ISSUE 1 APRIL 2017

INVESTMENT FUNDS INSIGHT

Global focus

ashurst

Welcome

Fund formation is an international business.

Even a domestic fund structure, with a single-country investment strategy, needs to be structured to meet the needs of international investors, and promoted in compliance with a multitude of inconsistent and constantly evolving regulatory restrictions. For international funds, investing across multiple jurisdictions and with a management team operating from offices worldwide, the tax and regulatory complexity can be daunting.

In this edition of Investment Funds Insight, we explore some of the current hot topics across Europe, the US and Asia. In particular, Dean Moroz considers how, in contrast to the increasingly global nature of fund management businesses, focused single-country funds are becoming more popular in Asia. And with fund structures globally having to cope with new tax regimes, Paul Miller and Alistair Ladkin look at how the OECD's base erosion and profit shifting project ("BEPS") is likely to spur the most significant changes to the taxation of international business in nearly 30 years. The combination of a global perspective and incisive local knowledge has never been so important.

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ASIA

Fundraising in Asia

In Asia, country-focused funds continue to outnumber pan-Asia private equity style fund raisings by a significant margin, illustrating the unique characteristics, challenges and opportunities represented by Asia markets for both country-focused and pan-Asia fund raising strategies.

The dominance of country-focused funds

In Asia, country-focused funds continue to outnumber pan-Asia private equity style fund raisings by a significant margin, in contrast to Europe where the opposite is true. This article considers why country-focused funds continue to predominate over pan-Asia funds and points to the obvious but often underappreciated diversity of Asian markets as a key factor.

ASIA AND EUROPE – THE DIFFERING SIGNIFICANCE OF 2:1

Over the past decade the number of single country Asia-focused fund raisings, on which the Ashurst funds practice has worked, vastly outnumbers pan-Asia funds. The exceptions have been notable, but few. A stroll through Preqin's databases confirms that our firm's experience is representative of a broader trend in Asia markets. Of the approximately 776 pooled funds established since 2014 having their main geographic focus in Asia (of all sizes and across all strategies, asset classes and industries), slightly more than two-thirds were single country-focused. For every two country-specific funds raised in Asia there is approximately one pan-Asia fund.

In contrast, a survey of funds raised over the same period in Europe (again, of all sizes and across all strategies, asset classes and industries) reveals the reverse trend. Some 1,361 funds were raised during that period, of which two-thirds were pan-European funds according to Preqin data. Thus, for every two pan-Europe funds in Europe there is approximately one country-specific fund raised.

It is worthwhile to try and account for this mirror difference in results between the two continents, as doing so reveals something of the unique characteristics, challenges and opportunities represented by Asia markets for both country-focused and pan-Asia funds.

ASIA – NOT ONE BUT MANY (HETEROGENEOUS) MARKETS

It seems an obvious observation to make that Asia is not a single, uniform market. Yet the significance of this to fund raising activity in Asia cannot be understated; and nor should it be underestimated.

Whereas modern-day Europe is the product of years of economic and political integration that can be (formally) traced to the establishment in 1957 of the European Economic Community under the Rome Treaties, its closest parallel in Asia, the Association of South East Asian Nations (ASEAN) was founded in 1967 principally as a security-orientated rather than a trade-promoting organisation.

Although the EU's genesis is necessarily understood against the backdrop of the security, and existential, threat to Europe's existence represented by two World Wars and their aftermath in the first half of the Twentieth Century, 60 years of political, economic and monetary integration in Europe have (at least until recently) helped allay those concerns. In contrast, ASEAN's mandate has not been to strive towards the deep integration that the EU has embraced as a customs union with a common trade policy. Moreover, ASEAN's membership does not include China and India, the two biggest markets and most populous nations in Asia. Consequently, Asia, unlike the European common market, remains fragmented and diverse – far less homogenous than the EU – and cannot be understood as one, but remains many heterogeneous markets and political economies.

To be certain, there are other factors that distinguish Asian and European markets, including Europe being a more mature market in counter-distinction to most parts of Asia, excluding Japan, which being in the developing world and with their comparatively youthful demographics offers more potential for growth. Nevertheless, these factors only partly explain the predominance of country-focused funds in Asia and diversity remains the principal distinguishing feature for reasons that we will explore in greater detail below.

ASIA'S DIVERSITY – IMPLICATIONS FOR COUNTRY-SPECIFIC AND PAN-COUNTRY FUND RAISING STRATEGIES

The diversity that characterises Asia's markets raises a practical challenge for sponsors wishing to pursue pan-country fund strategies. The lower levels of risk that can be seen to attend a portfolio diversified across several markets is a key argument in favour of raising a pan-country fund. On the other hand, the successful sourcing and execution of the acquisition and divestiture of investments across more than a single country requires a commensurately greater commitment of time, money and personnel resources, including, importantly, resources on the ground. While this observation is universally true (including in the comparatively more homogenous European common market and its environs), the challenge is exacerbated in Asia precisely because of Asia's greater heterogeneity.

Significant investments of time and money are required to acquire local commercial market knowledge in Asia across more greatly fragmented markets, whether on a green or brown-field basis. Similarly, the pursuit of investments requires an understanding of the legal,

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Asia markets, being more diverse and less homogenous than the European common market, pose higher entrance barriers for raising pan-Asian funds than comparable pan-Europe fundraising.

Higher entrance barriers have resulted in Asia markets being predominated by country-specific funds.

Country-focused funds require a lower level of internal resources to manage but portfolios are of consequence less diversified across markets.

Opportunities exist for both single-country and pan-country strategies in Asia if properly considered and executed.

regulatory and tax features of diverse target markets, often varying significantly from country to country. The challenge is further magnified when one considers other characteristics common of many Asia markets: the generally smaller size of their economies and less diversification within them (though not without exception, China and India being notable examples), relatively illiquid capital markets and the prevalence of shareholding structures concentrated in closely held family and corporate groups, which provide more limited entry points and exit options than in more mature developed markets.

Smaller fund sizes too are both reflective of Asia markets as well as symptomatic of the challenges Asia funds face, as it is more difficult to achieve the economies of scale represented by the ideal of raising a large amount of capital for deployment in a small number of investments in a uniform market. Although such an ideal is likely nowhere achievable (it is, after all, an ideal), in Asia, with few exceptions, markets' greater diversity means that it is generally necessary to spread fewer resources farther or invest greater resources than in more homogenous markets in an effort to acquire the local market knowledge and deal execution expertise upon which establishing a successful track record depends. A third option is simply to focus on fewer countries or a single market. Not surprisingly, particularly given the greater number of smaller and first time fund managers again characteristic of growth/developing markets and the correspondingly

smaller private fund sizes raised in Asia, a balance between these competing priorities can often only be obtained by focusing on a single country, in-depth market knowledge about which a particular sponsor may have acquired painstakingly over a number of years.

