Understanding Hedge Fund Marketing Restrictions

Two major international investor markets – Japan and UK

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This article reviews marketing restrictions in two major markets that hedge fund managers often visit in search of capital for their strategies: the United Kingdom and Japan. These markets comprehensively regulate the activity of approaching institutional and other professional investors to solicit investment in hedge funds. First we review the basic regulatory framework governing solicitation activities in each jurisdiction before addressing pragmatically relevant exemptions.

The United Kingdom's regulatory framework

The UK regime governing the promotion and offering of hedge funds to UK investors has been complicated by the implementation of the European AIFMD. We can tease out the following principles:

- The "offering" of a non-EEA hedge fund to UK investors triggers the AIFMD private placement overlay;
- An European Economic Area (EEA) AIFM duly authorised by the local regulator may offer an EEA AIF to professional investors using the EEA-wide passport and will be subject to the transparency requirements of the overlay;
- To the extent such offering is to non-professional investors, the regimes under S.21 or S.238 of Financial Services and Markets Act (FSMA) will also apply;
- To the extent such offering is to professional investors, those regimes under FSMA will not apply;
- Promotion of a hedge fund falling short of "offering" triggers only either the S.21 or S.238 regime; and
- The "offering" of an FCA-recognised UCITS hedge fund is outside AIFMD and the promotion and/or offering thereof is subject to the S.21 regime.

Note that the EEA-wide marketing passport is only available currently to UK and other EEA based managers of EEA hedge funds. For simplicity, we ignore offerings of permanent capital hedge funds in this UK section.

The regulation of promotion of hedge funds in the UK

S.21 of the Financial Services and Markets Act 2000 (FSMA) prohibits a person from communicating any financial promotion unless it is issued or approved by a FSMA-authorised person or it is issued to categories of exempt investor or in circumstances specified under the Financial Promotions Order (FPO). So, the prohibition only applies to promotional activity by unauthorised persons. There are exemptions for investment professionals, high-net-worth entities and independently certified sophisticated investors, certain other exemptions for communications that are one-offs or communications to previously overseas customers of a non-UK promoter who are now in the UK.

Under S.238 of FSMA authorised persons may communicate an invitation or inducement to invest in a collective investment scheme (CIS) to the public only if the CIS is regulated (e.g., UCITS hedge funds). Hedge funds are typically unregulated CIS (UCIS). Authorised persons may only promote UCIS to an investor who falls within one of the exempted categories in the relevant FCA rules or an exemption in the CIS Promotions Order.

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Unauthorised persons may only promote UCIS in accordance with S.21, which allows them to promote UCIS to an investor who falls within one of the exempted categories in the FPO.

AIFMD overlay

The AIFMD overlay will apply where an alternative investment fund (AIF) is offered (as opposed to merely promoted) to investors domiciled or with a registered office in the UK. The term "AIF" covers any fund that is not a UCITS. Hedge funds and funds of hedge funds whether open-ended or closed-ended, listed or unlisted, a feeder or master fund will typically qualify as AIFs and their managers as AIFMs.

An AIFM (wherever based) who wishes to offer a third-country hedge fund into the UK (or any EEA country) will have to comply with the overlay, which comprises three elements. First, there are transparency requirements for annual reports, disclosure to investors, and reporting to regulators and private equity requirements where the AIFM acquires major holdings in or "control" of an unlisted or listed EEA company.

Second, cooperation agreements will need to be in place between the competent authorities where the AIF is to be marketed, the supervisory authority of the domicile of the third country AIF and that of the country where the non-EEA manager is established. Third, at the time of offering, neither the non-EEA AIF nor the non-EEA manager should be authorised or registered in a country classified by the Financial Action Task Force as non-cooperative.

Let us focus on the provisions of the UK AIFMD regulations governing the marketing of a third-country AIF and an EEA feeder AIF (with a third-country master) managed by a UK AIFM authorised by FCA, and a third-country AIF managed by a third-country small AIFM or a third-country AIFM that is not a small AIFM.

In the first case, the UK AIFM must give written notification to FCA before marketing such an AIF. The notification must confirm that the AIFM complies with the requirements of AIFMD, appropriate cooperation arrangements are in place between the FCA and the regulator of the relevant third country, and such country is not listed as non-cooperative by FATF. The AIFM is required to ensure that one or more entities are appointed to carry out cash-monitoring, safekeeping and oversight in respect of the AIF and inform the FCA of their identity.

In the second case where the manager is a small third-country AIFM, the AIFM must give written notification to the FCA before offering the AIF. The notification must confirm that the AIFM is the person responsible for complying with the overlay and that it qualifies as a small third-country AIFM.

The AIFM must provide FCA with such information as the FCA directs on the main instruments in which the AIFM trades and the principal exposures and most important concentrations of the AIFs that it manages, in order to enable the FCA to monitor systemic risk effectively.

