to maximise returns and match their assets with their liabilities, they represent a high cost for the many small pension funds. Whether this may force a consolidation of smaller pension funds into larger entities, or an accelerated winding-down of defined benefit plans that such funds have traditionally offered, remains to be seen.

Pensions and their costs have become increasingly important subjects in public debate, in particular following the insolvency of Norwegian pension insurance company Silver Pensjonsforsikring AS, where the estate was bought by Storebrand. The bankruptcy was directly connected to obligations relating to closed pension schemes with defined benefits stemming from conversion to defined contribution schemes or where employees have left the relevant employer. Norwegian occupational pension rules were generally poorly adapted to the situation where employees have several employers throughout their career. The government has tried to remedy this with new rules on pension accounts for defined contribution schemes, whereby pension contributions are allocated to a personal account for each employee, with individual rights to transfer the account between offerors (also outside the insurer chosen by the employer).

ii Real property
There is no specific regulation of real property funds established in Norway (see Section II). Such funds typically fall outside current investment fund regulation (as they normally are closed-ended).

Norwegian real property funds are typically unlisted private limited companies, but public companies also exist.14 The sale of shares in such companies will be subject to public offering rules, and services related to such shares (e.g., brokerage services) are investment services subject to the ST Act, unless the fund in question is established as a limited partnership.

The management and marketing of real property funds are regulated by the AIF Act. Additional requirements concerning marketing to non-professional investors, requiring that

---

14 See, for example, Norwegian Property ASA, listed on the Oslo Stock Exchange.
managers are authorised under the AIFMD, has led to changes in governance for funds directed at such investor categories. Specifically, management is now typically undertaken by an external and authorised manager.

### iii Hedge funds

Prior to July 2010, the establishment and marketing of mutual funds that employed investment strategies similar to those used by funds regularly referred to as hedge funds were not allowed in (or into) Norway. As of 1 July 2010, amended legislation was enacted that allowed the establishment and marketing of such funds to investors qualifying as professional clients under the ST Act (both per se and elective professional clients). These rules essentially widened the scope of the IF Act to include mutual funds with investment strategies typical of hedge funds. The IF Act refers to this category of funds as special funds, and both the management and marketing of shares in such funds are regulated under the IF Act. This means that special funds are subject to regulation based on the UCITS rules, but with wide exemptions concerning investment strategies.

Special funds established in Norway may only be managed by management companies authorised under the IF Act, or foreign management companies authorised under equivalent rules in their home state. In practice, only management companies established in another EEA Member State will be eligible. Managers exceeding the threshold values of the AIF Act (€100 million or €500 million under management) must be authorised in accordance with the AIF Act (or local legislation implementing the AIFMD).

The marketing of shares in hedge funds to professional investors is (for above-threshold managers) subject to the provisions of the AIF Act. It may be noted that the FSAN has held that the marketing rules of the IF Act apply to marketing of such funds. The rules are, however, substantively similar. Different marketing rules apply depending on the jurisdiction of establishment of the fund and the AIFM.

Sub-threshold managers may market shares in hedge funds pursuant to the rules of the IF Act. This requires prior authorisation from the FSAN, and such authorisation may only be granted if, inter alia, an agreement on supervision has been entered into between Norway and the home state of the manager of the foreign special fund, and the foreign special fund and its manager are subject to home state regulation that grants investors in Norway protection at least on par with that offered by the IF Act. In practice, authorisation may only be obtained if the manager is subject to AIFM-level regulation.

### iv Private equity

There is no specific regulation of private equity funds in Norway (see Section II). Such funds typically fall outside the current fund regulation (as they normally are closed-ended). However, the management and marketing of such funds is now regulated in the AIF Act.

Norwegian private equity funds have traditionally been organised according to the typical private equity fund organisation, consisting of a fund and an adviser. The fund will then be organised as a Norwegian partnership, silent limited partnership or similar foreign entity (e.g., Guernsey or Jersey limited partnership). The AIF Act, implementing the AIFMD, relies on a different system, whereby the fund is expected to have one single manager responsible for both risk management and portfolio management, the latter including taking investment decisions on behalf of the fund. This has required some adaptations for Norwegian sponsors to comply with the AIF Act, while still offering investors a model they are used to. Certain advisers have chosen to offshore their operations in order to avoid changes.
Other sectors

Other than what has been described above, there is no other general regulation of asset management activity in Norway, with the exception of individual portfolio management, which is an investment service subject to the ST Act. With the implementation of the AIFMD, one relatively common investment product has received added regulatory scrutiny, namely project finance or syndicated projects.

Project finance has been a traditional product in the Norwegian investment market, attracting investors to invest in special purpose vehicles holding typically one or a few capital-intensive assets, often called single asset funds. The management and marketing of funds not falling within the IF Act had been unregulated in Norway prior to the advent of the AIF Act. Consequently, there have been few regulatory concerns. In May 2019, the FSAN issued a circular in which it clarified that it considered most typical project finance and syndicated investments to fall within the definition of an ‘alternative investment fund’. This means that the special purpose vehicle must appoint a manager that is either registered or authorised. Further, marketing of alternative investment funds to non-professional investors may only be done with prior authorisation from the FSAN. This may produce a decrease in products offered in the retail segment until the relevant actors have obtained the necessary approvals and completed any reorganisations that may be required. FSAN scrutiny may also mean that some products with inappropriate risk-reward profiles are denied marketing authorisation.

The Government Pension Fund Global: the Petroleum Fund

The Petroleum Fund is a sovereign wealth fund established on the basis of a special act. As such, it is not a fund in the traditional sense, but a body of assets owned by the government and deposited in an account with the Central Bank of Norway. Further, it is not a pension fund in the traditional sense; it is not liable to earmarked payments, but is rather a tool for government savings and value preservation.

There is broad political consensus concerning an ‘action rule’ on the use of the state’s income from oil extraction. This action rule sets out that the annual use of funds from such income shall not exceed an estimated return on the investment of the fund. For several years this has been set to 4 per cent of the value of the fund, but was lowered to 3 per cent in 2017, as returns over time have been lower than 4 per cent. The object of the action rule is to avoid macroeconomic stress and inflation in Norway as a result of excess public spending. Although a political majority may choose to reorganise or liquidate the Petroleum Fund in part or in whole, the curbed spending of income from oil and the current organisational model of placing the state’s income from oil extraction in the Fund are subject to broad political consensus.

The management of the Fund is delegated to the Ministry of Finance, which has in turn delegated its duties to the Central Bank via a regulation. The Fund is managed by a department of the Central Bank called Norges Bank Investment Management (NBIM). On 23 June 2017, a working group headed by a former chair of the Central Bank delivered its report assessing the Central Bank Act and the organisation of the management of the Petroleum Fund. The working group proposed spinning off NBIM into a separate company.

---

16 Regulation No. 1414 of 8 November 2010.
(to be wholly owned by the government) in order to separate the Central Bank from the management of the Petroleum Fund. The government, however, chose not to propose any substantive changes to the current model, whereby the management of the fund is carried out by an internal department. The question of the governance and supervision of the Fund are also likely to be a question going forward, irrespective of whether the Fund should grow (by deposits or profits), or decrease (through consumption or in particular underperformance).

The Ministry of Finance has appointed a strategy council to advise on the investment strategy of the Fund. Further, the Ministry has adopted ethical guidelines for the Fund, and an ethics council has been appointed.

The investment mandate of the Petroleum Fund has been under continuous development. In December 2014, a committee appointed by the Ministry of Finance delivered a report concerning exclusion of oil and coal extraction from the investment universe of the Fund as a tool to combat climate change. This has also been linked to the more prosaic concern of delinking the Fund from exposure to the oil extraction industry, towards which the Norwegian economy is already broadly exposed. An expert committee proposed to exclude such shares in upstream companies from the investment universe of the Fund. This report is currently subject to a public consultation. In April 2016, the Ministry slightly changed the allocation of the fund to increase the maximum exposure to real estate (to 7 per cent). At the same time, the Ministry concluded that the investment universe should not be expanded to investments in infrastructure. The Petroleum Fund is prohibited from investing in Norway.

**The Government Pension Fund Norway**

The Government Pension Fund Norway constitutes part of the Government Pension Fund, and is based on the same act as the Petroleum Fund. As such, it is not a fund in the traditional sense, but a body of assets owned by the government that manages capital in its own name.

The mandate of the Fund is specified in a regulation. The capital can be placed in equity instruments taken up to trade in regulated marketplaces in Norway, Denmark, Finland and Sweden, and in interest-bearing instruments where the issuer is resident in Norway, Denmark, Finland or Sweden, or has equity capital taken up to trade in regulated marketplaces in those countries. The Government Pension Fund Norway owns approximately 5 per cent of the market value of the Norwegian stock market and 10 per cent of the main index on the Oslo Stock Exchange.

**Argentum Fondsinvesteringer and Investinor**

Argentum Fondsinvesteringer AS, an important government-owned private equity investor, has developed into a private equity actor in its own right by expanding from primary investments to co-investments with funds in which Argentum is an investor, and due to its relatively high investment activity in the secondary market. Argentum has also established investment programmes whereby other investors are invited to invest alongside Argentum. The value of its investment portfolio at the end of 2017 was 7.6 billion kroner, marking the best ever results of that company with 1.6 billion kroner in profits.

---

18 Regulation No. 1790 of 21 December 2010.
Investinor AS was established by the government as an investment fund to invest directly in Norwegian businesses with essentially a venture fund investment strategy, investing in the early growth and expansion stage of such businesses. Investinor is the largest investor in the Norwegian venture and expansion market, managing, as at the end of 2018, approximately 4.2 billion kroner.

VII TAX LAW

Taxation under Norwegian tax law of collective investment schemes will depend on whether the scheme is regarded as opaque or transparent for tax purposes. Mutual funds are not tax-transparent, while private equity funds are either organised as tax-transparent entities (silent partnerships or similar) or opaque entities (limited liability companies). Tax transparency implies that the fund is not a separate taxpayer, and that the investors are taxed directly on the profits of the fund.

The rules concerning taxation of mutual funds were changed with effect from the 2016 tax year. The previous rules resulted in non-Norwegian ‘combination funds’ (funds investing both in equities and fixed income instruments) being a tax-favourable alternative for Norwegian investors. The new rules aim at neutralising the favourable tax treatment of foreign combination funds. Under the new rules, all mutual funds shall be treated equally for Norwegian tax purposes. All types of mutual funds shall be subject to the tax exemption method, but the taxation of investors will depend on the actual allocation of a fund’s portfolio of equity investments and fixed income investments. The rules imply that investors will not be subject to taxation on a running basis, but only upon distribution or realisation, or both, as under the previous rules.

With respect to taxation of Norwegian investors, the rules imply that distributions from mutual funds with an equities portion higher than 80 per cent are taxed as share distributions in full (at a rate of 0.66 per cent for corporate investors and 31.68 per cent for individual investors on distributions that exceed a tax-free allowance). Distributions from mutual funds with an equities portion lower than 20 per cent are taxed fully as interest income (at a flat rate of 22 per cent for both corporate and individual investors). Distributions from mutual funds with an equities portion between 20 and 80 per cent are divided into one part that is taxed as share distribution and one part that is taxed as interest, calculated proportionally based on the value of the fund’s equities portion compared with the total value of the fund at 1 January of the relevant income year (where cash is excluded from the fund’s total value). The simplified rule for determining the fund’s equities portion applies correspondingly for the taxation of any gain upon realisation, however, so that only the equities portion in the year of purchase and the year of realisation is relevant.

The proportion of equity investments of a fund must be reported to the Norwegian tax authorities. Foreign funds will not have an automatic reporting obligation, but can report voluntarily. If not, the reporting obligation lies with the Norwegian investors. Failing to provide sufficient documentation implies that distributions and gains will be fully taxed as interest income.

Non-Norwegian investors in Norwegian mutual funds and private equity funds organised as opaque entities are only taxable in Norway on any distribution of dividends from the fund (Norway does not currently impose withholding tax on capital gains and
The domestic tax rate is 25 per cent, but is reduced to 15 per cent (or lower) in most tax treaties. In addition, corporate investors resident in the EU or EEA may be exempt from dividend withholding tax under specific rules.

Non-Norwegian investors in Norwegian private equity funds organised as tax-transparent entities may have tax liability in Norway for a fund’s income (irrespective of whether the income of the fund is distributed to the investors or not) due to participation in a business being managed from Norway. However, for corporate investors, capital gains on shares are as a main rule tax-exempt, while dividends are as a main rule taxed at an effective rate of 0.66 per cent. The same 0.66 per cent tax rate also applies to distributions from a private equity fund to corporate investors.

Norwegian asset managers (and other financial sector undertakings) are subject to a ‘financial sector tax’, effective as of 2017, originally as a result of the long-standing discussion of introducing VAT on financial services.

VIII OUTLOOK

i Regulatory waiting game

The Norwegian asset management industry (and indirectly investors, both Norwegian and foreign) has been affected by the delay in implementing EU asset management and securities legislation. Tellingly, EMIR entered into force in Norway on 1 July 2017, several years later than in the EU. Neither the revised EU Transparency Directive nor the updated market abuse rules of the EU Market Abuse Regulation have been implemented or incorporated into the EEA Agreement. As the regulations concerning EuVECA, EuSEF and ELTIF funds have not yet been implemented, Norwegian fund managers have not been able to pursue these opportunities yet. As providing loans is a regulated activity in Norway, these new fund types may have a particular use under Norwegian law, providing managers with greater flexibility in their investment activity in the unlisted markets. For managers of open-ended funds investing essentially in listed markets, there is uncertainty as to the impact of MiFID II in terms of costs and benefits. The new rules on inducements under MiFID II may also affect asset managers in terms of how they distribute funds in a cost-effective manner.

For asset managers active in the retail markets the impact of the PRIIPs Regulation may introduce increased competition and cost transparency. It remains to be seen whether the increased transparency will also affect the marketability of different segment (and higher cost) funds in the retail markets, and whether this transparency will also affect the approach of institutional investors, especially smaller institutional investors that are not large enough to directly influence costs of management.

Recent government initiatives in the retail segment may lead to increased inflows into mutual funds: the rules concerning an ‘equities savings account’ for private individuals (see Section III) as well as rules for a new personal pension plan for private individuals with tax incentives. Increased focus on pension savings is likely to contribute to growth in these sectors. The regulator has also alluded to adopting rules for a mandatory key information document for pension products. Towards the end of 2018, approximately half of all assets in Norwegian equities mutual funds held by natural persons were held outside an equities account, and the transitional rule to transfer shares into such account has been extended by a year, to year-end 2019.

There are several underlying trends of increased use of delegation and possible offshoring among Norwegian asset management and financial services providers; necessary
software solutions are increasingly migrating to ‘cloud services’, and may present a better value proposition for firms. The financial sector tax will increase costs for each Norwegian employee. This may be compounded by the expected strain – and necessarily reduced responsiveness – of the Norwegian regulatory authorities, who will be required to implement a quite large backlog of EU legislation into Norwegian law. It is uncertain how the future exit of the United Kingdom from the EU will affect the Norwegian asset management industry. The traditional close relationship and extensive trade between Norway and the UK lead us to believe that Norwegian authorities will strive to achieve a solution securing free trade to the greatest extent possible.

ii Nascent comparative advantages
Recent developments may provide Norway, as an asset management jurisdiction, with some advantages compared to neighbouring jurisdictions. These developments span from the general legislative landscape to tax law and regulator scrutiny.

The authorities have for some time endeavoured to simplify company law and the administrative burden of private companies. These measures are beginning to show results, with more flexible capital rules for limited liability companies and better online tools for establishing the legal entities necessary for an asset management structure. Increasingly, Norwegian asset managers establish Norwegian structures for co-investments that foreign and foreign institutional investors have accepted. Broader investor acceptance of Norwegian structures will likely provide for easier transitioning to such structures going forward.

Further, legal certainty for private equity managers has been strengthened following decisions by Norwegian courts that carried interest shall not be taxed as personal income, and that such amounts shall also be within the scope of the tax-exemption method, provided a beneficiary is sufficiently exposed to financial risk through his or her investment.

Finally, the Norwegian regulator has been both pragmatic and focused in its supervisory action in the asset management field. Case handling times have been relatively low, with reasonable documentation requirements, the regulator seemingly having focused on products in the retail segment. We do, however, expect that the regulator will intensify its review of AML measures in the sector going forward.

Provided the Norwegian legislature is able to keep pace with the EU in terms of transposition of EU law and securing passporting rights for Norwegian actors, Norway will be advantageous from a regulatory perspective as it relies solely on EU law and avoids gold-plating or other more stringent rules.
I OVERVIEW OF RECENT ACTIVITY

The asset management industry in Pakistan is dominated by open-ended retail mutual funds, which account for over 66 per cent of the total assets under management (AUM). Other asset management categories such as discretionary and non-discretionary portfolio management (20.5 per cent), real estate investment trusts (5 per cent), modarabas (5.5 per cent), private equity funds (0.5 per cent) and pension funds (2.5 per cent) make up the remainder.

The asset management industry in Pakistan has been able to make only limited inroads in mobilising investments and generally has low penetration levels in the economy. The total AUM account for only around 5 per cent of the total banking sector deposits of the country. This represents a significant potential for growth in the industry. Pakistan also has a low savings to GDP ratio of less than 10 per cent, with investors preferring to invest in real estate assets over financial products. In order to encourage investment in equities and fixed income products, Pakistan’s tax laws provide various incentives for investors to invest in mutual funds (as further discussed below).

Between July 2016 and July 2017, the asset management industry in Pakistan grew by around 30 per cent. However, between July 2017 and May 2018, the sector saw a much more modest increase of 5 per cent, primarily on account of the prevailing political uncertainty and resultant decline in the value listed equities on the Pakistani Stock Exchange. Over the last eight years starting from the beginning of this decade, the asset management industry has experienced an average annual growth rate of around 16 per cent per year. From June 2010 to May 2018 the total assets of non-banking finance companies (NBFC) grew by over 220 per cent. The largest increase was seen in shariah-compliant funds, which experienced growth of 720 per cent, whereas conventional funds saw growth of over 150 per cent. However, between June 2018 and May 2019, the sector saw a downward trend and there was negative growth of 4.61 per cent primarily on account of the general economic slowdown, monetary tightening by the State Bank of Pakistan, sharp currency devaluation and the resultant decline in the value listed equities on the Pakistani Stock Exchange.

Although Pakistan’s stock market has for most of past decade been among the world’s best performing stock markets delivering returns of around 26 per cent per year in US dollar terms between 2009 and 2015, the recent economic slowdown has dampened market sentiment despite Pakistan being upgraded as an emerging market to the MSCI Emerging Markets Index in 2017. Pakistan has also experienced a sizeable currency devaluation of

---

1 Haroon Jan Baryalay is a partner at FGE Ebrahim Hosain.
around 60 per cent over the past two years which has further reduced the value of listed securities, in US dollar terms, on the stock market. The Pakistan Stock Exchange experienced a decline in market capitalisation from a peak of 10 trillion rupees (US$100 billion) in May 2017 to 7 trillion rupees (US$41 billion) in June 2019.

As at May 2019, there are 23 asset management companies or investment advisory companies licensed by the SECP which manage over 202 mutual funds. Of these, 10 asset managers are also licensed to manage pension funds. There is a total of 28 modarabas, four REIT management companies and four domestically licensed private equity firms. The total size of the asset management industry in Pakistan is around 945 billion rupees (US$6 billion). Given the size of Pakistan’s economy (around US$300 billion), the asset management sector is quite small in relative terms, showing low penetration levels of asset management companies in the economy.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

Asset managers in Pakistan are regulated by the Securities and Exchange Commission of Pakistan (SECP), a statutory independent body formed under the Securities and Exchange Commission of Pakistan Act, 1997.

The Securities Act, 2015 (Securities Act) regulates the provision of financial services such as acting as a securities manager or securities adviser, and the entities that provide such services. Under the Securities Act, the services provided by the ‘securities manager’ and ‘securities adviser’ constitute regulated activities and entities providing such financial services are required to be licensed by the SECP. A ‘securities manager’ is defined as a person who manages a portfolio of securities belonging to another person, whether on a discretionary or non-discretionary basis. A ‘securities adviser’ is defined as a person who provides, inter alia, advice on investing and managing a portfolio of securities for another person without holding the property of that person.

In Pakistan, asset management companies fall within a broader category of financial institutions generally known as ‘non-banking finance companies’.  

Section 282 (A to N) of the repealed Companies Ordinance, 1984 continues to govern NBFCs in Pakistan.

Modaraba companies are similar to investment funds but they must invest their capital in a shariah-compliant manner. Modarabas are regulated under a separate law known as the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 (the Modaraba Ordinance).

The SECP has issued further detailed rules and regulations pursuant to Section 282 (A to N), which set out regulatory requirements for NBFCs. These additional rules and regulations include the following:

- NBFC (Establishment and Regulation) Rules 2003 (the NBFC Rules);
- Non-Banking Finance Companies and Notified Entities Regulations, 2008 (the NBFC Regulations);
- Private Funds Regulations, 2015 (the Private Funds Regulations);

3 In addition to asset management companies etc., NBFCs also include investment banks and investment finance companies, leasing companies and microfinance banks.

4 This section remains in force despite repeal of the remaining provisions of the Companies Ordinance, 1984.

5 The Companies Ordinance, 1984 has been repealed by the Companies Act, 2017 (Act XIX of 1997).
d. Real Estate Investment Trust Regulations, 2015 (the REIT Regulations); and
e. Voluntary Pension System Rules, 2005 (the VPF Rules).

Furthermore, where a fund is established as a unit trust, the declaration of trust and appointment of trustee is governed by the Trust Act 1882.

The NBFC Rules divide NBFC's into two categories: (1) fund management NBFCs; and (2) lending NBFCs. A fund management NBFC means an NBFC licensed by the SECP to undertake asset management services or REIT management services or pension fund scheme business or private equity and venture capital fund management services or investment advisory services.

i. Establishment and regulation of NBFCs

The NBFC Rules prescribe the manner of setting up an NBFC and set out their reporting and compliance requirements. An NBFC is licensed by the SECP and is required to renew its licence every three years. A company cannot be issued an NBFC licence if a similar category of licence is held by another group company. An NBFC may not alter its constitutional documents without approval of the SECP (an NBFC may, however, increase its authorised share capital without permission from the SECP).

ii. Management

The promoters, directors and chief executive of a proposed NBFC must also fulfil the fit and proper criteria laid out by the SECP. The promoters must be issued at least 25 per cent of the paid-up share capital. The shares held by the promoters or majority shareholders and the directors must be deposited in a blocked account with the Central Depository Company and such shares cannot be transferred without the approval of the SECP. The NBFC's chief executive cannot hold a similar position in any other company, except an investment company managed by the NBFC, and any change in the chief executive or the board must be approved by the SECP.

iii. Reporting and accounting

An NBFC is required to maintain an accurate and up-to-date accounts book, which shall represent a true and fair view of its affairs and must be prepared in accordance with International Accounting Standards (IAS) and audited by an auditing firm licensed by the SECP. The NBFC must also adhere to the requirement of submitting quarterly unaudited and annually audited financial statements to the SECP. The asset management company must also appoint an internal auditor, compliance officer and a chief accounting officer having the minimum prescribed experience and qualifications. Furthermore, an NBFC is prohibited from removing any of its records or documents from Pakistan without prior permission of the SECP.

---

6 A lending NBFC is one that is to undertake leasing or housing finance services or investment finance services or discounting services.
iv Rating
An NBFC is required to obtain an annual rating from a credit rating agency registered with the SECP and publish such rating in its annual report and quarterly reports, as well as the annual and quarterly reports of any funds managed by it.7

v Change of control
A sale of a strategic investment, a sale of shares of a subsidiary or associated company, or any merger or acquisition of an NBFC requires prior approval of the SECP.

vi Other
An NBFC must also comply with the applicable laws and directions relating to money laundering, terrorist financing and other unlawful activities.

The applicable rules and regulations regulate not only the asset manager but also require the fund vehicle itself to be registered with the SECP as a 'notified entity', which is thereafter regulated under the applicable regulatory regime.

III COMMON ASSET MANAGEMENT STRUCTURES
Under the NBFC Rules, a fund management NBFC can be licensed by the SECP to undertake any of the following activities:

\[ a \] asset management company services;
\[ b \] real estate investment trust (REIT) management services;
\[ c \] pension fund scheme business;
\[ d \] private equity and venture capital fund management services; and
\[ e \] investment advisory services.

These licensed activities are not categorised in any order of hierarchy and a licensee must obtain a separate licence or approval in order to undertake each particular category of regulated activity.

Asset management services are defined as the business of providing services for management of collective investment schemes. Investment advisory services mean the services provided for, managing discretionary or non-discretionary portfolios for both individual and institutional clients and include the business of advising others as to the value of securities or as to the advisability of investing in, purchasing or selling of securities, for remuneration. The other regulated activities listed above relate to each type of licence granted by the SECP and are further discussed below.

A collective investment scheme can either be a closed-end scheme or an open-ended scheme. A closed-end scheme is required to specify its maturity period and must not continuously offer its units or certificates to investors. The holder of a certificate is entitled to receive a proportionate share of the net assets of the closed-end scheme. An open-ended scheme, on the other hand, can offer units based on net asset value on continuous basis.

---

7 At present, there are two rating agencies licensed by the SECP, namely the JCR-VIS and Pakistan Credit Rating Agency (PACRA).
without specifying any duration for redemption. The certificate entitles the holder of such units on demand to receive its proportionate share of the net assets of the scheme less any applicable charges on redemption or revocation.

Under the NBFC Regulations, an open-ended scheme can only be established as a unit trust whereas a closed-end scheme can be established as an investment company as well as a unit trust. Private equity and venture capital funds, pension funds and REITs are required to be structured as unit trusts. Unlike some other jurisdictions, Pakistan does not have a limited partnership law and accordingly it is not possible to establish a private equity or other fund using the typical limited partnership structure.

In unit trust structures, the appointment of a trustee requires SECP’s prior approval. The trustee and the asset management company are required to be independent entities. A trustee can only be a bank licensed in Pakistan that has at least an AA- rating, a subsidiary of a scheduled bank, a foreign bank operating in Pakistan and operating as trustee internationally, a central depository company registered with the SECP, an investment finance company that has at least an AA- rating, or such other company as the SECP may specify.

Where a closed-end fund is set up as an investment company, it must take the corporate form of a public limited company. In this case, the investment company must appoint an independent custodian to hold legal title to the fund assets and enter into an investment management agreement (IMA) with the asset management company. The IMA shall be valid for a period not exceeding 10 years unless its renewal is approved by the shareholders of the investment company at a general meeting.

IV MAIN SOURCES OF INVESTMENT

The SECP’s website only makes sources of investment available for certain categories of funds. As noted above, mutual funds, and in particular open-ended funds, are the dominant category of funds operating in Pakistan.

Local investors are by far the largest source of investment into domestic mutual funds, with only 0.29 per cent of investment coming from foreign sources. Institutional investors dominate the investment side and contribute around 65 per cent of the overall investment capital whereas individual retail investors collectively contribute around 35 per cent of investments. Among the institutional investors, domestic corporates account for around 26 per cent, followed by retirement funds (14.5 per cent) and funds of funds (5.5 per cent). The remainder is contributed by insurance companies (4 per cent), associated banks and development financial institutions (5.5 per cent) and other institutional investors.

There are only four domestic private equity funds licensed by the SECP (Ijara Capital, PNO Capital, JS Investments and Lakson Investments), which manage three private equity funds currently licensed by the SECP. There are also a few foreign private equity and venture capital players active in the Pakistani market. The prominent foreign funds include the Abraaj Pakistan Fund (established in collaboration with the now insolvent Abraaj), Pakistan Catalyst Fund (with JS Group) and Baltoro Growth Fund (with Baltoro Capital) in collaboration with the United States Agency for International Development (USAID), which had contributed 50 per cent of their initial US$50 million seed capital under its Private Public Investment Initiative in 2016/17. Although these funds are mandated to invest only in Pakistan, the funds have been established offshore in Mauritius, which has a more well regarded regulatory framework regulating private equity funds. An offshore-based venture capital fund Sarmayacar, which recently received a US$2.5 million investment from IFC, has been active.
in the domestic market having made a number of seed capital or Series A round investments in start-ups focusing primarily on the technology and IT space. However, despite the tax incentives for domestic private equity and venture capital funds, the bulk of private equity investments tend to be made via offshore fund structures or by high net worth individuals and family groups as direct investments in the target entities.

Investment by foreign investors is also affected by Pakistan’s restrictive foreign exchange regime. Domestic securities can be issued, transferred and exported on a repatriable basis to the foreign investors provided the investment falls within one of the general exemptions under the State Bank’s Foreign Exchange Manual. The general exemption requires that the purchase price of the securities being purchased by the foreign investor should not be less than the market value for listed securities and not less than the break-up value for unlisted securities. Pakistan’s foreign exchange regime allows for repatriation of dividends and divestment proceeds provided the initial investment is routed through banking channels and is registered with the State Bank via authorised dealers. On a sale of the securities, the sale price cannot exceed the market value for listed securities or the break-up value for unlisted securities.

Most private equity funds raise capital through their association with a local business group. Where they raise capital through direct contributions from high net worth individuals, this is usually due to close business or familial relations with the business group operating the private equity fund. Pension funds, provident funds and insurance companies are restricted from investing in private equity and venture capital funds in Pakistan as the regulator considers private equity funds to be risky investments which pension funds, etc. should not be exposed to.

For foreign investors, the UAE and Mauritius tend to be the preferred jurisdictions for setting up offshore funds due to the double tax treaties Pakistan has with these countries.

V KEY TRENDS

The first set of reforms in Pakistan’s asset management industry took place in the first decade of this millennium as the SECP introduced a number of new rules and regulations to modernise and regulate the sector. This included the introduction of NBFC Rules, VPF Rules and NBFC Regulations. In addition, in order to promote the development of private equity and venture capital funds, new regulations were introduced in 2008 which have now been replaced by the Private Funds Regulations of 2015. Also in 2015, the SECP introduced the REIT Regulations. The SECP has also recently proposed certain amendments to the regulatory regime governing NBFCs and has published them on its website for public comment. The amendments primarily relate to requirements for promoters at the time of incorporating NBFCs. In addition, in 2018 the SECP amended the regulations governing REITs. Under the recent amendments, a REIT is no longer limited to making investments in a single real estate project and is now required to pay dividends only through cash and not via issuance of bonus units. REITs are also permitted to invest surplus funds in money market funds in addition to depositing such funds with banks.

Pakistan’s asset management industry is primarily inward looking with virtually no significant investments made by domestic asset managers outside the country, for which State Bank of Pakistan approval is required in order to remit foreign exchange outside the country.
Investments made by mutual funds in Pakistan can be broken down into: term deposits (42.39 per cent); equities (35.64 per cent); government securities (6.30 per cent); debt securities (6.92 per cent); and others (8.76 per cent).

Over the past year, with the UAE-based Abraaj Capital going into provisional liquidation and restructuring in the Cayman Islands, a number of domestic and foreign investors have shown a keen interest in acquiring their Pakistan assets. While the sale of K-Electric to Shanghai Electric awaits regulatory approvals, certain other assets have been acquired or are in the process of being acquired by domestic and foreign investors. However, the decline in the value of Pakistan’s currency has dampened interest from foreign investors who have seen the value of repatriated profits decline in US dollar terms (with profits repatriated declining by 40 per cent year on year). Similarly, the value of foreign direct investment in the country has experienced a decline of around 50 per cent year on year up to June 2019. Activity on the domestic front has also slowed, with institutional investors preferring to invest in short-term government debt (T-bills), which were recently issued at attractive interest rates of around 14 per cent. Further, increased rates of taxation have eroded returns thus making it harder for investors to find attractive investment avenues on the equity side or in the private sector that can offer comparable returns.

VI SECTORAL REGULATION

i Asset management companies

An asset management licence entitles the manager to manage a collective investment scheme, which can be a closed-end fund or open-end scheme. The NBFC Regulations define a ‘collective investment scheme’ as a vehicle that enables investors’ funds to be pooled together for investment in a ‘portfolio of securities, or other financial assets for profits, income or other returns’, and where the investors do not have day to day management control.

Funds that have been set up under the NBFC Rules as ‘collective investment schemes’ are typically retail mutual funds. Such funds are required to comply with the prospectus and disclosure requirements under the NBFC Rules, NBFC Regulations and the Securities Act.

The vast majority of collective investment schemes in Pakistan are open-ended mutual funds that are set up as unit trusts. There are only four listed closed-end mutual funds currently established as investment companies.

Marketing and fundraising

The units or shares of a collective investment scheme may be offered for investment to the public and listed on a stock exchange in Pakistan. The shares of a closed-end fund that has been established as an investment company can also be listed (but not if it is established as a unit trust).

A public offer of securities is subject to the provisions of the Securities Act and the NBFC Regulations. These regulations specify the required disclosures that must be made in the prospectus, which require the SECP’s prior approval. The Securities Act contains

---

8 Foreign direct investment in the country has also declined significantly from US$3.16 billion in the financial year ending June 2018 to US$1.6 billion during the financial year ending June 2019.
provisions barring certain types of ‘bad actors’ from making a public offer of securities, which includes any person that has been declared a defaulter or who has been delisted for violating listing regulations.

The NBFC Regulations set out detailed requirements and the information that is required to be disclosed in the prospectus or offering document. The prospectus must be signed by the fund’s promoters.

In addition, prior to a public offer of the fund’s units or shares, the fund must be registered with the SECP as a notified entity and any public offer underwritten by an underwriter that is approved by the SECP.

Restrictions on investments
Generally, public funds are only entitled to invest in listed securities or tradeable debt instruments. A fund manager requires special permission to make overseas investments on behalf of the scheme.

Fund management NBFCs are restricted from undertaking activities permitted to lending NBFCs or to use the assets of a collective investment scheme to make a loan or advance money to any person. These prohibitions preclude mutual funds from undertaking direct lending activities, although are not prohibited from investing in debt securities.

An asset management company is prohibited from investing the funds of a collective investment scheme that will vest the management or control of the investee company in the asset management company.

An asset management company can only manage a maximum of three investment funds, but it may be eligible to manage more than three funds subject to fulfilment of certain conditions, including demonstrating a good track record such as maintaining a minimum rating (of the fund and for itself) and compliance with applicable laws.

Redemption, distribution and fees
The NBFC Regulations prescribe maximum limits on the management and other fees that a fund manager is entitled to charge. A collective investment scheme is mandated to distribute at least 90 per cent of its accounting income to the investors from sources other than capital gains and less any expenses. Where a collective investment scheme makes such distribution, it is exempt from any further corporate income tax.

Pensions
The VPF Rules regulate pension funds and pension fund managers. A pension fund manager under the VPF Rules must either be an asset management company or a life insurance company.

A pension fund scheme in Pakistan may only be structured as a unit trust, and must consist of an equity sub-fund, a debt sub-fund, a money market sub-fund, or any other sub-fund allowed by the SECP.

Under the VPF Rules only Pakistani nationals over 18 years of age are eligible to contribute to and participate in pension funds. The retirement age for participants in a pension fund is any age between 60 and 70 years, or 25 years since the age of first contribution to a pension fund, whichever is earlier. The age of retirement may be reached in the event the participant suffers serious physical debilitation or disabilities.
The VPF Rules specify the mandatory benefits that must be paid to participants on retirement. Pension fund managers are restricted from merging or acquiring management of another pension fund without prior approval from the SECP. Pension fund managers are also prohibited from accepting deposits from another pension fund.

iii Real property

Real estate management companies (RMCs) are regulated by the SECP pursuant to REIT Regulations. The REIT Regulations apply in addition to the NBFC Rules and NBFC Regulations. An RMC is authorised to undertake REIT management services, which are services for the management of a REIT scheme. A REIT scheme must be established as a closed-end fund registered under the REIT Regulations, and is permitted to invest in real estate projects. The REIT Regulations require a REIT scheme to be listed.

Under the REIT Regulations, there are two types of REIT funds that can be established to invest in real estate assets: a rental REIT scheme and a development REIT scheme. As the names suggest, a rental REIT is established to invest in industrial, commercial or residential real estate with the purpose of generating rental income. A development REIT is intended to invest in real estate to develop, construct or refurnish such real estate for industrial, commercial or residential purposes.

An RMC cannot offer units of a REIT scheme for subscription to the public unless it has obtained SECP approval. For such approval, an RMC is required, inter alia, to ensure that the real estate is free from all encumbrances including outstanding debts. The REIT Regulations require RMCs to pay dividends in cash.

An RMC requires prior approval of the SECP in order to transfer the proposed real estate under the REIT scheme under its management. Furthermore, the real estate must be located within the territorial limits of certain specified cities in Pakistan.9

Although the investment policy of a REIT scheme is restricted to real estate, a REIT scheme is allowed to invest any surplus funds in government securities or deposit such funds with a scheduled commercial bank or money market fund.

iv Private equity

Private funds are governed by the Private Funds Regulations, which subdivides private funds into two categories: private equity or venture capital funds, and alternative funds.

A private fund is only permitted to be established as a closed end-fund and structured as a unit trust.

In general, the requirements set out in the NBFC Rules and the NBFC Regulations would apply to private funds and alternative funds to the extent they are not in conflict with the Private Funds Regulations.

Marketing and fundraising

The Private Funds Regulations prohibit a private fund manager from soliciting investments from the public or listing the units of a private fund on a stock exchange. The investments in the private fund must be limited to a maximum of 30 investors who qualify as 'eligible investors'. In order to be an eligible investor, a person has to offer a minimum investment

---

9 So far, this is limited to Islamabad, Rawalpindi, Karachi, Lahore, Peshawar and Quetta, or any other city approved by the SECP.
of 3 million rupees (US$20,000) and provide a written confirmation of their understanding of the investment risks. Other than the ‘eligible investor’ exemption, there are no other safe havens pursuant to which funds can be offered to sophisticated or institutional investors.

The category of eligible investors is intended to capture qualified institutional buyers (QIB), high net worth individuals (HNWI) or sophisticated investors, and exclude retail investors. The criteria for determining eligible investors requires the fund manager to obtain written confirmation from the investor that they understand the risks involved in investing in a private fund.

The Private Funds Regulations set out the minimum disclosures required to be made in the private placement memorandum for a private fund. This includes prescribed language for warnings, which must be clearly displayed in the private placement memorandum.

Management
The Private Funds Regulations do not prescribe any specific requirements relating to the management of a private fund. However, when granting approval to the fund manager and when registering the private fund, the SECP will ensure that the fund manager has adequate resources and qualified personnel to be able to undertake the regulated activity of managing a private fund.

Restrictions on investment
A private equity or venture capital fund is permitted to invest in securities only, limited to the following categories: (1) unlisted company; (2) listed company or a company listed on the SME board if the objective of the investment is to ‘turn around’ such company; or (3) unlisted company with the objective to expand its business or which is engaged in the business of investing in developing a new product or process.

Private fund managers are entitled to invest in securities outside Pakistan subject to compliance with applicable regulatory requirements, which would include obtaining permission from the State Bank of Pakistan to allow investment capital to be remitted abroad.

Any change in investment objectives of a private fund require supermajority approval from investors and an updated private placement memorandum must be submitted to the SECP. Investments with connected persons can only be made on an arm’s-length basis and are subject to making adequate disclosures.

Foreign funds
There is no exemption under the Securities Act or other applicable regulations that allows a foreign sponsor or promoter to register itself, or a foreign offering of securities within Pakistan, with the SECP. The Private Funds Regulations permit only a fund manager licensed in Pakistan to manage a domestic licensed fund. The SECP has publicly expressed the view, through various newspaper advertisements, that foreign issuers and fund managers cannot offer securities in the domestic market to Pakistani investors and the regulatory regime does not contain any exemptions or safe havens for foreign offerings within the domestic market.

Most foreign private equity fund managers prefer to invest into Pakistan through offshore funds based primarily in the UAE and Mauritius.

The rules and regulations governing NBFCs do not envisage a domestic fund manager managing or operating a foreign fund; nor is it possible for a foreign fund manager to operate and manage a domestic fund in Pakistan.
v Hedge funds
The Private Funds Regulations also regulate what are known as ‘alternative funds’. There are no alternative funds registered in Pakistan at present. An alternative fund is a fund other than a private equity or venture capital fund that is permitted to use leverage or invest in derivatives. This category of funds is intended to capture what are commonly known as hedge funds.

An alternative fund can be established in the form of a unit trust only.

Alternative funds are required to disclose in their offering documents details of the use of derivatives, leverage or other proprietary investment strategies used by them. Such funds are required to demonstrate to the SECP that they have the required expertise for the use of their specific investment strategies, including the use of derivatives.

vi Modaraba companies
In general, a modaraba is an arrangement in which the investor entrusts money to a financial manager, who invests the capital on behalf of the investor. Any profits or losses will be shared between them in an agreed manner, whereas the financial manager is also entitled to charge certain management fees for its services.

Under the Modaraba Ordinance, modarabas have separate legal personality and are entitled to sue and be sued in their own name through the modaraba company. The assets and liabilities of each modaraba must be separate and distinct from those of another modaraba and also from those of the modaraba company.

The Modaraba Ordinance envisions two types of modarabas: (1) specific purpose modarabas, and (2) multi-purpose modarabas. A modaraba can last either for a fixed period, or for an indefinite period. Modaraba businesses cannot operate in contravention of the injunctions of Islam, and for this purpose, every modaraba company has to be certified by the religious board constituted under the Modaraba Ordinance. The Modaraba Ordinance allows modaraba companies to receive remuneration in the form a fixed percentage of the net annual profits of the modaraba; however, such percentage is capped at a maximum of 10 per cent.

VII TAX LAW
Pakistan’s tax code contains several tax incentives to make investing in mutual funds and other collective investment schemes attractive for investors to encourage greater participation. Under Pakistan’s tax laws, the definition of securities includes shares and units of a collective investment scheme.

i Tax credits and exemptions for mutual funds
A resident individual investing in listed mutual funds is entitled to tax credit under the Income Tax Ordinance 2001; however, such tax credit is only allowed if the units are held for at least 24 months. The amount allowed for the tax credit will be lesser of the total cost of acquiring the units; 20 per cent of the individual’s taxable income for the year; or 2 million rupees.

Under the Income Tax Ordinance 2001, any income derived by any mutual fund, investment company, or a collective investment scheme or a REIT scheme or private equity and venture capital fund from any instrument of redeemable capital is exempt from taxation provided not less than 90 per cent of its income of that year is distributed among the unit holders.
ii Capital gains tax

Under the Income Tax Ordinance 2001, no capital gains tax applies on redemption of units of a mutual fund, a collective investment scheme or REIT scheme by domestic investors that are held for more than four years. However, if the holding period of such units is less than four years, then an individual or an association of persons would have to pay capital gains tax at the rate of 10 per cent and a company would have to pay capital gains tax at the rate of 10 per cent for stock funds and 25 per cent for other funds. Further, capital gains tax on sale of shares or assets to a private equity and venture capital fund is capped at 10 per cent. By comparison, on a sale of shares to a foreign private equity fund, the normal regime of capital gains tax applicable on the sale of securities would apply.

The tax incentive offered to domestic private equity funds at the time of acquisition could potentially be wiped out when the domestic fund liquidates its investment, at which time it would have to pay capital gains tax under the normal regime as compared to the 10 per cent capital gains tax applicable under the double tax treaties with countries such as Mauritius or the UAE.

iii Withholding tax on dividends

Varying rates of withholding tax ranging between 15 and 25 per cent apply to dividends paid out to investors by domestic mutual funds and private equity and venture capital funds. In contrast, withholding tax on dividends payable under the double tax treaty with Mauritius is capped at 10 per cent and generally ranges between 10 and 15 per cent under the double tax treaties with the UAE and other countries.

VIII OUTLOOK

Although the SECP has tried to jump-start the sector through legislative reforms, Pakistan’s asset management industry remains relatively minuscule (at US$6 billion) compared with the size of its own economy as well as in comparison with the global asset management industry (which is estimated to be around US$100 trillion). Despite recent and past legislative enactments, the industry lacks depth due to lack of corporatisation and formalisation of the economy, which translates into a dearth of investible assets.

The past decade has witnessed consolidation in the asset management industry with large market players taking over smaller entities in order to increase their market share. According to the JCR-VIS sector update on the mutual fund industry, in 2007 there were only 76 mutual funds in Pakistan being managed by 29 asset managers, while at present 23 asset management companies are managing over 220 funds. According to the same report, the profile of investors is primarily composed of institutional investors; however, the share of retail investors has seen a gradual increase over a period of time. At the end of June 2017, retail investors accounted for 32 per cent of industry assets under management, whereas as of June 2019 their share has increased to 35 per cent. According to the JCR-VIS report, a lack of understanding of mutual funds has hindered the growth of the investor base but recent

---

10 Under the Income Tax Ordinance 2001, a stock fund is defined as a collective investment scheme or a mutual fund where more than 75 per cent of the investible funds are invested by way of equity shares in companies.
marketing initiatives undertaken by asset managers coupled with diversification in product portfolio and financial incentives (both tax and others) have helped to expand the investor base of the industry.

The SECP, however, remains committed to introducing further reforms with the assistance of international agencies such as USAID in order to improve its own understanding of the industry and to help further develop and grow the sector. The recent tax amnesty coupled with the government’s push to widen the tax net and document the economy could act as a boon for the sector.

Over the short to medium term, given the headwinds currently being faced by the Pakistani economy, especially a sharp devaluation in the Pakistani rupee coupled with performance of the Pakistan Stock Exchange, the outlook for the asset management industry is expected to remain subdued for the foreseeable future.

The government of Pakistan has embarked on an aggressive economic stabilisation programme under a US$6 billion IMF facility, which is expected to curb growth but also help the government manage its budget and current account deficits and lead to economic stabilisation. As these measures begin to have an effect, the asset management industry can expect to recover, although it may be a while before an economic recovery in the real sector trickles down to the domestic securities markets.

Despite challenges, the sector has seen double digit growth over the past decade and as the economy grows, the asset management industry is likely to experience further expansion and play an increasingly important role in channelling capital towards productive assets in the economy.
Chapter 17

PORTUGAL

Carlos Costa Andrade, Marta Pontes, Gerard Everaert, Duarte Araújo Martins and Domingos Braga

I OVERVIEW OF RECENT ACTIVITY

Asset management is a vital source of economic growth, providing a link between investors seeking beneficial savings vehicles and the real economy’s financing needs.

At the end of the first quarter of 2019, the assets managed by the Portuguese asset management industry amounted to €94,083,100,000.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual asset management</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(discretionary mandates)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>59.6%</td>
<td>61.3%</td>
<td>63.9%</td>
<td>67.6%</td>
<td>68.7%</td>
<td>68.6%</td>
<td>70.3%</td>
<td>70.4%</td>
<td></td>
</tr>
<tr>
<td>Collective asset management</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(investment funds)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>40.4%</td>
<td>38.7%</td>
<td>36.1%</td>
<td>32.4%</td>
<td>31.3%</td>
<td>31.4%</td>
<td>29.7%</td>
<td>29.6%</td>
<td></td>
</tr>
</tbody>
</table>

Discretionary mandates are generally invested more conservatively, with more exposure to low-yield debt, whereas investment funds tend to be more heavily invested in equity.

The key factor behind this large proportion of discretionary mandates in Portugal is the significant number of financial conglomerates operating an asset management company that carries out a group’s general asset management by way of discretionary mandates.

As a result of the financial crisis and the consequent collapse in share prices, asset managers saw a sharp fall in the value of assets under management (an approximately 30 per cent fall since 2009).

An important aspect of the organisation of the Portuguese asset management industry is the extent to which asset management firms operate as stand-alone companies or form part of financial services groups. The activities of these groups can be dominated by a particular type of financial services, or may consist of a mix of asset management companies, banks and insurance undertakings.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

i Asset management in Portugal

Asset management activities in Portugal are, in general, divided into five core areas:

a collective investment undertakings in securities;

---

1 Carlos Costa Andrade and Marta Pontes are partners, Gerard Everaert and Duarte Araújo Martins are associates and Domingos Braga is a trainee at Uría Menéndez – Proença de Carvalho.
Collective investment undertakings in securities and real estate

Collective investment undertakings in securities and in real estate (both in the form of investment funds and investment companies) are regulated under the Legal Framework of Collective Investment Undertakings (RGOIC), codified by Law No. 16/2015 of 24 February and Portuguese Securities Market Commission (CMVM) Regulation No. 2/2015. This legal framework is to be construed in accordance with the Undertakings for Collective Investment in Transferable Securities Directive (UCITS IV Directive), the Alternative Investment Fund Managers Directive (AIFMD) and the Markets in Financial Instruments Directive (MiFID) II. The RGOIC combines and homogenises the regulation of collective investment undertakings in securities and real estate, removing some of the legal asymmetries applicable to these undertakings. Hence, there are now two main categories of collective investment undertakings: UCITS, and an alternative collective investment undertakings concept that includes alternative investment undertakings in securities (non-UCITS), real estate investment undertakings and investment undertakings in non-financial assets.

Unit-linked products

Given their hybrid nature as both insurance and investment products, unit-linked products are regulated under Decree Law No. 94-B/98 of 17 April (which establishes the legal framework on the taking up and pursuit of insurance and reinsurance activities in the EU) and Decree Law No. 72/2008 of 16 April (which establishes the legal framework applicable to insurance contracts), in respect of their insurance component; and CMVM Regulation No. 2/2012, in respect of their marketing as investment products.

Hence, unit-linked products are supervised by the insurance sector’s regulator, the Portuguese Insurance and Pension Funds Supervisory Authority (ASF), in respect of their insurance component, and by the securities market regulator, the CMVM, in respect of their marketing.

Pension funds

The legal framework for pension funds and their respective management entities is set out in Decree Law No. 12/2006 of 20 January, implementing Directive 2003/41/EC into Portuguese law. This legal framework is to be construed in accordance with MiFID II. Pension funds are supervised by the ASF.

---

3 Directive 2009/65/EC.
4 Directive 2011/61/EU.
5 Directive 2014/65/EU.
Private equity and venture capital

The legal framework on private equity and venture capital is set out under Law No. 18/2015 of 4 March, partially transposing the AIFMD into Portuguese law, and CMVM Regulation No. 3/2015. This legal framework is to be construed in accordance with MiFID II. This sector is supervised by the CMVM.

ii Supervision in Portugal: model of specialised supervision

Portugal’s supervisory approach is based on three authorities: the Bank of Portugal, the ASF and the CMVM, which are distinct and independent from each other, forming a system referred to as institutional supervision.

The system entails a supervisor for each financial sector: banking, insurance and securities (including collective investment undertakings). Notwithstanding the broad separation, the fact that activities carried out by financial entities are diversified and interact in significant ways renders the supervision under this model somewhat complex.

Indeed, banks have been carrying out transactions in capital markets and acquiring capacity to mediate insurance, thereby extending the range of services provided. There has been a general increase in the integration of financial services offered by financial conglomerates providing services in sectors such as banking, insurance and asset management.

Moreover, prudential supervision, traditionally linked to the banking sector and commonly associated with the goal of ensuring the financial health of supervised entities, and the stability of the financial system as a whole, have also become regulatory objectives of the securities market, where idiosyncratic risk is particularly significant, especially in the context of clearing systems and counterparty structures for securities transactions.

Conversely, the Bank of Portugal has the authority to supervise certain aspects of the conduct of credit institutions and financial companies, which means that this kind of conduct of business supervision is not carried out exclusively by the ASF and the CMVM.

III COMMON ASSET MANAGEMENT STRUCTURES

i Collective investment undertakings

In Portugal, under the umbrella of ‘collective investment undertakings’, the main structures used for asset management are investment companies and investment funds. Both these structures involve the collective investment of equity raised from investors, and are subject to a risk-sharing principle and the pursuance of the investor’s exclusive interests.

Investment companies are entities with legal personality that carry out asset management activities, or that purport to manage investment funds that pursue such activities.

In contrast, investment funds are segregated assets lacking legal personality that are managed by a third entity – a managing entity (which may be an investment company) – and are subject to an investment policy that is determined upon its creation.

In terms of structure, investment funds may be open-ended or closed-ended.

Open-ended funds are represented by a variable number of units, being the unitholders entitled, in accordance with the terms established in the fund’s incorporation documents, to their redemption and corresponding net asset value. They are thus associated with higher liquidity.

Closed-ended funds have a fixed number of units and hence a limited number of participants, who, as a general rule, cannot redeem their units.
Another structure to consider is the exchange-traded fund (ETF), which is an investment fund characterised by, on one side, an investment policy based on replicating an index or a basket of securities and, on the other side, its admission to trading on organised markets, with higher liquidity resulting therefrom. Taking into account the concerns of European regulators regarding these instruments, it is likely that ETFs will soon be subject to more detailed regulation, both at the international and domestic levels.

ii Unit-linked products

Unit-linked products offered by insurance undertakings are becoming increasingly popular as an asset management structure. They are life insurance agreements having a variable capital in which the premiums paid by the policyholder are invested through an investment fund. When the relevant event occurs, the proceeds to be received by the beneficiary appointed by the policyholder will depend, totally or in part, on a value of reference represented by the fund’s units. It is up to the insurance undertaking and the policyholder to agree on the terms and conditions of any redemption rights attributed to the latter.

Broadly speaking, unit-linked products can be invested in the following:

a internal insurance funds, which represent segregated sets of assets under custody on specific custody accounts in the name of the relevant insurance undertaking; and

b external funds, consisting of regular collective investment undertakings offered by the banks and the fund industry, which the insurance undertaking makes available to the policyholder in the unit-linked product. The units or shares representing these collective investment undertakings are acquired by the insurance undertaking as underlying investments in the unit-linked product.

One of the most attractive features of unit-linked products is the fact that their beneficiary is not subject to succession laws either in respect of his or her appointment as a beneficiary or in respect of the determination of the amount to be paid to him or her by the relevant insurance undertaking. The policy proceeds from the unit-linked product will not form part of the estate of the deceased, and the beneficiary will receive them directly from the insurance undertaking and not through the life assured.

IV MAIN SOURCES OF INVESTMENT

On aggregate, institutional investors account for approximately 70 per cent of assets under management in Portugal, with retail clients accounting for the remaining 30 per cent, reflecting Portugal’s ability to attract large institutional mandates from insurance companies.

In this regard, assets managed for retail clients suffered a much sharper decline in 2008 than those managed for institutional clients. This occurred for two main reasons.

First, the equity exposure of financial portfolios tends to be higher for retail clients than for institutional investors in general. This is explained by the fact that European households tend to hold the majority of their financial wealth in cash, savings accounts and retirement products, which tend to be low-risk stores of value, while resorting to the expertise of asset managers for managing the portion of their savings that is invested in equity and balanced funds, shares and other types of assets carrying more risk.

Second, insurance companies and pension funds – the two largest categories of institutional clients – primarily invest in debt securities and investment funds, which are managed in-house or by third-party asset managers.
V KEY TRENDS

The main novelties worth highlighting with regard to the legal framework for asset management in Portugal are the implementation of the new regulatory framework on financial markets and instruments, based on MiFID II, and the implementation of the EU Regulation on key information documents for packaged retail and insurance-based investment products (EU PRIIPs Regulation).6

The main focus of MiFID II, which was transposed into the Portuguese legislation by Law No. 35/2018 of 20 July, is to promote the protection of non-professional investors. In addition to strengthening the information that must be provided to clients, the duties upon financial intermediaries (FIs) to get to know their customers are also strengthened, in order to determine which products and services best suit their profile. FIs should also ensure that their employees have the appropriate knowledge and skills to provide information to customers.

MiFID II (and related regulations) also requires FIs to adopt internal procedures and policies that prevent and minimise conflicts of interest and to have a policy of governance of the products they produce or distribute (FIs are required to define the characteristics and typology of customers for each product (the target market), the most appropriate channels of distribution of such products, and cannot promote financial instruments outside the identified target market).

The EU PRIIPs Regulation introduces the key investor information document (KIID), a standardised pre-contractual disclosure document applicable to issuers and distributors of PRIIPs, which are investment products with an investment element such as investment funds, life insurance policies and structured deposits. The EU PRIIPs Regulation came into force on 29 December 2014, and has applied directly in all Member States since 31 December 2016.

Until the applicability of the EU PRIIPs Regulation, CMVM Regulation 2/2012 on complex financial products was the legal regime applicable to PRIIPs in Portugal. However, due to the lack of harmonisation between Regulation No. 2/2012 and the EU PRIIPS Regulation, the CMVM approved, on 5 December 2018, Regulation No. 8/2018, which establishes the new legal regime applicable to PRIIPs in Portugal. Regulation No. 8/2018 governs the information and commercial obligations relating to PRIIPs, sets the language regime for the KIID, establishes a set of rules on the content of PRIIP’s marketing materials and prior notification of the KIID, further setting out the rules on matters that are essential both for the protection of professional investors and non-professional investors, complementary to the rules implemented by MiFID II.

VI SECTORAL REGULATION

i Securities and real estate

Open-ended funds

The incorporation of open-ended funds is subject to authorisation by the CMVM.

Except in the case of funds that raise equity solely from professional investors, a prospectus and a KIID must be prepared for each open-ended fund and delivered to its subscribers prior to the subscription of the units.

Each open-ended investment fund might be divided into different compartments, named sub-funds. The assets of each compartment are independent and segregated from the investment fund, as well as from the assets pertaining to other compartments. The creation of each compartment is subject to authorisation from the CMVM.

The obligation to ensure a minimum portion of investment in assets that generate periodic revenues (such as rents) is now established.

**Closed-ended funds**

The incorporation of closed-ended funds is also subject to authorisation from the CMVM.

The term of closed-ended funds may not exceed 20 years, although such term can be extended for a period up to the initial term through a resolution of unitholders, provided that the unitholders that vote against such resolution can have their units redeemed. If no term is established, authorisation for the creation of the fund will only be granted if the incorporation documents foresee that the units will be listed and admitted to trading on a regulated market.

A resolution of unitholders is required to amend certain key aspects of a fund’s status quo, including any change to its investment policy or any change allowing the entrance of new unitholders by way of an increase in the number of the fund’s units. In this case, unless otherwise established in the incorporation documents, unitholders of closed-ended funds hold a right of first refusal in connection with the subscription of new units.

For closed-ended funds that are incorporated through a public offering of units, a prospectus and a KIID must be prepared and delivered to its subscribers prior to the subscription of the units.

As in the case of open-ended investment funds, and under the same regime, closed-ended funds might also be divided into different compartments.

**Management entities**

Both open-ended and closed-ended investment funds are offered and managed by a management entity, which may be a collective investment undertakings management company (management company) or, in the case of closed-ended funds, certain credit institutions with a minimum net worth of €7.5 million.

The incorporation of collective investment management companies must be authorised by the Bank of Portugal, whereas the carrying out of the financial intermediation activity of managing collective investment undertakings is subject to registration with the CMVM.

The functions attributed to management entities include the following:

- selecting the assets comprising the fund;
- managing the fund’s assets;
- valuating the portfolio and the value of the units;
- distributing profits;
- issuing and redeeming units;
- conserving the fund’s documentation; and
- marketing the units.

Management companies of both securities investment funds and real estate investment funds must have a share capital of at least €125,000.

Management companies of both securities and real estate investment funds must still hold additional equity corresponding to 0.02 per cent of the value of assets under management.
in excess of €250 million. Subject to prior authorisation from the CMVM, even if they hold assets under management in excess of €250 million, management companies will still be able to hold additional equity for an amount lower than that imposed by the general rule (up to 50 per cent lower), if the difference is secured by a guarantee or bond issued for their benefit by a credit institution or an insurance company incorporated in the EU.

Without prejudice to the foregoing, the sum of the initial share capital of the management company and the additional equity must not exceed €10 million or fall below 25 per cent of the total operating costs incurred in the previous year.

As for management companies managing real estate funds, they must hold additional equity not inferior to 0.5 per cent of the net value of assets under management up to €75 million of the net value of assets under management; and if the net value of assets under management exceeds €75 million, 0.1 per cent of such excess value.