The challenges outlined above are not lost on either sponsors of or investors in Asia-focused pooled funds. There is a general awareness that adequate depth and breadth of relevant market specific expertise and experience is required of sponsors across levels of their organisation. This includes market-specific expertise and experience at the deal team level, which suggests more than one individual, certainly, and likely also more than one team, each focused on its relevant market, with attendant implications for costs.

But market-specific experience and expertise is also required within the management team and, importantly, at the investment committee level. An investment committee that has not been adequately briefed, or that is otherwise insufficiently knowledgeable of a particular local market, may not fully appreciate the subtle and not so subtle differences between markets. The challenges of operating in Asia local markets include having to recalibrate one's understanding of risk/return trade-offs and many others that local deal and management teams will be well aware of.

This disconnect can manifest itself in two equally unsatisfactory ways: (i) overly conservative investment committee decisions resulting in a dearth of approved deal flow and frustrated deal teams on the ground; or (ii) with the investment committee relying too heavily upon the "on-the-ground" team, unknowingly throwing caution to the wind and taking on too much risk. The balance can be difficult to attain in particular for non-mainstream or "niche" markets. Against this backdrop, the predominance of single country-focused funds in Asia can again be better understood.

Duplicating roles among individuals or teams to focus on different markets can seem like an exercise in creating redundancy, but the point is to ensure that the market-specific knowledge and expertise required effectively to execute and establish a track record across markets that vary greatly is achieved. There is no substitute for local market knowledge in markets characterised by their great diversity and that axiom holds equally true for both country-specific and pan-country funds. Until Asian markets attain a greater degree of homogeneity characteristic of European ones, the greater resources required by pan-Asia funds to attain the required institutional critical mass suggests that one should expect country-focused funds to continue to predominate over pan-country funds in Asia.

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GLOBAL

What is or are BEPS?

The base erosion and profit shifting ("BEPS") project is likely to spur the most significant changes to the taxation of international business in nearly 30 years

Fund structures are having to cope with a number of new sets of international tax rules. The background to all of that is the OECD's project on BEPS. The OECD BEPS project was mainly driven by certain practices of large multinational groups which resulted in very low effective rates of tax. Some of the proposals are more difficult to apply in a context where a fund is structured as a limited partnership with limited partners in a multitude of different jurisdictions. This article considers the position of such funds in relation to two of the main BEPS actions, namely BEPS 6 aka "treaty abuse" and BEPS 2 aka "hybrid mismatches".

INTERMEDIATE HOLDING COMPANIES – THE BACKGROUND

Over time, certain jurisdictions have developed as regional holding platforms for investing into their local area. For example, Luxembourg and, to a lesser extent, Ireland, the Netherlands and the UK are often seen as useful places from which to manage and hold a pan-European fund. Singapore and Mauritius each play an analogous roles for a wide range of investee jurisdictions in their vicinity.

Turning then to the tax position, many countries impose withholding taxes on cross-border payments of dividends and/or interest. Moreover, many countries also

BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity.

charge a form of non-resident capital gains tax. What that means is that where a non-resident disposes of shares in a local company at a gain, the local jurisdiction seeks to tax the non-resident on the capital gain on the share disposal. Since that could lead to an element of double taxation (i.e. once in the source state and once where the payee is resident), a large number of bilateral treaties have been negotiated between countries which, subject to a number of conditions, operate to allow investor entities to avoid the sorts of tax set out above. All of Luxembourg, Singapore and Mauritius have wide double tax treaty networks which mitigate the above local taxes. The question is whether establishing intermediate holding companies in those countries will be challenged by investee authorities as a result of the BEPS 6 proposals outlined below.

BEPS 6 – TREATY ABUSE

BEPS 6 will be implemented by a "multilateral instrument" which, over the course of the next few years, will act to change treaties between participating countries. In many cases, this is likely to mean that the relevant treaty is subject to relevant changes. In this context:

(a) first, there will be a statement that the treaty is not intended to facilitate tax avoidance; and
(b) second, a new principal purpose test ("PPT") will be included in the treaty.

Under the PPT, the benefit of the treaty will not be allowed if "it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."

There is a huge range of views as to how to apply the PPT Test in practice. There is some draft guidance of the

application of these rules to funds (called non-CIVs) at http://www.oecd.org/tax/treaties/Discussion-draft-non-CIV-examples.pdf. However, the examples are so obviously on the right side of the line that they give no useful insight into practical issues.

What may become critical is the view of the "source" state as to what the purpose of the treaty is. For example, we note that the UK is currently relatively relaxed about funds establishing lending platforms in Luxembourg to make loans into the UK. However, other source countries may take a much stricter approach. On the other hand, many countries have already developed or strengthened their own domestic anti-avoidance rules over the last few years. There is thus a school of thought that actually these BEPS 6 changes may not be that much more onerous than the existing domestic rules. The jury is out. One possible outcome though is that one or more senior fund executives with real deal experience may ultimately need to be moved to the relevant intermediate holding company jurisdiction.

BEPS 2 – HYBRID MISMATCHES

Perhaps the change that may end up being more momentous is the rules that are designed to prevent cross-border tax mismatches. Part of the driver for these new rules was the fact that certain multinationals had set up structures that meant that large amounts of income "fell between the gaps"; the income was not taxed anywhere in the world. However the response to this in BEPS 2 (known as hybrid mismatches) is very widely drafted and catches a surprising range of structures. There is further detail on the UK's implementation of this legislation at https://www.ashurst.com/en/news-and-insights/legal-updates/hybrid-mismatch-legislation-and-guidance/.

Turning though to the impact we expect in a funds context, we currently expect the following main issues to arise:

(a) In cash terms, portfolio companies may be denied deductions for certain amounts, particularly on intra-group payments (e.g. of interest or royalties).

(b) The issue at (a) may be removed or at least lessened if the portfolio companies have sufficient information about the identity and tax position of the limited partners. Therefore we expect a widening of the existing powers for the general partner to call for investor information. As investee jurisdictions implement BEPS 2 over the next few years, those additional investor request powers will ensure that the portfolio companies can analyse their own local tax position.

(c) Increased consideration of whether to check entities opaque or transparent for US purposes will be necessary.

(d) Care will be required when using hybrid funding instruments within fund structures. For example, the use of CPECs in Luxembourg companies will need care, particularly where they ultimately fund more vanilla debt instruments lower down the structure.

