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Marketing

K&L Gates Partners Offer Practical Guidance for Hedge Fund Managers on Raising Capital in Australia, the Middle East and Asia

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By Vincent Pitaro, *Hedge Fund Law Report*

Pension funds and sovereign wealth funds are important potential sources of capital for hedge fund managers. Australia and Japan have about $1.7 trillion and $1.2 trillion in pension assets, respectively, while the sovereign wealth funds of Middle East nations hold another $1.8 trillion. The Chinese market has huge potential as well. In that regard, a recent presentation by international law firm K&L Gates LLP offered a comprehensive overview of the regulatory regimes and marketing requirements that affect fund managers seeking capital in Australia, the Middle East, Japan, China, Hong Kong and Singapore. The program, entitled "Raising Private Fund Assets in the Global Markets – Focus on Asia, Australia, and the Middle East," was moderated by K&L Gates partner Cary J. Meer. The other speakers were her partners Natalie R. Boyd, Elizabeth A. Gray, Betsy-Ann Howe, Tsuguhito Omagari and Choo Lye Tan. For a similar global regulatory roundup, see "KPMG Report Highlights Key Developments in Hedge Fund Regulation in the Americas, the Asia-Pacific Region, Europe, South Africa and the Middle East," Hedge Fund Law Report, Vol. 7, No. 33 (Sep. 4, 2014). For a discussion of regional "passport" initiatives that may facilitate marketing of funds in Asia and Australia, see "How Can U.S. Hedge Fund Managers Use Passport and Mutual Recognition Initiatives to Market to Investors in Asia?," Hedge Fund Law Report, Vol. 7, No. 27 (Jul. 18, 2014).

Australia

Gray said that the Australian investment management industry, with $2.2 trillion in assets, is the third largest in the world after the U.S. and Luxembourg. The main reason is Australia's mandatory pension system, referred to as "superannuation," which takes in 9% of every person's income; she said the contribution rate was recently increased to 12%. With $1.7 trillion in assets, the system is larger than the Australian economy and is expected to quadruple in size in the next 18 years. Australia also has one sovereign wealth fund (SWF) with about $90 billion in assets. Gray added that the pension system is overweight Australian equities and Australian property, so more money will have to be invested offshore. In that regard, growth is expected in allocations to offshore fixed income products, as well as offshore infrastructure and real estate. As of June 2012, Australian pension funds had $800 billion invested offshore or with non-resident managers. Despite recent growth in funds of funds, a pull-back is expected. Australia has had many boutique asset managers, but many more large global managers are entering market. Australia's pension funds are divided into three main segments: 42% of its "super" (pension) funds

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are in not-for-profit industry, public sector and corporate funds; 27.4% are in for-profit retail funds (owned by banks or insurance companies); and 30.6% are in self-managed funds that are typically established by high net worth (HNW) individuals. The self-managed segment is expected to grow significantly over the next five years; many advisers forget to consider this segment.

Gray said that, though the asset management industry is highly regulated, Australia still has a "very open regulatory environment." The primary regulator of financial services and products is the Australian Securities and Investments Commission. The most important law is the Corporations Act. Regulations govern licensing, disclosure, compliance, operations and reporting:

- *Financial Services License (FSL).* An FSL is needed to provide services in Australia. However, an SEC-regulated adviser dealing with institutional clients does not need an FSL license; such an adviser must apply for an exemption, which is available through a simple, inexpensive process. She said that, as an adviser's services expand, it may be preferable to establish an Australia-based subsidiary that obtains an FSL license. Gray said that exemptions from licensing requirements are evergreen as long as the entity continues to satisfy the requisite conditions.
- *Fund Setup and Structure.* There is an eight page disclosure document for traditional fund products other than hedge funds or real estate investment trusts (REITs). Offshore managers find the document very challenging because of its condensed format. Managers of REITs and certain other vehicles must meet special requirements when purchasing local assets. Funds are subject to detailed compliance and reporting requirements. Fund structure is also unique because there are no corporate collective investment vehicles, limited partnerships (LPs) or limited liability companies (LLCs). Managers use unit trusts that are subject to state-based trust law, which complicates fund setup for offshore managers. Such managers usually start with an outsourced trust operation using an established local manager. After an offshore manager has a few funds, it is more likely to bring management in-house.

Gray said that pension funds must report to regulators, who release fee and performance information to the public. Consequently, Australian funds face significant fee pressure and competition; offshore managers cannot expect to charge standard fees. She added that five key asset consultants represent about 85% of the pension market; it is essential for offshore managers to work with them and build relationships with them. See "Getting to Know the Gatekeepers: How Hedge Fund Managers Can Interface with Investment Consultants to Access Institutional Capital (Part Two of Two)," Hedge Fund Law Report, Vol. 6, No. 28 (Jul. 18, 2013). Gray noted that there are now over 300 Australian pension funds and that regulators, concerned that there are too many funds, apparently want to reduce that number to around 100. A manager entering the market should investigate which funds are growing and avoid those likely to be taken over. She added that larger funds are bringing management of some assets in-house as they grow, especially local investments. She cautioned that if a manager decides to enter the Australian market, it should commit to it for the long-term: A manager who leaves and tries to re-enter will not be accepted back easily.