Finally, management entities of both securities investment funds and real estate investment funds are prevented from carrying out specific transactions, including:

- contracting and granting loans and security on their behalf;
- acquiring, on their behalf, units in investment funds, excluding cash funds and money market funds, if such funds, in the case of securities investment funds, are not managed by them;
- acquiring, on their behalf:
  - in respect of management companies of securities investment funds, any other financial instruments other than certain money market instruments; and
  - in respect of management companies of real estate funds, any other securities with exceptions for public debt and listed securities having a certain rating;
- acquiring real estate that is not indispensable for pursuing their commercial purpose; and
- uncovered short selling.

**Investment companies**

In 2010, Portuguese legislation established a legal framework for securities investment companies and real estate investment companies, which differs from the framework for securities investment funds and real estate investment funds, given that the former structures have legal personality. Investment companies may be self-managed (i.e., managed by their own corporate bodies) or managed by another company (either a collective investment company or certain credit institutions having a minimum net worth of €7.5 million).

Investment companies may be categorised as having either variable or fixed capital. Investment companies with variable capital are the equivalent of open-ended investment funds, whereas investment companies with fixed capital are the equivalent of closed-ended funds.

As with investment funds, the incorporation of investment companies must be authorised by the CMVM.

Again as with investment funds, each investment company might be divided into different compartments. The assets of each compartment are independent and segregated from the investment company, as well as from the assets of other compartments. The creation of each compartment is subject to authorisation by the CMVM.

Securities investment companies must have a share capital of at least €300,000, whereas real estate investment companies must have a share capital of at least €375,000.
The additional equity requirements applicable to both these types of companies, when they are self-managed, are the ones described above, respectively, for management companies of securities investment funds and management companies of real estate investment funds.

**Hedge funds**

Hedge funds are usually characterised as investment funds that do not raise equity from the public, having only professional investors as unitholders. Broadly speaking, such funds are subject to the same rules as the other securities investment funds, except in respect of the duty to disclose a prospectus and a KIID, which does not apply to them.

**ii Unit-linked products**

The incorporation of insurance undertakings that offer and manage unit-linked products is subject to authorisation by the ASF. Without prejudice to the authorisation required for the incorporation of collective investment undertakings in which they might be invested (see Section III), unit-linked products themselves are not subject to authorisation by or registration with any regulatory entity.

As a result of the dual supervision model applicable to unit-linked products resulting from their nature as both insurance and investment products, they are qualified as complex financial products, meaning that, inter alia, a KIID may have to be made available to the relevant investors or policyholders, and their marketing materials may be subject to prior approval by the CMVM.

**iii Pensions**

In line with the Portuguese legal framework, the assets of pension funds exclusively cover the pension plans underlying the funds, the payment of management and deposit remuneration, and the payment of insurance premiums.

The obligations under pension plans are borne exclusively by the fund’s assets or by the assets of each specific compartment of the fund whose net assets are the only security.

Pension plans can be classified as:

\[
\begin{align*}
& a \quad \text{plans with a defined benefit, in which the benefits are previously defined and contributions are calculated in order to guarantee the payment of the benefits;} \\
& b \quad \text{plans of defined contribution, in which contributions are previously defined and benefits are determined pursuant to the amount of contributions delivered and accumulated income; and} \\
& c \quad \text{mixed plans, which combine features of both types (a) and (b).}
\end{align*}
\]

With regard to the financing structure, pension plans can be divided into contributive plans (involving contributions from participants) and non-contributive plans (which are financed exclusively by the associate).

Pension funds may be structured as either open-ended or closed-ended funds. Open-ended pension funds do not require a connection between the participants: participation is exclusively dependent on acceptance by the managing entity. Closed-ended funds relate to one or more associates with a common corporate, associative, professional or social nature interest. When there is a plurality of associates, authorisation is required from each associate to admit new participants.
Pension funds may be managed by companies incorporated exclusively for that purpose, or by insurance undertakings that legally operate in the life insurance sector and hold a permanent establishment in Portugal.

iv Private equity and venture capital

The legal framework for private equity and venture capital set out in Law No. 18/2015 of 4 March, partially transposing the AIFMD into Portuguese law, aims explicitly at encouraging the growth of private equity and venture capital activities as a support tool for corporate start-ups, restructurings and expansions, with a particular emphasis in the scientific and technological fields. In order for private equity and venture capital activities to benefit from such regime, they must comply with the requirements set forth therein.

The legal framework applies to private equity and venture capital activities, defined as follows: acquiring, for a limited period of time, equity and debt instruments in companies with high development potential in order to benefit from future appreciation.

To benefit from this regime, private equity and venture capital activities can be carried out through three different types of structures: private equity companies, private equity funds and individual private equity investors assuming the form of single-person limited companies.

Supervision is carried out by the CMVM, with whom the above entities must register (in a simplified procedure) before starting activities. However, if those entities do not raise equity from the public and their equity is solely held by professional investors (or by investors that, independently of their nature, subscribed at least €500,000), a simple communication to the CMVM before starting activities will suffice.

Private equity and venture capital companies must have own funds corresponding to 0.02 per cent of the amount of the net value of assets under management exceeding €250 million.

Private equity companies, private equity funds and individual private equity investors may not:

a) enter into transactions not related to their scope or investment policy;

b) invest more than 50 per cent of their assets in securities admitted to trading on a regulated market;

c) hold rights regarding to real estate; or

d) invest in venture capital for a period of time (continuous or combined) exceeding 10 years.

Private equity funds are independent and segregated assets with no legal personality, and belong to the respective unitholders. They are managed by managing companies, which may be private equity companies, regional development companies and entities legally able to manage closed-ended securities investment funds.

Law 18/2015 also instituted social entrepreneurship funds and social entrepreneurship companies aimed at investing, for limited periods of time, in equity and debt instruments issued by entities developing suitable solutions to social matters; and specialised alternative collective investment undertakings directed solely at professional investors and aimed at investing in assets of any kind for limited periods of time (each asset may not represent more than 30 per cent of the net asset value of the relevant undertaking).
VII TAX LAW

i Securities investment funds

As of 1 July 2015, Decree-Law 7/2015 of 13 January 2015 introduced new special tax rules only for income derived by securities investment funds that are created under Portuguese law. Thus, the special rules do not apply to income derived by non-resident securities investment funds (which are taxed under the same rules as applied to other non-resident entities).

Under the special tax regime, Portuguese-resident securities investment funds are, as a general rule, subject to corporate income tax (CIT) on their annual taxable profits at the standard rate of 21 per cent. However, investment and real estate income, as well as any capital gains obtained by investment funds, are not subject to CIT, except if said income is distributed or due by companies resident in a listed tax haven or resulted from the transfer of a shareholding in such a company.

Portuguese-resident securities investment funds are also subject to stamp tax, levied quarterly on their global net asset value (i.e., the average net asset values notified to the CMVM or published by the management entity of the fund, excluding the value of units in funds or shareholdings in investment companies), at a rate of 0.0125 per cent or, in the case of funds investing in money market instruments or deposits, at a rate of 0.0025 per cent.

Income derived by a Portuguese-resident company from units held in Portuguese securities investment funds is subject to withholding tax at a rate of 25 per cent on account of the final tax due.

Income derived by a Portuguese-resident individual from units held in a Portuguese securities investment fund is subject to withholding tax at a rate of 28 per cent in the case of profits distribution or redemptions, and to personal income tax (PIT) at a special rate of 28 per cent in the case of a disposal of units in a securities investment fund. Resident investors may opt to aggregate the income with the rest of their taxable income, thus being subject to the general PIT rates. In this case, any withholding tax paid has the nature of a payment on account of the final tax due by the investor.

As a general rule, an exemption applies to income paid by a securities investment fund to non-resident individuals, as well as to non-resident companies. The exemption does not apply to investors resident in a listed tax haven or, in the case of companies, if more than 25 per cent of the share capital is held, directly or indirectly, by Portuguese-resident companies or individuals, except where the non-resident companies are resident in another EU Member State, in an European Economic Area (EEA) State (which is bound by administrative cooperation in tax matters similar to the regime established within the EU) or in another state that has a double tax treaty with Portugal in force that foresees exchange of information procedures.

These rules (regarding both taxation of the income and gains derived by securities investment funds, and taxation of investors regarding the income and gains derived with respect to their units) also apply to securities investment companies created under Portuguese law.

The new rules applicable to Portuguese securities investment funds also establish a transitory regime in which income generated before 1 July 2015 and only paid or realised after that date is separated and subject to a specific set of rules that ultimately leads to a proportionate application of the regimes in force before and after 1 July 2015.
ii Real estate investment funds

Under the new special tax rules, only income derived by a real estate investment fund created under Portuguese law is generally subject to CIT and stamp tax on the same terms referred to in Section VII i.

Income derived by a Portuguese-resident company from units held in Portuguese real estate investment funds is subject to withholding tax at a rate of 25 per cent on account of the final tax due.

Income derived by a Portuguese-resident individual from units held in a Portuguese real estate investment fund is subject to withholding tax at a rate of 28 per cent in the case of profits distribution or redemptions, and is subject to PIT at a special rate of 28 per cent in the case of a disposal of units in the real estate investment fund. Resident investors may opt to aggregate the income with the rest of their taxable income, thus being subject to the general PIT rates. In this case, any withholding tax paid has the nature of a payment on account of the final tax due by the investor.

Regarding income paid by Portuguese real estate investment funds to non-resident individuals or companies, said income is subject to a final withholding tax at a rate of 10 per cent in the case of profits distributions or the redemption of units, and to a special final tax rate of 10 per cent in the case of gains arising from the disposal of units in the real estate investment fund. This reduced rate does not apply to investors resident in a listed tax haven or, in the case of companies, if more than 25 per cent of the share capital is held, directly or indirectly, by Portuguese-resident companies or residents, except where the non-resident companies are resident in another EU Member State, in an EEA State (which is bound by administrative cooperation in tax matters similar to the regime established within the EU), or in another state that has a double tax treaty with Portugal in force which foresees exchange of information procedures.

These rules (regarding both the taxation of income and gains obtained by real estate investment funds, and the taxation of investors regarding income and gains obtained with respect to investment units) also apply to real estate investment companies created under Portuguese law.

The transitory regime established by the new rules applicable to Portuguese securities investment funds mentioned in Section VII.i also applies to Portuguese real estate investment funds.

iii Unit-linked products

Under Portuguese law, income arising from unit-linked products issued by a Portuguese insurance company and paid to resident individual investors is subject to a final withholding tax at a rate of 28 per cent. Resident investors may opt to aggregate the income with the rest of their taxable income, thus being subject to the general PIT rates. In this case, the withholding tax paid has the nature of a payment on account of the final tax due by the investor.

Income derived from unit-linked products issued by a Portuguese insurance company and paid to non-resident individual investors is always subject to a final withholding tax at a rate of 28 per cent. However, these investors may benefit from a treaty-reduced tax rate applicable to the payments if they are resident in a state that has signed a double tax treaty with Portugal.

A partial exemption for resident and non-resident individual investors is applied on the income derived from unit-linked products issued by a Portuguese insurance company provided that at least 35 per cent of the premiums contractually due were paid during the first
half of the term of the contract. As a result, for contracts in force for between five and eight years, only four-fifths of the income received is subject to PIT, and for contracts in force for more than eight years, only two-fifths of the income received is subject to PIT.

Income derived by a Portuguese-resident company from unit-linked products is subject to Portuguese CIT at the standard rate of 21 per cent, possibly added to a state surcharge, levied on taxable profits in excess of €1.5 million at a rate of up to 9 per cent, and a municipal surcharge also levied on taxable profits at rates of up to 1.5 per cent (depending on the municipality).

As for non-resident companies, income derived from unit-linked products issued by Portuguese insurance companies is subject to a final withholding tax at a rate of 25 per cent. Again, the investors may benefit from a treaty-reduced tax rate as long as they are resident in a state that has a double tax treaty signed with Portugal.

iv Pension funds

Income derived by pension funds created under Portuguese law is generally exempt from tax. As regards CIT, contributions made by a company to a pension fund for the benefit of its employees are, as a general rule, and provided certain conditions are fulfilled, deductible for CIT purposes.

With regards to the taxation of income obtained by individuals from pension funds, different complex tax regimes apply depending on whether the contributions for the pension funds are made by the beneficiaries or by other entities (in particular by employers), on whether the income is received by means of a redemption or remission or as a pension, as well as on whether the individuals are Portuguese residents or are non-residents.

v Private equity

Private equity companies are entitled to deduct from their taxable income (as computed after the deduction of any losses carried forward) investments made in companies with potential growth and capital appreciation. The deduction is limited to the sum of the CIT due in the previous five tax years (this deduction may be taken in the tax year in which the relevant investment is made, or otherwise in the following five tax years).

Income earned by private equity funds created under Portuguese law is exempt from taxation.

Income earned by resident individuals from units held in a Portuguese private equity fund is generally subject to a 10 per cent final withholding tax. However, individual investors may opt to aggregate the income with the rest of their taxable income, to be subject to taxation at the general applicable rate. In this case, the withholding tax paid has the nature of a payment on account of the final tax due by the investor and, in cases where the income distributed by the private equity fund includes income derived from a distribution of profits made by a company to the private equity fund or from the liquidation of a company, the investors may be entitled to deduct 50 per cent of that income for tax purposes, provided that certain conditions are fulfilled.

As a general rule, income and gains derived by non-resident individuals from units in a Portuguese private equity fund are exempt, except when the non-resident individual is resident in a listed tax haven. In this case, the income will be subject to a 10 per cent final withholding tax.

Income derived by a Portuguese-resident company from units held in a Portuguese private equity fund is generally subject to a 10 per cent withholding tax on account of the
final tax due (the investors must aggregate this income with their remaining taxable income subject to the standard CIT rate, as applicable). Should the income distributed by the private equity fund include income derived from a profit distribution made by a company to the private equity fund or from the liquidation of a company, the investors may be entitled to deduct 50 per cent of that income for tax purposes provided that certain conditions are fulfilled.

As a general rule, income and gains derived by non-resident entities from units held in Portuguese private equity funds are exempt from tax in Portugal (except in the case of non-resident investors resident in a listed tax haven; or income and gains derived by non-resident entities held directly or indirectly in an amount of more than 25 per cent by Portuguese residents, which will be subject to tax at a flat rate of 10 per cent).

VIII OUTLOOK

The legal framework regulating the creation and operation of different asset management structures in Portugal has recently been modified and is prepared to respond to difficulties arising from the financial crisis.

In this regard, Portuguese legislation on asset management already grants the supervisors of Portugal’s financial sector – the Bank of Portugal, the CMVM and the ASF – a wide range of powers to control and sanction the activities of asset managers under Portuguese jurisdiction.

Furthermore, the legal framework for asset management for each sector establishes capital requirements designed to discourage excessive risk-taking. In particular, this is carried out through restrictions on the percentage of assets that may be invested in one sole entity and on the level of leverage that can be raised to finance the corresponding investment policy.
Chapter 18

SAUDI ARABIA

Nabil A Issa, James R Stull, Macky O’Sullivan and Sayf Shuqair

I OVERVIEW OF RECENT ACTIVITY

The Saudi Arabian economy, while remaining strong and stable relative to other countries in the region, has entered a period of transition. Saudi Arabia remains the largest economy in the Middle East growing by 2.21 per cent in 2018 compared to the previous year, albeit at a slower rate than previously seen during the oil boom early this decade. The 2019 budget for Saudi Arabia, which was announced in December 2018, sets out increased government spending of about 7 per cent to US$295 billion in 2019 in an effort to spur economic growth.

While the economy is still driven by abundant oil reserves and related hydrocarbon industries, with oil prices at their lowest in over a decade, the country’s leadership has adopted a national transformation plan named ‘Vision 2030’ to modernise and diversify the economy, and has entrusted a vast amount of assets under the authority of the Public Investment Fund (PIF), which is now the world’s largest sovereign wealth fund. Vision 2030 focuses on increasing employment, particularly in the private sector, in retail, education and healthcare. The government has also announced a broad privatisation programme in many key sectors, which is expected to include an initial public offering (IPO) of a 5 per cent stake in Saudi Arabian Oil Company (Saudi Aramco), which analysts believe could be worth upwards of US$2 trillion. The effects of Vision 2030 have been felt, as non-oil sector private sector growth has substantially increased since the start of 2017.

In response to predicted budget deficits, Saudi Arabia has raised billions in sovereign issuances in the past three years (after nearly a decade without any public debt issuances) including:

a in October 2016, a US$17.5 billion public bond, the largest ever bond sale by an emerging market nation;
b in April 2017, a US$9 billion sukuk (Islamic bond);
c in July 2017, a 17 billion riyal domestic sukuk;
d in August 2017, a 13 billion riyal domestic sukuk;
e in September 2017, a 7 billion riyal domestic sukuk;
f in September 2017, a US$12.5 billion bond;
g in April 2018, a US$11 billion bond, the largest dollar bond sale by an emerging market country up to June 2018; and
h in April 2019, a US$12 billion bond, which was met with US$100 billion in orders.

---

1 Nabil A Issa and James R Stull are partners, Macky O’Sullivan is a senior associate and Sayf Shuqair is an associate at King & Spalding LLP in cooperation with the Law Office of Mohammed AlAmmar.
In addition to efforts targeted towards attracting increasing local investment in sovereign issuances, as evidenced by the Saudi Arabian Capital Market Authority’s (CMA) recent approval of the first Saudi sovereign sukuk fund managed by SAMBA Capital and Investment Management Company, it is also widely speculated that the government will issue an additional sovereign bond and continue to tap into international debt markets to cover the deficit and to avoid further deterioration of its reserves.

The government is also focusing on increasing foreign investment into the country. In a long-awaited and very welcome move, the government opened the Saudi Arabian Stock Exchange (Tadawul) to foreign investment in June 2015, and liberalised the foreign ownership rules in May 2016, August 2016, January 2018 and June 2019. The CMA has also been encouraging many of the country's blue chip and large family operated companies and financial services companies to list, and created a small cap market, the Parallel Market, in February 2017, which saw 10 listings in its first year. Further, Saudi Arabia has introduced a real estate investment trust (REIT) regime, and in November 2016, Riyadh REIT was the first REIT to be listed in Saudi Arabia (and only the second REIT to be listed in the Middle East), and was followed by another 16 REITs up to July 2019. More recently, the CMA has published regulations for listed funds, and it is hoped these will spur the development of exchange-traded private equity funds. In general, listings and capital raises in Saudi Arabia have continued to be strong over the past year, while capital markets in other regional and oil-driven economies have dried up.

Over the past two years, the CMA has released numerous regulations covering the establishment of new corporate vehicles, the IPO process and foreign investment in Saudi Arabia, and has promised a complete revamp of existing financial services regulations. Three regulations in particular are pivotal for asset managers looking to raise Saudi Arabia-targeted funds: the rules on the offer of securities and continuing obligations, the amended investment fund regulations, the real estate investment traded funds instructions and the closed-ended investment traded funds instructions. These new regulations provide opportunities to investment banks, private equity firms and asset managers to expand their product offerings and access additional investor bases, particularly with the latest proposed amendments to the rules on the offer of securities and continuing obligations that were announced for public consultation by the CMA on 7 May 2019, which would potentially allow foreign companies to list their shares on the Tadawul main market.

Saudi Arabia is home to the largest number of investment funds domiciled in the Gulf Cooperation Council (GCC). Funds and asset managers have been gradually diversifying from primarily real estate investments into other parts of the economy, with a particular focus on venture capital and private equity, as these sectors are being supported by the CMA, PIF, the Ministry of Labour, the Small and Medium Enterprise Authority (SMEA), the Saudi Technology Development and Investment Company (TAQNIA) and other government institutions. Additionally, managers, investors and many government-owned vehicles are being encouraged to reinvest capital and proceeds into Saudi Arabia rather than deploying funds into foreign investments.

The government has empowered forward-thinking regulators that have implemented relatively clear, stable and predictable funds and capital markets regimes. It is encouraging to many investors and commentators to see the Saudi Arabian markets opening up. As a result, it was recently announced that Saudi Arabia has joined the FTSE and MSCI emerging market indexes, which are moves that will potentially foster more growth and lead to a greater influx of capital into the country’s markets.
II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The CMA and the Saudi Arabian Monetary Authority (SAMA) are the governmental bodies that regulate asset management and financing transactions in Saudi Arabia.

The CMA regulates Saudi Arabia’s capital markets, including securities, sales of assets, equity securities and debt securities (such as sukuk). Its power is granted under the Capital Market Law, which was originally implemented in 2003.

The CMA has issued the implementing regulations governing the management and offerings of securities, including but not limited to the following:

a the Rules on the Offer of Securities and Continuing Obligations, which govern the offering of securities in Saudi Arabia on both a private and public basis;

b the Authorised Persons Regulations, which govern the establishment of asset managers, their conduct of business, systems and controls and handling of client money and assets (which were recently amended and reduced requirements for applicants to obtain a management licence and dramatically reduced the required share capital (in some cases to as little as 5 million riyals);

c the following rules and regulations, which govern the activities, operations and management of companies publicly traded on the Tadawul and the Parallel Market:
  • the Listing Rules;
  • the Parallel Market Listing Rules;
  • the Merger and Acquisition Regulations;
  • the Market Conduct Regulations;
  • the Instructions of Book Building Process and Allocated Method in Initial Public Offerings;
  • the Regulatory Rules and Procedures relating to Listed Joint Stock Companies; and
  • the Corporate Governance Regulations;

d the Rules for Special Purpose Entities, which are intended to promote sukuk and the offering of other debt instruments;

e the Rules for Qualified Foreign Financial Institutions Investment in Listed Shares, which govern investment by foreign investors in shares listed on the Tadawul and the Parallel Market;

f the Investment Funds Regulations, which govern private equity funds, hedge funds, money market funds and private real estate funds, significant amendments to which were implemented in November 2016;

g the Real Estate Investment Traded Funds Instructions, which provide for certain public real estate funds to be listed on the Tadawul as real estate investment traded funds, amendments to which were proposed in February 2018;

h the Closed-Ended Investment Traded Funds Instructions, which govern the establishment and listing of certain non-real estate funds (e.g., private equity funds) on the Tadawul;

i the Real Estate Investment Funds Regulations, which govern publicly placed real estate funds;

j the Instructions for the Foreign Strategic Investors’ Ownership in Listed Companies;

k the Credit Rating Agencies Regulations, which regulate and monitor the conduct of rating activities; and

l the Securities Business Regulations, the Prudential Rules and the Investment Account Instructions, which govern the operations and actions of asset managers.
In late 2017, the CMA issued the Financial Technology Experimental Permit Instructions, which introduce a ‘sandbox’ accelerator under which certain financial services companies can apply for licences for products and services in new sectors. In addition, the SAMA announced the launch of the FinTechSaudi initiative in May 2018, which is also aimed at supporting the fintech ecosystem alongside the efforts of the CMA. On 6 February 2019, the CMA announced the issuance of an experimental permit for Falcom Financial Services Company to create an equity crowdfunding platform.

The SAMA acts as the central bank of Saudi Arabia, and is responsible for issuing currency and regulating the insurance industry. It is also responsible for encouraging the development of the Saudi Arabian banking system in both the public and commercial sectors. Additionally, the SAMA is Saudi Arabia’s investment authority, and is responsible for managing the country’s assets, both inside and outside of the country, although this role is being largely transferred to the PIF.

With few exceptions, individuals who are not citizens of a GCC country and non-GCC corporate entities (including Saudi entities with direct or indirect non-GCC ownership) must register with the Saudi Arabian General Investment Authority (SAGIA) prior to owning non-listed shares or real property in Saudi Arabia. The SAGIA registration process adds expense and time to any transaction. The primary exemptions to SAGIA registration are ownership in a CMA fund and investment in listed shares (or units in exchange-traded funds or REITs) through the qualified foreign investor (QFI) framework, the CMA-regulated swap regime and potentially pursuant to the Instructions for the Foreign Strategic Investors’ Ownership in Listed Companies.

To date, the SAGIA rules have not governed foreign ownership in a CMA fund. Accordingly, there is no requirement that non-GCC investors in a CMA fund obtain SAGIA approval. A foreign investor’s ownership of units in a CMA fund is only governed by the rules and regulations of the CMA. Moreover, GCC nationals and companies that are majority-owned by GCC nationals (and partly owned by non-GCC nationals) are permitted to invest directly in listed securities in Saudi Arabia. Additionally, financial institutions that register with the CMA as a QFI are permitted to buy and sell shares of publicly listed companies in Saudi Arabia on their own behalf and on behalf of their clients without SAGIA approval and other foreign corporate investors may own shares under the Instructions for the Foreign Strategic Investors’ Ownership in Listed Companies.

III COMMON ASSET MANAGEMENT STRUCTURES

For tax and other regulatory reasons, the majority of structures used in Saudi Arabia are domestically based. The primary structures for asset management in Saudi Arabia are managed accounts and investment funds regulated by the CMA. As opposed to other Saudi Arabian vehicles, a CMA fund is relatively inexpensive to establish and maintain and allows for significant structuring flexibility. Further, a manager can structure the fund so that investors are truly passive, unlike many other vehicles where investors actually have statutory veto rights and other substantial minority protections.

A CMA fund is a contractual entity formed between the fund manager and its investors upon execution of the terms and conditions of the fund. Under CMA regulations (and from the perspective of other governmental authorities and ministries), a CMA fund is not considered to be a legal entity separate from the fund manager. Accordingly, the Saudi Arabian Ministry of Commerce and Investment (MOCI) will not issue a commercial registration to
a CMA fund. Therefore, all actions of a CMA fund, including ownership of real property, assets and shares in Saudi companies, must be performed by a CMA-licensed fund manager or a CMA-licensed custodian on the CMA fund’s behalf. The CMA issued a circular in August 2015 requiring that independent CMA-licensed custodians must mandatorily hold the assets of all real estate funds, and in November 2016 adopted amendments to the funds regulations requiring all funds to have independent custodians. These amendments to the funds regulations codify many of the unwritten practices and procedures of the CMA that have been adopted over the past decade.

The Saudi CMA fund is arguably the most efficient vehicle for structuring investments into Saudi Arabia. If properly structured, they create the ability to minimise restrictions from SAGIA and can also provide certain tax efficiencies not available with other structures.

Before the rise in popularity of CMA funds, most collective investment vehicles in Saudi Arabia took the form of limited liability companies. However, they are relatively inflexible vehicles that statutorily provide substantial rights to their shareholders, which makes it hard for managers to enforce any default provisions or even to exit investments or wind down a fund. For example, structuring and enforcing a capital commitment structure in a Saudi limited liability company is very complex. The government enacted new companies regulations in May 2016, which permit single-shareholder companies and give other clarifications to corporate formations and structures. However, it is unlikely that any corporate structures will surpass the popularity of CMA funds, although the SMEA, MOCI and the CMA are jointly collaborating to explore the legal and regulatory framework for companies necessary to nurture start-ups and small businesses.

There has been a recent upsurge in the utilisation of asset management and investment structures in the Abu Dhabi Global Market (ADGM) in relation to assets in Saudi Arabia. The ADGM is a financial free zone based in the Emirate of Abu Dhabi, United Arab Emirates, which has a legal regime based on English law. Companies domiciled in the ADGM can be deemed ‘GCC’ when conducting business in Saudi Arabia and potentially would not need to be registered with SAGIA. Under certain circumstances ADGM companies can also elect to be treated as Saudi tax residents with the tax authorities. As such, due to various tax, regulatory, legal and practical considerations, managers and investors have increasingly explored using ADGM for Saudi business and investment ventures.

IV MAIN SOURCES OF INVESTMENT

With over 500 domestic funds currently in operation, Saudi Arabia has the largest number of funds domiciled in the Middle East by a large margin. Historically, investment funds in Saudi Arabia were offered to retail clients and invested in traditional asset classes such as listed equities, money market instruments and corporate and sovereign debt. More recently, the private funds market has thrived. Private funds have tended to invest in real estate, which has been the asset of choice for high net worth and institutional Saudi investors and is easier to structure in order to be shariah-compliant than many alternative assets. More recently, there has been a surge in private equity and venture capital funds due to the encouragement of the CMA, SMEA and other government authorities and various incentive programmes. In early 2018 the government introduced a framework for credit funds, and it is expected that several private credit funds will eventually launch in this sector.

While the vast majority of investors in Saudi Arabian funds are Saudi nationals, Saudi-domiciled institutions and family offices, and government-backed entities and
organisations, there is also a significant level of investment from GCC nationals and institutions in such funds. Traditionally, most funds in Saudi Arabia had been publicly offered and had targeted retail investors, but there has been a significant shift toward privately placed funds due to the relative ease of their establishment both in terms of timing and regulatory scrutiny. Since the primary sources of capital for Saudi Arabian funds are family offices and the government, it is expected that most investors will easily be able to meet the basic qualifying criteria under the Investment Funds Regulations, namely investing at least 1 million riyals or qualifying as a sophisticated investor.

V KEY TRENDS

i Equity capital markets

The government is encouraging significant investment into the economy from both local and foreign investors. There were many IPOs in 2014, including the IPO of the National Commercial Bank (NCB), which was the largest ever regional IPO, and the second-largest globally in 2014. While Saudi Arabia only witnessed six IPOs in 2015, raising approximately US$1.4 billion, such trend was reflected in most of the GCC region, which only witnessed two other IPOs (one in the UAE and one in Oman). Saudi Arabia witnessed four IPOs in 2016, including the offering of L’azurde Company for Jewellery, which was backed by regional private equity heavyweights including Investcorp, and the listing of Riyadh REIT, the first Saudi Arabian-listed REIT. In 2017, there were 16 IPOs in Saudi Arabia, although all but one (Zahrat Al Waha for Trading Co) were REITs and small-cap listings on the Nomu. It has been speculated that a number of prominent Saudi companies, including ACWA Power, units of Saudi Arabian Airlines, Bateel International, Dar Al-Arkan Properties and potentially Saudi Aramco, are preparing for listing in the near future on the main market of the Tadawul.

In June 2015, foreign investors were permitted to directly own shares listed on the Tadawul through the QFI framework. The foreign ownership rules were twice liberalised in 2016, with further amendments becoming effective in January 2018. Only foreign institutions that have a minimum of US$500 million in assets under management and five years of experience will be permitted to register with the CMA as a QFI. Once registered, a QFI can purchase or arrange for its clients to purchase shares of companies listed on the Tadawul (except for six companies that have substantial real estate holdings in Mecca and Medina, where ownership of real property is limited to Saudi Arabian nationals). Holdings in a single company by a QFI or its clients will be limited to 10 per cent, and holdings in a single company by QFIs in the aggregate will be limited to 49 per cent.

Prior to June 2015, foreign investors could participate in listed companies through swap arrangements only, which allowed investors to participate in the profits of the companies but did not provide for voting rights. It is expected that, as a result of the new regulations, foreign investment in the Saudi Arabian stock market will grow from US$7 billion to nearly US$35 billion in the future. In addition to the QFI framework, the CMA more recently on 26 June 2019 announced the introduction of the Instructions for the Foreign Strategic Investors’ Ownership in Listed Companies, which were widely welcomed as they pave the way for relaxing the regulatory framework for foreign investment in Saudi listed companies. Prior to the introduction of these instructions, foreign participation in the Tadawul was

---

2 A parallel equity market with lighter listing requirements that serves as an alternative platform for companies to go public. Investment in this market is restricted to qualified investors.
limited to investment through swap arrangements or under the QFI regime and subject to a maximum limit of 49 per cent of the share capital of a single company for all foreign investors. However, the newly introduced instructions allow non-financial entities to invest in Saudi listed companies and it is hoped that foreign strategic shareholders will be permitted to own shares in excess of 49 per cent of a company’s share capital without being subject to overly restrictive lock-up periods.

In February 2017, the CMA and Tadawul created the Parallel Market to allow for alternative and small-cap listings. This move was widely anticipated and well received, improves SMEs’ access to capital and encourages better corporate governance. As of July 2019, 10 companies are listed on the Parallel Market, with the latest being Raoom Trading Company whose approval for listing on the Parallel Market was announced by the CMA on 30 June 2019.

In October 2016, the CMA’s Real Estate Investment Traded Funds Instructions (REIT Regulations) were introduced, which allow managers to list certain public real estate funds on the Tadawul. As of the end of June 2018, the Tadawul is host to 13 listed REITs and it is widely expected that the REIT Regulations will further spur the real estate market in Saudi Arabia.

In October 2018, the CMA issued the Closed-Ended Investment Traded Funds Instructions, which govern the establishment and listing of certain non-real estate funds on the Tadawul. Following the introduction of the REIT Regulations, it is anticipated that listing of private equity funds under these instructions will gain traction as retail investors are given exposure to privately held companies with minimal investment.

During the first half of 2019, the CMA announced the approval of four IPOs of Maharah Human Resources Company, Nayifat Finance Company, Ataa Educational Company and Arabian Centres Company, the latter being the largest IPO in the Kingdom during the last five years and the first offering in the Kingdom under Rule 144a, which allows the sale of securities to qualified institutional investors in the United States. In addition, the market has recently started to witness signs of consolidation among various sectors, in particular the banking sector, which already saw the successful merger between the Saudi British Bank and Alawwal Bank earlier this year in addition to a more recent merger between National Commercial Bank and Riyad Bank that has been announced to create a combined group with US$183 million in assets. In line with the consolidations in the banking sector, it is also expected that consolidations will follow in the insurance sector as the market expects that the minimum capital requirement for SAMA licensed insurance companies is due to increase from 100 million riyals to 500 million riyals.

ii Debt capital markets

Historically, the majority of debt issues from Saudi Arabia have been in the form of sukuk. While it is expected this trend will continue in the long term, the government has recently launched several large conventional bond programs.

Sukuk and bond issuances are regulated by the CMA. It is expected that the CMA will issue regulations in the near future governing the process to list and trade sukuk and bonds on the Tadawul.

From 2016 through to mid-2018, the government issued US$40 billion in international bonds and sukuk, including a US$17.5 billion public bond, along with multiple riyal-denominated sukuk. Prior to 2016, most sukuk in Saudi Arabia were predominantly domestic, Saudi Arabian-riyal denominated and privately placed.
The current population demographics of Saudi Arabia are significant in supporting strong growth in the domestic consumer market. It is estimated that approximately 80 per cent of Saudi Arabia's population is under the age of 35, providing the potential for a greater demand for property mortgages, automobile loans and general personal borrowing. It is expected that retail lenders will inevitably need to tap the international capital markets to meet the potential increased demand for retail borrowing. The growth of the domestic market should also encourage the expansion of business interests that may require access to debt capital markets to help finance them. A number of Saudi Arabian banks are considering *sukuk* to meet required capital adequacy requirements, and there have been *sukuk* of over 1 billion riyals issued in recent years by NCB, Riyad Bank, Saudi British Bank and AlJazira Bank, which are among the country's largest lenders.

### Investment funds

The CMA has increasingly scrutinised blind-pool investment funds and real estate development funds. Owing to this heightened scrutiny and the relative ease with which managers can establish private CMA funds, there has been a significant shift toward single asset funds, particularly single asset real estate funds with very limited numbers of investors.

In November 2016, the CMA adopted revised the Investment Funds Regulations, which were intended to provide clarity by codifying unwritten practices of the CMA and encourage more managers to launch funds. The CMA had intended for years to revamp the Investment Funds Regulations to address problems of investor protection that arose during the financial downturn, and to cover the launches of a diverse range of new funds, many of which were not contemplated by the original Investment Funds Regulations that were issued in 2006.

The local turbulence within Saudi Arabia has led many investors to look outside of Saudi Arabia (and the wider MENA region) towards the more established markets of Europe and the United States, which, despite the geopolitical events in those jurisdictions, are widely seen as significantly more stable than Saudi Arabia. This sentiment has not gone unnoticed by foreign asset managers, who are increasingly approaching high net worth individuals, families, sovereigns and institutions and marketing their foreign funds as being better alternative investments vehicles to those available in Saudi Arabia (which has experienced a turbulent past year). Noticing this trend, Saudi-based asset managers are increasingly setting up investment funds whose investment strategy is focused on investing mainly in the United States and Europe, with a particular focus on the real estate sector, and foreign asset managers are becoming increasingly interested in offering their funds to Saudi investors.

Foreign funds may only be offered in Saudi Arabia as a private placement (to investors making an investment of at least 1 million riyals or alternatively to sophisticated investors) and must be placed by a CMA-licensed distributor;

- the manager of the foreign fund must be authorised in a jurisdiction that employs regulatory standards and requirements at least equivalent to those of the CMA. It is unclear whether managers established in many offshore jurisdictions would meet these criteria, although the CMA regularly allows for funds domiciled in major offshore jurisdictions (such as the Cayman Islands) to be offered in Saudi Arabia;
- there is a one-year limit on the offering period of foreign funds in Saudi Arabia; and
- the distributor must provide a report to the CMA of all Saudi investors that subscribed for units in the fund.
VI SECTORAL REGULATION

i Insurance

The SAMA regulates the insurance industry in Saudi Arabia. In particular, insurance companies are governed by the Law on Supervision of Co-operative Insurance Companies and its Implementing Regulations, and the Investment Regulations issued by the SAMA.

Every insurance company must adopt an investment policy approved by the SAMA. Any material changes to the investment policy must also be approved by the SAMA.

If the SAMA does not approve an insurance company's investment policy, or an insurance company does not have any investment policy, then the insurance company must adhere to the investment standards set out in Table 1 of the Implementing Regulations (see below), provided that investments outside Saudi Arabia will not exceed 20 per cent of the total investments and are in accordance with Article 59(2) of the Implementing Regulations. Article 59(2) provides that the insurance company must invest 50 per cent of its total invested assets in riyals. The SAMAs written approval is required if the insurance company wishes to reduce this percentage.

The Regulations are silent on what constitutes investments outside Saudi Arabia.

<table>
<thead>
<tr>
<th>Investment type</th>
<th>% for general insurance</th>
<th>% for protection and savings insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi authorised banks</td>
<td>20 maximum</td>
<td>10 maximum</td>
</tr>
<tr>
<td>Saudi government bonds</td>
<td>20 maximum</td>
<td>10 maximum</td>
</tr>
<tr>
<td>Saudi riyal-denominated investment funds</td>
<td>10 maximum</td>
<td>15 maximum</td>
</tr>
<tr>
<td>Foreign currency-denominated investment funds</td>
<td>10 maximum</td>
<td>10 maximum</td>
</tr>
<tr>
<td>Foreign government bonds</td>
<td>5 maximum</td>
<td>5 maximum</td>
</tr>
<tr>
<td>Bonds issued by domestic companies</td>
<td>5 maximum</td>
<td>5 maximum</td>
</tr>
<tr>
<td>Bonds issued by foreign companies</td>
<td>5 maximum</td>
<td>5 maximum</td>
</tr>
<tr>
<td>Equities</td>
<td>15 maximum</td>
<td>15 maximum</td>
</tr>
<tr>
<td>Real estate in Saudi Arabia</td>
<td>zero maximum</td>
<td>5 maximum</td>
</tr>
<tr>
<td>Loans secured by real estate mortgages</td>
<td>zero</td>
<td>5 maximum</td>
</tr>
<tr>
<td>Loans secured by policies issued by the insurer</td>
<td>zero</td>
<td>5 maximum</td>
</tr>
<tr>
<td>Other investments</td>
<td>15 maximum</td>
<td>15 maximum</td>
</tr>
</tbody>
</table>

Insurance companies must take into account the investment concentration risks. Concentration in an investment instrument must not exceed 50 per cent in any one of the investment instruments mentioned in the table above.

Insurance companies are prohibited from investing in derivatives, option contracts, hedge funds, deposits with foreign banks, private equity investments and any off-balance sheet instrument, and these should also not form part of the insurance company's asset allocation unless specifically approved by the SAMA, and must be based on efficient portfolio management justification. An insurance company can, with the approval of the SAMA, invest in derivatives subject to the following conditions:

- such derivatives must be listed on a stock exchange, capable of being readily closed out and based on underlying admissible assets, and must have a prescribed pricing basis;
b the insurance company must set aside assets that can be used to settle any obligations under these derivatives, and set out adequate provisions for any adverse changes to the derivatives and their coverage; and
c the counterparty must be reputable and in an acceptable financial condition.

Investment in *sukuk* is allowed provided they are equivalent to bonds and the percentage allocation in them does not conflict with those outlined in the table above. The maximum limit of allocating *sukuk* that are issued by local companies in which the government has a significant ownership is 20 per cent, and the solvency margin is equivalent to the government’s participation in the capital.

ii Pensions

There are two large governmental institutions in Saudi Arabia focused on pensions and payments of employee benefits: the Public Pension Agency (PPA) and the General Organisation for Social Insurance (GOSI). Additionally, Saudi Aramco Investment Management Company (SAIMCO), which invests the capital for the Saudi Aramco pension and retirement plans, is a big player. Otherwise, private pension plans are not particularly active players in asset management in Saudi Arabia.

**PPA**

Government employees in Saudi Arabia are entitled to pensions of up to 80 per cent of their final salary. The PPA, which is a division of the Saudi Arabian Ministry of Finance, manages all retirement programmes for civil and military pensioners.

The PPA primarily invests in shares of Saudi Arabian companies listed on the Tadawul, and it is believed that its local stock market holdings are worth more than 40 billion riyals. However, the PPA also has substantial investments in real estate and fixed income products.

**GOSI**

All employers in Saudi Arabia are obligated to register with the GOSI, and to enrol all Saudi and non-Saudi employees in the GOSI. The payment obligations to the GOSI are as follows:

a Saudi employees are required to be registered under the Annuities Branch of the GOSI subject to the payment of 18 per cent of the employee’s wage. The employer shall pay 9 per cent of the subscription amount, and the remaining 9 per cent must be deducted from the employee’s salary on a monthly basis; and

b Saudi and non-Saudi employees are required to be registered under the Occupational Hazards Branch of the GOSI. The employer shall pay the subscription amount of 2 per cent of the employee’s wage for Saudi and non-Saudi employees.

Over 6 million individuals and corporate bodies are covered by this regime. GOSI investments are distributed among a number of major investment fields such as cash investments, bonds, loans, shares and real estate investments, but the GOSI is primarily focused on international private equity investments. The GOSI follows a long-term investment management strategy that aims to avoid risks, seeks large revenues that enable it to meet its liabilities towards its contributors and beneficiaries, and concentrates on profitable local investments. Although the direct objective of GOSI investments is to maintain fund sustainability to cover contributors’
insurance benefits, they also indirectly support development projects in Saudi Arabia. These investments are usually directed to developmental projects that play an important role in containing labour force and developing human and material resources.

It is estimated that the GOSI has US$116 billion in assets under management, invested primarily in Saudi Arabian listed equities with additional investments in other securities and financial instruments and real estate.

**Saudi Aramco**

Another active player is Saudi Aramco, the government-owned oil and gas company. Saudi Aramco is quite different from the government entities described above, as it is primarily an industrial operating company, and less frequently associated with the financial services and asset management industries. However, with annual revenues of over US$300 billion, Saudi Aramco is an active investor in technology, energy and venture capital investments both in Saudi Arabia and worldwide. Through its investment management division, SAIMCO, Saudi Aramco invests a substantial portion of its revenues for the benefit of its retirement and pension plans. Saudi Aramco's energy investments division, Saudi Aramco Energy Ventures, is also an active investor both in Saudi Arabia and abroad.

**iii Real property**

The Real Estate Finance Regulations were passed in July 2012 and provide a provisional framework for secured and structured finance transactions pertaining to real estate assets. This is a positive development for the potential growth of an asset-backed securitisation market in Saudi Arabia.

Public real estate funds are governed by the Real Estate Investment Funds Regulations implemented by the CMA. Public real estate funds that also comply with the REIT Regulations can be listed on the Tadawul. All privately placed real estate funds are governed by the private placement rules in the Investment Funds Regulations, which are significantly more comprehensive and provide managers with much greater flexibility. The vast majority of private funds in Saudi Arabia are real estate-focused.

In July 2012, Saudi Arabia released the long-anticipated Real Estate Registered Mortgage Regulations (Mortgage Regulations). The Mortgage Regulations provide the foundation for the creation of all mortgages in Saudi Arabia. The legislation represents a significant milestone in the registration, prioritisation and enforcement of security rights within Saudi Arabia. Many asset managers believe this will increase liquidity for potential home buyers in Saudi Arabia, and as a result are keen to acquire and develop properties. Most banking transactions have not yet complied with the Mortgage Regulations; however, the SAMA has recently issued circulars requiring banks to start registering mortgages under the Mortgage Regulations, and has issued various incentives for mortgage holders.

**iv Hedge funds**

Hedge funds are regulated by the Investment Funds Regulations, which provide specific requirements regarding the diversification parameters and amount of leverage a fund can incur. Further, the regulations require that all open-ended funds allow for sales and redemptions at least twice a week. These subscription and redemption requirements apply unless formally waived by the CMA. However, the CMA has taken the position that such requirements do not apply to private placed funds.
Saudi Arabia witnessed a considerable decrease in private equity deal value and volume in 2016 and 2017 (compared to prior years) driven by consistently low oil prices (which began to rebound later during this period), uncertainty regarding the impact of regulatory, legal and fiscal reform (which included a major anticorruption campaign in November 2017) and the occurrence of several geopolitical events in the region. A number of investors have commented that this makes forecasting potential investees’ future results more difficult, resulting in a lower level of deals in Saudi Arabia.

As previously mentioned, the new draft Investment Funds Regulations became effective in November 2016. The Regulations allow Saudi-domiciled funds to implement many of the terms utilised by managers based in more developed markets that are prevalent in private equity funds in traditional funds jurisdictions.

We continue to see an increase in the use of single asset funds for private equity deals. Privately placed CMA funds offer a means to pool Saudi, GCC and foreign investors in a vehicle to acquire an asset, while avoiding the challenges involved in partly foreign-owned limited liability companies making private equity investments in Saudi Arabia.

The SMEA is spearheading a review of the private and equity and venture capital environment in Saudi Arabia in an effort to make it easier for entrepreneurs to establish small businesses and for investors to comfortably provide capital to Saudi-domiciled companies.

Most investment in Saudi Arabian funds and other vehicles comes from two investor classes: family offices and investment companies, and government entities.

Family groups such as SEDCO, Olayan, Al Fozan, Muhaideb, Bin Saedan, Al Rajhi and MASIC are major players in the asset management field in Saudi Arabia. Many of these groups are now CMA-licensed themselves or substantial shareholders in CMA-licensed entities, and are moving from their traditional roles of investing family money to a new role of raising and managing third-party funds.

While Saudi Arabian government investment vehicles historically have not been as prominent as some of the sovereign wealth funds elsewhere in the GCC (such as the Abu Dhabi Investment Authority, the Qatar Investment Authority and the Kuwait Investment Authority), the government is a major player in the asset management and investment arenas, particularly with the astronomical growth of the PIF over the past three years. The SAMA, the GOSI, the PPA, the PIF and other government-owned organisations are estimated to have over US$1 trillion under management (not including Saudi Aramco, which is owned by the PIF and which is estimated to have a value of between US$2 trillion and US$10 trillion). The majority of that sum is deployed in non-Saudi investments, although there has been a strong push for these organisations to increase the amounts of their investments in Saudi Arabia. The PIF in particular is expected to dramatically grow in size in the foreseeable future, as the government intends to convert it into Saudi Arabia’s primary sovereign wealth fund and has moved its stake in Saudi Aramco to the fund. Additionally, the PIF made waves in June 2016 when it closed on a US$3.5 billion investment in Uber, in October 2016 when it announced it would be investing up to US$45 billion in SoftBank Vision Fund and, again in October 2017, when it committed US$20 billion to a Blackstone infrastructure fund.

The growth of the PIF comes on the heels of the government recently establishing two sovereign wealth funds: Sanabil Al-Saudia in 2008 and Hassana Investment Company in 2009. Sanabil and Hassana were established to manage the assets and investments of the PIF.
and the GOSI, respectively. The intention of these organisations is to diversify the existing investments of the PIF and the GOSI within the various industries of Saudi Arabia, and also to provide training and expertise to Saudi nationals. Additionally, it has been announced that Saudi Arabia will establish another sovereign wealth fund, and it is expected that the National Reserve Fund will be officially launched in the near future.

The Islamic Development Bank (IDB) is a multilateral development financing institution owned and funded by 56 primarily Islamic countries spread across the globe and headquartered in Jeddah, Saudi Arabia. IDB has long invested in infrastructure projects and educational programmes, but is also becoming a more active investor in both regional and international shariah-compliant private equity funds, real estate funds and other alternative investments. Further, IDB, as a highly rated supranational body, has become an important issuer of sukuk, in addition to being an increasingly important and active investor in funds.

While endowments of universities and colleges are not major institutional investors generally in Saudi Arabia, King Abdullah University for Sciences and Technology (KAUST) is a powerful exception. KAUST, which opened in 2009, is an international, graduate-level research university in Saudi Arabia dedicated to inspiring a new age of scientific achievement in Saudi Arabia. With an endowment of approximately US$20 billion, KAUST is a respected, and frequently approached, institutional investor. Its focus is on the advancement of science and technology to improve the lives of people in Saudi Arabia and the world, but it invests across asset classes both inside and outside Saudi Arabia.

VII TAX LAW

Taxation in Saudi Arabia is administered by the Saudi Arabian General Authority for Zakat and Taxation (GAZT). The main taxes levied on businesses in Saudi Arabia are income tax on business profits and zakat (i.e., mandatory Islamic charitable giving).

Zakat and income tax

The tax exposure of wholly Saudi-owned and GCC-owned entities formed in Saudi Arabia is limited to zakat and, for entities formed in other GCC jurisdictions, a withholding tax on dividends and capital gains. A Saudi Arabian corporate vehicle will only be subject to zakat at 2.5 per cent on the higher of its net worth or its profits so long as it is wholly owned by Saudi or GCC shareholders, or both.

To the extent that a portion of a Saudi-domiciled corporate entity is owned by non-GCC foreigners, a corresponding portion of the entity’s profits will be subject to tax at a rate of 20 per cent on such profits. The portion of the entity’s profits corresponding to the ownership by Saudi and GCC shareholders will continue to be subject to zakat at a rate of 2.5 per cent.

The Saudi Arabian tax and zakat regulations provide for the look through of ownership shareholdings in a Saudi Arabian company from a GCC state to determine whether such shareholding should be subject to income tax. This means that if any of the corporate shareholders in a Saudi-domiciled corporate structure that targets Saudi investments has any non-GCC foreign shareholders, the Saudi-domiciled company will be liable to pay income tax to the extent that its ultimate owners are non-GCC foreigners.

Additionally, in June 2016, the Cabinet approved the introduction of a tax on undeveloped real estate. While the implementing regulations for the tax are still being introduced, the government intends to impose a 2.5 per cent annual tax on the value of undeveloped urban land.
ii  Withholding tax
A withholding tax is payable on payments for income derived from Saudi Arabia made to non-Saudi nationals and companies. Withholding tax will not apply to non-Saudis who are resident in Saudi Arabia or have a permanent establishment in Saudi Arabia.

If a Saudi company or individual makes a payment that is from a source in Saudi Arabia to a non-Saudi, then such payment is subject to withholding tax at various rates depending on the nature of the payment. The withholding tax will not apply to payments made on contracts for goods, but will apply to payments made for services and on interest payments under loan agreements.

A dividend paid by a Saudi Arabian company to a non-Saudi resident shareholder results in withholding tax at a rate of 5 per cent. This tax will apply to dividends attributable to non-Saudi GCC shareholders and non-GCC foreign shareholders.

Capital gains on the sale of shares in an unlisted company in Saudi Arabia by a non-resident shareholder results in withholding tax at a rate of 20 per cent on the amount of the gain. This tax will apply to non-Saudi GCC shareholders and non-GCC foreign shareholders.

iii  Value added tax
In January 2018, value added tax (VAT) of 5 per cent became effective in Saudi Arabia on most transactions. This is currently only assessed on transactions between Saudi parties. As such, a foreign manager or adviser would not be assessed for VAT on fees charged to Saudi clients. However, fees payable to a Saudi manager or adviser by a Saudi client would be subject to VAT.

iv  Effect of Saudi tax issues on structuring
To avail itself of the least tax exposure, any corporate vehicle organised in, or conducting business within, Saudi Arabia should be structured so that it is Saudi-domiciled and wholly owned by Saudi or GCC nationals, or both (i.e., foreign investment should not be sought at the Saudi or GCC level) to avoid exposure to income tax at a rate of 20 per cent (on the portion of profits relating to its foreign shareholders); and the exit of the shares in the target company in Saudi Arabia from the investment should be done by a holding entity in Saudi Arabia.

A 100 per cent Saudi or other GCC-owned entity incorporated outside the GCC (e.g., in the Cayman Islands) will be treated as a foreign entity for the purposes of the regulations in Saudi Arabia.

v  Exceptions
Saudi funds are extremely tax-efficient vehicles. To date, the GAZT has not assessed any taxes on Saudi funds, their investments or unitholders in a Saudi fund; however, it has reserved the right to tax funds in the future and on a retroactive basis, and in fact the Shura Council, an influential advisory body to the government, has recommended that closed-ended investment funds be subject to tax. Therefore, it is recommended that parties closely consult with tax advisers in Saudi Arabia and take into consideration the fact that a tax may be applied retroactively.
VIII OUTLOOK

Saudi Arabia has the largest economy in the Middle East. Following the significant slump in the price of oil, the government is maintaining aggressive plans to grow, modernise and diversify its economy. Accordingly, this is an exciting time for the asset management industry, particularly with the opening of the Tadawul to foreign investors and the introduction of new regulations intended to spur foreign investment and new products in the country. Additionally, the funds industry in Saudi Arabia has been a success story compared with the rest of the region, and locally domiciled funds have flourished. The CMA and other regulators have encouraged this growth and stability, and have been revolutionising the structuring of private equity and real estate deals in Saudi Arabia. Finally, the extensive activity of the PIF and other government bodies has created many opportunities for those operating in the asset management industry and other investment sectors. As such, it is expected that Saudi Arabian markets will continue to expand in the coming year.
I OVERVIEW OF RECENT ACTIVITY

Global economic activity has slowed down considerably in recent times. The escalation of US-China trade tensions, macroeconomic stress in Argentina and Turkey, disruptions to the German auto sector, and tighter credit policies in China have all contributed to this decline. The International Monetary Fund projects that the rate of global growth is likely to fall to 3.3 per cent in 2019, down from 3.6 per cent in 2018.²

Amid the global slowdown, the investment outlook in Asia remains sanguine as assets under management (AUM) in Asia-Pacific is expected to outpace other regions by almost doubling from US$15.1 trillion in 2017 to US$29.6 trillion in 2025.³ Singapore will greatly benefit from this trend given its role as a financial node in the region.

Singapore has always enjoyed a sterling reputation for being an investor and business-friendly jurisdiction, in view of its political stability, efficient government, excellent infrastructure and communications systems and skilled work force.⁴ In the asset management space, the Singapore government takes a proactive role in encouraging the growth of the industry and has, over the years, introduced various attractive schemes, incentives, laws and regulations to promote such growth.

Based on the 2017 Singapore Asset Management Survey (the 2017 Survey) conducted by the Monetary Authority of Singapore (MAS), as at the end of 2017, total assets managed by Singapore-based asset managers grew strongly by 19 per cent to S$3.3 trillion (approximately US$2.4 trillion),⁵ compared to S$2.7 trillion (approximately US$1.96 trillion) as at the end of 2016; this has outpaced the five-year average AUM growth rate of 15 per cent per annum, underscoring the strength of the asset management industry in Singapore, against the backdrop of an anaemic global economic environment.

1 Danny Tan is a partner at Allen & Gledhill LLP.
More recently, the Singapore government introduced a new legal framework, the Variable Capital Companies Act (the VCC Act), to encourage investment funds to domicile in Singapore. The VCC Act introduces a new corporate entity that is tailored for investment funds (VCC) and is expected to come into effect in the second half of 2019. The VCC addresses a key weakness in the current fund regime, which lacks a variable fund structure to cater to the specific needs of certain types of funds. If the VCC structure is well received, Singapore will be able to capture a greater share of the full value chain of fund management, especially in the fund servicing space⁶ and enjoy a growth in fund inflows through new product ranges created and managed in Singapore.⁷

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

Fund management is one of the ‘regulated activities’⁸ regulated under the Securities and Futures Act, Chapter 289 of Singapore (SFA). Fund management is defined under the SFA as managing the property of, or operating, a collective investment scheme, or undertaking on behalf of a customer (whether on a discretionary authority granted by the customer or otherwise) (1) the management of a portfolio of capital markets products, or (2) the entry into spot foreign exchange contracts for the purpose of managing the customer’s funds, but does not include real estate investment trust management.

A corporation that carries on business in fund management in Singapore is prima facie required to hold a capital markets services licence (CMS licence) for fund management under the SFA (and its staff who conduct the regulated activities must be individually notified as representatives under the Representative Notification Framework), unless one of the exemptions under the SFA can be invoked.

Fund management companies (FMCs) operating in Singapore will have to fall under one of the following two categories:

a Registered FMCs (RFMCs): these are FMCs whose AUM do not exceed S$250 million, and who carry on business in fund management for not more than 30 ‘qualified investors’, of which not more than 15 are funds (including funds structured as limited partnerships). The underlying investors of such funds will have to be accredited investors or institutional investors, or both (each as defined under the SFA). RFMCs will operate under a registration regime, and will be able to commence business in fund management after the MAS has published the registration of the RFMC on its website.

---


⁸ Apart from fund management, the other ‘regulated activities’ under the SFA are (1) dealing in capital markets products; (2) advising on corporate finance; (3) real estate investment trust management; (4) product financing; (5) providing credit rating services; and (6) providing custodial services.
Licensed FMCs (LFMCs): these are FMCs that hold a CMS licence for fund management. LFMCs are divided into A/I LFMCs who carry on business in fund management with ‘qualified investors’ only, with no restriction on the number of ‘qualified investors’; and Retail LFMCs who may carry on business in fund management with all types of investors.

All FMCs are required to meet certain competency, business conduct and capital requirements. The following is a brief summary of some key points:

- **Singapore incorporated**: an FMC should be a Singapore incorporated company with a permanent physical office in Singapore.
- **Base capital**: an FMC must at all times meet the base capital thresholds, which range from S$250,000 to S$1 million depending on the type of fund management activity that is carried out. An FMC is encouraged to maintain an additional capital buffer over and above the requisite base amount.
- **Risk-based capital**: at all times, an LFMC has to meet the risk-based capital requirement and ensure that its financial resources are at least 120 per cent of the operational risk requirement.
- **Competency requirements**: an FMC should ensure that its staff who conducts fund management, and other regulated activities integral to fund management, has relevant experience and meet applicable entry and examination requirements (if applicable). An FMC should also satisfy the MAS that its shareholders, directors, ‘representatives’ (as defined under the SFA) and employees, as well as the FMC itself, are ‘fit and proper’.
- **Compliance arrangements**: an FMC needs to have in place compliance arrangements that are commensurate with the nature, scale and complexity of its business. Ultimate responsibility for compliance with applicable laws and regulations rests with the FMC’s CEO and board of directors, even though compliance support may be provided by a foreign related entity or third-party service providers, or both.
- **Risk management framework**: an FMC has to put in place a risk management framework that identifies, addresses and monitors the risks associated with customer assets and which is appropriate to the nature and size of its operations, and nature and complexity of the assets it manages. The risk management function should be segregated from and independent of the portfolio management function and all pertinent risks associated with customer assets should be identified and measured. The FMC should also develop and maintain procedures to ensure that these identified risks are closely monitored and that management is kept informed of risk exposures on a continual and timely basis. All policies, procedures and reports relating to the risk management function should be properly documented and maintained.
- **Internal audit**: the business activities of an FMC must be subject to adequate internal audit. The internal audit may be conducted by the internal audit function or outsourced.
- **Independent annual audits**: an FMC must meet the annual audit requirements set out in the SFA and Securities and Futures (Licensing and Conduct of Business) Regulations. The MAS may direct the FMC to appoint another auditor if the appointed auditor is deemed to be unsuitable, having regard to the scale, nature and complexity of the FMC’s business.
- **Professional indemnity insurance (PII)**: the MAS may impose a licence condition requiring a retail LFMC to obtain PII that meets with specified minimum requirements.
A/I LFMCs and RFMCs are strongly encouraged to maintain adequate PII coverage. An FMC should disclose to all customers, both potential and existing, its PII arrangements or the absence of such arrangements.