The UK and, to a lesser extent, Denmark have already introduced rules that implement these BEPS 2 rules. As more countries do so, some of the implications will become clearer.

OTHERS

There are a number of other BEPS actions not considered above. The corporate interest restriction under BEPS 4 is going to be particularly important to the modelling of local tax payable and thus fund returns. Finally, many larger groups are going to have to file reports of how much tax they pay in each country in which they operate.

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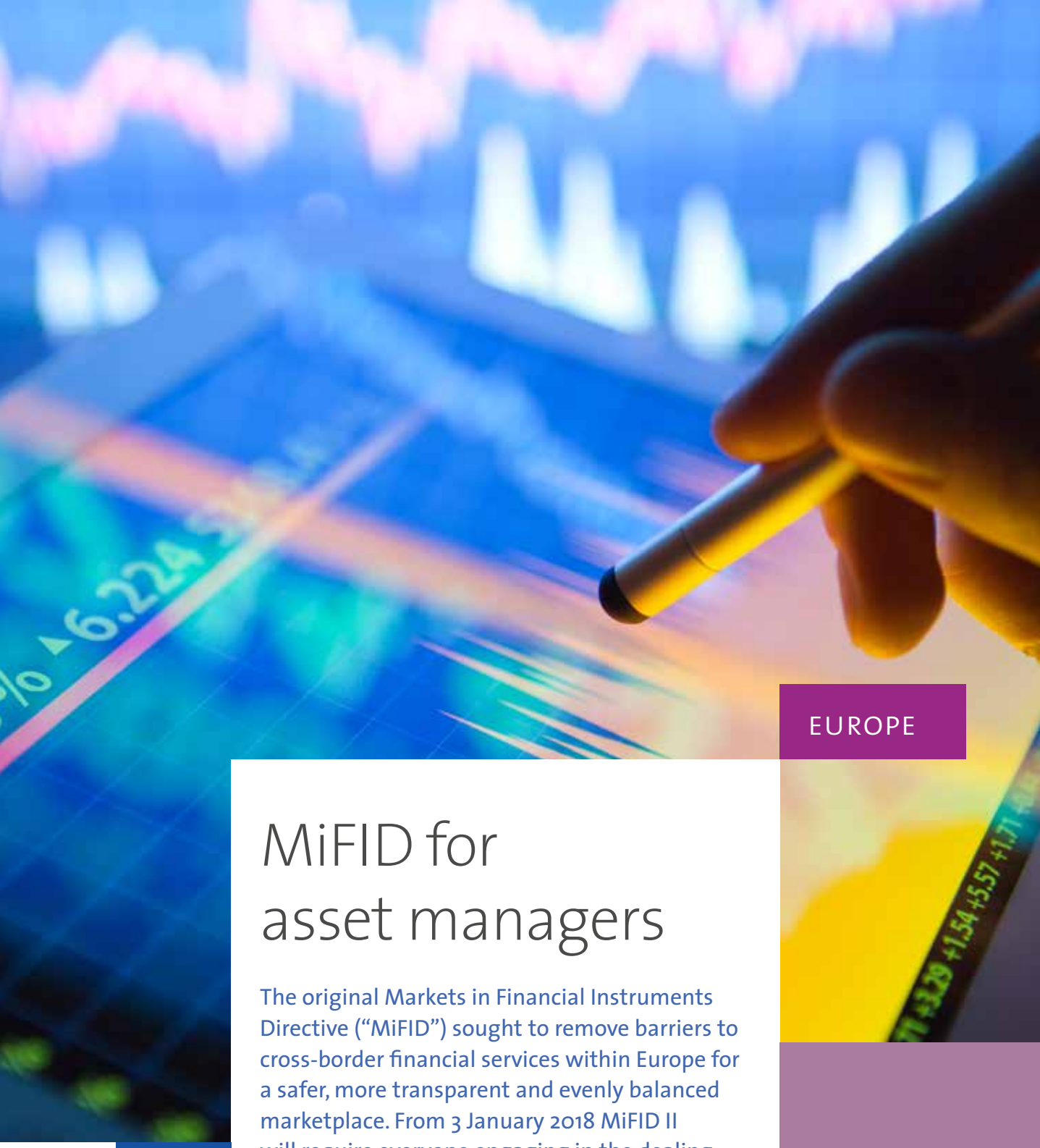


EUROPE

MiFID for asset managers

The original Markets in Financial Instruments Directive ("MiFID") sought to remove barriers to cross-border financial services within Europe for a safer, more transparent and evenly balanced marketplace. From 3 January 2018 MiFID II will require everyone engaging in the dealing and processing of financial instruments to implement new policies, procedures and systems to ensure compliance with the new regime.

A look at the steps asset managers should be taking now

It would be difficult to not have noticed that the financial services industry has stopped simply talking and has started to implement the Markets in Financial Instruments Directive II ("MiFID II"). MiFID II will replace the current MiFID ("MiFID I") as the framework legislation that regulates a significant proportion of firms providing investment services and activities in the EU including many asset managers. In this article we set out some of the key issues that asset managers should be considering.

BACKGROUND

MiFID II comprises a regulation (MiFIR) and a directive (the MiFID II Directive), collectively known as MiFID II, as well as regulatory technical standards and EU guidance that runs to thousands of pages. In addition, each member state must implement MiFID II and so there are different interpretations and gold-plating in each jurisdiction. MiFID II is a significant change as it substantially alters and expands many of the current MiFID I obligations. "MiFID investment firms" – those authorised and regulated under MiFID need to undertake a significant amount of work to ensure compliance. MiFID II will come into effect from 3 January 2018.

MiFID II will have a substantial impact on the asset management industry regardless of whether a firm is regulated under MiFID, AIFMD or UCITS (or a combination). While not directly applicable to the latter two types of firm there is significant gold-plating by regulators (including the FCA) to ensure many rules apply equally to AIFMs or UCITS management companies. It is also likely that firms and market operators will require changes to arrangements to ensure that they can comply with their own obligations thus indirectly affecting asset managers.

Whilst final rules (and national implementation of these rules) are still being finalised there are some key areas where asset managers must start working towards implementation. We have highlighted below certain areas where asset managers will be required to build new systems, controls, processes and / or policies. In many cases asset managers will need to engage with their counterparties and third party providers.