Tax Considerations

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Howe said that Australian pension funds take four important considerations into account when making investment decisions:

- They avoid foreign tax filings, especially U.S. filings.
- They try to minimize tax leakage: Pensions receive preferential tax treatment (a 15% regular rate, and 7.5% rate on capital gains); if they pay a higher rate in a foreign jurisdiction, the excess tax payment may be lost.
- They avoid taxation on an "attribution" basis: Investments in controlled foreign companies may be taxed on undistributed income.
- They seek investments eligible for capital gains tax treatment.

Howe said that all investment vehicles, including LPs, are treated as companies in Australia. Thus, investments in foreign LPs may fall within the controlled foreign company regime, and their distributions may be treated as dividends. That regime is generally acceptable to Australian investors; however, investors are averse to taxation on unrealized gains in a portfolio. She said that new regulations will allow some foreign hybrid vehicles, such as LLCs, to be treated as pass-through vehicles; to be eligible, a vehicle must be taxed as an "entity" in its home jurisdiction. The type of vehicle also affects the availability of foreign tax credits: A non-transparent vehicle will not be able to use foreign tax credits. As an example, Howe explained that a Cayman fund would not qualify as a preferred foreign hybrid vehicle because it is not subject to tax in the Caymans; consequently if five or fewer Australian investors owned 50% or more of a Cayman fund, the fund would be deemed a controlled foreign corporation, and its income would be subject to taxation on an attribution basis. In addition, there is generally no flow-through of foreign tax credits for Cayman funds, but there are case-by-case exemptions. Finally, Howe noted that an Australian unit trust is the vehicle of choice for foreign investments, as it is the only available tax-transparent entity. A U.S. fund would typically invest in an Australian unit trust that serves as a feeder fund to a pension fund. See "Key Hedge Fund Tax Developments in the U.K., the European Union, Ireland, Germany, Spain, Australia, India and Puerto Rico," Hedge Fund Law Report, Vol. 6, No. 26 (Jun. 27, 2013).

The Middle East

Boyd said that the Gulf Cooperation Council (GCC) was created in 1981 as a political and economic union, but not a monetary union. It includes Saudi Arabia, Kuwait, Oman, the United Arab Emirates (UAE), Qatar and Bahrain. She said there is little opportunity for foreign investment in the Middle East outside of the GCC. The GCC has more than one third of the world's sovereign wealth funds (SWFs), and over $1.8 trillion in assets. The three largest SWFs are the Abu Dhabi Investment Authority ($773 billion), the Saudi Arabian Monetary Agency ($533 billion) and the Kuwait Investment Authority ($296 billion). Wealth in the GCC has continued to grow despite recent political turmoil in the region. Boyd noted that, with the exception of the Qatar Investment Authority ($100 billion), other GCC SWFs are now looking internally for investment opportunities. See "Why and How Do Middle Eastern Sovereign Wealth Funds, Pension Funds and High Net Worth Individuals Invest in Private Funds?," Hedge Fund Law Report, Vol. 6, No. 23 (Jun. 6, 2013).

Boyd added that regional regulations are expected to tighten in line with worldwide trends. There is no license passporting across the GCC. In addition, the "tolerated practice" approach, under which occasional fly-in, fly-out trips for marketing are not challenged, is changing. Such activities are no longer tolerated in Saudi Arabia, the UAE or, with regard to collective

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investment vehicles, Bahrain. An adviser can target clients in other countries if it does not have a physical presence and is "relatively discrete": Visits to the country should be limited; and the adviser may offer general information, but not seminars, offering documents or other specific marketing materials. Specific materials should be sent from outside the jurisdiction; and documents should be executed, and funds transferred, from outside the jurisdiction.

Boyd said that the Dubai International Financial Centre (DIFC) has a preferred status: It is treated as an offshore free zone, has no corporate taxes and has its own common law. However, there is no licensing or passporting between the DIFC and the rest of the GCC. Consequently, a firm cannot set up a branch or representative office in the DIFC and then market across the region. "Tolerated practice" is still accepted in the DIFC. The DIFC has only nine domestic funds. It recently established a qualified investor fund regime aimed at qualified HNW individuals that is less heavily regulated than other types of funds: Offerings must be private placements with a minimum of 50 unit holders; there must be a minimum subscription of $500,000. She noted that firms established in the DIFC are relying on reverse solicitation as a means of marketing.