In the second case where the manager is a third-country AIFM that is not a small AIFM, the AIFM must give written notification to FCA before marketing such an AIF. The notification must confirm that the AIFM is the person responsible

for complying with the AIFMD and complies with the overlay, as in the first case, save that the depositary-lite regime will not apply.

FCA has entered into cooperation agreements with over 40 third-country regulators worldwide including Japanese FSA, MAFF and METI and regulators in the key offshore fund domiciles. Significantly, the overlay does not apply to any offering or placement of units or shares of an AIF to an investor made at the initiative of the investor, which is a potentially useful exclusion known as "reverse solicitation."

The sanctions for contravention of the overlay reflect those for breach of the S.21 and S.238 regimes and differ depending on whether the unlawful marketing is by unauthorised or authorised persons. Regarding unauthorised persons, contravention is a criminal offence punishable on conviction on indictment by an unlimited fine and/or a term of imprisonment not exceeding two years; investment agreements entered into in consequence of unlawful marketing are rendered unenforceable against the investor who is entitled to recover any money or other property paid or transferred by him under the agreement and compensation for any loss sustained by him as a result of having parted with it. Regarding authorised persons, unlawful marketing is actionable at the suit of a private person who suffers loss as a result of such marketing.

Available solicitation exemptions – the promotion of hedge funds by authorised persons

Pursuant to the S.238 regime, under the FCA rules, authorised persons may promote hedge funds to, among others:

- A client of the authorised person who qualifies as an eligible counterparty or a professional client, i.e., non-retail clients. Importantly, the term "professional client" covers individuals considered to have sufficient experience and understanding to be classified as such with their written consent and having been warned in writing about the protections they may thereby lose;
- An individual who certifies he either has an annual income of £100,000 or more or holds net assets to the value of £250,000 or more and who signs a prescribed disclaimer;
- An individual who has a written certificate signed by an authorised person confirming he has been assessed as sufficiently knowledgeable to understand the risks associated with investing in hedge funds and who signs a prescribed disclaimer;
- An individual who certifies he is sufficiently sophisticated by reference to at least one of four specified criteria and who signs a prescribed disclaimer.

Interestingly, there is an exception regarding promotional activity in the UK for US persons classified as such for US tax purposes and persons who own a US qualified retirement plan, but it only allows for the promotion of US mutual funds registered under the US Investment Company Act.

Under the CIS Promotions Order, authorised persons may promote hedge funds to, among others:

- "Investment professionals," which includes authorised persons, governments and local authorities;
- A body corporate that has (or is a member of the same group as an undertaking that has) called-up share capital or net assets of £500,000 or more (provided that it has or that it is a subsidiary undertaking of an undertaking that has, more than 20 members) or otherwise £5 million or more;
- An unincorporated association or partnership that has net assets of not less than £5 million;
- The trustee of a trust where, broadly, the value of its cash and investments before deducting its liabilities is £10 million or more; and
- A certified sophisticated investor, that is, a person who has a certificate from an authorised person to the effect he is sufficiently knowledgeable to understand the risks associated with investment in hedge funds and who has signed a prescribed disclaimer.

Direct promotion by hedge funds

Hedge funds are not authorised persons and therefore are subject to the S.21 regime and may promote themselves directly to certain investors by relying on exemptions set out in the FPO. The most common exemptions in the FPO reflect the exemptions described above in connection with the CIS Promotions Order.

Promotion of hedge funds through UK intermediary

UK investors classified as professional clients or eligible counterparties can purchase UCIS through advised sales on the part of authorised firms. Following the tightening of the relevant FCA rules at the start of 2014 it is no longer permissible for authorised firms to promote UCIS to people for whom they have deemed the investment to be suitable or in respect of whom the firm has assessed the potential investor to be able to make his own investment decisions and understand the risks involved.

Japan's Regulatory framework

Japanese investors gain exposure to offshore fund investment strategies through two principal channels: the "Securities Distribution Channel"– investments in fund securities that are soldthrough distributors directly to "general" (retail)and "professional" (institutional) investors; and the "Asset Management Channel" – the grant by investors of investment management mandates to registered discretionary investment managers that then select the assets (including offshore funds) into which investments are made.

Although the end result is similar (Japanese investor money flowing into strategies largely implemented outside Japan), each channel is regulated separately and represents a different business model and approach to raising capital in Japan.

Securities marketing registrations available in Japan

The Japanese regulatory framework for financial instruments business operators effective since 1 October 2007 is contained in the Financial Instruments and Exchange Act (FIEA). The FIEA regulates the business of soliciting and dealing in financial instruments (including equity and fixed income securities and derivatives instruments), the provision of asset management services to Japanese investors (under the "Asset Management Registration"), and lastly furnishes investment advisory services. In principle it covers any transaction where one party is a resident (including a foreign national resident) of Japan.