PRODUCT GOVERNANCE

MiFID II introduces new obligations for firms to have appropriate systems and controls for the design, marketing and ongoing management of "products". Under MiFID II, an asset manager may be viewed the "manufacturer" of a product that it manages. The manufacturer is responsible for:

- ensuring that the product is designed to meet the needs of an identified target market;
- the strategy for distribution is compatible with the identified target market; and
- taking reasonable steps to ensure that the financial instrument is distributed to the identified target market.

These manufacturer obligations will require asset managers to have a product approval process to specify an appropriate target market and ensure relevant risks are identified. This includes product testing, including assessing the risk of poor outcomes and the circumstances that these might occur (such as during a period of market deterioration or commercial unviability of the fund).

Most European distributors such as placement agents (and also many asset managers themselves) are MiFID firms and so are under obligations to understand the products they distribute, assess the product's compatibility with an identified target market and are required to distribute products only when in the best interests of the client (investors). This means distributors will need to put in place effective arrangements to obtain from the asset manager any necessary information about products.

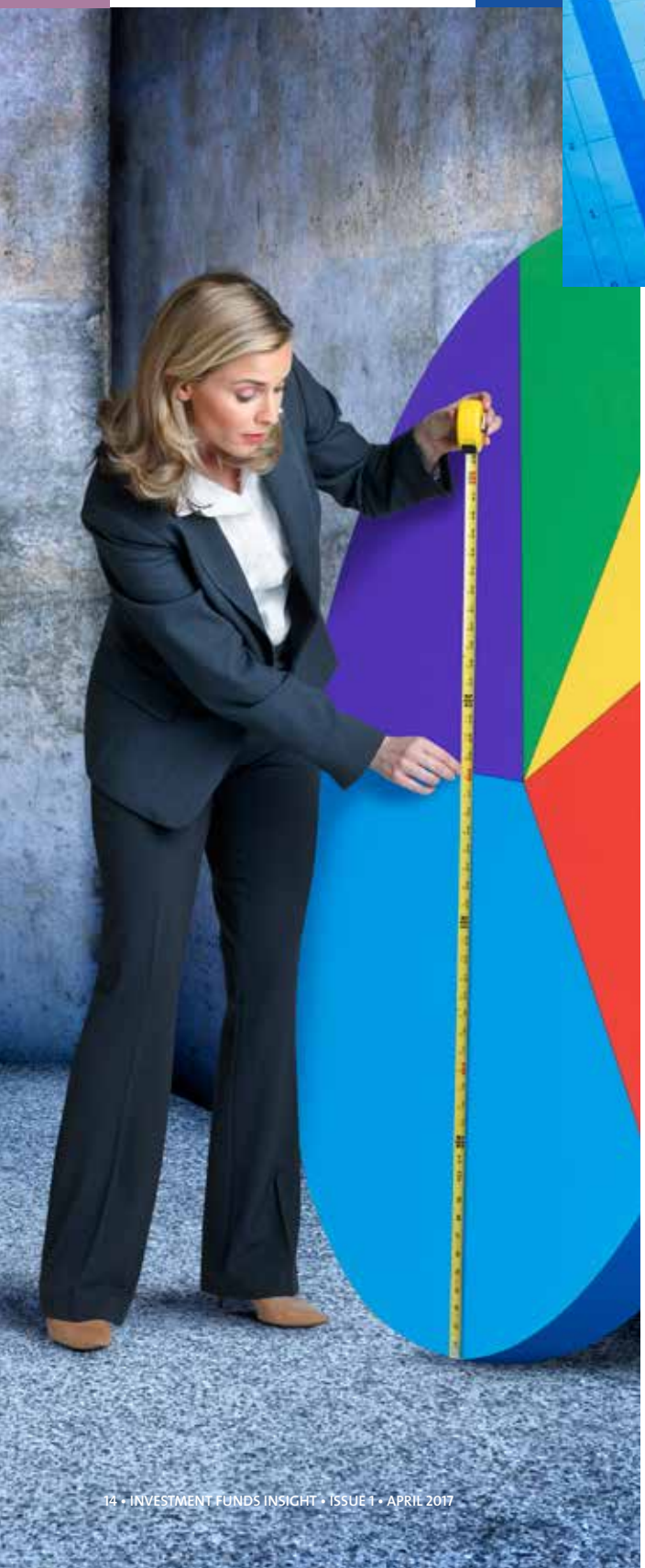
The rules take into account proportionality, so for simpler products the assessment of the target market is less granular. Likewise, for asset managers that provide products only to professional investors this will require limited work. However, if complex funds are sold to natural persons through distribution channels a more detailed assessment will need to be undertaken. A related, but separate piece of legislation, Packaged Retail and Insurance-based Investment Products KID Regulation ("PRIIPS"), is also coming into effect on 3 January 2018. This will require asset managers to provide a pre-contractual disclosure document (a key information document or KID) to retail persons prior to the retail investor making an investment in the fund.

ACTION

Asset managers might start considering the necessary approval committees and ensure that they can justify their product governance arrangements as appropriate.

RESEARCH UNBUNDLING/PROHIBITION ON INDUCEMENTS

Under the MiFID II inducements regime, asset managers will be prohibited from receiving "free" or "bundled" research (with some very limited exceptions). Instead, MiFID II requires asset managers to purchase research and execution services separately (and for sell-side institutions



to unbundle their execution and research charges). This will require decisions by asset managers on their research strategy and commercial negotiations with research providers. Asset managers should consider what research they are willing to purchase.

There are (broadly) two models for purchasing research, either (i) direct payments by the asset manager out of its own resources (profit and loss model) or (ii) payments from a separate research payment account ("RPA") controlled by the investment firm. For an RPA, a number of conditions relating to the operation of the account must be met (for instance the RPA can only be funded by a specific research charge to the client and requires appropriate disclosures to clients). Setting up the RPA will require new systems and controls for asset managers.

ACTION

A key consideration for asset managers over the forthcoming months will be the research they are willing to pay for and how they want to fund it. Implementing internal systems and procedures for RPAs will require discussions with the sell-side.

TRANSACTION REPORTING

There are potentially significant developments in an asset manager's transaction reporting obligations under MiFID. Whereas currently the buy-side does not (generally) transaction report (rather the broker does) – this will no longer be possible under MiFID II.

This is a key area for asset managers who must assess the extent to which they will execute transactions (i.e. when they undertake reception and transmission, execution or making an investment decision). Asset managers will need to have IT systems that can generate and submit relevant reports as well as detailed information from clients. While other MiFID firms will have been subject to the current (less onerous) MiFID transaction reporting obligations this is likely to be a new obligation for asset managers and will require significant effort to build systems.

Helpfully, the FCA has stated that they will exclude AIFMs from this obligation entirely (including those with top up permissions).

