DechertOnPoint

Second Quarter 2010

Financial Services Quarterly Report

In this issue

Real Estate and Private Equity Funds in Ireland

By **Declan O'Sullivan** and **Barbara Cronin**

While Ireland is widely recognised as a centre for UCITS funds and it led the way in the development of regulated hedge fund structures, its offering in relation to real estate and private equity funds is less well known. Real estate and private equity funds have generally been established in off-shore jurisdictions such as the Channel Islands or using structures such as the English limited partnership. More recently, Luxembourg has used its double taxation treaty network to facilitate the establishment of efficient real estate and private equity fund structures investing through multiple conduit structures in Europe, Asia and beyond. The development of similar products in Ireland was hampered by the perception that Irish funds did not possess these inherent tax advantages.

This article reviews the regulatory regime in place in Ireland for both real estate and private equity funds and demonstrates how Irish securitisation vehicles are being used to gain access to Ireland's double taxation treaty network.

Qualifying Investor Funds

Real estate and private equity funds cannot be established as UCITS and while there are other structures in place, it is the Qualifying Investor Fund ("QIF") that is the structure of choice for

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such private funds. The QIF is aimed at institutional and sophisticated private investors who must meet minimum subscription requirements. As a tax exempt vehicle, the QIF is exempt from Irish tax on its income and gains and is also exempt from withholding tax on its income distributions to non-Irish resident investors, provided a non-resident declaration is in place. A qualifying investor is defined as a natural person with minimum net worth (excluding main household and residence goods) in excess of €1,250,000 or an institution owning or investing, on a discretionary basis, a minimum of €25,000,000. There is an initial minimum subscription requirement in the QIF of €250,000 (or its equivalent in other currencies) per investor and no limit on subsequent subscriptions.

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Regulatory Framework and Legal Structures

QIFs are established in Ireland under the non-UCITS regulatory regime and are governed by the Financial Regulator's Guidance Note 1/07 and the Non UCITS Notice NU 24. While the regulatory framework in relation to appointment of service providers and governance applies to QIFs, they are not subject to any investment or borrowing restrictions, and QIFs established as investment companies or investment limited partnerships are exempted from the requirement to produce half-yearly reports. QIFs are most commonly established as investment companies or unit trusts, but they may also be established as investment limited partnerships or common contractual funds. As onshore EU domiciled funds, QIFs will meet the requirements of, and be passportable under, the Alternative Investment Fund Managers Directive.

Investment Restrictions

While there are no investment or borrowing restrictions for QIFs, there are a number of factors that must be taken into consideration when structuring a QIF.

- A QIF that invests more than 50% of its assets in any one collective investment scheme ("CIS") will be considered to be a feeder fund, necessitating disclosure in relation to the underlying fund.
- While the Financial Regulator does not generally impose risk diversification requirements, QIFs established as investment companies are required to comply with the principle of risk spreading and it is a matter for the board to ensure that this occurs. This risk spreading requirement does not apply to non-corporate structures such as unit trusts, investment limited partnerships and common contractual funds.
- While QIFs cannot raise capital from the public through the issue of debt securities, the Financial Regulator does not object to the issue of notes by authorised CIS, on a private placement basis, to a lending institution in order to facilitate financing arrangements, provided such arrangement are clearly and fully disclosed in the QIF's prospectus.
- An initial offer period of up to a year is permissible, provided that investors are not prejudiced by this.
- The investment objectives and investment and borrowing policies must be comprehensive and accurate, readily comprehensible to investors and be sufficient to enable investors to make an informed judgement of the investment proposed to them.

24-Hour Authorisation Process

The most significant feature of the QIF product is that, provided that all of the parties to the QIF (most importantly, the directors and the investment manager) have been approved, then a letter of authorisation will issue on the day following the submission of a complete application to the Financial Regulator.

The application will contain a form of certificate from the QIF that all regulatory requirements have been complied with and the QIF will look to its chosen law firm to ensure that this certificate can be given.

However, the Financial Regulator expects applicants to discuss proposals that have novel or unusual features in advance of submitting a formal application and, again, the chosen law firm will have a key role in advising what constitutes "novel or unusual" features.

Use of Subsidiaries and SPVs

QIFs are permitted to establish multi-layered special purpose vehicles ("SPVs"), provided they are wholly owned by the QIF or by its wholly owned subsidiary(ies) and subject to certain criteria relating to the registration of their shares. The QIF custodian must be appointed to each SPV and be in a position to demonstrate that it has controls in relation to each layer of the SPV structure. The assets of the SPV must be valued as if they were assets of the QIF.

Ireland's emergence as a real estate and private equity fund domicile is timely, given the likely application of the Alternative Investment Managers Directive and the renewed interest in these asset classes as the global economy edges toward recovery while still affording opportunities with respect to distressed assets.

The intention to establish SPVs must be clearly disclosed in the prospectus, and the periodic reports of the QIF must disclose the names and place of establishment of all SPVs. While, as a general rule, the Financial Regulator will require the majority of directors appointed to the board of the SPV to be directors of the QIF, derogations or exemptions may be granted, provided that at least one director is common to the SPV and the QIF.

Closed-Ended and Limited Liquidity Schemes

Real estate and private equity funds would typically be closed-ended – meaning that they will be subject to the provisions of the EU Prospectus Directive and be required to comply with the regulatory requirements for the publication of a prospectus in the markets where the funds are marketed and listed. One of the advantages of complying with the Prospectus Directive is that a QIF that obtains approval for its prospectus in Ireland may avail of the passporting provisions of the Prospectus Directive to market in other EU jurisdictions. Some QIFs may decide to opt-in to the provisions of the Prospectus Directive to avail of these opportunities. However, as QIFs by virtue of their minimum investment amount come within the exemption for compliance with the Prospectus Directive, most opt not to produce a Prospectus Directive-compliant prospectus. However, in so doing, promoters should ensure that the offering document is not styled as a prospectus and is called an offering memorandum instead.

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Prior to the implementation of the Prospectus Directive, QIFs that offered redemption facilities less frequently than quarterly were considered to be closed-ended and, therefore, subject to the provisions of the Prospectus Directive. To address this, the Financial Regulator introduced the concept of investment funds with limited liquidity – meaning those that offer liquidity less frequently than quarterly. For these QIFs, the limited nature of the redemption facilities must be clearly set out in the prospectus and QIFs that offer liquidity at least annually may style themselves as "open-ended with limited liquidity".

Real Estate Funds

The key regulatory requirements for real estate funds established as QIFs are set out in a letter from the Financial Regulator to the industry on 13 October 2006 and the Financial Regulator's Guidance Note 1/07 on the Authorisation of QIFs.

These requirements are set out below.

- Because real estate is not generally a regulated asset class, the Financial Regulator will consider the appointment of unregulated promoters and investment managers where appropriate expertise can be demonstrated, and subject to a review of the applicant's fitness and probity.
- There must be full disclosure in the prospectus in relation to the use of partly paid shares and commitments.
- An independent valuer must be appointed, the basis of the appointment must be set out in the prospectus, and details of valuers appointed must be set out in the periodic reports.
- Properties must be valued twice yearly at "market value". At least one valuation shall be based on a full physical valuation, but the second valuation may be a desk-top valuation.
- Valuation must take place in accordance with recognised professional standards, such as those established by the Royal Institute of Chartered Surveyors.
- Subsidiaries and SPVs may be used as described above.
- Real estate-related assets can include other collective investment schemes, real estate derivatives and investment through unit-linked schemes.
- While properties may be registered in the name of the QIF and not the custodian, detailed procedures must be put in place to ensure that properties cannot be disposed of without the prior consent of the custodian.
- Warehousing of assets is permitted, provided that details of the arrangement (including fees) are disclosed in the prospectus and assets are acquired at the lower of market value or cost price.

Private Equity Funds

The private equity fund regime has developed in tandem with the real estate regime, as similar issues with respect to liquidity, partly paid units, commitments and drawdowns arise.