As a general matter, no person other than a relevant registered financial instruments dealer may engage in the activity of soliciting a securities purchase or sale or the offering of a money management mandate (investment management agreement) to a Japanese investor.

Classifications of securities and persons authorised to solicit

"Securities" under the FIEA are broadly separated into two categories: securities defined under Paragraph 1 of Article 2 of the FIEA and securities defined under Paragraph 2 of Article 2 of the FIEA. Paragraph 1 securities relevant to fund managers include financial instruments such as shares of capital stock companies making collective investments, and units of investment trusts.

Paragraph 2 securities relevant to asset manager include certain "illiquid" financial instruments such as interests in limited partnerships, limited-liability partnerships and certain limited-liability companies.

Subject to certain exceptions, any party engaging in the marketing and distribution of paragraph 1 securities is required to hold a Type 1 Financial Instruments Business registration. Similarly, subject to certain exemptions, any party engaging in the

marketing and distribution of paragraph 2 securities is required to hold a Type 2 Financial Instruments Business registration.

Thus, in principle, solicitation of investments from investors (including both retail and institutional investors) may only be undertaken by a registered financial instruments dealer and foreign managers may not travel to Japan to engage in such solicitation. Note also that financial instruments dealers holding asset management registrations and investment advisor business registrations may not engage in solicitation of the purchase and sale of fund securities under those registrations.

Soliciting mandates to manage money

The Investment Management business registration is required for any party to engage in the discretionary investment of assets in Japan, including all relevant collective investment schemes. Thus, as with solicitation of investments in securities, subject to a limited exemption foreign asset managers may not solicit asset-management mandates from Japanese investors without registering as a discretionary asset manager in Japan.

Under the "Asset Management Conduit," only registered investment managers may seek money management mandates from (institutional) investors and either sub-delegate assets mandated to affiliated managers outside Japan, or exercise their discretion to direct those assets into offshore collective-investment vehicles managed by affiliated, foreign-qualified asset managers, or manage relevant investments directly from their Japan office following registration. Thus, use of the Asset Management Conduit to raise capital will involve dealing with, or acting through, a registered investment manager.

Available solicitation exemptions

With respect to solicitation of investments in corporate or trust-form funds (paragraph 1 securities), there is no exemption that would allow a foreign asset manager to travel to Japan to solicit investments in corporate or trust form funds.

With respect to paragraph 2 investment fund securities (i.e., limited partnership form funds), an important "exemption" exists under Article 63 of the FIEA. It provides for an exemption for "Special Business Activities Directed at Qualified Institutional Investors". Under this exemption, by submitting a notification to the relevant financial bureau, the general partner of the limited partnership fund is permitted to engage in a "self-offering" (jikoboshu) and "self-management" (jikounyo) of the relevant investment fund. As these two activities would normally require the general partner to be respectively registered as Type 2 Dealer and as an investment manager under the FIEA, the Article 63 Exemption has become a popular method by which general partners of offshore funds elect to distribute their partnership funds into Japan.

For the general partner to be able to rely on the Article 63 Exemption, the limited partnership fund must satisfy certain requirements. First, the limited-partnership interests in the offshore partnership fund must be viewed as being equivalent to interests in a "collective investment scheme". While such determination must be made on a case-by-case basis, as a general matter, limited partnerships established in the Cayman Islands are viewed as meeting this requirement.

Second, in order to rely on the Article 63 Exemption, the fund must satisfy the following investor profile requirement during its existence: there at least one Qualified Institutional Investor; and no more than 49 non-Qualified Institutional Investors may have acquired interests in the fund in any given six month period.

Third, as the Article 63 Exemption is intended as a "self-offering" exemption, only officers and employees of the general partner (and not officers, directors or delegates of any affiliated manager of the limited partnership) may engage in solicitation of fund securities thereunder.

Finally, because under Japanese law, the general partner of a limited partnership is deemed to be providing investment management services to any Japan-limited partners, the Article 63 Exemption also serves exempt from registration the investment management activities of the general partner with respect to Japanese investors in the fund.

Exemptions when soliciting asset management mandates

With respect to soliciting "asset management mandates," unregistered foreign managers are permitted to approach (by telephone, email or in person) only registered asset managers in Japan for the purpose of seeking investment management mandates. Solicitation of all other classes of investor (including banks, trust banks, insurance companies, high net worth individuals and general business corporations) is prohibited without a separate registration.

Moreover, entry into an asset management agreement with a Japanese investor from abroad is viewed as the conduct of an asset management business in Japan requiring registration and may be sanctions in the absence of such registration, i.e., all investments under the "Asset Management Conduit" must flow through registered asset managers. **THFJ**

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