

**MARKET ACCESS FOR REGULATED FUND MANAGERS
IN THE UNITED STATES AND THE EUROPEAN UNION**

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Trends towards globalization have prompted money management firms that traditionally served investors in a single country to pursue asset management opportunities in other world markets. US firms are interested in selling regulated funds in Europe and elsewhere, and European firms are interested in entering the US market as well as other markets to sell regulated funds, too.¹ Both the US and European markets have been attractive because they potentially offer large, continent-wide markets of retail investors, the type of investors for whom regulated funds are particularly appropriate. In addition, many professional or institutional investors choose to invest in regulated funds. In this paper, the term “regulated fund” refers to (1) an investment company registered under the Investment Company Act of 1940 (RIC), in the case of a US domiciled fund, and (2) UCITS or “undertakings for collective investment in transferrable securities,” that are established and authorized in a Member State of the European Union (EU), in the case of an EU fund.²

As described in this paper, there is comparable access for US and EU regulated fund managers to retail markets in the United States and the European Union. The access of US and EU professional investors to RICs and UCITS differs, however; it is substantially more difficult for RICs to be marketed to professional investors in the European Union than it is for UCITS to be marketed to such investors in the United States.

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Regulated funds are essential to helping people save and invest to meet their most important goals and the substantial advantages that these funds provide to investors are consistent across international borders. They include professional management, diversification, and reasonable cost, as well as the benefit of substantive government regulation and oversight. All these characteristics likewise are attractive to professional and institutional investors. This paper compares market access for foreign firms offering regulated funds in the United States with market access for US firms offering regulated funds in the European Union.

Foreign domiciled management companies are readily able to enter the US retail market through the establishment of a RIC. The US regulatory approach to foreign managers marketing a RIC³ is consistent with World Trade Organization (WTO) principles of non-discrimination and

¹ Generally, we refer to regulated funds (or mutual funds) as those types of funds that are regulated to make them eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. Such funds have substantive regulation in areas such as disclosure, form of organization, custody, minimum capital, valuation, investment restrictions (*e.g.*, leverage, types of investments or “eligible assets,” concentration limits and/or diversification standards).

² The use of the term “Europe,” “European,” or “EU” in this paper refers to the European Union (EU) or as relevant the European Economic Area (EEA).

³ For ease of reference in this paper, we refer to all types of US registered investment companies – including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts – as “RICs,” unless the context requires otherwise. See

national treatment: a foreign domiciled management company may organize and register a RIC on the same basis as a US domiciled management company. In advising a RIC, a foreign manager also receives unconditional national treatment: it is on equal footing with a US management company in registering as an investment adviser with the Securities and Exchange Commission (SEC).

A fundamental goal of US regulation of RICs and asset management is the protection of investors.⁴ Requirements for foreign domiciled managers that wish to market shares of a RIC are not any more stringent than the requirements for domestic managers. Moreover, sensitive to the concerns of foreign management companies seeking access to the US market and recognizing the desire of US investors for investment advice regarding foreign markets, Congress and the SEC have made efforts to accommodate foreign management companies entering the United States. In some instances, as described below, the SEC has placed foreign managers in a more favorable position than domestic managers.

Part I of this paper describes the establishment and marketing of RICs and foreign domiciled funds, including UCITS, in the United States by foreign money managers. Part II of the paper describes the requirements for US money managers to establish and market UCITS and RICs in Europe. The paper focuses on the distribution of regulated funds, like RICs and UCITS, in the United States and Europe and shows that it is no more difficult for European or other foreign domiciled money managers to access the US retail market to sell RICs than it is for US or other non-EU managers to offer UCITS funds to retail investors in Europe.

UCITS also can be readily offered and sold to professional or institutional investors in the United States through so called “private offerings.” By contrast, the current process of selling RICs to professional investors in the European Union under the Alternative Investment Fund Managers Directive (AIFMD) is far more complex and difficult. Potentially adding a specific barrier for RICs, in September 2016, the European Securities and Markets Authority (ESMA) recommended as one option for the extension of the AIFMD passport to the United States, that the passport only be extended to those US funds that are not RICs.⁵ If implemented, this would impose a barrier that is not present for the similar distribution of UCITS in the United States. Please see Appendix A for a chart summarizing access in the United States and the European Union for US and EU fund managers.

the 2016 Investment Company Fact Book, Appendix A, for a description of US registered investment companies and their operation, available at <http://www.icifactbook.org/>.

⁴ Section 1(b) of the Investment Company Act of 1940 provides that “It is hereby declared that the policy and purposes of this title...are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in [section 1] which adversely affect the national public interest and the interest of investors.”

⁵ Under the AIFMD, managers based in the European Union have the ability to establish funds in one Member State that can be “passported” or marketed to professional investors throughout the European Union. The ESMA advice on the extension of this passport offers three possible options, all aimed at severely limiting or completely prohibiting access to the AIFMD passport for RICs.

As US and EU officials consider market access over the coming years in various trade and other negotiations, it is imperative that each respect the WTO principles of non-discrimination and national treatment. To support global economies and growth, comparable market access must be maintained and even strengthened, for the benefit of investors and markets.

I. MARKETING REGULATED FUNDS IN THE UNITED STATES

To obtain access to the entire US retail market, a foreign domiciled investment management firm usually will organize RICs. Alternatively, a foreign manager lawfully may sell foreign domiciled funds in the United States in a more limited manner, generally through private offerings to certain investors. Notably, since 2013, under changes to the US rules governing private offerings, US and foreign funds have been permitted to broadly solicit and generally advertise an offering without such action constituting a “public offering,” provided they comply with certain conditions.⁶

A. Offering of US Funds

1. Registration under the Investment Company Act

The most practical method for a foreign investment management firm to publicly market and sell investment company shares in the United States is to organize a fund in the United States and register the fund under the Investment Company Act of 1940 (1940 Act).⁷ The 1940 Act imposes the same regulatory standards on all funds, regardless of whether they are managed by a domestic or foreign manager. Further, the United States achieved a true continent-wide market for RICs as a result of legislative changes in 1996, which makes it possible and considerably easier for all firms, including foreign firms, to access the entire US market.⁸

The 1940 Act imposes substantive requirements and prohibits certain activities for the protection of investors. In particular, the 1940 Act requires safeguarding of fund assets, imposes substantial

⁶ See Rule 506(c) of Regulation D under the Securities Act of 1933, available at <http://www.ecfr.gov/cgi-bin/text-idx?SID=0a94ea1a8a9ecce212ec25025efed3af&node=17:3.0.1.1.12.0.46.181&rgn=div8>. See also SEC Fast Answers on Rule 506 of Regulation D, available at <https://www.sec.gov/answers/rule506.htm> (describing the ability of issuers relying on the Regulation D private offering exemption to engage in general solicitation, and the conditions that need to be met).

⁷ Form N-1A, the registration form for open-end investment companies, is an integrated form that allows registration of the fund under the 1940 Act and the shares under the Securities Act of 1933, allowing the fund to be registered and eligible for public sale. In addition, certain aspects of RIC operations and distribution are regulated under the Securities Exchange Act of 1934.

⁸ Prior to 1996, RICs were not only subject to regulation at the federal level but also by individual states, which imposed their own substantive requirements and marketing rules. With the passage of the National Securities Markets Improvement Act of 1996 (NSMIA), however, once registered with the SEC, RICs do not have to comply with state regulations except that states can require the filing of any documents filed with the SEC for notice purposes, along with a consent to service of process, and to charge fees in connection with the filings.

restrictions on transactions with affiliates, and limits leveraging. In addition, the 1940 Act imposes a number of corporate governance provisions and disclosure requirements on registered funds.⁹

Although the investor protection requirements of the 1940 Act are strict, there are several areas that are not subject to detailed regulation in the United States in contrast to many other countries. The 1940 Act does not impose high capital, residency, or US place of business requirements, and the absence of requirements in these areas contributes to the ease of access foreign firms have to the United States. The initial seed capital for a new fund that is required under the 1940 Act is only \$100,000, and the 1940 Act does not require RICs to have directors or managers who are residents or citizens of the United States. A RIC also can be administered outside of the United States.

