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Offering UCITS to US Institutional Investors: A Post Dodd-Frank Overview — Part 2 of 2

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This article discusses the impact of recent rulemaking by the US Securities and Exchange Commission (Commission) and the Commodity Futures Trading Commission (CFTC) on offering Europe's undertakings for collective investment in transferable securities (UCITS) to US institutional investors in the wake of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] Part 1 of this Article appeared in the August 2012 issue of *The Investment Lawyer,* in which the authors highlighted certain regulatory considerations in offering shares of UCITS to US residents under the US Securities Act of 1933, the US Investment Company Act of 1940 (Investment Company Act), the US Securities Exchange Act of 1934, as amended (Exchange Act) and state "blue-sky" laws. Here, in Part 2, the authors explore the regulatory considerations for promoters and advisers of UCITS offered to US persons in the wake of new rulemaking under the US Investment Advisers Act of 1940 (Advisers Act) and the US Commodity

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Exchange Act (CEA) post the Dodd-Frank Act. Finally, this Article will highlight certain other material issues that should be considered by UCITS promoters prior to offering UCITS in the United States.

I. ADVISERS ACT CONSIDERATIONS

One of the most significant recent changes in US regulation affecting promoters that wish to offer UCITS to US residents involves the promulgation of rules governing the regulation of the investment advisory function of a UCITS. These rules make the prospect of targeting the US institutional market much more difficult post the Dodd-Frank Act.

A. Registration

Section 202(a)(11) of the Advisers Act generally defines the term "investment adviser" to be any person who, for compensation, is engaged in the business of providing advice to others or issuing reports or analyses regarding securities.[2] The Advisers Act generally requires persons that meet the definition of investment adviser to register with the Commission, unless an exemption from such requirement applies.[3] While each element of the definition of the term "investment adviser" can be analyzed on a facts and circumstances basis, the definition is interpreted fairly broadly and applies to both US and non-US entities.[4] It is also important to note that the definition does not make a distinction between the terms "manager," "management company" and "investment adviser" as is the case in many non-US jurisdictions.[5] In addition, the term "investment adviser" applies to both discretionary and non-discretionary investment activities.[6]

As such, an investment adviser to a UCITS will generally be deemed to meet the definition of investment adviser under the Advisers Act and must therefore be either registered with the Commission or otherwise exempt. Prior to the Dodd-Frank Act, investment advisers to UCITS that offered and sold to US institutional investors relied on a widely used exemption from registration under the Advisers Act called the "private adviser exemption," which was previously set forth in Section 203(b)(3) of the Advisers Act.[7] Under the now repealed private adviser exemption, advisers with fewer than 15 "clients" who met certain other requirements were exempt from registration. For purposes of the exemption, the term client was interpreted to mean the fund itself (for example, a UCITS).[8]

Title IV of the Dodd-Frank Act eliminated the private adviser exemption.[9] In 2011, the Staff of the Commission adopted rules and rule amendments designed to give effect to the provisions of Title IV,[10] including requiring advisers to certain "private funds" to register with the Commission.[11] In addition, the Commission Staff created several new exemptions from Advisers Act registration, including two that could be useful to advisers that wish to offer UCITS to US institutional investors.[12]

1. Foreign Private Adviser Exemption

Although the Dodd-Frank Act eliminated the private adviser exemption, it created the "foreign private adviser exemption."[13] Under Section 202(a)(30), a "foreign private adviser" is defined as an investment adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 US clients and US investors in private funds advised by the investment adviser (such clients and investors, US Persons); (iii) has aggregate assets under management attributable to US Persons of less than $25 million (the SEC is granted authority to increase this threshold); and (iv) neither (a) holds itself out generally to the public in the United States as an investment adviser nor (b) advises investment companies or business development companies.[14]

Rule 202(a)(30)-1 under the Advisers Act contains definitions of some of the key terms used in interpreting the foreign private adviser exemption, including the term "foreign private adviser."[15] For example, the application of the foreign private adviser exemption for a UCITS manager may turn on the definition of "in the United States." This term is used in several contexts, including: (i) limiting the number of, and assets under management

attributable to, an adviser's "clients" "in the United States" and "investors" "in the United States" in private funds advised by the adviser; (ii) exempting only those advisers without a place of business "in the United States"; and (iii) exempting only those advisers that do not hold themselves out to the public "in the United States" as an investment adviser.[16] The Rule also contains a clarifying note that specifies that for purposes of the definition of foreign private adviser, a person that is "in the United States" may be treated as not being "in the United States" if such person was not "in the United States" at the time of becoming a client or, in the case of an investor in a private fund, at the time the investor acquires the securities issued by the fund.[17] A UCITS fund is considered a private fund for the purpose of this definition and, as such, should carefully consider the application of the definitions under Rule 202(a)(30)-1 according to its own facts and circumstances.[18]