Boyd said that the key Emirates in the funds industry are Abu Dhabi and Dubai; key regulators are the UAE Central Bank and the Emirati Security and Commodities Authority (ESCA). As of 2012, tolerated practices were completely prohibited. To market funds there, an adviser must have a licensed presence outside of the DIFC, either through a stand-alone company, a branch of a foreign-regulated company, or a representative office. A representative office may only be used for marketing; clients cannot be on-boarded there. A local promoter must register with ESCA and have its prospectus approved by ESCA. There are exemptions for marketing to government-owned institutions, dealing with foreign accounts and reverse solicitation. An adviser may have general discussions with non-governmental institutions, but a prospect cannot contact the firm within the country about investing. For a more detailed look at the UAW from Boyd, see "United Arab Emirates Implements Licensing Regime for Firms Providing Investment Management Services," Hedge Fund Law Report, Vol. 7, No. 20 (May 23, 2014).

Boyd said that Saudi Arabia has the most restrictive regulations. Unless an exemption is available, foreign funds must register and act via an "authorized person" licensed by its Capital Market Authority (CMA). There are no public offerings of foreign funds. The CMA has issued stern warnings against offering funds without complying with the regime. She noted that the CMA may "lighten" the regulation, but that the authorized person requirement will remain.

Boyd said there are sovereign immunity issues across the region, so it may be difficult to enforce agreements against SWFs. Meer noted that governing documents often limit GCC funds to Sharia-compliant investments, so it may be hard to figure out what investments a GCC fund is allowed to do. Boyd said that the onus is on the Islamic investor to buy units only in funds that are Sharia-compliant. See "The 'New-Age' Sukuk Market: How Investors Can Profit While Safeguarding Against Legal Risk," Hedge Fund Law Report, Vol. 4, No. 33 (Sep. 22, 2011).

Japan

Omagari explained that two primary laws regulate marketing to Japanese investors: The Financial Instrument and Exchange Act (FIEA) covers private placements and licensing of marketing and investment management. The Investment Trust and Investment Corporation Act (ITICA) governs the offering of interests in foreign investment trusts and corporations. Omagari said that rules may vary depending on whether a foreign fund is a corporate fund; and investment trust; or another collective vehicle, such as an LP or LLC. Liquid fund interests

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(Type 1), such as corporate shares and unit investment trusts, are treated differently from other securities (Type 2), including LP and LLC interests.

Offering Requirements Under the FIEA

The rules for private placements under the FIEA depend on the type of securities offered. A private placement of Type 1 securities can be to either 49 or fewer *offerees* or to Qualified Institutional Investors (QIIs). A private placement of Type 2 securities is available if there are fewer than 500 *investors* (i.e., no limit on offerees).

Offerings Requirements Under the ITICA

Omagari explained that foreign investment trusts and foreign investment corporations must notify the regulator before marketing a private placement. The main offering document must be in Japanese; supporting documents may be filed in English. Meer said that the process can take around three weeks; translation is the longest part. Omagari said that there is no waiting period and no filing fee; marketing may commence when the filing receipt is issued. A firm must update its filings as needed. He added that a foreign investment trust (but not a foreign investment corporation) must also file an investment management report at the end of each calculation period (except on offerings to QIIs).

Licensing Under FIEA

Omagari said that a different Financial Instrument Dealing License is required for marketing Type 1 versus Type 2 securities. There are two types of exemptions. The first is for "self-solicitation" by a corporate issuer (but not trusts, LPs or LLCs). Second, a foreign broker-dealer that is licensed to market in a foreign jurisdiction may market into Japan to (1) a licensed Japanese broker (whether from inside or outside Japan) or (2) to certain professional investors (but only from outside Japan and not directly to Japanese pension funds). Regulators have not provided clear guidance as to what constitutes marketing in Japan. A foreign broker-dealer cannot have a business base in Japan, but may be able to come to Japan on short-term business trips to meet professional investors.

Investment Management Licenses Under the FIEA

The general partner (GP) of an LP (or managing member of an LLC) must have an investment management license. A manager of a foreign investment trust or foreign investment corporation is not required to have a license.

Marketing Exemptions for Foreign LPs and LLCs

A GP or managing member of an LP or LLC may pursue "self-solicitation" (marketing its own fund interests) so long as there is at least one QII and 49 or fewer non-QII Japanese investors; the offering document must set forth offering restrictions and the manager must file a "Form 20" in advance. A fund's investment manager has two available exemptions: The first is available if there is at least one QII and 49 or fewer non-QII Japanese investors, and a Form 20 is filed in advance. The second is available if all Japanese investors are QIIs, there are fewer than 10 QIIs in total, and those QIIs make less than 30% of total fund contributions.