As a result, it is easy for a foreign firm to establish RICs in the United States. For example, a foreign manager can organize a RIC in the United States and structure it to replicate an existing foreign fund, referred to as a “mirror fund.” The portfolio of the mirror fund can be identical to the portfolio of a foreign fund (provided it is consistent with the requirements of the 1940 Act), and the fund can be managed and administered outside the United States. Moreover, the SEC’s flexibility in permitting performance information in prospectuses also helps foreign managers compete effectively in the United States against US fund managers. In marketing a mirror fund, which does not have a US track record, a foreign manager may be able to include in the prospectus of its RIC the performance of its foreign fund that is managed with substantially similar investment objectives, policies, and strategies.¹⁰

2. Registration under the Investment Advisers Act

A foreign or domestic management company that acts as an investment adviser to a RIC is required to register under the Investment Advisers Act of 1940 (Advisers Act).¹¹ A management company must file a Form ADV with the SEC and comply with certain recordkeeping and regulatory

⁹ See the 2016 Investment Company Fact Book, Appendix A, for a description of the core principles underlying the regulation of RICs, available at <http://www.icifactbook.org/>.

¹⁰ The SEC staff has taken the position that a RIC may include in its prospectus, and in its advertisements or supplemental sales literature, performance information of other registered funds or private accounts that are managed by the RIC’s adviser with investment objectives, policies, and strategies substantially similar to those used in managing the RIC, provided that such information is not presented in a misleading manner and does not obscure or impede understanding of required information in the prospectus or is presented as a substitute for the RIC’s own performance information in advertisements. GE Funds (pub. avail. Feb. 7, 1997); ITT Hartford Mutual Funds (pub. avail. Feb. 7, 1997); Nicholas-Applegate Mutual Funds (pub. avail. Feb. 7, 1997); Nicholas-Applegate Mutual Funds (pub. avail. Aug. 6, 1996). *See also* Salomon Brothers Asset Management Inc. and Salomon Brothers Asset Management Asia Pacific Limited (pub. avail. July 23, 1999) n. 2 (certain records could support use of non-US fund’s performance unless differences between the unregistered fund and the registered fund, such as different valuation methods, make use of the information misleading). Under positions taken by the Financial Industry Regulatory Authority (FINRA), which are effectively applicable to most RICs, related fund performance cannot be used in advertising or sales literature.

¹¹ NSMIA also divided regulatory responsibilities for investment advisers between the SEC and the states. For investment advisers that are registered with the SEC, state law is preempted except for the anti-fraud provisions.

requirements.¹² Under court interpretations of the Advisers Act, an adviser owes a fiduciary duty toward its clients.¹³ The Advisers Act does not impose any capital or US place of business requirements, nor does it require the management company be a US company. Foreign management companies may establish wholly-owned affiliates in the United States or provide services from overseas.

Prior to the early 1990's, foreign investment advisers that registered under the Advisers Act were subject to all of the provisions of the Advisers Act with respect to both their US and non-US clients. In some instances, registration with the SEC acted to prohibit foreign advisers from engaging in business practices that were legal and customary in their home countries. For example, historically, one of the most difficult provisions of the Advisers Act for foreign advisers was the prohibition against performance-based advisory fees.

Since the early-1990's, however, amendments to the Advisers Act and evolving SEC positions have permitted foreign advisers significantly greater flexibility in complying with the provisions of the Advisers Act without disrupting their non-US activities. First, the performance fee prohibition of the Advisers Act does not apply to the foreign adviser's non-US clients.¹⁴ Therefore, a foreign manager registered with the SEC may charge its non-US clients performance-based fees.¹⁵

Second, the SEC revised its approach to regulating the relationship of registered foreign advisers with their clients residing outside the United States. Prior to this time, a foreign adviser only could avoid subjecting all of its operations to the Advisers Act by forming a separate subsidiary to provide advice to US clients. The SEC required that the subsidiary be capitalized adequately and have personnel who were dedicated to rendering investment advice to the subsidiary's clients (and not engaged in the advisory business of the parent). If the subsidiary did not meet these conditions, the SEC required registration of the parent as well as the subsidiary. Foreign advisers found operating under these conditions difficult.

Beginning in 1992, the SEC staff adopted a "conduct and effects" approach whereby the substantive provisions of the Advisers Act generally do not govern the relationship between a foreign

¹² Form ADV consists of two main parts. Part 1 is primarily designed to be used by regulators for administrative purposes. Part 2, which consists of two parts and is provided to clients, includes key information about the adviser, including the types of advisory services provided, the advisory fees charged, the adviser's affiliations with other securities professionals and financial institutions, types of clients, disciplinary information, as well as a supplementary brochure for those supervised persons that provide advisory services to a particular client.

¹³ See *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.* 375 U.S. 180, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963).

¹⁴ Section 205(b)(5) of the Advisers Act.

¹⁵ Investment advisers also are permitted to charge performance fees to sophisticated US clients under certain conditions. See Rule 205-3 of the Advisers Act.

adviser and its foreign clients even if the adviser is registered with the SEC.¹⁶ Under the conduct and effects approach, a foreign adviser may create and register a subsidiary in the United States without registering the foreign adviser parent if the affiliated companies are separately organized and the registered entity is staffed with personnel (whether physically located in the United States or abroad) who are capable of providing investment advice.¹⁷ The SEC requires, however, that all persons who provide advice to US clients or have access to information concerning which securities are recommended to US clients prior to effective dissemination of the recommendation be deemed “associated persons” of the registered adviser.¹⁸ This requirement places responsibility on the registered adviser to assure these persons do not violate US securities laws with respect to these activities. The SEC staff has also indicated that if a foreign entity’s national laws prohibit it from meeting the conditions of the SEC staff’s no-action letters, it may accept alternative representations or commitments.¹⁹

Although the SEC asserts no jurisdiction over the activities of a foreign adviser registered in the US with respect to its foreign clients, the SEC would be concerned if the adviser’s activities abroad adversely affected its US clients. Specifically, the SEC is concerned that it remain in a position to assure that a foreign adviser does not engage in practices that would operate as a fraud on its US clients by, for example, systematically treating its US clients less favorably than its foreign clients in allocating securities. Accordingly, a foreign adviser, on request, must provide the SEC with access to foreign personnel with respect to all its activities to enable the SEC to monitor and enforce a registered foreign adviser’s performance of its obligations to its US clients and to ensure the integrity of US markets. The foreign adviser also must provide on request access to trading and other records of each affiliate involved in or having access to US advisory activities and to its personnel (including the trading records of such personnel) to enable the SEC to monitor and police conduct that may harm US clients or markets.

3. Registration as a Commodity Pool Operator

¹⁶ Murray Johnstone Holdings Limited (pub. avail. Oct. 7, 1994); Mercury Asset Management plc (pub. avail. Apr. 16, 1993); Uniao de Bancos de Brasileiros S.A. (pub. avail. July 28, 1992). This position was reaffirmed in the 2011 release adopting rules implementing new exemptions from the registration requirements of the Advisers Act that were enacted as part of the Dodd-Frank Act. *See* Release No. IA-3222 (June 22, 2011) at 127.

¹⁷ Royal Bank of Canada (pub. avail. June 3, 1998); Murray Johnstone Holdings Limited (pub. avail. Oct. 7, 1994); Mercury Asset Management plc (pub. avail. Apr. 16, 1993). The SEC has also reaffirmed that it would not recommend enforcement action, subject to certain conditions, against an unregistered non-US adviser that is affiliated with a US registered adviser despite sharing personnel and resources. *See* Release No. IA-3222 (June 22, 2011) at 125-128.

¹⁸ *See* Sections 202(a)(17) and 204A of the Advisers Act. A registered investment adviser may be subject to sanctions by the SEC for failing reasonably to supervise the activities of its associated persons who are subject to its supervision and for failing to implement procedures designed to prevent its associated persons from violating certain federal securities laws. *See, e.g.*, Section 203(e)(6) of the Advisers Act.

¹⁹ ABN AMRO Bank, N.V., et al. (pub. avail. July 1, 1997).