2. Private Fund Adviser Exemption

The Dodd-Frank Act also created an exemption for investment advisers that solely manage "private funds" with assets under management in the United States of less than $150 million. In applying this exemption, Rule 203(m)-1 under the Advisers Act requires non-US advisers (that is, advisers with their "principal office and place of business"[19] outside the United States) to count only private fund assets that are managed from a "place of business"[20] within the United States toward the $150 million threshold, while it requires US advisers to consider all of their asset management activities worldwide. A non-US adviser can qualify for this exemption regardless of the size or nature of its activities outside of the United States, provided that all of its clients that are US persons are qualifying private funds.[21]

Investment advisers that rely on the "private fund adviser exemption" are called "exempt reporting advisers" under Commission rules, and are required to submit to the Commission, and update at least annually, certain reports on Part 1 of Form ADV[22] disclosing, among other things, organizational and operational information, information about potential conflicts of interests, as well as other detailed information about the private fund.[23]

The information reported by exempt reporting advisers is publicly available and may be used by the Commission and other regulators to determine whether the activities of an exempt reporting adviser warrant further attention, as these advisers would be subject to examination by US regulators.[24]

One of the practical limits to the private fund adviser exemption post the Dodd-Frank Act is that, unlike the prior private adviser exemption, the new exemption no longer fully exempts the adviser. Rather, the new private fund adviser exemption is a reporting regime as opposed to a blanket exemption.[25]

B. Anti-Fraud Considerations

Investment advisers to UCITS that wish to target US residents should consider the accompanying cost and compliance requirements associated with the registration or exempt reporting regimes. In addition, all advisers must comply with the anti-fraud provisions under Section 206 of the Advisers Act.[26] These anti-fraud provisions apply to both registered and unregistered investment advisers.[27] Section 207 of the Advisers Act further prohibits any willful misstatement or omission of material fact in any communication by an adviser, including a foreign adviser.[28] Compliance considerations and the costs of building a compliance program that accompany registration, as well as anti-fraud considerations under the Advisers Act may outweigh the potential asset-gathering benefit for UCITS within the US.

II. CFTC CONSIDERATIONS

In addition to the Advisers Act requirements noted above, UCITS should also consider potential regulation under the CEA prior to offering to US persons.

A. CEA and CFTC Regulation Considerations (Futures, Options and Swaps)

Generally speaking, an entity that acts for US customers, whether they are direct customers or investors in a fund (for example, a

UCITS) that the entity operates or advises, is required to register in an appropriate capacity with the CFTC if the entity engages in exchange-traded commodity futures, security futures, options on futures, commodity options or swap transactions. Entities without CFTC registration may, however, still rely on certain exemptions from registration and/or regulation, as was the case prior to the Dodd-Frank Act. The CFTC registration and exemption regime, however, is currently in flux as a result of the Dodd-Frank Act and related CFTC rulemakings.[29]

1. When CFTC Registration Requirements Apply

Under the CEA and implementing CFTC regulations, an investment fund may be considered to be a "commodity pool" subject to CFTC regulation if the investment fund transacts in exchange-traded commodity futures, security futures, options on futures, commodity options or swap transactions (commodity interests).[30] Thus, even a UCITS that is predominantly a vehicle for investment in securities and uses securities futures solely for hedging purposes may be deemed to be a "commodity pool" under CFTC requirements.

Without registration in an appropriate capacity with the CFTC, a firm and its employees may not solicit investors for a commodity pool (that is, under CFTC interpretations, a fund which engages in securities futures transactions to any extent) or offer to act for them in commodity interest trading activity conducted through a pool or brokerage or managed account program. Unless an exemption is available (as discussed below), the operator of a commodity pool must register as a commodity pool operator (CPO), and one who manages or directs an account that trades in commodity interests or who gives advice about commodity interest trading must register as a commodity trading advisor (CTA).[31] Marketing personnel and their supervisors would be required to register as associated persons of the registered firm.