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Japanese Pension Regime

Omagari said that all Japanese nationals must participate in a public or private pension fund. Japan's "National" and "Employees" public pension plans are managed by the Government Pension Investment Fund, which delegates management of all assets (other than passive investments in domestic bonds) to banks and investment managers. Public pensions have ¥127 trillion in assets. Although private pensions may be self-managed under certain circumstances, they are typically managed through trust agreements with trust banks, life insurance and outside investment managers.

Hong Kong, Singapore and the People's Republic of China

Tan said that Hong Kong and Singapore are seen as gateways to the region. Hong Kong is the only practical gateway into the People's Republic of China (PRC). Singapore is still part of the British Commonwealth. Both still use the British company regime and common law. Unlike Hong Kong and Singapore, there is no registration or license available in the PRC that permits marketing by foreign advisers. Moreover, in the PRC, if an activity is not covered by regulation, a firm must assume that it is prohibited. Consequently, marketing directly into the PRC is generally prohibited; Tan noted that firms do market discretely into the PRC through lunches, infrequent visits and other informal means. Unlike the Middle East, however, there are no tolerated practices; firms solicit business at their peril. Tan added that the PRC is known for introducing "game-changing" legislation without any advance notice, such as the new Stock Connect program, which is now going live and will permit cross-border trading of shares. She added that the PRC adopted a mutual recognition regime with Hong Kong last year and plans for the Renminbi to be restriction-free by 2015.

Tan explained that Hong Kong and Singapore require licenses for marketing funds, but that exemptions are available for marketing to institutional investors. In Hong Kong, an exemption is only available for a person acting in a principal capacity, not someone acting through a paid agent; however, regulators have agreed that an investment adviser that sets up a fund would be considered a principal for purposes of the exemption. Both jurisdictions also have registration requirements for the investment units being offered. She discussed similarities between the Hong Kong and Singapore fund environments:

- Set-up logistics should not be a driving force: Costs are comparable in both jurisdictions, and the time frame in both is about 12-15 weeks.
- Both have safe harbor exemptions from prospectus requirements for certain small offerings, offerings with specified minimum subscriptions and offerings to professional investors. She cautioned that there is a difference between licensing for marketing activities and the registration of offering materials; being exempt from one does not mean that a firm is exempt from the other.
- Both have minimum local capital and liquidity requirements. How a firm may satisfy those requirements depends in part on the type of investors it has.
- Tax rates are comparable. In Hong Kong, an investment adviser is typically incorporated offshore for tax reasons.

Tan said that in Hong Kong the key licenses that foreign advisers may need are for dealing in securities (Type 1), advising on securities (Type 4) and asset management (Type 9). Temporary or provisional licenses may be available. Once an adviser has those licenses it still needs to

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comply with prospectus requirements. Occasional visits to Hong Kong may not trigger a licensing requirement. Licensing in both Hong Kong and Singapore is straightforward, but the documentation process is "very painful," and includes identification of a firm's beneficial owners. Authorization of collective investment schemes is required in Hong Kong only for retail schemes (offerings to more than 50 persons), which are treated like IPOs. Singapore's rules and regulators generally follow English principles. For a detailed overview of the Hong Kong and Singapore markets, see Hedge Fund Law Report's four-part series, "Primary Regulatory and Business Considerations When Opening a Hedge Fund Management Company Office in Asia," Part One of Four, Part Two of Four, Part Three of Four and Part Four of Four.

As indicated above, the PRC has no specific laws on marketing; even direct marketing to the PRC's SWF is prohibited. Consequently, a firm may have to work with PRC firms using programs for qualified foreign or domestic limited partners (QFLPs and QDLPs). The QFII/RQFII fund programs for China-focused investments by foreign institutional investors have also become popular. See "China Launches Landmark Reforms Impacting Hedge Fund Capital Raising, Investments and Operations," Hedge Fund Law Report, Vol. 5, No. 30 (Aug. 2, 2012). The Hong Kong–China mutual recognition agreement is another possible route into the PRC. Tan said that reverse solicitation is often used in all three jurisdictions, and may be the only way in the PRC. In the PRC, reverse solicitation is used as a defense or a justification in the event of regulatory action. A firm should keep documentation of its activities to assist in establishing a defense.

Tan said that, in deciding whether to enter the Hong Kong, Singapore or PRC market, a firm should consider whether its goal is short-term or long-term. She noted that regulators have long memories: It may be better to apply for a temporary license for a short-term effort to assure that regulators are happy. She cited the high cost of setting up an office in Hong Kong. Another consideration is where the adviser's investors are based: Singapore is popular for marketing to south Asian nations, especially in light of the new regional passports. Hong Kong's big selling point is that it is the only point of access to the PRC. She added that most HNW individuals in the PRC actually have accounts in Hong Kong, so a presence there can give an adviser exposure to PRC investors without the risk of entering the PRC. Finally, certain types of investment vehicles are easier in one jurisdiction than in the other. For example, real estate and debt may be easier in Singapore.

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