As of 2012, operators of RICs that engage in more than a *de minimis* amount of commodity-related trading activities are required to register with the Commodity Futures Trading Commission (CFTC) as commodity pool operators (CPOs). For RIC CPOs, the CFTC's regulations largely permit substituted compliance based upon the RIC's compliance with applicable SEC regulations. In order to take advantage of this substituted compliance regime, the RIC CPO must file a notice of its use of the substituted compliance regime with the National Futures Association, the self-regulatory organization for the futures industry, and satisfy several other conditions. The RIC CPO, however, remains fully subject to systemic reporting obligations applicable to all CPOs under CFTC regulations, and certain other CFTC regulations applicable to CPOs.

4. Current Market Share of Foreign Managers in the US Regulated Fund Market

Under this regulatory framework, foreign management companies²⁰ manage a significant proportion of total RIC assets, the dollar amount of which has more than doubled since 2000. As of December 2016, \$2.11 trillion of the total value of US open-end investment company assets, which represents 13.1% of open-end assets, were managed by foreign-owned investment advisers or their affiliates. These figures compare with approximately \$897.69 billion, or 12.6%, as of June 2000.

More specifically, European-owned managers represent the largest segment of foreign-owned managers of RICs. As of December 2016, \$1.4 trillion of the total value of US open-end RIC assets, which represents 8.7% of open-end RIC assets, were managed by European-owned investment advisers or their affiliates. In comparison, as of June 2000, European-owned management companies managed \$716.78 billion in open-end RIC assets. These statistics indicate that foreign-owned management companies, and especially European-owned companies, are readily accessing the US regulated fund market.²¹

B. Offering of Non-US Funds by Foreign Managers

A foreign management company that does not want to establish funds in the United States but, rather, wants to market its existing foreign funds in the United States has two options. First, under Section 7(d) of the 1940 Act, an investment company organized in a foreign jurisdiction may offer publicly its securities if the SEC finds by order that "it is both legally and practically feasible to effectively enforce" the provisions of the 1940 Act against the fund. Section 7(d) represents a prudential standard to ensure that US investors receive the same essential investor protections whether they acquire shares in a

²⁰ The term "foreign management company" or "foreign investment adviser" refers to an investment adviser that has a non-US parent company. These figures do not include RIC assets that are sub-advised by investment managers with a non-US parent company because we do not track this information.

²¹ Similarly, US domiciled asset managers are readily accessing the UCITS market. For example, as of September 2013, US headquartered members of ICI manage more than \$1.7 trillion in UCITS. Further, according to data published by Lipper, five of the top 12 top-selling fund groups in Europe are sponsored by firms with US based parent companies, as of December 2012.

foreign fund or a US-domiciled fund.²² Admittedly, because the requirements of Section 7(d) impose practical constraints on the ability of foreign investment funds to sell their shares publicly in the United States because of differences in business and regulatory environments in the United States and the country from which a fund originates, only a few foreign funds have chosen this approach.²³

Second, a foreign management company may sell its foreign fund shares privately without registering the fund or receiving approval to sell the fund from the SEC under Section 7(d) of the 1940 Act. To sell shares of a foreign fund into the United States on a private basis, a foreign manager is required to: (i) claim an exception for the fund itself under the 1940 Act; (ii) claim an exemption for the shares of the fund under the Securities Act of 1933 (Securities Act);²⁴ (iii) register or claim an exemption for itself and the fund under the Commodity Exchange Act (CEA); and (iv) otherwise qualify the fund under state blue sky laws.²⁵ A foreign manager of a fund sold privately in the United States also may need to register as an investment adviser if it does not qualify for an exemption from registration under the Advisers Act.

1. Exclusion from the Investment Company Act

Under US law, a foreign manager may be able to take advantage of two exceptions in the 1940 Act. By offering its shares in the United States in reliance on these exceptions, a foreign fund does not have to register with the SEC. Section 3(c)(1) provides an exception for funds that have not made a “public offering” of their shares and have no more than 100 beneficial owners.²⁶ Section 3(c)(7) provides an exception for funds that have not “publicly offered” their shares and have been sold exclusively to “qualified purchasers.”²⁷ Since 2013, foreign funds, like US domiciled funds, may attract

²² For a detailed explanation of the history of, and rationale for, Section 7(d), and why, as a prudential standard, Section 7(d) should not be regarded as a trade issue, *see* ICI, “Section 7(d) of the Investment Company Act of 1940 and National Treatment,” January 16, 1996, available at http://www.ici.org/pdf/96_7d_national_paper.pdf.

²³ Fifteen foreign fund companies have received permission to register and publicly offer their shares for sale in the United States under Section 7(d) of the 1940 Act; of those 15, we understand that only two companies continue to operate and sell shares in the United States.

²⁴ In addition, certain activities related to the fund may be subject to regulation under the Securities Exchange Act of 1934 unless otherwise subject to an exemption.

²⁵ A foreign fund that is offered on a private basis in the US generally must make a notice filing and pay a fee in each state in which an investor in the fund resides.

²⁶ Section 3(c)(1) of the 1940 Act provides an exception (for almost all purposes) from the definition of investment company for any fund that is not conducting, and does not propose to conduct presently, a public offering of its securities and that does not have more than 100 beneficial owners. The SEC staff takes the position that, for purposes of Section 3(c)(1), an offering is non-public if it complies with Section 4(2) of, or Rule 506 under, the Securities Act. Rule 506(b) requires that sales only be made to “accredited investors” and up to 35 non-accredited investors, while Rule 506(c) requires that all investors be “accredited investors.” *See* Rule 501(a) of the Securities Act for the definition of “accredited investor” and footnote 31.

²⁷ Section 3(c)(7) of the 1940 Act provides an exception (for almost all purposes) from the definition of investment company for any fund the securities of which are owned exclusively by persons who, at the time of acquisition, are qualified

investor interest by means of general solicitation or advertising by relying on Rule 506(c) of Regulation D under the Securities Act, without becoming subject to the 1940 Act's registration requirement.

The SEC staff has taken the position that a foreign fund may make a private US offering under these exceptions concurrently with an offshore public offering. This means that a UCITS could be sold publicly in the European Union and privately in the United States.²⁸ Moreover, as interpreted by the SEC staff, a foreign fund remains eligible for an exception so long as it has 100 or fewer US persons as beneficial owners or has US investors who are qualified purchasers, regardless of the number or sophistication of its non-US investors.²⁹

In addition, the SEC staff has issued interpretations that provide additional flexibility for foreign funds. For example, the SEC staff has permitted foreign funds to exceed the 100 US beneficial owner limit or to have US investors who are not qualified purchasers if this is a result of independent actions of the fund's security holders (*e.g.*, as a result of the relocation of foreign security holders of the fund to the US or because of offshore secondary market transactions not involving the foreign fund or its agents, affiliates, or intermediaries).³⁰

2. Considerations under the Securities Act

Foreign managers of funds sold privately will want to avoid registration of the shares themselves, which can generally be accomplished by selling shares only to "accredited investors"³¹ and

purchasers and that is not conducting, and does not at that time propose to conduct, a public offering of its securities. The term "qualified purchaser" is defined in Section 2(a)(51) of the 1940 Act and includes (i) individuals and certain family-owned companies that have not less than \$5 million in investments; (ii) certain trusts if both the trustee or other person with investment discretion and all settlor or other contributors are qualified purchasers; (iii) other persons that own and invest on a discretionary basis not less than \$25 million in investments; and (iv) most "qualified institutional buyers" as defined in Rule 144A under the Securities Act (generally institutions with at least \$100 million of investment securities).

²⁸ Goodwin, Proctor & Hoar (pub. avail. Feb. 28, 1997); Touche Remnant & Co. (pub. avail. Aug. 27, 1984).

²⁹ Goodwin, Proctor & Hoar (pub. avail. Feb. 28, 1997). Similar to a US fund relying on Section 3(c)(7), a foreign fund may become subject to registration and reporting requirements under the Securities Exchange Act of 1934. Private foreign funds may exclude from the numerical limit or qualification requirements certain "knowledgeable employees" under Rule 3c-5 of the 1940 Act.