Minimising Tax Leakage

As discussed above, QIFs are tax-exempt vehicles. While the advantages of tax-exempt status are obvious, there is a concern that, in certain jurisdictions, the benefits of Ireland's extensive double taxation treaty network will not apply to persons who are not subject to tax in Ireland. This may result in withholding tax leakage in certain jurisdictions. The way to avoid this leakage is to structure the QIF's investment through entities that are subject to tax on their profits in Ireland and, thereby, obtain treaty access.

In addition to ease of establishment, as one of Europe's most open economies and as a common law jurisdiction, the Irish legal, tax, banking and real estate regimes are well used to dealing with the cross border aspects of real estate and private equity fund transactions.

Using Section 110 Companies

Section 110 of the Taxes Consolidation Act 1997 of Ireland refers to Irish resident companies established in accordance with the Companies Acts 1963-2009 that hold or manage a wide range of financial assets, including shares, loans, futures, options and swaps ("Section 110 Companies"). Section 110 Companies are not subject to a minimum capital requirement or to specific local management requirements. There is no withholding tax on interest payments made or dividends paid by Section 110 Companies to persons resident in the EU or in any tax treaty country.

In accordance with the SPV requirements set out above, the Section 110 Company would be established as a wholly owned subsidiary of the QIF. The Section 110 Company would also issue a profit participating note to the QIF, which would strip out the profits of the Section 110 Company. The residual profits of the Section 110 Company would be taxed at 25% and, as a taxable entity, the Section 110 Company that would be the investing vehicle for the QIF would have access to Ireland's double taxation treaties. The Section 110 Company would then make its interest and dividend payments to the QIF on a gross basis.

This structure has been utilised successfully by private funds across not only real estate and private equity funds but also by loan funds and life settlement funds. Specialist tax and legal advice will be required regarding the application of this structure in particular jurisdictions, based on the relevant double taxation treaties and on the structure's application to particular asset classes.

Conclusion

Ireland's emergence as a real estate and private equity fund domicile is timely, given the likely application of the Alternative Investment Managers Directive and the renewed interest in these asset classes as the global economy edges toward recovery while still affording opportunities with respect to distressed assets. Many of the principal fund administrators and custodians have put in place separate teams to service these products. In addition to ease of establishment, as one of Europe's most open economies and as a common law jurisdiction, the Irish legal, tax, banking and real estate regimes are well used to dealing with the cross border aspects of real estate and private equity fund transactions.

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Reforming the UK Regulatory System


By **Jim Baird** and **Gus Black**

In his speech to London bankers and merchants at the Mansion House earlier this month, George Osborne, the Chancellor of the Exchequer, confirmed the Coalition Government's proposals for sweeping changes to the UK's system of financial regulation. For a summary of the proposals, please refer to the *DechertOnPoint* dated June 2010, "United Kingdom Regulatory Reforms: Twin Peaks Revisited?" available at http://www.dechert.com/library/FS_9_06-10_United_Kingdom_Regulatory_Reforms.pdf. The key points of the proposals are noted below.

Centralised Regulation of Systemic Risk

While the changes will affect almost every part of the UK regulatory system, one of the most fundamental changes proposed is to centralise prudential regulation within the Bank of England (the "Bank"). In combination with this, the Bank would be given greater powers to prevent the build up of systemic risk.

A new Financial Policy Committee (the "FPC") would be established within the Bank, with responsibility for macro-prudential regulation. In addition, the Bank would take back its micro-prudential regulatory role so as to closely combine the role of macro-prudential risk assessment with ready access to prudential information at the individual firm level (through reporting from a new Financial Regulation Division) and powers to address macro-prudential risks. Further, there would be closer links between macro-prudential control and monetary control exercised by the Bank's Monetary Policy Committee.

The proposals are intended to avoid the uncertainties that arose in the lead up to and during the financial crisis as to who had responsibility for monitoring systemic risk and who was responsible for tackling it.

Focus on Consumer Protection

The proposals also include a number of measures to bolster consumer protection. A new Consumer Protection and Markets Authority (the "CPMA") would be created to address concerns previously expressed

by the Conservative party about poor consumer protection in the financial services sector. The CPMA is intended to take a tougher approach to consumer protection and be more consumer-oriented, focussed and transparent than the FSA.

The CPMA would have responsibility for the Financial Ombudsman Service and the Financial Services Compensation Scheme. In addition, in line with the stated intention of increasing consumer awareness, the CPMA would oversee a newly created Consumer Financial Education Body.

These two principal changes would complete the move to the so called "twin peaks" system of regulation, whereby regulation of day-to-day conduct of business is separated from oversight of overall systemic risk.

Potential Impact

There is much speculation as to what impact these proposed changes will have on sectors of the financial services industry. While the regulatory structure will look radically different, it remains to be seen what changes in substance will result for individual firms.

The discussion so far has focussed on major financial institutions, specifically banks. Little has been said about the asset management industry directly. For alternative asset managers at least, the EU Alternative Investment Fund Managers Directive ("AIFMD") seems likely to present a greater challenge (along a similar implementation timeline).

For banks, the prospect of further reform lies ahead in the form of the Independent Commission on Banking also announced by the Chancellor earlier this month. The Commission will consider, amongst other things, whether to split retail and investment banking and whether to impose a levy on banks (the latter also is addressed in the Chancellor's recent budget).

Conclusion

Consideration has been given to a transition process, with the need to minimise uncertainty and transitional costs being a stated aim. This is to be welcomed at a time where the sector faces the prospect of dramatic change on a number of fronts (although it remains to be seen whether it will be borne out in practice).

The proposals are still at a very high level and little can be gleaned at present as to the compliance (or even structural) changes that firms may have to make to accommodate them. In the meantime, it is very much "business as usual" for the FSA and firms should continue to comply in full with the existing regime.

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CESR Issues Guidelines for Common Definition of Money Market Fund

 

By **Christopher D. Christian** and **Declan O'Sullivan**

In the wake of regulatory reform in the United States with respect to the money market fund industry, the Committee of European Securities Regulators ("CESR") published guidelines on May 19, 2010 ("Guidelines") on a common definition of European money market funds. The Guidelines set out a two-tiered approach for a definition of a European money market fund: (i) short-term money market funds and (ii) money market funds. The Guidelines will enter into force in line with the transposition deadline for the revised UCITS IV Directive, while money market funds that existed before July 1, 2011 are allowed a six-month transitional period until December 31, 2011.

Background

Money market funds have been authorized in Europe as "UCITS" and non-UCITS for many years, although it was only with the implementation of UCITS III that money market instruments were recognized as an asset class. There had been, however, no uniform European definition of a money market fund, and individual Member States were free to apply local requirements to their authorization and supervision. While there was a degree of industry self-regulation through compliance with the guidelines of the Institutional Money Market Funds Association ("IMMFA"), in light of the market events beginning in 2007, and most notably the impact of the Lehman Brothers' failure on the money market industry in Europe, CESR Members agreed, in 2008, that better coordination at the EU level was necessary with respect to both the categorization and regulation of EU money market funds. Specifically, CESR recognized the need to define the term "money market fund" and impose restrictions on the assets in which money market funds may invest, in order to limit exposure to credit, market and liquidity risks and, ultimately, to protect investors.

In December 2009, CESR issued a consultation paper ("Consultation") that sets forth proposals for a common definition of European money market fund. CESR proposed a two-tiered approach to define or categorize European money market funds as either: (i) short-term money market funds, which utilize amortized cost valuation (similar to U.S. Rule 2a-7 money market funds) – constant NAV funds, or (ii) longer-term money market funds, which have a fluctuating or variable net asset value and which generally have a longer weighted average maturity ("WAM") and average weighted life ("WAL") than short-term money market funds. The deadline for comments on the Consultation was December 31, 2009, and CESR issued the Guidelines the following May.