Letter of responsibility: where appropriate, the MAS may require an LFMC to obtain a letter of responsibility from its parent company.

Independent custody: an FMC must ensure that the assets it manages are subject to independent custody. Independent custodians include prime brokers, depositories and banks that are regulated in their respective jurisdictions. This requirement does not apply in relation to (1) capital markets products that are not listed for quotation or quoted on an organised market, and (2) interests in a closed-end fund where the closed-end fund is to be used for private equity or venture capital investments and interests in the closed-end fund are offered only to accredited investors or institutional investors (and the FMC has made certain disclosures to the customer and obtained their acknowledgement).

Independent valuation: an FMC must ensure that the assets it manages are subject to independent valuation and customer reporting. The independent valuation may be conducted by a third-party service provider (e.g., a fund administrator or custodian) or performed by an in-house fund valuation function that is segregated from the investment management function.

Mitigating conflicts of interest: an FMC has to mitigate any actual or potential conflict of interest that may arise from the management of assets and where appropriate, disclose such conflict to the customer.

Disclosure: an FMC should ensure that there is adequate disclosure to its customers in respect of each fund or account that it manages. Information that should be disclosed includes, among others, the investment policy and strategy and the risks associated with the strategy, the valuation policy and performance measurement standards, and the use of leverage. Disclosure should be made not only on a periodic basis, but as and when material changes occur.

On 20 October 2017, a new regulatory framework applicable to venture capital FMCs (VCFMs) came into effect. Although VCFMs are considered to be LFMCs, VCFMs are exempted from various requirements applicable to LFMCs, such as base capital, risk-based capital and compliance arrangements, resulting in a much shorter and simpler application process.

III COMMON ASSET MANAGEMENT STRUCTURES

Funds established in Singapore typically take one of three forms: the limited liability company, the limited liability partnership and the unit trust. A fourth form will be introduced when the VCC Act comes into force in the second half of 2019. The salient features of each of these vehicles are discussed below.

Companies

The incorporation and management of companies in Singapore is governed by the Companies Act, Chapter 50 of Singapore and regulated by the Accounting and Corporate Regulatory Authority. Companies limited by shares can be public or private, with the key difference being that a public company may have more than 50 shareholders and is subject
to greater regulation than a private company. The advantage of a company is that it has a separate legal personality which allows its shareholders to enjoy limited liability protection. The disadvantage would be that there is a higher level of statutory regulation applicable to companies such as restrictions on the return of capital to shareholders.

ii Limited partnerships

The limited partnership is a well-established fund vehicle in many fund jurisdictions. In Singapore, limited partnerships are governed by the Limited Partnerships Act, Chapter 163B. A Singapore limited partnership must consist of at least one limited partner and one general partner, who may be either individuals or corporations. A general partner is liable for all debts and obligations of the limited partnership incurred while it is a general partner in the limited partnership. A limited partner, on the other hand, will generally not be liable for the debts and obligations of the limited partnership beyond the amount of its agreed contributions. The limited partnership is a natural framework for a fund structure as it is tax transparent, provides limited liability for investors and provides for the relative ease of cash repatriation even in the absence of profits. However, as a limited partnership does not have separate legal personality, to be afforded the benefit of limited liability, limited partners must not take part in the management of the limited partnership.

iii Unit trusts

A unit trust is a trust arrangement whereby the legal ownership of the scheme’s assets is vested in a trustee who holds those assets on trust for the benefit of unitholders. A unit trust is constituted by an instrument of trust usually between a manager and a trustee. The trust instrument typically governs the appointment and retirement of the trustee and manager, their respective duties, distribution or accumulation of trust income, investment powers, dealing and valuation. The applicable legislation with regard to trusts in Singapore is the Trustees Act, Chapter 337 of Singapore. A unit trust structure, being largely contractual, is fairly flexible. Like a limited partnership, it is tax transparent and can provide limited liability for investors as well as relative ease of cash repatriation even in the absence of profits. One disadvantage of a unit trust is that it does not have separate legal personality. The requirement to have a trustee may also add costs to the structure and investors in certain jurisdictions may not be very familiar with such a structure.

iv Variable capital companies (VCCs)

The VCC is an upcoming corporate structure solely made for investment funds. The VCC can be set up as a single standalone fund or an umbrella fund with two or more sub-funds. The VCC addresses the limitations of the existing fund structures and introduces in Singapore a structure comparable to that of other leading international fund domiciles such as Luxembourg and Dublin. For instance, a VCC can issue and redeem shares without the need for shareholder approval and pay dividends out of capital. This is not possible for companies incorporated under the Companies Act. Another key advantage is that a VCC constituted as an umbrella fund enjoys economies of scale as the sub-funds therein can share a common board of directors and service providers.
IV MAIN SOURCES OF INVESTMENT

According to the 2017 Survey, 78 per cent of total AUM attributable to Singapore FMCs was sourced from outside Singapore, demonstrating Singapore’s primary role in serving regional and international investors. In 2017, the percentage of assets invested in equities rose from 42 per cent to 44 per cent, led by increased investments into Asia-Pacific and North America while investment into bonds pared by 2 per cent to 21 per cent, with outflows seen broadly across all regions. Allocations in other asset classes such as collective investment schemes, cash/money markets and alternative investments remained relatively unchanged since the past year at about 4–21 per cent for each class.

According to the same survey, for several years, the Asia-Pacific region has been the key investment destination for Singapore-based asset managers, accounting for 67 per cent of total AUM in 2017, a slight increase from 66 per cent in 2016. The relatively stable numbers reflect continued strong investor interest in the region.

V KEY TRENDS

Over the past few years, there has been an increase in both the number of asset managers being set up in Singapore and the AUM of Singapore asset managers, especially in relation to private equity investments. As at the end of 2017, total assets managed by Singapore-based asset managers stood at S$3.3 trillion (approximately US$2.4 trillion), representing a five-year average AUM growth rate of 15 per cent per annum.

Asset managers also continue to view Singapore as a conducive place to conduct portfolio management activity. In 2017, there was a net increase of 55 registered and licensed fund managers, bringing the total number of registered and licensed fund managers to 715.10 As the Asia-Pacific continues to be the fastest-growing region in the world,11 Singapore’s position as one of the leading asset management hubs globally is expected to strengthen.

Even with the uncertainties in the global economy that arise from time to time, many expect the trend of growth in Singapore’s asset management industry to continue in view of the relative economic stability and reputation as a safe haven. Going forward, Singapore is likely to benefit from greater offshore inflows from China as Chinese HNWIs increasingly prefer to book their assets in Singapore over Hong Kong. Crucially, Singapore is less proximate to the Chinese authorities, which brings the wealth of these Chinese HNWIs out of China’s reach.12 This key advantage that Singapore has over Hong Kong was in the spotlight recently after a reported increase in interest in movement of funds from Hong Kong to Singapore following concerns over a proposed bill to allow the extradition of suspects from Hong Kong to face trial in China.13

---

9 Monetary Authority of Singapore (n 4).
10 ibid.
12 Asian Private Banker (n 9).
The global trend towards economic substance has and will continue to push Singapore to the forefront as asset managers move away from the traditional offshore tax havens. The various factors and strengths of Singapore carefully developed and built up over time including the robust business infrastructure coupled with Singapore’s reputation as the place with the highest quality of living in Asia\(^\text{14}\) will continue to attract asset managers to strongly consider Singapore as a place to locate, making the MAS’ emphasis on economic substance an easier pill to swallow. The extensive network of double taxation treaties that Singapore has entered into also adds to the attraction of using Singapore as a fund domicile.

VI SECTORAL REGULATION

i **Insurance**
Insurance asset management is regulated under the general fund management regulatory regime.

ii **Pensions**
Pension fund management is regulated under the general fund management regulatory regime.

iii **Real property**
A fund manager is exempt from the requirement to hold a CMS licence to carry on fund management if it carries on business in fund management in Singapore on behalf of ‘qualified investors’ where the assets managed by it comprise securities issued by one or more corporations or interests in bodies unincorporate, where the sole purpose of each such corporation or body unincorporate is to hold, whether directly or through another entity or trust, immovable assets.

iv **Hedge funds**
Hedge fund management is regulated under the general fund management regulatory regime.

v **Private equity**
Under the general fund management regulatory regime, an FMC must ensure that the assets it manages are subject to independent custody. Independent custodians include prime brokers, depositories and banks that are regulated in their respective jurisdictions.

The MAS recognises that for private equity and venture capital investments, independent custody may not be appropriate in all circumstances, hence the MAS allows this requirement to be waived for FMCs that manage closed-end private equity or venture capital funds (involving capital markets products that are not listed for quotation or quoted on an organised market).

---

VII TAX LAW

i Tax treaties

Singapore’s comprehensive tax treaty network coupled with a relatively low corporate tax rate of 17 per cent is highly attractive to many multinational corporations including fund management companies and fund companies looking to establish a presence here. Additionally, the Singapore government has introduced a wide range of tax concessions and incentives to promote Singapore as a hub for financial services activities, and in particular the fund management industry.

As of June 2019, Singapore had approximately 85 comprehensive avoidance of double taxation agreements (DTAs) (agreements that generally cover all types of income), seven limited treaties (agreements that cover only income from shipping or air transport, or both) and seven treaties that are signed but not ratified (either comprehensive agreements or limited treaties that are not ratified and therefore do not have the force of law).15

DTAs between Singapore and another country not only serve to prevent double taxation of income, they also clarify the taxing rights between Singapore and the treaty partner on different types of income arising from cross-border economic activities between the two countries. In some circumstances, the agreements also provide for reduction or exemption of tax on selected types of income.

ii Singapore’s tax regime for funds

In Singapore, income tax is a tax on income and there is no capital gains tax.

Singapore follows a territorial basis of income taxation. In other words, Singapore income tax is imposed on income accruing in or derived from Singapore. On the other hand, foreign-sourced income will generally not be taxable in Singapore, unless it is received or deemed to be received in Singapore under local income tax legislation.

Certain foreign-sourced income may be exempt from tax when received in Singapore by a Singapore tax resident. For example, foreign-sourced dividends are exempt from tax if the dividends or the underlying profits from which the dividends are paid have been subject to foreign tax and the headline tax rate in the foreign country is at least 15 per cent. Certain concessions and clarifications have also been announced by the Inland Revenue Authority of Singapore with respect to the above conditions.

Income derived by a fund that is managed in Singapore is generally regarded as Singapore-sourced and therefore subject to Singapore income tax.

In line with the government’s effort to develop the fund management industry in Singapore and to promote and enhance Singapore’s attractiveness as a fund management hub, various tax exemption schemes have been introduced over time to ensure that there is no tax disincentive for a fund to be managed in Singapore. The main tax incentive schemes are listed below and will be discussed briefly in this section:

a tax exemption under Section 13CA of the Income Tax Act, Chapter 134 of Singapore (ITA) (the Qualifying Fund Scheme);

b tax exemption under Section 13R of the ITA (the Resident Fund Scheme);

iii Offshore fund regime – Qualifying Fund Scheme

An offshore fund managed by a Singapore-based fund manager will be exempt from tax on ‘specified income’ from ‘designated investments’ if the fund is a qualifying fund. To be a qualifying fund in general, a fund cannot be a tax resident in Singapore.

In broad terms, ‘specified income’ covers income and gains in respect of ‘designated investments’. The list of ‘designated investments’ includes most types of investment – for example, stocks, shares and securities. Immovable property in Singapore is excluded from the list.

Even if the fund is a qualifying fund, its investors must still be qualifying investors to avoid being taxed on their share of the fund’s income and gains. Generally, Singapore-resident or Singapore-based corporate entities that beneficially own, alone or with their associates, more than 30 per cent (or 50 per cent if the fund has 10 or more investors) of the total value of the issued securities of the qualifying fund will be deemed to be non-qualifying investors. A non-qualifying investor is required to pay an amount to the Singapore tax authorities – effectively the corporate income tax on its share of the income and gains of the fund.

iv Resident Fund Scheme

The Resident Fund Scheme was introduced to encourage fund managers to base their fund vehicles in Singapore by giving them the same tax exemptions that are given to the qualifying offshore funds described above. The main advantage that a Singapore resident fund has over an offshore fund is its access to Singapore’s large tax treaty network, covering more than 85 countries. The exemption is subject to approval by the MAS and there are additional conditions to be satisfied under the Singapore resident fund scheme. In particular, the fund vehicle must be a Singapore tax-resident company and must have an expenditure of S$200,000 or more in each financial year. A Singapore-based fund administrator must also be appointed.

Similarly to the Qualifying Fund Scheme, under the Resident Fund Scheme, ‘specified income’ in respect of any ‘designated investments’ derived by an approved Singapore resident fund is exempt from Singapore income tax.

To qualify for the Singapore resident fund scheme, an application must be submitted to the MAS on or before 31 December 2024. Once a fund is approved under the scheme, the tax exemption period is indefinite, subject to the fund continuing to meet all conditions for the scheme.

As with the Qualifying Fund Scheme, investors of an approved Singapore resident fund that are non-qualifying investors are liable to corporate income tax on their share of the income and gains of the fund.

v Enhanced-Tier Fund Scheme

Introduced with effect from 1 April 2009, the ETF Scheme provides greater flexibility to fund managers in sourcing their mandates. Fund vehicles that satisfy the conditions for the scheme must submit an application to the MAS by 31 December 2024.
Unlike the Qualifying Fund Scheme and the Resident Fund Scheme, the ETF Scheme does not limit the percentage of the investments in an approved fund that may be held by persons in Singapore. In addition, the type of fund vehicle and place of tax residence of the fund vehicle are generally not relevant conditions under the scheme.

As with the Resident Fund Scheme, MAS approval is required under the ETF Scheme. The criteria for approval to be granted include, but are not limited to:

- a minimum fund size of S$50 million at the time of application;
- at least S$200,000 of local expenditure for each financial year; and
- the Singapore-based fund manager managing or advising the fund employing at least three investment professionals in Singapore.

Provided they meet the required conditions, funds approved under the ETF scheme are granted tax exemption on ‘specified income’ in respect of any ‘designated investments’ for the life of the fund (similar to the Qualifying Fund Scheme and the Resident Fund Scheme).

In 2010, the ETF Scheme was amended to include a master-fund structure in the application framework. If a master-feeder fund structure is adopted and the feeder funds that invest solely in the master fund do not trade, the structure as a whole need only meet one set of economic conditions. ‘Economic conditions’ refers to:

- the minimum fund size of S$50 million at the point of application; and
- the minimum local business spending of S$200,000 for each fund in each basis period relating to any year of assessment.

The remaining non-economic conditions for the ETF Scheme will continue to apply to each master and feeder fund entity. However, if the feeder funds invest solely in the master fund and these feeder funds trade, the master-feeder structure as a whole must meet the sum of the economic conditions and commitments expected from each fund entity to satisfy the conditions under the scheme.

In 2015 the ETF Scheme was further extended to master-feeder-special purpose vehicle (SPV) fund structures to extend to SPVs established by the approved fund. Additional conditions under such extended scheme include the following:

- the master fund must be a Singapore entity and is regarded as a Singapore tax resident for each basis period; and
- the economic conditions must be met on a multiple-fold basis, depending on the number of SPVs.

**Fund management incentive**

The FSI-FM Award aims to promote fund management activities in Singapore. This incentive provides a concessionary tax rate of 10 per cent for fund management and investment advisory services provided to incentivised funds. ‘Incentivised funds’ are funds that rely on one of the tax exemption schemes for fund management (e.g., a fund relying on the Qualifying Fund Scheme or a fund approved under the Resident Fund Scheme or the ETF Scheme). For new applicants engaged only in the fund management or investment advisory services, the qualifying criteria include the following:

- the applicant must be licensed or exempt from having a CMS licence in respect of its fund management or investment advisory activities; and
- the applicant must have a minimum AUM of at least S$250 million.
The MAS may also take into consideration other qualitative factors – such as growth targets in terms of AUM, business spending and the number of investment professionals – when assessing the eligibility of the applicants for the FSI-FM Award.

Once a fund manager receives the FSI-FM Award, it must submit an annual review return to the MAS within four months of the end of its financial year.

The FSI-FM Award usually runs for a fixed period from the approval date. The fund manager must renew it with the MAS before it expires. In assessing whether to renew the FSI-FM Award, the MAS examines the incremental economic contributions (e.g., incremental headcount, business spending, value added) that would be made by the fund manager to Singapore’s economy.

**VIII OUTLOOK**

The global trend towards economic substance will see more interest to set up FMCs as well as funds in Singapore. The upcoming VCC fund structure will also give a boost to Singapore’s fund management industry as it complements and expands on the existing suite of fund structures available in Singapore. This will provide investors with a comprehensive range of fund structures to support their needs.

All this comes at an opportune time as the AUM in the Asia-Pacific is expected to grow rapidly over the new few years and Singapore will be well positioned to capture this growth with its enhanced fund ecosystem.
I OVERVIEW OF RECENT ACTIVITY

The asset management industry in Spain is comparatively young. Nevertheless, during approximately three decades of activity, it has undergone a remarkable process of development to become a highly professional and efficient market.

The downturn in the financial markets following the global credit crisis (and, in particular, the European sovereign debt crisis) in 2007 and 2008 severely affected Spanish collective investment schemes and pension funds and, generally, the asset management industry in Spain. The recovery started in 2013, and still continues to strengthen. At the macroeconomic level, Spain’s GDP grew by 2.6 per cent in 2018, driven primarily by domestic demand, favourable credit conditions, an increase in confidence among households and the labour market. Spain nevertheless continues to have one of the highest unemployment rates in the EU, and unemployment seems to be a structural problem that the country is unable to overcome even during periods of economic expansion.

On the regulatory side, the EU has launched two major legislative initiatives in recent years: the Alternative Investment Fund Managers Directive (AIFMD) and the revised version of the Markets in Financial Instruments Directive (MiFID II). The AIFMD, which aims to provide a regulatory framework for alternative investment managers, was transposed into Spanish law in 2014 by means of Law 22/2014, of 12 November, on venture capital entities, other closed-ended collective investment undertakings and their management companies (Law 22/2014). On the other hand, MiFID II aims to increase transparency, safety and efficiency in European financial markets and, although it should have been fully transposed by 3 January 2018, by such date Spain had only carried out a partial transposition as regards the legal regime applicable to Spanish trading venues for financial instruments by means of Royal Decree Law 21/2017, of 29 December, on urgent measures to adapt Spanish law in accordance with European Union regulations in relation to the securities market (RDL 21/2017). The transposition of the pending sections of MiFID II was completed at the end of 2018 through Royal Decree Law 14/2018 of 28 September 2018, which amends Royal Legislative Decree 4/2015 of 23 October, approving the restated text of the securities market law (Securities Market Law and RDL 14/2018, respectively) and Royal Decree 1464/2018 of 21 December (RD 1464/2018) which, among others, develops the Securities Market Law and the RDL 21/2017.

---

1 Juan Carlos Machuca Siguero is a partner and Anna Viñas Miquel is an associate at Uría Menéndez Abogados, SLP.
2 RD 1464/2018 also amends, among others, RD 1082/2012 to regulate the research fees that collective investment schemes can be charged. The new regulation requires, among other aspects, the unbundling of
On the investor side, the data for 2018 showed that assets under management of collective investment schemes decreased by 2 per cent, whereas assets under management by pension funds decreased by 3.7 per cent. Forecasts for 2019 suggest investment schemes and pension funds will resume positive growth in their portfolios, which was only interrupted in 2018 because of the negative performance of the securities markets. The International Monetary Fund forecasts 2.1 per cent growth in Spain’s GDP for 2019, which is slightly higher than the forecast of 1.3 per cent growth in the eurozone’s GDP, reinforcing expectations regarding a slower but sustained growth in the overall economy.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The Spanish asset management industry is not regulated by all-encompassing legislation applicable across the board, although the Securities Market Law codifies and organises some of the regulations in this field. The existing dispersion in regulations is due, inter alia, to the fact that asset management activities can be carried out in Spain by a wide array of different entities, each of which requires specific regulation. Before giving a brief overview of the rather fragmented asset management regulatory framework in Spain, it is worth noting the remarkable pace of its evolution during the past few years, and the increasing number of amendments to the relatively new laws and regulations in place.

Below is a brief summary of the main regulations applicable to the asset management industry in Spain.

i Investment firms

Such entities, whose main activity is rendering investment services over financial instruments to third parties on a professional basis, are primarily regulated under the Securities Market Law and Royal Decree 217/2008 of 15 February on the legal regime of investment firms (RD 217/2008) and are subject to the supervision of the Spanish Securities Exchange Commission (CNMV).

RD 14/2018 and RD 1464/2018 introduced significant changes to the legal regime applicable to investment firms. The main novelties introduced focus, among others, on the concept of significant investment firms, the combined buffer requirement for investment firms, the provision of investment services by third-party states, internal organisational measures in relation to asset management and title transfer financial collateral arrangements and inducements. Perhaps one of the most significant novelties in terms of impact on the market is the prohibition to accept or retain inducements when independent advice and discretionary management portfolio services are rendered as well as having to comply with specific requirements if inducements are accepted or retained when rendering other investment services.


4 Secondary regulation is usually delivered by means of royal decrees, orders issued by the Ministry of Economy and Business Support as well as circulars issued by the CNMV covering, inter alia, solvency, reserved information or financial disclosures and annual accounts of investment firms.
With regard to the provision of investment services in Spain by companies from other countries, the main change is that these companies need to establish a branch in Spain in order to provide investment services or activities to retail clients or professional elective clients. In addition, and this is something that goes beyond the scope of MiFID II, depending on the volume of the activity, the complexity of the products or services, or for reasons of general interest, the CNMV may require that a third-country company establish a branch if it provides or intends to provide investment services or activities in Spain to professional clients per se or to eligible counterparties.\(^5\)

ii  Collective investment schemes

Collective investment in Spain is carried out by means of two different types of scheme, depending on the nature of the commitment assumed by the relevant investors: open-ended schemes, which allow investors to apply for the redemption of their investment against the assets of the scheme at any time, or upon short notice; and closed-ended schemes, where the investor assumes an irrevocable commitment and may not apply for redemption until a certain deadline.

The regulation of these two categories in Spain has undergone a change driven, principally, by two EU directives and their transposition into Spanish Law: the UCITS Directive,\(^6\) implemented in Spain by means of Law 31/2011, which amended Law 35/2003, of 4 November, on Collective Investment Schemes (the CIS Law); and the AIFMD,\(^7\) as transposed in Spain by means of Law 22/2014. These categories are regulated in Spain as follows: Spanish open-ended collective investment schemes and their management companies and depositaries are regulated at a general level under the CIS Law and by Royal Decree 1082/2012, by which the regulation expanding upon the CIS Law was approved (RD 1082/2012);\(^8\) and Spanish venture capital entities and closed-ended collective investment schemes as well as their management companies, are subject to Law 22/2014.\(^9\) Collective investment undertakings that do not qualify as UCITS should be considered AIFs. Therefore, AIFs may take the form of closed-ended schemes, open-ended schemes, private equity firms, venture capital entities (VCEs) and other minority entities. Depending on the form they take, AIFs may be managed by an open-ended schemes management company (SGIIC) or a closed-ended schemes management company (SGEIC).

The entities referred to above are subject to the supervision of the CNMV.

iii  Pension funds

Pension funds and their management and depositary companies are regulated by Royal Legislative Decree 1/2002 as amended by, inter alia, Law 22/2014 (the Pension Funds Law) and its developing regulation, including Royal Decree 304/2004 (the Pension Funds Regulations).

---

8 It is worth noting, nonetheless, that free IICs and IICs of free IICs are mainly regulated by RD 1082/2012.
9 In addition, Law 22/2014 expressly acknowledges and regulates the existence of European venture capital funds and social entrepreneurship funds.
Both pension funds and their management companies are supervised by the Ministry of Economy and Business Support and the General Directorate of Insurance and Pension Funds (DGSFP), which is the same regulator supervising insurance companies.

iv Insurance companies

The management of insurance companies’ assets and their rules are contemplated in Law 20/2015, of 14 July, on Regulation, Supervision and Solvency of Insurance and Reinsurance Entities and Royal Decree 1060/2015, of 20 November, on the Regulation, Supervision and Solvency of Insurance and Reinsurance Entities (jointly, the Private Insurance Regulations).

The Private Insurance Regulations transpose into Spanish law the Solvency II Directive\(^{10}\) aiming to improve the corporate governance of insurance entities. Among other matters, it strengthens the requisites of honourableness and professional skills to perform the effective management of insurance and reinsurance companies; develops the legal framework on risk management and compliance; and strengthens the requirements of solvency and financial transparency.

Insurance and reinsurance entities are supervised by the DGSFP.

v Securitisation funds

Securitisation funds and their management companies are now regulated in Law 5/2015 of 27 April on the promotion of business financing (Law 5/2015), which, among other issues, consolidates into one piece of legislation the (until now) dispersed legal framework on securitisation. The entry into force of Law 5/2015 has brought relevant novelties to the landscape of securitisation in Spain, with one of the most significant being the faculty of management companies that manage securitisation funds to ‘actively manage’ the securitised portfolio of assets of open-ended securitisation funds. As this ability was not previously contemplated under Spanish law, the role of this type of management company was limited to merely passive actions such as monitoring the credits rights securitised, collecting them or, eventually, enforcing them.

Both securitisation funds and their management companies are supervised by the CNMV.

vi Real estate investment listed companies

Real estate investment listed companies (SOCIMIs) are specifically regulated under Law 11/2009, of 26 October (SOCIMIs Law), a regulation inspired by that regulating US real estate investment trusts.

vii Asset management companies

To comply with the undertakings of Spain under the memorandum of understanding on financial sector policy conditionality signed by the Spanish and European authorities in July 2012 (MoU), Law 9/2012 and Royal Decree 1559/2012 were enacted. The purpose of these regulations was to set up a comprehensive framework for the restructuring and resolution of credit entities by the Spanish authorities. One of the most prominent instruments of such a framework is the use of asset management companies (AMCs), which are entities intended

---

to manage the ‘toxic’ assets from credit entities in financial trouble. Law 9/2012 and Royal Decree 1559/2012 also contemplated a single AMC – the Company for the Management of Assets proceeding from Restructuring of the Banking System (SAREB) – incorporated to manage the toxic assets from the banks undergoing restructuring or resolution processes since 2012, as well as certain separate pools of assets defined as banking assets funds (BAFs).

Law 9/2012 was partially superseded by Law 11/2015, and only some of its provisions amending other regulations and certain additional provisions remain in force.

Law 11/2015 constitutes a continuation of the regime set forth in Law 9/2012 and shares the same principles as it, replicating, to a great extent, its structure and sections; however, it applies not only to credit institutions but also to investment firms (hereinafter, Law 9/2012, Royal Decree 1559/2012 and Law 11/2015, jointly and as in force in each case, the Credit Entities Resolution Regulations).

Among other amendments introduced by Law 11/2015, there is the reform on securities clearing, settlement and registration, and the creation of the National Resolution Fund, which received contributions from credit institutions and investment funds and will be replaced by the EU Single Resolution Fund. Credit institutions will need to contribute to the EU Single Resolution Fund in the coming years (investment firms will continue to contribute to the National Resolution Fund).

III COMMON ASSET MANAGEMENT STRUCTURES

There is a panoply of structures under which assets can be managed in Spain. Each structure poses certain specific features that indicate the sector within which its business takes place or the nature of the assets under management.

i Investment firms

Investment firms are those whose main activity is rendering investment services over financial instruments to third parties on a professional basis, those services being listed and described in the Securities Market Law.

Investment firms can be categorised as follows (from the broadest to the narrowest scope):

a broker-dealers;

b brokers;

c portfolio management companies; or

d financial advisory firms.

This category depends, broadly speaking, on whether investment firms operate in their own interests or solely in the interests of third parties, and on the variety of services that they are entitled to render.

Typically, asset management business is carried out by portfolio management companies, which are entities that can only render the following investment services: discretionary portfolio management activities on an individual basis and in accordance with a mandate received from a client, and investment advice (i.e., the provision of personal recommendations to a client, either upon the latter’s request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments). They may also provide those ancillary services specifically foreseen in the Securities Market Law.
It is worth noting, however, that both broker-dealers and brokers are also legally entitled to render those services (albeit brokers can only do so in third parties’ interests), as well as credit entities (to the extent that their legal regime, articles of association and administrative authorisation allow them to do so). Portfolio management companies may not own or hold in their name either the funds or the financial instruments made available to them by their clients for their discretionary management or that are the result of said management.

Investment firms must be authorised by the CNMV and registered in the CNMV’s relevant registries.

ii Collective investment schemes

Open-ended collective investment schemes (IICs)

Open-ended collective investment schemes (IICs) can be described as schemes whose purpose is to collectively invest funds attracted from the public, whose functioning is subject to the principle of risk-allotment and whose units are repurchased with a charge to the assets of the institution upon request of the investor. IICs can be categorised in various manners.

Based on their legal form, IICs can be categorised as investment funds or investment companies. Investment funds are IICs that are structured as a separate pool of assets without legal personality that belong to a number of investors (including other IICs), and whose management and representation are performed by an SGIIC with the assistance of a depositary entity.

Investment funds can be divided into separate divisions, each being given a different name but under the general denomination of the fund. Each division issues its own units, which represent the part of the net worth of the fund that is attributed to that division. The subscribers to the relevant units of the investment fund will be considered unitholders. Each fund must have at least 100 unitholders, who will not be responsible for the liabilities of the relevant fund except up to the amount of their investment.

Investment companies are IICs that are structured as Spanish open limited liability companies. The share capital of investment companies needs to be fully subscribed and paid-up from their incorporation date and be represented by shares. As with investment funds, it is possible to create investment companies with different divisions. Again, the number of shareholders cannot be fewer than 100, and in certain cases, it is necessary for these companies to appoint an SGIIC. Besides, since Law 22/2014 came into force, the general rule is that investment companies also need to appoint a depositary entity.

Based on the type of assets in which they invest, IICs can also be categorised as financial IICs or non-financial IICs. Financial IICs, which, when incorporated as investment companies, are also known as SICAVs, are IICs whose purpose involves investing in financial assets and instruments. The investment strategy of financial IICs must be undertaken within certain boundaries, inter alia, only assets that are listed and described in the CIS Law are available for investment; liquidity ratios must be complied with to guarantee investors’ refunds; and the risk profile of the total investments must be adequately diversified (in

---

11 Inter alia, securities and financial instruments admitted to trading in certain stock exchanges and other markets or organised trading systems; shares or units in certain UCITS not allowed to invest more than 10 per cent of their assets in shares or units of other IICs; or shares or units in certain open-ended alternative investment funds (Spanish open-ended AIFs) not allowed to invest in other IICs.
general, assets issued by a specific issuer cannot exceed 5 per cent (which figure, under certain circumstances, may be increased to 10 per cent) of the IICs' assets or 15 per cent in relation to that issuer’s group).

A particularly relevant subcategory of financial IICs is made up of free IICs (or hedge funds) and IICs of free IICs (or funds of hedge funds). These are, basically, IICs (not qualifying as UCITS) that are subject to requirements similar to those of conventional IICs, but with certain features that, in general, allow for more flexible management and investment strategies.

For instance, investment in these free IICs requires a minimum disbursement of €100,000, except for those qualifying as professional investors; and potential non-professional investors are required, before acquiring shares or units of these IICs, to sign a document declaring themselves aware of the risks arising from the investment, except in those cases in which the client has a portfolio management agreement authorising the investment in these IICs, and such agreement contemplates similar warnings to those in the aforementioned document.

The CIS Law only appears to expressly contemplate as non-financial IICs the real estate IICs whose principal activity involves investing in urban real estate property for letting. Additionally, real estate IICs are allowed to invest in securities admitted to trading in secondary markets. The investments made by this type of IIC must comply with certain liquidity and diversification ratios. These IICs can be incorporated as companies or as funds.

Based on whether they are authorised under the UCITS Directive, IICs can be categorised as UCITS, otherwise as Spanish open-ended AIFs. If open-ended AIFs are managed by SGIICs or managers authorised in another EU Member State, they may be freely marketed throughout the EU using a straightforward passporting procedure.

**SGIICs**

SGIICs are Spanish open limited liability companies incorporated for an indefinite time, whose corporate purpose involves managing the investments, and controlling and managing the risks, the administration and the management of the subscriptions and reimbursements of IICs. In doing so, SGIICs exercise powers corresponding to those of the owner of the funds without being their owners, and act jointly with depositaries. SGIICs’ share capital (which needs to be represented by registered shares) must comply with a minimum required amount requirement and be fully paid up.

After the entry into force of Law 22/2014, SGIICs are also allowed to manage, represent and commercialise VCEs, closed-ended schemes, European venture capital funds and social entrepreneurship funds. SGIICs must specify the criteria used to assess the adequacy and proportionality of their risk management policies as to the nature, scale and complexity of the activities of the management companies and the IICs managed by them. Additionally, SGIICs are now required to apply specific rules to control and manage potential conflicts of interest.

To incorporate an SGIIC, it is necessary to obtain authorisation from the CNMV. Such authorisation is conditional upon meeting a number of requirements, some of which may involve having a good administrative and accounting organisation, and adequate technical and human resources. Furthermore, in order to ensure fair treatment among shareholders or unitholders of IICs, or to maintain the stability and integrity of the financial system, the CNMV can temporarily require one or several SGIICs to reinforce their portfolio liquidity.
SGIICs are accountable with regard to the unitholders or shareholders of the IICs they manage for any damages arising from infringement of their obligations.

**Closed-ended schemes**

Law 22/2014 brought closed-ended investment structures into Spanish law. These closed-ended schemes consist of collective investment mechanisms that raise capital from a number of investors by means of marketing activities to invest the funds in any type of assets (financial or non-financial) according to a defined investment policy and that have no commercial or industrial target.

Law 22/2014 also regulates VCEs, categorising them as a type of closed-ended investment scheme that raise capital from investors by means of marketing activities, the commercial aim of which is to generate gains or returns for its investors, and the basic corporate purpose of which involves acquiring temporary interests in the share capital of non-financial or non-real estate companies (or both) that, as of the moment when the interest is acquired, are not listed companies. Additionally, these entities can invest in securities issued by companies in which real estate properties represent more than 50 per cent of their aggregate assets to the extent that at least 85 per cent of such real estate assets are devoted, on a continuing basis during the entire time when the shares are held by the VCE, to the development of an economic activity.

Closed-ended collective investment schemes are managed by specific management entities (SGEICs) or by SGIICs that in both cases need to be authorised for such purposes. Besides, management entities have to appoint a depositary entity for every fund or company they manage whose assets under management are above certain thresholds. Additionally, closed-ended collective investment schemes may take the legal form of a fund or a company.

Both closed-ended collective investment schemes and their managers are regulated entities in Spain, and subject to the supervision of the CNMV. Their incorporation is subject to the authorisation of the CNMV, and their operations are subject to information, audit and investment policy requirements.

Closed-ended collective investment schemes shall only be marketed to professional investors save when the same requirements as those in respect of hedge funds or funds of hedge funds are met. As mentioned above, AIFs may take the form of closed-ended schemes. The regime on cross-border marketing of closed-ended AIFs according to Spanish law may be summarised as follows: marketing of Spanish AIFs in the EU and EU AIFs in Spain is possible through the passporting process; and marketing of non-EU AIFs by EU alternative investment funds managers (AIFMs) and by non-EU AIFMs is possible by prior verification of the relevant conditions and submission for filing all the requested information in order to apply for the authorisation and registration of the non-EU AIFs. EU AIFMs and non-EU AIFMs both need to be registered with the CNMV.

**iii Pension funds**

**Pension funds**

Spanish pension funds are pools of assets without legal personality that are set up as instruments to implement pension schemes.

Each Spanish pension scheme must be related to a pension fund in a manner such that the contributions to the pension scheme made by its constituents and unitholders are
deposited in a certain account held within the fund. The obligations with regard to the
unitholders in the scheme are satisfied with monies withdrawn from such an account, which
will also receive returns from investments made by the fund and attributable to that scheme.

As described below, Spanish legislation contemplates three different types of pension
schemes depending on their constituents: an employment system’s pension scheme, an
associate system’s pension scheme and an individual system’s pension scheme. Pension funds
can either operate for pension schemes within the first category, in which case they would
be classified as employment pension funds, or within the second and third categories, in
which case they are labelled personal pension funds. Additionally, pension funds can be
either open-ended or closed-ended depending on whether they are limited to only channel
investments from related pension schemes (i.e., with an account held in the fund). The
Private Insurance Regulations have further developed the rules on open-ended pension funds,
widening and making their scope of operation more flexible and allowing for more diversified
investment policies and management. The incorporation of pension funds is subject to prior
approval by the Ministry of Economy and Business Support and the General Directorate
of Insurance and Pension Funds, which holds a registry of pension funds and pension fund
management companies.

**Pension fund managers**

Spanish pension funds are managed by pension fund management companies with the
assistance of depositary entities and under the supervision of a control committee.

Pension fund management companies, which take the form of Spanish open limited
liability companies, need to obtain suitable administrative authorisations and are subject to
the supervision of DGSFP. Such companies also need to meet a number of requirements,
including certain paid-up capital and net-worth minimum requirements, and limiting their
corporate purpose to managing pension funds. In addition, pension funds may also be
managed by insurance companies authorised to operate in the life insurance area in Spain
provided that they meet certain prerequisites, including the previously mentioned minimum
requirements as to paid-up capital and net worth.

**Pension fund investments**

The investment activity of pension fund assets is subject to certain restrictions as set out in
the Pension Funds Law and the Pension Fund Regulations. First, investments must be carried
out according to certain criteria including security, profitability, diversification, liquidity,
monetary consistency and suitable terms. Additionally, pension funds must invest at least
70 per cent of their assets in financial securities traded on regulated markets, derivatives
traded in organised markets, banking deposits, mortgage-backed credits, properties or real
estate IICs. Further limitations to Spanish pension schemes or funds business apply.

---

13 Spanish pension funds may also invest in securities admitted to trading on the Alternative Stock Market,
the Alternative Fixed Income Market and in venture capital funds (up to 3 per cent of the fund’s assets).

14 For instance, pension funds are subject to maximum investment limits and some establish maximum
percentages that certain assets may represent in relation to their total assets; pension funds may not
generally borrow funds, with certain exceptions; and the financial and actuarial system of the schemes have
to be revised by an actuary, such revision needing to be carried out, in general, at least every three years.
iv Insurance companies

There are several types of insurance companies under Spanish law, including insurance companies with a fixed prime, insurance companies with a variable prime and insurance cooperatives. Each type of entity needs to comply with a number of requirements to render insurance services in Spain. One such requirement is the setting-up of adequate technical provisions, which must be established and maintained in such an amount that they are able to cover all the risks arising from underwritten insurance and reinsurance policies, as well as to support the company's stability against random or cyclical shifts in claims or special risks.

Those technical provisions may be invested in certain acceptable assets\(^\text{15}\) according to the principles of consistency, profitability, security, liquidity, dispersion and diversification; all of the foregoing refer to the type of operations carried out by the insurance company and its commitments.

v Securitisation funds

Securitisation funds are separate pools of assets and liabilities, without legal personality and with a zero capital net worth whose patrimony will consist of, on the assets side, credit rights (current or future) that meet the criteria set forth in Law 5/2015; and on the liabilities side, fixed interest rate issuances carried out by them as well as the loans they have been granted.\(^\text{16}\)

Securitisation funds can be either open or closed-ended depending on whether new assets and liabilities can be added to their patrimonies once they have been incorporated.

As regards open-ended funds, Law 5/2015 allows their management companies to actively manage their securitised portfolio of assets. Such faculty shall have to be contemplated in the fund's incorporation deed, which shall describe its management policies. In addition, if applicable, the prospectus in relation to the fund shall also contain a description of such policies.

It is worth noting that since the entry into force of Law 5/2015, the assignment in favour of a securitisation fund of credit rights recorded as assets of the originator no longer has to be in full, unconditional and for the entire remaining term until maturity, which gives much more flexibility to this type of structure.

Securitisation fund managers

Securitisation fund managers are Spanish open limited liability companies, incorporated for an indefinite time, whose corporate purpose comprises the incorporation, management and legal representation of securitisation funds as well as BAFs. In addition, their minimum share capital amounts to €1 million, and needs to be fully subscribed and paid up as well as represented by nominative shares.

These entities are subject to a wide range of organisational and transparency requirements that are more stringent in respect of securitisation fund managers that choose to actively manage the securitisation funds they manage (mainly as regards management's and employees' remuneration rules).

\(^{15}\) The acceptable assets are listed and described in the Private Insurance Regulations as well as in EU Regulations directly applicable to insurance companies.

\(^{16}\) It is worth noting that, under certain circumstances, management companies of securitisation funds are allowed to enter into swaps or other types of derivative contracts on behalf of the funds under their management.
The incorporation of securitisation funds managers is subject to the prior authorisation of the CNMV. In addition, once authorised and prior to the commencement of their activities, they need to be registered with the CNMV.

vi SOCIMIs

There are two main types of entities under Spanish law the purpose of which is to invest in real estate assets: real estate IICs and SOCIMIs.

SOCIMIs are Spanish-listed open limited liability companies, which may opt for a special tax regime provided that they comply with certain requirements, one of which is that their main purpose be direct or indirect investment in urban real estate assets for rental, including both housing and business premises, residences, hotels, garages and offices. Indirect investment may be conducted by means of the acquisition of interests in other SOCIMIs, in other entities that are subject to similar profit distribution requirements or in real estate IICs.

Investment activity by SOCIMIs must be carried out within certain boundaries. In particular, it can only be made in respect of those assets listed and described in the SOCIMIs Law. Additionally, at least 80 per cent of their assets must be invested in those assets referred to in the previous paragraph. Finally, SOCIMIs are required to distribute the following as dividends: 100 per cent of any dividends and profit participations received as a consequence of their stake in other entities; at least 50 per cent of any profits deriving from divestment of real estate property and share capital interests; and at least 80 per cent of any remaining profits.

Tighter regulation of these entities was enacted in 2017, requiring SOCIMIs to comply with a minimum threshold of minority shareholders (i.e., shareholders who hold less than 5 per cent of the SOCIMIs’ share capital) to become listed companies. Previously, SOCIMIs were allowed not to comply with this minimum threshold for the first year of their listing.

Given their nature, SOCIMIs are subject to double supervision: the Spanish tax authorities supervise compliance with the necessary requirements for special tax treatment and the CNMV supervises the operation of SOCIMIs in the securities market.

vii AMCs, SAREB and BAFs

The bursting of the housing bubble, together with the collapse of the real economy, left most Spanish credit entities with enormous portfolios of real estate assets, often as a consequence of mortgage foreclosure proceedings or property-backed non-performing loans. The maintenance of these assets in their balance sheets jeopardises both their solvency and their chances of survival.

In view of the foregoing, the EU resolved in 2012 to put in place a Financial Assistance Programme for the Spanish banking sector by means of the MoU. One of the main objectives of the MoU was the establishment of a well-defined and effective framework for the management of the banking crisis. AMCs are one of the most relevant instruments within such framework (the landscape is completed by SAREB and BAFs).
Over the past few years, Spanish banks have significantly reduced their exposure to problematic assets such as non-performing loans and foreclosed assets, moving closer to the EU average. 18

AMCs

AMCs are Spanish open limited liability companies that are incorporated in the context of the restructuring and resolution process of a credit entity to isolate toxic assets within such entity’s balance sheet, and are currently regulated by Law 11/2015. The Fund for the Orderly Restructuring of the Banking Sector (FROB) can oblige a credit entity to transfer certain categories of assets in its balance sheet (or to direct an entity under its control to effect such a transfer) to an AMC when those assets are particularly damaged or their maintenance on the balance sheet is deemed detrimental to the entity’s viability.

The purpose of these transfers (and the very existence of AMCs) is to direct the transmission of risks to entities as remote from the depositors as possible, to minimise the need for public funding and the occurrence of market distortion and, ultimately, to facilitate the disposal of dangerous assets in an isolated fashion.

The FROB lists in each case the categories of transferable assets. The Credit Entities Resolutions Regulations set out a number of rules, the aim of which is to facilitate the effectiveness of those transfers 19 as well as the obligation to conduct value adjustments on a pre-transfer basis.

Finally, it is worth noting that AMCs are entitled to raise debt by issuing bonds.

SAREB and BAFs

While AMCs are meant to apply to all the processes that may need to be undergone in the future, the Credit Entities Resolution Regulations also set out the rules for the incorporation of SAREB, whose purpose was to acquire the toxic assets from those credit entities that were nationalised in 2012. 20

SAREB is a Spanish open limited liability company incorporated by the FROB. It was created with the exclusive purpose of managing and disposing of certain assets received from the nationalised credit entities. 21 Each such transfer has been subject to pre-transfer value adjustments.

The FROB holds a 46 per cent interest in the share capital of SAREB, while private investors (mostly, Spanish credit entities) hold the remaining 54 per cent. In terms of corporate governance, SAREB is subject to the Spanish Companies Law. Its management is

---

19 For example, no third-party consent may be needed, no restrictions on the transferability of assets in articles of association or contracts will apply, and these transfers are not subject to clawback or mandatory takeover bid rules.
20 Pursuant to Royal Decree-Law 24/2012, these entities were BFA-Bankia, Catalunya Banc, NCG Banco-Banco Gallego, Banco de Valencia, BMN, Liberbank, Caja3 and Ceiss.
21 The assets that SAREB has received are within one of the following categories: foreclosed real estate assets with a net book value above €100,000; loans financing real estate with a net book value above €250,000 (not limited to non-performing loans); or equity in real estate companies controlled by banks.
entrusted to a board of directors within which an auditing committee and a remunerations and appointments committee are set up. SAREB is also subject to the supervision of a monitoring committee.

SAREB’s mandate is to complete the disposal of its full portfolio within 15 years of its incorporation (albeit no minimum annual divestment thresholds apply). To do so, it has a particularly relevant instrument at its disposal: the BAF.

BAFs are insolvency-remote pools of assets and liabilities without legal personality incorporated by SAREB; any portion of their portfolio can be allocated, and must be filed with a certain registry held by the CNMV. These funds (which can be open-ended or closed-ended) are governed by the Credit Entities Resolution Regulations, as well as by the regulations applicable to asset securitisation funds, mortgage securitisation funds and collective investment schemes, as applicable. BAFs are managed by asset securitisation fund management entities that comply with the requirements set out under the aforementioned Regulations.

BAFs can be divided into different divisions, each of which may issue securities or undertake obligations on a separate basis. The transfer of assets and liabilities from SAREB to each BAF benefits from the same rules that are applicable to the transfer of assets to AMCs. Finally, one of the most notable features of the BAF is its privileged tax regime.

When using this instrument, the disposal by SAREB – and hence, the investment by potential acquirers – will take place through a purchase of units of the BAF. There are only six BAFs currently registered with the CNMV clearly reflecting that it is not investors’ preferred route.

**IV MAIN SOURCES OF INVESTMENT**

i **Size of the industry and recent trends**

According to the latest report issued by the CNMV, assets under management by financial investment funds decreased by 2.3 per cent in 2018 to €259.1 billion. The number of funds in operation decreased to 1,725 registered funds, slightly lower than in 2017 (1,741). The number of unitholders increased by 9 per cent compared to 2017. The biggest inflow of new investors was received by international equity funds and global funds, whereas passive management funds registered the largest losses for investors.

Regarding real estate schemes, the main figures have worsened, mainly because of a shift of investment towards SOCIMIs. There was a significant decrease of 14.1 per cent in the value of assets managed, a trend driven primarily by portfolio losses.

The total volume of investments by foreign collective investment schemes marketed in Spain has been expanding since 2012 and, although the volume seemed to be beginning to stabilise in 2016, it increased again in 2017 and in 2018. The assets managed by these entities increased by 20.3 per cent as compared to the end of 2017, which represents 37 per cent of all assets held in collective investment schemes marketed in Spain. Additionally, the number of foreign collective investment schemes registered with the CNMV rose from 1,013 at the end of 2017 to 1,024 at the end of 2018.

---

22 SAREB received a portfolio of 197,474 assets valued at €50.781 million (80 per cent are financial assets and 20 per cent are real estate assets).

23 This information is taken, except unless otherwise stated, from the CNMV’s Quarter I 2019 Bulletin.
The amounts under management of pension funds in 2018 decreased to €107.03 billion.24 This represents a decrease of 3.7 per cent with respect to the 2017 figure, which constitutes a significantly worse performance than in the preceding two years.

Contributions to pension schemes were slightly below those made in 2017 at €4.88 billion, and the number of schemes at the end of 2017 was 2,523 (a 1 per cent drop compared with 2017 figures).

From 2017 to 2018, the number of SICAVs decreased to a total of 2,713, and their aggregated assets decreased by 11.4 per cent compared with 2017 figures.

ii Types of investors

Unlike other European countries, in Spain households are the main investors of collective investment schemes. In 2018 assets of collective investment schemes were owned as follows: 62 per cent by Spanish households, 10 per cent by insurance companies and pension fund schemes, 17 per cent by other financial intermediaries and 11 per cent by non-financial companies. In 2018, Spanish households invested 39.9 per cent of their financial assets in bank deposits and cash (much stronger than the European average of 30.3 per cent), whereas they allocated 16.5 per cent of their financial assets to pension funds and insurance (much weaker than the European average of 35.5 per cent).

In comparison to the European average, investment of Spanish households is lower in pension funds and insurances, and higher in relation to bank deposits and cash equivalents. However, it is notable that since 2008, Spanish households have significantly increased the percentage of their financial assets invested in collective investment schemes, which has increased from 8.9 per cent in 2008 to 14.8 per cent in 2018.25

V KEY TRENDS

Again in 2018, with a 2.6 per cent increase in GDP, the Spanish economy outperformed the majority of European countries, which, on average, registered GDP growth of 1.8 per cent. Households and companies are increasing their wealth and diversifying their investment portfolios, apart from gradually reducing their debt, and the level of foreign direct investment shows that the trust of international investors has remained strong in 2018.

On the collective investment schemes side, assets under management of collective investment schemes decreased by 2 per cent in 2018.26 As in 2017, investors are more willing to invest in medium-to-high-risk investment funds in the expectation of obtaining higher returns, even though there were some shifts late last year due to poor performances of the financial markets (which increased risk aversion levels and led to a reduction of almost

24 All the information in this section related to pension funds, except unless otherwise stated, is taken from the information made available to the public by the Spanish Association of Collective Investment Schemes and Pension Funds (INVERCO): http://www.inverco.es/archivosdb/c86-ahorro-financiero-de-las-familias-iics-y-fp-2018.pdf.


26 Unless otherwise indicated, the information in this section on collective investment schemes for 2018 is taken from the CNMV’s Quarter I 2019 Bulletin.
£4 billion in assets managed). This is why global funds, mixed equity funds, international equity funds and absolute return funds recorded a high level of subscriptions. On the other hand, passively managed funds and fixed income funds recorded the largest redemptions.

Data from the first quarter of 2019 seems to indicate that the data on collective investment schemes in 2019 will be very similar to those registered in 2018. Investment funds have registered an increase of £4.7 billion in terms of assets managed compared to December 2018, which represents an increase of 1.8 per cent in just three months. Investors’ preferences in these first months of 2019 continue to be for medium-to-high-risk products, mainly global funds, mixed equity funds and international equity funds.

Despite some instability in 2018, the asset management industry is expected to keep growing worldwide, and reach £145 billion in value by 2025 (almost twice the assets’ value in 2016). In Spain, those expectations are even higher, as assets managed by investment funds in Spain are still behind the levels of Scandinavian and English-speaking countries. Nonetheless, obtaining positive returns is becoming a harder task, which is why pension funds are shifting from a defined benefit formula to a more defined contribution system. Furthermore, demographic changes are encouraging the creation of new and diverse clients that need to save portions of their income as the public pension system begins to crumble. They are also more tech-savvy and socially conscious, which has led to a significant increase in environmental, social and governance-based investments worldwide, and this trend is expected to gain momentum in Spain as well.

VI SECTORAL REGULATION

i Insurance

Asset management by insurance companies is governed by the Private Insurance Regulations. The purpose of such Regulations is quite broad, setting up the regime and supervision of private insurance activity in Spain with a view to protecting policyholders, enhancing transparency within the insurance industry and promoting private insurance business in Spain.

In doing so, the Private Insurance Regulations set out, inter alia:

a the conditions and requirements that must be met by an entity to undertake insurance business;
b the types of legal entity that may engage in such activity;
c the supervision of insurance companies;
d the rendering of insurance services on a cross-border basis;
e reinsurance activity;
f policyholder protection; and
g the regime applicable to pension mutual funds.

27 Unless otherwise indicated, the information in this section related to investment funds in the first quarter of 2019 is taken from the information made available to the public by the Spanish Securities and Exchange Commission (CNMV): http://www.cnmv.es/DocPortal/Publicaciones/Boletin/Boletin_1_2019.pdf.
ii  Pensions

Asset management of pension funds is regulated by the Pension Funds Law and the Pension Funds Regulations, the purpose of which is to establish the framework for Spanish pension schemes, including pension funds.

Pension schemes may be classified in various ways according to the Pension Funds Law depending on their constitution and the nature of their commitments.

iii  Real estate property

As previously noted, investments in real estate assets are typically conducted in Spain in the form of two types of entity: real estate IICs and SOCIMIs. Real estate IICs are regulated by the CIS Law.

As so few SOCIMIs had been incorporated since 2009, the regime was relaxed in December 2012.29 The general purpose of the reform was to facilitate the application of the tax regime by reducing the applicable requirements. A number of changes were introduced to that effect, one of the most relevant being that the shares of these listed entities can be traded not only in regulated markets, but also, for instance, in the Alternative Stock Market, whose admission requirements are less stringent. Additionally, the minimum share capital requirement has been reduced from €15 million to €5 million.

These changes have proven effective: on 31 March 2019, 72 SOCIMIs were listed, either on the Continuous or the Alternative Stock Market, 24 more entities than by the end of 2017, and the investment in SOCIMIs since 2013 has surpassed €21 billion (more than €5 billion in 2018 alone, which is approximately 2.5 times more than in 2017).30 Therefore, Spain is now effectively the second-highest country with most SOCIMIs (or equivalent figures) in the world, surpassing Japan’s 63 J-REIT (SOCIMIs in Japan), and only behind the United States, although their total capitalisation is still behind several countries (as at March 2019, Spain is the tenth-largest market in the world, with a total asset value of €23.18 billion).31

In the coming years, though, more competition can be expected in the Iberian market, as Portugal enacted a law approving the figure of SIGI (equivalent to SOCIMIs and REITs) in order to attract more foreign investment in the sector.32

Halfway between the real estate market and the regulatory environment for credit entities are AMCs, SAREB and BAFs. Even though their purpose is to serve as instruments for the restructuring or resolution of banks, the nature of the assets currently under SAREB’s management (real properties or real estate-related credits) makes them noteworthy.

iv  Hedge funds

Spanish hedge funds are regulated under the CIS Law within a specific section relating to financial IICs that do not qualify as UCITS and RD 1082/2012 (which, inter alia, foresees the acceptable assets for investment as well as their obligations with regard to third parties).

---

29 Law 16/2012 which adopts tax measures aimed at consolidating public financing and promoting economic activity.
v Private equity

The private equity industry in Spain has traditionally used the legal form of VCEs, which are now regulated by Law 22/2014. The sector is adapting itself to the new regime and regulations.

VCEs need to have a defined investment policy, which covers, inter alia, the sectors and geographical areas where the investments will be focused; the minimum and maximum stake that the VCE will hold in the relevant companies; and the type of financing that will be granted to the companies they hold an interest in.

At least 60 per cent of the calculable assets of a VCE needs to be invested in:

a shares or other securities or financial instruments that confer the right to acquire such securities in the capital of companies that comply with the requirements set out by Law 22/2014;

b participative loans in such type of entity, the interest of such loans being fully correlated to the results of the borrower in a manner that, if the borrower’s results are negative, no interest will be paid on the loan;

c other participative loans to companies within its corporate purpose with a limit of 30 per cent of its aggregate computable assets; and

d shares or interests in other VCEs.

Management entities are subject to transparency obligations in respect of the venture capital entities they manage (e.g., to make available to the public an informative prospectus and an annual report).

VII TAX LAW

Within the framework of the comprehensive reform of November 2014 to comply with the MoU conditions and boost Spanish competitiveness, the government approved a new Corporate Income Tax (CIT) Law,\(^33\) which made, inter alia, significant amendments to CIT and non-resident income tax (NRIT). However, the reform did not have a significant impact on the taxation of collective investment schemes, although investors did benefit from reduced tax rates. In addition, UCITS-qualified collective investment schemes located in an EU Member State have been granted equal tax treatment to domestic UCITS-qualified collective investment schemes.

Nevertheless, in 2019 the then Socialist Spanish government proposed an amendment to the CIT introducing a number of measures, including minimum CIT payment of 15 per cent over the positive taxable base, a 95 per cent exemption on dividends and capital gains (rather than a full exemption), the potential strengthening of the tax measures included in the ATA Directives,\(^34\) the introduction of an additional CIT payment for SOCIMI’s retained earnings, the granting of further authority to the Spanish tax administration to review the favourable CIT status of domestic UCITS qualified collective investment schemes incorporated as a SICAV, additional rules targeted at the use of tax havens, and the implementation of other international tax actions and recommendations. Although the

\(^{33}\) Law 27/2014 of 27 November on corporate income tax.

\(^{34}\) Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market and Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (together, the ATA Directives).
Proposal was not passed by Parliament, as a result of the Spanish general elections of April 2019, a new Spanish government led by the same Socialist party is expected to be formed and thus the CIT proposals will likely be again submitted to Parliament.

Regarding Spanish resident collective investment schemes, open-ended IICs are non-transparent entities subject to Spanish CIT, albeit at a rate of 1 per cent. As for closed-ended IICs (including VCEs), these are subject to the general 25 per cent Spanish CIT rate. Spanish-resident pension funds remain taxed under the CIT Law, but at a rate of zero per cent.

Income deemed to be obtained in Spain by a non-resident is subject to NRIT, generally at a rate of 24 per cent; however, income obtained by residents in an EU Member State\(^{35}\) is subject to a rate of 19 per cent. Certain income items are specifically taxed at a reduced rate of 19 per cent regardless of the residence of the non-resident taxpayer, namely dividends, interest and capital gains. Each income stream is subject to taxation separately on a gross basis (no expenses are deductible, with certain exceptions). Normally, a withholding tax equal to the non-resident’s final tax liability is levied on interest, dividends and capital gains on IICs.

As regards non-Spanish resident managers of collective investment schemes, any Spanish-sourced income earned when carrying out their management activity (fees, commissions or any other returns) will be subject to Spanish NRIT at the general 24 per cent rate (or 19 per cent when earned by residents in an EU Member State, Norway or Iceland), but most conventions for the avoidance of double taxation (CDTs) entered into by Spain provide for an exemption from tax on business profits obtained in Spain (unless those profits are earned through a Spanish permanent establishment). Spanish-sourced income includes interest paid by a Spanish-resident taxpayer or with respect to financing used in Spain, gains on the disposition of bonds issued by Spanish-resident persons, dividends distributed by Spanish-resident entities, including collective investment schemes, and capital gains on the disposition of shares and units issued by Spanish-resident entities, including IICs.

Generally, non-resident taxpayers are subject to NRIT on Spanish-sourced income, and must declare and pay NRIT during the first 20 days of April, July, October and January: NRIT is paid on income obtained during the immediately preceding calendar quarter.

Below is a brief description of taxation applicable to non-resident investors; the sections below refer to individuals or entities not resident in Spain for tax purposes and not acting through a permanent establishment located in Spain.

i Capital gains

In general, capital gains obtained in Spain by a non-resident taxpayer will be taxed under the NRIT at a 19 per cent rate. No withholding tax is levied on capital gains, except on those related to an investment in a Spanish open-ended IIC (with the exception of qualified exchange-traded mutual funds).

Domestic legislation provides for an exemption from taxation for residents of countries having concluded a CDT with Spain, which usually includes an exchange of information clause, in the case of transfers of shares or reimbursements of units in an IIC in an official Spanish secondary securities market.