³⁰ Investment Funds Institute of Canada (pub. avail. Mar. 4, 1996); Goodwin, Proctor & Hoar (pub. avail. Feb. 28, 1997).

³¹ The term accredited investor is defined in Rule 501 of Regulation D as: a bank, insurance company, registered investment company, business development company, or small business investment company; an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million; a charitable organization, corporation, or partnership with assets exceeding \$5 million; a director, executive officer, or general partner of the company selling the securities; a business in which all the equity owners are accredited investors; a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person; a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the

not engaging in a public sale of the shares. As described above, under a 2013 change to Rule 506 under Regulation D for private offerings, a fund is now able to engage in general solicitation or general advertising without registering the shares under the Securities Act, provided the other requirements of the Rule are satisfied.³²

3. CFTC Considerations

Foreign managers wishing to offer foreign funds to US persons also must consider potential regulation under the CEA. In general, an entity that acts for US customers, including investors in a fund that the entity operates or advises, is required to register in an appropriate capacity with the CFTC unless it is otherwise exempt. Commodity pool operators and commodity trading advisors are subject to certain registration and reporting obligations.³³

4. Exemption from the Investment Advisers Act

A foreign manager of a fund sold privately in the United States may avoid registration as an investment adviser if it qualifies for an exemption under the recently revised Advisers Act registration provisions. Although the long-established “private adviser exemption” was eliminated by the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2011,³⁴ foreign managers may be able to take advantage of one of two new exemptions under the Advisers Act, the “foreign private adviser exemption” or the “private fund adviser exemption.” To rely on the foreign private adviser exemption an investment adviser must: (i) have no place of business in the United States; (ii) have, in total, fewer than 15 US clients and US investors in private funds advised by the investment adviser; (iii) have aggregate assets under management attributable to US persons of less than \$25 million; and (iv) neither (a) hold itself out generally to the public in the United States as an investment adviser nor (b) advise RICs or business development companies.³⁵

current year; or a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

³² Rule 506(c) requires, among other things, that all investors be accredited investors and that the issuer take reasonable steps to verify accredited investor status.

³³ See Section I.A.3 regarding Registration as a Commodity Pool Operator.

³⁴ Until 2011, a foreign management company (as well as a US company) was permitted to advise clients without registering with the SEC if the adviser had fewer than 15 clients and neither held itself out to the public as an adviser nor advised a registered investment company. For purposes of determining its total number of clients, the adviser was able to count as one client a legal entity (such as a corporation) that received investment advice based on the investment objectives of the entity (rather than the individual investment objectives of its shareholders, partners, beneficiaries, or members).

³⁵ Section 202(a)(30) of the Advisers Act. For purposes of this exemption, 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. See Investment Advisers Act Rel. No. 3222 (July 6, 2011). The term “private fund” means an issues that would be an investment company, as defined in Section 3 of the 1940 Act, but for Section 3(c)(1) and 3(c)(7) of the 1940 Act. See Section 202(a)(29) of the Advisers Act.

Alternatively, a foreign manager that is unable to rely on the foreign private adviser exemption may be able to rely on the private fund adviser exemption, which is available to advisers that solely manage qualifying private funds with assets under management in the United States of less than \$150 million.³⁶ Non-US advisers are required to count only private fund assets that are managed from a “place of business” within the United States toward the \$150 million threshold, and may qualify for this exemption regardless of the size or nature of the adviser’s activities outside of the United States, provided that all of its clients that are US persons are qualifying private funds.³⁷ Although exempt from registration under the Advisers Act, private fund advisers nevertheless must report certain information to the SEC.

C. Tax Considerations

For both US and European managers, tax considerations will greatly affect the attractiveness of a fund domiciled in one country for investors in other countries. The tax ramifications of a cross-border investment in a fund can be quite complex. It requires an evaluation of the tax laws in an investor’s country of tax residence, in the country or countries where the fund invests (*e.g.*, the impact of withholding taxes and tax treaties), and in the country where the fund is domiciled. Any special tax status or position of the investor also will impact the investor’s evaluation of a fund.

1. RICs Domiciled in the United States

For US federal income tax purposes RICs are considered corporations. As such, they are taxed just like operating companies organized in corporate form, unless they qualify for the tax treatment provided by Subchapter M of the US Internal Revenue Code. Subchapter M is designed to provide RIC investors with tax treatment that is “comparable” to that received by direct investors in securities (*i.e.*, there is not “double” taxation at both the fund and shareholder levels). A RIC cannot qualify for Subchapter M treatment unless it meets several tests, including those regarding (i) registration with the SEC under the 1940 Act; (ii) the sources of its income; (iii) the diversification of its assets; and (iv) the distribution of its income. Virtually all RICs comply with Subchapter M.

One notable requirement involves RIC distributions. Under Subchapter M, a RIC must distribute to shareholders each taxable year at least 90 percent of its income (other than net capital gains). Importantly, the remaining 10 percent of ordinary income, and all capital gain, may be retained. All retained income, however, is taxed at regular corporate tax rates.

³⁶ A “qualifying private fund” means any private fund that is not registered under Section 8 of the 1940 Act and has not elected to be treated as a business development company. For purposes of this exemption, an investment adviser may treat as a private fund an issuer that qualifies for an exclusion from the definition of an investment company, as defined in Section 3 of the 1940 Act, in addition to those provided by Section 3(c)(1) or 3(c)(7) of the 1940 Act, provided that the investment adviser treats the issuer as a private fund under the Act and the rules thereunder for all purposes. *See* Rule 203(m)-1 under the Advisers Act.

³⁷ *See* Rule 203(m)-1 under the Advisers Act.

Because a RIC that incurs corporate tax provides a lower return than one that does not incur such tax, RICs generally attempt to distribute all of their income. In addition, because RICs are taxable under an excise tax unless they distribute essentially all of their income in the calendar year in which it is earned,³⁸ RICs typically distribute their income currently.

As a result, subject to certain conditions, a RIC's distributed net income and long-term capital gains generally flow through to shareholders without the fund also incurring federal taxes on the amounts distributed. The effect is that income is directly taxable to shareholders. As such, RICs are generally referred to as "distributing funds." This contrasts with the tax structure of many funds outside the United States, which are more typically structured as "accumulating" or "roll-up" funds as described below.

2. Regulated Funds Domiciled Outside the United States

Many foreign domiciled funds, including UCITS, have a roll-up tax feature whereby their income and capital gains are not distributed currently, and instead accumulate in the share value or price of the fund. Foreign regulated funds with this feature provide non-US investors with two very significant tax advantages over investments in comparable US domiciled RICs: (i) tax deferral, as income and gains are not recognized or taxed until an investor's shares are sold; and (ii) the conversion of dividend and interest ("ordinary") income into capital gains, which are often taxed preferentially at a lower rate.

The Internal Revenue Code, however, prevents US investors from achieving the tax advantages offered by the roll-up feature when investing in foreign funds. The passive foreign investment company (PFIC) rules, which effectively tax PFIC gains currently at ordinary income rates, generally apply to holdings by US investors of non-US funds. The PFIC rules seek to ensure that US investors in foreign domiciled funds do not have a tax advantage over RICs when sold to US residents. Specifically, the value of a US investor's PFIC shares generally is: (i) marked to market (at the investor's election) each year; or (ii) subject to an interest charge designed to eliminate any tax deferral benefit. Mark-to-market appreciation and all distributions are taxable at ordinary income rates. Gain from the sale of PFIC shares also is taxable at ordinary income rates. An alternative taxation regime for PFICs that elect treatment as "qualified electing funds" (QEFs) provides some opportunity for capital gain treatment; the QEF regime typically is not available to investors, however, as it requires the fund to calculate its income under US tax principles. The PFIC rules impose such significant tax costs that US taxpayers typically do not invest in non-US funds.

³⁸ Specifically, US tax law imposes an excise tax on any RIC that does not distribute essentially all of its income during the calendar year in which it is earned. A tax of four percent is imposed on the amount, if any, by which the RIC's required distribution exceeds the amount actually distributed. The excise tax, in effect, acts as an interest charge on undistributed amounts.