Summary of Guidelines

The Guidelines adopt the two-tiered approach set forth in the Consultation and categorize EU money funds as either "Short-Term Money Market Funds" or "Money Market Funds". The Guidelines apply to any investment fund labeling itself or marketing itself as a "money market fund" whether regulated as a UCITS or non-UCITS in its home Member State.

A "Short-Term Money Market Fund" must:

- have as its primary investment objective to maintain the fund's principal and seek to provide a return in line with money market rates;
- invest in money market instruments that comply with the criteria for money market instruments as set out in the UCITS IV Directive 2009/65/EC, or deposits with credit institutions (Non-UCITS money market funds must ensure that the liquidity and valuation of the portfolio is assessed on an equivalent basis);
- ensure that the money market instruments in which it invests are of high quality, as determined by the management company (e.g., the self-managed UCITS or its management company), which must take into account a range of factors including, but not limited to: (i) the credit quality of the instrument (generally, it must be rated in one of the two highest ratings categories by each recognized credit rating agency that has rated the security or, if unrated, be of equivalent quality); (ii) the nature of the asset class represented by the instrument; (iii) the liquidity profile of the instrument; and (iv) operational and counterparty risks for structured financial instruments;

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- limit investment in securities to those with a residual maturity until the legal redemption date of less than or equal to 397 days;
- provide daily NAV and price calculation and daily subscription and redemption;
- ensure its portfolio has WAM of no more than 60 days;
- ensure its portfolio has a WAL of no more than 120 days;
- not take direct or indirect exposure to equity or commodities, including via derivatives; and
- limit investment in other collective investment undertakings to those which comply with the definition of a Short-Term Money Market Fund.

A Short-Term Money Market Fund may have a stable or constant NAV and utilize amortized cost.

The provision of a pan-European definition of a money market fund will clarify the multiple types of money market fund products that are available across Europe and allow European (and other non-U.S. investors) to identify money market funds that are consistent with their investment objectives and risk profile.

CESR's guidelines for eligible assets for UCITS impose strict requirements regarding credit quality, sensitivity to market parameters, diversification and maturity of holdings, and they require a marked to market valuation on a regular basis.

A fund that is defined as a "Money Market Fund" under the Guidelines (as opposed to a Short-Term Money Market Fund) must generally follow the guidelines noted above, except that the Money Market Fund must:

- have a fluctuating or variable NAV;
- limit investment in securities to those with a residual maturity until the legal redemption date of less than or equal to two years, provided that the time remaining until the next interest rate reset date is less than or equal to 397 days (floating rate securities should reset to a money market rate or index);
- ensure WAM of no more than six months;
- ensure WAL of no more than twelve months; and
- limit investment in other collective investment undertakings to those which comply with either the definition of Short-Term Money Market Fund or Money Market Fund.

Conclusion

The provision of a pan-European definition of a money market fund will clarify the multiple types of money market fund products that are available across Europe and allow European (and other non-U.S. investors) to identify money market funds that are consistent with their investment objectives and risk profile. It is worth noting that the Guidelines will not permit the investment in floating rate securities by Short-Term Money Market Funds.

For those money market funds established in Ireland, which serves as a major hub for the global cash management business, the Guidelines will have little impact on those funds that are permitted by the Financial Regulator to refer to "money market funds" in their title and to follow an amortized cost valuation methodology. Despite the fact that Europe lacked common regulatory standards similar to U.S. Rule 2a-7, the Financial Regulator implemented Guidance Note 1/08 on the Valuation of Assets of Money Market Funds, using the methodology and criteria of both the ratings agencies for the granting of a triple A rating and of the IMMFA. The Guidelines will serve to apply similar principles across all European money market funds.

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"Pay-to-Play" in the U.S. Financial Services Industry[*]


By **Edward L. Pittman** and **Brenden P. Carroll**

Introduction

"Pay-to-play" concerns in the financial services industry were placed under a spotlight in 2009 as a result of scandals highlighted by an investigation of the New York State Common Retirement Fund ("NY Retirement Fund"), the third largest public pension fund in the United States. The investigation, led by the New York Attorney General ("NYAG"), revealed extensive kickbacks by investment advisers seeking business from the NY Retirement Fund. Throughout the United States, public pension funds and various state and local governments have called for, or adopted, reforms designed to prevent decisions of public funds from being improperly influenced.

At the federal level, the U.S. Securities and Exchange Commission ("SEC") voted in July of 2009 to propose an antifraud rule that would significantly restrict the ability of advisers and their employees to make political contributions to (or solicit such contributions for) elected officials who have the ability to influence investment decisions by a public fund. It would also effectively ban the use of third parties to market investment advisory services to public funds.[1] In addition, the SEC has announced the creation of a specialized unit within its Division of Enforcement focused on, among other things, fraud involving public funds.

Pay-to-play laws and policies apply to both U.S. and non-U.S. based advisers seeking business from public pension funds in the United States. This article discusses recent developments involving pay-to-play at the federal and state level. It also provides an overview of compliance structures designed to address these issues.

Proposed Investment Advisers Act Rule 206(4)-5

Following the scandals involving the NY Retirement Fund, the SEC published for comment in August 2009, proposed rule 206(4)-5 ("Proposed Rule") under the Investment Advisers Act of 1940 ("Advisers Act"). **After this article was written, the SEC adopted the Proposed Rule, with amendments, on June 30, 2010.**

The Proposed Rule would apply to all investment advisers seeking business from public entities, including state and local pension funds, state college savings ("529") plans, and local government investment pools. It would impose a two-year ban (euphemistically referred to as a "time out") on firms providing investment advisory services for compensation where there had been an impermissible political contribution by the firm, firm-controlled political action committees ("PACs"), and certain employees of the adviser (termed "covered associates") to elected "officials" that have the ability to influence the selection of an adviser.

Firms could avoid violating the Proposed Rule by not seeking advisory business from public funds if an impermissible contribution has been made. However, if they learn of an impermissible contribution while currently providing advisory services to a public fund, they would be in violation of the Proposed Rule if they continue to accept fees from the public fund. Penalties for violating the Proposed Rule would likely include forfeiture of fees as well as fines and other sanctions.

Political Contributions

The Proposed Rule has been criticized by some commenters because of the harsh consequences for inadvertent violations, the impact on otherwise appropriate political contributions, and the difficulty that firms may experience assuring compliance. Some of the more difficult issues that advisers may encounter in devising a compliance program if the Proposed Rule is adopted are determining which of their employees' political contributions are covered by the Proposed Rule, and what constitutes a political "contribution" or a "solicitation" (as described below).

The Proposed Rule would limit political contributions by the firm itself and any individuals that fall within the Rule's definition of a "covered associate." According to the SEC, covered associates and other individuals subject to limits on contributions are those that have an economic incentive to influence the selection of the firm by the public fund, such as a general partner or an employee of the adviser who solicits business from the public fund. In this category, the SEC also has specifically included various types of "executive officers" of the adviser, including managers of research and sales within the adviser, as well as indirect supervisors. In addition, the Proposed Rule would limit political contributions by a PAC controlled by the firm or its covered associates.

The Proposed Rule also would prohibit the "solicitation" of political contributions by the firm and its covered associates. Activities that are considered solicitations would include any fundraising attempts within the firm, or with friends, neighbors, or vendors, as well as "bundling" contributions. While simple in concept, in practice determining whether a particular activity amounts to a "solicitation" may prove difficult, particularly for larger organizations where the network of connected persons may be enormous.

A more daunting task for firms' compliance officials and the SEC may be determining whether or not a political contribution has been made. Volunteer activities specifically are not precluded. However, in addition to cash contributions, credit card payments or checks, the definition of a political contribution otherwise includes "anything of value." Common activities that may fall within the term include providing facilities or secretarial support for campaign activities, allowing employees to volunteer on paid company time, or paying the expenses of employees who participate in campaign activities. A separate requirement in the Proposed Rule would mandate that registered advisers keep records of political contributions.