As a result, any entity that acts as a CPO and/or CTA for a UCITS that transacts in commodity interests (for example, security futures) must be registered or otherwise exempt.

2. Exemption from CFTC Registration as a CPO

Under rule amendments that the CFTC recently finalized, the number of available CPO exemptions has been narrowed. Previously, a CPO to a private fund (for example, a UCITS) that limited US person investors to "qualified purchasers" as defined by the Investment Company Act,[32] could qualify for a registration exemption under CFTC Rule 4.13(a)(4), regardless of the amount of futures trading the private fund conducted.[33] However, effective April 24, 2012 for CPOs operating new commodity pools and December 31, 2012 for CPOs operating existing commodity pools as of April 24, 2012, the CFTC Rule 4.13(a)(4) exemption is no longer available.[34]

A CPO may still rely on the CPO registration exemption available under CFTC Rule 4.13(a)(3) if it meets certain requirements. In order for a CPO to a UCITS to qualify under this exemption, the UCITS (for which the CPO acts) may not be publicly marketed in the United States and may not be marketed as a vehicle for trading in commodity interests. In addition, its investors must meet the definition of "accredited investor,"[35] and the UCITS must meet one of two trading tests.[36] Alternatively, in some limited circumstances, a CPO to a UCITS may rely on the CPO registration exemption available under CFTC Rule 30.4(c).[37] In order to qualify under this exemption, the CPO must, among other things, be trading solely foreign futures or foreign options in the fund.[38]

In light of the changing regulatory landscape, UCITS promoters should carefully consider the application of relevant exemptions to CFTC regulation of CPOs in light of all facts and circumstances prior to accepting investments from US persons. For UCITS with US persons already invested, ongoing operational relief may be available for those classified as CPOs to UCITS, although some ambiguity remains.

3. Exemption from CFTC Registration as a CTA

An investment adviser to a UCITS should also consider the applicability of regulation as

a CTA to the extent the UCITS offers to US persons.

Pursuant to CFTC Rule 4.14(a)(5), persons who are exempt from CPO registration with regard to a UCITS may also be exempt from CTA registration with regard to providing commodity interest trading advice to that same fund. For example, a person qualifying for a CFTC Rule 4.13(a)(3) CPO registration exemption may also qualify for a CTA registration exemption with regard to the same fund pursuant to CFTC Rule 4.14(a)(5).

In addition, pursuant to CFTC Rule 4.14(a)(10), persons who, among other things, during the preceding 12 months, have not furnished commodity trading advice to more than 15 "persons" and who do not hold themselves out generally to the public as a CTA are eligible for an exemption from CFTC registration as a CTA.

Section 4m(3) of the CEA also provides an exemption from CTA registration with the CFTC for investment advisers registered with the Commission. In order to qualify for this exemption the adviser's business may not consist primarily of acting as a CTA and the adviser may not act as a CTA to a commodity pool that is primarily engaged in trading commodity interests.

CFTC Rule 4.14(a)(8) provides an additional exemption from registration with the CFTC as a CTA for SEC-registered investment advisers. In order to qualify for this exemption, (i) a fund must be organized and operated outside of the United States and can have less than 10 percent of its beneficial interests owned by persons who do not qualify as "Non-United States persons"[39] and such advisory services are solely incidental to the conduct of its business or (ii) the CPO of the fund must qualify for the CPO exemption under CFTC Rule 4.13(a)(3). In addition, in either instance, the person may only be providing its commodity interest trading advice to the fund solely incidental to securities advice that it is also providing to the fund and the person may not hold itself out as a CTA.

Alternatively, in some limited circumstances, a person providing commodity interest trading advice to a fund trading solely foreign options and foreign futures would not be required to register as a CTA under CFTC Rule 30.4(d) if the person is a bank or trust company, named fiduciary or trustee of any defined benefit plan subject to ERISA, or insurance company or otherwise as QEPs, no marketing of such persons is conducted, and no marketing of the fund is conducted from within the United States.

III. REPORTING CONSIDERATIONS

UCITS managers that offer and sell shares to US residents should also consider several recent reporting rules post the Dodd-Frank Act that may be triggered by US person shareholders.