\(^{35}\) Or by residents in a Member State of the European Economic Area with which Spain has an effective exchange of tax information as defined in Law 36/2006, of 29 November, on Measures to Prevent Tax Fraud.
In addition, legal persons resident in an EU Member State are entitled to an exemption on capital gains obtained upon a disposal of Spanish shares, provided that the non-resident entity has recently owned, for an uninterrupted period of one year, a minimum 5 per cent participation or a participation with an acquisition cost of at least €20 million, and to the extent the assets of the company to which the shares belong do not consist mainly, directly or indirectly, of real estate located in Spain.

Natural persons resident in an EU Member State are also entitled to an exemption on capital gains obtained upon the disposal of Spanish shares, unless the non-resident taxpayer has owned, at any time during the year prior to the transfer, shares representing 25 per cent or more of the transferred entity, or if the assets of the company to which the shares belong consist mainly, directly or indirectly, of real estate located in Spain.

The exemption will not apply if the said gains are obtained through tax haven jurisdictions.

Finally, most CDTs entered into by Spain provide for an exemption from capital gains tax, except when the assets are allocated to a Spanish permanent establishment or when the assets are Spanish real property. In some cases, when the assets consist of shares in a Spanish-resident entity, the exemption is subject to the holding being below significant participation thresholds (generally, 15 or 25 per cent).

### ii Interest and dividends

In general, interest and dividends obtained in Spain by a non-resident taxpayer will be subject to NRIT at a rate of 19 per cent, and will be subject to withholding tax.

Domestic rules provide certain tax exemptions on income obtained by non-residents. In addition, EU residents are entitled to an exemption on interest obtained in Spain, provided that the interest is not obtained through a tax haven jurisdiction.

Regarding dividends, no Spanish withholding taxes are levied on the dividends distributed by a Spanish subsidiary to its parent company resident in an EU Member State, Norway or Iceland to the extent that:

- either the parent company maintained an uninterrupted direct holding in the capital of the Spanish subsidiary of at least 5 per cent for the whole year prior to the date on which the distributed profit is due, or the acquisition value of such holding exceeded €20 million;
- the parent company is incorporated under the laws of an EU Member State, Norway or Iceland, and is subject to CIT in a Member State, without the possibility of an exemption; and
- the distributed dividends do not derive from the subsidiary's liquidation.

The Spanish implementation of the Parent–Subsidiary Directive includes an anti-abuse provision by virtue of which the dividend withholding tax exemption will not be applicable in the event that the majority of the voting rights of the parent company is held directly or indirectly by individuals or entities not resident in an EU Member State, Norway or Iceland, except if the incorporation of the parent company took place and its operations are conducted on the basis of valid economic reasons and substantial business motives.

---

36 Non-resident natural persons are not subject to this prerequisite; however, they will only be entitled to the referred exemption on capital gains to the extent that they did not hold a participation of 25 per cent or more in the share capital of the Spanish company in the 12 months prior to the transfer of shares.
Additionally, the right to apply the exemption on interest and dividend payments made to EU resident persons must be reviewed in the light of the recent Court of Justice of the European Union (CJEU) judgments related to the beneficiary ownership test and abusive practices (accumulated cases C115-16/ C118-16/ C119-16 and C299-16 for interest payments, and accumulated cases C-116/16 and C-1117/16 for dividend distribution). There are no official guidelines from the tax authorities on the impact of such rulings.

Finally, non-residents that reside for tax purposes in a country that has entered into a CDT with Spain will be entitled to apply the reduced tax rates provided in the relevant CDT (e.g., CDTs usually establish rates ranging from zero to 15 per cent on interest and dividends).

### iii Royalties

Royalties paid to qualified associated EU-resident companies are exempt from NRIT provided that certain requirements are met. Otherwise, a 24 per cent tax applies (19 per cent when earned by residents in an EU Member State, Norway or Iceland), which may be reduced by applicable CDTs.

### iv Spanish holding companies

Spanish holding companies (ETVEs) are defined as standard domestic companies subject to CIT, the corporate purpose of which includes the management of stakes that correspond to active domestic or non-Spanish resident entities and comply with certain formal requirements. ETVEs may also carry out any other non-exempt activities.

One of the main advantages of ETVEs is that dividends and capital gains obtained by non-Spanish resident shareholders from their interest in an ETVE are not subject to taxation in Spain if they indirectly derive from dividends and capital gains obtained by the ETVE from its interest in non-Spanish resident companies or permanent establishments located outside Spain.

### v Spanish real estate investment companies

SOCIMIs are subject to a zero-rated CIT on qualified real estate income, provided that certain criteria are fulfilled. They may, however, be subject to a 19 per cent CIT on the dividends and profit participations paid out to their shareholders provided that the following requirements are met:

- **a** the shareholder holds at least a 5 per cent interest in the SOCIMI’s share capital;
- **b** dividends received by the shareholder in its jurisdiction of residence are exempt or taxed at an effective tax rate lower than 10 per cent; and
- **c** the shareholder does not qualify as an entity regulated under the SOCIMIs Law or as a non-resident listed SOCIMI in respect of which its shareholders hold at least a 5 per cent of the SOCIMI’s share capital, and the dividends received are exempt or taxable at a tax rate lower than 10 per cent in its tax jurisdiction.

Non-Spanish resident shareholders are subject to the general tax regime on dividends and capital gains resulting from their investment in SOCIMIs, as discussed above. Although not enacted, there have been discussions regarding a future 15 per cent tax on their non-distributed earnings or profit to try and mitigate the tax haven status that some claim SOCIMIs might be benefiting from.
vi Regulated Spanish VCEs

VCEs benefit from a full exemption from tax on qualified dividends. Regarding capital gains, VCEs are entitled to a full exemption on capital gains triggered by the transfer of shares provided that, prior to it, these entities held more than 5 per cent of the shares of the company whose shares are disposed of or a stake in the company whose value is higher than €20 million during the 12-month period prior to the disposal. VCEs not meeting the foregoing requirements are entitled to a 99 per cent exemption on capital gains carried out between the second and the 15th year of holding. In addition, dividends or capital gains triggered by non-resident shareholders of a Spanish VCE are not subject to Spanish taxation (to the extent the shareholder is not resident in a tax haven jurisdiction).

vii Anti-avoidance rules

No specific anti-avoidance measures have been approved by Spain in connection with these types of investments and investors, except the aforementioned rules that limit the application of tax exemptions or other tax benefits to investors acting through a tax haven jurisdiction, as defined under Spanish tax provisions.

VIII OUTLOOK

Over the past few years we have witnessed sustained growth in Spain’s asset management industry, and all signs seem to indicate that this will remain the case in 2019, although growth rates will presumably become more moderate in the coming years. The political situation in Spain was complicated in 2018, as there was a change in the Spanish government, and the state of affairs in Catalonia as regards its independence was still ongoing. In 2019 there has been yet another change in government and the situation in Catalonia has not yet been resolved. Furthermore, the European Central Bank’s delay in implementing an interest rate normalisation policy will also affect the market’s performance in 2019. Nevertheless, Spain continues to have one of the higher forecasts for GDP growth among the developed economies, and the forecast for financial markets for the next year is in line with the positive performance of the past seven years.37

The implementation of the AIFMD in Spain has been a major event in the Spanish asset management market from a regulatory perspective, and will continue to be so in future years, since various of its provisions are still pending further development by means of regulations and CNMV circulars. In any event, the main consequence to have noticeable effects on the market is the right to freely market open-ended and closed-ended EU collective investment schemes (to the extent that they do not qualify as UCITS, which have their own regulations) throughout the EU using a simple passporting procedure.

As stated before, Spain has recently completed its MiFID II transposition and, therefore, it remains to be seen how the measures adopted will affect the asset management industry. Experts agree that one of the major impacts will be the prohibition on accepting or retaining inducements when independent advice and discretionary management portfolio services are

rendered. This prohibition, together with the comprehensive, accurate and understandable disclosure to the clients of fees, commissions and other payments received by investment firms, will most likely be a game-changer.

In the past few years we have witnessed a change in the real estate asset management landscape that is likely to last in the middle term, as investment in this sector is now mainly conducted through SOCIMIs (which play the role traditionally performed by real estate investment funds and companies). An example of this trend is SAREB’s creation of its own SOCIMI, which made its debut in the Spanish Alternative Stock Market in April 2018 and manages a total of €34.5 billion in real estate assets as at March 2019.
Chapter 21

SWITZERLAND

Shelby R du Pasquier and Maria Chiriaeva

I  OVERVIEW OF RECENT ACTIVITY

With its long tradition of banking and finance, Switzerland is one of the leaders at the international level in the asset management industry. Swiss asset management constitutes one of the main pillars of the Swiss financial centre.

The asset management industry in Switzerland is heterogeneous and applies different business models. Large banking institutions active in wealth management (private banking) coexist with a number of smaller niche players. Independent asset managers represent the lion’s share of the para-banking sector within the Swiss financial industry, with a limited level of regulatory oversight for the time being (see Section V.i on the future legislation regarding financial institutions). This situation will drastically change with the entry into force of two new statutes, expected in January 2020 – the Financial Institutions Act (FinIA) and the Financial Services Act (FinSA) (see Section II.v). As we will see, those new Acts will materially affect the organisation and activities of independent asset managers who will have to review and adapt, as the case may be, their business model.

Current challenges to the asset management industry in Switzerland include a wave of new regulatory activity and regulatory developments occurring at the EU level. The Swiss legal and regulatory framework is being adjusted on an ongoing basis to ensure its euro-compatibility to keep it in line with international standards and to enhance the protection granted to investors.

II  GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

Switzerland does not have a comprehensive licence for all financial services providers. Certain financial activities do require licences, whereas others can be conducted on a largely unregulated basis. The following financial services providers are subject to prior licensing and ongoing prudential supervision by the Swiss Financial Market Supervisory Authority (FINMA):

- banks;
- insurance companies;
- securities dealers;
- fund distributors; and
- fund administration companies; and managers of collective investment schemes (CISs).

---

1 Shelby R du Pasquier is a partner and Maria Chiriaeva is a senior associate at Lenz & Staehelin.

© 2019 Law Business Research Ltd
Switzerland is not a Member State of the EU; therefore, EU rules and regulations do not apply directly to financial services activities conducted in Switzerland.

With the exception of general rules that apply to all asset managers in Switzerland (see Section II.i), for the time being, the conduct of asset management activities is subject to specific regulations only where such services are rendered in connection with a CIS (see Section II.ii), or involve the trading of securities (see Section II.iii) or the management of Swiss pension funds assets (see Section II.iv). That being said, under the new regime expected to enter into force on 1 January 2020, asset managers, as a rule, will become supervised in Switzerland and will have to obtain a specific licence to conduct their activities (see Section II.v). In light of its practical relevance, we further set out an overview of the rules applicable to the distribution, in or from Switzerland, of interests in a non-Swiss CIS (see Section II.vi).

i Regulation of asset management in general

Direct regulation under the Swiss Anti-Money Laundering Act (AMLA)

Contrary to the situation prevailing in a number of other jurisdictions, asset management activities are not, for the time being (see Section II.v for an overview of the situation that will prevail in 2020), subject to prudential supervision in Switzerland unless these activities are conducted in connection with a Swiss or non-Swiss CIS (see Section II.ii), the asset manager is characterised as a securities dealer (see Section II.iii), or he or she manages assets of Swiss pension funds (see Section II.iv).

That said, asset managers qualify all instances qualify as financial intermediaries within the meaning of Article 2(3) of the Swiss Anti-Money Laundering Act (AMLA), and as such be subject to the Swiss regulations against money laundering, which are based on the standards adopted by the Financial Action Task Force on Money Laundering (FATF). In particular, AMLA requires that the relevant financial intermediary registers with and is subject to the supervision of a self-regulatory body recognised by FINMA or by FINMA directly (Article 12(c) AMLA).

The duties imposed upon financial intermediaries under AMLA are essentially know-your-customer rules and procedures, as well as certain organisational requirements (e.g., internal controls, documentation and continuing education) (Article 3 et seq. AMLA). In addition, financial intermediaries are required to report suspicious transactions to the regulatory body. Such reporting duty presupposes that the financial intermediary is aware, or has reasonable suspicion, of the criminal origin of the assets involved (Articles 9 and 10 AMLA). In this context, the regulatory body is also entitled to request information from third-party financial intermediaries that appear to be involved in the transaction or business relationship that triggered the reporting by another financial intermediary.

Under Swiss law, financial intermediaries must implement a two-step process after the reporting of suspicions to the regulatory body. First, they have to monitor the account in question for a period of up to 20 days during the review of the case by the regulatory body (with the aim of blocking any transaction that may result in preventing or complicating the confiscation of the concerned assets). As a second step, if the case is assigned to a criminal prosecutor, the financial intermediaries have to implement a full freeze on the account for up to five days until a decision to maintain the freeze is made by the criminal authority. An immediate freezing of assets is, however, required for assets connected to persons the details of whom were transmitted to the financial intermediary by FINMA, the Federal Gaming
Board or a self-regulatory organisation due to a suspicion of such persons being involved
with or supporting terrorist activities. Financial intermediaries may incur criminal liability
if they fail to comply with these duties.

It is worth noting that on 1 June 2018, the Federal Council opened up a consultation
procedure on a new revision of AMLA. The purpose of this revision is to reflect the outcome
of the latest review of the Swiss AML framework performed by the FATF. Among other
things, the draft provides for the extension of due diligence obligations to advisory services
related to the setting up, management and administration of offshore companies and trusts,
regardless of the absence of any purely financial intermediation activity. The draft further
provides for the removal of the 20-day deadline until which the regulatory body is to review
the reporting made by the financial intermediary and revert, as the case may be. The entry
into force of the revised AMLA is not expected before 2020.

**Indirect regulation under FINMA Circular 01/2009**

Furthermore, FINMA has defined certain requirements (outlined in FINMA Circular
01/2009) that asset managers are required to comply with in order for such managers and
their clients to benefit from certain exemptions under the Collective Investment Schemes Act
(CISA) (see Section II.vi). The duty to enforce the provisions of FINMA Circular 01/2009
lies with the self-regulatory bodies, which are in turn supervised by FINMA. As a result, it
is generally considered that asset managers are (for the time being) only indirectly regulated in
Switzerland (see, however, Section II.v, below).

FINMA Circular 01/2009 imposes on asset managers certain duties of care, loyalty
and information in relation to their clients, as well as a duty to comply with a fit and proper
test. In addition, FINMA Circular 01/2009 requires that the asset management agreement
entered into with clients sets out the terms of the remuneration of the asset manager.²

FINMA Circular 01/2009 also regulates the third-party inducements (retrocessions)
that may be received by asset managers. From a Swiss law perspective, the term ‘retrocessions’
generally refers to certain forms of fee payments agreed upon between financial intermediaries
(e.g., banks, securities dealers, asset managers). Typically, in the field of private wealth
management, a custodian bank may pay certain retrocessions to an external asset manager
who manages client assets deposited with the custodian bank. The Swiss Supreme Court
ruled³ that the distribution fees that the promoter of a financial product pays to the distributor
could be characterised as retrocessions, and are therefore subject to the legal regime set out
below.

Retrocessions are subject to a statutory restitution duty and are, as a matter of principle,
payable to the client of the receiving financial intermediary.⁴ Nonetheless, an arrangement

---

² Certain professional organisations also limit the level of compensation of asset managers. For instance,
the Code of Conduct issued by the Swiss Association of Asset Managers sets out a maximum amount
of management fees corresponding to 1.5 per cent per year calculated on the basis of the net asset value
of managed assets, or performance fees of a maximum of 20 per cent of the net capital increase (i.e., the
increase in value taking into account deposits and withdrawals in addition to any unrealised losses). If both
above-mentioned systems of fees are combined, management fees are capped at 1 per cent per year, and the
performance fees to a maximum of 10 per cent.

³ Decision of the Swiss Supreme Court of 30 October 2012 and published in the Official Court Reporter
under No. ATF 138 III 755.

⁴ Decision of the Swiss Supreme Court of 22 March 2006 and published in the Official Court Reporter
under No. ATF 132 III 460 (confirmed in subsequent decisions).
whereby the client agrees that a financial intermediary may retain retrocessions received from third parties is valid, provided the client was duly informed of the existence and calculation formula of such retrocessions and expressly waived his or her statutory restitution claim.

As a result of this case law, a Swiss financial intermediary (such as an asset manager) intending to retain retrocessions received from third parties should ensure that the contractual documentation governing its client relationships meets the requirements set forth by the Swiss Supreme Court. The Swiss Supreme Court further clarified in a 2017 decision that claims based on the above restitution duty are time-barred for 10 years after the receipt by the manager of the inducements in question. This decision brought an end to the debate among Swiss scholars, as well as the legal uncertainties regarding the term and the starting point of the limitation period applicable to restitution claims.

Finally, it is worth noting that, in August 2018, the Swiss Supreme Court confirmed that, depending on circumstances, failure to disclose retrocessions may constitute criminal mismanagement under the Swiss Criminal Code.

The level of information (ex ante disclosure) that needs to be provided to clients is set forth in FINMA Circular 01/2009 and in the guidelines of the relevant professional organisations. Asset managers must typically advise their customers of any conflicts of interest that might arise as a result of accepting third-party inducements. They are to inform their clients of the calculation parameters, as well as of the type of inducements they receive or might receive from third parties.

The above principles laid down in the Swiss case law and the FINMA Circular 01/2009 will be crystallised in the FinSA (see Section II.v). Under this new Act, retrocessions will continue to be allowed subject to complying with transparency requirements. Of note, the disclosure duty will apply irrespective of the presence of a mandate relationship (i.e., including in case of execution only transaction).

ii Regulation of CIS managers

Pursuant to the CISA, asset managers of both Swiss and non-Swiss CISs must obtain a licence from FINMA. That said, the CISA contains a de minimis rule, according to which asset managers of non-Swiss CISs whose investors are qualified investors (as defined in the CISA; see Section II.vi) are not regulated if they satisfy one of the following requirements:

a the assets under management, including those resulting from the use of leverage, do not exceed 100 million Swiss francs;
b the assets under management do not exceed 500 million Swiss francs, and the CISs are unleveraged and closed-ended for a five-year period (irrespective of whether the CISs are invested in target funds or other investments); or
c the investors are exclusively group companies.

The asset manager of a non-Swiss CIS that is exempt under the de minimis rule may, however, opt in and apply for a FINMA licence, provided that its registered office is in Switzerland, and Swiss law or the applicable foreign law requires such regulated status for the management of the assets of the CIS.

5 Decision of the Swiss Supreme Court of 16 June 2017 and published in the Official Court Reporter under No. ATF 143 III 348.
6 Decision of the Swiss Supreme Court of 14 August 2018 and published in the Official Court Reporter under No. ATF 144 IV 294.
Of note, under the FinIA, the *de minimis* rule will be extended to managers of Swiss CISs and pension funds (see Section II.iv). Asset managers benefiting from this exemption will, however, be supervised as any other asset manager and will therefore have to obtain a licence to conduct their activities in Switzerland (see Section II.v).

The CISA further provides for the possibility for a non-Swiss asset manager to operate in Switzerland as a branch for both Swiss and non-Swiss CISs. The authorisation of a branch is, however, subject to the following cumulative requirements: the non-Swiss asset manager is subject to adequate supervision by its home regulator; the non-Swiss asset manager has adequate organisation, sufficient financial resources, as well as competent staff to operate a branch in Switzerland; and a specific cooperation agreement is in place between FINMA and the non-Swiss asset manager’s home regulator. Those requirements will remain generally the same under the new FinIA.

Further, an agreement in principle was reached in December 2012 with the European Securities and Markets Authority (ESMA), acting on behalf of the national supervisory authorities of the EU Member States, as regards a model cooperation agreement. This agreement with ESMA is supplemented by bilateral agreements with each national supervisory authority in the EU and in the European Economic Area. In July 2015, ESMA recommended to the EU authorities the extension of the marketing passport under the AIFMD to Switzerland (as a third country). In its final advice of September 2016, ESMA confirmed its position. The latter is being reviewed by the European Commission, Parliament and Council, which are to make a decision on a political level as to such extension. For the time being, Swiss-based alternative investment fund managers are to rely on the national private placements regimes in each EU country for the purposes of their marketing activities.

### iii Regulation of professional securities trading

Depending upon the structure of their activities and of their client relationships, certain Swiss asset managers could fall within the ambit of the Swiss regulatory framework governing securities traders.

Professional trading in securities as a principal (either for own account or on behalf of clients) is, subject to certain exceptions, a regulated activity under the Swiss Federal Act on Stock Exchanges and Securities Trading (SESTA). Under the current regime, the concept of a securities dealer is defined in Article 2(d) SESTA as any person or entity who:

> purchases and sells securities in a professional capacity on the secondary market, either for its own account with the intent of reselling them within a short period of time or for the account of third parties, or makes public offers of securities to the public on the primary market, or creates derivatives and offers them to the public.

The Swiss regulatory definition of securities dealer covers five types of trading activities, which are detailed in Article 3 of the Swiss Federal Ordinance on Stock Exchanges and Securities Trading and may be summarised as follows:

- **a** trading in securities as a principal on a short-term basis (own-account dealer);
- **b** underwriting and public offering on the primary market of securities issued by third parties (issuing house);

---

7 In August 2015, FINMA entered into such cooperation agreement with the Jersey Financial Services Commission.
Switzerland

\(c\) issuance and public offering on the primary market of derivatives as a principal or as an agent (derivative supplier);

\(d\) trading in securities as a principal on a short-term basis, and offering sale or purchase prices in certain securities either permanently or upon request (market maker); and

\(e\) trading in securities as an agent for clients, and either holding accounts for the clients or holding securities in safe custody for the account of clients, either directly or with third parties (securities dealer operating for the account of clients).

Swiss securities dealers are subject to FINMA supervision, and are required to comply with organisational, conduct of business and prudential requirements broadly comparable with those applicable to Swiss banks. As a rule, asset managers or investment advisers that manage the assets of third parties on the basis of powers of attorney (i.e., who are acting as agent) are not characterised as securities dealers for the purpose of the SESTA and are, as things stand, only regulated under AMLA (see Section II.i; see also, however, Section II.v).

Under the new FinIA, securities dealers, newly called ‘securities firms’, will remain subject to FINMA supervision. Existing securities firms will not need to obtain a new licence but will have to comply, by January 2021, with the new regime’s requirements that will not significantly differ from the existing ones. The concept of securities firms will, however, be redefined in Article 41 FinIA as any person or entity who, on a commercial basis, trades in securities:

\(a\) in its own name but on behalf of clients;

\(b\) for its own account on a short-term basis, operates essentially on the financial market and (1) may have a negative impact on the functioning of the financial market or (2) participates in a trading venue; and

\(c\) for its own account on a short-term basis and quotes a price for specific securities on an ongoing basis or upon request (market maker).

Underwriters’ and derivative houses’ activities will also remain subject to licensing requirements under Article 12 FinIA and will necessarily have to be conducted by licensed banks or securities firms.

The SESTA will be repealed upon the entry into force of the new regime and a certain number of its provisions will be transferred in the FinIA.

\(\text{iv} \quad \text{Regulation of Swiss pension fund asset managers}\)

Under the current regime, Swiss pension funds may only appoint as external asset managers financial intermediaries that are subject to official supervision in Switzerland (or abroad). Regulated financial intermediaries such as banks and securities dealers may act as asset managers of Swiss pension funds without being subject to further licensing requirements. By contrast, unregulated asset managers (i.e., independent asset managers) and distributors of CISs under the CISA that intend to manage assets of Swiss pension funds are to secure a licence with the Swiss Supervisory Commission for Pension Funds (Commission).

Under the FinIA expected to enter into force on 1 January 2020, asset managers (other than banks, securities firms and fund management companies) will have to obtain a licence with FINMA to perform or continue to perform their activities if the assets they manage are above 100 million Swiss francs or, in the mandatory segment, if they manage more
than 20 per cent of the assets of one occupational pension scheme. In the event that those thresholds are not reached, asset managers of pension funds will still be required to obtain an authorisation as asset managers under the new FinIA (see Section II.v).

FinIA’s grandfathering rules provide that managers of pension funds will have to notify their intention to request an authorisation from FINMA within six months of the entry into force of this new Act. Further, such managers will have to file their authorisation request, as well as comply with the new requirements, by January 2023. In the meantime, they may continue to perform their activities, provided they are registered with a SRO for AML purposes.

v Regulation of asset managers under the new FinIA and FinSA

Under the FinIA and the FinSA expected to enter into force on 1 January 2020, asset managers will be newly supervised and will become subject to specific rules of conduct and organisational measures. In this context, asset managers will be subject to FINMA supervision (including authorisation process and enforcement proceedings). As regards their day-to-day supervision, they will be supervised by supervisory organisations approved and monitored by FINMA (SOs; yet to be established). As a result of this new supervisory framework, asset managers will cease to be under the direct supervision of FINMA for AML purposes (see Section II.i).

FinIA defines an asset manager as anyone who, acting on a professional basis, disposes of clients’ assets in their name and for their benefit. Under the draft implementing ordinance of the FinIA (FinIO), an activity is considered to be undertaken on a professional basis if any of the following thresholds are exceeded:

a. business relationships with more than 20 contracting parties;
b. gross turnover exceeding 50,000 Swiss francs;
c. power to dispose of third-party assets above 5 million Swiss francs; or
d. transactions with a total amount in excess of 2 million Swiss francs.

The FinIA and FinIO further provide for a limited number of exemptions. One of them provides that asset managers who exclusively manage assets of clients with whom they have ‘economic’ or ‘family’ ties do not fall within the ambit of the FinIA and do not need to obtain a licence to conduct their activities. Likewise, pure investment advice activities (without any control over clients’ assets) will remain unregulated, subject to the provisions of the FinSA (see below).

Under the new regime, in addition to the ‘fit and proper’ tests imposed on managers and qualified shareholders, the main licensing requirements for asset managers will be the following:

a. the registered office and administration of the asset manager must be in Switzerland;
b. the management is composed of at least two people having appropriate qualifications;
c. the implementation of appropriate internal organisation, in particular as regards risk management and internal control mechanisms;
d. a fully paid-up minimum share capital of 100,000 Swiss francs;
e. a minimum equity equivalent to one-quarter of the fixed annual costs according to the latest financial statements, up to 10 million Swiss francs; and
f. the conclusion of a professional indemnity insurance or the provision of sufficient financial guarantees.
The FinIA provides for grandfathering rules according to which asset managers who are already active are to notify FINMA of their intention to apply for a licence prior to July 2020 and request an authorisation prior to January 2023. By contrast, asset managers starting their activities after January 2020 will have to immediately notify FINMA and comply with the licensing requirements. In accordance with the draft FinIO, asset managers will, however, have to register with a SO and apply for a licence with FINMA within one year after an SO has been recognised by FINMA.

Foreign asset managers with a permanent presence in Switzerland will also fall within the ambit of the FinIA and will need to obtain an authorisation for a branch or representative office. Likewise, foreign asset managers providing their activities on a purely cross-border basis will have to first register the individuals providing financial services (‘client advisers’) in a client advisers’ registry (subject to potential limited exemptions for regulated financial services providers). This registration (with respect to pre-existing activities) will have to take place by July 2020, in accordance with FinSA’s grandfathering rules. As financial service providers, client advisers and the entities for which they act will also have to comply with the rules of conduct and organisational measures below.

Under the new FinSA, the provision of asset management activities (including purely investment advice activities) will require compliance with rules of conduct such as (1) an up-front obligation of information; (2) an obligation to verify whether a financial instrument or service is appropriate and suitable; (3) a documentation obligation and accountability requirement; and (4) transparency and due diligence requirements for the execution of client orders. In particular, when advising clients on individual transactions in the context of advisory or discretionary asset management services, financial services providers will have to perform an assessment of appropriateness. By contrast, they will have to perform an assessment of suitability when providing investment advice on the clients’ entire portfolio and/or in case of discretionary asset management services. Furthermore, asset managers will have to classify their clients (see Section II.vi) and apply the relevant rules of conduct based on such classification. Finally, under the new regime, asset managers will have to ensure that the client advisers have technical knowledge and follow appropriate training and implement relevant organisational measures.

In accordance with the grandfathering rules of the draft FinIO, those requirements will have to be complied with by 2021. Separately, asset managers will also have to be registered with a mediation body and will have to comply with this obligation by July 2020 or, if such body is not established by this date, six months after the recognition of such a body by the Federal Department of Finance.

vi Regulatory framework applicable to the distribution or offering of interests in non-Swiss CISs

The regulatory concept of distribution

Under the current CISA (in its version until 31 December 2019), any offer of or advertising for a CIS that is not exclusively directed towards regulated financial intermediaries (e.g., banks, insurance companies, securities dealers, fund administration companies, asset managers of CISs and central banks) is construed as distribution for the time being (see also Section V regarding distribution), irrespective of whether it is public or private, and is regulated under the CISA.
The CISA excludes the four situations outlined below from the definition of distribution. The provision of information on or the offer of interests in non-Swiss CISs are not deemed to constitute a distribution if they take place:

a. at the investor's request in the context of a long-term and remunerated advisory agreement or an execution-only relationship with a regulated financial intermediary (e.g., banks, securities dealers, fund administration companies, asset managers of CISs) or with an independent asset manager (subject to certain conditions);

b. upon the sole request of the investor in relation to a specific fund, and without any intervention or initial contact made by the financial intermediary (reverse solicitation);

c. within the context of a written discretionary asset management agreement entered into by the investor with a regulated financial intermediary or with an independent asset manager (subject to certain conditions); or

d. through the publication of prices, net asset values and tax data by regulated financial intermediaries.

Under the new FinSA expected to enter into force on 1 January 2020, the concept of distribution will be replaced with the concept of ‘offering’. The latter is defined as an invitation to acquire a financial instrument that contains sufficient information on the conditions of the offering and the terms of the financial instrument. The definition of ‘offering’ will be therefore more limited than the current understanding of ‘distribution’. As opposed to the current regime, not any advertisement will therefore fall within the ambit of the FinSA. Although the above exemptions under the current law will be removed with the entry into force of the FinSA, most of them will continue to apply in practice, such as:

a. the publication of prices, NAV and tax information, the provision of factual information will not be considered as an offering; and

b. private clients who have entered into an asset management agreement or an advisory agreement on a long-term basis with a regulated financial services provider will be considered as a qualified investors to whom foreign CIS may be offered without the need to appoint a paying agent and a Swiss representative.

Qualified investors

The concept of qualified investor is another important regulatory concept in the context of the distribution of interests in non-Swiss CISs. The current CISA narrows the definition of qualified investors as follows:

a. Regulated qualified investors:
   • regulated financial intermediaries, including banks, securities dealers, fund administration companies and managers of CISs, as well as central banks; and
   • regulated insurance institutions.

b. Unregulated qualified investors:
   • public entities and retirement benefit institutions (pension funds) with professional treasury management (this concept presupposes that the entity has at least one qualified professional in charge of the management of its financial assets);
   • companies with professional treasury management;
• high-net-worth individuals and private investment structures created for them, provided they have declared in writing that they wish to be deemed qualified investors (subject to certain conditions, such as minimum financial assets and technical competences) (opt-in declaration); and
• investors who have concluded a written discretionary asset management agreement with a regulated financial intermediary or with an independent asset manager (subject to certain conditions), provided that they do not exercise their right to opt-out of the qualified investors status.

It should be noted that the entry into force of the FinSA will not abolish the concept of qualified investor, which will coexist with the new client classification for the purposes of provision of financial services. As mentioned above, the FinSA will provide for an obligation to classify the clients of financial services providers with the following three main segments:

a Institutional clients:
• financial intermediaries (subject to the Banking Act, the FinIA and the CISA);
• foreign clients subject to a prudential supervision;
• insurance companies;
• central banks; and
• national and supranational public entities with professional treasury management.

b Professional clients:
• public entities with professional treasury management;
• pension funds/schemes with professional treasury management;
• companies with professional treasury management;
• large companies (i.e., companies where two of the following criteria are met (1) balance sheet total of 20 million Swiss francs, (2) turnover of 40 million Swiss francs, and (3) equity of 2 million Swiss francs);
• private investment structures with professional treasury management created for high net worth retail clients;
• high net worth retail clients (i.e., individuals with a net wealth of 2 million Swiss francs or (2) financial assets exceeding 500,000 Swiss francs and having sufficient knowledge about risks of investment as a result of their education or professional experience) and private investment structures without professional treasury management created for them, provided they have declared an ‘opting-out’; and
• managed and advisory retail clients without an ‘opt-in’ declaration.

c Retail clients: investors that are neither institutional nor professional clients.

The FinSA will provide for an opting in and out system across the different client categories. As an example, high net worth individuals and private structures created for them (without professional treasury management) will have the possibility to opt out to be considered as professional clients (instead of private clients). The opting in and out declarations are to be made in writing.

The provision of financial services, as well as the offered financial products will be adapted to the protection needs of the respective client segment. In this context, no specific rules will apply with respect to institutional clients. Likewise, professional clients will have the possibility to waive certain protection as regards information and documentation reporting.
**Distribution of non-Swiss CISs to non-qualified investors under the current CISA**

The offering documentation of non-Swiss CISs distributed to non-qualified investors must be approved by FINMA. Regular filing, notification and publication duties apply to the CIS, which must appoint a Swiss representative and paying agent. Additionally, the CISA requires the entering into of cooperation agreements between FINMA and the relevant foreign supervisory authorities.8

Any Swiss-based financial intermediary that distributes non-Swiss CISs to non-qualified investors must be licensed as a distributor by FINMA.

**Distribution of non-Swiss CISs to qualified investors under the current CISA**

The offering documentation of non-Swiss CISs distributed to qualified investors is not subject to approval by FINMA, but a Swiss representative, as well as a paying agent, must be appointed by the CIS.

Any Swiss-based financial intermediary that distributes non-Swiss CISs to qualified investors must be licensed as a distributor by FINMA. By contrast, non-Swiss financial intermediaries that are regulated in their home country may conduct distribution activities in connection with qualified investors, provided the foreign supervision is deemed appropriate by FINMA (i.e., their foreign regulatory status allows them to distribute CISs in their own jurisdiction). This carve-out could, for example, apply to the (regulated) non-Swiss asset manager of a non-Swiss CIS intending to distribute interests to certain qualified investors in Switzerland (without appointing a Swiss distributor).

**Offering of non-Swiss CIS under the new FinIA and FinSA (as expected from 1 January 2020)**

Under the new regime expected to enter into force on 1 January 2020, the requirements for the offering of non-Swiss CIS to non-qualified investors (i.e., retail clients) will not materially change. Foreign CIS will have to be subject to FINMA prior authorisation. Likewise, a paying agent and a representative will have to be appointed and cooperation agreements will have to be in place. As opposed to the current regime, distributors will no longer be regulated but will likely to be considered as financial services providers subject to the rules of conduct and organisational requirements under the FinSA.

The regime applicable to the offering of non-Swiss CIS to qualified investors will become more liberal. Only the offering of non-Swiss CIS to high net worth individuals and their investment structures without professional treasury management, provided they have opted out, will trigger the need for the non-Swiss CIS to appoint a paying agent and a representative. Otherwise, the offering of non-Swiss CIS to other qualified investors (i.e., institutional and professional clients under the new client classification), including managed and advisory retail clients without an opt-in declaration, will not be subject to specific requirements on the non-Swiss CIS. That being said, as mentioned above, the financial services providers offering the CIS will likely be subject to the FinSA and will have to comply with the new requirements.

---

8 At the time of writing, FINMA has entered into such cooperation agreements with the regulators of the following countries: Austria, Belgium, Denmark, Estonia, France, Germany, Guernsey, Hong Kong, Ireland, Jersey, Liechtenstein, Luxemburg, Malta, the Netherlands, Norway, Sweden and the United Kingdom.
III COLLECTIVE INVESTMENT SCHEMES

From a Swiss legal perspective, asset management services can be rendered either on the basis of a power of attorney that the client grants to the asset manager in relation to assets deposited with a bank (managed account) or through an investment, by the client, in interests or shares of a CIS.

The CISA provides for four different types of CISs for Swiss CISs:

- the contractual investment fund;
- the SICAV;
- the Swiss investment company (SICAF); and
- the Swiss limited partnership (Swiss LP).

The main characteristics of these legal institutions are set out below. One common requirement is for the Swiss CIS to have substance in Switzerland.

i The contractual investment fund

The Swiss contractual investment fund is a contractual pool of assets constituted for purposes of common investment, which is separately administered by a licensed fund administration company. The fund administration company, acting on behalf of the investors, deposits the assets of the investment fund with a custodian bank. This legal institution is the most commonly used structure in the Swiss asset management industry.

ii The SICAV

The Swiss SICAV is a special corporate vehicle governed by the CISA and subject to the supervision of FINMA. The Swiss SICAV’s corporate purpose is limited to the collective management of its own assets. Unlike a licensed fund administration company, a SICAV may not perform other activities or services, even ancillary ones such as the management of third-party assets. The Swiss SICAV is in many respects based on the model of the Luxembourg SICAV. The CISA distinguishes between self-managed and externally managed SICAVs. The relevant criterion is to determine whether the SICAV performs its own administration, or whether such administration is delegated to a licensed fund administration company. The Swiss SICAV has two types of shares: investor shares and promoter shares. The SICAV is thus composed of at least two segregated sub-funds, corresponding to the contributions of the investors and the promoter, respectively. Both types of shares have, as a rule, the same rights and obligations: votes are based on the principle of one share, one vote, there are no restrictions for a holder of one category of shares to hold also shares of the other category, and the creation of preference shares is expressly prohibited. There are important exceptions to the principle of equal treatment among the shareholders. The obligation to provide for the minimum capital contribution, as well as the duty to maintain the required capital adequacy requirements for self-managed SICAVs, rest only upon the holders of promoter shares who have the exclusive competence to resolve on the dissolution of the SICAV, to close a sub-fund and to request FINMA to liquidate the SICAV for cause.

SICAVs are required to keep a register of the ultimate beneficial owners (i.e., individuals owing more than 25 per cent of the company’s shares or voting rights) of its unlisted promoter shares. In parallel, holders of those shares are subject to a reporting obligation towards the SICAV. They are to disclose the name and the address of the ultimate beneficial owners in
the event that their participation reaches or exceeds 25 per cent. Breach of this reporting requirement may trigger restrictions or the cancellation of the economic and voting rights related to the investment.

iii  The SICAF

The SICAF is a Swiss company limited by shares whose corporate purpose is limited to the management of its own assets. The SICAF is not allowed to pursue any entrepreneurial activity. The SICAF is a closed-ended investment scheme, meaning that the investors do not benefit from a redemption (i.e., exit) right. The regulatory framework set forth in the CISA as regards the SICAF is rather limited. The SICAF is substantially governed by the provisions of the Swiss Code of Obligations that are applicable to regular companies limited by shares (including the disclosure requirements as regards holders of bearer shares and ultimate beneficial owners (see Section III.ii). In this context, a SICAF is not subject to the CISA if its shares are listed on a stock exchange or if its shareholders are exclusively qualified investors (see Section II.vi) and its shares are registered shares. To our knowledge, all Swiss SICAFs have so far relied on this regulatory safe harbour. As a result, there is currently no Swiss SICAF that is regulated by FINMA.

iv  The Swiss LP

The Swiss LP is a CIS that is aimed at private equity, alternative investments and real estate projects, and that has been designed to mirror the legal form of certain offshore limited partnership structures. The Swiss LP is subject to the supervision of FINMA. Swiss LPs are closed-ended investment schemes, meaning that the investors do not benefit from a redemption (i.e., exit) right. Swiss LPs are managed by one or more general partners (GPs) with unlimited liability for the commitments of a Swiss LP. The GP may delegate certain tasks to third parties to the extent such delegation is in the best interest of the Swiss LP. The asset management function may, however, only be delegated to a regulated asset manager of a Swiss CIS. The investors in a Swiss LP are the limited partners. They may not be involved in the management of the Swiss LP, which is the exclusive competence of the GP. That said, the limited partners benefit from information rights and certain governance rights, such as the delivery of periodic financial information, as well as information on the financial accounts. The Swiss LP is only open to qualified investors (see Section II.vi). The partnership agreement of the Swiss LP sets out the key rules that apply among the GP and the limited partners. Swiss law allows a significant freedom to the parties in the regulation of their relationship in the partnership agreement, subject to a limited set of contractual provisions that are required as a matter of law.

IV  MAIN SOURCES OF INVESTMENT

The Swiss asset management industry is heavily reliant upon the assets deposited with Swiss banking institutions. According to figures published by the Swiss Bankers Association in its 2018 Banking Barometer Report, the aggregate amount of assets under management held by Swiss banks amounted to over 7.291 billion Swiss francs at the end of 2017. This total is divided equally between assets held by Swiss-based and non-Swiss based clients. According to SFAMA, the Swiss CIS market was valued at 1.127 billion Swiss francs in May 2019.
V  KEY TRENDS

i  New regulatory regime for independent asset managers

The protection of investment advisory and asset managers’ clients has been at the top of the Swiss regulator’s agenda for several years now, and will be one of the most important legislative projects in the financial services sector for the year to come.

In November 2015, the Federal Council published the draft FinSA and FinIA. As mentioned above, the FinSA, which deals with the relationship between the financial intermediary and investors, essentially provides for rules of conduct aiming at protecting investors upon the provision, upon a professional basis, of financial services or financial instruments in Switzerland. Those rules are primarily based on the EU’s MiFID regulations. By contrast, the FinIA includes provisions concerning the relationship between the financial intermediary and the regulatory authority, and imposes general licensing and organisational requirements, irrespective of the authorisation regime.

On 15 June 2018, Parliament adopted the FinSA and the FinIA. Their expected date of entry into force (including the relevant implementing ordinances whose final drafts are expected to be released by November 2019) is currently 1 January 2020.

As mentioned above, according to the FinIA, asset managers will be newly supervised. In addition, under the new FinSA, those will become subject to specific rules or conduct and, as the case may be, client advisers (i.e., individuals providing financial services) will have to register with a client advisers’ registry. This new legislation will completely overhaul the current regulatory framework for financial service providers.

ii  Implementation of the automatic exchange of information in Switzerland

Another topic of current interest is the recent implementation of the automatic exchange of information, and in particular, its practical implications in the asset management field.

To comply with the new obligations imposed by the legal framework, which relies on the Common Reporting and Due Diligence Standard elaborated by the OECD, as transposed into Swiss law or in an international agreement, Swiss financial intermediaries such as banks have to collect and exchange foreign clients’ information, including information on beneficial owners, with the Swiss tax authorities. These transmit, in turn, this information to the tax authorities of the country of residence of the taxpayers, who have an agreement in place with Switzerland in this respect. The entry into force of this new automatic exchange regime took place in January 2017, and as a result, the first automatic exchanges of information with foreign countries have taken place in 2018.9

The introduction of the automatic exchange of information constitutes a complete change of paradigm in Switzerland, where banking secrecy does not allow the disclosure of any information outside the bank–client relationship (subject to certain exceptions). The impact of this significant change on the cross-border asset management industry in Switzerland, which represents a market share of more than 25 per cent at the international level, is difficult to assess for the time being.

---

9  To date, Switzerland has implemented automatic exchange of information with more than 50 partner states and territories, including the EU.
iii Limited qualified investment funds
In September 2018, the Swiss Federal Council announced its intention to introduce a new category of funds that are neither subject to approval by FINMA nor regulated under the CISA. This new category of funds, ‘limited qualified investment funds’, would be limited to qualified investors such as pension funds and insurers and would be managed exclusively by FINMA supervised fund asset managers.

This project aims at creating a Swiss alternative to similar foreign products and to ensure that more collective investment schemes be launched in Switzerland.

The consultation procedure on this CISA revision is open between 26 June and 17 October 2019. The entry into force of this new category of funds is not expected before 2020.

VI TAX LAW
Switzerland levies taxes at three different levels: the federal, cantonal and municipal levels.

i Taxation of CISs
As a matter of principle, Swiss CISs are not liable to income and capital taxes. Taxation does not take place at the level of the CIS, but usually directly targets (Swiss-resident) investors (see Section VI.iii), provided the CIS is deemed transparent for tax purposes. The taxation of CISs in Switzerland largely depends upon the legal structure under the CISA. Open-ended CISs, such as the contractual investment fund and the SICAV, are not considered to be entities subject to Swiss corporate income tax in their own right. In conformity with the principle outlined above, taxation is applied directly to investors according to their country of tax residence. The same regime is applicable to the Swiss LP. There are two exceptions to these general taxation principles: CISs owning real estate are taxed as corporations on the portion of their income that is directly derived from real estate; and a SICAF is subject to Swiss corporate income tax as it is treated as a separate taxpayer under Swiss tax law.

All income that is distributed by these CISs is subject to a withholding tax of 35 per cent, which is entirely or partially recoverable by the investor (as regards investors based outside of Switzerland, the reimbursement of the withholding tax depends upon the provisions of the applicable double tax treaty). Exceptions to this general principle are possible. For example, a distribution of net capital gains realised by a CIS is exempted provided that these capital gains are clearly separated from the income.

ii Taxation of fund administration companies
Fund administration companies are considered as taxpayers in their own right, as they are incorporated as a corporation. They are subject to corporate income tax as any other legal entity. Management and distribution services provided by such companies to Swiss and non-Swiss CISs remain generally exempt from Swiss value added tax.

iii Taxation of investors
Swiss-resident investors of CISs that are transparent for tax purposes will be taxed on their share of fund income. This taxation principle will depend upon the structure of the fund (i.e., distributing or growth) and the income received (i.e., capital gains or other ordinary income
realised by the CIS). Capital gains attributable to private investors are normally exempted provided that they are distributed with a separate coupon or that they are separately booked in the accounts of the CIS.

iv  **Stamp duty**

Stamp duty is due on the transfer of securities, including interests in CISs, provided that the transaction involves a Swiss securities dealer for stamp duty purposes acting as a broker or as a counterparty. Many exemptions may apply in specific cases: for example, Swiss or non-Swiss CISs qualify as exempt investors for stamp duty purposes. Accordingly, transactions involving Swiss or non-Swiss CISs acting as purchasers or sellers of taxable securities normally trigger a reduced stamp duty liability. Swiss asset managers usually qualify as Swiss securities dealers for stamp duty purposes, and may in practice delegate most of their obligations in relation to stamp duty to other Swiss securities dealers. Swiss stamp duty rules nonetheless involve specific compliance requirements, such as a duty to register with the Swiss tax authorities.

VII  **OUTLOOK**

In the coming months, the main legal and regulatory development will be the publication of the final version of the executing ordinances clarifying the future supervision of independent asset managers in the context of the entry into force of the FinSA and FinIA. This legislative reform, together with the implementation of the automatic exchange of information, represents another example of the regulatory adjustments implemented in Switzerland to fully align the Swiss regulatory framework with international standards. Another topic of interest will remain the issue of retrocessions (see Section II.i). In line with the developments taking place at the international level, Switzerland’s asset management industry is in the process of adjusting its remuneration structure to be less reliant on retrocessions. Nevertheless, contrary to the situation prevailing in the European Union, the Swiss legislative and regulatory perspective will keep allowing retrocessions albeit in a more transparent and restrictive manner.
Chapter 22

TURKS AND CAICOS ISLANDS

Wilbert Harvey and Mikhail Charles

I OVERVIEW OF RECENT ACTIVITY

The Turks and Caicos Islands (TCI), a British overseas territory, consists of two groups of islands: the Turks Islands including Grand Turk, which is the capital, seat of government and home to a cruise ship port, and the Caicos Islands of which Providenciales (known as Provo) is the economic centre of the TCI and is home to the vast majority of investments and financial services business.

The TCI is a common law jurisdiction modelled on the English legal system and with a court of final appeal to the Judicial Committee Privy Council in London (functionally, the English Supreme Court, albeit by a different name). The TCI, despite being a British overseas territory, uses the United States dollar as its legal tender currency.

The TCI is experiencing a time of transition (emerging from governance and constitutional concerns), as it seeks to reposition itself as a leading offshore jurisdiction, while being renowned as a leading tourist destination.

Within the ‘offshore’ space there continues to be legislative activity. That said, TCI stands alone in this part of the world with respect to asset management. At the time of writing there has been wholesale reform to the trusts, company and insolvency legislation. There is now insolvency legislation dealing comprehensively with both solvent and insolvent liquidations. The TCI has taken a pragmatic approach in this reform, mirroring the British Virgin Islands’ (BVI) own insolvency legislation.

It is anticipated that the useful body of case law flowing out of the BVI since 2003 as a result of very similar legislative drafting will be a useful tool for the discerning asset management professional, their legal advisers, as well as insolvency practitioners. This will improve the ability to assess important business issues inbound to an insolvent liquidation. An example of this is the approach taken on interim assessment of costs following a number of recent BVI Commercial Court decisions.

Of historical note, in December 2016 the financial sector was ranked as the second-largest contributor to the economy of the TCI. Tourism ranked in first place.2

At year end 2016 the financial sector consisted of assets amounting to US$1,774.1 million. This was distributed across six domestic banks, 19 insurance companies, nine trust companies and three money transmitters.3

---

1 Wilbert Harvey is an attorney and Mikhail Charles is a litigation paralegal at Prudhoe Caribbean.
3 ibid., 1.
Under the applicable insurance legislation, dispensation can be – and is – granted for placement of insurance products outside of locally licensed providers. This is especially useful to those seeking worldwide coverage from a TCI base.

The majority (US$1,703.9 million or 96 per cent) of the sector’s assets were deployed within the banking sector, with the remainder comprising of the insurance, trust and money transmitter sectors. The majority of the financial sector is foreign-owned with the trust sector being the only sector that is majority domestic-owned.

For the annual reporting period April 2015–March 2016, there was a total of 1,412 companies incorporated with producer-owned reinsurance companies accounting for approximately 62 per cent of the incorporation for the period; all together there were 15,801 active companies registered at the end of March 2016 and a total of 15,864 including limited partnerships.

The yearly incorporation for the period April 2016–March 2017 declined to 1,241 incorporated entities.

As at December 2018, the total value of investment portfolios of whatever description totalled US$1,075,984,517.

There are some 5,800 captive insurance companies domiciled in the TCI.

For the reporting period April 2017–March 2018, the total number of companies grew to 16,589. Of these, there were 5,670 domestic (ordinary) companies, 10,917 international and two protected cell companies. For the same reporting period there were 70 limited partnerships of which 46 were exempted (international) limited partnerships. This brought the total number of companies and limited partnerships to 16,659 – a number that is steadily growing.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The regulatory body in the TCI is the Financial Services Commission (FSC). Acknowledgement is given to the FCS for their kind cooperation in providing and confirming the information quoted in this chapter.

The FSC is also the umbrella entity for the TCI Registry of Companies, Trademarks, Patents and Business Names. The Registry of Companies is the entity charged by statute to register and monitor companies, and other corporate entities incorporated or registered (as appropriate) in the TCI. In this way, the FSC has overarching control over all asset management business carried out in the TCI.

The FSC was established by the Financial Services Commission Ordinance 2001 and continued to operate under the more recent Financial Services Commission Ordinance

© 2019 Law Business Research Ltd
2007, which itself has undergone several amendments and is currently known as the Financial Services Commission Ordinance 2014 Cap. 16.01 of the Laws of the TCI (the FSC Ordinance).

The FSC’s functions are set out by Section 4 of the FSC Ordinance and include:

- Supervision and regulation of licensees in accordance with the ordinance;
- Monitoring financial services business carried on in and from within the islands and acting against any person carrying on unauthorised financial business;
- Considering and determining applications of licensees;
- Monitoring compliance of licensees with the Anti-Money Laundering Regulations and any other ordinance, regulation or codes as may be prescribed by the legislature;
- Monitoring the effectiveness of the regulatory ordinance in providing for the supervision and regulation of financial services business carried on in or from within the islands to internationally accepted standards;
- Advising and making recommendations to the Governor and the Governor in Council for the amendment of existing or enacting of new legislation affecting the financial services business;
- The promotion of the continuing development of high professional standards within the financial services industry in the islands;
- Developing relationships with foreign regulatory authorities;
- Providing information and advice to licensees and the public as it considers appropriate; and
- Discharging such other functions as may be assigned to it under the ordinance or any other ordinance.

These functions cumulatively should promote the development of a modern regulatory framework to protect and enhance the reputation of the TCI.

The FSC has the necessary capacity and power to enforce the relevant legislation against those under its remit, and has corporate personality to bring suits and hold property in its own name.

The Companies Ordinance 2017 is the primary legislative mechanism for the setting up of corporate structures. These structures may be for domestic, international, protected cell or non-profit purposes.

Traditionally, asset management vehicles are set up as either domestic, international or protected cell companies or as a partnership under the Limited Partnerships Ordinance Cap. 16.15. Partnerships are governed by the Partnership Ordinance Cap. 16.16 and cannot be registered as an international company partnerships do not offer limited liability protection for any partner and may not be attractive from a foreign investment perspective.

As of 31 March 2017, the total number of licensed company service providers remained unchanged at 37. During this same period, there were six entities licensed under the Investment Dealers (Licensing) Ordinance and five licensed under the Mutual Fund Ordinance.

---

13 Partnership Ordinance CAP. 16.16 Section10.
The total value of the investment business portfolio at 31 March 2017 was reported as US$738.6 million.\(^{15}\)

Insurance companies (captive or not) are regulated by way of the Insurance Ordinance Cap. 16.06 of the Laws of the TCI and require a licence from the FSC. There is a minimum financial requirement that varies depending on the nature or category of insurance business intended to be set up.

To obtain a licence in the TCI\(^{16}\) the insurance company must show that the persons who control its affairs are competent, with evidence of relevant ability, integrity and experience in the field of insurance. To obtain an insurer’s, broker’s or manager’s licence, it is essential that the application contains a business plan. If the company will be engaging in reinsurance, and general (domestic or international) business, it should expect to have a minimum paid-up capital of US$100,000. For life assurance companies, this minimum paid-up capital figure will be US$180,000.

Application fees range from US$100 for a credit life reinsurer’s licence or a sub-agent’s licence to US$500 for an insurer’s, insurance manager’s or insurance broker’s licence.

For types or classes of insurers the annual licence fee is:

- b) Non-domestic (e.g., captives): US$2,000.
- c) credit life reinsurers: nil.
- d) Other: US$500.

The costs of various licence fees are as follows:

- a) Agents: US$100.
- b) Brokers: US$1,000.
- d) Principal representatives: US$1,000.
- e) Sub-agents: US$50.

It can be expected that some asset managers may use the limited partnership structure as it is, in many respects, identical to the BVI structures.

The FSC, through its company registration operations, is the custodian of public information filed pursuant to the Companies, Limited Partnerships and Partnership Ordinances.

Searches may be made of the companies’ registry for information, including a company’s incorporation, registration, registration of charges and qualifying documents filed.

A person may require a certified or uncertified copy or extract certificate of incorporation, restoration, merger, consolidation, arrangement, continuation, discontinuance, dissolution or good standing of a company, or a copy or an extract of any document or any part of a document of which he or she has custody, to be certified by the registrar.\(^{17}\) Some restriction applies to the inspection of certain documents, for example membership documents.\(^{18}\)

---

17 Companies Ordinances 2017 Section 293(1).
18 Companies Regulation 2018 (Legal Notice 11 of 2018) paragraph 27.
III COMMON ASSET MANAGEMENT STRUCTURES

Under TCI law, the following structures are available to the investor (domestic or foreign):

i Companies

There are several types of companies that can be established in the TCI:

- a company limited by shares;
- a company limited by guarantee that is authorised to issue shares;
- a company limited by guarantee that is not authorised to issue shares;
- an unlimited company that is authorised to issue shares; or
- an unlimited company that is not authorised to issue shares.

A company limited by shares may be incorporated as a protected cell company or, if it has already been incorporated, be registered as a protected cell company in accordance with Part XI of the Companies Ordinance 2017.

A company, other than a non-profit company, may be registered as an international company in accordance with Section 12 of the Companies Ordinance 2017.

The 2017 Ordinance introduced the establishment and maintenance of a register of beneficial owners and a register of charge and requires that all incorporated companies have a registered agent.19

These requirements were introduced to meet the TCI government’s commitment under the exchange of notes with the UK to establish a central registry of beneficial owners. The identification of the beneficial owners of a company has become a major law enforcement and policy initiative of the UK and EU.20

In relation to necessary disclosures of information for the purposes of giving evidence, there is a process under the Companies Ordinance 2017 (as amended) for disclosure; this is a discrete procedure and is conducted as such.

This applications process comes under Sections 299(A) and (B) of the Companies (Amendment) Ordinance 201721 and enables an application to be made for the use of material in the corporate register for specific evidential purposes. This abolishes the distinction under previous legislation as between what were then ordinary companies compared to exempt companies and lessens the impact of the Confidential Relationships Ordinance.

As noted above, the Insolvency Ordinance 2017 was introduced to reform the law relating to the liquidation of companies and to provide for the administration, receivership and liquidation of companies. These laws will help to modernise the country’s legislation, making the jurisdiction more attractive to investors.

As of early 2019, there is now, for the first time, a licensing regime for insolvency practitioners authorised under the Ordinance to fulfil the role of liquidator. That licensing regime is a close equivalent to the one used in the BVI.

As is widely known, the BVI is the largest-volume provider of companies outside of Delaware, United States, and therefore has high volumes of insolvency work. As a result of that, the experience requirements for licensing as an insolvency practitioner are onerous.

---

19 FSC Annual Report 2016/2017 at paragraph 7.5 page 35.
20 FSC Annual Report 2016/2017 at paragraph 7.6.1.3 page 36.
21 Companies (Amendment) Ordinance 2017 (Ordinance 21 of 2017) Section 45.
At the time of writing, there is currently a single licensed insolvency practitioner in the TCI, the contact details for whom are available from the FSC. There is a ‘public’ liquidator available for court appointments, and under the new regime this individual is known as the official assignee. This public official cannot accept appointments on an insolvency voluntary members’ resolution basis.

The current appointee as official assignee is a senior member of the FSC. As indicated, his stated view is that he is precluded from accepting appointments as a members’ appointee on a voluntary insolvent liquidation. The capacity of the offshore industry in the TCI to service the work that the new statutory insolvency regime is expected to generate remains a work in progress.

The most common type of company is a company limited by shares, of which there are over 12,000.

The current company law provides for the incorporation of four simplified categories of company: domestic companies, protected cell companies, international companies and non-profit companies.

There is also provision for registration of foreign companies. Existing companies incorporated under previous categories according to the former legislation have been automatically registered under transitional arrangements that have now run their course. This means, for example, that a former ‘exempted’ 22 or a ‘limited life’ 23 company becomes an international company under the new provisions.

The standard vehicle for onshore businesses or for the holding of land within the TCI will be a domestic company. 24 A business whose activities will be carried on principally outside the TCI will be an international company. 25 Tax exemption certificates issued to companies under the former ordinance continue to be valid under the new statutory regime. 26

**ii Partnerships**

Partnerships that are governed by the Partnership Ordinance Cap. 16.16 are also governed by the common law. 27 As its ordinance does not form part of the administered ordinances, partnerships are not regulated by the FSC, except for their name where the partnership name is different from the surnames and forenames of the partners. 29 Therefore partnerships are not discussed further within this chapter.

**iii Limited partnerships**

As at March 2018, there were 70 limited partnerships 30 in the TCI. They are governed by the Limited Partnerships Ordinance 2014 Cap. 16.15.

---

22 Companies Ordinance 2017 Schedule 1 paragraph 6. (1)(f).
23 Companies Ordinance 2017 Schedule 1 paragraph 6. (1)(g).
24 Companies Ordinance 2017 Section 29.
25 Companies Ordinance 2017 Section 12(3).
26 Companies Ordinance 2017 Schedule 1 paragraph 21.
27 Partnership Ordinance Cap. 16.16 Section 45.
28 Financial Services Commission Ordinance Cap. 16.01, Financial Services Commission (Prescribed Financial Services Ordinances) Regulations – Section 55 paragraph 3.
29 Business Names (Registration) Ordinance Cap. 17.01 Section 3.
30 Figures for the reporting period April 2017–March 2018 provided by FSC Companies Registry.
A limited partnership is required to be registered with the FSC, but the person who is the general partner of that limited partnership is not required to be licensed. A limited partnership can be an exempted limited partnership, which status will restrict the partnership from conducting business in the TCI.