Finally, a "look back" provision in the Proposed Rule would prevent an adviser from doing business with a public fund if it or its covered associates have made an impermissible contribution in the prior two years. This provision would not only affect the ability of the adviser to do business with the fund until the period had lapsed, but also would be a consideration in hiring new employees, engaging in mergers, or promoting current employees who have made impermissible political contributions in the two-year period prior to their new employment or promotion.

The Proposed Rule contains two exceptions from the two-year time out. The most important exception permits employees of the adviser to contribute up to $250 to elected officials for whom they are entitled to vote. The Proposed Rule also provides that if an adviser or its employees make impermissible contributions, the adviser may seek an exemption from the SEC under certain conditions.

Ban on Placement Agents and Finders

In addition to limiting political contributions, the Proposed Rule as published for comment would limit the ability of advisers to employ third-party placement agents or finders, other than affiliates, to solicit business from public funds. The NYAG's investigation revealed that a large number of advisers offering services to the public funds in New York State and New York City, relied upon placement agents or well-connected finders, many of whom may have been acting as unregistered broker-dealers. The SEC's proposed ban on placement agents echoes similar bans that were announced as a matter of policy or law by several states and major public pension funds in response to the scandals.

State and Local Laws and Public Fund Internal Policies

At the state, local, and fund level, there also have been a number of reforms proposed or adopted. Traditionally, advisers seeking business from public funds have had to comply with state and local ethics laws addressing limits on gifts and entertainment of fund employees as well as revolving door limitations. Prior to the scandals and the Proposed Rule, some states also had adopted specific laws addressing the conduct of persons seeking business from public funds and prohibiting the use of placement agents. Following the NYAG's investigation, several additional states have proposed legislation addressing placement agent activities, and many of the public funds themselves have revisited their guidelines regarding placement agents.

Where placement agents or finders are not barred, new laws have been proposed, or some existing laws interpreted, so as to limit contingent compensation or require that advisers or placement agents register as procurement lobbyists. Public funds also frequently request now that advisers supply information about placement agents, including whether or not they are registered as broker-dealers, the compensation they receive, backgrounds of principals of the placement agent, as well as annual compliance certifications.

Policies and Procedures

Political Contributions, Gifts, and Entertainment

If the Proposed Rule is adopted, it will present new challenges to the advisory industry, mandating compliance policies and procedures that are essentially the same as those currently used by organizations in many non-financial sectors that engage in government contracting. A robust program will involve the adoption of policies and procedures, as well as training, monitoring, and auditing of compliance with respect to such policies and procedures.

Even if the Proposed Rule is not adopted, advisers who seek business from public funds or other government entities must be cautious of the patchwork of state and local laws and fund policies that may affect their business. The following are general measures that advisers may consider in the context of their own business.

- *Seek Senior Management Buy-In.* It is important that this include enunciation of a strong statement of corporate values regarding compliance.
- *Communicate Values.* Policies may be communicated in conjunction with core ethical values addressing integrity and honesty. Organizations that engage in government contracting often include broad admonitions, such as: "It is never permissible to make or solicit a political contribution for the purpose of influencing the official conduct of an elected official" and "It is never permissible to use firm resources for political purposes without prior approval, or to seek reimbursement of political contributions or expenses made by yourself or another person."
- *Develop Internal and External Resources.* An initial measure in formulating a more significant compliance policy program may involve assigning specific responsibility to an individual or individuals who will serve as a point of contact and who will be responsible for understanding the relevant laws and developing strategies to assure compliance. Among other things, this would include awareness of whether certain political contributions or activities (including in-kind contributions) are likely to have an effect on the ability of the firm to do business with public funds. This might involve being able to respond to questions such as: "Does volunteering my personal services to a campaign count as a contribution to the campaign?" "Am I allowed to hold a campaign-related gathering at my house?" "Can my husband (who does not work for the firm) host a fundraiser at our house?" "Can I accept an invitation to attend a fundraiser if someone else paid for the table?" "Can I be reimbursed for travel expenses to attend a political function?"
- *Identify and Train Relevant Employees.* This may include general policies delivered to all employees. Those who are, or may be, subject to limits on their political activities, and others who may have direct or indirect supervisory responsibility for their actions, advise PAC committees, or regularly solicit government entities to offer non-advisory services (including brokerage, custody, cash management, administration, and banking), may need to receive additional training to avoid potential problems.
- *Pre-Screen Contributions and New Hires.* Normally, a fundamental part of any such compliance program is to require pre-approval (generally by the compliance or legal departments) regarding political contributions by the firm and its officers and employees, including PAC contribution requests. If the Proposed Rule is adopted, because it has a "look back" provision, a political contribution made by an employee prior to his or her association with the firm could be a disqualifying factor that would affect the ability of the firm to provide advisory services for a fee. In the context of a "lift out" or merger, the addition of new personnel who have made political contributions

in the prior two years also could affect the ongoing business of the adviser, as well as new business opportunities.

- *Conduct Quarterly Surveys and Periodic Audits.* Typically, compliance officers of municipal underwriters obtain information about political activity from political contribution request forms, as well as quarterly surveys of persons whose contributions are subject to limitations and disclosure or recordkeeping requirements. These surveys allow the firm to detect contributions that were not submitted for pre-approval, and also may require an affirmative statement that the individual has not made any non-disclosed contributions or solicited contributions from others. Quarterly surveys and reports of contributions and entertainment expenses also may be necessary to comply with state laws. Audits should be conducted periodically to detect patterns which suggest that disclosed contributions were solicited internally. In addition, public donor records may be sampled to check for non-compliance with firm policies (these records are also available to the public funds, as well as the press, competitors, and regulators).
- *Encourage Open Communication.* This is critical, both to prevent potentially problematic political contributions before they are made, and to promptly address any problems that arise. The Proposed Rule, for example, contains exemptions for different types of inadvertent violations. Similar exemptions may be found under state laws. Often in these circumstances, the ability to promptly cure an inadvertent violation, by recovering the contribution within a narrow window after it has been made, is an important element in relying on an exemption. For this reason, it is important to encourage employees to come forward if they believe a problematic contribution has been made.

Use of Consultants or Third Parties

Whether or not the SEC's ban on the use of intermediaries is adopted, any third parties acting on behalf of an adviser can raise problems if they engage in activities that violate either state or federal laws, or conflict with the policies of the public fund. Apart from business considerations, factors that may be relevant to the adviser or fund would include: whether the third party has complied with any requirements to be registered as a broker-dealer; the background of the third party's principals that will be interacting with the public funds, including any family or professional relationships with the public funds and their employees; and the nature of any political contributions by the third party or its principals. Both advisers and third parties also must be aware that it is becoming increasingly common for public funds to require disclosure or attestations regarding such information.

Conclusion

The Proposed Rule is well-intended, but may present many complex compliance challenges for advisers, with a real risk of inadvertent breach, if adopted in its current form. It is likely, however, that if it is adopted by the SEC, there will be an adequate transition period for advisers to develop compliance procedures, and that limits on political contributions under the Proposed Rule will only be applied on a prospective basis.

Even if the Proposed Rule is not adopted, developments at the state and local levels, including new policies or requirements adopted by the public funds themselves, should encourage both advisers and brokers to examine whether they have adequate knowledge of the laws and policies affecting their business in this area. And, they should consider whether their compliance procedures are adequate to alert their employees to potential problems, so that they can make any necessary filings and avoid engaging in activities that may affect their current or future business relationships with public funds (and other government entities).

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[1] See Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 2910 (Aug. 3, 2009).