1. Form PF

Form PF must be filed by SEC-registered investment advisers that advise one or more "private funds" if they manage at least $150 million of "regulatory assets under management"[40] attributable to private funds as of the end of the most recently completed fiscal year. The term "private fund" includes "any issuer who would be an investment company, as defined in section 3 of the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) under that Act."[41] Accordingly, a UCITS would be considered a private fund for purposes of Form PF if it relies on 3(c)(1) or 3(c)(7) when offering shares to US persons. UCITS that offer to US persons (or have US person subscribers) should consider the full application of the Form PF reporting regime.

2. Volcker Rule

Section 619 of the Dodd-Frank Act, the Volcker Rule, generally prohibits a "covered banking entity" from: (i) engaging in proprietary trading; or (ii) sponsoring a "hedge fund" or "private equity fund."[42] A "covered banking entity" includes: (i) a state member bank, bank holding company or savings and loan holding company; (ii) a foreign banking organization that has a US branch or agency office, or owns a US subsidiary bank; and (iii) all subsidiaries of such entities.[43] The terms "hedge fund" and "private equity fund" include any issuer relying on the

exception from the definition of investment company under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. Accordingly, as noted above, because UCITS offered in the United States typically seek to rely on one of these exceptions, a covered banking entity should consider the full application of the Volcker Rule to its sponsorship of a UCITS.

IV. TAX CONSIDERATIONS

All UCITS offering shares to US residents should not only consider the potential tax efficiency of the UCITS product for both US tax-exempt and US taxable[44] investors but also the impact of the US Foreign Account Tax Compliance Act of 2009[45] (FATCA). Generally, FATCA requires any entity in the broadly defined class of "foreign financial institutions" (FFIs) — including UCITS — to comply with an expansive reporting regime. If an FFI does not comply, it will be subject to a 30 percent withholding tax on (1) most US source payments made to the FFI and (2) proceeds from the disposition by the FFI of investments generating such US source income. These requirements will generally apply to non-US investment funds, including non-US UCITS, and will be effective for payments to, or dispositions by, such funds after December 31, 2012. While the specific impact of FACTA on UCITS organized in various jurisdictions is yet to be determined, no plan to offer UCITS to US persons should be considered without reviewing the impact of FACTA on the UCITS and its existing non-US retail investor base.

Notes

1. Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

2. 15 U.S.C. 80b-2(a)(11) (2011).

3. *See* 15 U.S.C. 80b-3 (2011).

4. *See* Jane A. Kanter and Steve S. Drachman, *Regulation of Investment Advisers*, Regulation for Asset Managers Outside the United States 2 (Sweet & Maxwell ed., 2008) (discussing the breadth of the definition of investment adviser); *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, Investment Advisers Act Release No. 1092, 52 Fed. Reg. 38400 (Oct. 16, 1987) (noting that whether a person providing certain types of financially-related services is an investment adviser "depends on all the relevant facts and circumstances").

5. *See* Kanter and Drachman, *supra* n.4.

6. *Id.*

7. 15 U.S.C. 80b-3(b), *repealed by* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

8. *Id.*

9. Dodd-Frank Act; *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3221, 76 Fed. Reg. 42949 (Jul. 19, 2011) [hereinafter, Implementing Release].

10. Implementing Release*, Supra* n.9.

11. *Id.*

12. *Id.*

13. Dodd-Frank Act.

14. *Id.*; 15 U.S.C. § 80b-2(a)(30) (2011).

15. 17 C.F.R. 202(a)(30)-1 (2012).

16. *Id.*

17. *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers,* Investment Advisers Act Release No. 3222, 76 Fed. Reg. 39646, 39673 (Jul. 6, 2011) [hereinafter, Exemptions Adopting Release].

18. A foreign private adviser is an investment adviser that has no place of business in the United States, has fewer than 15 clients and investors in the United States in private funds advised by the adviser, and less than $25 million in aggregate assets under management from those clients and investors. Exemptions Adopting Release, *supra* n.17, at 39647. *Compare id.* at 39679 (stating that, for purposes of the look-through provision, non-US advisers are not required to count persons investing in a foreign private fund through Canadian retirement accounts); Comment Letter of Investment Funds Institute of Canada (Jan. 24, 2011), available at *http://www.sec.gov/comments/s7-37-10/s73710-100.pdf,* with Comment Letter of European Fund and Asset Management Association (Jan 24, 2011), available at *http://www.sec.gov/comments/s7-37-10/s73710-38.pdf*.

19. "Principal office and place of business" is generally defined as the executive office from which the officers, partners or managers of the investment adviser direct, control and coordinate the adviser's activities. *See* Rule 203(m)-1(d)(3) under the Advisers Act.