The primary advantage of a limited partnership structure for a United States national is obviously an issue requiring advice on a state-by-state basis. However, as a general concept, the US tax regime looks favourably on control issues via involvement in a limited partnership. A body corporate can also be a general or limited partner of a limited partnership.

The market for limited partnerships in the TCI seems to have been driven historically by US domestic tax policy as outlined above.

iv Mutual funds

The number of mutual funds in the TCI as at 31 December 2018 was nine, with the amount of assets under management in these mutual funds amounting to US$210,946,471.

Mutual funds as governed by the Mutual Funds Ordinance 2018 Cap. 16.07 requires that all mutual funds be registered, recognised, licensed or exempted. It also requires that a mutual fund have a mutual fund manager who is licensed.

The Investment Dealer’s (Licensing) Ordinance 2001 (IDLO) also applies as a regulatory mechanism for ‘investment businesses’.

The four categories of investment businesses under the IDLO are: a full investment dealer; investment dealer execution only; fund manager; and investment adviser must be licensed to operate. The IDLO provides for certain investment business activities to be exempted from the requirement for a licence.

<table>
<thead>
<tr>
<th>Breakdown of investment by type/value</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of licensees</td>
</tr>
<tr>
<td>-----------------</td>
</tr>
<tr>
<td>1</td>
</tr>
<tr>
<td>5</td>
</tr>
<tr>
<td>3</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>5</td>
</tr>
</tbody>
</table>

Data provided by the FSC on 14 June 2019.

33 Limited Partnerships Ordinance CAP. 16.15 Revised Edition 2014 Section 16(1) taken from TCI 2018 revised Laws.
35 Confirmed by the FSC dated 14 June 2019.
36 Mutual Funds Ordinance CAP. 16.07 Section 3(1).
37 Mutual Funds Ordinance CAP. 16.07 Section 12(1).
38 Adapted from the FSC, 14 June 2019.
39 ibid.
Registered mutual funds are mutual funds constituted under the laws of the TCI and are only authorised to issue equity interests to investors who meet the prescribed qualification or in which the equity interests are listed on a stock exchange recognised by the FSC. 40 The stock exchanges currently recognised are 41 Australia, Bermuda, Canada, the Cayman Islands, Hong Kong, Japan, a Member State of the European Union, New Zealand, Singapore, Taiwan, and the United States.

Depending on the outcome of Brexit, we would expect the United Kingdom expressly to be added.

Recognised mutual funds are mutual funds constituted under the laws of a foreign country or territory and the equity interests are listed on a stock exchange specified by the FSC. 42

Licensed mutual funds are licensed mutual funds other than registered or recognised mutual funds. 43

Any decision by the FSC not to register, recognise or license a mutual fund is final and not subject to an appeal. 44 It is an open issue whether that is itself open to judicial review.

Exempted mutual funds are mutual funds that have 15 or fewer members and the majority of whom can appoint or remove the fund operator, 45 or are only authorised to issue equity interests to professional investors provided that at all times the fund administrator provides an office in the TCI for the funds. 46 For this reason, they are exempted from the requirement to be registered, recognised or licensed.

To meet the criteria of a professional investor a person has to be a qualified licensed securities broker or have or represent an investor who has US$5 million or more in securities quoted on a stock exchange recognised by the TCI and have significant knowledge and experience by which to understand the funds stated in the prospectus.

Mutual funds are also required to have a licensed administrator. The administrator is obligated to report to the commission on the honesty, good character and conduct of any operator or manager of the fund. The administrator of a mutual fund can be a company and in such instances the company will be required to include in its articles of association that there be two directors sitting on its board and ensure that there are in fact two directors sitting at all times.

v  Banks
A total of 19 financial institutions are under supervision of the FSC’s Bank and Trust Department, of which seven are banks. 47 Banks are governed by the Banking Ordinance 2018 Cap 16.02, which places their governance under the FSC.
Total assets held by the banks tended downwards to US$1.67 billion for the second consecutive year;\textsuperscript{48} the decrease reflects a reduction in loans and advancement and placements to other financial institutions. Although there was a reduction in loans, they remain the largest asset of the banks at US$865.9 million.

Non-performing loans (NPLs) were at US$86.3 million down from US$124.4 million in the previous year. NPLs accounted for 10 per cent of total loans and were concentrated in construction and land development and the personal loan sectors.\textsuperscript{49}

\textbf{vi Trusts}

There are a total of nine trust companies under supervision by the FSC’s Bank and Trust Department\textsuperscript{50} with an on-balance sheet asset valued at US$19.7 million.\textsuperscript{51} This asset had cash and cash equivalents as its largest component at 42 per cent and two of the nine companies accounting for 80 per cent of the sector’s assets.\textsuperscript{52}


This legislation, along with the supporting Trusts Companies (Licensing and Supervision) Ordinance 2016 Cap. 16.11, Trusts Companies Regulation 2016 and the Trust Companies Code 2016,\textsuperscript{53} represents significant modernisation.

Section 8 of the Trusts Companies (Licensing and Supervision) Ordinance 2016 Cap. 16.11 gives the FSC the authority to regulate the trust industry in the TCI. Any decision by the FSC in refusing the granting of a licence is stated to be final and not subject to an appeal or review by any court.

Trusts have to be licensed and can either be licensed as an unrestricted trust company with the authority to carry on trust business in and from within the TCI or a restricted trust company, which is subject to the conditions specified in regulations.

\textbf{IV MAIN SOURCES OF INVESTMENT}

The main source of investment into the TCI is foreign direct investment (FDI). The TCI as a British overseas territory with a stable legal system has been attractive to FDI for decades. FDI comes mainly in the form of wealthy individuals and companies seeking an attractive tax-neutral jurisdiction with easy international access, friendly immigration policies and progressive governance.

\textbf{V KEY TRENDS}

The main commercial hub of Providenciales in the TCI (where the court system is housed, it is one of eight main islands and is the most populous) is a thriving luxury property market for high net worth and ultra-high net worth individuals.

\textsuperscript{48} FSC Annual Report 2016/2017 at paragraph 3.7.2 page 16.
\textsuperscript{49} ibid., 48.
\textsuperscript{50} FSC Annual Report 2016/2017 at paragraph 3.1 page 14.
\textsuperscript{51} FSC Annual Report 2016/2017 at paragraph 3.8 page 17.
\textsuperscript{52} FSC Annual Report 2016/2017 at paragraph 3.8 page 18.
\textsuperscript{53} Taken from the FSC website <https://tcifsc.tc/trust-companies/> accessed 23 May 2019.
The TCI continues to position itself via an improved reputation as an international financial centre. The legislative activity as described above supports this. There have been a number of strategic returns to the jurisdiction for the purpose of the TCI serving as a base of operations for a number of professionals with a strong existing platform.  

VI SECTORAL REGULATION

i Insurance
The FSC as the sole regulatory body in the TCI holds the mandate to regulate and control the insurance sector. The FSC does this by administering the domestic insurance sector and monitoring the active international insurance business sector.

As at 31 December 2017, there were 11 insurance brokers with combined assets of US$27,238,000, which was more than double the assets from year end 2016.

The operative legislative framework is contained in the Insurance Ordinance Cap. 16.06 and Insurance Premium Sales Tax Ordinance Cap. 19.17. It provides a mechanism for the licensing of persons wishing to carry on insurance business within the TCI; a person may hold one or more of six different types of class of licence.

Each licence type has basic conditionalities built in, for example, reporting requirements to the FSC and may have restrictions placed on the scope of activity.

It is an offence for any person to conduct insurance business without a licence from the FSC.

ii Pensions
There is not yet a specific regulatory regime in the TCI relating to pension funds.

iii Real property
Property is at a premium in the TCI; the islands are relatively small with a combined land mass of 238 square miles. Property may be freely held by citizens and non-citizens alike.

Real estate can be held as freehold title absolute or leasehold.

The Strata Titles Ordinance Cap. 9.04 allows for the registration of a strata plan against a land parcel to create individual strata lots, each of which is registered with its own derivative title and the remainder held as ‘common property’ by a strata corporation. Strata titles are used as the preferred structure for condominium developments.

There is a Registered Land Ordinance Cap. 9.01, which governs the real property regime in the TCI. It allows for the conveyance of real property to be held by natural and legal persons.

There is no locally imposed tax on real estate other than stamp duty at the time of purchase. A TCI company is the most common form of entity used to own investment real estate.

Under the Land Holding Companies (Transfer Duty) Ordinance Cap. 19.06, the transfer of shares of a company that is the registered owner of land (or the transfer of any

54 For example, Tim Prudhoe exited the partnership of international disputes firm Kobre & Kim LLP for the purposes of founding the TCI-based pan-regional disputes firm Prudhoe Caribbean and David Stewart left Olswangs LLP in London to join an existing law and fiduciary services firm, Griffiths & Partners.
beneficial interest in the shares of that company) is dutiable at the rate of 8 per cent of the value of the land held by the company multiplied by the proportion of the shares of the company changing hands.

This would encompass any other company that holds TCI real estate.

The definition of a dutiable transfer is drafted widely and encompasses the shares of holding companies or interests in any other entity further up the chain of ownership.

Liability for the duty remains vested in the landholding company itself.

As far as TCI legislation is concerned, there is no impediment for a TCI company to hold real estate in other jurisdictions.

There are no restrictions on foreign ownership of real estate in the TCI, although certain formalities may apply to different types of purchaser.55

Any investor should consider the primary sources of law, including the Registered Land Ordinance Cap. 9.01, the Physical Planning Ordinance Cap. 9.02 and the Stamp Duty Ordinance Cap. 19.05. Other laws may apply depending on the nature of the transaction and how it is structured.

iv Hedge funds

There is no specific regulatory regime in the TCI relating to hedge funds. Typically, structured hedge funds are usually limited partnerships and as such can be registered under the Limited Partnerships Ordinance Cap. 16.15.

There are no registered hedge funds in the TCI.

v Private equity

There is no statutory regime in the TCI governing private equity funds. As these are usually private arrangements, they fall outside of the remit of the FSC except where, due to their business model, they are registered under the Limited Partnership Ordinance CAP. 16.15 or the Mutual Funds Ordinance Cap. 16.07 or they are otherwise an offering to the ‘public’.

vi Other sectors

There are no other statutory regimes in the TCI relating to other asset management entities and sectors (including sovereign wealth funds).

VII TAX LAW

The TCI currently do not impose any taxation on income or capital gains of an investment fund or their investors or corporation profits. The Companies Ordinance 2017 preserved the validity of tax exemption for companies exempted under the former legislation, which is valid for 20 years from the date of incorporation.

Value added tax is not applied in the TCI, nor is there any form of withholding tax applicable. The TCI does not directly tax income (of whatever provenance) or capital gains.56


There is much more to the TCI than just tourism. The financial sector continues to gain measured traction.

The real estate sector remains strong, and is becoming even stronger. Of interest are managed villa properties (with established market players already in the space), large-scale mixed condo/villa developments and luxury condos.

The TCI is committed to encouraging inward investment within the jurisdiction. In that regard, the Companies Ordinance 2017 will play a significant role. The law simplifies the registration of companies, provides greater flexibility and modernises the scope for use of corporate entities.\(^57\)

\(^{57}\) FSC Companies Ordinances presentation 2017.
Chapter 23

UNITED ARAB EMIRATES

Nabil A Issa, James R Stull, Macky O’Sullivan and Sayf Shuqair

I  OVERVIEW OF RECENT ACTIVITY

The United Arab Emirates (UAE) is arguably the centre of the private equity and asset management industries in the Middle East. With a recent focus on economic and legal reforms, a low-tax regime and a high quality of life, numerous international firms have set up their regional hubs in the UAE, and many talented and educated expatriate and local professionals have put down roots here. Among other factors, the historical strength of the UAE’s economy and stable government as well as the country’s expected growth led MSCI to upgrade the UAE to its emerging market index in mid-2014.

Within the UAE, Dubai has become the epicentre of financial services transactions and innovation in the asset management sector in the Gulf Cooperation Council (GCC) and greater Middle East region, surpassing Beirut, Bahrain, Kuwait and Riyadh. Abu Dhabi, the country’s capital, is known for its more conservative and patient investment strategy, and is home to some of the world’s largest and most prominent sovereign wealth funds.

During the global financial crisis, Dubai, with a focus on financial transactions, was particularly hard hit, resulting in a near-default on its debt payments and a subsequent bailout from Abu Dhabi. Many predicted the financial crisis would be the end of Dubai, and would result in a transformative change to Dubai’s free-spending and ‘casino-like’ culture. However, following certain significant restructurings and policy changes, Dubai has entered a period of sustainable growth, with significant projects in the tourism and real estate sectors announced in anticipation of the World Expo in 2020.

Abu Dhabi weathered the financial crisis by implementing a patient economic vision, buoyed by high oil prices. This approach resulted in four straight years of double-digit fiscal surpluses in the lead-up to 2015, which in turn led to massive budgets for the government to invest in mega-projects, and to focus on important sectors of the economy such as healthcare and education. With an economy predominantly based on oil and related hydrocarbon revenues, the recent slump in oil prices has drastically reduced revenues for Abu Dhabi, which appears to be entering a stage of economic transition toward a more sustainable and diversified economy highlighted in Abu Dhabi Vision 2030.

The slump in oil prices has taken a considerable bite out of the total market capitalisation, as many of the companies listed on the stock exchanges in the UAE (NASDAQ Dubai, the Dubai Financial Market (DFM) and the Abu Dhabi Securities Exchange (ADX)) derive substantial revenues from oil production and related-energy industries. Stock exchanges in

1 Nabil A Issa and James R Stull are partners, Macky O’Sullivan is a senior associate and Sayf Shuqair is an associate at King & Spalding LLP.
the UAE have recorded lower net profits. The total trading value on ADX fell 18 per cent in 2016 to 49 billion dirhams from 60 billion dirhams in the previous year. In 2017, ADX underperformed by 3.3 per cent. Although the total traded volume of stocks on ADX dropped 26 per cent in 2018, the performance of First Abu Dhabi Bank (which comprises just below one-third of the index, in value terms) was strong enough to provide an overall boost to the market. The ADX index finished the year 10.7 per cent higher. Dubai’s stock market ended 2018 with a 25 per cent annual loss, the worst year since the global financial crisis a decade ago, as the real estate and tourism sectors struggled. Although oil prices have recovered from early 2016’s multi-year lows, they remain below the average prices of previous years. In response to the new reality of lower oil revenues, the UAE has reformed its budget by cutting spending through a reduction in fuel subsidies and electricity subsidies. In Abu Dhabi, for example, electricity subsidies have been scaled back and water tariffs increased.

To create additional income to cover the decrease in oil revenues, the government is imposing corporate taxes on onshore companies and a recently implemented value-added tax (VAT). The International Monetary Fund has hailed this decision, which it believes will strengthen the country’s fiscal position. It is not expected that taxes would be imposed on companies operating in a free zone in the UAE, where most funds and investment managers are domiciled. Accordingly, it is not expected that the proposed taxes will have a substantial negative impact on the asset management industry in the UAE.

On 21 January 2017, the President of the UAE, His Highness Sheikh Khalifa bin Zayed Al Nahyan, issued a law creating the Mubadala Investment Company, a company wholly owned by the government of Abu Dhabi. The new company is the merger of two of Abu Dhabi’s sovereign wealth funds, the International Petroleum Investment Company (IPIC) and Mubadala Development Company (Mubadala), and their respective assets. The law formalised the announcement made in 29 June 2016 that IPIC and Mubadala would merge, thereby creating an entity with assets worth an estimated US$130 billion. The merger is viewed as part of a larger government strategy to diversify the economy and create stronger entities for its growth. While some cost-saving measures have been put in place and attempts have been made by the government to rein in spending, there has also been investment into other regional asset managers, with the completion of the acquisition of an aggregate 20 per cent interest by Mubadala in Bahraini investment manager Investcorp being an example of this. The merger of IPIC and Mubadala was followed by the announcement in March 2018 by Crown Prince Sheikh Mohammed bin Zayed of the consolidation of Abu Dhabi Investment Council (ADIC) with Mubadala Investment Company. ADIC will become part of the Mubadala group, with a combined portfolio worth over US$200 billion. This is the latest consolidation of state-run companies in Abu Dhabi and is another step towards efforts being made by the government to accelerate the diversification of the UAE’s economy. Lower oil prices have led the UAE to tighten its spending and to consolidate its investment vehicles to generate higher returns.

Abraaj, the largest private equity firm in the Middle East with assets under management of US$13.6 billion, filed for provisional liquidation in June 2018, and has been in discussions with a number of global asset managers and private equity firms about the potential sale of some of its key funds and assets. This followed the resignation of its chair and founder, and the finding by Deloitte that Abraaj had commingled about US$95 million after it faced cash shortages. It is currently unclear what effect these developments will have on the private equity and asset management industry in the UAE and the wider Middle East region. However, there are concerns that this will impact the appetite of fund investors to commit,
decrease investor perceptions of a lack of transparency and adversely affect the capabilities of fund managers to raise capital. Despite the burgeoning tech economy, concerns about governance and due diligence in the region may be blunting investors’ enthusiasm for Middle East-focused funds, with data provided by Emerging Markets Private Equity Association (EMPEA) showing that in 2018 only US$91 million was raised through two vehicles. Despite some uncertainty, the future of the asset management industry in the UAE, albeit being in a state of transition, looks strong, and the UAE is a very bright spot in a turbulent region. To sustain the growth in the financial services and asset management sectors, the UAE and the emirates of Dubai and Abu Dhabi have recently published new financial services and funds regulations seeking to provide clarity and confidence to both managers and investors alike and to encourage further growth of the industry. The UAE also introduced a federal bankruptcy law in December 2016, which modernises the insolvency regime in the country to be more in line with international norms, and which should assist asset managers and other businesses when operating in the UAE.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

Financial services such as investment management are generally provided in the UAE from three hubs, namely onshore in the UAE (i.e., outside of a designated free zone), the Dubai International Financial Centre (DIFC) and the Abu Dhabi Global Market (ADGM), each of which has its own rules and regulations. The DIFC and the recently created ADGM are economic free zones within the UAE that have been created to encourage foreign investment by offering foreign businesses attractive concessions and a number of investment incentives, including a zero per cent tax rate and the ability to own a 100 per cent subsidiary (foreign ownership restrictions apply outside the free zones).

i Onshore UAE

From 2012 to 2014, primary responsibility for overseeing the licensing, regulation and marketing of investment management was transferred from the UAE Central Bank (the Central Bank) to the Emirates Securities and Commodities Authority (SCA), with the SCA confirming the implementation in the UAE of a ‘twin peaks’ model of financial services regulation and supervision. Under this model, the Central Bank remains responsible for systemic stability, prudential oversight and monetary policy, while the SCA is responsible for conduct of business matters (including consumer protection and financial markets oversight). Any firm (whether based inside or outside the UAE, including free zones in the UAE) that intends to conduct investment management activities in the UAE outside of a free zone must obtain a licence from the SCA prior to conducting such activities. The Investment Management Regulations implemented by the SCA define ‘investment management’ as the management of securities portfolios for the account of third parties, or the management of mutual funds in accordance with the investment objectives and policies defined in the investment management agreement between the investment manager and its client.

In July 2016, the SCA adopted new investment fund regulations (2016 Fund Regulations), which repealed the prior investment fund regulations (which were adopted in 2012 and amended in 2013), clarified the formation process for the establishment of locally domiciled funds and introduced significant changes to the marketing of foreign domiciled investment funds in the UAE. The 2016 Fund Regulations impose substantial hurdles and costs for managers seeking to promote foreign funds in the UAE, and have generally been
United Arab Emirates

subject to negative feedback. Managers wishing to market foreign funds onshore in the UAE had far fewer options: they could register the fund with the SCA and enter into a distribution arrangement with a locally licensed placement agent, engage in reverse solicitation (where the investor inside the UAE initiates the transaction) or rely on a private placement exemption when offering to sovereign entities. However, in January 2017, the SCA issued regulations governing promotion and marketing that reintroduced several private placement exemptions, contemplate the potential listing of certain types of funds and explicitly allow for foreign funds to rely on reverse solicitation when offering in the UAE. Additionally, in March 2019, a new passporting regime was introduced to allow locally domiciled funds to be marketed across the UAE, the DIFC and the FSRA as further discussed in Section V below.

ii DIFC

The Dubai Financial Services Authority (DFSA) is the independent regulator of all financial and ancillary services conducted through the DIFC, including investment management. The rules and regulations governing investment management in the DIFC are set out in the Collective Investment Law 2010, the Collective Investment Rules module of the DFSA Rulebook (CIR) and the Regulatory Law. The Regulatory Law provides that financial services may only be carried on in the DIFC by a firm authorised and licensed by the DFSA. Managing a collective investment fund is defined under the General Module of the DFSA Rulebook as being legally accountable to the unitholders in a fund for the management of the property held for or within a fund under the fund’s constitution; and establishing, managing or otherwise operating or winding up a collective investment fund. A DFSA fund management licence is required to manage a collective investment fund in the DIFC. Fund managers from reputable jurisdictions outside the DIFC (external fund managers) may establish and manage DIFC-based domestic funds without having to obtain a DFSA licence provided certain conditions are satisfied. For example, the domestic fund must be managed from a place of business that is in a jurisdiction either included in the DFSA’s Recognised Jurisdictions List (as published on the DFSA website) or assessed by the DFSA as providing an adequate level of regulation.

iii ADGM

In October 2015, the ADGM financial services regulations (the Regulations) were enacted. Under the Regulations, firms carrying on financial services business such as investment management in the ADGM are subject to licensing by both the ADGM (in terms of the obligation to hold a commercial licence) and the ADGM Financial Services Regulatory Authority (in respect of the financial services licensing). The Regulations contain two key prohibitions, namely providing financial services without a licence or exemption, and making an authorised financial promotion. The Regulations to some extent mimic the types of funds permitted in the DIFC, and contemplate public funds, exempt funds and qualified investor funds. The ADGM has also sought to be a hub for real estate asset management in the region, and has introduced a private real estate investment trust (REIT) regime that has proven to be popular.

III COMMON ASSET MANAGEMENT STRUCTURES

The most common forms of asset management in the UAE are privately managed accounts and offshore structures. Privately managed accounts have long been popular in the region
as managers have targeted capital from high-net-worth individuals, family offices and government-related investors in the UAE. For collective investment schemes, managers have generally looked to the Cayman Islands (and to a lesser extent other offshore jurisdictions) as the domicile of choice due to comprehensive corporate and funds laws and predictable legal regimes. Additionally, locally domiciled funds in the DIFC and ADGM have become increasingly utilised in the past couple of years.

Large local banks, such as First Abu Dhabi Bank (created upon the merger of National Bank of Abu Dhabi and First Gulf Bank in April 2017) and Emirates NBD Bank, have established public mutual funds onshore under the Central Bank and SCA regulations. However, to manage an onshore fund, a manager requires an SCA fund management licence, which the SCA only recently began issuing. Similar to other funds jurisdictions in the region, onshore funds are not legal entities, but rather are contractual entities formed upon execution by the manager and the investors of the fund’s terms.

The DIFC and DFSA have actively promoted the funds industry in the DIFC, with the DIFC recently publishing its 2024 growth strategy, which outlines fund management as its strategic focus area of the long term. However, the DIFC funds industry has yet to flourish, and only approximately 35 funds have been established in this jurisdiction. However, the DIFC recently adopted the qualified investor fund (QIF) regime, which can be established in an expedited time frame and is subject to significantly less oversight than other UAE-based fund structures. A QIF structure is designed to be offered only through private placement to experienced investors, with a minimum investment of US$500,000 per investor and a maximum of 50 investors per fund. To manage a QIF or any other DIFC-domiciled fund, an entity must be licensed by the DFSA. As further encouragement to consider establishing in the DIFC, the DFSA has introduced a fast-track licensing process with reduced fees and share capital for those entities that are seeking to establish in the DIFC for the purpose of launching a fund.

The DIFC has also adopted a special purpose company (SPC) structure through which many managers effect their private equity, real estate and alternative investments. Managers have looked to the SPC structure due to the short time frame to establish an SPC (i.e., one week versus potentially months to establish in other local jurisdictions), as well as the DIFC’s legal regime (which is based on English law) and the general recognition and treatment of DIFC companies as onshore companies for tax and regulatory purposes in the GCC. The ADGM has recently introduced a comparable entity, the special purpose vehicle (SPV), which is quicker and more flexible (but less tested) than the SPC. The SPV has garnered substantial interest from managers and investors (and more recently start-ups and venture capital firms) in a short period of time since its introduction.

IV MAIN SOURCES OF INVESTMENT

The UAE is home to several prominent sovereign wealth funds, including the second-largest in the world in terms of assets under management (Abu Dhabi Investment Authority, with an estimated US$696.66 billion under management as of June 2019). These sovereign wealth funds are funded through revenues of the government, which are primarily generated through the sale of oil and other related hydrocarbons, and income from their existing portfolios.

The UAE is also home to the DIFC, which is arguably the most popular and successful financial centre in the Middle East. In 2014, assets under management of fund managers
and financial institutions in the DIFC stood at US$10.4 billion. This is expected to grow to US$250 billion by 2024, signalling the expected growth in the asset management industry in the UAE.

Local banks dominate the mutual funds industry in the UAE. These mutual funds generally target retail investors in the UAE and invest into listed equities, primarily in the UAE and the greater GCC region, but also into rated debt and other fixed income products.

Many regional and international asset managers in the UAE (e.g., Abraaj, Fajr Capital, Franklin Templeton and NBK Capital) have based their operations in the DIFC. These private equity managers tend to target institutional investors and family office investors. Over the past five years, fund managers have deployed nearly US$2.1 billion in capital to UAE-based companies, primarily investing in the retail and healthcare sectors.

V KEY TRENDS

In July 2019, the UAE Cabinet approved 122 qualifying activities across 13 sectors eligible for up to 100 per cent foreign ownership in the UAE. The list of sectors includes renewable energy, space, agriculture, the manufacturing industry, information and communications, transport and logistics, healthcare, education, construction and hospitality. To benefit from this scheme, applicants will need to make an application to the Foreign Direct Investment (FDI) Authority and satisfy certain obligations including providing evidence of the deposit of the company’s capital in a bank account, appointment of one or more licensed auditors for a renewable period of one year (up to six consecutive years), implementation of Emiratisation policies in the company and ongoing collaboration with the foreign direct investment (by notably maintaining regular accounts for the FDI project, notifying the date of commencement of work or production date, providing information and statistics). The decision aims to support the growth environment and to reaffirm the UAE’s position on the global arena as a hub for investment.

On 11 March 2019, the SCA, the Financial Services Regulatory Authority of the ADGM (FSRA) and the DFSA announced that a new fund passporting regime will be implemented to facilitate the promotion of funds domiciled in each of onshore UAE, the ADGM and the DIFC. Under the new regime (which only applies to locally domiciled funds and not to the marketing of foreign funds), a fund manager of a DIFC domiciled fund, for example, can register with the DFSA under the passporting regime and the DFSA will notify the other regulators (i.e., the FSRA or SCA) who will then include the fund on their own respective register of funds allowing the fund to be marketed to investors in the ADGM and onshore in the UAE. The implementation of the passporting regime is seen as an important step to encourage the development of the mutual funds’ market so as to achieve the goal of having more diversified investment opportunities and products.

The country’s sovereign wealth funds have long invested internationally into diversified portfolios. Because of less exposure in the region, which has seen a downturn due to the slide in oil prices, and more investment in stronger international markets, the value of these funds’ portfolios has not dramatically dwindled. However, it can be expected that the future budgets for UAE sovereign wealth funds will be significantly lower if the country is facing a budget deficit.

The primary asset classes for investment by local managers have been regional listed equities and real estate. With the local stock markets hit by the slump in oil revenues, managers have fallen back onto real estate more than ever. However, as opposed to the 2008
downturn, recently managers have looked to other alternative classes such as debt, venture capital and private equity. While real estate remains the dominant asset class, the past two years have seen a rise of credit funds (across the sector, including mezzanine, distressed and real estate financing funds) as well as blind-pool venture capital and private equity funds.

In an effort to attract new fund managers and provide a cost-effective option to establish and maintain fund management companies in the DIFC, the DIFC Authority recently introduced significantly reduced fees. Fund managers looking to establish a presence in the DIFC will find that there is now no application fee payable (previously US$8,000), and there is a two-year waiver of the annual commercial licence fee of US$12,000. The DIFC has also introduced incentives for venture capital funds and managers, including flexible office space options. Additionally, there has been a reduction in the regulatory capital requirement, from US$500,000 to US$70,000 for QIFs and exempt funds, and US$140,000 for public funds. It is expected that many managers will take advantage of the lower fees and the streamlined QIF regime (a more flexible structure that is as quick to establish as vehicles in more traditional offshore funds jurisdictions). Managers setting up investment funds in the DIFC have generally been focused on private equity and real estate assets.

In February 2017, Chairman Decision No. 3/R.M of 2017 concerning Promoting and Introducing Regulations (PIR) came into effect. Importantly, the PIR expressly provides an exemption in relation to the promotion of foreign securities (including fund interests) onshore in the UAE based on a documented reverse solicitation. Foreign fund interests are otherwise generally not permitted to be promoted onshore in the UAE unless such promotion is to a qualified investor or the securities are registered with the SCA and an agreement with a locally licensed promoter is concluded.

There has been a surge in interest in the fintech sector in the UAE in the past year, with both the DIFC and the ADGM recently launching fintech accelerators. The ‘FinTech Hive in the DIFC’ was launched as a platform to help identify leading technology entrepreneurs and companies through a competitive process, and then offer them the opportunity to develop, test and modify their innovations in collaboration with top executives from the DIFC and regional financial institutions. In the ADGM, the Regulatory Laboratory was recently launched, authorising fintech participants for a period of up to two years to develop and test their propositions. The first group of participants was announced in May 2017, with the second group commencing activities in July 2018. In June 2018, the ADGM launched its framework to regulate spot crypto asset activities, including those undertaken by exchanges, custodians and other intermediaries in the ADGM. The framework also includes guidance from the ADGM Financial Services Regulatory Authority on the regulation of crypto asset activities in the ADGM and an application form for interested applicants to operate a crypto asset business within the ADGM. This is aimed at instilling proper governance, oversight and transparency over crypto asset activities, positioning the ADGM as a destination of choice for crypto asset players.

VI SECTORAL REGULATION

Insurance

The UAE Insurance Authority recently passed new regulations (the Financial Regulations) restricting how insurance firms operating in the UAE can invest their money and how much exposure they can have in a particular asset class, and restrictions in relation to the domicile of investments. Insurers are permitted to hold assets in a foreign jurisdiction with a
sovereign rating that is better than or at least equivalent to the sovereign rating of the UAE. However, total invested assets held outside the UAE must not exceed 50 per cent of the total invested assets or 100 per cent of the total technical provisions for policies outside the UAE (excluding unit-linked funds), whichever is greater. The Financial Regulations came into force on 29 January 2015, with insurers licensed in the UAE required to restructure their investment portfolios to comply with the Financial Regulations within the following time frames: within three years in relation to assets held in respect of life insurance contracts (by 29 January 2018); within three years for investments in real estate assets; and within two years for investments in non-real estate assets (by 29 January 2017).

ii  Pensions
In general, pensions in the UAE are regulated by the General Authority for Pensions and Social Security (GAPSS). The primary objectives of GAPSS have been to expand insurance coverage for UAE nationals and expatriate residents in the UAE, and the rapid disbursement of insurance, pension and other compensation to its beneficiaries. It is expected that GAPSS may play a larger role in the future, as the UAE has contemplated pension schemes for expatriates resident in the UAE in addition to the existing pensions for UAE nationals.

The Abu Dhabi Retirement Pensions and Benefits Fund (ADRPBF) manages contributions, pensions and employee benefits for UAE nationals working for government, semi-government and private employers in Abu Dhabi. The ADRPBF is an active investor in private equity funds and has a large diversified portfolio of investments.

The UAE Ministry of Labour requires employers to pay employees ‘end-of-service gratuity’ pay upon termination of their employment. This payment is calculated based on the term of an employee’s employment with a company, provided that the maximum gratuity payable is two years’ wages. As an alternative, employers can establish pension schemes that employees can opt into in lieu of the ‘end-of-service gratuity’ system. However, such pension schemes are not common.

iii  Real property
Real estate remains the asset of choice for investors in the UAE, despite the precipitous drop in value during the financial crisis. 2013 and 2014 saw a dramatic surge in prices, but the government has taken steps to regulate the market through limited loans and mortgages, imposing transfer fees on sales and limiting certain investment structures.

Real estate companies in the UAE are increasingly seeking public listings allowing such companies to raise funds while enabling investors to gain direct exposure to prime real estate assets. Recent examples include the high-profile listing on the DFM of Dubai Parks and Resorts (a Meraas Holding group company), raising approximately US$680 million; and DAMAC Properties’ trading of global depository notes on the London Stock Exchange.

In the DIFC, the CIR sets out rules and regulations specific to real estate funds, including restrictions on the types of assets a real estate fund can invest into (e.g., a real estate fund may in certain circumstances only invest up to a maximum of 40 per cent of cash in government and public securities), the type of legal structure that can be used to establish a property fund in the DIFC and requirements in relation to the establishment of an advisory committee for real estate funds.

The past year has seen an increase in REITs activity. In March 2017, Emirates NBD REIT was listed on NASDAQ Dubai. This is the second listed REIT in the UAE following the listing of Emirates REIT on NASDAQ Dubai in 2014. Several other managers, such as
Gulf Islamic Investments, Abu Dhabi Financial Group and Al Mal Capital, have announced new REITs that are expected to be listed on exchanges in the UAE in the next 12 months. REITs listed on NASDAQ Dubai are regulated by the DFSA and must comply with the public funds regulations. As of August 2017, NASDAQ Dubai is the only UAE stock exchange permitting the listing of REITs. However, the SCA and the DFM (along with the Dubai Land Department) have announced efforts to finalise regulations to permit the formation of SCA-regulated REITs to be listed on DFM.

iv  Hedge funds

Hedge funds in the DIFC are regulated by the CIR, similar to other investment funds. The DFSA has implemented the Hedge Fund Code of Practice, which sets out the principal risks associated with hedge funds and similar structures and sets out best practice standards. Hedge fund managers are permitted a degree of flexibility to adapt the standards to suit their particular businesses in light of market conditions and emerging issues. These standards, inter alia, address back-office systems, valuation procedures, and the skills and resources of managers.

v  Private equity

According to Preqin, there were 17 private equity-backed buyout deals in the MENA region in 2018, which was the same number as in 2017, but considerably lower than completion numbers in 2016, 2015, and 2014, when 32, 31 and 46 deals were completed respectively. Fundraising as a whole for the MENA private equity industry was slow in 2018 with the decline of Abraaj believed to be a crucial factor that has made fundraising difficult with investors having concerns about governance and due diligence in the region.

In the DIFC, the CIR sets out rules specific to private equity funds. For example, a fund manager of a private equity fund must ensure that, unless the purpose of the private equity fund is to invest in a single venture or undertaking, it does not invest more than 25 per cent of the fund in one such venture or undertaking. Additionally, the CIR sets out guidelines that must be followed by the fund manager of a private equity fund prior to entering into related-party transactions (e.g., prior investor approval by special resolution).

vi  Other sectors

Sovereign wealth funds

The UAE is home to some of the most prominent sovereign wealth funds: the Abu Dhabi Investment Authority (ADIA), the Abu Dhabi Investment Council (ADIC), the Mubadala Investment Company (Mubadala), the Emirates Investment Authority (EIA) and the Investment Corporation of Dubai (ICD). ADIA, ADIC and Mubadala are all resident in Abu Dhabi, and focus on investments for the benefit primarily of Abu Dhabi but also for the UAE as a whole. EIA is also based in Abu Dhabi, but is a sovereign wealth fund established for the benefit of the seven emirates of the UAE. ICD was established in 2006 to hold the assets of the government of Dubai.

ADIA currently has an estimated US$696.66 billion in assets under management, which it commits to private equity, venture capital, real estate, debt and other alternatives. ADIA invests the surplus oil revenues generated in Abu Dhabi and focuses on international investments (with a focus on North America, Europe and emerging markets). ADIA tends to be a passive investor relying on the managers of the funds and companies in which it invests.
Formed in 2007, ADIC is a spinoff of ADIA and, similar to ADIA, it invests surplus oil revenues. Whereas ADIA primarily makes international investments, ADIC maintains a stronger focus on UAE and Middle East investments. ADIC is agnostic as to asset class, and will make both direct and fund investments. It is estimated that ADIC has approximately US$111.8 billion in assets under management. ADIC is currently being consolidated with Mubadala Investment Company.

Mubadala is a sovereign wealth fund established with the purpose of diversifying the Abu Dhabi economy and providing social benefits to the UAE. It has focused on infrastructure, transportation and energy, including renewable energy. One of its most prominent investments is Masdar City, located outside Abu Dhabi, which is designed to be a hub for clean-tech energy companies and is committed to zero carbon. Mubadala recently merged with IPIC, which held the UAE’s overseas oil assets, in an effort to realise synergies and promote growth in the energy, utilities, technology and aerospace sectors. It is estimated that the merged entity has approximately US$125 billion in assets under management.

EIA was established in 2007 by royal decree to represent the seven emirates of the UAE. EIA invests in many companies that operate across the UAE, such as telecommunications companies and local banks. EIA currently has an estimated US$22 billion in assets under management.

ICD is a sovereign wealth fund owned by the government of Dubai. ICD’s purpose is generally to supervise and manage the assets of the government while adding value to the portfolio. ICD owns assets in the energy, transportation, banking, industrial, real estate and other sectors, including stakes in some of Dubai’s most prominent companies, such as Emaar Properties, Emirates NBD Bank and Emirates Airlines. It is estimated that ICD has approximately US$196 billion in assets under management.

Family offices

Family groups are significant players in the asset management industry in the UAE, both on the manager and investor side, and are widely expected to be a very active investor group over the next year. While these family offices invest globally, many have a vested interest in investing in their home economies and the regional markets. There has been a trend of UAE family offices moving away from blind-pool funds and focusing more on trying to take direct stakes in their investments.

VII  TAX LAW

Historically, the UAE has been a zero-tax jurisdiction. However, in October 2016, the UAE federal law establishing the UAE Federal Tax Authority (FTA) was issued. The FTA will be tasked with overseeing taxation in the UAE and, in particular, the implementation of the newly introduced VAT, which was implemented in January 2018. The FTA will be responsible for formulating UAE federal tax rules and regulations, including VAT, and will oversee the UAE’s application of international tax obligations pursuant to tax treaties, tax information exchange treaties and global tax information exchange programmes. In addition, the FTA will be responsible for implementing all aspects of tax law including assessments, evaluations of returns, audits and the resolution of disputes.
Notwithstanding the introduction of VAT, the following taxes are not applicable in the UAE: withholding tax, corporate tax, personal income tax and capital gains tax. Oil, gas and petrochemical companies and branch offices of foreign banks are, however, required to pay taxes.

Entities established in the DIFC and the ADGM and their employees are subject to a zero rate of tax (income tax, corporate tax, withholding, capital gains, etc.). It is not expected that the new proposed taxes will be assessed on free-zone entities. Therefore, it is hoped that the tax regulations will have a negligible effect on the asset management industry in the UAE.

VIII OUTLOOK

Throughout the financial downturn and the recent slide in oil prices, the UAE has shown its resilience. It has proved that its economy operates outside of the oil and energy sectors, and that it has the infrastructure to maintain and grow its asset management industry. Regional and international managers see the UAE as the logical regional centre for the asset management industry, with Dubai serving as the hub. The DIFC is seeking to capitalise on this success by introducing simpler funds regulations to encourage more growth of the industry. In Abu Dhabi, the authorities have sought to emulate this success and make the ADGM a competitor to the DIFC as a regional funds jurisdiction. (However, recent developments with Abraaj have raised concerns about transparency, and could have an adverse effect on investor confidence and deal making in the UAE and the wider Middle East region.) Despite the tumult around the region, it is expected that Dubai will continue to be resilient, and will continue to lead the way for the MENA region in the asset management and private equity sectors. The UAE economy is expected to recover in 2019 and is forecast to achieve an average real GDP growth rate of 3.8 per cent between 2019 and 2023 (according to the Dubai Chamber of Commerce), supported by a rise in investment flows and private consumption.
Chapter 24

UNITED KINGDOM

Paul Dickson

I OVERVIEW OF RECENT ACTIVITY

The regulatory landscape for asset management continues to focus at EU and domestic level on the reform of existing financial regulation to protect market stability and prevent the build-up of systemic risk in the financial system. Recent large-scale reforms have been, to a large extent, driven by European initiatives, with many new measures originating at EU level; for instance, revisions to the Alternative Investment Fund Managers Directive (AIFMD) and the UCITS IV Directive (UCITS Directive) as part of the EU’s implementation of its capital markets union initiative, the revision of the markets in financial instruments regime (MiFID II), and the preparation of a revised EU prudential framework for investment firms. However, the UK authorities have also continued their focus on building fairer and more effective financial markets. The Fair and Effective Markets Review – instigated by HM Treasury and the Bank of England to focus on fixed income, currency and commodity markets – came to a close during 2015, and the outcomes of that review seek to instigate change at both a domestic and international level. The UK Financial Conduct Authority (FCA) also continues to focus its attention on the asset management sector, with notable recent supervisory activity including its Asset Management Market Study. Meanwhile, overlaying this all, the impact of Brexit looms large.

The view of the Investment Association (IA) is that asset managers emerged from the financial crisis relatively unscathed. However, a fresh wave of significant economic uncertainty, triggered by the result of the UK’s referendum on membership of the European Union, raises concerns about the competitiveness of the UK as a global financial centre going forward. At present, the FCA notes that nearly £8 trillion assets are managed in the UK, and the UK’s asset management industry is the largest in Europe, managing funds of both UK-domiciled and overseas investors. In fact, the UK accounts for around 35 per cent of all European assets under management. The IA has stated that the UK’s place as a pre-eminent centre of asset management has been undisputed for a number of years, but warns that this is

---

1 Paul Dickson is a partner at Slaughter and May. The author would like to thank Tamara Raoufi, Tanja Velling and Anders Jay for their assistance in preparing this chapter.
2 See Section VII of the European Overview chapter.
3 The IA was formed by a merger between the Investment Management Association and the Investment Affairs Division of the Association of British Insurers in June 2014.
4 Towards more effective stewardship, speech by Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA, 3 April 2019.
5 Asset management: A regulatory perspective, speech by Andrew Bailey, Chief Executive of the FCA, 26 April 2018.
by no means guaranteed in the future. It points to Brexit as raising several challenges to the asset management industry, in particular in relation to fund passporting, maintaining access to skilled personnel and the transfer of data.6

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

i The Financial Services and Markets Act 2000

The main framework for the regulation of asset management activities in the UK is contained in the Financial Services and Markets Act 2000 (FSMA) and various instruments introduced under the powers contained in the FSMA.

Regulated activities

The FSMA regulates the provision of financial services, including investment services, in the UK through the concept of regulated activities that may only be carried out by persons who hold appropriate authorisations or are otherwise able to take advantage of a specific exemption from the usual authorisation requirement.7 Regulated activities are specified activities set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (Regulated Activities Order)8 that are carried on by way of business in connection with certain specified investments also listed in the Regulated Activities Order.9 Specified investments include a wide range of financial products including shares, bonds, government securities, deposits, units in collective investment schemes (CISs) and contracts of insurance.

The list of specified activities includes:

a dealing in investments as principal or agent;

b arranging deals in investments;

c managing investments;

d establishing, operating or winding up a CIS;

e managing an alternative investment fund (AIF);10 and

f managing an undertaking for collective investment in transferable securities (UCITS) (see Section III.i);10 and

g advising on investments.

Many investment managers and certain investment fund vehicles in the UK will require FCA authorisation as they are likely to be carrying out regulated activities, such as advising clients on investments, managing investments or dealing in investments as an agent on their

---

7 Section 19 FSMA.
8 SI 2001/544.
9 Section 22 FSMA.
10 Activities (e) and (f) were introduced from 22 July 2013 by the Alternative Investment Fund Managers Regulations 2013. If a person has permission to manage an AIF or a UCITS scheme, they need not obtain permission to operate a CIS in respect of that AIF or UCITS scheme; however, an investment manager that manages AIFs and UCITS schemes must hold permissions for both activities.
clients’ behalf. It is a criminal offence, potentially punishable by up to two years in prison and a fine, for any person who is not authorised or exempt to carry out any regulated activity in the UK.\footnote{Section 23(1)(b) FSMA.}

**Financial promotion**

The FSMA contains a basic prohibition on any person who is not appropriately authorised, acting in the course of business, from communicating an invitation or inducement to engage in investment activity.\footnote{Section 21(1) FSMA.} Investment activity for these purposes includes entering or offering to enter into an agreement, the making or performance of which by either party would be a regulated activity. However, this prohibition will not apply where an appropriately authorised person has approved the content of the proposed communication or if an exemption to the basic prohibition applies.\footnote{Section 21(2) and 21(5) FSMA. The exemptions to the basic prohibition on financial promotions by unauthorised persons are set out in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 (SI 2001/1335) (as amended).}

**CISs**

The concept of a CIS is a central part of the system of regulation of asset management vehicles in the UK. These are widely defined in the FSMA to include:

> any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements . . . to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.\footnote{Section 235(1) FSMA.}

Participants in a CIS must not have day-to-day control over the management of the property.\footnote{Section 235(2) FSMA. The meaning of the term day-to-day control was considered by Laddie J in *Russell Cooke Trust Co v. Elliott* [2001] All ER 197, in which he concluded that the mere fact that investors have a right to be consulted or can give directions to an investment manager of a fund did not necessarily mean that they had day-to-day control over the property of that fund.} In addition, the relevant arrangements must involve the pooling of participants’ contributions and the profits or income out of which payments are to be made to such participants, or the property must be managed as a whole by, or on behalf of, the operator of the scheme,\footnote{The glossary in the FCA Handbook makes clear that the term operator means the person or entity responsible for management of the scheme or property within the scheme.} or both.\footnote{Section 235(3) FSMA.} The potentially wide definition of a CIS included in the FSMA is narrowed by the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (Collective Investment Schemes Order),\footnote{SI 2001/1062.} which excludes, among other arrangements, all bodies corporate (other than open-ended investment companies (OEICs) and limited liability
partnerships), contracts of insurance, and occupational and personal pension schemes. A CIS need not have any particular legal form and, subject to the exemptions outlined above, the concept attaches to a wide range of legal vehicles and contractual arrangements.

If an arrangement is classified as a CIS, a number of important regulatory consequences follow. Units (i.e., rights or interests) in a CIS are a specified investment, and establishing, operating or winding up a CIS are specified activities under the FSMA that require FCA authorisation. The restrictions on financial promotion summarised above will also become relevant. Furthermore, Section 238 FSMA prohibits authorised persons from promoting or marketing unregulated CISs, such as unauthorised unit trusts (UUTs) and hedge funds, except in certain circumstances (e.g., where the promotion is made only to investment professionals). The promotion of unregulated CISs, together with certain close substitutes called non-mainstream pooled investments, is prohibited to the majority of retail investors.

ii FCA

The FCA is the conduct-of-business regulator for all authorised firms. It is also responsible for the prudential regulation of all firms not authorised by the Prudential Regulation Authority (PRA). PRA-authorised firms (being, broadly speaking, banks, insurance companies and certain systemically important investment firms) are dual-regulated by the PRA for prudential matters and the FCA in respect of conduct of business. Most investment managers and investment vehicles requiring authorisation are regulated solely by the FCA; however, those deemed to be of significant importance to the UK’s wider financial system fall within the ambit of the PRA’s supervision.

The FSMA confers a wide range of regulatory functions and powers on the FCA. The FCA’s statutory objectives include:

- ensuring that relevant markets function well;
- protecting and enhancing the integrity of the UK financial system;
- promoting effective competition in the markets for regulated financial services in the interests of consumers; and
- securing an appropriate degree of protection for consumers.

Under the FSMA, the FCA has extensive rule and code-making powers; it is permitted to issue such rules that it considers necessary or expedient for the purpose of advancing one or more of its statutory objectives. The rules and guidance applicable to FCA-authorised firms are consolidated in the FCA Handbook, which includes high-level standards, conduct-of-business requirements, regulatory guides and specific specialist sourcebooks applicable to a wide range of asset management vehicles and arrangements. The content of the FCA Handbook is heavily influenced by EU legislation; for instance, the Markets in Financial Instruments Directive (MiFID), which sets out various organisational and conduct-of-

19 Schedule to Article 3, Paragraphs 17, 20 and 21 Collective Investment Schemes Order.
20 Articles 81 and 51ZE Regulated Activities Order.
21 Exemptions from Section 238 FSMA are set out in the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (SI 2001/1060) and the FCA’s Conduct of Business Sourcebook (COBS).
22 COBS 4.12.
23 The FCA Handbook is available at www.handbook.fca.org.uk/handbook.
business requirements that apply to authorised investment firms. The FCA substantially updated the FCA Handbook to reflect the MiFID II regime, which came into force in January 2018.

The FCA makes use of a number of supervisory tools in its oversight of the asset management industry, including thematic reviews and market studies, which involve investigations into key current or emerging risks relating to a specific issue or product. Notably, the FCA recently published the final report on its wide-ranging asset management market study in June 2017. The key findings of that study focused on price competition in a number of areas of the asset management industry, fund performance, how asset managers communicate their objectives to clients, and the role of investment consultants and other intermediaries in the asset management sector (see further details in Section V.vi, below).

In March 2017, the FCA published the final report on its Financial Advice Market Review (FAMR). The latter was launched jointly by HM Treasury and the FCA in August 2015 to explore the ways in which the government, industry and regulators could stimulate the development of a market that delivers affordable and accessible financial advice and guidance. The final report set out a series of recommendations intended to tackle barriers to consumers accessing advice and guidance. Those recommendations fall into three key areas: the affordability and accessibility of advice, liabilities of investment advisers and redress. As part of the implementation of those measures, the report recommended that the FCA and HM Treasury should work together to develop an appropriate baseline and indicators to monitor the development of the advisory market. The FCA published its baseline report in June 2017. It launched a call for input asking for feedback on its proposed approach to reviewing the outcomes of the FAMR in May 2019, with the publication of the review findings currently expected in autumn 2020.

Another key area of interest for the FCA over the past few years has been potential conflicts of interest between asset management firms and their clients, particularly in relation to the clarity of fund charges, inducements given or received by investment firms, and the way in which commissions charged to customers were spent. Prior to the implementation of MiFID II, the FCA had reformed its rules on the use of dealing commission to make clear that commissions should only be spent on the actual costs of executing customer orders, goods and services related to the execution of trades, or goods and services related to the provision of research. Under the new MiFID II inducements regime however, many asset managers are now prevented from charging clients for research on a bundled basis, and must either pay for the research directly from their own balance sheets or charge the costs back to clients via a special research payment account. The FCA has reviewed how asset managers are implementing these rules and how firms are pricing research and corporate access services. The review concluded that while most asset managers calculated transaction costs in accordance with the new rules, there are problems with the way some asset managers are calculating transaction costs and how they disclose them. Further, the FCA has been

24 See Section III of the European Overview chapter.
25 Recent thematic reviews include a 2015 thematic review about benefits provided and received by firms conducting MiFID business, and those carrying out regulated activities in relation to a retail investment product: TR 16/3 Meeting of investors’ expectations, TR15/1 Asset management firms and the risk of market abuse, TR14/19 Wealth management firms and private banks – conflicts, and TR14/7 Clarity of fund charges.
26 See Section III of the European Overview chapter.
expanding its interest in innovation, big data, technology and competition. The FCA has set fintech as one of its cross-sector priorities, particularly noting that it is driving change in markets and encouraging innovations. The FCA has launched programmes to enable the development of fintech, for example, by providing assistance to firms using innovation to improve consumer outcomes through its Innovate programme. Firms can test the commercial and regulatory viability of their innovative concepts before investing in them in the FCA's regulatory 'sandbox'. In the context of asset management specifically, the FCA launched its Advice Unit to provide regulatory feedback to firms developing automated models to deliver lower-cost advice and guidance to consumers, and on 21 May 2018 published guidance in relation to automated investment services, and specifically its approach to the supervision of automated or ‘robo’ advice. In a review of the impact and effectiveness of its innovation programme, published in April 2019, the FCA noted that asset management was one of the sectors from which it had received comparatively low numbers of applications for the regulatory sandbox, despite proactive attempts to engage with the sector.

The FCA issued its first decision under competition law in February 2019, penalising three asset managers found to have shared strategic information in relation to initial public offerings and one placing. The FCA issued fines of £306,300 and £108,600 (one of the asset managers was given immunity under the competition leniency programme), and it was widely regarded as the start of a crackdown on information sharing in equity capital markets transactions. The FCA also recently published a package of measures to improve competition in the investment platforms market. The measures include provisions designed to allow consumers to switch platforms and remain in the same fund without having to sell their investments, together with restrictions on exit fees.

III COMMON ASSET MANAGEMENT STRUCTURES

A range of legal vehicles is commonly used for asset management activities in the UK. These include limited companies, trusts and limited partnerships, as well as certain bespoke legal forms specific to the investment funds context. The choice of legal form of an investment fund will often be influenced by the tax treatment of that fund and the regulatory implications for both the fund and the fund manager that follow from that choice.

i Open-ended investment vehicles

Open-ended funds issue and redeem securities to and from investors in a fund on an ongoing basis at a price that is based directly on the underlying net asset value of the investment portfolio held by the fund. In the UK, an open-ended investment vehicle may take the form of a UUT or one of three forms of authorised CIS: authorised unit trusts (AUTs), OEICs and authorised contractual schemes. Such authorised CISs may, in turn, be UCITS schemes, non-UCITS retail schemes or qualified investor schemes, as discussed below.

---

27 FCA, Automated investment services – our expectations, 21 May 2018. See also Finalised Guidance FG 17/8, Streamlined advice and related consolidated guidance, September 2017.
29 FCA, The Impact of Effectiveness of Innovate, April 2019.
**Unit trusts and AUTs**

The original form of open-ended fund in the UK is the unit trust. This relies upon the English common law concept of trust, under which a trustee holds the legal title to the trust property on behalf of the beneficiaries (in this case, the investors) who themselves have a beneficial interest in the underlying trust assets. Typically, the trustee will be a financial institution with experience in offering trust services (in the case of AUTs, it is important that the trustee is authorised under the FSMA\(^{31}\)). However, unlike other general forms of trusts, there will also be a separate fund manager to formulate and implement the unit trust’s investment strategy, working alongside the trustee. Trusts themselves do not have any legal personality under English law and therefore cannot contract in their own name. Instead, they are characterised by the trust relationship between the trustee and the beneficiaries, which will be established by the relevant document constituting the trust (which, in the case of unit trusts, is typically termed the ‘trust deed’).

An AUT scheme is defined in the FSMA as a unit trust scheme authorised in accordance with Section 243 FSMA.\(^{32}\) The FCA may authorise a unit trust scheme if it is satisfied that the requirements contained in that Section are met, the rules in the FCA’s Collective Investment Schemes Sourcebook (part of the FCA Handbook, commonly referred to as COLL) have been satisfied, and it has been supplied with a copy of the trust deed constituting the AUT and a certificate signed by a solicitor that states that the requirements in Section 243 and COLL have been met.

AUTs enjoy two key advantages that flow from FCA authorisation. First, an AUT is able to make invitations or financial promotions to participate in the scheme directly to the public in the UK.\(^{33}\) Secondly, AUTs are not liable to pay UK tax on the chargeable gains realised on a disposal of assets in their underlying investment portfolios.\(^{34}\)

It is possible for unit trusts to be unauthorised, meaning that no FCA approval has been granted under Section 243 FSMA. This has the advantage that the UUT is not subject to the detailed requirements in COLL, but it does not benefit from the exemption on the prohibition on financial promotions to the public in the UK and, unless all of the investors in the UUT are exempt from UK tax on capital gains other than by reason of their residence or the UUT benefits from pre-6 April 2014 grandfathering, it will broadly be taxed as though it was a UK-resident company. This tends to mean that unauthorised trusts are attractive to a narrower range of professional investors and are unsuitable for use as retail investor schemes.

**OEICs**

OEICs were introduced in the UK partly as a response to the unfamiliarity of overseas investors with the trust structure underlying unit trusts. They represent a compromise position in English law by permitting a company to have a variable capital structure.\(^{35}\) In many ways, OEICs are similar to AUTs (the statutory and regulatory provisions applying to

---

31 Acting as trustee of an AUT is a specified activity under Article 51ZB (in relation to UCITS schemes) or Article 51ZD (in relation to AIFs) of the Regulated Activities Order, as applicable.
32 Section 237(3) FSMA.
33 Section 238(4)(a) FSMA, which disappplies the general restriction on the promotion of CISs in Section 238(1).
34 Section 100 Taxation of the Chargeable Gains Act 1992.
35 Traditionally, English company law has resisted the idea of companies having variable capital, and has imposed relatively strict maintenance of capital rules that have prevented companies from being suitable
both often use similar wording and concepts), but OEICs are bodies corporate and therefore have separate legal personality. As a result, OEICs are not based on the English law concept of the trust, and the OEIC itself will hold the beneficial interest to the investment portfolio (while the investment assets must be entrusted to a depositary, which will hold legal title to them). Therefore, investors in an OEIC are, to an extent, in a similar position to shareholders in a traditional limited company. An OEIC must also have an authorised corporate director that will assume responsibility for the OEIC’s ongoing operating duties. Although an OEIC may theoretically have additional directors, this is rare in practice, and it is far more common for the authorised corporate director to be the sole director of the OEIC.

The Treasury is empowered under the FSMA to make rules that regulate OEICs, and the current regulatory framework operates through two distinct sets of regulations: the Open-Ended Investment Companies Regulations 2001 (OEIC Regulations), and those parts of COLL relevant to OEICs. OEICs are not regulated by the general company law provisions contained in the Companies Act 2006, despite their status as bodies corporate under English law.

The formation of OEICs is governed by Part II of the OEIC Regulations, which states that an OEIC is incorporated upon the coming into effect of an authorisation order from the FCA. Since the only method of incorporating an OEIC is through this FCA authorisation procedure, it is not possible to have an unauthorised OEIC in the UK (unlike a unit trust, which may be either authorised or unauthorised).

To grant authorisation, the FCA must be provided with a copy of the company’s instrument of incorporation and a certificate from a solicitor that attests that the instrument of incorporation complies with FCA requirements, including the inclusion of certain key statements and matters set out in Schedule 2 to the OEIC Regulations. As with AUTs, OEICs must also permit shareholders to have their shares redeemed or repurchased on request at a price related to the net value of the OEIC’s investment portfolio and determined in accordance with the OEIC’s instrument of incorporation and the rules in COLL. Alternatively, or in addition, shareholders must be entitled to sell their shares on open-ended investment vehicles. Prior to the development of OEICs, closed-ended investment trusts (which are actually companies under English law) were the typical form of body corporate employed as a collective investment vehicle.

36 Regulation 5 OEIC Regulations.
37 See Chapter 6 of COLL, which sets out the ongoing operating duties and responsibilities of the authorised corporate director of an OEIC.
38 Section 262 FSMA.
39 SI 2001/1228.
40 Regulation 3(1) OEIC Regulations.
41 These include, for example, that the OEIC’s shareholders are not liable for its debts (Paragraph 2(c)), and that the charges and expenses of the OEIC may be taken out of the scheme property (Paragraph 2(e)). In addition, the instrument of incorporation must contain provisions stating the object of the OEIC (Paragraph 3(1)(a)), the currency in which its accounts are to be prepared (Paragraph 3(1)(c)), the maximum and minimum sizes of its capital (Paragraph 4(1)(c)), and the rights attaching to each class of its shares (Paragraph 4(1)(f)).
42 Regulation 15(11)(a) OEIC Regulations.
an investment exchange at a price that is not significantly different from the redemption or repurchase price. UK OEICs are not subject to the restriction on the promotion of CISs contained in Section 238 FSMA.