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Hong Kong: The Hub for an Asian ETF Strategy

By **Angelyn Lim**, **Kher Sheng Lee** and **Jessica Shao**

Asian ETF Markets are Ripe for Growth

Asian exchange-traded fund ("ETF") markets are poised for imminent rapid growth. While ETF markets are still in their nascent stages of development in many parts of Asia, and lag behind those of the United States and Europe in terms of maturity and size, ETFs have become increasingly popular with both institutional and retail investors, and their vast potential can be appreciated from a number of perspectives.

Driven partly by core drivers of growth, including convenience, cost effectiveness, liquidity, flexibility and transparency, Asian ETF markets have demonstrated a robust momentum on the back of the global financial crisis and general volatile market conditions. In terms of assets under management ("AUM"), Japan's ETF market is the largest in Asia at USD27.3 billion. The total amount of AUM in ETF markets in the Asia ex-Japan market increased from USD27 billion in 2007 to USD40.6 billion by the end of the first quarter of 2010.[1] Outside Japan, Hong Kong has become the largest ETF market in Asia at about USD22.2 billion. In terms of turnover, Hong Kong is also the second-largest ETF market in Asia after Mainland China.[2]

There were 62 ETFs listed on the Stock Exchange of Hong Kong ("SEHK") as at the end of May 2010,[3] an increase of 18 new ETFs since the beginning of this year. On the Mainland, there are currently 10 ETFs listed, an increase from six ETFs in January this year.[4] Thus far, China's ETFs that are traded on the Shanghai and Shenzhen stock exchanges track only domestic markets. However, it is expected that, as domestic Mainland ETFs that track overseas markets are launched, this will allow domestic investors to broaden their exposure to international markets.

The growth potential could also be viewed from the perspective that many Asian ETFs have equity securities as their underlying product set. As more Asian investors embrace the ETF wrapper and markets continue to evolve, it would be reasonable to anticipate expansion beyond equity-based products, extending to other asset classes such as fixed income (other than government debt), commodities, hedge funds, currency and real estate. There is also an increasing investor demand for sector and thematic ETFs, especially those that provide exposure to Mainland Chinese equity strategies.

These developments point to the range of opportunities emerging in the ETF space in Asia. Global ETF managers would do well to develop or review their Asian and China strategy as an integrated part of their global expansion plans. With the current limited direct access to Mainland China's ETF market,[5] this article discusses a few key issues for a successful pan-Asian strategy that features Hong Kong as the hub for expansion into the region. It provides a brief description of the typical approval process for an overseas ETF in Hong Kong, followed by an examination of various streamlined processes for overseas ETFs listed either in an "Acceptable ETF Regime" or a jurisdiction that has entered into a mutual recognition

arrangement with Hong Kong. The relevant streamlined process can be comparatively more cost-efficient and less time-consuming than a typical application.

Gaining Market Entry to Hong Kong

Before it can conduct any form of public sales or subscriptions, an ETF in Hong Kong must apply to the Hong Kong Securities and Futures Commission ("SFC") for authorization and to the SEHK for listing. In a best-case scenario, it may take the SFC and SEHK about four months to approve these applications.

Application to the SFC

A collective investment scheme ("CIS") must be authorized by the SFC before it can be listed (and remain authorized by the SFC for so long as it is listed). As a CIS, an ETF is bound by the Code on Unit Trusts and Mutual Funds ("Code"). Appendix I of the Code contains the key requirements applicable to ETFs. Unless otherwise stated in the Code, ETFs must also comply with all applicable provisions in the Code, in particular, those governing index funds, as set out in Chapter 8.6 of the Code. When considering applications, the SFC will look into, among others, the following requirements:

- *Underlying Index*. In order to be accepted by the SFC, the underlying index tracked by an ETF must:

  a) have a clearly defined objective, and the market or sector it aims to represent should be clear;

  b) be broadly based (an index with a single constituent security weighing more than 40% or with its top five constituent securities weighing more than 75% would generally be considered too concentrated);

  c) be investible, in particular, the constituent securities of the index should be sufficiently liquid; and

  d) be transparent and published in an appropriate manner.

The SFC also requires the index provider of a relevant ETF to have possessed the expertise and technical resources to construct, maintain and review the methodology and rules of the index. With the implementation of the SFC's new revised Code from 25 June 2010, the underlying index will also be required to be objectively calculated and rules-based.

- *ETF managers*. Except for self-managed ETFs, fund managers must be approved by the SFC and, among other things:

  a) be engaged primarily in the fund management business;

  b) have sufficient financial resources, in particular have a minimum issued and paid-up capital and capital reserves of HK$1 million or its equivalent in foreign currency;

  c) not lend to a material extent; and

  d) maintain a positive net asset position at all times.

Application to SEHK

Concurrent with seeking authorization from the SFC, an ETF applicant must also apply to the Listing Division of the SEHK for listing. The Listing Division of the SEHK will normally grant a listing to an ETF applicant that has been authorized by the SFC. Chapter 20 of the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited ("Listing Rules") sets out the timeline to be followed and documents to be submitted when applying for the SEHK's approval. In practice, it is recommended that ETF applicants consult the SEHK to obtain prior guidance on document preparation and submission early, in parallel with the process of seeking authorization from the SFC.

Acceptable ETF Regimes: Streamlined Recognition for U.S.-listed ETFs

An overseas ETF that meets the core structural and operational requirements under the Code and is governed by an "Acceptable ETF Regime" may seek SFC authorization by way of a streamlined recognition process. An overseas ETF may be listed in a number of jurisdictions. For the purposes of assessing the suitability of a jurisdiction as an "Acceptable ETF Regime", the focus is on the particular overseas jurisdiction where there is substantial interest in the ETF and in which it is primarily listed.

A number of regulatory principles will be considered in assessing an Acceptable ETF Regime, including: (i) the availability of a mutual co-operation and assistance agreement for fund management activities between the overseas jurisdiction's principal securities regulator and the SFC; and (ii) whether the overseas jurisdiction's overall securities regulatory framework is similar to Hong Kong's so as to afford investor protection comparable to that provided under Hong Kong law.

An ETF from an Acceptable ETF Regime is exempt from certain Code requirements, including specific criteria on the acceptability of the underlying index tracked by the ETF and content requirements for the ETF's financial reports.

The United States is currently the only Acceptable ETF Regime recognized by the SFC. Hong Kong can thus support execution of an effective go-to-market strategy for U.S.-listed ETFs and their managers. The present indications are that the SFC is unlikely to expand the category of Acceptable ETF Regime further. Going forward, the preferred mechanism for the SFC to expand market access would appear to be the use of a mutual recognition arrangement, discussed below.

Mutual Recognition Arrangements

The different Asian ETF markets are at different stages of development. The Asian fund regulatory environment as a whole is fragmented. There is no singular regional fund regulatory standard or commonly accepted fund structure that allows a fund already offered in one Asian jurisdiction to be passported for sale in another Asian jurisdiction without having to comply with additional regulations in the second jurisdiction.

In the absence of such a fund passport scheme (akin to the EU UCITS regime) or an analogous multi-lateral or regional response to support a pan-Asian distribution strategy, bilateral mutual recognition arrangements or similar cooperative agreements which facilitate cross-listings likely represent the next best alternative. These would allow an ETF to offer investor access across the region, build economies of scale and boost trading volumes, and, generally, extend market access.

With its ETF market size and turnover both significantly larger than those of competing listing platforms in the Asia ex-Japan market, and its geographic position as the gateway to Mainland China, Hong Kong is in a unique position.

Hong Kong has initially established mutual recognition arrangements with each of Taiwan, Australia and Malaysia. In essence, the various bilateral arrangements chart a course for mutual recognition so as to facilitate cross-listing and offering of ETFs in each of the relevant markets. The market anticipates that similar arrangements will be entered into with other regional regulators in the fullness of time. These arrangements are predicated on reciprocity and are inherently flexible for the SFC to offer targeted regulatory relief that can vary from jurisdiction to jurisdiction.