II. MARKETING REGULATED FUNDS IN THE EUROPEAN UNION

This section reviews how a US domiciled asset management firm can obtain access to fund investors in the European Union under the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD). The UCITS Directive is generally viewed as a regulatory framework for funds that are authorized and appropriate for sale to retail investors and, as such, is viewed as having similar purposes to those of the 1940 Act, *i.e.*, providing a substantive regulatory regime for funds widely marketed and appropriate for retail investors.³⁹ Like RICs, UCITS also may be sold to professional or institutional investors. Similar to a foreign manager wishing to access the US retail market, a US management company that wishes to access the retail market throughout the European Union practically would be required to establish an EU “mutual fund” in the form of a UCITS. Those US managers wishing to offer RICs or “unregistered” US funds to professional investors may do so under the AIFMD as non-EU alternative investment funds (AIF).

Adopted in 2011, the AIFMD provides the regulatory framework for managers of essentially all funds other than UCITS (or AIF) that are marketed in the European Union.⁴⁰ While aimed at the managers of AIFs, the AIFMD includes many requirements that impact AIFs themselves (*e.g.*, disclosure, reporting, depositary, valuation, risk management). An authorized AIFM is permitted to market an AIF to professional investors⁴¹ throughout the European Union; the AIFMD additionally permits Member States to allow marketing of AIF to retail investors within that Member State subject to any additional requirements a Member State chooses to impose. There is no genuine US “alternative fund” corollary to the AIFMD in relation to the detailed disclosure and operational requirements that are imposed on both AIF managers and AIFs themselves.

To access investors under the UCITS Directive, a US management firm must establish (or domicile) a UCITS fund in the European Union. Alternatively, for marketing funds other than UCITS to EU investors, whether the fund is domiciled in the EU or outside the EU (so-called third country funds), a firm must rely on the framework of the AIFMD.⁴² Currently, managers of third country funds must comply with certain provisions of the AIFMD and can market such funds only as permitted under Member State rules. Further, under both the UCITS Directive and the AIFMD, only managers based in the European Union currently have the ability to establish an investment fund in

³⁹ UCITS, or “undertakings for collective investment in transferrable securities,” are collective investment schemes established and authorized under a harmonized EU legal framework, currently EU Directive 2009/65/EC, as amended by Directive 2016/91/EU (UCITS IV), under which a UCITS established and authorized in one Member State can be sold cross border into other Member States without a requirement for an additional full registration.

⁴⁰ EU Directive 2011/61/EU.

⁴¹ Under the AIFMD, a “professional investor” is any investor that is considered as, or may be treated as, a “professional client” under MiFID. The term generally includes regulated financial institutions such as banks, insurance companies, investment firms (broker-dealers), collective investment schemes and their management companies.

⁴² The AIFMD was enacted in 2011 and is effective as of July 2013.

one Member State that can be “passport” or marketed throughout the European Union rather than on a Member State by Member State basis. For the AIFMD, this passport is only for marketing to professional investors (the “AIFMD passport”). In accordance with the AIFMD, ESMA and other European co-legislators are currently considering extending to managers of third country funds the AIFMD passport, which will permit them to market third country funds to professional investors on a cross-border basis in the European Union.

A. Offering of Funds Domiciled in the European Union

The two primary EU laws relating to funds are the UCITS Directive and the AIFMD.⁴³ While the UCITS Directive only applies to funds domiciled in the European Union, the AIFMD has provisions for both EU-authorized funds and third country (or non-EU) funds.

1. UCITS Directive

The UCITS Directive was enacted in 1985 and has been amended several times since its passage. A central feature of importance for fund managers is that the UCITS Directive provides the framework for cross-border sales of retail funds in the European Union (referred to as a “UCITS passport”). The UCITS Directive allows a fund that qualifies under the Directive to be sold throughout the European Union subject to regulation by its home Member State regulator (*i.e.*, Member State in which it is domiciled). To distribute cross border, a UCITS must file a notification in each Member State in which it wishes to distribute the UCITS (a “host” Member State) and comply with any host Member State marketing rules. Importantly, the UCITS label has grown to establish itself as a global fund brand with the distribution and sale of UCITS to both retail and professional investors in many jurisdictions outside the European Union, including in both Asia and Latin America.⁴⁴

The UCITS Directive, as previously described, is limited by its terms to investment funds established in one of the Member States of the European Union. Therefore, to benefit from the UCITS Directive, a US domiciled asset management firm must establish a fund in the European Union and also locate the management company of the fund in the European Union. The investment fund

⁴³ Other laws also may impact the operation and management of funds in the European Union, whether a UCITS or an AIF, such as rules for funds designated as a European Social Entrepreneurship Fund (EuSEF) or European Venture Capital Fund (EuVECA) (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32013R0346:EN:NOT> and <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32013R0345:EN:NOT>). A Money Market Fund Regulation is also being actively pursued (available at http://ec.europa.eu/internal_market/investment/docs/money-market-funds/130904_mmf-regulation_en.pdf).

⁴⁴ The roll-up tax structure has also supported the global distribution of UCITS as most countries do not have a tax regime similar to the US PFIC regime.

and the management company, however, do not have to be located in the same Member State⁴⁵ and certain functions or activities can be delegated, subject to requirements, to other entities, including entities outside the European Union.⁴⁶ The depositary functions of UCITS funds generally must be carried out in the Member State in which the fund is established.⁴⁷

Despite the geographic presence requirement for the UCITS and its management company, the delegation provisions of the Directive, to date, have enabled UCITS to access portfolio management expertise outside the European Union. This has been important for managers seeking to offer UCITS with investment strategies that do not solely focus on European investments such as funds that primarily seek to invest globally or in specific regions like Asia or the United States.

While the European Union has made efforts to further develop and facilitate a single market for UCITS through the UCITS passport, the marketing of funds in the European Union under the UCITS Directive remains more challenging than the “national” marketing of RICs across the United States. The reason for this is two-fold.

First, given the presence of Member State regulators in cross-border distribution, there are still situations where different Member State regulators administer the provisions for accessing the Member State and marketing a UCITS differently. While the process has improved, for example, by new rules specifying the time period for registration through so called “notifications” among Member State regulators, this cross-border process still adds friction to the passporting of UCITS.⁴⁸ Second, the UCITS Directive does not have a single standard for marketing under the passport, so a UCITS must still comply with the marketing requirements of each host Member State in which it markets its shares.

⁴⁵ The ability of the management company of a UCITS to be established in a different Member State than the fund, the “management company passport,” was introduced in 2009.

⁴⁶ For example, Article 13 sets forth the general requirements for the delegation of portfolio management which include conditions such as notification to authorities, delegating only to entities authorized to provide asset management services and subject to supervision, and for third-country firms, cooperation agreements among the concerned authorities. Article 13(2) of the UCITS Directive also requires that a management company not delegate to such an extent that it becomes a “letter-box entity.”

⁴⁷ The administration of a UCITS fund is one function of the fund’s “depositary,” which also performs a custodian role. We note that there has been discussion of revising the requirement for this function to be carried out in the fund’s home Member State. *See e.g.*, European Commission, Consultation Document – UCITS, Product Rules, Liquidity Management, Money Market Funds, Long-Term Investments (July 26, 2012) (discussion of depositary passport) (UCITS VI Consultation) available at http://ec.europa.eu/internal_market/consultations/docs/2012/ucits/ucits_consultation_en.pdf.

⁴⁸ The recent [EC consultation on distribution of UCITS](#) recognizes this issue, stating “Regulatory barriers have been identified in response to the Capital Markets Union green paper and to the Call for Evidence on the EU Regulatory Framework for Financial Services as including burdensome registration procedures, costly and diverse marketing requirements, inconsistent administrative arrangements and tax obstacles.”

This can often also result in varied requirements, although there are efforts to address these challenges too.⁴⁹ In contrast, it is much easier to sell and market RICs across the entire United States.

2. Regulation of the Management Company of UCITS

All UCITS are required to designate a “management company” to perform, or ensure the performance of, certain functions related to the management and administration of the UCITS. The management company of a UCITS is required to seek authorization by the regulators of the Member State in which it is established.⁵⁰ The regulation of the management company is however dependent to a considerable extent on the “form of organization” of the UCITS (*e.g.*, contract law, trust law, or other law). The appointment of the depositary to the UCITS also must be authorized by the relevant Member State regulator as must the instruments of incorporation (in the case of investment companies) or the fund rules (in other cases).