ACTION

For affected firms building appropriate IT systems will be substantive and take months. It is recommended that firms engage with counterparties and providers as soon as possible.

BEST EXECUTION

MiFID II is increasing the monitoring and reporting requirements firms are subject to in respect of their best execution obligation. Firms must now take "sufficient" steps to achieve the best possible result for a client rather than "reasonable" steps, although in practice there are not material changes.

However, a key change sees the new obligation to publish details of the top five venues (likely to mean "brokers") used for each class of instrument (on a consolidated basis). The aim is to improve transparency for the clients of the asset manager. Detailed regulatory technical standards have been provided to ensure that data is comparable.

ACTION

Implement the obligations for annual publication of best execution venues. Ensure best execution policy complies with new obligations.

COSTS AND CHARGES

MiFID II introduces more detailed cost and charges disclosures for asset managers. The regime is also extended to professionals and eligible counterparties (albeit with some opt outs available). There is now detailed post-sale information to be provided.

ACTION

For asset managers without a retail base there is again a requirement for new systems and controls. Firms should be identifying how they will provide adequate disclosure on a timely basis.

OTHER AREAS

MiFID II has a wide range of implications on a number of issues for both firms and markets. It is likely that, for instance, market operators (who are now much more widely captured under MiFID II) may need to change their terms of business and rulebooks in order to ensure that they can carry out their new obligations. Likewise investment firms subject to new rules may require changes to contracts with asset managers (regardless of their regulatory status).

INSIGHTS

Asset managers will be required to comply with new rules on a number of areas.

Some of these changes, such as new transaction reporting rules, require substantial systems build.

Firms not authorised under MiFID such as AIFMs may also be affected by gold-plating or by counterparties requiring changes to business terms.

The potential changes vary depending on the regulatory status of the asset manager, the type of clients and the investment strategies they deploy.

ACTION

Firms should undertake a gap analysis to determine the extent to which any other rules under MiFID II will affect their business. Much of this may be a negative scoping exercise or only require minimal changes. However, with less than 10 months until the implementation date firms risk complying on day one if they do not build systems soon.

LOOKING TO THE FUTURE – AIFMD 2

As noted, it is likely that many of these rules will be "copied" into AIFMD 2 in the future. ESMA has made it clear that the research rules and product governance rules should be applied to AIFMs and so in jurisdictions where there is no gold-plating this is likely to change. There are many other obligations in MiFID II such as telephone taping, client reporting, and costs and charges that may be implemented into AIFMD 2.

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AUSTRALIA

FFSP relief updates

ASIC extends its licensing exemption for foreign financial services providers and confirms it will consult on passport relief

BACKGROUND

Where a person or entity carries on a financial services business in Australia, it is generally required to hold an Australian financial services licence (AFSL) or rely on an exemption. The relevant Australian regulator, the Australian Securities and Investments Commission (ASIC), has issued relief to certain foreign financial services providers (FFSP Class Orders), which provides an exemption from the requirement to hold an AFSL, where (i) financial services are provided to wholesale clients only and (ii) the provider is regulated in an offshore jurisdiction that has been assessed by ASIC as being substantially equivalent to the Australian regulatory regime.

The underlying policy to the FFSP relief was to attract international fund managers and additional investment to Australia and investment options for Australian investors by minimising the regulatory burden associated with compliance with Australian regulations in cases where an FFSP was already subject to an essentially equivalent regulatory regime in the jurisdiction of incorporation or operation.

APPLICATION TO OFFSHORE FUND MANAGERS

These exemptions have in the past applied to offshore providers regulated by the following regulators:

(a) German BaFin;
(b) Hong Kong Securities and Futures Commission;
(c) Singapore Monetary Authority;
(d) UK Financial Conduct Authority;
(e) US Securities and Exchange Commission;
(f) US Commodities and Futures Commission; and
(g) US Federal Reserve and Comptroller of the Currency.

The Australian Securities and Investments Commission ("ASIC") recently extended the duration of existing relief granted to foreign financial services providers ("FFSP"), and extended the relief to certain Luxembourg fund managers. ASIC is also consulting with the industry and reviewing the effects of related relief. The FFSP and the related relief are relied on extensively by offshore firms and fund managers who provide financial services to wholesale clients, which may soon be subject to annual levies and fees-for-service.

EXTENSION TO LUXEMBOURG FUND MANAGERS

ASIC recently issued ASIC Corporations Instrument (CSSF-Regulated Financial Services Providers) 2016/1109, which provides a similar exemption in respect of Luxembourg fund managers that hold a current licence or authorisation which has been granted by the Commission de Surveillance du Secteur Financier, if the fund manager is:

(a) a management company, which can manage undertakings for collective investment in transferable securities relating to the law dated 17 December 2010 in respect of undertakings for collective investment of Luxembourg (Luxembourg Law) that fall under Chapter 15 of the Luxembourg Law; or
(b) an investment company that has designated itself as "self-managed" and was established under Part I of the Luxembourg Law.

COMPLIANCE WITH FFSP CLASS ORDERS

Continued reliance on these FFSP Class Orders is subject to the specific conditions of the relief being complied with. A key condition is the requirement for the provider to provide written disclosure to clients before the financial services are provided that the provider does not hold an AFSL and is regulated under the laws of the relevant offshore jurisdiction, which differ from Australian laws.

The FFSP Class Orders are very useful as they allow for a wide range of financial services and products to be provided to Australian wholesale clients, compared to other exemptions in the Corporations Act or Regulations which are more limited and restrictive in scope. Many offshore providers therefore rely on the FFSP Class Orders to conduct business with their Australian clients. The relevant exemption allows offshore firms to carry on business on a "fly-in" basis in Australia and by establishing an office in Australia.

ASIC effectively rolled over these exemptions for the next two years without any changes by issuing ASIC Corporations (Repeal and Transitional) Instrument 2016/396 (Instrument). The Instrument temporarily extends the effect of these Class Orders that were due to sunset between 1 October 2016 and 1 April 2017. This temporary extension of relief will sunset two years from

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ASIC has extended the effect of certain FFSP relief for two years.

ASIC has extended the relief under the FFSP relief to certain Luxembourg fund managers.

ASIC is consulting with the industry and reviewing the substantive operation of the FFSP relief.

ASIC proposes to repeal certain related relief following a one-year transitional period.

The businesses and activities of FFSPs that rely on the FFSP relief or the related relief should be considered in detail.

Draft legislation has been released under which ASIC will be able to recover its regulatory supervision costs through annual levies and fees-for-service.

the commencement of the Instrument unless ASIC takes action to preserve it. In providing the temporary extension, ASIC does not require the entities relying on the FFSP Class Orders to lodge any new notification to ASIC.