Taiwan

An ETF-specific framework was agreed with Taiwan on 22 May 2009. An approved ETF listed in Hong Kong or Taiwan and managed by asset managers licensed respectively by the SFC or the Financial Supervisory Commission in Taiwan ("FSC") will be mutually recognised in each other's jurisdiction for the purpose of cross-listings.

In principle, an ETF that is approved by the FSC and managed by a manager licensed and permitted under the relevant Taiwanese regulations will be deemed to have complied with the relevant provisions in the Code and generally will not be required to strictly observe its specific requirements, with certain exceptions. These exceptions pertain to: (i) appointment of a Hong Kong representative; (ii) dissemination of trading information by the ETF; (iii) disclosure in offering documents; (iv) advertising; (v) post-authorization requirements, including those on connected party transactions; and (vi) pricing error, financial reporting and notification requirements to investors, which must be complied with.

Likewise, an ETF which is authorized by the SFC and managed by an SFC licensed-manager will be deemed to have complied with the relevant provisions of the applicable Taiwanese regulations, with comparable exceptions pertaining to: (i) appointment of an agent; (ii) obtaining of approvals; (iii) information disclosure and reporting; and (iv) advertising and promotions.

The first Hong Kong ETF[6] was approved for offering in Taiwan in July 2009. Two other Hong Kong ETFs[7] were subsequently successfully listed on the Taiwan Stock Exchange. Together, these three Hong Kong ETFs have since their launch constituted a large proportion of the turnover, both in volume and value, in the Taiwan ETF market.[8] The first Taiwan ETF to cross-list in Hong Kong did so in August 2009. The latter cross-listing in Hong Kong is by way of a feeder fund.[9] This illustrates a situation where a direct cross-listing may not be practical because of the anticipated lower market demand. If so, a feeder structure may be considered. It is expected that more Taiwan ETFs will soon seek to list in Hong Kong.

Australia

An agreement was reached with Australia on 7 July 2008 whereby mutual recognition is extended to all authorized CISs (not just ETFs) that are regulated primarily by the SFC and managed by SFC-licensed managers, as well as Australian Securities and Investments Commission ("ASIC")-registered financial asset schemes except hedge funds.

Under the agreement, ASIC will exempt Hong Kong-listed ETFs from the requirement of registration with ASIC and grant certain reliefs provided that: (i) these ETFs are not principally aimed at investors in Australia; and (ii) the relevant ETF, its manager and trustee have not been exempted from compliance with the relevant Hong Kong regulatory requirements due to their being regulated in some other jurisdiction. Additional reliefs are available to the manager and trustee if they satisfy certain entry and ongoing eligibility requirements.

Correspondingly, an ETF that is registered with ASIC and managed by an ASIC-licensed manager will automatically be authorized by the SFC on the basis that it has substantially complied with all the disclosure, operational and reporting requirements of the Code, provided that no more than 30% of the value of such an ETF is marketed to investors in Hong Kong, and subject to the possibility of additional regulatory requirements being imposed by the SFC.

Malaysia

An agreement was reached on 9 November 2009 between the SFC and the Securities Commission of Malaysia ("SC") that provides a framework for the mutual recognition of Islamic CIS (including Shariah-compliant ETFs) offered to the public. As a result, Islamic ETFs will be permitted to be offered, marketed and distributed in Malaysia if they are: (i) authorized and primarily regulated by the SFC; (ii) managed by an SFC-licensed manager; and (iii) domiciled in Hong Kong or a jurisdiction that has broadly implemented international IOSCO Principles 17 to 20 and is a signatory to the IOSCO Multilateral Memorandum of Understanding concerning consultation and cooperation and the exchange of information and have broadly implemental such measures.

Such ETFs are also required to comply with certain requirements under the SC's Guidelines for the Offering, Marketing and Distribution of Foreign Funds, including: (i) the appointment of a Shariah Supervisory Board/Shariah adviser; (ii) granting of non-exclusive jurisdiction to Malaysian courts to entertain any action concerning the relevant ETF; and (iii) main market listing requirements of the Malaysian stock exchange. Similarly, Islamic ETFs primarily regulated and approved by the SC and managed by SC licensees shall be deemed to have substantially complied with the SFC's authorization requirements save for certain exceptions.

Looking to the Future: Hong Kong is Central to an Asian ETF Strategy

The ETF markets in Asia (especially those in Hong Kong and Mainland China) are ready for further development. As Asian markets continue to expand, the speed and intensity of their growth is persuasive argument for foreign ETF managers to view their Asian expansion plans as part of an integrated strategy, rather than a combination of different initiatives. Hong Kong should be seen as central to any coherent Asian strategy to create new and sustainable sources of competitive advantage.

With its ETF market size and turnover both significantly larger than those of competing listing platforms in the Asia ex-Japan market, and its geographic position as the gateway to Mainland China, Hong Kong is in a unique position to intermediate between the large and steady stream of liquidity both inbound for Mainland China (from foreign investors wishing to tap investment opportunities in China) and outbound (from Mainland Chinese investors able to invest overseas via the Qualified Domestic Institutional Investor ("QDII") programme). Industry sources indicate that a mutual recognition arrangement between Hong Kong and Mainland China (similar to the existing arrangement between Hong Kong and Taiwan) is in the pipeline and may be established, possibly, as soon as late 2010. It is a distinct possibility that the ETF markets and regulatory regimes in all three jurisdictions (Hong Kong, Taiwan and Mainland China) may soon be liberalized and synchronized so as to create a "One China" or "Greater China" fund passport.

Hong Kong provides a compelling regional springboard for fund managers to launch and manage ETFs in Asia whether with a China theme or a more general Asian focus (with the potential to gain diversified exposure to multiple regional markets through one ETF).

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1 "ETF Landscape Industry Review End of Q1 20120," ETF Research and Implementation Strategy, BlackRock, April 2010.

2 According to a speech (http://www.sfc.hk/sfc/doc/EN/speeches/speeches/10/Alexa_20100608.pdf) given by Ms. Alexa Lam (Executive Director and Deputy Chief Executive Officer of the Hong Kong Securities and Futures Commission) in June 2010, average daily turnover for Hong Kong ETFs in 2009 increased by 13% from levels in 2008.

3 Please refer to http://www.hkex.com.hk/eng/prod/secprod/etf/etfindex.htm.

4 Please refer to http://www.sse.com.cn/sseportal/ps/zhs/zqpz/etf_show2003.jsp and http://disclosure.szse.cn/main/etfgg.htm.

5 Mainland China's legal regime does not currently allow foreign fund managers to directly participate in its ETF market. Some foreign fund managers have launched ETFs on the Mainland through joint venture alliances (in which foreign managers are permitted, subject to appropriate regulatory approvals, to hold up to a 49% interest in a joint venture asset management company) with Chinese domestic fund managers. To qualify as the foreign partner in such a joint venture, the foreign partner must: (i) be a financial institution experienced in managing financial assets; (ii) have sound financial status and good credit standing; (iii) be duly established in a jurisdiction with sound securities laws and an effective securities regulatory system, and whose securities regulator has entered into a Memorandum of Understanding with the China Securities Regulatory Commission; (iv) have adequate paid-up capital (approximately US$43.5 million); and (v) have a clean regulatory record (with no regulatory penalties imposed in the immediately preceding three years). The joint venture establishment will take about seven months in a best-case scenario.

6 W.I.S.E. Polaris CSI 300 Securities Investment Trust Fund.

7 Hang Seng H-Share Index ETF and Hang Seng Index ETF.

8 Ibid, 2.

9 Polaris Taiwan Top 50 Tracker Fund (HK).

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Continued Controversy over the EU Alternative Investment Fund Managers Directive

By **Jim Baird**

The European Commission Proposal for a Directive on Alternative Investment Fund Managers (the "Directive") was published in April last year in the wake of the financial crisis. With the approval this past May of draft texts by the Committee on Economic and Monetary Affairs of the Parliament (the "Parliamentary Draft") and by the Council of Ministers (the "Council Draft"), the legislative process has now entered the so called "trialogue" negotiations designed to establish a compromise position between the Commission, the Council and Parliament. However, there remain considerable differences between the drafts, and the Parliamentary Draft and to a lesser extent the Council Draft (which arguably provides a more workable framework for the industry) still pose significant difficulties and uncertainty for many alternative investment fund managers ("AIFM") both inside and outside the EU.