The UCITS Directive imposes a number of organizational, conduct and governance requirements on the management company including ensuring it maintains sufficient financial resources to conduct its business. The financial resources that the management company must maintain are based on the size of the UCITS subject to a minimum which also takes account of the fixed overhead costs of the company. Recent revisions to the Directive strengthened the role, appointment and liability for the loss of assets (*e.g.* through fraud) of fund depositaries; specified rules governing the compensation/remuneration of the staff of management companies; and introduced a regime for sanctions for non-compliance.

3. Alternative Investment Fund Managers Directive

The AIFMD generally applies to managers of funds in the European Union or funds marketed in the European Union that are not subject to the UCITS Directive (with limited exceptions). The AIFMD was enacted in 2011 and Member States were required to implement the Directive in their respective jurisdictions by July 22, 2013.⁵¹

⁴⁹ For example, changes introduced in 2009 require host Member States to review compliance with the marketing requirements in the host Member State after the start of marketing. This has helped alleviate delays in the initial marketing of a UCITS cross-border but increased the risk of later disciplinary action in the event that marketing material is deemed non-compliant with host Member State rules. *See* Recital 64 of UCITS IV.

⁵⁰ A UCITS may be either “externally managed” or “self-managed.” In cases where a UCITS is deemed to be “externally managed” (*i.e.* a separate management company has been designated), both the fund and the management company are required to seek separate authorisation of the regulator in the Member State(s) in which they are established unless the management company already has a valid authorisation (*e.g.* for another UCITS for which it has been designated a management company). Most funds constituted under trust law are deemed to be self-managed (also known as internally managed) and as such the management company and the fund are subject to a single authorisation in the Member State under whose trust law the fund is established.

⁵¹ The AIFMD provided for transitional arrangements until July 22, 2014 for AIFMs in operation before July 22, 2013.

The Directive was intended to regulate managers of “alternative” funds sold to professional investors (*e.g.*, hedge funds and private equity funds). Its broad scope, however, captures funds with a variety of investment objectives and strategies and includes funds that had previously been authorized by Member States for domestic sale to retail investors, as well as RICs.

The AIFMD by its terms regulates the managers of AIFs yet includes significant and substantial provisions impacting the operation of these funds. Following the style of the UCITS Directive, the AIFMD permits an EU management company of an EU AIF to qualify for an EU “passport” to market the EU AIF cross-border in the European Union solely to professional investors. The possibility of marketing AIF to retail investors is subject to the discretion of Member States which may impose additional requirements.⁵² Germany, for example, imposes additional requirements if an AIF is to be distributed to retail investors.⁵³ There is no EU-wide passporting right for marketing AIF to retail investors. Like RICs in the United States with respect to retail investors, UCITS remain the only vehicle by which passporting funds to retail fund investors on a pan-European basis is available.

Similar to UCITS, while the AIFMD gives firms the ability to passport AIF to professional investors throughout the European Union (provided there is proper notification in a host Member State), Member States control and administer the regulations for marketing AIF to investors located in their jurisdictions (*e.g.*, whether an AIFM can engage in general public advertising).

In the United Kingdom, for example, properly notified EU AIFs⁵⁴ may be marketed relatively freely to UK persons that qualify as professional investors, subject to general compliance with applicable FCA rules regarding “financial promotions” (*e.g.*, communications must be fair, clear and not misleading).⁵⁵ In addition to marketing to professional investors, the UK rules⁵⁶ also permit such AIFs

⁵² Member States may not impose stricter or additional rules for the marketing of AIFs cross-border to retail investors in their territory than they impose for AIFs that are marketed domestically. *See* Recital 71 of the AIFMD.

⁵³ For example, AIFs marketed in Germany to retail investors must meet specific requirements regarding eligible assets, investment limits and restrictions.

⁵⁴ The AIFMD has been implemented in the United Kingdom, including through the issuance of The Alternative Investment Fund Managers Regulations 2013 (UK AIFMD Legislation) which came into force on 22 July 2013. Under Article 32(2) and Annex IV of the AIFMD, the general EU passporting requirements include the provision of the following documentation and information, among others, to the AIFM’s home regulator: (i) a notification letter, including a program of operations identifying the AIFs the AIFM intends to market and information on where the AIFs are established; (ii) the AIF rules or instruments of incorporation; (iii) a description of, or any information on, the AIF available to investors; (iv) indication of the member state in which the AIFM intends to market the units or shares of the AIF to professional investors; and (v) information about arrangements made for the marketing of AIFs and, where relevant, information on arrangements established to prevent units or shares of the AIF from being marketed to retail investors.

⁵⁵ *See*, FCA Conduct of Business Sourcebook (COBS), Section 4.

⁵⁶ *See*, Financial Services and Market Act 2000 (FSMA), Section 21; FSMA, Section 238. EU AIFM also may market to a relatively few “natural person-type” investors, such as “certified sophisticated investors,” however these categorizations require additional vetting and suitability assessments prior to marketing the EU AIF. For example, marketing or promotion

to be promoted to other types of investors that may not qualify as professional investors but otherwise meet certain requirements, such as certain investment professionals⁵⁷ and “high net worth businesses.”⁵⁸ In marketing to such investors, an EU AIFM may initiate, for example, unsolicited communications (*i.e.*, bulk newsletters, emails, direct mail), present at conferences/industry events/road shows, and conduct in-person meetings.⁵⁹ Where an FCA-authorized AIFM promotes an EU AIF in which it is addressed to or disseminated in such a manner that it is likely to be received by a “retail client” (*i.e.*, not a professional client under the AIFMD), a record must be made certifying that the invitation or inducement complies with additional restrictions set out for such investors.⁶⁰

Similar to legislation in the United Kingdom, Germany has added additional requirements in its implementing legislation.⁶¹ In addition to compliance with certain requirements imposed by AIFMD, the German regulator, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), also currently

to certified sophisticated investors requires: (i) a written certification of sophistication from an FCA-authorized person (other than the person making the promotion) dated within the last three years, and (ii) a loss of protection statement signed by the investor within the last twelve months. In addition, amongst other things, an authorized EU AIFM will need to certify that the UK investor is “sufficiently knowledgeable to understand the risks associated with engaging in investment activity in” the EU AIF.

⁵⁷ Under UK law, an “investment professional” may include, among others: (i) an FCA or Prudential Regulation Authority (PRA) authorized person/firm, such as a UK bank, UK broker, UK financial intermediary, or non-UK EEA firms passported under AIFMD (*see* the Financial Services Register for a list of all FCA or PRA authorized persons and firms); and (ii) an exempt person under the FSMA), provided that the communication relates to an activity for which the exempt person is exempt.

⁵⁸ Under UK law, a “high net worth business” includes: (i) a corporation which (1) has called-up share capital or net assets of at least £5 million or (2) is a member of a group in which includes a company with called-up share capital or net assets of at least £5 million (but where the corporation has more than 20 shareholders or it is a subsidiary of a company with more than 20 shareholders, the £5 million share capital / net assets requirement is reduced to £500,000); (ii) a partnership or unincorporated association with net assets of at least £5 million; and (iii) a trust which has had gross assets (*i.e.* total assets held before deduction of any liabilities) of at least £10 million at any time within the year preceding the promotion.

⁵⁹ Furthermore, under UK rules, if presentations at conferences and in-person meetings provide generic discussions relating to investment strategies that do not refer to a particular AIF, they are unlikely to comprise marketing. They are, therefore, not subject to the UK restrictions on marketing and may be performed without registration or notification if to professional, investment and high net worth business investors. Cold calls may comprise marketing, depending upon the content of the communication and whether the AIFM is FCA-authorized or not. *See*, COBS, Section 4.8.2. Additionally, under UK rules, activities such as general image or brand advertising and responding to unsolicited inquiries generally are not considered marketing for purposes of AIFMD, and may be conducted without notification or registration. *See*, UK AIFMD Legislation, Regulation 47. A confirmation from the investor that the offering or placement of shares of the AIF was made at its own initiative, should normally be sufficient to demonstrate that reverse solicitation has taken place, provided this is obtained before the offer or placement takes place.