**Authorised contractual schemes**

The Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013 (Contractual Scheme Regulations) came into force on 6 June 2013. The Contractual Scheme Regulations provide for a new form of authorised CIS: an authorised contractual scheme (ACS). Previously, collective investment activity authorised by the FCA could only be carried out through AUTs or OEICs, neither of which are tax-transparent (although neither AUTs or OEICs are generally liable to pay UK tax on the chargeable gains realised on the disposal of investment assets, nor are they generally liable to pay UK tax on their dividend income). ACSs, on the other hand, are tax-transparent collective investment vehicles, meaning that they are not within the charge to direct taxes and any tax liability is at the investor level. The introduction of ACSs is intended to increase the competitiveness of the UK’s asset management industry.

The ACS may take the form of a co-ownership scheme or a limited partnership scheme. An ACS is defined in the FSMA as a contractual scheme that is authorised in accordance with Section 261D(1) FSMA. The FCA may authorise a contractual scheme if it is satisfied that the scheme complies with the requirements of Sections 261D and 261E FSMA; the scheme meets the requirements of the contractual scheme rules (set out in COLL); and it has been provided with a copy of the contractual scheme deed and a certificate signed by a solicitor stating that the deed complies with the necessary requirements.

The general restriction on the promotion of CISs does not apply to ACSs. However, to protect retail investors, an ACS must not allow retail investors to be participants in a scheme unless they invest £1 million or more.

**UCITS schemes**

UCITS schemes are not a separate type of open-ended investment vehicle, but rather they are AUTs, OEICs or ACSs that meet the criteria laid down in the UCITS Directive. The UK has implemented the requirements of the UCITS Directive primarily through the FCA’s COLL Sourcebook, and the insertion and amendment of certain provisions in the FSMA by the UCITS Regulations 2011.

A UCITS scheme must comply with the following criteria: it must be an AUT, an OEIC or an ACS; the sole object of a UCITS scheme must be collective investment in

---

43 Regulation 15(11)(b) OEIC Regulations.
44 Section 238(4)(b) FSMA disapplies the general restriction on the promotion of CISs in Section 238(1) FSMA.
45 SI 2013/1388.
46 Section 235A FSMA.
47 Section 237(3) FSMA.
48 Section 261D(1) FSMA.
49 Section 238(4)(aa) FSMA disapplies the general restriction on the promotion of CISs in Section 238(1).
50 Section 261E FSMA.
51 SI 2011/1613.
transferable securities\textsuperscript{52} or in other permitted financial instruments\textsuperscript{53} operating on the principle of risk-spreading; and the units in the fund must, at the request of the unitholders, be repurchased or redeemed, directly or indirectly, out of the scheme’s assets (which includes action taken by or on behalf of the scheme on a stock exchange to ensure that the value of its units does not vary significantly from their net asset value).

Alternatively, a UCITS scheme may be an umbrella scheme, having sub-funds that each would be a UCITS scheme if they had separate FCA authorisation.

A scheme will not constitute a UCITS scheme for the purposes of the rules in the FCA Handbook if its instrument of incorporation (for an OEIC), trust deed (for an AUT) or contractual scheme deed (for an ACS) contain a provision that means that its units may only be sold to the public in non-European Economic Area (EEA) states.

UCITS schemes must comply with the general obligations applicable to UCITS funds under the UCITS Directive,\textsuperscript{54} as well as specific investment and borrowing power rules.\textsuperscript{55} The general UCITS investment limits have been incorporated into the UK regulatory regime through COLL, and include spread limits and specific rules for government securities and for derivatives.\textsuperscript{56} The investment powers and borrowing limits for UCITS feeder funds are also included in COLL; these include a general obligation that a feeder UCITS must invest at least 85 per cent in value of its property in units of a single master UCITS.\textsuperscript{57}

UCITS schemes must comply with a more stringent regulatory regime; however, they may benefit from cross-border passporting, which allows a UCITS authorised in one EEA State to market its units into any other EEA State. Provisions allowing for the cross-border marketing of UCITS schemes of other EEA States are included in the rules for recognised overseas schemes in COLL 9 and in Section 264 FSMA. The competent authorities of the home Member State of the relevant UCITS fund are required to notify the FCA that the fund has been authorised under the UCITS Directive in that Member State, following which the fund will have the right to begin marketing units in the UK immediately.

COLL also contains the UK rules on UCITS management company passports, both in respect of UK UCITS management companies operating other EEA UCITS schemes and EEA UCITS management companies acting as authorised fund managers (AFMs) of UK UCITS schemes.\textsuperscript{58} The rules applicable to UK management companies make clear that they are subject to a range of general compliance and conduct requirements contained in

\textsuperscript{52} Transferable securities are defined in COLL 5.2.7 as shares, debentures, alternative finance investment bonds, government and public securities, warrants or certain certificates conferring contractual or property rights in connection with such securities. However, under COLL 5.2.7(2), investments will not constitute transferable securities if the title to them cannot be transferred, or cannot be transferred without third-party consent (except, in the case of a body corporate, any consent required by the body corporate itself, its members or its debenture holders, which may be excluded under COLL 5.2.7(3)).

\textsuperscript{53} COLL 5.2.6A sets out the permitted types of property that may be included in the portfolio of a UCITS scheme. This includes transferable securities, approved money-market instruments (broadly speaking, liquid instruments normally traded on money markets), units in CISs, derivatives and forward transactions, and deposits. In the case of OEICs, this also includes any movable or immovable property that is essential for the direct pursuit of the OEIC’s business.

\textsuperscript{54} COLL 1.2.2 and COLL 3.2.8.

\textsuperscript{55} COLL 5.2 to COLL 5.5.

\textsuperscript{56} COLL 5.2.

\textsuperscript{57} COLL 5.8.2.

\textsuperscript{58} COLL 12.
COLL and in the FCA’s conduct of business rules, but they also make clear that where a UK management company operates a UCITS scheme through a branch in another EEA state, it will be subject to the relevant requirements of that state’s regulatory authorities so that in certain situations, regulatory responsibility may be shared between the FCA and that state’s competent authorities.\(^{59}\) The rules relating to EEA management companies that operate a UK UCITS (either through a branch or under a general cross-border passport) set out the requirements for certain information to be provided to the FCA in relation to depositary and delegation arrangements,\(^{60}\) and the rules in COLL and the conduct of business rules to which the EEA management company is subject.\(^{61}\) These include detailed rules on:

\(\begin{align*}
&a \quad \text{the issue and redemption of units in a UCITS scheme;} \\
&b \quad \text{investment policies and limits;} \\
&c \quad \text{the calculation of the value of the scheme property;} \\
&d \quad \text{the distribution of income;} \\
&e \quad \text{disclosure and reporting requirements; and} \\
&f \quad \text{marketing requirements.}
\end{align*}\)

**Non-UCITS retail schemes**

Like UCITS schemes, non-UCITS retail schemes (NURSs) are not a separate type of investment vehicle, but rather are AUTs, OEICs or ACSs that do not comply with the requirements to be a UCITS. The regulatory regime applying to NURSs in the UK is less stringent than that which applies to UCITS schemes, and the applicable investment restrictions are therefore more relaxed. However, as a consequence, NURSs will not qualify for EU cross-border passporting under the UCITS regime.\(^{62}\) For example, NURSs are permitted to invest up to 20 per cent of the value of the scheme property in unlisted securities or unregulated investment schemes, and may also invest in gold and real estate assets.\(^{63}\) In addition, the limit for investment in the units of another authorised scheme is 35 per cent of the NURS’s assets\(^{64}\) (which permits a higher level of investment concentration than the 20 per cent limit applicable to UCITS schemes\(^{65}\)), while the limit for a NURS’s exposure to a single counterparty in an over-the-counter derivative transfer is limited to 10 per cent of the scheme value,\(^{66}\) rather than the usual 5 per cent limit for UCITS schemes.\(^{67}\)

Nonetheless, there are still important limitations on the investment powers of NURSs that are intended to retain a degree of investor protection in the absence of the demanding UCITS requirements. A NURS (except for a feeder NURS\(^{68}\)) cannot invest in the units of a CIS unless that CIS meets certain minimum requirements, including that the CIS is effectively subject to an equivalent level of regulation as a NURS or UCITS fund (or

---

59 COLL 12.2.  
60 COLL 12.3.4.  
61 COLL 12.3.5.  
62 See the guidance in COLL 5.6.2.  
63 COLL 5.6.4 and COLL 5.6.5.  
64 COLL 5.6.7(6).  
65 See COLL 5.2.11(9).  
66 COLL 5.6.7(5).  
67 COLL 5.2.11(7) (although the limit for UCITS schemes is raised to 10 per cent if the derivative counterparty is a financial institution recognised by the FCA rules as an approved bank).  
68 A feeder NURS is a NURS that invests in units only in a single CIS that is itself a NURS, a UCITS scheme or a recognised overseas scheme.
otherwise that no more than 20 per cent by value of the NURS’s assets are invested in that CIS; the CIS operates on the principle of the prudent spread of investment risk; and the CIS is prohibited from having more than 15 per cent in value of its property in units in other CISs.69

NURSs are also subject to certain of the same provisions in COLL regarding:

a) limiting the amount of cash that can be retained in the scheme property;70
b) general borrowing powers;71
c) the ability to lend money and other property;72 and
d) the power to provide guarantees or indemnities.73

In October 2019, the FCA began consulting on proposals to reduce the potential for harm to retail investors in funds that hold illiquid assets.74 This is of particular interest to NURSs, which invest in illiquid assets such as property. Under the FCA’s proposals, funds may be required to suspend trading in certain circumstances, produce contingency plans, and disclose more information about liquidity risks.

**Funds of alternative investment funds**

COLL includes provisions governing the operation of funds of alternative investment funds (FAIFs) that are NURSs (or sub-funds of umbrella NURSs) operated in accordance with specific rules set out in COLL 5.7 (some of which incorporate general rules that are applicable to all NURSs from COLL 5.6). The regulatory regime for FAIFs is therefore essentially a relaxed version of the rules that apply to NURSs, providing increased flexibility in respect of investment powers.

The key attribute of FAIFs is that they are permitted to invest all of their assets in CISs, provided that those CISs prudently spread risk and do not themselves invest more than 15 per cent in value of their assets in units in CISs (or, in the absence of any such restriction, provided that the fund manager of the FAIF is satisfied on reasonable grounds that no such investment will in fact be made).75 There is no requirement that the CIS in which a FAIF invests must itself be subject to the rules governing NURSs or the UCITS requirements. However, the fund manager of a FAIF must carry out appropriate due diligence on any CIS in which the FAIF intends to invest.76 The guidance in COLL 5.7 makes clear that this due diligence should include an assessment of, among other factors, the experience and qualifications of the CIS’s investment manager, the adequacy of the CIS’s governance arrangements and risk management processes, the level of liquidity and the redemption policy offered by the CIS, and any relevant conflicts of interest between the CIS’s investment manager and any other parties.77

---

69 COLL 5.6.10.
70 COLL 5.5.3.
71 COLL 5.5.4(1)–(3) and (8), although significantly a NURS’s borrowing powers are not limited only to borrowings on a temporary basis, as COLL 5.5.4(4) and (5) do not apply to a NURS.
72 COLL 5.5.6 and COLL 5.5.7(1), (2) and (4).
73 COLL 5.5.9.
74 FCA, Consultation Paper CP18/27, Consultation on illiquid assets and open-ended funds and feedback to Discussion Paper DP17/1.
75 COLL 5.7.2 and COLL 5.7.7.
76 COLL 5.7.9.
77 COLL 5.7.11.
Qualified investor schemes

As with UCITS schemes and NURSs, qualified investor schemes (QISs) are not a specific legal form of investment vehicle. Rather, QISs are authorised CISs that are designed to be marketed only to certain types of sophisticated investors, rather than to general retail customers, and the fund manager of a QIS is required to take reasonable care to ensure that the units in the QIS are sold only to such persons.

The regulation of QISs is more relaxed than that of UCITS schemes and NURSs, and QISs have greater flexibility in respect of their investment and borrowing powers. The assets in which a QIS invests must be permitted investments under the QIS’s constitution and its marketing prospectus, but otherwise they can consist of a wide range of assets including shares, debentures, alternative finance bonds, real estate, precious metals, exchange-traded commodity contracts, options, contracts for difference and units in CISs. Unlike UCITS schemes and NURSs, there are no specific rules that would limit concentration of a QIS’s assets in certain investments (except for units in certain CISs), although there is a general requirement that the fund manager of a QIS must take reasonable steps to ensure that the investments provide a suitable spread of risk in light of the investment objectives of the scheme. In relation to investments in CISs, a QIS may only invest in regulated CISs or schemes that otherwise meet certain minimum requirements (and if the scheme is of the latter type, the QIS must not invest more than 20 per cent in value of its assets in unregulated schemes or other QISs unless the fund manager has taken reasonable care to ensure that the target scheme complies with all relevant legal and regulatory requirements).

The limitations on the borrowing powers of QISs are similarly relaxed. There is a general rule that the borrowing of a QIS must not exceed 100 per cent of the value of its assets, and the fund manager must take reasonable care to ensure that arrangements are in place that will enable borrowings to be closed out to ensure compliance with that rule. However, there is no requirement that borrowings can only be of a temporary nature.

ii Closed-ended investment vehicles

Closed-ended funds differ from open-ended funds by issuing a fixed number of securities, usually determined by the fund’s constitutional documents or by the general requirements of the law regulating the type of fund entity, or both, with investors realising their investment either by selling the securities in the secondary market or upon the winding-up of the fund at the end of its life. Therefore, unlike open-ended funds, closed-ended funds do not undergo the constant expansion and contraction of the number of securities in issue throughout their life in response to ongoing investment and redemption. In the UK, the most common closed-ended structures are investment trusts (which are actually companies) and partnerships.

---

78 QISs fall within the definition of non-mainstream pooled investment and therefore are subject to the marketing restrictions in COBS 4.12 (see Section II.i).

79 COLL 8.1.3.

80 COLL 8.4.3.

81 COLL 8.4.4.

82 COLL 8.4.2.

83 COLL 8.4.5.

84 COLL 8.4.10.
**Investment trusts**

Investment trusts, despite their misleading name, are not trusts, but rather are public limited companies that are listed on a recognised stock exchange. As such, the usual company law provisions contained in the Companies Act 2006 apply to investment trusts, and there is no separate legal regime governing their form and structure (e.g., as there is for OEICs). However, to constitute a valid investment trust for tax purposes, a company must meet the criteria set out in Section 1158 of the Corporation Tax Act 2010 and be approved as such by HM Revenue & Customs (HMRC).

Unlike open-ended funds, the shares in an investment trust may trade at a discount or a premium to the net asset value of the company’s underlying assets, depending on levels of supply and demand on the stock exchange. It is usual for the shares of investment trusts to trade at a discount, which can lead to considerable time being spent on attempting to manage the level of this discount. In particular, investment trusts commonly seek general shareholder authority (usually on an annual basis) to make purchases of their own shares in the market from time to time in order to support the price at which their shares trade.

As listed entities, investment trusts are subject to the Listing Rules (LRs) that form part of the FCA Handbook and are published by the FCA acting in its capacity as the UK Listing Authority. In particular, Chapter 15 of the LRs contains specific rules with which listed closed-ended investment funds (which includes investment trusts) must comply. In addition to meeting the minimum requirements for listing that apply to all listed securities, the LRs stipulate that investment trusts must invest and manage their assets in such a way as to spread investment risk, and that the board of directors of the investment trust must be able to act independently from its investment manager. In addition, an investment trust must make investments in accordance with a published investment policy, and any material changes to that policy must be approved by shareholders and, if the change is not proposed to enable the winding-up of the investment trust, by the FCA.

Investment trusts themselves do not require authorisation under the FSMA. However, following the implementation of the AIFMD, managers of investment trusts either require FCA authorisation or, in certain limited instances, to be registered with the FCA to carry out the activity of managing the investment trust. Investment trusts have a board of directors, but management is usually delegated to an investment management company; this external manager must therefore be authorised and comply with the requirements of the AIFMD. If the investment trust is internally managed, the investment trust itself must be authorised or registered.

Under the Collective Investment Schemes Order, investment trusts do not qualify as CISs, and therefore the restrictions on the promotion of CISs in Section 238 FSMA do not apply. However, shares in an investment trust will constitute specified investments under Article 76 of the Regulated Activities Order, and therefore they fall within the general restrictions on financial promotions.

---

85 Although LR 15 is stated to apply only to closed-ended investment funds with a premium listing, LR 1.5.1 makes clear that investment trusts will require a premium listing for their equity shares.

86 LR 15.2.2.

87 LR 15.2.11.

88 LR 15.4.2 and LR 15.4.8.

89 SI 2001/1062.

90 See Paragraph 21 of the Schedule to the Collective Investment Schemes Order.
**Limited partnerships**

Limited partnerships are formed under the Partnership Act 1890 and registered under the Limited Partnerships Act 1907 (LPA 1907). A limited partnership is defined as consisting of one or more general partners who are liable for all the debts and obligations of the partnership, and one or more limited partners whose liability is limited to the amount of capital that they contribute.\(^{91}\) It is a key requirement of limited partnerships that the general partner alone is responsible for the day-to-day operation and management of the partnership’s affairs: if a limited partner becomes involved in the management of the partnership’s business, that limited partner will lose the benefit of limited liability and will be treated as a general partner.\(^{92}\) For this reason, in the asset management context it is usual that an entity connected with the investment manager of a fund that is established as a limited partnership acts as general partner or that management responsibility is delegated to a third party, while investors act as limited partners.

Limited partnerships must be registered with the Registrar of Companies (which acts, for these purposes, as the Registrar of Limited Partnerships) in accordance with the provisions of the LPA 1907.

English limited partnerships do not have separate legal personality, and therefore cannot hold property or contract in their own name. Scottish limited partnerships differ in this respect: Section 4(2) of the Partnership Act 1890 makes it clear that a Scottish partnership is a legal person distinct from the persons of whom it is composed. Both English and Scottish limited partnerships are treated as fiscally transparent in the UK. In July 2015, HM Treasury consulted on proposed changes to the LPA 1907 as it applies to funds by a legislative reform order. It stated that it remains committed to exploring the possibility of allowing English limited partnerships to elect for legal personality, but that such a change would be fundamental and hence would not be possible using the proposed legislative reform order. Further work will be needed to explore the implications and legislative changes required.\(^{93}\)

Limited partnerships benefit from flexible governance arrangements, as the LPA 1907 contains few rules on the division of responsibilities between the general and limited partners (other than the overriding requirement that the limited partners must not become involved in the day-to-day management of the partnership business). The general law relating to partnerships is flexible, and it is entirely possible to establish a partnership (although not a limited partnership, owing to the need for registration) without a written partnership agreement. In reality, investment funds will be constituted through a written agreement that sets out the rules and arrangements for that particular partnership. Certain changes to the regime for limited partnerships are proposed by HM Treasury, in particular an ability for a limited partnership to be designated as a private fund limited partnership that would carry certain regulatory benefits. The timescale within which these changes will be brought about remains unclear.\(^{94}\)

Most investment funds operated as limited partnerships will be CISs within the definition under Section 235 FSMA, as they will involve the pooling of investment assets in an arrangement whereby investors do not have day-to-day control over the management of the partnership.

---

\(^{91}\) Section 4 LPA 1907.

\(^{92}\) Section 6(1) LPA 1907.

\(^{93}\) HM Treasury consultation on draft legislation, Proposal on using Legislative Reform Order to change partnership legislation for private equity investments, July 2015.

\(^{94}\) ibid.
of the fund’s property. In addition, such limited partnerships are likely to be AIFs for the purposes of the AIFMD (see Section III.iii). As a result, the fund manager (whether this be the general partner or a third-party manager) is likely to require FCA authorisation for the regulated activities of establishing, operating or winding up a CIS or for the regulated activity of managing an AIF.

**Private fund limited partnerships**

The private fund limited partnerships (PFLP) regime came into force on 6 April 2017 pursuant to the Legislative Reform (Private Funds Limited Partnerships) Order 2017 (the PFLP Order), which amended the LPA 1907 in certain respects. The PFLP regime is the result of the government’s initiative to make the UK a more competitive jurisdiction for fund formation by relaxing or removing some of the more burdensome requirements of the LPA 1907 in relation to such funds, while retaining the flexibility and fiscal advantages of limited partnership structures.

A limited partnership must apply to be designated as a PFLP before it can avail itself of the PFLP regime. To be a PFLP, a limited partnership must satisfy two conditions: it must be constituted by an agreement in writing, and it must be a CIS (as defined in Section 235 FSMA, but ignoring any order made under Section 235(5) FSMA).

The PFLP regime relaxes a number of rules relating to limited partnerships as they apply to PFLPs. In particular, the regime introduces a non-exhaustive ‘white list’ of permitted activities that limited partners may undertake without jeopardising their limited liability status (such as consulting or advising with a general partner or any person appointed to manage or advise the partnership about the affairs of the partnership or about its accounts).\(^{95}\) The PFLP regime also removes the requirement for partners to make a capital contribution to the partnership, and it removes certain other administrative burdens, such as the need to advertise changes to the partnership in the Gazette. Given that the PFLP Order overlays existing limited partnership law, it has the advantage of maintaining most of the features of the existing limited partnership law that are familiar to investors and asset managers. Crucially, the tax status of the limited partnership is not affected by the PFLP Order.

**Limited liability partnerships**

Limited liability partnerships (LLPs) are a relatively recent introduction in the UK, having been created by the Limited Liability Partnerships Act 2000. They are a form of hybrid legal entity that are bodies corporate with their own legal personality,\(^{96}\) but that enjoy the organisational flexibility and tax transparency of traditional partnerships coupled with limited liability for each member. LLPs must be incorporated through the Registrar of Companies.\(^{97}\)

It is possible for an investment fund incorporated as an LLP to constitute a CIS under Section 235 FSMA in circumstances where the investors do not have control over the day-to-day management of the property of the LLP.\(^ {98}\) In practice, this will depend upon how the LLP is established and operates. Unlike limited partnerships, every member of the LLP is

---

\(^{95}\) Section 6A(2)(i) LPA 1907 (amended by the PFLP Order).

\(^{96}\) Section 1(2) Limited Liability Partnerships Act 2000. As such, they may hold property and enter into contracts in their own name.

\(^{97}\) Section 3 Limited Liability Partnerships Act 2000.

\(^{98}\) LLPs are specifically excluded from being able to take advantage of the general exclusion for bodies corporate in Paragraph 21 of the Schedule to the Collective Investments Schemes Order.
capable of being involved in its day-to-day operation. Similarly, FCA guidance confirms that it is possible for LLPs to fall within the definition of an AIF under the AIFMD.\textsuperscript{99} In such cases, the appropriate FCA authorisation will be required.

### iii Alternative investment funds

The UK implementation of the AIFMD, by means of the Alternative Investment Fund Managers Regulations 2013 (AIFM Regulations),\textsuperscript{100} has resulted in a further regulatory category for investment funds: alternative investment funds (AIFs). An AIF is a collective investment undertaking\textsuperscript{101} that raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and that is not a UCITS scheme.\textsuperscript{102}

Like UCITS schemes, AIFs are not a separate type of investment vehicle. Rather, the AIFMD regime constitutes a further layer of regulation applicable to managers of investment funds that meet the definition above. An AIF can be open-ended or closed-ended, and constituted in any legal form, including under a contract, by means of a trust or under statute.\textsuperscript{103} This broad definition of AIF means that many of the categories of investment fund described above and below fall within its scope, including authorised CISs that are NURSs or QISs, investment trusts, hedge funds, real estate funds and private equity funds. The majority of pension funds (unless they are co-investing with other pension funds) and all insurance funds are excluded. Where a fund does constitute an AIF, the fund itself will remain regulated in the manner set out above, but the manager of such a fund will be regulated pursuant to the AIFMD (although some obligations may indirectly affect the way in which the manager operates AIFs).

Although the implications of the AIFMD for AIFs themselves may be relatively minor, the impact on alternative investment fund managers (AIFMs) is far greater. An AIFM is defined as a legal person, the regular business of which is managing one or more AIFs.\textsuperscript{104} Managing an AIF means performing at least risk management or portfolio management for the AIF.\textsuperscript{105} The AIFM may be an external manager or, if the legal form of the AIF permits internal management, the AIF itself.\textsuperscript{106}

The various requirements of the AIFMD have been incorporated into the UK regulatory regime through the AIFM Regulations and changes to FCA rules and guidance, including the introduction of the Investment Funds Sourcebook (FUND). There is a degree of overlap, in that managers of NURSs and QISs who are authorised as AIFMs must refer to the new Sourcebook as well as to COLL. Where there is a conflict between a rule implementing the

\begin{itemize}
  \item \textsuperscript{99} The FCA’s Perimeter Guidance Manual (PERG) 16.2, question 2.2.
  \item \textsuperscript{100} SI 2013/1773.
  \item \textsuperscript{101} PERG provides further guidance on the definition of a collective investment undertaking. Broadly, the following characteristics should, if all apply, show that an undertaking is a collective investment undertaking: it does not have a general commercial or industrial purpose; it pools together capital raised from its investors with a view to generating a pooled return; and the investors, as a collective group, have no day-to-day discretion or control.
  \item \textsuperscript{102} Regulation 3(1) AIFM Regulations.
  \item \textsuperscript{103} Regulation 3(2) AIFM Regulations.
  \item \textsuperscript{104} Regulation 4(1) AIFM Regulations.
  \item \textsuperscript{105} Regulation 4(2) AIFM Regulations.
  \item \textsuperscript{106} Regulation 4(3) AIFM Regulations.
\end{itemize}
AIFMD and another rule in the FCA Handbook, the AIFMD requirements will prevail.\textsuperscript{107} The AIFMD Level 2 Regulation,\textsuperscript{108} which is directly applicable in the UK, contains further detailed requirements relating to certain matters, including the calculation of assets under management and leverage, transparency and operating conditions.

\textbf{Authorisation}

An AIFM must be authorised under Part 4A FSMA to carry on the regulated activity of managing an AIF. To be authorised under Part 4A, the AIFM must comply with a number of obligations, including the following:

\begin{itemize}
  \item[a] an initial capital requirement.\textsuperscript{109} For an internally managed AIFM, this is at least €300,000, while an external manager must have initial capital of at least €125,000, plus an additional amount of capital calculated on the basis of its assets under management.\textsuperscript{110} Most asset management companies already hold substantial capital pursuant to the relevant EU capital requirements rules;\textsuperscript{111} however, this was a new requirement for private equity funds;\textsuperscript{112}
  \item[b] the AIFM must be the only AIFM of each AIF it manages;
  \item[c] the persons who conduct the business of the AIFM must be of sufficiently good repute and sufficiently experienced; and
  \item[d] the shareholders or members of the AIFM must be suitable taking into account the need to ensure prudent management.
\end{itemize}

The AIFMD allows for managers of portfolios of AIFs the value of whose assets under management does not exceed €100 million, or €500 million where each managed AIF is unleveraged and has a lock-in period of five years (small AIFMs),\textsuperscript{113} to be subject to a lighter regulatory regime.

Full-scope UK AIFMs authorised under Part 4A are subject to the full requirements of the AIFMD as set out in the AIFM Regulations and FUND. Small AIFMs may also be authorised to carry out the regulated activity of managing an AIF; however, certain small AIFMs that meet the conditions in Regulation 10 AIFM Regulations need not be authorised under Part 4A and need only be registered as a small registered UK AIFM.\textsuperscript{114} Small AIFMs are not required to comply with the requirements of the AIFMD, with the exception of certain registration, reporting and notification requirements contained in Article 3 of the

\begin{itemize}
  \item[107] FUND 1.1.2.
  \item[108] Regulation 231/2013.
  \item[109] Regulation 5(3)(c) AIFM Regulations and Article 9 AIFMD.
  \item[110] Article 9 AIFMD.
  \item[111] See Section VII.ii of the European Overview chapter.
  \item[113] Regulation 9 AIFM Regulations.
  \item[114] Broadly, Regulation 10 allows for the registration of: internally managed, closed-ended investment companies (such as investment trusts); external managers of certain property funds; and managers of European social entrepreneurship funds and European venture capital funds. Schedule 8 of the Regulated Activities Order provides for small registered UK AIFMs to be excluded from the regulated activity of managing an AIF.
\end{itemize}
AIFMD. As a consequence, small AIFMs do not benefit from the AIFMD's managing and marketing passports unless they opt in to meet the full requirements of the AIFMD. A small authorised UK AIFM will also be subject to the relevant parts of the FCA Handbook.

A UK AIFM may manage a non-EU AIF that is not marketed in the EU provided that it complies with the AIFMD (with the exception of the requirements for a depositary and annual report). There must also be appropriate cooperation arrangements in place between the FCA and the supervisor in the country in which the AIF is established. Provisions requiring non-EU AIFMs to be authorised are expected to come into force when the passport becomes available (see Section III.iii).

Prudential and conduct of business requirements

AIFMs must comply with a number of conduct, organisational and prudential requirements.

In particular, AIFMs must implement adequate risk management systems, including by monitoring liquidity risks for each AIF under management and setting a maximum level of leverage. AIFMs must also have adequate procedures and policies in relation to conflicts of interest.

The most significant and controversial additions to the FCA's prudential and conduct of business rules are the AIFMD requirements relating to remuneration, delegation and depositaries. These are more restrictive than previous requirements.

AIFMs must establish, implement and maintain remuneration policies that promote effective risk management and apply to, inter alia, any senior managers and other staff whose professional activities have a material impact on the risk profiles of the AIFM or AIFs under management. There are also restrictions on the levels of remuneration paid to such staff: at least 40 per cent of variable remuneration (i.e., bonuses) must be deferred for a period of at least three to five years unless the life cycle of the AIF concerned is shorter than this period. If the bonus is particularly high, at least 60 per cent must be deferred.

In respect of delegation, there are a number of restrictions. An AIFM must notify the FCA before any delegation arrangements become effective, and the AIFM must be able to justify the delegation objectively. The AIFM must not delegate its functions to the extent that it becomes a letterbox entity, and the services provided by the delegate must be reviewed on an ongoing basis. The AIFM's liability towards the AIF and its investors is not affected by the AIFM delegating its functions to a third party or by any further sub-delegation. The meaning of letterbox entity has been the subject of considerable debate. Article 82 AIFMD Level 2 Regulation (reproduced in FUND 3.10.9) lists a number of non-exhaustive situations in which an AIFM will be deemed a letterbox entity and not the manager of the AIF.

AIFMs must appoint a single depositary for each AIF, and the assets of the AIF must be entrusted to the depositary for safekeeping. Rules and guidance relating to the use of such

---

115 These reporting requirements are contained in the FCA’s Supervision Sourcebook (SUP) 16.18.
116 FUND 3.6.3 and 3.7.
117 Senior Management Arrangements, Systems and Controls (SYSC) 10.1.
118 SYSC 19B.1.2 and 19B.1.3.
119 SYSC 19B.1.18.
120 FUND 3.10.
121 FUND 3.10.2.
122 FUND 3.11.4.
depositaries are set out in FUND 3.11. AIFMs must also ensure the proper valuation of AIF assets, conduct at least annual valuations (either internally or through an independent valuer) of the assets of each AIF and disclose the results of the valuation to investors.\textsuperscript{123}

The European Commission has proposed a revised legislative framework for prudential requirements for investment firms, set out in the proposed Investment Firms Regulation (IFR) and Investment Firms Directive (IFD). Political agreement was reached between the Council and the European Parliament in February 2019, and the texts are expected to be formally adopted later in 2019.

**Transparency and disclosure**

The AIFMD requires certain information to be made available to investors and the FCA by AIFMs. A UK AIFM must disclose specified information to investors (set out in FUND 3.2) for each AIF that it manages or markets, both prior to investment and on a periodic basis thereafter. For instance, it must disclose the investment strategy of the AIFM, a description of the AIF’s risks and risk management, and a description of all fees that are borne directly or indirectly by investors.

The AIFM must also make an annual report available to investors\textsuperscript{124} and regularly report to the FCA on the matters set out in FUND 3.4 (including the main instruments in which it is trading, its risk profile and, if the AIF employs leverage on a substantial basis, details of the level of leverage employed). Managers of private equity funds and hedge funds, among others, may have to report significantly more information to their investors under this regime than they previously had to.

**Private equity provisions**

An AIFM must notify the FCA when an AIF that it manages acquires, disposes of or holds significant holdings in a non-listed company.\textsuperscript{125} Further, when an AIF acquires, individually or jointly, control of a non-listed company, its AIFM must notify the company, the company’s shareholders and the FCA, and must make various disclosures as to the intentions of the AIF with regard to the future business of the company.

In addition, there are asset-stripping provisions whereby the AIFM must use its best efforts to prevent any distributions, capital reductions, share redemptions or the acquisition by the company of its own shares in the first two years after the AIF acquires control.\textsuperscript{126} This restriction is subject to certain qualifications; for instance, only distributions that would cause the company’s net assets to fall below the subscribed capital or that would exceed available net profits are prohibited.\textsuperscript{127} These requirements are particularly relevant to managers of private equity funds; hence, they are known colloquially as the private equity provisions.

**Marketing and passporting**

The AIFM Regulations implement the AIFMD passporting regime under which authorised EU AIFMs are able to manage and market EU AIFs to professional investors in other Member

\textsuperscript{123} FUND 3.9.
\textsuperscript{124} FUND 3.3.
\textsuperscript{125} Regulation 38 AIFM Regulations.
\textsuperscript{126} Regulation 43(1) AIFM Regulations.
\textsuperscript{127} Regulation 43(2) AIFM Regulations.
States without additional authorisation. Guidance on management and marketing passports for UK purposes is set out in the FUND, Supervision (SUP) and PERG Sourcebooks in the FCA Handbook. To exercise passport rights, a UK AIFM must meet the conditions set out in Schedule 3 FSMA, including notifying the FCA of its intention to manage or market an AIF in the EU.128 The availability of the marketing passport was originally expected to be extended to non-EU AIFs and EU AIFs managed by non-EU AIFMs in certain jurisdictions in 2015, and possibly to non-EU AIFMs wishing to market into the EU from 2018.129 However, this has since been delayed, and considering the demands of Brexit, it is not expected to be introduced in the near future.130 If the regime is extended, non-EU AIFMs will have to be authorised by their Member State of reference,131 and comply fully with the AIFMD, to take advantage of the passport.

Currently, non-EU AIFs and EU AIFs managed by non-EU AIFMs may be marketed to professional investors in the UK under the national private placement regime. To do so, an AIFM must comply with certain requirements, including notification to the FCA, and compliance with the transparency requirements and private equity provisions.132 The national private placement regime is not available to EU AIFs managed by EU AIFMs, which can now only be marketed to professional investors in accordance with the AIFMD as described above.

No changes have been made to the range of AIFs that may be marketed to the general public in the UK (including NURSs and investment trusts) and the domestic rules on the promotion of AIFs to retail investors continue to apply, but each of these must now be managed by an authorised AIFM.

IV MAIN SOURCES OF INVESTMENT

An estimated £9.1 trillion of funds were under management in the UK at the end of 2017.133 The UK is the second-largest global fund management centre, after the US, and is the largest centre of asset management in Europe, where it accounted for 35 per cent of all assets under management in 2018. Assets managed in London on behalf of European clients increased by almost 30 per cent from 2017 to 2018.134 London is the leading centre for fund management in the UK, but other large fund management centres include Aberdeen, Liverpool, Manchester, Edinburgh, Bristol, Oxford, Cambridge, Glasgow and Birmingham.

The UK fund management industry has a strong international orientation: out of the £7.7 trillion of funds under management by IA members in 2017, £3.1 trillion was managed for overseas clients, which translated to earnings representing 6 per cent of net services

128 See SUP 13.4.
129 Article 67 of the AIFMD provides the European Commission with the power to adopt a delegated act to such effect after receiving positive advice from the European Securities and Markets Authority (ESMA). Although ESMA published two pieces of advice on this subject in July 2015 and July 2016, it considers that it needs to conduct further assessments of certain jurisdictions.
130 See Section V of the European Overview chapter.
131 The Member State of reference should be determined in accordance with Article 37(4) AIFMD.
132 Regulations 57 and 59 AIFM Regulations.
134 All figures in this section are taken from the IA, Asset Management in the UK 2017–2018, The Investment Association Annual Survey, September 2018.
exports. In addition, £1.7 trillion of funds under management by IA members in 2017 was managed for overseas funds (up from £1.3 trillion at the end of 2016), of which 84 per cent consisted of funds domiciled in Ireland or Luxembourg.

Institutional clients provide the majority of funds under management in the UK, with nearly half of funds under management by IA members in 2017 managed for UK institutional clients. Within this metric, 63 per cent were managed for pension funds, and 25 per cent for insurance companies.

UK retail investor funds under management in UK authorised and recognised funds grew 15 per cent to £1.2 trillion in 2017. Of this, £147 billion was held in funds domiciled overseas. Net retail sales were £47.1 billion, of which £13.8 billion constituted sales of outcome and allocation funds, and £13.2 billion constituted fixed income funds. Equity growth sales were £10 billion, reflecting the fact that UK equity remains out of favour in the aftermath of the Brexit referendum.

V KEY TRENDS

i Asset allocation

The past 15 years have seen a gradual reduction in the allocation of funds to equity investments, an increase in investment in bonds and generally more diversification of investments. In the institutional investment industry, this trend has been influenced by a range of factors, including changing regulatory requirements, an increasing focus on liability driven investments (see Sections VI.i and ii) and a move away from volatile equity markets.

ii Concentration and consolidation

The top five fund managers by UK assets under management increased to 43 per cent of total funds under management from 39 per cent in 2015, and the top 10 managers for 58 per cent.135 Overall, the UK fund management industry remains a highly competitive environment, with considerable change outside these top 10 firms. Of the 10 largest firms, around half are now stand-alone asset management firms, with the other half comprising members of larger insurance or banking groups. This reflects a trend over recent years of stand-alone asset managers having increasing significance; in 2003, they accounted for 11 per cent of assets under management in the UK.136 There was a particularly significant increase from 2008 to 2009, reflecting a wave of divestments by banks as part of their post-2008 restructurings, such as the acquisition of Barclays Global Investors by BlackRock in June 2009.137 Merger and acquisition activity has continued in the fund management sector, with the strength of activity in recent years continuing. Notable recent large deals involving UK firms include the acquisition by Canada Life Group (UK) of Retirement Advantages, the acquisition of L&G’s mature savings business by Swiss Re and the acquisition by Amundi of Pioneer Investments.138

Corporate governance

The UK Stewardship Code (Stewardship Code) was first published by the Financial Reporting Council (FRC) in July 2010, with the aim of improving the engagement of firms who manage assets on behalf of others with the companies in which they invest. It is directed at institutional investors with equity holdings in UK listed companies, and sets out seven principles covering the monitoring of and engagement with companies on matters such as strategy, performance, risk, remuneration and corporate governance. The FRC finished consultations on a new edition of the Stewardship Code in March 2019. The proposed revised Stewardship Code includes new requirements for investors to report how their purpose, values and culture enable them to meet their obligations to clients and beneficiaries. It also refers to environmental, social and governance (ESG) factors, and expects investors to exercise stewardship across a wider range of assets where they have influence and rights (i.e., beyond listed equity). It also includes rules to promote disclosure on asset managers’ engagement and investment strategies under the Revised Shareholder Rights Directive (SRD II). The IA published the executive summary of its response to the proposed revisions to the Stewardship Code in March 2019, voicing its concerns that, among other things, the revised definition of stewardship conflicts with asset managers’ and owners’ fiduciary duties, and the Stewardship Code is excessively prescriptive and insufficiently flexible. It remains to be seen whether these issues will be addressed when the finalised Stewardship Code is published later in 2019.

The Stewardship Code is of particular significance to those pension funds that delegate investment management to others; they are expected to satisfy themselves that they have in place a process for monitoring how their asset managers apply the Stewardship Code. They are also expected to ensure that managers are adhering to a fund’s stewardship policy, and to seek to hold their managers to account for their stewardship activities.

Since 6 December 2010, UK-authorised asset managers have been required by the FCA to disclose whether they comply with the Stewardship Code. The IA has published the results of its survey on how investment managers have complied with the Stewardship Code; as of 30 September 2016, managers and owners surveyed tended to have a public policy statement on how they will discharge their responsibilities under the Stewardship Code. Of the 77 asset managers surveyed, all except two were signatories to the Stewardship Code. Around half of the 51 asset owners surveyed were also signatories. In particular, asset managers noted that a large majority of their institutional clients expect them to exercise stewardship. A further survey published in November 2018 found that all respondents (59 asset managers) except one were signatories to the Stewardship Code. The FRC published a new edition of the UK Corporate Governance Code in July 2018, with revisions aligned with those in the 2019 Stewardship Code. In June 2011, the government established the Kay Review, which was tasked with reviewing the operation of the UK equity markets and their impact on the long-term performance and governance of UK quoted companies. The final report, published in July 2012, stated that asset managers have become the dominant player in the investment chain, and the appointment and monitoring of asset managers is too often

---

144 FRC, The UK Corporate Governance Code, July 2018.
based on short-term relative performance.\textsuperscript{145} The report recommended that asset managers should contribute more to the performance of businesses through greater involvement in the companies in which they invest, and suggested that the Stewardship Code should be developed to incorporate a more expansive form of stewardship, encompassing strategic issues as well as corporate governance.\textsuperscript{146} In line with this recommendation, the 2012 edition of the Stewardship Code emphasised that stewardship should include matters of company strategy, and this is expected to be continued in the 2019 edition of the Code. The report also recommended that all participants in the investment chain, including asset managers, should be subject to fiduciary standards in relation to their clients, which should not be overridden by contractual terms in investment management agreements. In October 2014, the Department for Business, Innovation and Skills reported on the UK’s progress in implementing the Kay Review recommendations. It noted that good progress had been made, and that initiatives were in place to encourage effective shareholder engagement and stewardship investment, improve the quality of reporting and dialogue in the investment chain, and build trust-based relationships and align incentives through the investment chain.

iv The Retail Distribution Review

In June 2006, the FSA launched a review of retail distribution in the UK with the aim of helping consumers to achieve a fair deal from the financial services industry, and to have confidence in the products they buy and the advice they take.

The rules implementing the outcomes of the Retail Distribution Review came into effect on 31 December 2012, and apply to all advisers in the retail investment market, regardless of the nature of firms. The rules aim to improve clarity for investors and reduce the conflicts of interest that previously arose from the remuneration of financial advisers. They prevent commission payments, and require advisory firms to disclose explicitly and charge clients separately for their services. Firms are also required to describe their advisory services clearly as either independent or restricted. In addition, the rules require individual advisers to adhere to consistent professional standards.\textsuperscript{147}

v The Fair and Effective Markets Review

In June 2014, the Chancellor of the Exchequer and the Governor of the Bank of England launched a review aimed at reinforcing confidence in the wholesale fixed income, currency and commodities (FICC) markets: the Fair and Effective Markets Review.

The final report of the Fair and Effective Markets Review, published on 10 June 2015, set out 21 recommendations to promote fairer FICC market structures while also enhancing effectiveness. A further implementation report was published on 28 July 2016.

The recommendations also include extending the senior managers and certification regime to cover a wider range of firms that are active in FICC markets. The report notes that this would include: MiFID investment firms, including asset managers and interdealer brokers; hedge funds under the AIFMD; and fund managers under the UCITS Directive. The government has implemented this change via the Bank of England and Financial Services

\textsuperscript{146} ibid., p. 45.
United Kingdom

Act 2016, which makes provision for the extension of the senior managers and certification regime to all UK authorised firms (including the asset management firms mentioned above). The FCA published near-final rules in July 2018.\textsuperscript{148}

\textbf{vi The asset management market study}

In November 2015, the FCA launched the asset management market study, a review of the asset management sector, with a view to understanding how the retail and institutional asset management sector works for investors. The FCA published an interim report in November 2016, followed by its final report, together with a further consultation on implementing certain conclusions of the study in June 2017.\textsuperscript{149}

In its final report, the FCA stated that it had concerns about weak price competition in the asset management sector, particularly in relation to active mandates for retail clients, in respect of which it concluded that price competition is not working as effectively as it could be. The FCA also considered whether there is a relationship between fund performance and the level of fees charged by managers, and concluded that both actively managed funds and passive funds – for retail and institutional investors – failed to perform like active managers. Additionally, the regulator noted that it had concerns about how managers communicate investment objectives with their clients, particularly in relation to retail investors. Finally, the FCA voiced concerns about the role of investment consultants and other intermediaries in the asset management sector, particularly in relation to competition among investment consultants.

The FCA proposed certain remedies to the issues it identified in its final report. One of those remedies included proposals to strengthen the duty of asset managers to act in the best interests of their clients, and a proposal for consultations on requiring managers to return certain box profits to their funds and making it easier for managers to switch investors to cheaper share classes. Other measures were aimed at increasing price competition in the asset management sector, including the FCA restating its support of the disclosure of an ‘all-in’ fee to investors, and the consistent and standardised disclosure of costs and charges to institutional investors. The FCA also stated that it would make a reference to the Competition and Markets Authority (CMA) to develop the FCA’s investigation to date into the investment consultant and fiduciary management sector. The CMA launched a market investigation into investment consultants on 14 September 2017, which culminated in the publication of a final report in December 2018 and a package of reforms, including a recommendation to HM Treasury to broaden the FCA’s regulatory scope to include the activities of investment consultants.\textsuperscript{150}

In April 2018, the FCA finalised a number of the proposed remedies outlined in its final report, including measures to improve fund governance.\textsuperscript{151} The proposed measures focus on the duty to act in the best interests of clients, in line with the FCA’s final report, and include rules that will require AFMs to carry out an assessment of whether funds managed

\textsuperscript{148} FCA PS 18/14, Extending the Senior Managers and Certification Regime to FCA firms – Feedback to CP17/25 and CP17/40, and near-final rules.
\textsuperscript{149} FCA CP17/18, Consultation on implementing asset management market study remedies and changes to Handbook.
\textsuperscript{150} CMA, Investment Consultants Market Investigation, Final Report, 12 December 2018.
\textsuperscript{151} FCA, Policy Statement PS18/8, Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CO17/18, April 2018.
by them will deliver value to investors. AFMs will then have to publish an annual statement assessing this value, either in the fund’s annual report or in a separate report. Additionally, the new rules will make it easier for AFMs to move investors to cheaper but otherwise identical classes of the same fund by removing the need for an AFM to seek consent from each investor before converting them to a different share class. In February 2019, the FCA also set out final rules that require AFMs to explain why they have used a benchmark in a fund’s prospectus and other consumer-facing communications that include fund-specific information and that, where an AFM describes a fund’s past performance, it should describe such performance against the relevant benchmark. The new rules also include requirements relating to how performance fees are calculated, and disclosure of fund objectives and investment policies.

vii Responsible and sustainable investment

Growing concerns around the impact of climate change, along with increased scrutiny surrounding equality and diversity, has resulted in a marked growth of interest in responsible and sustainable investment, with an apparent increased integration of ESG factors across asset managers’ strategies.

On climate change in particular, there has been a hive of activity in recent years. In 2017 the Financial Stability Board’s Task Force on Climate-Related Financial Disclosures (TCFD) developed voluntary, climate-related financial risk disclosures, with the aim of providing decision-useful information to companies’ stakeholders. In the UK, there has also been growing interest in climate-related financial risks among its regulatory bodies. In 2018, the FCA published a discussion paper on climate change and green finance, which considers, among other things, a ‘comply or explain’ approach to the TCFD’s disclosures. And in April 2019, the PRA and FCA hosted the first meeting of the Climate Financial Risk Forum, bringing together representatives from across the financial sector, including asset managers, in order to share best practice and produce practical guidance to further the financial sector responses to the financial risks from climate change.

VI SECTORAL REGULATION

i Insurance

The UK insurance industry is the largest in Europe and the fourth-largest in the world. It contributes significantly to the UK economy, managing investments of over £1.8 trillion and paying nearly £12 billion in taxes to the government. UK insurance funds totalled over £1.1 trillion in 2016, which represented close to 13 per cent of funds under management in the UK. Around 55 per cent of insurance companies’ assets are managed by in-house asset management subsidiaries. The remaining funds are outsourced to third-party asset management firms, although third-party management is increasing.

In terms of asset allocation, the proportion of UK quoted shares held by insurance companies was estimated at 4.9 per cent at the end of 2016, continuing the fall seen in recent years and the lowest percentage since 1963 (when records began). This decrease reflects

155 TheCityUK, UK Fund Management. April 2018.
a move from investment in equities to bonds and alternative investments, and for greater
diversification overseas. This trend is partly attributable to the relative under-performance
of stocks. Insurers may also have been pushed to become more cautious by solvency
requirements. Asset allocation may be further affected by recent changes to the regulatory
regime. In particular, the transposition of the European Solvency II Directive (Solvency II),
which came into effect on 1 January 2016, is likely to have an impact on the way in which
asset managers invest insurance assets, as certain asset classes now attract higher capital
charges than others.

Insurers are dual-regulated, in that they are subject to prudential regulation by the PRA
and are regulated by the FCA in respect of conduct of business. The investment of insurers’
assets is subject to restrictions arising from the prudential regulatory regime for insurers, which
in the UK is set out in the PRA Rulebook. The PRA Rulebook reflects, and expands upon,
the requirements of various European directives. The Solvency II Regulations were made
on 6 March 2015, making a number of amendments to the FSMA and other primary and
secondary legislation. Alongside these changes, the PRA and the FCA have made a number
of amendments to their respective rules to reflect the changes required by Solvency II. These
amendments came into force on 1 January 2016. In addition, insurers are subject to directly
applicable regulations adopted by the European Commission pursuant to Solvency II.

The requirements of the relevant European directives have been supplemented and
elaborated on in the UK regulatory regime. Aspects of the UK regulatory regime that may
affect investments made by insurers include the permitted links regime and requirements that
apply to with-profits business.

The permitted links regime

Rule 21.3.1 of the FCA’s COBS Sourcebook stipulates that insurers are not permitted to
provide benefits under linked long-term contracts of insurance that are determined by
reference to fluctuations in any index that is not an approved index, or by reference to the
value of, income from, or fluctuations in the value of, property, other than property that is on
the list of permitted links set out in COBS 21.3.1(2). Under Solvency II, the UK has preserved
the permitted links regime, but has amended it to meet the Solvency II requirements that it
can only apply where the direct investment risk is borne by a policyholder who is a natural
person (e.g., a defined contribution pension scheme member) and that it must not be more
restrictive than the regime for CISs under the UCITS Directive. As a result of this, the list of
permitted links has been extended to include approved money market instruments. Insurers
offering linked policies to policyholders that are not natural persons now fall outside the rule
in COBS 21.3.1 and so are able to link benefits to any type of asset as long as they continue
to comply with relevant prudential requirements.

Under the new Solvency II regime, insurers are allowed to use derivatives to cover their
technical provisions in respect of linked business without being subject to the requirement

---

158 Directive 2009/138/EC.
159 SI 2015/575.
160 Principally an index that is calculated independently, transparently and based on constituents that are
permitted links.
161 See FCA, Policy Statement PS15/8, Solvency II, March 2015 and FSA, Consultation Paper CP11/23,
Solvency II and linked long-term insurance business, November 2011.
that derivatives are held only for the purpose of efficient portfolio management or reduction of investment risks, unless the assets are held in respect of any guarantee of investment performance or other guaranteed benefit provided under the linked long-term contract of insurance.\textsuperscript{162} However, any use of derivatives will still need to satisfy the prudent person principle more generally.

**With-profits business**

A peculiarity of the UK regulatory regime for insurance is the additional layer of requirements for with-profits funds (long-term insurance funds in which policyholders are eligible to participate, broadly, in any excess of assets over the liabilities of the fund). Additional conduct of business rules, set out in COBS 20, apply to the management of these funds, and additional prudential requirements are set out in the With-Prosits part of the PRA Rulebook for both Solvency II and non-Solvency firms. Under Solvency II, additional conduct requirements, but not additional prudential requirements, continue to apply to in-scope firms.

**ii  Pensions**

Occupational pension schemes do not fall within the scope of the MiFID regime and are not CISs under FSMA; however, the investment of fund assets is generally delegated to an external fund manager who is likely to be subject to those regulations. The investment of the assets of occupational pension schemes is, however, subject to restrictions in the Pensions Act 1995 (as amended by the Pensions Act 2004) and the Occupational Pension Schemes (Investment) Regulations 2005 (the Pension Schemes Regulations).

Subject to any restriction in a scheme’s trust deed and rules, pension scheme trustees have the power to invest the scheme’s assets as if absolutely entitled to those assets and to delegate investment management to a fund manager, provided that manager is either authorised or exempt for the purposes of the general prohibition in the FSMA.\textsuperscript{163} Trustees will not be responsible for the acts or default of a fund manager provided they take reasonable steps to satisfy themselves that the manager has appropriate knowledge and experience for managing the investments of the scheme, and carries out his or her work competently and in compliance with provisions governing his or her investment choices.\textsuperscript{164} The trustees must ensure that a statement of investment principles (a written statement of the principles governing decisions about investments for the purposes of the scheme) is prepared and revised on a regular basis.\textsuperscript{165} The statement must cover various matters, including the trustees’ policies in relation to:

\begin{itemize}
  \item[a] the kinds of investments to be held;
  \item[b] the balance between different kinds of investments;
  \item[c] risks, including the ways in which risks are to be measured and managed;
  \item[d] the expected return on investments;
  \item[e] the realisation of investments; and
\end{itemize}

\textsuperscript{162} Investments 5.1 and 5.2 of the PRA Rulebook for Solvency II firms.

\textsuperscript{163} See Section II.i.

\textsuperscript{164} Section 34 Pensions Act 1995.

\textsuperscript{165} Section 35 Pensions Act 1995 (as amended by the Pensions Act 2004). Regulation 2(1) of the Occupational Pension Schemes (Investment) Regulations 2005 specifies that the statement of investment principles should be reviewed at least once every three years, and in any event following any significant change in investment policy.
the extent (if any) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.\textsuperscript{166}

Where trustees make investment decisions (rather than delegating to a fund manager), they are also required to obtain and consider proper advice as to whether a particular investment is satisfactory, having regard to the requirements of the Pension Schemes Regulations and the statement of investment principles. If the provision of the investment advice constitutes a regulated activity for the purposes of Section 19 of the FSMA, proper advice must be given by a person entitled to give it (i.e., by an authorised or exempt person).\textsuperscript{167}

Regulation 4 of the Pension Schemes Regulations sets out the manner in which trustees’ investment powers in relation to a scheme’s assets must be exercised and the restrictions on the assets in which trustees can invest. The scheme’s assets must be invested in the best interests of the members and beneficiaries.\textsuperscript{168} Investment powers must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio, and assets must be properly diversified so as to avoid accumulations of risk in the portfolio as a whole.\textsuperscript{169} Scheme assets must consist predominantly of investments admitted to trading on regulated markets, and investments in assets that are outside of this category must be kept to a prudent level.\textsuperscript{170} In addition, derivative instruments may only be used to the extent that they contribute to a reduction of risks or facilitate efficient portfolio management.\textsuperscript{171}

The requirement for scheme assets to consist predominantly of investments admitted to trading on a regulated market does not prevent a pension scheme from holding investments in investment funds as it is permissible to look through investments held in a CIS to the underlying assets.\textsuperscript{172} In addition, pension schemes are not restricted from investing in qualifying insurance policies,\textsuperscript{173} such as annuities, which are treated as investments on a regulated market and, to the extent that the assets of a scheme consist of such policies, they are deemed to satisfy the requirement for proper diversification.\textsuperscript{174}

There is a further requirement for defined benefit pension schemes in Regulation 4(4), which prescribes that the assets held to cover a scheme’s technical provisions (i.e., the value of the scheme’s defined benefit liabilities) must be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme.

The major trend in pension fund investment over the past two decades has been a fall in the proportion invested in equities. A number of factors are likely to have contributed to this trend. In addition to the stock market downturn of 2000 to 2003, and the Myners Report of 2001 (which recommended an increased focus on strategic asset allocation), investment strategies have been influenced by the closure of defined benefit schemes to new members and their consequent maturation, and by the introduction of new accounting standards. Many defined benefit schemes, established in the 1950s and 1960s, are now in maturity, and their fund managers have sought to de-risk and pursue more liability-driven investment strategies.

\textsuperscript{166} Regulation 2(3) Occupational Pension Schemes (Investment) Regulations 2005.
\textsuperscript{167} Section 36 Pensions Act 1995.
\textsuperscript{168} Regulation 4(2) Occupational Pension Schemes (Investment) Regulations 2005.
\textsuperscript{169} Regulation 4(3) and (7) Occupational Pension Schemes (Investment) Regulations 2005.
\textsuperscript{170} Regulation 4(5) and (6) Occupational Pension Schemes (Investment) Regulations 2005.
\textsuperscript{172} Regulation 4(9)(a) Occupational Pension Schemes (Investment) Regulations 2005.
\textsuperscript{173} As defined in the Occupational Pension Schemes (Investment) Regulations 2005.
\textsuperscript{174} Regulations 4(9)(b) and 4(10) Occupational Pension Schemes (Investment) Regulations 2005.
where the assets invested in are matched to the fund’s liabilities to its members. The FRS17 accounting standard, introduced in 2001 and mandatory from January 2005, states that pension schemes’ funding positions must be recognised on company balance sheets, meaning that a company’s pension scheme deficit would affect its financial results. FRS102, which is mandatory for accounting periods beginning on or after 1 January 2015, also contains this requirement.

As the number of active members in defined benefit schemes has fallen, contributions to defined contribution (or money purchase) schemes have risen, and their importance will continue to increase as they replace the closing defined benefit schemes. During 2012, the government introduced reforms to enrol employees into employee pension schemes automatically, with the ability to opt out, in contrast to the previous system, which enabled employees to opt in to their employer’s pension arrangements if any such arrangements were available. This has, according to the Pensions Policy Institute, made a ‘phenomenal change to pensions landscape’ in the United Kingdom, and could lead to the number of people saving in private sector pension schemes increasing to up to 14.5 million by 2030, with up to £495 billion in defined contribution assets (as against a forecast of six million savers and £350 billion in defined contribution assets without automatic enrolment).

Further significant reforms came into force in April 2015, which included removing the requirement for savers with ‘money purchase’ schemes to purchase an annuity, thereby increasing the flexibility for individuals when they draw their benefits on retirement. New governance requirements for trustees of defined contribution schemes and restrictions on charges in those schemes were also introduced in April 2015. In its 2014 budget, the government announced plans to introduce legislation to allow new pension scheme products in the UK based on the ‘collective defined contribution’ scheme model, in which investment of savers’ individual funds is pooled to facilitate the sharing of risk and generate economies of scale. However, the legislation providing for this has not yet come into force.

On 18 June 2018, the Department for Work and Pensions published a response to the Law Commission’s report on social impact investing. The response also announced the launch of its consultation to clarify and strengthen trustees’ investment duties. From 1 October 2019, trustees will be required, among other things, to update their statement of investment principles to clarify how they take account of financially material considerations, including: ESG issues such as climate change; their policies on the stewardship of investments; and a statement on how they will take account of members views of, for example, ESGs. The government considers that these new policies align with the FCA’s proposed changes in relation to regulated pension fund activities.

---


176 Section 28: Employee Benefits.


178 Law Commission, Pension Funds and Social Investment, June 2017.

iii Real property

Background

Traditionally, UK commercial property has often been held through various offshore vehicles, including Jersey property unit trusts, to take advantage of favourable offshore tax treatment. It is also common for investors to hold property through UK listed property companies (in addition to unit trusts) that allow pooling of assets to overcome cost-related barriers to entry into the property market, and to take advantage of a lower rate of stamp duty levied on transactions involving shares than is payable in respect of direct transactions involving real property. However, investing in this manner puts shareholders at a disadvantage when compared with investing directly in property because of the possibility of double taxation.