What has perhaps surprised many informed observers the most is that, even at this advanced stage in the process, there are new or surviving elements, particularly in the Parliamentary Draft, that would be unworkable for many industry participants or that would seem to defeat the stated purposes of the Directive.

Depositaries

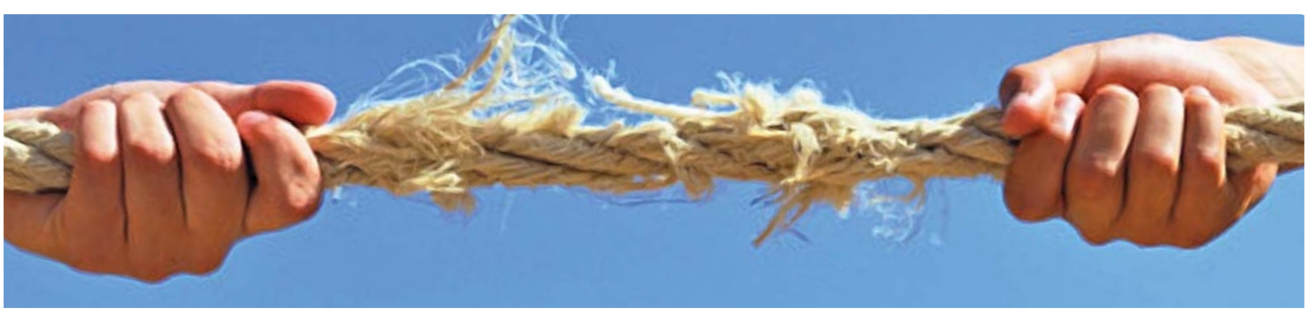
By way of example, the Directive would require AIFM to ensure that a single depositary was appointed for each alternative investment fund ("AIF") it managed. Both Drafts would require that the depositary be EU-domiciled or authorized and, under the Parliamentary Draft, the depositary for an EU AIF must be domiciled in the same Member State as the AIF.

Following the recent crisis, there has been an industry-led trend towards use of multiple prime brokers by hedge funds, primarily driven by a desire to spread and minimize counterparty risk exposures (with benefits for the AIF, their investors and counterparts alike). The proposal for a single, EU-based depositary would seem likely to increase, not reduce, the potential for systemic risk by reducing scope for AIF to spread counterparty risk and also by concentrating that risk within the EU and among a smaller number of eligible depositaries. It is hard to reconcile these proposals (which would seem to reverse many of the risk mitigation measures taken by the industry) with the stated intention of reducing systemic risk and these measures will be perceived by many as protectionist.

Marketing

Another controversial area is the restriction on EU marketing rights for third country AIFM and AIF. While the Council Draft leaves open the possibility of third country marketing rights through private placements (provided certain provisions of the Directive are complied with), there is also a requirement for cooperation agreements between the relevant third country and each Member State where marketing is to take place. The content of the cooperation agreements is to be set out in secondary legislation and as such it is unclear, and will remain so for several years, whether these agreements will be achievable in practice.

At first glance, the Parliamentary Draft looks more positive in that it expressly extends the marketing "passport" to non-EU AIFM and AIF. However, the conditions that would apply are so extensive that it is doubtful whether these could be met, even by many developed jurisdictions. The conditions include a requirement that third country AIFM agree to comply with the Directive and that the third country regulator agree to enforce the Directive on the third country AIFM. It is hard to imagine that the SEC, for example, would submit to EU legislation in this way. In any



event, to the extent of any conflict between the local regulations and the EU regime, this approach would be unworkable.

As a more general matter, adopting a stance where EU marketing rights for third country AIFM and AIF are conditional on compliance with, and enforcement of, EU standards in those countries is likely to be perceived as aggressive or isolationist. If this stance were to prevail, there is a risk that global professional investor markets would be polarized into one grouping that subjected itself to compliance with the EU standards and a separate (and largely segregated) grouping that did not. This polarization would be amplified if other jurisdictions were to adopt the same stance as the Parliament and make compliance with their domestic frameworks a condition of access to domestic investors.

Under such a regime, AIFM groups operating on an international basis would face the prospect of compliance with multiple, and potentially conflicting, regulatory regimes if they wished to access investors on a global basis. This would likely be costly and inefficient.

A further difficulty under the Parliamentary Draft would be that the "passport" for non-EU AIFM and AIF would not provide for a single point of entry into the EU, as it does for EU AIFM. Instead, cooperation agreements would be required to be entered into between the relevant third country and each relevant Member State before a meaningful marketing network would be available. Many third country and international AIFM will perceive these restrictions on marketing as rendering their international marketing structures unworkable (in the case of the Parliamentary Draft) or subject to prolonged uncertainty (in the case of the Council Draft).

As marketing would, in any event, be restricted to professional investors, who by their nature are expert in making investment decisions, many will question whether the investor protection or other objectives of the Directive justify marketing restrictions that would have a negative impact on investment choice for EU professional investors and increase the risk of reciprocal protectionist action by non-EU jurisdictions.

Management

Similarly, while the Parliamentary Draft notionally extends the management "passport" to non-EU AIFM, requirements similar to those for the marketing passport would apply, including the requirement that the AIFM comply with, and its regulator enforce, the provisions of the Directive. This currently would be unworkable for many, if not the majority, of non-EU AIFM with European management mandates. While such arrangements might be achieved through the delegation route provided for under the Council Draft, this would be unworkable for many under the Parliamentary Draft.

The Parliamentary Draft also requires that any delegation of portfolio management must be to an authorised AIFM, with the result that many EU managers operating global or emerging markets strategies would no longer be able to directly access local management expertise, with negative impacts on performance.

These aspects of the Parliamentary Draft could require non-EU management groups to implement structural changes to management delegation arrangements in order to service existing EU clients.

Conclusion

If adopted in its current form, the Parliamentary Draft would require very significant restructuring of many international portfolio management structures, imposing a cost burden that in large part would be borne by end investors. Many of the proposals would appear to have potential for adverse impacts that outweigh the potential benefits. Reaching political agreement on these points has proved impossible within the planned timetable and the process has been deferred until September.

There is a real risk that the stance under the Parliamentary Draft would trigger reciprocal action by other jurisdictions, resulting in unnatural dislocations in investor capital flows and dislocation of a currently global industry.

The recent financial crisis has shown that systemic risks are increasingly global in nature and require coordinated global measures to address them. Proposals that would tend to set the EU at odds with other jurisdictions would be viewed by many as, at best, a missed opportunity in this regard.

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New Tax Rules Adopted in Russia Governing Derivatives, Repo Transactions and Other Securities Transactions


By **Valentin Andrianov** and **Jeff Browne**

An article in the First Quarter 2010 issue of the *Financial Services Quarterly Report* available at http://www.dechert.com/library/Financial_Services_Report_03-10.pdf, analyzed the new regulation on trading derivatives and other financial instruments introduced by Federal Law No. 281-FZ "On Amendments to Part One and Part Two of the Tax Code of the Russian Federation and Certain Legislative Acts of the Russian Federation," dated November 25, 2009 (the "Tax Law").

This article focuses on the new taxation rules introduced by the Tax Law, in particular with respect to the taxation of financial derivatives, repo transactions, securities transactions, and the income of clearing systems. The amendments to the Russian Tax Code proposed in the Tax Law are substantial and for the first time address specifically the taxation of derivatives and repo transactions under Russian law. The Tax Law came into force on January 1, 2010 (save for certain provisions).