⁶⁰ *See*, COBS, Section 4.11.1R(2A).

⁶¹ The AIFMD has been implemented in Germany through: (i) the issuance of the German Investment Code (Kapitalanlagegesetzbuch, KAGB) and (ii) additions and changes to the various existing laws. Most notably, the former German Investment Act (Investmentgesetz) has been revoked effective July 22, 2013 and its content is now included in the KAGB (*see*, KAGB, Ch. 4 for provisions regarding the sale and purchase of investment funds).

requires EU AIFMs to notify BaFIN (via notification from the home state authority) before marketing the EU AIF in Germany to professional or semi-professional investors.⁶² Similar to activity allowed for in the United Kingdom, while EU AIFMs marketing in Germany to professional and semi-professional investors may initiate unsolicited communications, in-person meetings, and conferences/road shows, EU AIFMs may not broadly market to retail investors under an AIFMD passport unless obtaining additional approvals from BaFIN.⁶³

Substantively, the AIFMD imposes on AIF managers a range of organizational, conduct, governance and disclosure based requirements related to the management and operation of AIFs. Like the UCITS Directive, the AIF must have a depositary to perform certain functions including safekeeping of assets, monitoring cash flow and oversight of AIFM operations. In some circumstances other parties external to the management company, such as pricing services, or valuers, may perform functions. The AIFMD, similar to the UCITS Directive, permits management companies to delegate certain activities to other entities including entities outside the European Union. Such delegation arrangements are subject to conditions such as a “letter box entity” standard, under which sufficient substance must be performed by the AIFM.⁶⁴

B. Offering of Third Country (Non-EU) Funds

As discussed above, the UCITS Directive is limited to funds established in the European Union that meet the substantive requirements of that Directive. It does not provide any means by which third country funds, wherever managed, can be authorized under the UCITS Directive. As such, third country funds cannot benefit from any passporting rights granted by the UCITS Directive to market their shares to retail investors across the European Union.

The AIFMD, however, does include within its scope those third country funds that are either managed from within the European Union and/or marketed to EU investors. The Directive provides, for the first time, minimum EU-wide requirements for the distribution of third country funds to professional investors in EU Member States. Currently, third country AIF managed by a non-EU manager may be marketed only under individual Member State private placement regimes and must

⁶² See, KAGB, sec. 323 (notification and procedures allowing for AIF marketing to professional/semi-professional).

⁶³ See, KAGB, sec. 323(2) (ensuring that there are BaFIN-approved arrangements in place to ensure AIF marketing does not reach retail investors or otherwise breach similar marketing regulations of the KAGB); KAGB, sec. 317-320 (providing the requirements in order to market EU AIFs to retail investors).

⁶⁴ The so-called “letter box entity” test is specified in greater detail under the AIFMD than the UCITS Directive (see Recital 83 and Article 20 (3) of Directive 2011/61/EU and Recital 91 and 93 and Article 82 of Commission Delegated Regulation EU (No) 231/2013 available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF> and <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:EN:PDF>).

comply with certain provisions of the AIFMD, *e.g.*, disclosure and reporting.⁶⁵ Unfortunately, the private placement regimes differ significantly from one Member State to another, including some Member State regimes that in practice amount to a prohibition on the distribution of third country funds to professional investors in their territory.

While the AIFMD seeks to introduce minimum harmonized standards for EU domiciled AIF, the framework for third country AIF is both new and complex. There remain considerable differences among Member States on marketing and private placement of AIF for third country funds and managers to learn. The need to navigate the various Member State rules for the marketing of third country funds to professional investors stands in contrast to the US private placement regime, which does not distinguish between US domiciled funds and their managers and non-US funds and their managers, and does not necessitate significant navigation through the laws of individual States.

Nevertheless, third country AIF access to the European Union may change, and improve for some jurisdictions, as the AIFMD contemplates extending the AIFMD passport to third country AIFs and third country AIFMs.⁶⁶ Such third country AIFMs and AIFs would generally be required to comply with all of the provisions of the AIFMD and certain other conditions would need to be met by the third country. The AIFMD also contemplates the abolition of national private placement regimes upon which third country AIFs currently rely, subsequent to the activation of the AIFMD passport for third country funds and managers.⁶⁷ Managers and/or funds from jurisdictions that have not received a positive passport assessment under the AIFMD may therefore be unable to market funds to EU investors under either the AIFMD or Member State national private placement regimes.

Under the AIFMD, ESMA was required to issue an opinion on the functioning of the passport and advice on the possible extension of the passport to third country managers and funds by July 2015.⁶⁸ In September 2016, ESMA issued case-by-case assessments for twelve countries, based on the following criteria: investor protection, market disruption, competition, and monitoring of systemic risk.⁶⁹

⁶⁵ Third country AIF that are managed by an EU AIFM must comply with all provisions of the AIFMD.

⁶⁶ Specifically, the AIFMD provides that, if the AIFMD passport is “activated” in respect of a particular country, an AIFM from that country that manages AIFs domiciled in that country may apply to the relevant Member State regulator for full authorization under (and be subject to full compliance with) the AIFMD. Such AIFM may then market those non-EU AIF throughout the EU on the basis of the AIFMD marketing passport in the same manner as an EU AIFMD marketing an EU AIF. *See* Articles 35-42 of the AIFMD.

⁶⁷ ESMA is required to issue advice on the termination of the national private placement regimes three years after entry into force of a delegated act by the European Commission specifying the date of activation of the third country passport. The Commission is supposed to adopt such delegated acts within three months of receiving positive advice from ESMA, although ESMA in July 2015 advised the Commission to delay doing so until a sufficient number of non-EU countries have been assessed.

⁶⁸ The opinion is issued to the European Parliament, the Council of the European Union and the European Commission.

⁶⁹ ESMA has given positive assessments to Guernsey, Jersey, Switzerland, Canada, Japan, and, subject to an amendment to local law, Australia. The United States, Hong Kong and Singapore have received limited positive assessments. Bermuda, the

ESMA issued a limited positive assessment with respect to the United States. ESMA stated that, in its view, the market conditions in the European Union that would apply to US funds dedicated to professional investors if the passport were extended would be different from the market access conditions in the United States applicable to EU funds dedicated to professional investors.⁷⁰ ESMA further explained that this is due to registration requirements under the US regulatory framework (which generate additional costs),⁷¹ and particularly in the case of EU funds “marketed by managers involving a public offering.”⁷² It therefore advised the Commission that, if the AIFMD passport were granted to the United States, possible options could include granting the passport:

- only to those US funds that are not RICs;
- only to those funds dedicated to professional investors to be marketed in the European Union by managers not involving any public offering; and/or
- only to those US funds that restrict investment to professional investors as defined in the AIFMD.

If all or some RICs are excluded from an AIFMD passport extended to the United States, and RICs become unable to rely on national private placement regimes (or such regimes are completely eliminated), US managers would be completely prohibited from marketing RICs in the European Union.

C. EU Investors – Taxation of European Funds and RICs

As described above, European domiciled funds such as UCITS are typically “roll-up” funds where investors do not incur taxes on fund income until their shares are sold. RICs, in sharp contrast

Cayman Islands, and the Isle of Man have not received positive assessments at this stage. *See* ESMA’s advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs, available at https://www.esma.europa.eu/sites/default/files/library/2016-1140_aifmd_passport.pdf (ESMA’s September 2016 Advice).

⁷⁰ ESMA acknowledges that in the case of funds marketed in the US by managers not involving a public offering, the market access conditions which would apply to US funds dedicated to professional investors in the EU would be broadly comparable to the market access conditions of EU funds dedicated to professional investors in the US. *See* paragraph 63 of ESMA’s September 2016 Advice.

⁷¹ ESMA’s statements indicate that it continues to misunderstand the distinction between, and regulation of, RICs eligible for sale to the retail public with the regulation of funds that are able to be sold only to professional investors. We raised similar concerns on ESMA’s prior advice on the extension of the AIFMD passport. *See* Letter from Paul Schott Stevens to Steven Maijoor, dated December 16, 2015, available at <https://www.ici.org/pdf/29653.pdf>.