Real estate investment trusts

Since 2007, it has been possible in the UK to establish real estate investment trusts (REITs), which, like other investment trusts, are actually companies that invest specifically in real estate and receive an advantageous tax treatment in that profits and gains arising from the company’s property rental business are exempt from corporation tax. In order to obtain this tax treatment, a number of detailed conditions have to be fulfilled and notice must be given to HMRC. These conditions include requirements that the REIT distributes at least 90 per cent of the profits from its real estate investment business and that the REIT’s ordinary share capital is listed or admitted to trading (and is actually trading) on a recognised stock exchange. The latter requirement is satisfied if the shares are traded on the Alternative Investment Market (AIM) of the London Stock Exchange or a similar recognised stock exchange overseas. REITs must also be widely held, unless they are owned by certain ‘institutional investors’ such as pension funds.

The British Property Federation website listed 51 UK REITS as of June 2019. Data published by the Property Industry Alliance (PIA) indicates that in 2016, UK REITs and listed property companies together held commercial property valued at £74 billion (as compared to £65 billion in 2014).

UK REITs are not CISs for the purposes of the definition in Section 235 FSMA; however, they may be AIFs. The FCA has indicated that a REIT is a concept used for tax purposes, and so there is no presumption as to whether a REIT is an AIF: this will be considered on a case-by-case basis.

Property authorised investment funds

Since 6 April 2008, it has also been possible to establish a property authorised investment fund (PAIF) in the UK to act as a tax-efficient vehicle for a property investment business. In contrast to REITs, PAIFs do not need to be listed or traded on a recognised stock exchange,
but they must be structured as OEICs, meaning that they do not benefit from the exemption from the definition of CISs available to other bodies corporate, and must therefore be authorised by the FCA.

To constitute a valid PAIF a number of detailed conditions have to be fulfilled and the fund manager must have given notice to HMRC for the PAIF rules to apply. Once an OEIC comes within the ambit of the regime, it benefits from favourable corporation tax treatment relating to its property investment businesses.

iv Hedge funds

As hedge funds are typically located in offshore jurisdictions (largely owing to the favourable tax treatment that can be obtained in those territories), there are relatively few UK-based hedge funds. However, London is the second-largest global centre for hedge fund managers (after New York). In practice, the regulation of hedge funds under English law has therefore tended to focus on the managers themselves, rather than the fund entities, which tend to be beyond the UK’s jurisdictional reach. All hedge fund managers, like other investment managers, are likely to be undertaking activities that constitute a regulated activity for the purposes of the FSMA and the Regulated Activities Order.186 As a result, they must have the necessary FCA authorisations to carry out such activities.

Certain funds that invest in underlying hedge funds (funds of funds) may be based in the UK and may be listed on the London Stock Exchange as investment trusts. As discussed earlier, investment trusts are not CISs for the purposes of the FSMA and do not require FCA authorisation themselves. Nonetheless, the investment manager of an investment trust will still need to be authorised. The advantage of a UK-listed fund of funds is that it can provide an indirect route to investment in multiple underlying hedge funds while still requiring adherence to the continuing obligations and reporting requirements contained in the UK Listing Authority’s Listing Rules.

In the past, the FSA (predecessor to the FCA) took the view that hedge fund managers, by virtue of managing offshore funds, have a low impact on the UK financial markets and represent little risk to UK retail investors.187 The FSA therefore made a conscious decision not to allocate a large amount of its supervisory resources to hedge fund managers. However, in recent years the regulator has become increasingly interested in the activities of hedge funds, and the potential systemic risks posed by such funds, particularly as counterparties to trades with financial institutions and others within the financial markets.188 The risks associated with hedge funds are reviewed on an ongoing basis, and the FCA has significantly increased its scrutiny of the hedge fund industry, including through enforcement action taken against hedge fund managers and their staff.

UK regulation of hedge funds is also led by the overarching provisions introduced by EU legislation such as the AIFMD. There has been recent growth in the number of UCITS-compliant hedge funds,189 the managers of which will not be required to comply

186 For example, such managers are likely to be managing investments under Article 37 of the Regulated Activities Order, advising on investments under Article 53 of the Regulated Activities Order or managing an AIF under Article 51ZC of the Regulated Activities Order.
188 See, for example, FSA, Accessing the possible sources of systemic risk from hedge funds – a report on the findings of the FSAs Hedge Fund Survey and Hedge Fund as Counterparty Survey’, February 2012.
189 The CityUK, Hedge Funds, May 2013.
with the AIFMD but will nevertheless likely require FCA authorisation for carrying out regulated activities as described above. Non-UCITS hedge funds are likely to fall within the definition of AIFs; the managers of such funds, as AIFMs, are subject to the requirements of that regime.

In 2008 the Standards Board for Alternative Investments (SBAI) (the Hedge Fund Standards Board, as it then was) was established to act as an industry body to represent hedge funds and to improve standards across the hedge fund industry. The SBAI publishes the Hedge Fund Standards, which are designed to encourage greater transparency and more effective governance across the hedge fund sector in an attempt to pre-empt the requirement for greater regulation and legislative intervention. Funds that adopt the Hedge Fund Standards are required to adhere to a ‘comply or explain’ regime, ensuring that certain information is disclosed to investors about how the standards have been complied with, or why certain requirements have otherwise not been met or are not appropriate in the context of a particular fund. As of August 2018, 130 hedge fund managers with combined assets under management of over US$1 trillion had committed to the Hedge Fund Standards.

v Private equity

In the UK, private equity firms typically use limited partnerships as investment vehicles to take advantage of their tax-transparent nature and their lower disclosure requirements as compared with limited companies or LLPs. The limited partners in the partnership are typically the institutional investors in the private equity fund, while the private equity firm will usually act as the general partner and will therefore be responsible for the day-to-day management of the partnership’s activities.

The UK is the largest and most developed private equity centre in Europe, second in size globally only to the US. Fundraising in the private equity sphere has improved significantly in recent years, with 2017 being the fifth consecutive year in which private capital fundraising surpassed the US$300 billion mark. Prequin, the alternative investment industry analyst, has noted that prices for assets have been at the forefront of investors’ and fund managers’ minds, although this did not affect the strong fundraising levels. A keynote address by Johannes Huth of KKR in the 2018 Prequin report noted that the UK’s decision to leave the European Union unleashed considerable volatility in the sterling exchange rate, and the full consequences of this event are yet to play out, with one particular concern being that the UK has a substantial current account deficit, meaning it is more vulnerable to shocks as compared with the eurozone, which currently has a current account surplus. However, it remains to be seen to what extent the UK’s exit from the EU will have a significant impact on private equity fundraising or investment in the UK.

There have been some initiatives in recent years to improve the transparency of the private equity industry in the UK in order to address criticism that the activities of private equity funds are opaque and to counteract the perception that they are insufficiently regulated. In November 2007, the Walker Guidelines were introduced to encourage improved

---

190 ibid.
193 TheCityUK, UK Fund Management, April 2018.
195 ibid.
These voluntary guidelines recommend that private equity firms that meet certain specified criteria should publish annual reviews or regular updates on their websites containing information about their investment approaches and portfolios. In addition, the Walker Guidelines state that private equity firms should provide various performance data on a confidential basis to an independent third party appointed by the British Private Equity and Venture Capital Association (BVCA) in an effort to encourage increased transparency about the overall private equity industry. As a result of a consultation by the Walker Guidelines Monitoring Group, the Walker Guidelines were amended in July 2014 to enhance the reporting requirements therein to include the information required by the Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013.

In September 2009, the Institutional Limited Partners Association (ILPA) published its first set of private equity principles with the aim of encouraging improvements in private equity practice by furthering the relationship between general partners and limited partners for the long-term benefit of participants in the industry. A revised set of principles was subsequently released in January 2011 following feedback from industry participants. The ILPA principles encourage a greater focus on transparency, governance, and the alignment of interests between private equity managers and their investors.

Traditionally, private equity has been a relatively lightly regulated area of asset management in the UK although, in common with other asset management entities, private equity firms have required FCA authorisation if they are undertaking regulated activities specified in the Regulated Activities Order. This relatively relaxed treatment changed, however, following the implementation of the AIFMD, as managers of private equity funds fall within the scope of the regime. The private equity industry has voiced concerns over the potential impact of the AIFMD on private equity activities. The rules on remuneration are likely to have an impact on policies at private equity firms, particularly in relation to the requirements for deferred remuneration. Furthermore, the private equity provisions (intended to limit asset-stripping of companies) may interfere with some of the usual funding structures adopted by private equity funds, potentially restricting corporate reorganisations and targeted disposals of parts of a target company’s business.

197 Under the Walker Guidelines, a private equity firm is defined as ‘a firm authorised by the FSA that is managing or advising funds that either own or control one or more UK companies or have a designated capability to engage in such investment activity in the future where the company or companies are covered by the enhanced reporting guidelines for portfolio companies’. In turn, a portfolio company is defined as ‘a UK company (a) acquired by one or more private equity firms in a public to private transaction where the market capitalisation together with the premium for acquisition of control was in excess of £300 million, more than 50 per cent of revenues were generated in the UK and UK employees totalled in excess of 1,000 full-time equivalents; [or] (b) acquired by one or more private equity firms in a secondary or other non-market transaction at enterprise value at the time of the transaction is in excess of £500 million, more than 50 per cent of revenues were generated in the UK and UK employees totalled in excess of 1,000 full-time equivalents’.
199 See, for example, the statement by Simon Walker, Chief Executive of the BVCA, on the AIFMD on 26 October 2010, in which he referred to the AIFMD as a ‘defective Directive’, and argued that the EU had taken a ‘hostile interest in the wrong industry at the wrong time and for the wrong reasons’.
Managers of certain venture capital funds may benefit from the European Venture Capital Funds Regulation (VCF Regulation).\(^{200}\) The VCF Regulation applies to managers of collective investment undertakings (other than UCITS schemes) that are established in the EU, are registered in their home Member State in accordance with the AIFMD and manage portfolios of qualifying venture capital funds. Generally, the VCF Regulation applies to managers of collective investment undertakings with assets under management that do not exceed €500 million in total. Such managers may use the European venture capital fund designation if they meet a number of conditions. The VCF Regulation introduces a marketing passport, which can be used to market funds with European venture capital status to EU investors, subject to complying with certain requirements. This allows managers of qualifying funds to benefit from cross-border marketing without having to comply with the full requirements of the AIFMD.

vi Other sectors

**Sovereign wealth funds**

While the UK does not operate a sovereign wealth fund (SWF) of its own, London remains a popular location for foreign SWFs to establish branches to pursue their investment activities, and the government has generally sought to encourage foreign direct investment into the UK. Continuing on from a period of sustained growth in SWF investment in the UK during the economic downturn, the assets under management of SWFs increased by 19 per cent in 2016 to a record US$7.4 trillion.\(^{201}\)

There is no specific regulatory regime that applies to foreign investment by SWFs in the UK; instead, the position is regulated by general provisions in domestic and EU law that may permit review of proposed transactions in certain defined circumstances that are of general application. For example, an acquisition of UK assets is always liable to review under the merger control regimes established under the Enterprise Act 2002 or by the EC Merger Regulation\(^ {202}\) if there are concerns that the transaction would result in a significant reduction in competition in a particular market. It is also possible for the government to intervene in certain circumstances where the investment involves issues of special public interest – for example, where a transaction might have an adverse effect on media plurality by concentrating control of the supply of newspapers or provision of broadcasting.\(^ {203}\) Subject to the range of specific requirements, however, there is no other overriding rule that requires approval for foreign direct investment in the UK.

**Exchange-traded funds**

Exchange-traded funds (ETFs) are passively managed open-ended funds that are listed and traded on a stock exchange. The fund’s trading price is linked to the net asset value of the underlying assets, and typically tracks the performance of an index such as the FTSE 100. The key characteristics of an ETF are that it is tradeable, and that it offers simple exposure

---

200 Regulation 345/2013.
201 TheCityUK, UK Fund Management, April 2018.
203 Section 59 Enterprise Act 2002.
to a more complex underlying asset or index. ETFs are popular with investors as they have lower operating expenses than actively managed funds and a transparent structure (as a listed company), and are tax-efficient. In the UK, ETFs are OEICs.

ETFs have performed well in recent years, venturing into emerging markets, real estate, infrastructure, private equity and hedge funds, such that the assets under management of ETFs grew to US$4.3 trillion in the third quarter of 2017. Following a Federation of Small Businesses report on ETFs in April 2011, which highlighted the potential risks of the rapid increase in value of the ETF industry, European regulators have begun to focus attention on these structures. ESMA published revised consolidated guidelines on ETFs and other UCITS-related issues in August 2014, and an updated questions and answers paper on ETFs and other UCITS-related issues in February 2016. The FCA has incorporated ESMA’s guidelines into the COLL Sourcebook.

**Venture capital trusts**

The venture capital trusts (VCTs) scheme was introduced in the UK in April 1995 as a means of encouraging individual investors to support higher-risk unlisted start-up companies through providing certain reliefs for such investors from UK income and capital gains tax. VCTs, like investment trusts, are not trusts, but companies that are admitted to trading on a regulated market in the EU. They invest in securities issued by small unquoted trading companies for which there is no liquid market. VCTs help mitigate this investment risk for investors by spreading their investments across a range of such companies, and by providing liquidity through the VCT’s own listed shares to overcome the illiquidity of its underlying assets. To be treated as a VCT, a company must meet a number of detailed conditions and be approved as such by HMRC.

**VII TAX LAW**

**i Taxation at the level of the investment vehicle**

**Taxation of domestic funds**

Taxation at the fund level is determined by the type of fund vehicle and, depending on the vehicle type, detailed eligibility criteria may have to be met and notifications given to, or approvals obtained from, HMRC before the desired treatment is available. The table below provides a high level summary of the UK tax treatment by vehicle type and, for these purposes, it is assumed that, in each case, all applicable eligibility criteria have been met and notifications given to, or approvals obtained from, HMRC.

---

204 TheCityUK, UK Fund Management, April 2018.
205 In Section VCM55180 of HMRC’s Venture Capital Schemes Manual, HMRC indicates that shares traded on AIM are regarded as unquoted for the purposes of the VCT regime.
<table>
<thead>
<tr>
<th>Type of vehicle</th>
<th>Taxation of income</th>
<th>Taxation of realised capital gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment trust</td>
<td>Dividend income generally exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td></td>
<td>Non-dividend income generally taxable at 19%*</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Distributions to investors tax deductible (to the extent made up of interest income) if an election is made</td>
<td></td>
</tr>
<tr>
<td>Authorised investment funds (OEIC/AUT)</td>
<td>Dividend income generally exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td></td>
<td>Non-dividend income generally taxable at 20%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Distributions to investors tax deductible (to the extent made up of interest income) if more than 60% of the vehicle's investments are debt instruments or similar investments</td>
<td></td>
</tr>
<tr>
<td>PAIF</td>
<td>Dividend income generally exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td></td>
<td>Income from real estate investment exempt</td>
<td></td>
</tr>
<tr>
<td></td>
<td>All other income taxable at 20%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Distributions to investors not tax deductible</td>
<td></td>
</tr>
<tr>
<td>REIT</td>
<td>Dividend income generally exempt</td>
<td>Gains from real estate investments exempt</td>
</tr>
<tr>
<td></td>
<td>Income from real estate investment exempt</td>
<td>Gains from other investments taxable at 19%*</td>
</tr>
<tr>
<td></td>
<td>All other income taxable at 19%*</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Distributions to investors not tax deductible</td>
<td></td>
</tr>
<tr>
<td>Exempt UUT</td>
<td>Typically no tax payable: whilst income is taxable at 20%, all income is deemed to be distributed to investors annually and that distribution is treated as tax deductible</td>
<td>Exempt</td>
</tr>
<tr>
<td>Non-exempt UUT</td>
<td>Dividend income generally exempt</td>
<td>Gains taxed at 19%*</td>
</tr>
<tr>
<td></td>
<td>Non-dividend income taxable at 19%*</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Distributions to investors not tax deductible</td>
<td></td>
</tr>
<tr>
<td>VCTs</td>
<td>Dividend income generally exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td></td>
<td>Non-dividend income generally taxable at 19%*</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Distributions to investors not tax deductible</td>
<td></td>
</tr>
<tr>
<td>Authorised contractual scheme</td>
<td>Fiscally transparent</td>
<td>n/a</td>
</tr>
<tr>
<td></td>
<td>(Investors are treated as directly receiving a share of income subject to the scheme)</td>
<td></td>
</tr>
<tr>
<td>Limited partnership</td>
<td>As for authorised contractual schemes</td>
<td>Fiscally transparent</td>
</tr>
<tr>
<td></td>
<td>(Investors are treated as owning a share of the limited partnership's capital assets)</td>
<td></td>
</tr>
<tr>
<td>Limited liability partnership</td>
<td>As for authorised contractual schemes</td>
<td>As for limited partnerships</td>
</tr>
</tbody>
</table>

* The UK corporation tax rate is due to decrease to 17% from 1 April 2020.
Taxation of foreign funds

Subject to certain exceptions (some of which are highlighted below), a foreign fund would not be subject to UK tax unless it carries on a trade in the UK, and a foreign fund will not be treated as carrying on a trade in the UK merely by virtue of engaging an independent investment manager in the UK to carry out transactions on its behalf, provided that certain conditions as to the manager’s activities, relationship with the foreign fund and remuneration are met.  

Even if a foreign fund does not carry on a trade in the UK, the fund may be liable to tax in the UK in the form of:

a. withholding taxes on UK-source payments, such as payments of annual interest, royalties and rent. The UK does not, however, impose any withholding tax on the payment of dividends;
b. stamp taxes on the transfer of shares, certain other marketable securities and UK real estate; and
c. taxes on income from a UK property business and taxes on gains from the disposal of UK real estate under a new regime enacted as part of the Finance Act 2019 (new NRCGT regime). With effect from April 2019, foreign funds may be liable to UK tax on any gain realised on the disposal of UK real estate or in a UK real estate rich company. The manner in which the new NRCGT regime applies would depend on the structure of the foreign fund. In addition, certain elections may be available under the new NRCGT regime to modify the default tax treatment of the fund as well as the investors.

ii Taxation at the level of the investor

What follows below is a high level summary of certain UK tax rules that may affect all investors irrespective of their jurisdiction of tax residence or foreign investors. A detailed discussion of the tax treatment of different types of UK tax resident investors is beyond the scope of this publication.

Taxation of investors in domestic funds

The following table summarises certain key aspects in respect of the taxation of investors in domestic funds irrespective of their jurisdiction of tax residence.

<table>
<thead>
<tr>
<th>Type of vehicle</th>
<th>Withholding tax on profit distributions to investors</th>
<th>Stamp taxes on transfer of interests in fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment trust</td>
<td>No</td>
<td>Payable on transfers of shares</td>
</tr>
<tr>
<td>Authorised investment fund (OEIC/AUT)</td>
<td>No</td>
<td>Generally exempt</td>
</tr>
<tr>
<td>PAIF</td>
<td>20% in respect of distribution made up of income and gains from real estate, but exemptions (e.g., payment to UK companies) may apply or treaty relief may be available</td>
<td>Generally exempt</td>
</tr>
<tr>
<td></td>
<td>No, in respect of other distributions</td>
<td></td>
</tr>
</tbody>
</table>

---

<table>
<thead>
<tr>
<th>Type of vehicle</th>
<th>Withholding tax on profit distributions to investors</th>
<th>Stamp taxes on transfer of interests in fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>REIT</td>
<td>20%, unless an exemption applies (e.g., payment to UK companies) or treaty relief is available (but note that holdings in REITs of over 10% attract a tax penalty, so having a qualifying shareholding of a size that avoids source taxation under the dividends article will generally not apply)</td>
<td>Payable on transfers of shares</td>
</tr>
<tr>
<td>UUT (exempt or non-exempt)</td>
<td>No</td>
<td>Generally exempt</td>
</tr>
<tr>
<td>Authorised contractual scheme</td>
<td>Fiscally transparent (No withholding tax on fund distributions, but withholding tax applicable on payments to the scheme may be affected by investor identity and tax residence)</td>
<td>Generally exempt</td>
</tr>
<tr>
<td>Limited partnership</td>
<td>As for authorised contractual schemes</td>
<td>Payable on transfers of partnership interest only if partnership assets include shares, certain other marketable securities or UK real estate</td>
</tr>
<tr>
<td>Limited liability partnership</td>
<td>As for authorised contractual schemes</td>
<td>As for limited partnerships</td>
</tr>
</tbody>
</table>

**Foreign investors investing in UK real estate**

Under the new NRCGT regime, foreign investors in domestic or offshore funds holding UK real estate or shares in UK real estate rich companies may be subject to UK tax on a disposal of their interest in the fund or, if the fund is treated as fiscally transparent for the purpose of the UK taxation of capital gains, a disposal by the fund of such real estate or shares. As indicated above, the manner of application of the rules depends on a number of factors and a detailed discussion of these rules is beyond the scope of this publication.

Foreign investors may also be subject to UK tax in respect of REIT or PAIF distributions to the extent that they are made up of income and gains from the REIT’s or PAIF’s real estate investment or, if they have invested in a domestic or foreign fund that is treated as fiscally transparent for the purpose of the UK taxation of income profits, in respect of income from a UK real estate business carried on by that fund.

**VIII OUTLOOK**

i  **Brexit and the transition period**

Brexit and its potential impact on the UK financial sector continue to be topics of discussion. On 19 March 2018, the government published a draft withdrawal agreement, which provides for a transition period of a little under two years (ending 31 December 2020) during which the UK would continue to be subject to EU law and would benefit from the same rights as at present (e.g., passporting). At the time of writing, the withdrawal agreement has been rejected three times by Parliament, and the government has agreed an extension to the UK’s ‘exit day’, which has been set as 31 October 2019. There remains considerable uncertainty about whether the UK and the EU will reach agreement on the withdrawal agreement (including the envisaged transition period) and, thereafter, the extent to which Brexit will be ‘hard’ or ‘soft’. Asset managers have generally already implemented their contingency plans, but the IA stated in March 2019 that it was ‘extremely disappointed’ in the failure of the British
government to pass the withdrawal agreement and the continued uncertainty surrounding Brexit, citing the fact that, since the referendum, nearly £15 billion has been withdrawn from UK equity funds by British savers.\textsuperscript{207} It stressed that avoiding a no-deal exit was paramount.

Statements made by ESMA in July 2017 raised doubts about the continuing viability post-Brexit of the ‘delegation model’ employed by many international fund management groups, in which a fund manager authorised in one country delegates fund management or advisory duties to an affiliate in another jurisdiction (which may be outside the EU).\textsuperscript{208} More recently, however, the Chair of ESMA, Steven Maijoor, noted that ESMA is not seeking to undermine or put in doubt the delegation model. ESMA acknowledges that the delegation model is a key feature of the investment funds industry that has contributed to the success of the industry by providing the requisite flexibility to organise centres of excellence in different jurisdictions. ESMA has sought to clarify that it does not envisage changing the legal requirements, but is rather seeking to aid their practical application and help authorities when supervising delegation arrangements so that national regulators would be able to interpret the requirements consistently.\textsuperscript{209} In support of this, ESMA signed a memorandum of understanding (MOU) with the FCA in February 2019 ensuring that asset managers would continue to be able to employ the delegation model in a scenario where the UK leaves the EU without a deal.

ii Senior managers and certification regime

The senior managers and certification regime (SMCR), which currently covers banking firms, and to a more limited extent insurers, is being extended to all FCA solo-regulated firms, including asset managers. While the implementation date for FCA solo-regulated firms is expected to be 9 December 2019, the FCA has published ‘near final’ rules for the regime’s extension.

The FCA has sought to adopt a proportionate approach to the extension, reflecting the diverse businesses across the financial services sector and the different sizes and complexities of individual firms. Firms will be categorised as ‘limited’, ‘core’ or ‘enhanced’, largely based on size, with a different level of requirements applying to each. However, the FCA will have discretion to elevate smaller but more complex asset managers to the category of ‘enhanced’ if it believes such firms merit greater scrutiny, which will require them to comply with a broader set of requirements.

The new regime will require all firms to:

\begin{itemize}
  \item[a] identify their senior manager functions (SMFs) and prepare SMF statements of responsibilities;
  \item[b] identify employees within the certification regime, and, for ‘enhanced’ firms, prepare ‘responsibilities maps’ setting out the firm’s management and governance arrangements; and
  \item[c] identify SMF handover procedures.
\end{itemize}

\textsuperscript{207} IA, Investment Association responds to the meaningful vote, 12 March 2019.
\textsuperscript{208} European Securities and Markets Authority, Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union, 13 July 2017.
\textsuperscript{209} ESMA, Keynote Address, CMU, Brexit and ESA review – What’s next?, 20 March 2018.
Senior managers will be subject to conduct rules and a duty of responsibility in relation to the business areas they head up. A prescribed responsibility will apply to AFMs, which requires a senior manager (usually the chair) to take reasonable steps to ensure the firm complies with its obligation to carry out an assessment of value, its duties relating to independent directors and to act in the best interests of fund investors.

Applying the rules may be more challenging for asset managers, where partnerships and flatter operating structures are more common.

### iii Regulatory scrutiny

In its business plan for 2019 to 2020, the FCA identified certain priority themes. The areas that are of particular significance to the asset management industry are:

a investment management (including implementing the rule changes following the asset management market study, the implementation of the Revised Shareholder Rights Directive, and consultation on a new prudential regime for MiFID investment firms);

b pensions (including the implementation of further remedies arising from the FCA's Retirement Outcomes Review); and

c wholesale financial markets (including the continued implementation of the market abuse and MiFID regimes, and the replacement of LIBOR).
I OVERVIEW OF RECENT ACTIVITY

In response to the financial crisis, Congress adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). The Dodd-Frank Act was intended to improve the functioning of the financial markets, enable enhanced monitoring of systemic risk and provide better investor protections. However, much of the Dodd-Frank Act was not self-executing and required various regulatory agencies to adopt rules implementing its provisions. As a result, the majority of regulatory changes over the past several years affecting asset managers related to the continued implementation of the Dodd-Frank Act by regulators. In addition to the changes mandated by the Dodd-Frank Act, regulators have also independently adopted or proposed other regulatory reforms to achieve the goals of the Dodd-Frank Act. The most significant changes affecting asset managers are described in more detail in Section V.

The Dodd-Frank Act is widely regarded as the most sweeping reform of asset management regulation in the US since the 1940s. As a result, since the enactment of the Dodd-Frank Act and the promulgation of related regulations, asset managers subject to US law have devoted significant time and resources to designing new or revised compliance programmes, hiring new compliance personnel, drafting new disclosures to the government and investors, and amending agreements to meet new requirements.

Since 2017, the Trump administration has pursued a largely deregulatory agenda, including a proposed repeal of some provisions of the Dodd-Frank Act. The most significant proposals affecting investment advisers are described herein.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The key statute in the US applicable to investment advisers generally is the Investment Advisers Act of 1940 (Advisers Act). An investment adviser is defined under the Advisers Act to include a person or entity who, for compensation, engages in the business of advising
others as to the value of securities or as to the advisability of investing in, purchasing or selling securities. Absent an exemption, an investment adviser must register as such with the Securities and Exchange Commission (SEC).

The most common exemptions from registration as an investment adviser are for advisers solely to venture capital funds, family offices, and advisers solely to private funds that have less than US$150 million in assets in the aggregate. Detailed rules have been adopted under each of these exemptions, as well as the exemptions described in the next paragraph, to define applicable terms.

Non-US advisers have two additional exemptions: the private fund adviser exemption and the foreign private adviser exemption. Under the foreign private adviser exemption, an investment adviser is exempt from registration if it:

a. has no place of business in the US;
b. has fewer than 15 US clients and investors in private funds advised by the adviser;
c. has aggregate assets under management attributable to US clients and investors in private funds advised by the adviser of less than US$25 million;
d. does not hold itself out generally to the public in the US as an investment adviser; and
e. does not act as an adviser to a US registered investment company or a business development company.

Under the private fund adviser exemption, an investment adviser with its principal office and place of business outside of the US is exempt from registration if it has no client that is a US person except for one or more private funds, and all assets under management by the adviser at a place of business in the US are solely attributable to private fund assets, the total value of which is less than US$150 million. To rely on the exemption, the adviser must make certain publicly available periodic informational filings with the SEC.

Advisers that have registered with the SEC are exempted from state registration requirements. However, such advisers remain subject to state anti-fraud provisions, as well as reporting requirements under certain circumstances. With certain exceptions, advisers with less than US$100 million in assets under management are not permitted to register with the SEC. As a result, these smaller advisers may be subject to state registration requirements if they have clients in a particular state.

An adviser registering with the SEC must file Form ADV, which consists of four parts. Part 1A requests information regarding the adviser and its clients, including assets under management, types of clients, affiliates, disciplinary history and ownership. An adviser to private funds must also provide in Part 1A certain information regarding each private fund that it manages. Part 2A is a brochure containing detailed narrative information regarding the firm’s policies, practices, fees, personnel and conflicts of interest. Part 2B is a brochure.
supplement containing information regarding certain advisory personnel. In June 2019, the SEC amended Form ADV to add a new Part 3, Form CRS. Form CRS prescribes the content of ‘relationship summaries’ that registered broker-dealers and investment advisers will be required to deliver to retail customers beginning in 2020. Parts 1A, 2A and 3 are filed with the SEC and are publicly available. Parts 2A, 2B and 3 must be delivered to clients upon engagement and periodically thereafter.

Advisers that are registered (or required to register) with the SEC are subject to many substantive requirements of the Advisers Act. The Advisers Act and related SEC rules regulate, inter alia, certain terms of advisory agreements, performance fees, client solicitation arrangements, certain political contributions, trading practices, advertising, record-keeping, proxy voting, personal securities reporting and custody of client assets. A registered adviser must have written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act, which must be administered by a chief compliance officer. The Advisers Act also imposes broad anti-fraud prohibitions that extend to dealings with clients, prospective clients, and investors and prospective investors in private funds that are advised by the adviser. Additionally, the SEC may examine registered investment advisers for compliance with the Advisers Act, and has the power to bring enforcement actions for non-compliance with the Act, and to impose fines, suspensions and other penalties for violations.

Depending on the type of advisory client and the nature of investments managed by the adviser, other regulatory schemes may apply to the adviser as well. For example, an adviser that uses certain derivative products in client portfolios will need to comply with the Commodity Exchange Act; an adviser that has certain types of retirement plan clients will need to comply with the Employee Retirement Income Security Act of 1974 (ERISA); and an adviser that advises a US-registered investment company will need to comply with the Investment Company Act of 1940 (Investment Company Act). These and other applicable regulatory schemes are discussed in more detail below.

### III COMMON ASSET MANAGEMENT STRUCTURES

#### i Separately managed accounts

The most common structure for managing assets in the US is a separately managed account (SMA). In an SMA, the client’s assets are held by a custodian (typically hired by the client itself), and the adviser enters into an investment management agreement with the client to manage the assets. In this asset management structure, the client and the adviser will negotiate key terms, such as fees and investment objectives, strategies and restrictions. Unlike the funds described below, no corporate form is used to hold the assets, and no securities are issued.

---

7 See Advisers Act Section 205, Rule 205-3, Rule 206(4)-3, Rule 206(4)-5, Section 206, Rule 206(4)-1, Rule 204-2, Rule 206(4)-6, Rule 204A-1 and Rule 206(4)-2, respectively, and related SEC guidance.

8 See Advisers Act Rule 206(4)-7.

9 See Advisers Act Section 206 and Rule 206(4)-8.

10 See Advisers Act Section 203.
Another common structure used to manage assets in the US is an investment company. Investment companies are generally structured as Massachusetts business trusts, Delaware statutory trusts or Maryland corporations\(^{11}\) that issue shares to investors. While investment companies are typically eligible for investment by retail investors, many are intended primarily for institutional investors, or offer separate share classes designed for institutional investors (such as pension funds). Investment companies are generally formed as open-ended funds (which issue redeemable securities and typically engage in a continuous offering of their shares), closed-ended funds (which issue non-redeemable securities, typically engage in a single offering or periodic offerings and typically list their shares for trading on an exchange), exchange-traded funds (ETFs) (which offer and redeem shares in creation units (share increments of 25,000 or more) and have shares that trade on an exchange) and business development companies (BDCs) (which invest principally in ‘eligible portfolio companies’ – typically small, private US companies that are not investment companies or private funds and that the BDC controls or to which it offers significant managerial assistance).\(^{12}\)

Investment companies (other than BDCs, which file a notice of election to be regulated as a BDC) must register as such with the SEC under the Investment Company Act. An investment company registers with the same registration statement used to register its shares for public offering under the Securities Act of 1933 (Securities Act). A registered investment company is subject to the substantive provisions of the Investment Company Act, which generally require, inter alia, a board of directors to govern the investment company (at least 40 per cent of which must be independent of the fund’s adviser and underwriter) and a written investment management agreement approved by the independent directors prior to execution and annually thereafter (following an initial two-year term). Additionally, the Investment Company Act prohibits, with certain exceptions, transactions with affiliates and the issuance of senior securities (such as incurring debt or issuing preferred shares – which significantly constrains the ability of registered investment companies to employ various forms of portfolio leverage). In addition, certain matters must be approved by shareholders, including, with limited exceptions, new or amended investment management agreements, election of the board of directors and certain changes to investment restrictions. Although BDCs are not registered investment companies, they are subject to many of the same, or similar, provisions.

If offered to the public, investment company shares must be registered with the SEC under the Securities Act.\(^{13}\) Registering shares under the Securities Act requires preparing and filing with the SEC a registration statement, which contains disclosure about, inter alia, the fund’s investment objectives, strategies, investment advisers, board of directors, investment restrictions, fees and expenses. A prospectus or summary prospectus, which forms a part of the registration statement, must be delivered to shareholders before, or concurrently

---

\(^{11}\) These states have regimes that are advantageous for investment companies (e.g., exempting an investment company from the requirement to hold an annual shareholders’ meeting).

\(^{12}\) There are other forms of pooled investment vehicles subject to certain specialised provisions of the Investment Company Act, such as unit investment trusts, face amount certificate companies and business development companies.

\(^{13}\) A small percentage of registered investment companies offer their shares only in a private offering, and, therefore, do not register their shares under the Securities Act.
with, the sale of shares of the investment company. Investment companies that engage in continuous offerings must update their registration statements annually (and must update their prospectuses sooner if certain material changes occur).

Investment companies must make periodic reports to their shareholders and follow the proxy solicitation rules adopted by the SEC under the Securities Exchange Act of 1934 (Exchange Act) when shareholder approvals are sought. The Exchange Act and the rules of relevant stock exchanges also impose additional requirements on investment companies with shares that trade on exchanges, such as certain governance requirements.

Because of the difficulties inherent in complying with the Investment Company Act and other US law, non-US investment companies rarely publicly offer their shares in the US.14

iii Private funds

Another structure commonly used to manage assets in the US is the private fund. Private funds typically rely on either Section 3(c)(1) (available to a fund with fewer than 100 investors) or Section 3(c)(7) (available to funds with investors that meet certain high-wealth thresholds, known as qualified purchasers) of the Investment Company Act to be excluded from the definition of investment company. To qualify under Section 3(c)(1) or 3(c)(7), funds must not make a public offering of their securities.15 Private funds in the US are typically structured (usually under Delaware law) as limited partnerships or limited liability companies. Such funds may also be established in non-US jurisdictions, such as the Cayman Islands or Bermuda, to achieve tax efficiency for non-US or tax-exempt investors. Private funds may be either open-ended (the most common structure for a hedge fund) or closed-ended (the most common structure for real estate, private equity and venture capital funds). Most closed-ended private funds have a limited life (usually about 10 years) and, rather than requiring an upfront investment, require investors to commit capital that can be called from time to time by the fund.

IV MAIN SOURCES OF INVESTMENT

The United States mutual fund industry is the largest in the world, with a total of US$17.7 trillion in total net assets at the end of 2018.16 The largest source of assets flowing into investment companies is households, which had 21 per cent of their assets managed by investment companies in 2018.17

The private equity market in North America is the largest in the world, raising approximately US$240 billion in aggregate capital in 2018.18 At the beginning of 2018, private and public pension funds together made up the largest percentage of private equity

14 For example, non-US investment companies must apply to the SEC for special permission to register as an investment company or publicly offer their shares.
15 If there is no public offering under the Securities Act, the proxy rules and certain other provisions of the Exchange Act do not apply to the private fund (provided that the number of investors remains below certain numerical thresholds). State securities law might still apply, although for most private offerings, only state notice filings (at most) are required.
17 id. at p. 34.
investors (23 per cent), followed by foundations (14 per cent) and family offices (10 per cent). Pension funds also issued the largest percentage of private equity mandates that year (22 per cent), followed by fund of funds managers (19 per cent), family offices (11 per cent) and insurance companies (8 per cent).

At the end of 2018, North American hedge fund managers managed approximately 74 per cent of global hedge fund assets. This percentage is down from 82 per cent at the beginning of the decade. North American managers, in over 3,900 firms, manage approximately US$2.64 trillion of total hedge fund industry capital. The largest investors in hedge funds include public pension funds (22 per cent), private sector pension funds (17 per cent) and sovereign wealth funds (11 per cent).

V KEY TRENDS

As noted above, in response to the financial crisis, Congress and regulators have adopted and proposed a number of reforms affecting the asset management industry. Some of the most important changes are summarised below. Additionally, the SEC has recently announced areas of focus for its compliance examinations of registered investment advisers. Certain recent deregulatory initiatives are also described below.

i Derivatives

The Dodd-Frank Act included substantial new requirements with respect to over-the-counter derivative transactions. The changes were largely designed to mitigate systemic risk by decreasing credit risk between parties to derivatives transactions and by increasing transparency in derivatives markets. Many of the new requirements have become effective, but certain other requirements have not yet been implemented. For example, many rules to be adopted by the SEC with respect to the regulation of security-based swaps are not yet in place.

Some of the key requirements are as follows.

Clearing

Certain interest rate swaps and credit default index swaps are required to be cleared through a central clearing house, and some other types of derivatives transactions may become subject to this requirement in the future.

Margin

Central clearinghouses impose initial and variation margin requirements on cleared derivatives transactions, which can change at any time and that are often higher than margin requirements for uncleared derivatives transactions. In addition, under rules adopted by the
Commodity Futures Trading Commission (CFTC) and US bank regulators, swap dealers are required to post and exchange variation margin with respect to most types of uncleared derivatives with financial end users (which include, among other entities, funds and pension plans). Swap dealers will be required to post and receive a minimum amount of initial margin for such transactions with financial end users with at least US$8 billion in notional amount of derivatives transactions beginning in September 2020. Similar rules are expected to be adopted by the SEC with respect to security-based swaps. It is uncertain what effect these higher margin requirements will have on the liquidity of the derivatives markets.

Trading

Certain benchmark interest rate swaps and frequently traded credit default index swaps are required to be executed on a swap execution facility or exchange, rather than on a bilateral basis. Some other types of derivatives transactions may become subject to this requirement in the future. There is an exception from this requirement for block trades, which are trades sufficiently large to exceed thresholds established by the CFTC from time to time. To execute transactions on a swap execution facility, asset managers have to become a member of such swap execution facility and therefore become subject to its rules.

Reporting

All over-the-counter derivatives transactions are (or will be) required to be reported to a swap data repository. The swap data repository makes the reported data available to various regulators, and makes certain of the reported data (not including the identity of the parties) available to the public. If one of the parties to a derivatives transaction is registered as a swap dealer and the other party is not, under CFTC rules, the swap dealer is the only party with the reporting obligation (regardless of whether the swap dealer is organised in the US).

The SEC has adopted reporting rules for security-based swaps, although compliance with such rules is not yet required. In general, under these rules, if one of the parties to the security-based swap is a security-based swap dealer, the latter will have the reporting obligation, although the other party to the security-based swap may have an obligation to report certain parent and affiliate information.

Documentation and business conduct standards

Swap dealers are required to have swap trading relationship documentation (such as an International Swaps and Derivatives Association (ISDA) master agreement) in place with their derivatives counterparties before a derivatives transaction is executed, and are subject to rules regarding timely confirmation of trades and a requirement to conduct periodic portfolio reconciliation with their counterparties. Swap dealers have also generally been seeking substantial additional representations from their counterparties to comply with (and meet certain safe harbours under) business conduct standards. Many market participants have amended their derivatives documentation to comply with these requirements by adhering to market protocols prepared by ISDA.

ii Cybersecurity

The cybersecurity of investment funds and investment advisers has been an important focus of the SEC staff in recent years in light of cyber attacks on a wide range of financial services firms. The SEC has established a cyber unit to focus on enforcement in this area, and has
consistently placed cybersecurity among its top enforcement priorities. This recent SEC focus contrasts with the long-standing focus of the states and their attorneys general on cybersecurity; indeed, the vast bulk of the law of cybersecurity in the United States stems from state laws, including the cybersecurity regulations of the New York Department of Financial Services, dozens of state data security laws, including most notably the Massachusetts information security regulations (21 CMR 17.00), and the 54 state and territorial data breach notification laws. In general, these state regulations are not pre-empted by federal law and drive most of the cybersecurity compliance activities of US investment advisers.

Registered investment advisers are required under Rule 30(a) of Regulation S-P (Privacy of Consumer Financial Information) to adopt policies and procedures reasonably designed to ensure the security and confidentiality of customer records and information; protect against any anticipated threats or hazards to the security or integrity of customer records and information; and protect against unauthorised access to, or use of customer records or information, that could result in substantial harm or inconvenience to any customer.

In April 2014, the SEC’s Office of Compliance Inspections and Examinations (OCIE) announced the first of three cybersecurity examination initiatives (or ‘sweeps’ in the vernacular) to assess investment advisers’ implementation of cybersecurity procedures and controls, with a focus on such matters as governance and risk assessment, access rights and controls, data loss prevention, vendor management, training and incident response.

In its 2017, 2018 and 2019 examination priorities, OCIE highlighted the need for investment advisers to review their operations and compliance programmes, and assess whether they have measures in place to mitigate their exposure to cybersecurity risk. In its exam priorities, OCIE has emphasised its expectation that advisers will have in place policies and procedures that are adapted to the specific risk profile of the adviser in question, and it has emphasised that a ‘cookie-cutter’ approach of commoditised policies and procedures will not suffice.

iii Money-market fund reform

In response to well-publicised ‘races to the exit’ that occurred in 2008 as money-market fund investors sought to avoid sharing in losses such funds sustained in Lehman Brothers securities, the SEC adopted rules designed to reduce possible systematic risks that regulators believe money-market funds may present. Previously, money-market funds generally valued their portfolio holdings using the amortised cost method, which resulted in a stable net asset value of US$1 per share (for purposes of shareholder purchases and redemptions) even in circumstances where the underlying portfolio holdings might have been worth fractionally more or less than US$1.

Under the new rules, certain money-market funds are prohibited from using amortised cost to value their investments and consequently will have a floating net asset value per share. The new rules provide for certain liquidity fees on redemptions and give the fund’s board of directors authority to suspend redemptions in certain circumstances. More stringent requirements relating to diversification, disclosure, stress-testing and reporting have also been imposed.

iv  Investment company portfolio disclosure and liquidity risk management regulations

In October 2016, during the closing months of the Obama administration, the SEC adopted three new rules relating to investment companies, as part of then-SEC Chair Mary Jo White’s extensive rule-making agenda focused on the systemic importance of the asset management industry to the securities markets and the financial system as a whole. One of these rules (referred to as ‘Investment Company Reporting Modernisation’) requires registered investment companies to make more frequent and extensive filings with the SEC regarding their portfolio holdings and characteristics, with some of this information made publicly available on a delayed basis. The second rule (referred to as the ‘Liquidity Management Rule’) requires open-ended investment companies (other than money-market funds) to adopt comprehensive portfolio liquidity risk management programmes. The third new rule will permit (but not require) open-ended funds to engage in ‘swing pricing’, under which they could in certain circumstances adjust the prices at which investors purchase and redeem fund shares, so as to pass on to the transacting investors the costs associated with those transactions, which would otherwise be borne by the fund itself.

v  The Jumpstart Our Business Startups Act

In 2012, Congress adopted the Jumpstart Our Business Startups Act (JOBS Act), which required, inter alia, that the SEC amend Regulation D (an exemption from registration under the Securities Act) to remove the prohibition on general solicitation or general advertising of certain offerings of securities to accredited investors (those who satisfy certain financial thresholds). In 2013, the SEC amended Regulation D, and private funds may now use general solicitation or general advertising to offer and sell fund interests so long as such fund takes reasonable steps to verify that the purchasers are in fact accredited investors. However, a study commissioned by the SEC found that only 4 per cent of all capital raised under Regulation D relied upon the new general solicitation exemption.27 This may be because of the fact that there is still regulatory uncertainty over advertising, vetting investors and whether general solicitations in the US might affect a fund’s ability to rely on private placement exemptions in non-US jurisdictions. In 2014, the CFTC issued exemptive relief from certain provisions in CFTC regulations, including Rule 4.13(a)(3) (see below), to permit commodity pool operators relying on these regulations to engage in general solicitation or general advertising in certain offerings under Regulation D.

vi  Department of Labor Fiduciary Rule

In April 2016, the Department of Labor (DOL) adopted a final rule regarding investment advice that subjects a wider group of advisers to fiduciary standards under ERISA. The rule assigned fiduciary status based on whether the advising party makes a ‘recommendation’ regarding an investment or investment management and receives direct or indirect fees as a result of dealing with a plan, plan participant or beneficiary, plan fiduciary, individual retirement account (IRA) or IRA owner. The DOL also finalised the Best Interest Contract Exemption, which permitted certain types of compensation that might otherwise create prohibited conflicts if investment advice fiduciaries met a series of conditions aimed at ensuring that the advice they give will be in the retirement investor’s best interests. The rule

---

took effect in June 2017; however, in March 2018, the rule was struck down by a decision of the Fifth Circuit Court of Appeals. The DOL has indicated that it intends to propose new rules in this area in December 2019.

vii Volcker Rule

The Dodd-Frank Act amended the Bank Holding Company Act of 1956 by adding a new Section 13, commonly known as the Volcker Rule, that curbs certain investment activities by banks and their affiliates. Simple in concept, the Volcker Rule is complex in practice. The Volcker Rule applies to ‘banking entities’, broadly defined to include banks, parents of banks and bank holding companies, and their subsidiaries and affiliates, as well as non-US banks with a US banking presence and their subsidiaries and affiliates. The Volcker Rule prohibits banking entities from engaging in proprietary trading in securities, derivatives or certain other financial instruments, and from investing in, sponsoring or having certain relationships with covered funds, including hedge funds, private equity funds and certain commodity pools, subject to a number of exceptions. Banking entities that serve as sponsors, investment managers or investment advisers to covered funds are also prohibited from extending credit to such affiliated funds, subject to limited exceptions.

Interpretive questions arose following the adoption of the final regulations to implement the Volcker Rule in December 2013. The Federal Reserve Board from time to time addresses frequently asked questions and posts them on its website.\(^2\)

As part of a broader package of banking legislation in 2018, modest changes were enacted to the Volcker Rule,\(^29\) but an effort to repeal the Volcker Rule in its entirety was unsuccessful. In May 2018, financial regulators responsible for Volcker Rule implementation and enforcement issued proposed regulations that would substantially limit its scope without repealing the statutory provisions of the Dodd-Frank Act, which would require an act of Congress.\(^3\)

Fully implemented eight years after its adoption, the future of the Volcker Rule is uncertain. Additional modifications to existing regulations will likely be implemented as a result of the rulemaking process under way. It is not possible to predict with certainty the outcome of these initiatives.

viii SEC examination priorities

In its current five-year strategic plan, the SEC highlighted three broad priorities:\(^3\)

a ensuring that retail investors better understand the different choices they have when seeking investment advice, and the different standards of conduct that govern investment professionals and investment advisers;

b allocating its resources appropriately in light of evolving trends in the capital markets; and

c enhancing the SEC’s analytical capabilities and develop its workforce.

3\ See the SEC’s Strategic Plan at https://www.sec.gov/files/SEC_Strategic_Plan_FY18-FY22_FINAL_0.pdf.
In December 2018, OCIE published its 2019 examination priorities, which reflect topics that the SEC staff perceives to present heightened risk, and to which the SEC’s national examination programme expects to allocate significant resources throughout 2019. In the 2019 examination priorities, OCIE listed the following priorities that are worthy of note:

a. OCIE will continue its Retirement-Targeted Industry Reviews and Examinations Initiative, launched in June 2015, which focuses on the services offered by investment advisers and broker-dealers to retirement account investors;

b. OCIE will continue to examine broker-dealers’ and investment advisers’ cybersecurity compliance and controls;

c. OCIE will continue to monitor the offer and sale, trading and management of digital assets and examine for regulatory compliance where products are securities. OCIE will also identify and assess the activities of market participants offering, selling, trading and managing these products or considering or actively seeking to offer them. Areas of focus will include portfolio management of digital assets, trading, safety of client funds and assets, pricing of client portfolios, compliance, and internal controls;

d. OCIE will continue its focus on wrap fee programmes offered by investment advisers and broker-dealers;

e. OCIE will continue its oversight of the Financial Industry Regulatory Authority (FINRA) (the self-regulatory organisation for broker-dealers) to assess the quality of FINRA’s examinations of individual broker-dealers;

f. OCIE will continue to examine whether SEC-regulated ‘financial institutions’, which include mutual funds but not registered investment advisers, are complying with their anti-money laundering obligations under the Bank Secrecy Act and related regulations;

g. OCIE will focus its examination on mutual funds and ETFs that:
   - seek to track custom-built indexes (for the purpose of reviewing potential conflicts between the manager and index provider);
   - have little secondary market trading value and smaller assets under management;
   - have higher allocations to certain securitized assets;
   - have a history of underperformance relative to their peers; or
   - have inexperienced management; and

h. OCIE will also focus on risks associated with advisers who provide advice to both registered investment companies and private funds with similar investment strategies.

ix. **Certain deregulatory initiatives**

The Trump administration has continued to emphasise a deregulatory agenda, announcing its intention ‘to provide swift relief’ from a number of previously enacted regulations. In January 2017, only days after taking office, President Trump signed an executive order freezing most new and pending regulations and setting forth the goal that, for every new regulation issued, at least two prior regulations be identified for elimination. At the time of the executive order, the SEC had 19 rules required by the Dodd-Frank Act still pending

---

Although the executive order does not legally bind the SEC, SEC Chair Jay Clayton has announced a number of initiatives intended to ease regulatory burdens on companies. Although the focus of these initiatives is primarily on capital formation issues and issues of market liquidity and structure, rather than the regulation of asset managers directly, they do signal a heightened level of attention to the accumulated costs and burdens of financial regulation.36

x  Cryptocurrencies

The regulation of cryptocurrencies, including coins and tokens such as bitcoin and ether, as well as related funding mechanisms such as initial coin offerings (ICOs) and simple agreements for future tokens (SAFTs), continues to evolve and come into sharper relief. However, the market for cryptocurrencies is global and highly dynamic, and regulators must continuously react to significant developments after they happen.

Cryptocurrencies include virtual currencies and digital assets that use complex encryption techniques to verify the transfer of funds and the generation of new units. Cryptocurrencies are not typically tied to specific governments or central banks, but rather are processed through a decentralised network of private computers linked through shared computer programs. Transactions in cryptocurrencies are processed through a distributed ledger known as a blockchain, on which transactions are verified and trust is established throughout the network.

In the US, cryptocurrencies are subject to regulation by several different regulators, including the CFTC and the SEC. The CFTC has determined that virtual currencies such as bitcoin are ‘commodities’ subject to limited oversight by the CFTC, and this view has been affirmed in at least one US district court. The CFTC has the authority to prosecute fraud and manipulation in the cryptocurrency spot markets and is charged with the general oversight of the cryptocurrency derivatives markets.

The SEC has also been regulating the cryptocurrency markets through a variety of enforcement actions, including actions involving fraudulent and misleading ICOs and token offerings. In addition, the SEC issued a report regarding the offering of tokens by a digital autonomous organisation known as ‘The DAO’ in 2017. In the DAO Report, the SEC examined the terms of The DAO’s token offering utilising the traditional ‘Howey’ test to determine whether the tokens were ‘investment contracts’ (and therefore ‘securities’) under the federal securities laws. Howey defines an ‘investment contract’ as a contract, transaction or scheme whereby (1) a person invests his or her money in (2) a common enterprise and is led to (3) expect profits (4) solely from the efforts of the promoter or others. The DAO Report indicated that The DAO’s offering of tokens constituted an unregistered offering of securities, and subsequent transfers of tokens would have been required to be transferred through registered securities exchanges.

Since the DAO Report, the SEC has brought a number of actions and made a number of statements that indicate that it continues to see the Howey test as the appropriate measure of whether a cryptocurrency is a security for the purposes of the Securities Act. In late 2017, the SEC weighed in on a specific ICO involving Munchee, Inc. Munchee launched an ICO for a ‘utility token’ that would allow its users to access a computer application that it was

---

35 See www.sec.gov/spotlight/dodd-frank.shtml#.
developing. The SEC intervened to halt the ICO, noting that despite being characterised as a utility token, the token was a security and therefore must be offered in compliance with the federal securities laws. In addition, Chairman Clayton has stated on several occasions before and after Munchee that, in his view, most ICOs appear to involve offerings of securities subject to the federal securities laws.

In June 2018 remarks primarily focused on ether, an SEC official expressed the view that neither bitcoin nor ether are securities for the purposes of the Securities Act, and that offers and sales of these cryptocurrencies are not securities transactions. The official also indicated that even though the initial issuance of a digital asset may have represented a securities offering, once the asset is no longer controlled by a central authority or used primarily to purchase goods or services on a functioning network, it may not be appropriate to regulate the digital asset as a security. The official reiterated that the SEC will continue to evaluate cryptocurrencies and ICOs using the Howey test, with the determination of whether a coin or token is a security depending on the facts and circumstances of each offering. In addition, the official provided a series of factors to be used to analyse whether a particular cryptocurrency or digital asset offering should be considered an investment contract under the Howey test.

To date, while much of the US regulatory activity relating to cryptocurrencies has come in the form of enforcement actions and settlements, regulators have started to provide guidance to issuers and investors regarding the status of various coins and tokens. Going forward, to get the full regulatory picture it will be important to monitor both enforcement actions and settlements as well as regulators’ statements on how they intend to regulate cryptocurrencies.

Duties of broker-dealers and investment advisers

In June 2019, the SEC clarified the duties of broker-dealers and investment advisers by adopting a package of rules and interpretations designed to improve retail investors’ understanding of the relationships and services being provided or offered. The SEC also adopted Regulation Best Interest, which requires broker-dealers and natural persons associated with a broker-dealer to follow a ‘best interest’ standard of conduct when recommending to retail customers any securities transaction or investment strategy involving securities.

VI SECTORAL REGULATION

i Insurance

Insurance companies are regulated primarily by the states and therefore each state will have different laws regarding the management of insurance company assets. Although there is no comprehensive federal insurance regulatory scheme, many of the federal laws described above affect insurance company investments.

Assets of insurance companies are typically managed in general accounts or separate accounts. When an insurance company issues variable annuity or life insurance policies, the

insurance company will segregate in a separate account assets to satisfy its obligations under the policies. Typically, separate accounts are organised as unit investment trusts, which in turn invest in an open-ended investment company that invests directly in securities. Separate accounts may also be organised as open-ended investment companies that invest directly in a portfolio of securities. Separate accounts holding assets from publicly offered variable annuity or variable life insurance products are considered investment companies under the Investment Company Act, and are subject to applicable provisions of the Investment Company Act and the Securities Act and related SEC regulations.

Insurance company general account assets are managed on behalf of the insurance company (rather than for the benefit of a specified group of policyholders). If general account assets are managed by the insurance company itself, the general account is not considered a client of the insurance company for Advisers Act purposes (as the investment advice is not being provided to others).

ii Pensions

The requirements of ERISA apply to the manager of a pooled investment vehicle or SMA if the underlying assets are treated as ‘plan assets’. If a benefit plan investor invests in a pooled investment vehicle or SMA, then unless an exception applies, the underlying assets of the fund are deemed to be plan assets for the purposes of ERISA. Benefit plan investors include most US private sector retirement plans (such as pension and 401(k) plans), Taft-Hartley (multi-employer) union pension plans and IRAs. Exceptions exist for funds that issue publicly offered securities, registered investment companies, venture capital operating companies and real estate operating companies (which exempts many private equity, venture capital and real estate funds), and funds in which benefit plan investors hold less than 25 per cent of each class of equity interest.

If the assets of a fund or account are treated as plan assets, then the manager must satisfy ERISA’s fiduciary standards. Under these standards, the manager must:

- act solely in the interest of an investing plan’s participants;
- act prudently with respect to decisions affecting the plan;
- diversify the plan assets under its management (subject to the investment guidelines issued to it by the plan’s trustee); and
- act in accordance with the documents and instruments governing the plan.

Additionally, the manager:

- cannot receive more than reasonable compensation;
- must not engage in, or cause the client to engage in, non-exempt prohibited transactions (i.e., transactions with parties related to an investing plan, including other service providers for the plan, and self-dealing); and
- must be bonded under a fidelity bond.

Finally, the manager must assist the investing plans in satisfying their reporting obligations, including disclosing its compensation for the services provided.

If an adviser is a qualified professional asset manager (QPAM) and satisfies certain conditions, certain of the rules regarding prohibited transactions are relaxed. This exemption is relied upon by most large managers of plan assets.
if the conditions for using the QPAM exemption are met, the prohibition on transactions with parties related to the plan applies only to those parties that have (or whose affiliates have) the ability to appoint or terminate the manager, parties that (together with their affiliates) account for more than 20 per cent of the manager’s total client assets under management and parties in interest that are a person related to the QPAM under complex common ownership rules. To qualify as a QPAM, the adviser, if not a bank or insurance company, must be registered under the Advisers Act, and generally must have more than US$85 million in assets under management and more than US$1 million in shareholder or partner equity.

Certain transactions are limited or prohibited for ERISA clients under the self-dealing rules, even if the adviser is a QPAM. These include certain incentive compensation arrangements, cross trading and use of an affiliated broker-dealer. However, conditional exemptions from these and other prohibitions are relied upon by many advisers.

If a fiduciary breaches its duties under ERISA, the fiduciary will be required to restore any losses to the plans and disgorge any profits resulting from the breach, and may be subject to certain penalties and taxes.

iii Real property

As the Advisers Act definition of investment advisers relates only to advice with respect to securities, advisers dealing in real estate are only required to register under the Advisers Act if they provide advice relating to securities in addition to real estate. However, as such advisers may advise on real estate-related securities (e.g., mezzanine loans, mortgage-backed securities or limited partner interests in partnerships that own real estate), many real estate advisers have registered as investment advisers.

Real estate advisers commonly provide investment advice to clients through SMAs (which may co-invest with the adviser or other clients, or with both, in real estate joint ventures), single asset or programme joint ventures, real estate investment trusts (REITs) and private funds.

Real estate private funds that may invest in securities often rely on Section 3(c)(5)(C) under the Investment Company Act for exclusion from the definition of investment company (available to funds primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate) and on Regulation D under the Securities Act.

REITs allow investors to make passive investments in real estate on a tax-advantaged basis. Qualification as a REIT is complex, and requires ongoing compliance with organisational, asset and income tests under the Internal Revenue Code, which are summarised in Section VII. REITs may be privately or publicly offered. Privately offered REITs are typically offered pursuant to Regulation D under the Securities Act. Publicly offered REITs are subject to the Securities Act and Exchange Act, including the reporting requirements for public companies. REITs that may invest in securities typically rely on Section 3(c)(5)(C) for an Investment Company Act exemption.

41 Institutional real estate private funds that invest in real-estate related securities typically also qualify under Section 3(c)(7) of the Investment Company Act for exclusion from the definition of investment company.

42 Private REITs that invest in real estate-related securities may also choose to qualify under Section 3(c)(7) of the Investment Company Act.
iv Hedge funds
A number of the key trends discussed above (e.g., derivatives regulation, cybersecurity risks, Commodity Exchange Act registration and the JOBS Act) directly affect hedge funds and their advisers. As previously noted, the Volcker Rule requires banking entities to limit substantially certain relationships they may have had with hedge funds. As previously noted, the Volcker Rule prohibits banking entities from investment in, and sponsorship of, private investment funds, including hedge funds, subject to limited exceptions. It also places credit and other restrictions on relationships between banking entities and private investment funds for which they are a sponsor, investment manager or investment adviser.