EXTENSION OF RELATED RELIEF

Class Order 03/824 (the related relief) exempts providers from the requirement to hold an AFSL where the person provides regulated financial services to wholesale clients, where the only reason the person is taken to be carrying on a financial services business in Australia is as a result of section 911D of the Corporations Act.

Section 911D provides an expanded definition of when a financial services business is taken to be carried on "in Australia". It provides that a person carries on a financial services business in Australia if the person engages in conduct that is intended to induce people in Australia to use the financial services the person provides or is likely to have that effect, whether or not the conduct is also aimed at persons in other jurisdictions. Therefore, a wholly offshore business may still be captured under the Australian licensing requirements, if Australian clients are targeted.

Class Order 03/824 is therefore generally relied on by those offshore providers who do not have any presence or staff in Australia, and cannot avail themselves of the FFSP Class Orders (e.g. because they are regulated in a jurisdiction which has not been assessed as being sufficiently equivalent to the Australian regime under an FFSP Class Order and where specific relief is required, or because they are not regulated at all).

In late 2016 ASIC released Consultation Paper 268 Licensing relief for foreign financial services providers with a limited connection to Australia (CP 268), which proposed that Class Order 03/824 be revoked (following a one-year transitional period), as ASIC considers the exemption is substantially covered by the licensing exemption under section 911A(2E) (as inserted by regulation 7.6.02AG). Interestingly, section 911A(2E) provides limited relief as it only covers dealing, advice, or market making services to professional investors in derivatives, foreign exchange contracts, and carbon and emission units.

On 28 March 2017, ASIC released the outcome of its Consultation Paper 268, which related to the status of Class Order 03/824. Notwithstanding its earlier stated proposal to revoke the Class Order, the outcome of ASIC's consultation is that its future status can be considered together with the status of the FFSP Class Orders which, as noted above, have also been extended to that date. The new instrument is ASIC Instrument 2017/182.

INDUSTRY LEVY FOR ASIC SUPERVISORY COSTS

Following a recommendation in the final report of the Financial System Inquiry, the Australian government has released draft legislation that will enable ASIC to recover its regulatory supervision costs though annual levies and fees-for-service. Effectively, entities that are "regulated" by ASIC in a financial year will be required to pay a levy that will recover ASIC's regulatory costs for that financial year.

Interestingly, it is proposed that the levies will extend to FFSPs who have been granted an exemption by ASIC. The explanatory material suggests this is justified on the basis that ASIC may still incur some regulatory costs and exert regulatory effort in relation to these entities.

Currently, the draft legislation contemplates that the methods or formulas that will be used to apportion ASIC's regulatory costs will be set through a combination of regulations and legislative instruments. An annual return must be lodged with ASIC by 31 October each year. After the amounts of levy have been determined for a financial year, ASIC will issue notices to entities setting out the amount of levy and when it will be due and payable.

Failure to pay the levy by the required date will attract a late payment penalty at the rate of 20 per cent per annum. Where an amount remains unpaid for more than 12 months, a range of administrative actions may be taken, including deregistration, licence suspension, or cancellation.

NEXT STEPS

In respect of the industry levy, the submission process for the draft legislation closed on 10 March 2017. Additional public consultation will be held on the regulations necessary to implement the details of the funding model.

In light of the ongoing review by ASIC in respect of the effect of the FFSP relief and the proposed revocation of the related relief, we recommend that you consider the impact of the proposals in CP 268 to entities in your group that might be relying on the Class Order 03/824, and notify relevant legal or compliance counterparts in offshore jurisdictions as appropriate.

Businesses which already rely on the FFSP Class Orders 03/824 should continue to monitor developments, and in particular, should keep a watchful eye out for ASIC's consultation on these exemptions, expected to take place later in 2017.

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SPAIN

Direct lending updates

Spain's inability to form a Government in 2016 led to a very slow market. The increased activity at the beginning of 2017 has created more awareness around old and new issues.

The start of 2017 has seen increasing levels of direct lending activity in the Spanish markets despite the political uncertainty (at least locally) of a year without a national Government in place and the risk of market-averse political parties forming a national Government.

SECURITY

One of the issues affecting funds when lending into Spain is understanding the extent to which they can benefit from the same security package as banks (and under similar terms). There are a number of fall-backs here, namely:

(a) in the event the relevant fund wants hard asset security, there are certain types of mortgages (notably the so-called "floating mortgages") which are only available to credit institutions; and

(b) as a general rule Spanish law does not allow for foreclosure on the assets given by way of security, and typically enforcement occurs by means of a public auction of the asset. An exception is if the security falls within the Spanish implementation of the EU Collateral Directive (Royal Decree Law 5/2005), "RDL 5/2005", which as a general rule does not benefit credit funds, in which case (a) the security had specific protections in the event of an insolvency of the security provider; and (b) it allowed enforcement by direct sale or appropriation. This specifically affects security interests over shares in Spanish *sociedades anónimas* or S.A.S and security interests over bank account balances.

A recent EU Court of Justice ruling in connection with a Latvian case has however cast a shadow over the usefulness of pledges over bank accounts under RDL 5/2005. The ruling not only limits the insolvency protection to only moneys credited to the pledged account prior to the declaration of insolvency, but it also deals with the concept of when a pledge over a bank account is deemed to fall within the RDL 5/2005.

In this respect, the court ruling found that the RDL 5/2005 requires that the beneficiary of the pledge is given control of the secured assets. In practice, in order for a pledge to benefit from the protection afforded by the account pledge, the pledge/lender must ensure that the pledger/borrower is prevented from being able to freely use the pledged account.

The natural consequence of this is that it is now very difficult to impose this type of security interest on borrowers in the market (other than in very specific circumstances, such as debt service reserve accounts in project financings). Bank lenders are therefore turning away from bank account pledges that follow this structure and are now in this respect operating on a level playing field with credit funds.

INSIGHTS

Increased activity in the Spanish market.

A recent EU court of Justice ruling has cast doubts around the types of security available to banks.

Super senior facilities in the context of the restructurings is being backed by court rulings

SUPER SENIOR MONEY IN RESTRUCTURINGS

The other development we have witnessed in recent months is related to super senior facilities provided in the context of a restructuring. Since Spain enacted the last reform to the so-called homologation process, a restructuring that effectively abides by creditor majorities set out in Additional Provision 4 of the Spanish Insolvency Act can easily be sanctioned by a court and can then only be opposed by creditors on two grounds, namely either: (i) that the necessary majorities were not achieved; or (ii) that there is a disproportionate sacrifice for the dissenting creditors challenging it.