⁷² In supporting this position ESMA cites to the 1973 SEC release on the nonpublic offering exemption under the Securities Act, available at <https://www.sec.gov/rules/final/33-4552.htm>. ESMA does not appear to have taken into consideration the fact that, as described above, both US and non-US funds intended for professional investors may engage in general solicitation and advertising under Rule 506(c) of Regulation D.

to the roll-up structure, are distributing funds where investors incur current taxes on the fund's distributions.

European investors, if confronted with the option of investing in either a RIC or a UCITS (assuming other features are the same) typically choose to invest in the UCITS to obtain the more favorable tax treatment. As described above, RICs elect to qualify under Subchapter M of the Internal Revenue Code to ensure that there is not taxation at both the fund and the investor level. The Internal Revenue Code does not permit a "roll-up" structure and there also are other tax disadvantages to RICs for EU investors. Generally, the disadvantages for EU investors are: (i) US taxation of non-US source income;⁷³ (ii) current distribution (and therefore current taxation) of income and gains;⁷⁴ and (iii) resident country taxation at "regular" rates of capital gain distributions where capital gains would receive favorable treatment in the investor's residence country.⁷⁵ As a consequence RICs are simply not attractive investments for European investors when compared with European domiciled funds such as UCITS.

A temporary legislative change enacted in 2005, which has now been made permanent, has made certain RICs more attractive to non-US investors than they were previously; funds focused on investments in debt issued in the US in particular benefit from these provisions. Specifically, distributions from RICs that relate to US-source interest and short-term gain can be treated as such items of income by non-US investors. Non-US investors are thus now able to take advantage of the exclusions from US withholding tax for "portfolio interest" and capital gains paid to non-US persons. This allows non-US investors in RICs to receive tax treatment comparable to that received by non-US investors that invest in the US directly or through a non-US collective investment vehicle. Only long-term gains previously were exempt from US withholding tax when paid by a RIC to a non-US investor. Importantly, this legislation did not apply to non-US-source interest income received by a RIC and distributed to its shareholders. All such income is treated as dividend income subject to US withholding tax.

⁷³ EU investors in a RIC would be taxed in the United States when the RIC invests outside the United States. Because a RIC's distributions are treated as US-source dividends, they are subject to US withholding tax (at 30 percent or a lower treaty rate). Any EU investor investing in the same non-US securities directly or through an EU fund would not incur any US tax. Thus, the income may be taxed in three countries (the source country, the United States, and the residence country) when the investment is made by an EU investor through a RIC, whereas the income would be taxed only twice (or perhaps once) if the investment is made directly or through an EU fund. While an EU investor may be able to claim a foreign tax credit for the US withholding tax, such a credit in all likelihood would not be available for the tax withheld by the source country on the payment to the RIC.

⁷⁴ EU investors in RICs in all likelihood will be taxed currently in their country of residence on the RIC's annual distributions. Residence country taxation occurs irrespective of whether that country otherwise permits deferral of tax through funds that do not distribute their income.

⁷⁵ We understand that under EU tax laws, a RIC's capital gain dividends would generally be treated as "regular" dividends; the preferential "capital gains" nature of the distribution is not retained for EU tax purposes. Thus, a RIC's distributions of capital gains typically would not qualify for any tax preference provided in a residence country for capital gains.

One last relevant feature of US tax law involves information reporting of amounts paid by US funds to non-US investors. US payers (including brokers, banks, and funds) must report such payments to investors and to the IRS. This tax information is available to resident-country governments under exchange of information provisions in US tax treaties and/or FATCA intergovernmental agreements (IGAs).

II. CONCLUSION

For funds intended to be marketed and sold to retail investors, the 1940 Act permits non-US fund management companies to establish funds in the United States on the same basis as US management firms. The UCITS Directive framework takes a similar approach and requires funds to be established in the European Union to reach the broad retail market in the European Union.

For managers of regulated funds, there is no requirement that an investment adviser to a US fund registered under the 1940 Act be physically located in the United States; by contrast, a UCITS management company must be established in the European Union. Nevertheless, the delegation provisions of the UCITS Directive (to date) have enabled US management companies to provide portfolio management services to UCITS.

The United States has a well-established “national” private placement regime for accessing professional fund investors throughout the United States, including through the use of general solicitations and advertising. Under this framework, non-US funds and managers are able to access professional investors in the same manner as US funds and managers and are subject to the same regulatory requirements.⁷⁶

In the European Union, the AIFMD encompasses the marketing and sale of AIFs to EU professional investors. EU domiciled AIFMs and AIFs must comply with the entire AIFMD and have access to an EU passport for cross-border marketing to EU professional investors. Third country AIFs and AIFMs, however, do not have access to such a passport. They, must instead comply with certain provisions of the AIFMD and the requirements of individual Member States for the private placement of AIFs to professional investors on their territory. Further, due to current considerations regarding the extension of the AIFMD passport to third country managers and funds, as well as the status of national private placement regimes, certain third country funds may ultimately be prohibited from marketing in the European Union to professional investors either through the AIFMD or national private placement regimes.

Specifically for the United States, in September 2016, ESMA recommended as an option that the AIFMD passport only be extended to those US funds that are not RICs. Even putting aside the possible outcomes for US funds and managers with respect to the extension of the AFIMD passport, it

⁷⁶ As described above, non-US managers may additionally take advantage of certain exemptions from investment adviser registration and SEC interpretations.

is currently more challenging for a US fund manager to access professional investors throughout the European Union than it is for an EU fund manager to access professional investors on a continent-wide basis in the United States.

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In considering the current fund regulatory regime in the European Union, the most effective way for a US manager of regulated funds to obtain access to the European market as a whole is to establish funds in the EU under the UCITS Directive (which requires the manager to be domiciled in the EU). Similarly, establishing an EU fund with an EU manager under the AIFMD is an alternative for a US manager if the manager wishes to benefit from the passport to market to professional investors.⁷⁷ A US manager currently also may sell a US fund to professional investors by complying with some provisions of the AIFMD and utilizing national private placement regimes. Nevertheless, under both Directives, the “passport” for EU domiciled funds is an important feature that better facilitates cross-border distribution of a fund throughout the EU. .

For EU and other non-US managers, the most effective way for such managers to distribute and sell to US retail investors is to establish US-domiciled funds under the 1940 Act. Registration under the 1940 Act allows a fund to be sold in all 50 states, subject to minimal state filings (*e.g.*, notice filings). For accessing US professional investors, EU and non-US fund managers can simply use the US private placement regime. Such managers may be subject to the Advisers Act and the CEA but there is no requirement for a geographic presence in the United States so the manager and the fund can both be domiciled outside the United States. Such an approach also gives managers access on a continent-wide basis.

⁷⁷ Specific details in the UCITS Directive and the AIFMD may impact why a manager chooses to utilize one Directive or the other (*e.g.*, certain investment strategies may not be permitted under the UCITS Directive).

APPENDIX A

Access to US Investors by EU and Non-US Managers			Access to EU Investors by US Managers		
	Retail Investors	Professional Investors		Retail Investors	Professional Investors
US RICS <ul style="list-style-type: none"> publicly offered no residency requirements for manager 	✓	✓	EU UCITS <ul style="list-style-type: none"> publicly offered EU residency requirement for manager 	✓	✓
EU or Non-US funds relying on Section 3(c)(1) or (7) of the 1940 Act <ul style="list-style-type: none"> comply with US private placement rules may generally solicit and advertise under Rule 506(c) of Reg. D no residency requirement for manager manager may need to register under Advisers Act 	✗	✓	Third country AIF under AIFMD <ul style="list-style-type: none"> comply with certain AIFMD provisions use MS private placement regimes may be eliminated 	✗	✓
			AIFMD passport for US funds (as of November 2016) <ul style="list-style-type: none"> if available, comply with full AIFMD not yet granted to US eventual passport may exclude RICs (ESMA Sept. 2016 advice) 	✗	✗

Sale of AIF to retail investors is subject to MS discretion; practically not applicable for third country AIF.