The Taxation of Derivatives

The key introductions concerning the taxation of derivatives include:

- the definition of a "derivative", which, for the purposes of corporate income tax, is narrow and excludes weather derivatives, emission reduction-linked derivatives, and derivatives linked to statistical indices;
- derivatives that are not recognized under Russian law will not be regarded as derivatives for corporate income tax purposes and any losses resulting from such contracts will not be tax deductible under Russian tax law. There is currently uncertainty as to whether a cross-border derivative with a Russian company is enforceable if it is governed by Russian law, and therefore it is unclear whether going forward a Russian company would be able to utilize losses from these trades for its tax purposes;

The amendments to the Russian Tax Code proposed in the Tax Law are substantial and for the first time address specifically the taxation of derivatives and repo transactions under Russian law.

- currency and mark-to-market revaluations of derivatives cannot be included as taxable income (save for actually paid or received amounts) and will only be included as taxable income when the transactions are closed out;
- a taxpayer may choose between treating a transaction for tax purposes as a derivative or treating a transaction as a supply transaction with delayed

execution (e.g., a forward contract), but only with respect to those transactions that provide for physical settlement (therefore, forwards which are not physically settled are explicitly excluded). Transactions which do not provide for physical settlement must be treated as derivatives; and

- payments made under derivative contracts (including premium amounts, mark-to-market payments, and other periodic or one-off payments) are exempt from VAT. However, the transfer of underlying assets under derivatives will ordinarily be subject to VAT.

The Taxation of Repo Transactions

The Tax Law introduces a definition of a "repo transaction" into the Tax Code. The Tax Law also recognizes a number of key concepts (such as substitution and set-off) intended to enable the repo transaction market to operate efficiently.

There remains uncertainty with respect to the payment of withholding tax. The Tax Law provides that if there is any dividend on shares sold under the first part of a repo by a foreign entity to a Russian buyer, the latter must, prior to the transfer of that dividend to the foreign seller, deduct the portion of tax that the issuer has failed to withhold. It is, however, unclear how this provision would operate in practice in cases where this provision conflicts with the terms of a double taxation treaty to which Russia is a party.

While generally repo transactions are exempt from VAT based on Section 3 Article 149 of the Tax Code, a taxpayer may waive this exemption. Hence, it may be appropriate to include a specific representation as to absence of such waiver into the repo documentation.

The Taxation of the Sale and Purchase of Securities

The Tax Law taxes the sale of securities that are quoted on a recognized securities market and unquoted securities differently. A security will be deemed to be a quoted security only if a market quote for this security has been determined in accordance with applicable law at least three months prior to the date of the sale. If a security is quoted, the sale price will be accepted for tax purposes if it falls within the range between the maximum and minimum prices registered on the relevant exchange during the three months prior to the trade (the previous reference period was twelve months) and, if it exceeds this range, then there must be a downward adjustment.

With respect to unquoted securities, a taxpayer must calculate the reference price either on its own or with the assistance of an independent appraiser, but nevertheless pursuant to written methods and procedures which the taxpayer is obliged to set out in its accounting policy. As of 2011, however, the reference price must be determined in accordance with rules that will be developed by the Ministry of Finance and implemented by the Federal Service for Financial Markets.

The Tax Law taxes the sale of securities that are quoted on a recognized securities market and unquoted securities differently.

The Tax Law clarifies that dividend income from shares held under the Russian equivalent of a trust relationship (доверительное управление), where property is held for the economic benefit of another person, is treated as the dividend income of its beneficial owners and not of the trustee. If the trustee is a Russian legal entity and the beneficiaries are foreign entities, the trustee is required to act as a tax agent and withhold tax on dividends, if such tax was not already fully withheld when the dividends were paid.

Stock Lending

Stock loans are taxed in a similar way to repo transactions under the Tax Law. In order to qualify as a stock loan, the term of the stock loan should not exceed one year and interest payments must be made in cash. Should the borrower fail to return the securities within one year, both the lender and the borrower would have to record a sale and purchase of the securities.

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Upcoming and Recent Events

JULY 13, 2010
New U.S. Requirements for Hedge Funds and Advisers
London
The Dodd-Frank Wall Street Reform and Consumer Protection Act is expected to be signed into law by July 4, 2010. Our speakers will take a first look at the provisions of Title IV of the Act, which will impact hedge funds and investment advisers based outside of the United States. These provisions include new registration requirements for certain investment advisers and changes in the private placement standards impacting all hedge funds, with immediate effect.

JUNE 23, 2010 AND MAY 26, 2010
Top Ten Things to Consider When Investing in Russian Securities
New York and London

In this seminar, members of Dechert's Financial Services, Corporate and Securities, and Tax Practices, including senior lawyers from our Moscow office, provided practical advice on structuring and carrying out investments in Russia, taking into account changing regulatory requirements, tax considerations, and shareholder rights.

JUNE 22, 2010
The UK as Fund Domicile of Choice?
London

The proposed AIFM Directive and other investor considerations are prompting alternative and other fund managers to establish new regulated funds. While Luxembourg and Ireland are traditional jurisdictions for such funds, recent regulatory and tax changes have made the United Kingdom an attractive fund domicile. This seminar examined each of these alternatives.

JUNE 8, 2010
Best Execution
London

This seminar examined the duty to achieve best execution. Speakers discussed best execution compliance requirements for both investment managers and broker-dealers, with particular focus on the requirements and differences in approach of the UK Financial Services Authority and the U.S. Securities and Exchange Commission.

MAY 13, 2010 AND MAY 14, 2010
Accessing Europe: UCITS, Separately Managed Accounts, and Other Solutions
New York and Boston

U.S. investment managers continue to look abroad for new sources of assets, and in particular to Europe. These seminars focused on product solutions offered to and by U.S. investment managers to access Europe. Speakers highlighted the regulatory challenges faced by U.S. managers marketing to investors in Europe and the use of managed accounts and UCITS to meet the growing investor demand for liquidity and transparency.

MAY 11, 2010
Can European Funds Be Sold to US Investors?
London

The seminar focused on issues raised when considering whether to sell shares of European funds (both UCITS and non-UCITS) to U.S. investors. Topics included U.S. private placement requirements, "blue sky" requirements, ERISA issues, Commodity Futures Trading Commission issues, investment adviser and broker-dealer registration requirements (and exemptions) and tax issues.

APRIL 13, 2010
Checklist for Acquiring a Minority Stake in a US Company
London

The seminar focused on legal and compliance issues that arise when an asset manager decides to acquire a minority interest in a U.S. company on behalf of one or more clients. The goal of the session was to provide a checklist of issues for legal and compliance personnel to consider, including ongoing large shareholder reporting requirements, Hart-Scott-Rodino (antitrust) issues, tax issues, CFIUS issues (investment in companies raising national security concerns) and OFAC issues.

APRIL 8, 2010
Navigating the New Regulatory Structure Governing Money Market Funds
Webinar

The SEC has adopted new rules and amendments to existing rules governing the regulation of money market funds. The amendments are designed to strengthen Rule 2a-7's risk-limiting conditions, enhance portfolio information disclosure, and improve fund operations. Speakers discussed what boards and their advisers need to know regarding the new regulatory model for money market funds.

APRIL 1, 2010
Jones v. Harris Associates: Supreme Court Upholds Gartenberg Standard
Teleconference

On March 30, 2010, the U.S. Supreme Court handed down its long-awaited decision in *Jones v. Harris Associates* L.P., interpreting section 36(b) of the Investment Company Act of 1940. In a unanimous opinion, the Court held that the correct standard in determining whether a fund's investment adviser has breached its fiduciary duty with respect to the receipt of compensation was the standard applied by the Second Circuit Court of Appeals in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.* In this teleconference, speakers discussed highlights of the decision.

For more information, or to receive materials from the seminars listed above, please contact Kei Miller at +1 202 261 3493 or kei.miller@dechert.com.

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