RULES AND REGULATION

ANGELYN LIM AND **KARL EGBERT**, OF **DECHERT FINANCIAL SERVICES GROUP**, PROVIDE SOME CLARITY ON NEW US AND EUROPEAN REGULATORY INITIATIVES AND THEIR IMPACT ON ASIA-BASED MANAGERS

Angelyn Lim is a partner in Dechert's financial services group and leads its Asian financial services practice. She advises a wide range of global asset managers and other intermediaries on all aspects of fund formation (both retail and private funds) as well as on Hong Kong securities regulatory issues.

Karl Egbert is a member of Dechert's financial services group. He advises mutual funds, closed-end investment companies, hedge funds, private US funds and offshore funds on regulatory, corporate and business matters. He has significant experience in advising Hong Kong and Asian hedge fund managers.

In recent months, there has been much more clarity on new regulatory initiatives originating from the US and from Europe, bringing some relief for Asia-based managers on whom the impact of these new initiatives may not be as far-reaching as many had previously feared.

NEW US EXEMPTIONS FROM ADVISER REGISTRATION

With effect from 21 July 2011, Asian advisers have contemplated the loss of the most commonly used exemption from US investment adviser registration. The Dodd-Frank Act eliminated the 'private adviser exemption' whereby an adviser was exempt from US adviser registration if it advised fewer than 15 US clients. The SEC has now adopted new exemptions, but these exemptions are significantly narrower:

- **Foreign Private Adviser Exemption:** a non-US adviser with both (a) less than $25m attributable to US clients and investors and (b) less than 15 US clients or investors will generally be exempt from registration. But this standard is considerably stricter than the old private adviser exemption whereby only 'clients' (for example, funds or accounts) were counted towards the 15 client limit. Under the 'new' foreign private adviser exemption, both US funds and individual investors count towards this limit. As a result, many Asian fund managers may not be able to continue relying on this exemption route.

- **Exempt Reporting Advisers:** a non-US adviser with less than $150m in assets managed in the US will be exempt from registration but will be subject to certain record keeping and reporting requirements. This exemption is likely to be of use to many Asian advisers because only assets that are managed from a place of business within the US count towards the $150m threshold figure.

A significant problem with the exempt reporting adviser regime is that it is available only to advisers that manage solely private funds. An adviser that manages US separate accounts is ineligible. As a result, many Asian managers may choose to register in the US to retain some flexibility. While US registration comes with many compliance hurdles, Asian managers should generally be able to take advantage of a scaled back set of regulations (known as 'registration-light') available to most advisers without any actual operations in the US.

FATCA

When the US Foreign Account Tax Compliance Act (Fatca) was first enacted in March 2010, the 2013 compliance date for this wide-reaching law seemed far off, and some in the fund industry did wonder if the US Internal Revenue Service (IRS) would ultimately exclude many private funds. But only one year later, in mid-2011 (and still two years away from the compliance date), it is clear that a wait-and-see approach will not work. The IRS has been unwilling to limit Fatca's scope, and Asian fund managers, particularly those that do not deal with US regulators, should really begin to focus now on building the appropriate infrastructure to facilitate compliance.

Fatca attempts to identify US tax-payers who are evading US taxes by requiring that non-US foreign financial institutions (FFIs) (including private funds) enter into an agreement with the IRS to identify and disclose US shareholders. However, Fatca also creates a punitive mechanism to enforce disclosure: FFIs will be subject to a 30% withholding tax on US-source interest, dividends, profits and income if they do not comply. The 30% withholding includes gross proceeds from the disposition of any property that can produce US-source interest or dividends. Because Fatca applies even to private funds with no US investors, Fatca ensnares funds in Asia that were previously unaffected by any US regulation.

The IRS has issued guidance limiting the scope of Fatca, but this has so far been disappointing: for now, only exchange-traded funds and FFIs whose interests are held by other financial institutions are 'deemed compliant' with Fatca and will escape its disclosure obligations.

Any other FFI must enter into agreements with the IRS that it will identify US accounts (accounts held by US persons, or certain US-owned entities). There is, however, an added complexity in that terms used in Fatca (for example, 'US person') are defined differently by the IRS than by other US regulators. Additionally, the threshold to determine whether an entity is 'US-owned' is a very low 10%. Funds and asset managers must, therefore, incorporate these new definitions and concepts into their investor identification process to facilitate their Fatca compliance. The IRS has recently extended some Fatca deadlines to 2014, but the complexity of the infrastructure required to ensure compliance demands that industry participants begin work now.

"FOR NON-EU AIF MANAGERS, THE MAIN PIECE OF GOOD NEWS IS THAT ACCESS TO EUROPEAN INVESTORS VIA THE PRIVATE PLACEMENT REGIME IS STILL AVAILABLE"

AIFM DIRECTIVE

After two years of negotiation, and four rotating presidents later, the final version of the Alternative Investment Fund Manager Directive (AIFM Directive) was published in the Official Journal on 1 July 2011 and entered into force on 21 July 2011. Managers of all investment funds managed in or sold in Europe which do not fall within the scope of the Ucits Directive (Alternative Investment Funds or AIFs) will be required to comply with the new Directive and AIFs will be subject to substantial new regulations. The key provisions include:

- **EU Passports:** EU AIF managers marketing non-EU AIF, and non-EU AIF managers marketing AIF, in the EU may apply for an EU passport with a two-year transition phase (coming into force in 2015). Full compliance with the Directive by non-EU AIF managers is stipulated (except in certain situations, for example, where the third country's laws conflict with the Directive and are not yet deemed to be equivalent). Non-EU AIF Managers must appoint a de facto EU member state as its home state supervisor in the EU. The Directive requires coordination between that member state, other member states where the AIF is marketed and the third country where the AIF manager is established.

- **Existing Private Placement Regimes:** remain in place until three years after the introduction of the EU passport (2018). EU AIF managers marketing non-EU AIF under these provisions must comply with majority of the AIFM Directive's provisions except those concerning depositaries; but non EU AIF managers benefit from further exemptions from the AIFM Directive.

- **Delegation:** Portfolio management or risk management may be delegated to a non-EU adviser provided that co-operation arrangements are in place between the relevant authorities of the AIF manager's home Member State and the supervisory authority of the non-EU adviser.

- **Remuneration:** Restrictions taken directly from the Banking Directive will apply to AIF managers, to ensure that risk taking inconsistent with the risk profiles of the AIF is not encouraged.

- **Depositaries:** The depositary must be domiciled in the same member state as the AIF or (in the case of third country AIFs) in the same jurisdiction as the AIF or the home member state/member state of reference of the AIF managers. A prime broker acting as a counterparty to an AIF may not act as the AIF's depositary. If certain conditions are met, the depositary may, however, delegate custody function to the prime broker provided that contract provides that the AIF or AIF managers can claim damages from the delegate.

The 'Level 2' secondary rule-making process has now begun, with the European Securities and Markets Authority playing a central role. Binding legislation will be adopted using three basic processes: delegated acts, implementing acts and technical standards, each of which must be formally adopted by the EU Commission.

For non-EU AIF managers, the main piece of good news is that access to European investors via the private placement regime is still available, and that the Directive does permit delegation of portfolio management functions to non-EU entities although this is reliant on co-operation arrangements between the competent authorities in the relevant member state and non-EU country. ■