A recent court ruling in a homologation proceeding backed a credit fund that had bought debt in the senior piece of the financing structure of a borrower in the secondary market and, in the context of the restructuring, had structured a super senior financing. One of the reasons for the rejection of the disproportionate sacrifice arguments from a dissenting creditor was that the new money piece had been offered to all existing senior creditors, and thus a dissenting creditor voluntarily deciding not to take part in the super senior facility was not entitled to claim that it had been treated worse than other creditors.

The concept we have started to see of disproportionate sacrifice is still not entirely developed. More court rulings in the market are helping set the boundaries of what the insolvency courts consider qualify as such. The existence of several significant restructurings in the market that are going through homologation will in all likelihood help to refine the concept and add more certainty for credit funds interested in that segment of the market.

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USA

Retail sales of complex investments

Selling complex or illiquid investments to retail customers in the US

Complex and/or illiquid investments (including hedge funds, real estate funds, structured products and asset-backed securities) are not new, but sales of these products to retail investors is a fairly recent and growing trend. And to put it mildly, US securities regulatory authorities are not entirely comfortable with the trend. Their concerns range from inherent structural complexities, to the supervision of operations and distribution-related matters.

This article will focus on the sales practice issues that those selling or planning to sell these investments to retail investors face. Specifically, it will cover four main areas: marketing, training, suitability and supervision. These are the four areas FINRA and the SEC appear to be focusing on, both from a guidance and an enforcement standpoint.

MARKETING

As securities, complex or illiquid investments are subject to the same broad rules regarding communications with the public that apply to any other security. Marketing materials: (a) must be fair and balanced, and provide a sound basis for evaluating the benefits, costs and risks of the security; (b) cannot omit any material facts if the omission would cause the communication to be misleading; and, (c) cannot be cured of deficient disclosures by risk disclosure in the offering documents.

Neither the SEC nor FINRA have not been shy about interpreting these standards in the context of complex or illiquid investment and have insisted that marketing material should explain, in plain English, how the investment works. If an investment cannot be adequately described in simple narrative terms, the regulators take the position that it should not be sold to retail investors.

Communications should explain that principal is not guaranteed (unless specified) and that the product price and liquidity will be affected by the lack of a secondary market. The name of the investment should not be

Complex or illiquid investments including hedge funds, real estate funds, structured products and asset-backed securities are not new, but sales of these products to retail investors is a fairly recent and growing trend in the USA.

misleading, and marketing materials should include detailed, accurate and complete disclosure of the risks associated with the investment. Marketing material may not predict or project the expected performance of the investment or overstate the likelihood that an investor will get all of his or her money back.

TRAINING

Before a firm allows its sales force to market and recommend a particular complex or illiquid investment the firm must provide adequate training. The training should be both general and more specific. The training must give the sales force an in-depth understanding of the complexities of the investment and should include explanations of the payout features, fees and costs, liquidity and valuation. Furthermore, sales representatives should be able to explain the investment fairly and accurately and in sufficient detail to a retail investor. Most importantly representatives must understand and appreciate that the average retail investor is unlikely to understand the investment on his or her own, augmenting the responsibility of representatives to the customer.

Sales teams should receive training on the structural conflicts of interest inherent in some complex investment products. In particular, sales teams should be aware of the ways the issuer, the manager, the distributor, and their affiliates earn their compensation. In addition, they should understand which expenses are borne by the various service providers, and which are passed on to the investors, and if there is any leeway in the way such expenses are allocated.

The training materials should be consistent with all the materials relating to the investment provided to prospective investors. In a recent SEC order involving a large financial institution selling complex investments in the retail market (in this case, structured notes), a significant part of the SEC's case was based on the fact that some information provided to potential investors was not part of the firm's training materials. The SEC used the existence of this inconsistency as evidence of inadequate supervision of the training process.

What this suggests is that firms should strive for consistency in all of their descriptions of an investment, including offering documents, training materials and

materials provided to third parties, and should also be able to explain and justify any inconsistencies between such materials. Justifiable inconsistencies could include different audiences, different purposes and different modes of communication, for example, a registration statement versus a one-pager.

FINRA has also indicated that firms should have a specific process in place for ensuring that sales representatives cannot sell these types of investment products until they have been trained and not just a policy limiting sales to those trained. Firms should train supervisors as well as sales staff, and should make the training available for as long as the investment is offered.

SUITABILITY

To meet its obligation to ensure that recommendations of complex or illiquid products are suitable, a firm should engage in the following three-step process:

Perform due diligence on the product

Firms must analyse the costs and risks of the specific offering including the restrictions on redemptions and transfers, payout structure, valuation methodology, volatility and liquidity of underlying assets, and any other associated risks. Additionally, firms should conduct an analysis of likely investment performance in a wide range of normal and extreme market conditions. Finally firms should not rely solely on issuer or third party information, which may be incomplete or inaccurate.

Establish a process for determining eligible investors

FINRA suggests limiting the pool of customers who are eligible to consider the investment to those who have been approved for options trading. Firms that choose not to follow this recommendation should (i) develop other comparable procedures (such as restrictions based on age, assets, and trading experience), and (ii) be prepared to defend the decision not to limit eligible investors to those with options accounts.

Establish a process for determining customer-specific suitability

Before recommending a complex or illiquid investment to a retail customer, sales teams must consider the nature of the investment and the objectives and trading experience of the customer, as well as whether a less complex or costly investment could achieve the same objectives. Sales personnel should not assume that if investing in the underlying asset class is suitable, then investing in a pool, fund or other structure consisting of or linked to that asset class must also be suitable.