20. "Place of business" is generally defined as: (i) the office at which the adviser regularly provides investment advisory services or communicates with clients; and (ii) any other location that is held out to the general public as a location at which the adviser provides investment advisory services or communicates with clients. *See* Rule 222-1(a) under the Advisers Act.

21. The treatment of non-US advisers is intended to establish appropriate limits on the extraterritorial application of the Advisers Act.

22. Exempt reporting advisers are not obligated to prepare, file or deliver to clients the narrative brochure required of registered advisers by Part 2 of the Form ADV.

23. Implementing Release, *Supra* n.9.

24. However, the SEC had indicated that it does not expect to subject exempt reporting advisers to routine examinations. *Id.*

25. *Id*. at 42963.

26. 15 U.S.C. § 80b-6 (2011).

27. John O'Hanlon, *Regulation of Investment Advisers: Compliance Requirements*, Regulation for Asset Managers Outside the United States 29, 30 (Sweet & Maxwell ed., 2008); *see also* Implementing Release, *supra* n.9.

28. 15 U.S.C. § 80b-7 (2011).

29. The Dodd-Frank Act brought sweeping changes to the CFTC's jurisdiction. Prior to its enactment, the CFTC only maintained jurisdiction over exchange-traded futures and options contracts. The Dodd-Frank Act granted the CFTC jurisdiction over off-exchange or over-the-counter products, such as swaps. Since 2010, the CFTC has been proposing and promulgating rules required under the Dodd-Frank Act. Many of these rules will not be effective until the CFTC and SEC jointly define the word "swap."

30. 7 U.S.C. § 1a(10) (2011).

31. 7 U.S.C. § 6(m) (2011).

32. A qualified purchaser is any person with more than $5 million in investments, or any company owning more than $5 million in investments owned directly or indirectly by two or more family members, or any trust whose settlor and any trustees own more than $5 million in investments, or any person, acting for its own account or the accounts of other qualified purchasers, who owns and invests at least $25 million in investments in the aggregate. 15 U.S.C. § 80a-2(a)(51) (2011).

33. Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11252 (Feb. 24, 2012) (rescinding 17 C.F.R. § 4.13(a)(4)).

34. *Id*.

35. 17 C.F.R. § 230.501(a) (2012).

36. In order to meet one of the two trading tests, at all times, all of the Fund's commodity interest positions must be limited such that either (i) the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the Fund's portfolio (taking into account unrealized profits and losses on such positions and excluding in-the-money amounts for commodity options that were in-the-money at the time of purchase), or (ii) the aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the Fund's portfolio (taking into account unrealized profits and losses on such positions and excluding in-the-money amounts for commodity options that were in-the-money at the time of purchase).

37. 17 C.F.R. 30.4(c) (2012).

38. In addition, the UCITS may have no more than 10 percent of its investors be US participants and the aggregate value of the fund held by US investors may not exceed 10 percent. *Id.*

39. *Id*.

40. Regulatory Assets Under Management (RAUM) is a definition recently adopted under the amendments to Form ADV, and measures assets under management (AUM) gross of outstanding indebtedness and other accrued but unpaid liabilities. Form PF also provides additional requirements on how to determine the $150 million threshold, referring to the instructions on Form ADV for further guidance about the calculation. Generally, in the case of a private fund, RAUM is calculated in two steps. The calculation begins with the current market value of the private funds' assets according to the same method it uses to report account balances to clients or calculate fees for investment advisory services. Next, this number is increased by the contractual amount of any uncalled commitment pursuant to which a person is obligated to acquire an interest in or make a contribution to that private fund.

41. 15 U.S.C. § 80b-2(a)(29) (2011).

42. Dodd-Frank Act.

43. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (Feb 14, 2012) (to be codified at 17 C.F.R. pt. 75).

44. US taxable investors investing in a UCITS would be subject to the passive foreign investment company (PFIC) tax regime and controlled foreign corporation regime designed to prevent deferral of tax, and conversion of ordinary income, through investing in a non-US fund. The CFC regime is likely not applicable unless there are US investors, each of which owns a 10 percent or greater interest in the UCITS, that together own more than 50 percent of the UCITS. Since this is unlikely, the CFC tax regime should not apply, but in its absence, the PFIC regime will apply.

45. Pub. Law 111-147, 124 Stat. 97 (Mar. 18, 2010).

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