Additionally, the SEC requires registered hedge fund advisers to file Form PF, containing detailed information about each hedge fund managed by the adviser. The form is filed with the SEC on a confidential basis (either annually or quarterly, depending on the adviser’s hedge fund assets under management), and includes extensive information regarding a fund’s strategy, investors, derivatives, leverage, investments, counterparties, turnover, exposures, risk metrics, financing and investor liquidity.43

v Private equity
As with hedge funds, cybersecurity risks, the JOBS Act and the Volcker Rule will affect the operations of private equity funds and their advisers. Applying the Advisers Act, which is primarily designed for advisers managing publicly traded securities for retail investors, to private equity firms has proven to be complicated. As a result, private equity firms have been put in the position of internally resolving numerous interpretive issues without clear guidance from regulators.

In their examinations of, and public statements regarding, private equity firms, the SEC staff has focused on the valuation of private equity investments, allocation of fees and expenses between the adviser and the funds and the adviser and portfolio companies, and the allocation of co-investment opportunities. Additionally, the SEC staff has raised questions as to whether broker–dealer registration should be required in respect of certain common practices of private equity firms, including the marketing of private equity fund interests and the receipt by private equity firms of transaction-based compensation in connection with capital markets or merger and acquisition activity relating to portfolio companies.

Advisers to private equity funds must also file Form PF annually. Depending on the amount of the private equity firm’s private equity fund assets under management, these filings must include certain information regarding each fund’s leverage, derivatives holdings, investors and portfolio companies.

The Financial Choice Act, which has passed one house of Congress, would exempt managers of ‘private equity funds’ from registering under the Advisers Act. However, the breadth of the exemption and the definition of ‘private equity fund’ under this Financial Choice Act remain unclear, as do prospects that the proposed Act will ever become law.

vi Registration under the Commodity Exchange Act
Under the Commodity Exchange Act, the operator of a commodity pool (i.e., a fund that has the authority to invest in commodity interests) must register as a commodity pool operator

43 Advisers who are registered with the CFTC as commodity pool operators and commodity trading advisors are required to file Form PQR and Form PR, respectively, on a quarterly basis.
(CPO),\textsuperscript{44} and an adviser providing advice with respect to commodity interests must register as a commodity trading advisor (CTA) (in each case, absent an exemption from registration). Before the Dodd-Frank Act, commodity interests subject to the Commodity Exchange Act included futures, options on futures, options on commodities, and certain foreign exchange and metals contracts. The Dodd-Frank Act amended the definition of commodity interests to encompass a much broader range of derivatives contracts, including interest rate derivatives, derivatives on a broad-based securities or credit index, other commodity derivatives and currency derivatives (other than deliverable currency forwards and certain other currency instruments).

In addition, although not mandated by the Dodd-Frank Act, the CFTC in 2012 amended its rules to eliminate a significant exemption from CPO registration (which permitted a fund to use commodity interests without limit so long as certain investor minimum investment portfolio size and other requirements were met).\textsuperscript{45} As a result, the only remaining potential CPO registration exemption for most CPOs who operate funds with US investors (or that are offered to US investors) is under Rule 4.13(a)(3), which provides an exemption only if all investors meet certain minimum income or net-worth standards, the fund complies with certain marketing limitations, there is no public offering of fund interests\textsuperscript{46} and either no more than 5 per cent (in the aggregate) of the fund’s net asset value is used as initial margin, premiums or other upfront payments required to establish a commodity interest position or the aggregate net notional value of the fund’s commodity interest positions does not exceed 100 per cent of the fund’s net asset value.

The CFTC takes the position that the operator of a fund (including a fund organised and operated outside the US) with one or more US investors (or that is marketed to US investors) is subject to CPO registration (or must qualify for and claim an exemption).

A registered CPO or CTA is subject to various reporting, disclosure and record-keeping requirements (which may vary depending on the nature of the client or investors in the fund). Additionally, a registered CPO or CTA must become a member of the National Futures Association (NFA), a self-regulatory organisation, and is subject to periodic examination by the NFA.

vii Municipal advisers

On 20 September 2013, the SEC adopted rules\textsuperscript{47} to establish a permanent registration regime for municipal advisers. These rules implement provisions of the Dodd-Frank Act, which generally prohibit municipal advisers from soliciting or providing certain advice to municipal entities without first registering with the SEC. Municipal advisers include persons who provide advice to or on behalf of a municipal entity with respect to municipal financial products or the issuance of municipal securities, or undertake a solicitation of a municipal entity. ‘Municipal entities’ are US states, their political subdivisions and certain related

\textsuperscript{44} The CPO is typically the general partner, managing member or each director of a private fund or the adviser of a registered investment company.

\textsuperscript{45} There are various CTA registration exemptions as well, although these have not been changed materially recently (with the exception of various CTA exemption tests amended to reflect the broader definition of commodity interests).

\textsuperscript{46} As discussed above, the CFTC has issued exemptive relief to CPOs from the public offering restriction with respect to certain offerings made under Regulation D.

entities. In general, SEC-registered investment advisers are excluded from the definition of municipal adviser to the extent that a registered investment adviser ‘is providing investment advice in such capacity’. Unregistered investment advisers may be considered municipal advisers if a municipal entity has invested the proceeds of an issuance of municipal securities in a fund or SMA managed by such adviser. Unregistered investment advisers to SMAs for municipal entities may also be considered municipal advisers if the account holds any swaps or securities-based swaps. Unregistered investment advisers have a due diligence requirement to determine whether a fund or account holds the proceeds of a municipal securities issuance.

In October 2014, the SEC approved the first dedicated rule of the Municipal Securities Rulemaking Board (MSRB), MSRB Rule G-44, for municipal advisers regarding supervisory and compliance obligations along with related amendments to already existing rules on books and records to be maintained by brokers, dealers and municipal securities dealers. 48 MSRB Rule G-44 primarily employs a principles-based approach to supervision and compliance, and is modelled after existing broker-dealer and investment adviser standards. Since then, the MSRB has adopted or amended restrictions on pay-to-play activities, standards of conduct, limitations on gifts, supervision requirements and professional qualification requirements.

VII TAX LAW

i Separately managed accounts

For US clients, net investment income generated by investments is generally taxed as ordinary income, although qualifying dividends are taxed to individuals at lower capital gains rates. Taxes on capital gains from the sale of securities will be determined by how long the client owned the investments that generated them. To the extent that US clients are taxed by non-US jurisdictions due to investments in non-US issuers (such as a foreign withholding tax), US tax credits may be available to such clients.

Non-US clients will be subject to withholding at a rate of 30 per cent on dividends from US sources, although the withholding may be reduced depending on the status of the investor (e.g., foreign governments are generally exempt), or the tax treaty between the US and the country of the non-US client. Interest income from US sources is generally exempt from US withholding for non-US non-bank investors that meet certain requirements (such as submitting a Form W-8BEN). Non-US clients that are not otherwise engaged in a US trade or business will typically not need to file a US tax return as a result of investments in the US, except in limited circumstances, such as investments in United States real property interests (i.e., direct interests in US real property, as well as the stock of any corporation that holds sufficient interests in US real property to be considered a United States real property holding company), or investments in pass-through entities with US trade or business activities.

ii Registered investment companies

An investment company that qualifies as a regulated investment company under Subchapter M of the Internal Revenue Code generally will not be subject to US federal income tax on its income and capital gains that it timely distributes to shareholders. To qualify as such, the investment company generally must, inter alia:

a be treated as a domestic corporation for US tax purposes;

b. derive at least 90 per cent of its gross income for each taxable year from certain specified sources or other sources with respect to its business of investing in stock, securities or currencies;
c. meet certain asset diversification tests; and
d. distribute with respect to each taxable year at least 90 per cent of the sum of its ‘investment company taxable income’ (which includes short-term, but not long-term, capital gains), and any net tax-exempt interest income, for such year.

If an investment company were to fail to meet the income, diversification or distribution tests described above, and were ineligible to or did not cure such failures in the manner presented in the Internal Revenue Code, the investment company would be subject to tax on its taxable income and gains at corporate rates, and all distributions from earnings and profits would be taxable to shareholders as ordinary income.

Dividends received from an investment company, as well as any gains from the sale of company shares, are generally subject to tax in the hands of shareholders subject to US federal income tax.49

Distributions to non-US shareholders from investment companies that qualify as regulated investment companies of long-term capital gain, short-term capital gain and US-source interest income (‘exempt distributions’) generally are exempt from US federal income tax withholding, provided that such companies report a distribution as such to shareholders. Such an investment company is not required to, and therefore might not, report distributions as eligible for any such exemption, even if it is available. Under current law, a non-US shareholder generally is subject to 30 per cent US federal income tax withholding (or a lower applicable tax treaty rate) on dividends it receives from an investment company that are not exempt distributions, even if the income or gain underlying such dividends would not be subject to such withholding if it had been paid directly to the non-US shareholder by the underlying issuer.

iii REITs
Requirements for a REIT to qualify for pass-through taxation include that a REIT must invest at least 75 per cent of its assets in real estate or qualifying assets, distribute at least 90 per cent of its annual taxable income to shareholders as dividends, and have at least 100 shareholders and not be closely held.

iv Private funds
Private funds in the US typically elect to be treated as a partnership for US federal income tax purposes if they are not so treated by default.50 If the fund were not treated as a partnership, but as an association taxable as a corporation, fund income or gains would be taxed, and

49 Very generally, distributions of investment income and net short-term capital gains are taxed at ordinary income rates. Distributions of net long-term capital gains and, so long as the fund and the US shareholder meet certain requirements, dividends constituting ‘qualified dividend income’, are taxed at the lower rates applicable to long-term capital gains.
50 In some cases, tax-exempt investors invest through a corporation to prevent certain disadvantageous tax attributes from applying to investments.
losses trapped, at the fund level rather than being passed through to the partners of the fund; distributions to investors in the fund would be treated as dividends; and additional adverse tax, reporting and filing consequences could be triggered.

As a partnership for tax purposes, the fund itself generally will not pay US federal income tax. Income, gains, losses, deductions and credits of the fund will be allocated to the investors for US federal income tax purposes in accordance with the applicable governing documents, the Internal Revenue Code and the regulations thereunder.

In general, the US federal tax treatment of a non-US investor in a private fund treated as a partnership will depend on whether the fund is deemed to be engaged in a US trade or business. US-sourced income not effectively connected with a US trade or business may be subject to US withholding tax. If the fund were determined to be engaged in a US trade or business, either as a result of the fund’s own activities or because the fund invests in turn in a pass-through entity (such as a partnership) so engaged, the investor’s distributive share of the fund’s income that is effectively connected with such trade or business would be subject to US federal income taxation (potentially including branch profits taxes in the case of corporate investors), some or all of which may be satisfied by withholding on each non-US investor’s distributive share of such income. Further, each non-US investor would be required to file a US federal income tax return reporting such income (and potentially all its other US-sourced income for the taxable year). In addition, any income from the disposition of a US real property interest held directly or indirectly through a pass-through entity by the fund would be treated as income effectively connected with a US trade or business. Accordingly, such income would be subject to US taxation and withholding, and each non-US investor would be required to file a US federal income tax return reporting its distributive share of such income. Under a change to the Internal Revenue Code enacted in 2017, withholding is required on the disposition of an interest in a fund treated as a partnership engaged in a US trade or business, unless the investor certifies that it is a US person or, under proposed regulations, the fund or investor, as applicable, makes a certification as to the limited extent of the fund’s effectively connected assets as of the time of the transfer or the effectively connected income that was allocated to the investor in the years preceding the transfer.

v Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act, as codified in Sections 1471–1474 of the Internal Revenue Code and the US Treasury and Internal Revenue Service guidance issued thereunder (collectively, FATCA), establishes an information reporting regime designed to identify US persons holding assets through offshore entities and overseas accounts. Subject to certain exceptions, non-compliance with FATCA’s reporting and diligence requirements generally leads to a 30 per cent withholding tax on certain entities with respect to certain US-sourced income (including, among other types of income, dividends and interest) (together, a withholdable payment). In addition, withholding under FATCA potentially may apply in the future on certain payments of non-US sourced income (pass-through payments). Regulations proposed in 2018 and on which taxpayers may rely abrogated withholding on gross proceeds from the sale or other disposition of property that can produce US-sourced interest or dividends, which was otherwise set to begin on 1 January 2019.

Since the enactment of FATCA, the US Treasury has signed various intergovernmental agreements (IGAs) with foreign jurisdictions to help implement FATCA’s requirements abroad. The objective of the IGAs is to gather the same information regarding US accounts as is required under the FATCA regulations, while resolving local law conflicts and reducing
burdens for IGA-country financial institutions. Additionally, FATCA's implementation has spurred on the development of other tax information reporting regimes, such as a regime similar to FATCA in the United Kingdom, and the Common Reporting Standard, an initiative developed by the Organisation for Economic Co-operation and Development aimed at global tax transparency.

VIII OUTLOOK

The effects of the changes in regulation described above are not yet completely known. As a result, there are still many questions that may be answered in time, including how the derivatives markets will adjust to new regulation and whether the new regulations will, in fact, improve the functioning of the markets, better protect investors and help prevent another financial meltdown, or whether they will only increase transaction and compliance costs and create barriers to entry into the asset management business. In addition, under the Trump administration, there are significant efforts to roll back regulation, including under Dodd-Frank, and it remains to be seen what the full outcome of these efforts will be.

As noted earlier, the SEC in June 2019 issued new rules and interpretations for broker-dealers and investment advisers that are ‘designed to enhance the quality and transparency’ of their relationships with retail investors.\(^\text{51}\) While these recent adoptions help clarify the legal obligations broker-dealers and investment advisers owe to their clients and establish a new standard of conduct for broker-dealers when making recommendations to certain retail customers, they do not take full effect until 2020, and the practical consequences of the new rules and interpretations are therefore still unknown.

ABOUT THE AUTHORS

CARLOS COSTA ANDRADE

_Uría Menéndez – Proença de Carvalho_

Carlos Costa Andrade has been a partner in the Lisbon office of _Uría Menéndez – Proença de Carvalho_ since 2005. Between 1996 and 1999 he was in-house counsel (issuers and market division) at NYSE Euronext Lisbon – Sociedade Gestora de Mercados Regulamentados SA.

His practice includes M&A, capital markets and banking laws. He has advised on takeovers and other public M&A transactions, public offers and listings of shares, structured bonds and other complex securities, regulated and non-regulated securities markets, regulatory authorities on the drafting of new regulations, corporate governance and structured finance agreements.

Mr Andrade is currently the secretary to the shareholders’ meeting of OPEX – Sociedade Gestora de Mercado de Valores Mobiliários Não Regulamentado SA, and is a member of the Equity, Fixed Income and Derivatives Committee of BM&FBOVESPA – Bolsa de Valores, Mercadorias e Futuros.

Mr Andrade is among the most highly regarded banking and finance and capital markets lawyers in Portugal according to _Chambers Global_, _Chambers Europe_, _IFLR1000_ and _The Legal 500_.

HAROON JAN BARYALAY

_FGE Ebrahim Hosain_

Based in Islamabad, Haroon is managing partner of FGE Ebrahim Hosain’s Islamabad office. Haroon specialises in advising funds and fund managers on private equity, banking and finance and debt capital markets. Haroon’s areas of practice also include general corporate and commercial matters, and mergers and acquisitions.

Haroon has acted for both lenders and borrowers in a number of large and mid-sized financings and restructurings involving both conventional and Islamic facilities. Haroon has also acted for purchasers and sellers in domestic and cross border mergers and acquisitions and private equity deals.

Prior to joining FGE Ebrahim Hosain, Haroon worked in Dubai for seven years with major regional and international law firms, and before that in Karachi for four years with one of Pakistan’s top corporate law firms.

Haroon has an LLM from Harvard Law School (2005) and an LLB from University of London (2004). Haroon obtained his bachelor’s degree in economics from Lahore University of Management Sciences (2001).
EMMANUELLE BAUER  
*Deynecourt*

Emmanuelle Bauer co-heads Deynecourt’s asset management practice and provides legal advice to private equity funds, real estate funds, investment fund managers, banks and HNWI on Luxembourg regulated and unregulated alternative investment funds. Having gained sound experience assisting companies in relation to their general corporate affairs, joint venture transactions, restructurings and migrations, Emmanuelle regularly assists clients on regulatory, compliance and corporate governance matters. She also is a regular speaker at conferences and seminars on corporate law. Emmanuelle started her career at Gérard & Associés in Brussels. In 2000, she joined Philippe & Partners in Belgium, where she gained significant experience in corporate and business laws, advising national and international companies and non-profit organisations on restructuring and various other corporate matters.

Emmanuelle has been recommended by *The Legal 500* since 2016.

NICK BONSALL  
*Slaughter and May*

Nick Bonsall has been a partner in the financial regulation group at Slaughter and May in London since May 2016. He advises on the supervision and regulation of banks, asset managers, investment firms, payment institutions, insurance companies and building societies. Recently, his work has involved advising on various technical and transaction-based matters in the asset management sector, including in relation to prudential requirements. He has also advised on financial services outsourcing, the UK electronic money and payment services regimes, and agreements for the distribution of retail investment products. He graduated from the University of Edinburgh with a degree in mathematics and statistics, and qualified as a solicitor in England and Wales in 2009.

ELIZABETH BOTHWELL  
*Arthur Cox*

Elizabeth Bothwell is head of the insurance group at Arthur Cox and advises on a wide range of non-contentious insurance and reinsurance transactions and regulation. She advises on establishment and authorisation, mergers and acquisitions, portfolio transfers, joint ventures, reorganisations and compliance with regulatory requirements.

Ms Bothwell holds an LLB from Trinity College Dublin and an LLM from the London School of Economics. She was admitted as a solicitor in 1993 and is a member of the International Bar Association. She was a contributor to the Irish Law Reform Commission’s Consultative Paper on Insurance Contract Law (2012).

DOMINGOS BRAGA  
*Uría Menéndez – Proença de Carvalho*


He assists entities from various sectors on matters including M&A and capital markets, particularly acquisition finance, rights issues, takeovers, privatisations, investment funds and corporate restructurings.
About the Authors

JASON E BROWN
Ropes & Gray LLP

Jason Brown has extensive experience representing investment advisers to private equity funds, real estate funds, hedge funds, real estate funds, separate accounts and commodity pools. He has assisted over 35 leading private equity firms in registering as investment advisers with the SEC and developing Advisers Act compliance programmes, and has assisted numerous non-US private equity firms in analysing their regulatory obligations under US law. In addition, he has advised a wide variety of US and non-US investment advisers on Advisers Act, Investment Company Act and Commodity Exchange Act matters as new funds or products are launched, compliance questions arise, new rules are adopted or SEC or NFA inspections occur. He also focuses on the representation of other investment management clients, including open and closed-ended mutual funds and their directors. Mr Brown received his JD, cum laude, from Harvard Law School and his BS, summa cum laude, from the University of Pennsylvania, Wharton School.

MICHAEL CHAAYA
Corrs Chambers Westgarth

Michael Chaaya is known for his commerciality and being at the forefront of financial services reform and regulation.

Specialising in financial services regulation, funds management, superannuation and pensions, general and life insurance, and regulatory banking, Michael provides strategic advice to Australia’s leading financial services entities. He also advises foreign financial services providers seeking to enter the Australian market on their licensing and disclosure obligations.

On behalf of his clients he works closely with key regulators including the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission, the Australian Transaction Reports and Analysis Centre and the Australian Taxation Office.

Having gained valuable client-side experience on secondments as in-house legal counsel at MLC/National Australia Bank and BT Financial Group, Michael has genuine insight into his clients’ needs.

Michael has published widely on financial services issues and is a regular speaker at industry conferences in Australia and abroad. He is a senior fellow at the University of Melbourne Law School, adjunct professor of law at the University of Western Sydney Law School, and lectures in the postgraduate programme.

MIKHAIL CHARLES
Prudhoe Caribbean

Mikhail Charles is an experienced litigator across the Caribbean region with Prudhoe Caribbean, a pan-Caribbean disputes and advisory firm operating out of the Turks and Caicos Islands. Mr Charles is not admitted to practise in the TCI itself but works with others within the firm on representation of companies and high net worth individuals globally, in matters relating to trusts, cross-border insolvency, international judgment enforcement and asset recovery. He also works closely with a licensed insolvency practitioner from within the firm. He has substantial international comparative legal experience and consultancy having worked for the Commonwealth Secretariat and the Eastern Caribbean Telecommunications Authority.
He is admitted to practise in Saint Vincent and the Grenadines, Grenada, St Lucia and the British Virgin Islands. He is also called to the Bar of England and Wales.

He has appeared before the United Nations Office on Drugs and Crime (UNODC – Vienna Office) in 2016 on anti-corruption and asset recovery issues and served as in-house counsel to the Eastern Caribbean Telecommunications Authority. He appeared in the Eastern Caribbean Court of Appeal in 2015 for the (then) largest money laundering case in its history and is currently involved with testing the newly passed Bankruptcy and Insolvency Act of Saint Vincent with the first ever recognition of a ‘foreign liquidator’ application.

MARCIA CHIRIAEVA
Lenz & Staehelin
Maria Chiriaeva is a senior associate in the Geneva office of Lenz & Staehelin, where she primarily advises in banking, finance and capital market matters. Her practice also includes commercial and contractual matters. Her areas of expertise also include compliance advisory and internal investigations. Ms Chiriaeva is admitted to the Bar in Geneva. She has a master’s in economic law from the University of Geneva.

TIM COAK
Maples Group
Tim Coak is a partner in the Maples Group's funds and investment management team. He specialises in the establishment, launch, ongoing maintenance and restructuring of all types of Cayman Islands investment funds, particularly hedge funds and private equity funds. He advises on commingled funds and managed accounts, and acts for a wide variety of clients, including large financial institutions and investment managers and smaller, start-up investment managers. He also regularly advises clients on a broad range of corporate and commercial transactions.

ELLEN CRAMER-DE JONG
Allen & Overy LLP
Ellen heads the investment management team at Allen & Overy's Amsterdam office. She has an extensive background in regulatory, securities and corporate law, and her main practice areas are the structuring of investment institutions, the implementation of these structures and advising on investment, custody, AIFMD management and depositary agreements. Ellen advises financial institutions, funds and asset management companies on the regulatory, corporate and securities law aspects of their activities. Furthermore, she advises investors around the world on participating in private equity, infrastructure and other alternative asset class funds. Ellen has published various articles on regulatory issues in the Dutch investment management market. She is a member of the Securities Law Association, board member of the Dutch institution for pension education (IVP) and vice chair of the supervisory board of Musoni BV, a micro credit institution.

Ellen is ranked as a leading lawyer for investment funds in The Legal 500 directories.
About the Authors

ALIX D’ANGLEJAN-CHATILLON
Stikeman Elliott LLP

Alix d’Anglejan-Chatillon is a partner at Stikeman Elliott LLP in its Montreal office and co-head of the firm’s financial products and services group. She practises principally in the areas of investment management, the regulation of capital markets and derivatives. Her clients include managers of investment funds based in North America, Europe and Asia, including private equity funds, hedge funds, venture capital funds, mutual funds and fund of funds, as well as other asset managers, broker-dealers, and commercial and investment banks. She also represents institutional, family office and high net worth investors in connection with their investments in various investment fund structures. She is a graduate of Queen’s University (BA, 1984) and the McGill University School of Law (LLB, 1987 and BCL, 1988). She was called to the Bar in Quebec and Paris in 1989 and 1994, respectively.

PIERRE DE BACKER
Deynecourt

Pierre De Backer has served as principal to the asset management practice since Deynecourt’s inception. Pierre specialises in the organisation and offering of regulated and non-regulated investment vehicles, and counselling funds and their sponsors in all aspects of their operations. He has significant experience advising clients that manage or offer alternative or novel investment products. Pierre has been active in assisting clients in structuring Luxembourg and offshore funds, including stand-alone and master-feeder structures, and international investors in negotiating the terms of their subscription in Luxembourg funds. He has broad transactional expertise involving funds and their managers, including merger and acquisition transactions and fund reorganisations and liquidations. Pierre also serves as a member of the board of directors for a limited selection of investment funds sponsored by the firm’s clients. He advises clients on the full range of issues that funds, their management bodies and advisers encounter day-to-day, including compliance matters, contract approvals and disclosure issues. He has spoken at various conferences on fund structuring, management and distribution topics.

Pierre’s expertise has been recognised in The Legal 500, where he has been named as being among Luxembourg’s recommended investment funds lawyers since 2013.

For the five years prior to joining Deynecourt, Pierre was a senior adviser, then principal and head, of the investment funds practice at other firms. Prior to his time in private practice, Pierre had held senior positions with private banks and hedge fund administration businesses in Luxembourg since 2000.

PAUL DICKSON
Slaughter and May

Paul Dickson is a partner at Slaughter and May with a broad corporate and commercial practice. He has experience of advising clients on a wide range of corporate matters, including in the field of asset management, as well as on M&A transactions, private acquisitions and disposals, and joint ventures and partnership structures.
MICHELE DIMONTE

BonelliErede

Michele Dimonte is a tax adviser and specialises in advising multinationals, investment funds, private equity funds, real estate investment funds and banks on corporate income tax, dividend tax and tax treaty application matters. He frequently acts as a VAT consultant on general tax matters to national and multinational companies.

Mr Dimonte is a lecturer at the Il Sole 24 Ore Business School in Milan and at the International Fiscal Association (Italian branch), teaching on subjects such as international and European tax law. He is a member of the Italian Association of Tax Advisers.

SHELBY R DU PASQUIER

Lenz & Staehelin

Shelby R du Pasquier is the head of the banking and finance group of Lenz & Staehelin in Geneva. Mr du Pasquier advises a number of Swiss and international financial institutions, as well as Swiss and offshore private equity, hedge funds and fund managers. He is regularly distinguished in professional directories (e.g., Chambers, Who’s Who Legal) as a leading individual in banking and finance and as regards investment funds. Mr du Pasquier is a frequent speaker at professional conferences on banking and financial law issues, as well as investment funds. Mr du Pasquier is admitted to the Bar in Geneva and New York. He has a Bachelor of Laws and a Bachelor of Business Administration from the University of Geneva, as well as an LLM degree from Columbia University School of Law. Mr du Pasquier is a member of the board of the Swiss National Bank.

JEFFREY ELLIOTT

Stikeman Elliott LLP

Jeffrey Elliott is a partner at Stikeman Elliott LLP in its Toronto office. His practice primarily focuses on securities law with an emphasis on investment funds. Mr Elliott acts for a broad range of financial institutions as well as investment fund managers, domestic and international dealers and advisers, and public and private investment funds. In addition, he has significant experience with mergers and acquisitions and public financings. Mr Elliott received his BA with honours from McMaster University in 1997 and obtained an LLB from Osgoode Hall Law School in 2000. He was called to the Ontario Bar in 2002.

GERARD EVERAERT

Uría Menéndez – Proença de Carvalho

Gerard Everaert joined the Lisbon office of Uría Menéndez – Proença de Carvalho in May 2014 as a trainee. Prior to joining the firm, he worked in a leading consultancy firm (Deloitte).

His practice is focused on tax law, specialising in real estate transactions, financial products, tax planning and compliance procedures.
CRISTIANA FERRARI

BonelliErede

Cristiana Ferrari has been an associate at BonelliErede since 2016. She practises banking and financial law, with a focus on matters relating to Italian and foreign supervised entities (banks, financial intermediaries, investment firms, asset management companies, payment services providers), including regulatory and supervisory profiles connected with extraordinary and M&A transactions, authorisation procedures and relationships with supervisory authorities, prudential regulation issues, corporate governance structures, internal control systems, remuneration of the corporate bodies.

Ms Ferrari graduated from the University of Padua in 2016 and was admitted to the Italian Bar in 2018.

FERNANDO J PRADO FERREIRA

Pinheiro Neto Advogados

Fernando J Prado Ferreira is a partner in Pinheiro Neto Advogados’ corporate department and has practised in the São Paulo office for over 30 years. He advises corporate, banking and investment management clients on corporate and regulatory matters, such as the incorporation of companies in Brazil, M&A transactions, foreign investments in Brazil, as well as the incorporation and accreditation of asset managers. Mr Ferreira holds an LLM from the University of Michigan, United States. He worked as a foreign associate at Sullivan and Cromwell, New York between 1989 and 1990.

LEIGH R FRASER

Ropes & Gray LLP

Leigh Fraser is co-leader of the firm’s private funds practice group and focuses her practice on issues related to hedge funds and derivatives. She advises a variety of financial institutions, including hedge funds, investment advisers, mutual funds and endowments, on derivatives transactions and arrangements with brokers and custodians, including compliance with the new requirements under the Dodd-Frank Act. She also has significant experience in forming onshore and offshore hedge funds, and advising these entities and their sponsors on an ongoing basis with respect to regulatory matters and structuring new investment products. Ms Fraser received her JD, magna cum laude, from Harvard Law School and her AB, magna cum laude, from Harvard University.

PABLO GAYOL

Marval, O’Farrell & Mairal

Pablo Gayol joined Marval, O’Farrell & Mairal in 1997. His practice in the firm is centred on capital markets, banking and derivative regulations.

He graduated as a lawyer cum laude from the Pontifical Catholic University of Argentina in 1996 and obtained a Master of Laws from the University of Chicago Law School in 1997 and a Master in Finance from the University of CEMA in 2002. Pablo has also been a CFA charterholder since 2012.

Pablo is a professor of derivatives law at Torcuato Di Tella University and the University of San Andrés. Pablo is also a professor at the University of CEMA.
JONATHAN GREEN
Maples Group
Jonathan Green is head of the Maples Group’s Cayman Islands funds and investment management team. He advises on all aspects of investment funds, specialising in private equity and hedge fund formation. Jonathan has extensive experience of corporate, partnership and trust structures, establishing and operating fund platforms, advising on fund regulatory matters, structuring downstream transactions and advising funds on matters arising throughout their life cycle. Jonathan was the chairman of the subcommittee that helped draft the Limited Liability Companies Law and is an alternate director of Cayman Finance (as well as being a chair and co-chair of a number of committees and subcommittees of Cayman Finance).

PETER HAMMERICH
Advokatfirmaet BAHR AS
Peter Hammerich has been the head of BAHR’s asset management and private equity group since its inception in 2005. He has extensive experience within financial services and regulation and the asset management industry generally, advising domestic and international asset managers, investment banks, insurers, pension plans, funds and government-sponsored enterprises across their operations. Peter’s areas of expertise include industry-wide regulations, compliance, fund formation, employment and executive compensation, pension and tax. He has for many years been recognised in independent rankings as one of the leading Nordic advisers within these fields.

WILBERT HARVEY
Prudhoe Caribbean
Wilbert Harvey is a second-career lawyer at Prudhoe Caribbean, a pan-Caribbean law firm specialising in complex and often cross-border disputes work. Previously a senior member of the Cable & Wireless team, where he managed a commercial department before embarking on his legal studies, Wilbert is admitted to practise in the Turks and Caicos Islands. He is also called to the Bar of England and Wales. His industry background is invaluable in his now specialist practice.

MARKUS HEISTAD
Advokatfirmaet BAHR AS
Markus Heistad is part of BAHR’s asset management and private equity group, and advises on financial regulatory matters as well as transactions typically involving regulated targets or counterparties (such as banks, insurers, payment institutions, investment firms and asset managers). Markus’s practice spans financial institutions’ businesses in the widest sense, and he regularly advises on matters concerning marketing laws, contracts and personal data as well as confidentiality and reporting obligations applicable to his clients’ operations. Markus also has wide experience from advising on application processes and dialogue with Norwegian and multinational financial and other regulatory bodies.
BEN HERON  
*Slaughter and May*  
Ben Heron is an associate and a corporate lawyer based in Slaughter and May’s Hong Kong office. He specialises in mergers and acquisitions, asset management and a wide range of corporate and commercial transactions. Mr Heron was educated at Cambridge University, and is qualified in England and Wales and in Hong Kong. He has published in the areas of hedge funds and asset management.

FUMIHARU HIROMOTO  
*Mori Hamada & Matsumoto*  
Fumiharu Hiromoto is of counsel at Mori Hamada & Matsumoto and advises on an extensive range of financial transactions and financial regulatory matters, including asset management, investment funds (including the public offering and private placement of foreign-domiciled investment funds), real property investments (including inbound investments using a TK-GK (a collective investment scheme) or a TMK (special purpose vehicle for asset securitisation) with leveraged debt financing), healthcare property investments (including hospitals and nursing care facilities), banking, derivatives and dispute resolutions relating to financial transactions. He received his LLB from the University of Tokyo in 1995 and his LLM from Columbia University School of Law in 2003. He also worked with Kirkland & Ellis in Chicago from September 2003 to August 2004. He is admitted in Japan (1997) and New York (2004) and is fluent in Japanese and English.

NABIL A ISSA  
*King & Spalding LLP in cooperation with the Law Office of Mohammed AlAmmar*  
Nabil A Issa is a partner at King & Spalding LLP. He splits his time between the Dubai and Riyadh offices. He is one of the market leaders for structuring and establishing investment funds and other vehicles in the GCC, with a particular focus on Saudi Arabia. His practice focuses on funds, corporate and finance matters, particularly on a shariah-compliant basis. He is regularly ranked as one of the leading lawyers in Saudi Arabia by *Chambers Global* and *Islamic Finance News*.

FADI C KHOURY  
*Corrs Chambers Westgarth*  
Fadi is one of Australia’s leading asset management specialist lawyers. He has advised fund managers, limited partners and other financial services firms for over 20 years in product, M&A and regulatory matters.  

He has deep experience from his work across the funds and asset management sector, including in real assets, private equity, hedge funds, infrastructure and agriculture.  

Clients benefit from his practical industry experience from roles at Deutsche Bank, Brookfield and AMP Capital.  

He is a postgraduate lecturer in investment and financial services regulation, and is the Australian legal sector representative on the Australian Financial Markets Association Accreditation Board.
He continues to be formally recognised as one of Australia’s ‘leading lawyers’ in both the investment funds and financial services sectors: ‘Fadi advises on a wide range of investment scheme matters and is particularly trusted by clients for structuring and dealing with regulators. Clients agree that he is without a doubt easy to deal with, technically responsive and commercial.’ (Chambers Asia-Pacific).

DAVID KILTY
Arthur Cox

David Kilty is a partner in the Arthur Cox tax group, which he joined in 2011 after completing his training with the firm. He advises on a broad range of commercial matters across all tax heads with a particular focus on tax aspects of structured finance transactions, establishment of investment funds, mergers and acquisitions, and cross-border reorganisations. Clients regularly advised include both Irish and international PLCs, domestic and international banks, investment managers and private equity funds as well as private international companies.

Mr Kilty holds a BBLS (international) degree from University College Dublin, and is an AITI chartered tax adviser and a member of the Irish Tax Institute. He was admitted as a solicitor in Ireland in 2011.

PETER LAKE
Slaughter and May

Peter Lake is a partner at Slaughter and May. He is involved in a wide range of corporate work, advising companies, financial institutions and fund management groups. He is a member of the investment products and financial services committee of the Hong Kong Law Society.

His work includes advising MTR Corporation Limited, Hong Kong’s mass-transit railway operator, in relation to its merger of railway operations with Kowloon–Canton Railway Corporation; PT Borneo Lumbung Energi & Metal Tbk, the Indonesian-listed coking coal producer, on its US$1 billion acquisition finance facility to fund the acquisition of an effective economic interest of approximately 23.8 per cent in Bumi plc, a leading natural resources group listed on the London Stock Exchange; Aareal Bank, Singapore, in respect of the transfer between private equity houses of a project financing relating to real property located in China; the Oxford Asset Management Group on the launch of the OxAM Quant Fund; Moore Capital on Hong Kong regulatory matters; and numerous financial institutions and borrowers on financing transactions. Mr Lake is qualified in England and Wales and in Hong Kong. He has published in the areas of asset management, banking and banking regulation.

JOHN M LODER
Ropes & Gray LLP

John M Loder is a partner at Ropes & Gray LLP, with which he has been associated since 1984, and for many years headed the firm’s investment management practice group. His practice focuses primarily on investment management industry clients, including investment advisers, mutual funds, hedge funds, private equity firms and the investment management activities and products of banks, broker-dealers and insurance companies. He has extensive experience in, inter alia, the following types of matters: the organisation of investment advisory firms and investment funds of all types; ongoing representation of and advice to
open and closed-ended investment companies, exchange-traded funds and their independent directors and trustees (currently including over 500 funds with collective assets totalling several hundred billion dollars); mergers, acquisitions and reorganisations of investment advisers and funds; advice with respect to governance, regulatory and compliance issues of all kinds affecting investment management industry clients; and advice regarding government enforcement matters. He also serves as counsel to the independent directors of a number of large real estate investment trusts. Mr Loder is a graduate of Harvard College and Harvard Law School.

JUAN CARLOS MACHUCA SIGUERO
*Uría Menéndez Abogados, SLP*

Juan Carlos joined Uría Menéndez in Madrid in 1996 and has worked out of the firm’s London office since January 2000. He is the current resident partner in the London office.

His practice focuses on corporate law, banking, finance, regulatory, investment funds, private equity and capital markets. He also advises clients on M&A transactions, and on insolvency and restructuring proceedings.

In 2007, he was one of the winners of the Iberian Lawyer ‘40 Under Forty Awards’, which recognise the achievements of the new generation of top lawyers in Spain and Portugal.

DUARTE ARAÚJO MARTINS
*Uría Menéndez – Proença de Carvalho*

Duarte Araújo Martins joined the Lisbon office of Uría Menéndez – Proença de Carvalho in September 2015 as a trainee lawyer and is currently a junior associate lawyer in the M&A and capital markets department. His practice is focused on capital markets, M&A, corporate finance and securities law.

Mr Araújo Martins assists entities from various sectors, particularly in M&A and capital markets, particularly acquisition finance, takeovers, debt and equity offerings, investment funds, corporate restructurings and regulatory issues.

KON MELLOS
*Corrs Chambers Westgarth*

Kon works with fund managers, superannuation funds, pension funds, sovereign wealth funds and other institutional investors on their domestic and international investment programmes, covering fund formation, fund investments, direct investments and co-investments.

He has been involved in the development of limited partnership legislation in Australia and has also prepared template documentation for private investment funds, including venture capital limited partnerships for the Australian Private Equity and Venture Capital Association.

Kon has particular expertise in domestic and international investment transactions in the venture capital, private equity, infrastructure and real estate sectors; and establishing and investing in domestic and international investment funds in the venture capital, private equity, private debt, infrastructure, real estate and hedge funds industries.
KEVIN MURPHY
_Arthur Cox_

Kevin Murphy is co-head of the asset management and investment funds group at Arthur Cox. He has extensive experience in advising on the legal and regulatory issues surrounding the establishment of investment funds in Ireland (including UCITS, QIAIFs, ICAVs, ETFs, hedge funds and private equity funds).

Mr Murphy was previously a corporate and securities partner in the United States with a leading US law firm.

He is a member of the Irish Prime Minister’s IFSC Funds Group, which advises on legislative and regulatory changes affecting the Irish investment funds industry. He is also past chair of the Irish Funds Industry Association.

Mr Murphy holds a BCL and an LLB from University College Cork, an LLM (commercial law) from University College Dublin and a JD from the University of Missouri School of Law. He was admitted as a solicitor in Ireland in 1992 and in England and Wales in 1996, and was admitted to the Missouri Bar in 1998. He is a member of the American Bar Association and the International Bar Association.

DAVID O’SHEA
_Arthur Cox_

David O’Shea is of counsel and is a member of the Arthur Cox asset management and investment funds group, which he joined in 2007 after completing his training with the firm. He advises on asset management with a particular focus on the establishment and regulation of mutual funds. He is a current member of the IFIA’s AML Working Group and formerly sat as a member on its Legal and Regulatory Working Group and Marketing Committee.

Mr O’Shea holds a BA (economics and law) and an LLB from the National University of Ireland, Galway, and a diploma in applied finance law from the Law Society of Ireland. He was admitted as a solicitor in Ireland in 2007.

MACKY O’SULLIVAN
_King & Spalding LLP_

Macky O’Sullivan is a senior associate at King & Spalding LLP. Mr O’Sullivan specialises in cross-border mergers and acquisitions, financial services regulation and investment funds. He has represented and advised clients on a broad range of corporate and investment fund matters, including the formation of and investment in conventional and shariah-compliant investment funds. He has been recognised by _Who’s Who Legal_ as a leading private funds lawyer in the United Arab Emirates.

RITA PAPADOPOULOU
_About Jaoude & Associates Law Firm_

Rita Papadopoulou is a partner (English solicitor) at About Jaoude & Associates Law Firm and heads the capital markets and structured products practice. Before joining AJA, Rita pursued a distinguished career for over a decade in London as a structured finance and derivatives lawyer, working with leading top-tier global investment banks, such as JPM Morgan Chase and Goldman Sachs, as well as with the leading global law firm Norton.
Rose Fulbright. Rita’s broad practice combines both transactional and advisory expertise and includes structured derivatives, capital markets and securities, structured finance, Islamic finance, private equity, funds, derivatives regulation and banking regulation. She has been integral in many award-winning innovative multibillion finance deals, with an emphasis on emerging markets, representing a broad range of global financial institutions and other clients on highly structured equity deals, finance-linked hedging, MTN restructurings and structured derivatives of all asset classes.

LUIS FERNANDO GRANDO PISMEL
Pinheiro Neto Advogados

Luis Fernando Grando Pismel is a junior-level associate in Pinheiro Neto Advogados’ corporate department and has practised in the São Paulo office for four years. He advises corporate, banking and investment management clients on corporate and regulatory matters, such as the incorporation of companies in Brazil, M&A transactions and foreign investments in Brazil, as well as the incorporation and accreditation of asset managers.

MARTA PONTES
Uría Menéndez – Proença de Carvalho

Marta Pontes joined the firm in 2004 to work in the Lisbon office. Before joining Uría Menéndez, she worked in a Portuguese law firm and in a leading consultancy firm (Ernst & Young). She became a partner in January 2014.

She focuses on tax law, specialising in the following areas: real estate transactions, financial products, capital markets, and mergers and acquisitions.

She has written several articles on tax issues, and frequently participates as a speaker at seminars and conferences pertaining to her fields of expertise.

NAOMI REIJN
Allen & Overy LLP

Naomi focuses primarily on remuneration within financial institutions and listed companies, from both a regulatory and a transaction perspective. Furthermore, she is experienced in employment law. From August 2015 until December 2015, she was on an in-house client secondment at NLFI, the shareholder of ABN AMRO Bank, SNS, ASR and Propertize. Naomi is part of the financial markets regulation practice group.

GIUSEPPE RUMI
BonelliErede

Giuseppe Rumi has been a partner at BonelliErede since 2006. His practice focuses on banking and financial law, with a particular emphasis on regulatory issues.

He advises major international and local banks, investment firms and asset management companies. He assists clients on all types of licence and authorisation procedures, as well as in analysing the impact of new regulations on the internal organisation, processes, policies and rules of banks and financial intermediaries. His work includes advice on anti-money laundering issues and assistance with inspection and penalty processes undertaken by the Italian regulators in relation to supervised entities.
Since 2001, Mr Rumi has been involved in some of the most important mergers and acquisitions in the Italian banking sector, and has specific experience in assisting multinationals, management companies and investment funds interested in working in Italian regulated sectors. He is currently working on wide governance reforms and internal audit investigations of credit institutions following changes in their corporate bodies and requests from the supervisory authorities (as a result of the single supervisory mechanism).

He assisted the new corporate bodies of the four bridge banks (Nuova Banca delle Marche, Nuova Banca dell’Etruria e del Lazio, Nuova Cassa di Risparmio di Ferrara and Nuova Cassa di Risparmio di Chieti) established in the first application of the Bank Recovery and Resolution Directive in Italy.

He regularly sits on panels of Italian associations that deal with prudential supervision and complex and innovative financial techniques for both the banking sector and finance companies. Giuseppe is also in charge of BonelliErede’s outpost in Frankfurt (at Hengeler Mueller’s offices), and of the European Financial Institutions Group, a group of experts in financial regulation from all the firms in the Best Friends network.

CHRISTIAN SCHMIES
Hengeler Mueller

Christian Schmies is a partner at Hengeler Mueller. He studied in Bonn, Bologna and Washington, DC. Dr Schmies holds a doctorate degree (Dr jur) from the University of Bonn and a master’s degree (MA) from the Paul H Nitze School of Advanced International Studies (SAIS) in Washington, DC. He was admitted to the Bar in 2007 and has since practised law in Hengeler Mueller’s Frankfurt office. Dr Schmies specialises in banking and capital markets, financial institutions, compliance, banking and finance, investment fund law, asset management as well as M&A transactions in the financial sector.

MICHAEL SHOVLIN
Arthur Cox

Michael Shovlin is a senior associate at Arthur Cox and a member of the firm’s pensions and benefits group. Michael trained at Arthur Cox and acquired a wide range of experience as a corporate lawyer with the firm prior to specialising in pensions and equity incentive work. For three years from 2008 to 2011 he worked in a senior policy role for the government of Ireland. His work today sees him advise employers and scheme trustees on the establishment, restructuring and day-to-day operation of pension and equity incentive schemes, including drafting scheme documentation, reviewing and negotiating items such as investment management agreements and other agreements governing relationships with service providers. He also advises on scheme reorganisations and on the pensions and equity incentive elements of corporate transactions.

Michael holds BCL and LLM (commercial law) degrees from University College Dublin and was admitted as a solicitor in Ireland in 2007. He is also admitted as a solicitor in England and Wales. Michael is a member of the Association of Pension Lawyers in Ireland and of the National Association of Stock Plan Professionals.
SAYF SHUQAIR
King & Spalding LLP in cooperation with the Law Office of Mohammed AlAmmar
Sayf Shuqair is an associate at King & Spalding LLP. Mr. Shuqair mainly advises clients on the structuring, formation and governance of various types of investment funds, including private equity, venture capital and real estate investment funds, and also generally advises clients on innovative corporate, commercial and investment structures in Saudi Arabia.

LUKE STOCKDALE
Maples Group
Luke Stockdale is a partner in the Maples Group’s dispute resolution and insolvency team, and has a broad range of experience in commercial litigation with an emphasis on complex and multi-jurisdictional matters. He has worked across a range of industry sectors, and has considerable experience in banking and finance and investment fund disputes, company law and trust disputes.

JAMES R STULL
King & Spalding LLP
James R Stull is a partner at King & Spalding LLP. He primarily focuses on asset management and investment funds across various asset classes, including venture capital funds, private equity funds, real estate funds, infrastructure funds, credit funds, hedge funds and shariah-compliant funds. His practice includes advising clients on the corporate and regulatory aspects of structuring, establishing and liquidating various fund structures, and he has substantial experience with securities regulations in the UAE, Saudi Arabia and other Middle East jurisdictions as well as in the United States. He has been recognised for his practice by Law360, Chambers Global, The Legal 500 and IFLR1000.

YASUZO TAKENO
Mori Hamada & Matsumoto
Yasuzo Takeno is a partner at Mori Hamada & Matsumoto. Since the early 1990s, he has had extensive experience in advisory work for both domestic and foreign investment managers and investment fund businesses, including structuring, public offerings and private placements of offshore investment funds in Japan. He has represented issuers of foreign investment trusts established in the Cayman Islands, Luxembourg, Ireland and other jurisdictions, providing advice on legal and execution issues where issuers offer their units, either publicly or privately, in Japan. His investment fund work also covers legal advice on the day-to-day management of investment fund businesses. As well as his work dealing with asset management, his practice spans corporate finance activities and financial regulation. He obtained his LLB from Waseda University in 1985 and his MLitt from Oxford University, Worcester College, in 1993. He was admitted to practise in Japan in 1987, and is fluent in Japanese and English.
DANNY TAN  
*Allen & Gledhill LLP*

Danny heads Allen & Gledhill’s private funds team and he specialises in investment funds and private equity.

With close to two decades of experience encompassing investment funds, capital markets, and mergers and acquisitions, Danny has extensive experience in fund formation and restructuring, fund investments and fund regulatory matters. His expertise with various types of onshore or offshore fund vehicles (including corporate entities, limited partnerships and unit trusts) is well regarded in the Singapore fund management industry, whether for private equity funds, hedge funds, funds of funds, real estate, infrastructure or venture capital funds. Danny acts for local and international fund managers, family offices, financial institutions, governmental bodies and sovereign wealth funds.

Danny has co-written articles for international publications such as the *International Financial Law Review*, including the Singapore chapter of the *International Guide to Hedge Fund Regulation* (Bloomsbury Professional, 2009) and has also been interviewed and quoted by publications such as the *Asian Venture Capital Journal* for his industry knowledge.

RICCARDO UBALDINI  
*BonelliErede*

Riccardo Ubaldini, tax adviser, advises mainly internationally operating corporate clients, and private equity and investment funds, on all areas of international taxation. He is often involved in international tax structuring and restructurings, international real estate investments, mergers and acquisitions, and structured finance transactions. He frequently acts as a VAT consultant on general tax matters to national and multinational companies.

Mr Ubaldini is a lecturer at Bocconi University in Milan and at the Italian School for Tax Inspectors, teaching on subjects such as mergers, split-offs, reorganisations, consolidated tax groups and structured financing. He is a member of the Italian Association of Tax Advisers.

DAPHNE VAN DER HOUWEN  
*Allen & Overy LLP*

Daphne specialises in financial and commercial litigation, and regularly advises financial institutions on the regulatory and civil law aspects of their activities. Daphne is part of the financial markets regulation practice group in the Amsterdam office. She mainly focuses on banking, insurance and securities law disputes and advises on transactions involving financial supervision aspects. Daphne has particular expertise in the field of conduct supervision and duty of care considerations. Prior to specialising in dispute resolution, Daphne worked in the Amsterdam capital markets practice.

In 2014, Daphne went on secondment for several months at De Nederlandsche Bank. She is a member of the financial markets regulation practice at Allen & Overy’s Amsterdam office and publishes regularly on financial law. Daphne is the editorial secretary to *Tijdschrift voor Financieel Recht*, a magazine on financial law.
FRISO VAN ORDEN

*Allen & Overy LLP*

Friso specialises in (international) tax law, tax compliance and tax litigation. His practice focuses on mergers and acquisitions, structured finance, tax structuring, PPP projects, tax and legal compliance services and court proceedings. Friso operates in integrated teams of corporate, finance, regulatory and litigation lawyers and is involved in the drafting of all forms of legal documentation as well as conducting legal proceedings.

GIULIO VECE

*BonelliErede*

Giulio Vece has been an associate at BonelliErede since 2011. He practises banking and financial law, focusing primarily on regulatory matters. He is regularly involved in prudential regulation issues and mergers and acquisitions concerning banks, asset managers, financial intermediaries and other regulated entities.

Mr Vece graduated *magna cum laude* from the LUISS University of Rome in 2011 and was admitted to the Italian Bar in 2014. In 2016 and 2017, he served as a visiting foreign associate at Hengeler Mueller’s financial regulation group in Frankfurt.

He assisted Quaestio Capital SGR in the structuring and incorporation of Atlante Fund and Italian Recovery Fund, and Banca Monte dei Paschi di Siena with regulatory matters concerning the precautionary recapitalisation of the bank.

ANNA VIÑAS MIQUEL

*Uría Menéndez Abogados, SLP*

Anna joined Uría Menéndez’s Barcelona office in 2012 and worked at the firm’s London office from March 2016 to August 2017, after which she returned to the Barcelona office. Her practice focuses on corporate law, M&A, private equity, regulatory and investment funds. Anna has been involved in some of the most significant transactions in Spain in recent years.

JASON WEBBER

*Slaughter and May*

Jason Webber is a partner at Slaughter and May, and is involved in a wide range of corporate, commercial and financing work, advising companies, financial institutions and fund management groups. He regularly advises in relation to complex matters involving the Hong Kong regulatory authorities and governmental bodies. Mr Webber has also worked in the London office of Slaughter and May. Other projects include advising MTR Corporation Limited, Hong Kong’s mass-transit railway operator, in relation to its privatisation, which was Hong Kong’s first (and to date only) privatisation of its kind; the merger with the Kowloon–Canton Railway Corporation; and the construction of various railway lines including the Disney Resort Line, the West Island Line, the Shatin to Central Line, the South Island (East) Line and the Express Rail Line. Mr Webber has advised JP Morgan JF
Asset Management Group on the launch of various retail funds, Oxford Asset Management Group on the launch of the OxAM Quant Fund, as well as numerous international hedge fund groups on their establishment and operations in Hong Kong.

Mr Webber is qualified in England and Wales and in Hong Kong. He has sat on a disciplinary committee of the Securities and Futures Commission and has published in the areas of asset management, mergers and acquisitions and the Hong Kong Listing Rules.
CONTRIBUTORS’ CONTACT DETAILS

ABOU JAOUDE & ASSOCIATES LAW FIRM
OMT Bldg
266 Sami El Solh Ave
PO Box 116-5079
Beirut
Lebanon
Tel: +961 1 395555
Fax: +961 1 384064
r.papadopoulou@ajalawfirm.com
www.ajalawfirm.com

ADVOKATFIRMAET BAHRS
Tjuvholmen allé 16
0252 Oslo
Norway

PO Box 1524 Vika
0117 Oslo
Norway

Tel: +47 21 00 00 50
Fax: +47 21 00 00 51
ph@bahr.no
marhe@bahr.no
www.bahr.no

ALLEN & OVERY LLP
Apollolaan 15
1077 AB Amsterdam
Netherlands
Tel: +31 20 674 1000
Fax: +31 20 674 1111
ellen.cramerdejong@allenovery.com
daphne.vanderhouwen@allenovery.com
naomi.reijn@allenovery.com
friso.vanorden@allenovery.com
www.allenovery.com

ALLEN & GLEDHILL LLP
One Marina Boulevard #28-00
Singapore 018989
Tel: +65 6890 7738
Fax: +65 6302 3109
danny.tan@allenandgledhill.com
www.allenandgledhill.com

ARTHUR COX
10 Earlsfort Terrace
Dublin 2
D02 T380
Ireland
Tel: +353 1 920 1000
Fax: +353 1 920 1020
kevin.murphy@arthurcox.com
elizabeth.bothwell@arthurcox.com
david.oshea@arthurcox.com
david.kilty@arthurcox.com
michael.shovlin@arthurcox.com
www.arthurcox.com
Contributors’ Contact Details

BONELLIEREDE
1 Via Barozzi
20122 Milan
Italy
Tel: +39 02 7711 31
Fax: +39 02 7711 3260
giuseppe.rumi@belex.com
riccardo.ubaldini@belex.com
michele.dimonte@belex.com
cristiana.ferrari@belex.com
giulio.vece@belex.com
www.belex.com

CORRS CHAMBERS WESTGARTH
Level 17
8 Chifley
8–12 Chifley Square
Sydney NSW 2000
Tel: +61 2 9210 6328/6500
Fax: +61 2 9210 6611
fadi.khoury@corrs.com.au
michael.chaaya@corrs.com.au

Level 25
567 Collins Street
Melbourne VIC 3000
Tel: +61 3 9672 3000
Fax: +61 3 9672 3010
kon.mellos@corrs.com.au

www.corrs.com.au

DEYNECOURT
2, rue Albert Borschette
1246 Luxembourg
Tel: +352 2040 9030
Fax: +352 2040 9031
pierre.de.backer@deynecourt.com
emmanuelle.bauer@deynecourt.com
www.deynecourt.com

FGE EBRAHIM HOSAIN
House 352-B, Street 68
M.P.C.H.S.
E-11/3 Islamabad
Pakistan
Tel: +92 51 8431474/65
h.baryalay@fge-eh.com
www.fge-eh.com

HENGELEX MUELLER
Bockenheimer Landstraße 24
60323 Frankfurt am Main
Germany
Tel: +49 69 17095 0
Fax: +49 69 17095 099
christian.schmies@hengeler.com
www.hengeler.com

KING & SPALDING LLP
Al Fattan Currency House
Tower 2, Level 24
Dubai International Financial Centre
Dubai
United Arab Emirates
Tel: +971 4 377 9900
Fax: +971 4 377 9955
jstull@kslaw.com
mosullivan@kslaw.com

King & Spalding LLP in cooperation with
the Law Office of Mohammed AlAmmar
Kingdom Centre, 20th Floor
King Fahad Road
Riyadh 11434
Saudi Arabia
Tel: +966 11 466 9400
Fax: +966 11 211 0033
nissa@kslaw.com
sshuqair@kslaw.com

www.kslaw.com

© 2019 Law Business Research Ltd
LENZ & STAHELIN
Route de Chêne 30
1211 Geneva 6
Switzerland
Tel: +41 58 450 70 00
Fax: +41 58 450 70 01
shelby.dupasquier@lenzstaehelin.com
maria.chiriaeva@lenzstaehelin.com
www.lenzstaehelin.com

PINHEIRO NETO ADVOGADOS
Rua Hungria, 1100
01455-906 São Paulo
Brazil
Tel: +55 11 3247 8400
Fax: +55 11 3247 8600
fpradoferreira@pn.com.br
lpismel@pn.com.br
www.pinheironeto.com.br

MAPLES GROUP
PO Box 309, Ugland House
South Church Street
George Town
Grand Cayman KY1-1104
Cayman Islands
Tel: +1 345 949 8066
Fax: +1 345 949 8080
jonathan.green@maples.com
tim.coak@maples.com
luke.stockdale@maples.com
www.maples.com

PRUDHOE CARIBBEAN
Suite 55, Salt Mills Plaza
Grace Bay Road
Providenciales
Turks and Caicos Islands
Tel: +1 649 941 4636
wilbert@prudhoecaribbean.com
mikhail@prudhoecaribbean.com
www.prudhoecaribbean.com

ROPES & GRAY LLP
Prudential Tower
800 Boylston Street
Boston MA 02199-3600
United States
Tel: +1 617 951 7942/7485/7405
Fax: +1 617 235 0533/0543/0066
jebrown@ropesgray.com
leigh.fraser@ropesgray.com
john.loder@ropesgray.com
www.ropesgray.com

MARVAL, O’FARRELL & MAIRAL
Av. Leandro N. Alem 882
C1001AAQ Buenos Aires
Argentina
Tel: +54 11 43100100
Fax: +54 11 43100200
pg@marval.com
www.marval.com

MORI HAMADA & MATSUMOTO
16th Floor, Marunouchi Park Building
2-6-1 Marunouchi, Chiyoda-ku
Tokyo 100-8222
Japan
Tel: +81 3 5220 1844 / +81 3 5223 7723
yasuzo.takeno@mhm-global.com
fumiharu.hiromoto@mhm-global.com
www.mhmjapan.com
SLAUGHTER AND MAY
47th Floor, Jardine House
One Connaught Place
Central
Hong Kong
Tel: +852 2521 0551
Fax: +852 2845 2125
jason.webber@slaughterandmay.com
peter.lake@slaughterandmay.com
ben.heron@slaughterandmay.com

One Bunhill Row
London
England EC1Y 8YY
United Kingdom
Tel: +44 20 7600 1200
Fax: +44 20 7090 5000
nick.bonsall@slaughterandmay.com
paul.dickson@slaughterandmay.com

www.slaughterandmay.com

URÍA MENÉNDEZ
Uría Menéndez – Proença de Carvalho
Praça Marquês de Pombal, 12
1250-162 Lisbon
Portugal
Tel: +351 21 030 86 00
Fax: +351 21 030 86 01
carlos.andrade@uria.com
marta.pontes@uria.com
gerard.everaert@uria.com
duarte.martins@uria.com
domingos.braga@uria.com

Uría Menéndez Abogados, SLP
125 Old Broad Street – 17th Floor
London EC2N 1AR
United Kingdom
Tel: +44 20 7260 1800
juancarlos.machuca@uria.com
anna.vinas@uria.com

www.uria.com

STIKEMAN ELLIOTT LLP
1155 René-Lévesque Boulevard West
41st Floor
Montreal
Quebec H3B 3V2
Canada
Tel: +1 514 397 3000
Fax: +1 514 397 3222
adanglejan@stikeman.com

5300 Commerce Court West
199 Bay Street
Toronto
Ontario M5L 1B9
Canada
Tel: +1 416 869 5500
Fax: +1 416 947 0866
jelliott@stikeman.com

www.stikeman.com