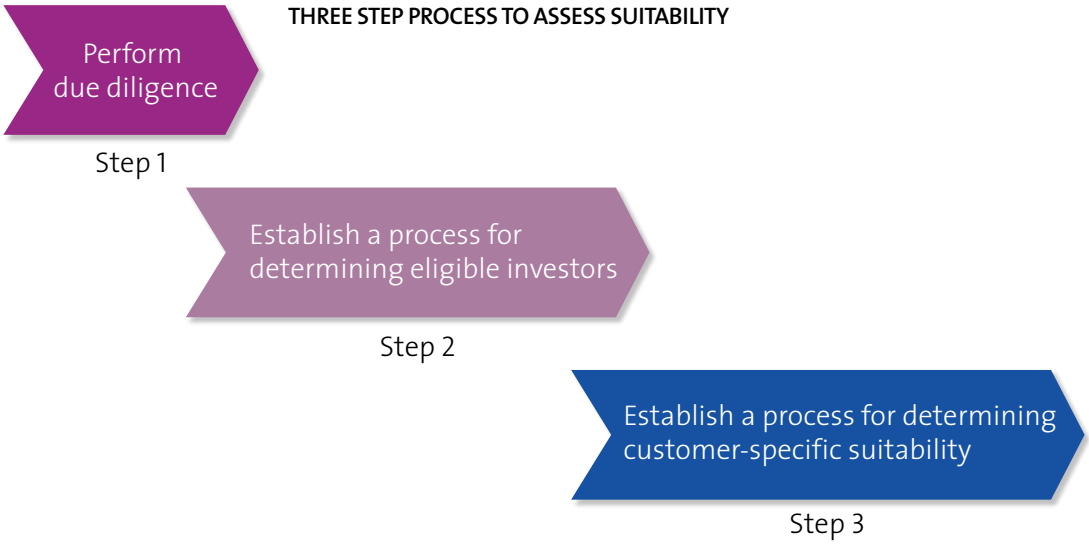
Firms must consider concentration limits and monitor for excess concentration. Monitoring should be dynamic, taking into account changing market conditions and the issuer's financial condition.

SUPERVISION

FINRA has explicitly stated that it requires heightened supervision with respect to marketing and selling complex or illiquid products to retail investors. This includes heightened policies and procedures for: product approval; approval of marketing materials; developing and implementing a training programme; and determining and documenting suitability analyses. Firms must analyse, test and verify the effectiveness of controls they have established.

In 2015, the SEC Office of Compliance Inspections and Examinations ("OCIE") conducted and reported on a sweep examination programme related to retail sales

THREE STEP PROCESS TO ASSESS SUITABILITY



of non-traditional products. Although the examination and report addressed only sales of structured notes, the findings are relevant to firms selling any sort of complex securities product in the retail market. OCIE indicated that it found significant weaknesses in the firms' effective implementation of supervision-related policies and procedures. OCIE in particular noted that in all of the firms examined:

- all had policies and procedures in place with respect to suitability, the processes for product approval, and the training of sales teams; but
- none of them maintained or enforced controls relating to suitability determinations; and
- none of them conducted compliance and supervisory reviews of sales persons' suitability determinations.

In addition, OCIE found evidence of the following kind of interactions with a view to identifying financial exploitation:

- sales to elderly customers;
- sales to customers without age information;
- sales to non-English speakers;
- sales in excess of internal concentration limits; and
- sales representatives retroactively

Both the SEC and FINRA have stopped short of saying that retail sales of complex or illiquid products are unsuitable per se, but both have demonstrated uneasiness about this activity and indicated that investment firms engaging in it have heightened and specific disclosure, training, suitability and supervisory obligations. In summary, although investment firms can sell these products in the retail market, they should do so with thought, preparation and caution, because the regulatory agencies are watching.

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EUROPE

AIFMD update

In the last few months ESMA has provided new guidance on delegation under AIFMD. Separately, the FCA has implemented new rules for Annex IV reporting. These will not affect all AIFMs but firms should determine whether this impacts their reporting obligations.

In the last few months both the FCA and ESMA have introduced measures that will have an impact on filing requirements and disclosure obligations under AIFMD for some alternative investment fund managers ("AIFMs"). Fund managers should be aware of these changes and, in respect of Annex IV reporting prepare accordingly.

Changes to AIFMD reporting and delegation

INSIGHTS

ESMA changes to delegation may affect future reporting and delegation obligation on firms.

FCA has also changed Annex IV reporting, which may affect non-EEA AIFMs.

ESMA CHANGES TO DELEGATION

Full scope AIFMs are required to notify their national competent authority ("NCA") if they are delegating certain activities to third parties. This includes the "core" activities of portfolio management and risk management (where the NCA must approve the delegation) but also includes "non-core" activities such as administration and marketing that can, but do not have to be, performed by the AIFM.

Most regulators (and industry participants) have taken the position that if the AIFM has not been appointed to undertake these "non-core" activities there would be no delegation if a third party carries out the activity in question. For instance, if a fund (AIF) appoints an administrator directly (rather than the AIFM) then there is no delegation of the administration function by the AIFM and no notification required. AIFMs will not therefore not need to apply their delegation policy in respect of the arrangement. Conversely, if the AIFM has been appointed as the administrator and delegates then this would require a notification (although a third party provider who simply assists is generally not considered a delegation).

ESMA stated in its November 2016 AIFMD Q&A update that it now considers that any such non-core AIFM activities that are not performed by the AIFM should be considered to be delegated by the AIFM to the third party who is performing them, regardless of whether there is an actual delegation by the AIFM. Essentially, activities which are not performed by the AIFM should be "considered as having been delegated by the AIFM to the third party". This means that the AIFM is responsible for ensuring that: (i) the AIFMD requirements on delegation are fulfilled; and (ii) there is compliance oversight of the relevant service providers, as set out in the AIFMD and irrespective of whether the AIFM or the AIF has made the appointment.

This position appears to be contrary to the AIFMD text which makes it clear that the AIF, rather than the AIFM, can be responsible for these obligations. It also runs contrary to (helpful) advice given by regulators such as the FCA, setting out where appointment of third parties may not be a delegation.

If taken literally, fund managers could be required to file multiple delegation notifications (for both previous and future funds) and repaper their arrangements with their third party providers. However, since November, there has been little movement by regulators to implement the ESMA Q&As. No regulator has either (i) notified AIFMs to not comply with this Q&A (which is not binding), or (ii) indicated that they are changing their position on the reporting of delegations.

FCA CHANGE TO ANNEX IV REPORTING

Another unwelcome change for the industry affects Article 42 (non-EEA) AIFMs marketing funds into the UK in respect of their Annex IV reporting obligations. Previously, where a manager only markets a feeder into the UK, the FCA has simply required feeder funds to report their interest in the master fund in its Annex IV report. However, the FCA now requires the fund manager to report the details of the holdings of the master as well, instead of simply just recording the interest the feeder holds in the master.

For some fund managers that only market their funds in the UK, this will require substantial additional work to collate this information and provide it in the Annex IV format. However, the UK position is now in line with most other EEA jurisdictions. Therefore for fund managers marketing more widely, the only additional obligation will be a similar report to the FCA.

Therefore, while this is unwelcome, for most fund managers it should simply be a case of reporting information they currently have. For fund managers that only market into the EEA it would be wise to ensure that you prepare future Annex IV reporting in good time and your compliance consultants are aware of the changes.

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